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GOVERNMENT OF INDIA FINANCES

Rise in consumption of petrol and diesel in FY2022 can absorb cut in cesses by Rs. 4.5/litre, without revenue loss to GoI relative to FY2021

JUNE 2021

Aditi Nayar
+91 124 4545 385
aditin@icraindia.com

Yash Panjrath
+91 124 4545 399
yash.panjrath@icraindia.com

Aarzoo Pahwa
+91 124 4545 873
aarzoo.pahwa@icraindia.com

Tiasha Chakraborty
+91 124 4545 300
tiasha.chakraborty@icraindia.com

OUTLOOK

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ICRA projects the YoY expansion in consumption of MS and HSD in FY2022 at ~14% and ~10%, respectively

Revenues from cesses imposed on MS and HSD are projected to rise to Rs. 3.6 trillion in FY2022 from Rs. 3.2 trillion in FY2021

If this additional revenue of Rs. 0.4 trillion is foregone, it can support a reduction in cesses by Rs. 4.5/litre each on MS and HSD

The strengthening of demand and favourable prospects of a global economic rebound brought on by the vaccine rollout optimism, have resulted in a nearly uninterrupted increase in the international crude oil prices since January 2021. Reflecting the weaker INR, higher cesses imposed by the Government of India (GoI) since March 2020 and increase in Value Added Tax (VAT) rates by more than three-fourths of the state governments, the average retail selling prices (RSP) of motor spirit (MS) and high-speed diesel (HSD) in the four metro cities have increased to record-high levels of Rs. 99.54/litre and Rs. 92.03/litre, respectively, as on June 25, 2021. Given the current scenario where domestic sentiment demand has been singed by the impact of the second wave of Covid-19, the all-time high retail prices of fuels are both weighing upon disposable incomes and consumption, and feeding into inflationary pressures.

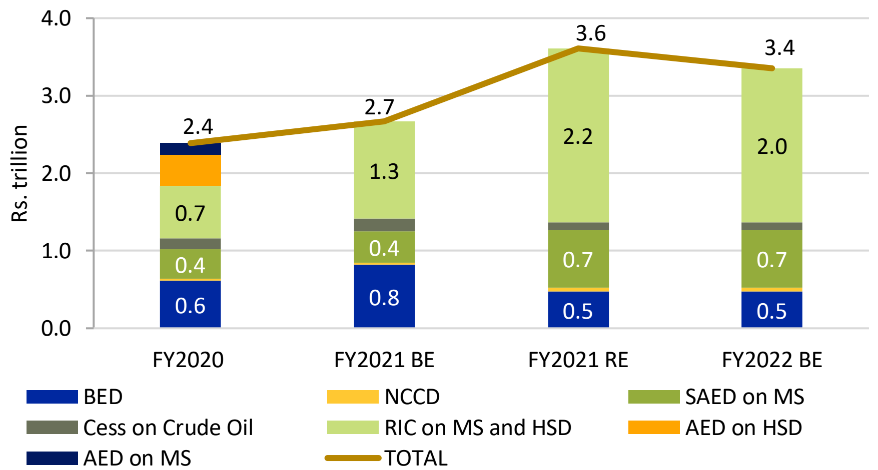
Benefitting from the anticipated rise in mobility and economic recovery aided by an acceleration of the coverage of Covid-19 vaccines, ICRA has forecast the year-on-year (YoY) expansion in the consumption of MS and HSD in FY2022 at ~14% and ~10%, respectively, on the low base of FY2021 (-6.8% and -11.9%, respectively). Our forecasts suggest that consumption in FY2022, relative to the pre-Covid level of FY2020, will be 6.7% higher in the case of MS, and 3.3% lower in the case of HSD. Assuming that the total cesses on unbranded MS and HSD remain unchanged at Rs. 32.9/litre and Rs. 31.8/litre, respectively, the aggregate revenue from such duties on these two fuels is projected by ICRA to expand by ~13% or Rs. 0.4 trillion to Rs. 3.6 trillion in FY2022 from Rs. 3.2 trillion in FY2021 (ICRA est).

