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WINDS OF CHANGE

Policy changes, crude prices energize oil, gas firms

Deregulation of diesel prices, gas price hike, direct transfer of LPG subsidy sidelined by crash in crude prices

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MUMBAI

While 2014 was a lacklustre year for many industries, for the country's oil and gas sector, the year will go down as one in which two controversial and politically sensitive decisions were finally taken.

On 18 October, the government decided to stop controlling diesel price, allowing it to be set by the market. This was accompanied by a decision to increase the domestic price of natural gas to $5.6 per million metric British thermal units (mmBtu) from the earlier $4.2 per mmBtu. The government also relaunched a scheme to directly transfer cooking gas subsidies to customers' bank accounts.

Together, the three decisions have set the stage for companies in the sector for the next few years, starting 2015.

Decontrolling diesel benefits the oil marketing companies (OMCs)—Indian Oil Corp. Ltd (IOCL), Bharat Petroleum Corp. Ltd (BPCL) and Hindustan Petroleum Corp. Ltd (HPCL)—the most.

They no longer have to sell the fuel below cost, which adds to under-recoveries. This also clears the way towards higher marketing margins and lower working capital needs.

In a 20 October note, Jal Irani of **Edelweiss Financial Services Ltd** said OMCs will have less working capital requirements now, leading to higher profits.

"Our preliminary calculations suggest that their (OMCs) profits could rise by 20-30% following dip in working capital requirements. Moreover, their profits could rise by a similar amount over the longer term, too, as we believe their current retail margins of ₹0.70 per litre shall increase, as the existing margins are not viable for new entrants," said Irani in the report.

Overall under-recoveries on fuel are also set to decline sharply to ₹78,600 crore in fiscal 2015 and ₹55,600 crore in fiscal 2016 from ₹139,000 crore in fiscal 2014, said a 18 December report by **Nomura International Plc**. BPCL is expecting to save ₹10,000 crore on cooking gas sales with the relaunched direct benefit transfer scheme, executive director (LPG) George Paul, told *Mint* in early December.

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Companies involved in energy exploration are also expected improve their financials in 2015.

The long-pending price increase of domestically produced natural gas came in below expectations for the producers, especially private sector explorers such as **Reliance Industries Ltd** (RIL). However, the 33% increase, with a provision for revising it every six months, definitely benefits India's biggest oil explorer **Oil and Natural Gas Corp. Ltd** (ONGC) and its smaller peer **Oil India Ltd** (OIL).

To be sure, new gas discoveries from deep- and ultra-deep-water blocks—RIL's D6 block in the KG basin falls in the latter category—will get a premium over the domestic price, though the formula to fix this premium has not been finalized.

For every one dollar increase in the price of natural gas, ONGC's annual net revenue increases by ₹4,000 crore and its annual net profit by ₹2,300 crore, D.K. Sarraf, chairman and managing director, ONGC told *Mint* in November. A similar but relatively smaller benefit is expected to accrue to OIL. State-owned upstream oil companies too will benefit from the deregulation of diesel prices, as these companies were bearing some of the burden of the subsidies, along with the government. With that burden reduced, ONGC and OIL could see an increase in their realizations, say analysts.

According to a 11 December report by Morgan Stanley Research, after diesel deregulation, subsidized volumes have declined to one-fourth at almost 21 million tonnes per annum (mtpa), which is much lower than the domestic production of ONGC and OIL.

"Sensitivity to oil has thus fallen from $650 million to $205 million for each $1/bbl ($1/barrel) change in oil prices. We estimate this also puts a floor of $45/bbl, as net realization for ONGC and OIL," the report said.

This is a marked shift from the $40 per barrel realization that ONGC earned in fiscal 2014.

However, a lot remains to be done. "The government has taken a very good step. Now, what we need are more project and business specific impetus from the government in the following year, or else we will miss the bus again," said Deepak Mahurkar, leader (oil & gas) at **PricewaterhouseCoopers** India.

Mahurkar says that clarity is needed on some provisions of the production sharing contracts. "There are almost 195-odd blocks where contractors are either awaiting extension of appraisal period or extension of time for submitting the field development plan," he said. Dhaval Joshi, analyst with brokerage Emkay Global Financial Services, adds that clarity is also needed on the premium for deep-water blocks if the government hopes to spur investments.

"Unless the extent of premium for deep-water blocks is clear, it will continue to deter private companies from investing in the sector," he said.

The crude price crash has added some uncertainty. Since the start of 2014, benchmark Brent crude prices have crashed by almost 43% to under $60 per barrel—the steepest drop in six years, according to *Bloomberg* data. "Diesel price deregulation, new gas price announcement, direct subsidy transfer were key developments of 2014, but by the end of the year, the single issue that dictated the agenda in the oil and gas sector was the crash in the crude prices and this issue will dominate the action in 2015 as well," said Debasish Mishra, senior director-consulting, **Deloitte Touche Tohmatsu India Pvt. Ltd.** While the fall helps public finances, it may lead to a decline in the gross refining margins for companies.

According to petroleum planning and analysis cell, a body under the oil ministry, the three OMCs have seen their GRMs—the main determinant of their profitability—fall to a four-year low.

Every one dollar per barrel drop in crude price trims annual net revenue by roughly ₹800 crore and net profit by ₹450-475 crore, A.K. Banerjee, director-finance at ONGC told *Mint* in November.

Experts suggest the best way out is to raise volumes.

"It is high time the capacities of BPCL Numaligarh and Bina refinery are expanded while a final decision is taken on HPCL's Barmer refinery. There should also be a strict monitoring of IOCL's upcoming Paradip refinery," said PwC India's Mahurkar.