We have calculated how much cess can be reduced per litre of MS and HSD, if the GoI chooses to forego this additional revenue of Rs. 0.4 trillion in FY2022. Based on the actual volumes in April-May 2021 and the expected level for June 2021, we estimate the GoI's cess revenues from MS and HSD in Q1 FY2022 at Rs. 0.8 trillion. To maintain the total cess revenues in FY2022 at the estimated level of Rs. 3.2 trillion for FY2021, collections of Rs. 2.4 trillion are required in the remaining three quarters of this fiscal. Our calculations suggest that the expected consumption of fuels can generate revenues of this magnitude in the next nine months, with a reduction in the cesses on MS and HSD by Rs. 4.5/litre each. Such a revenue neutral cut in cesses would shave off a modest ~10 bps from ICRA's forecast of 5.25% for the CPI inflation for July 2021, in terms of the first round impact, with a similar second round impact likely with a moderate lag.

Moreover, as per our estimates, the GoI needs ~Rs. 0.2 trillion during FY2022 to service the principal and interest related to the special bonds issued to Public Sector Oil Marketing Companies (OMCs) issued during 2005-2010. If this debt servicing is to be offset through the additional revenues collected through fuel cesses, then the extent of the potential duty cut would be restricted to Rs. 2/litre each on MS and HSD in the current fiscal.

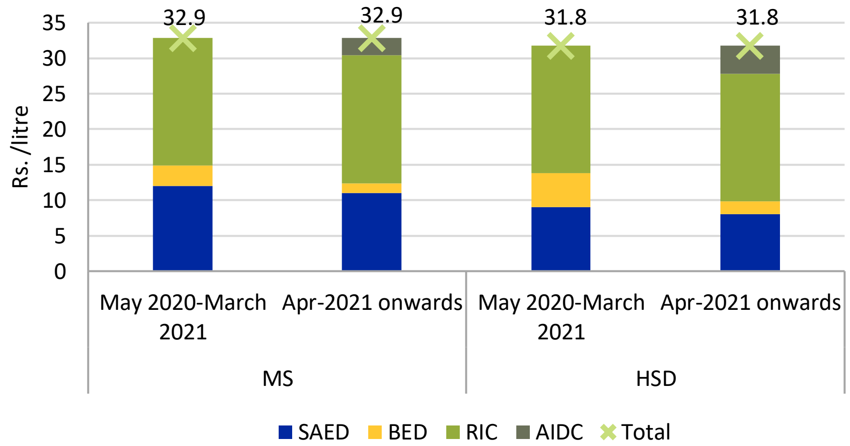
Robust Excise Duty collections in FY2021: The GoI's Revised Estimates (RE) for FY2021 for the union excise duty collections stood at Rs. 3.6 trillion, a sharp 35.2% higher than the budgeted Rs. 2.7 trillion (refer Exhibit 1). Within this, the cumulative inflows from Road and Infrastructure Cess (RIC) and Special Additional Excise duty (SAED) on MS and HSD were pegged at ~Rs. 3.0 trillion in FY2021 RE, a sizeable increase of Rs. 1.3 trillion from the amount included in the FY2021 Budget Estimates (BE; Rs. 1.7 trillion). This rise reflects the impact of hikes in SAED (Rs. 4/litre and Rs. 7/litre, respectively) and RIC (Rs. 9/litre each) on the prices of petrol and diesel by a cumulative Rs. 13/litre and Rs. 16/litre, respectively, that were undertaken by the Central Government between March 2020 and May 2020[1], when international crude oil prices were at all-time lows owing to the global demand shrinkage during the early part of the Covid-19 pandemic. Driven by the rise in the cess imposed on these fuels, the revenue collections surged despite the fall in consumption volumes of HSD and MS by 6.8% and 11.9%, respectively, during FY2021.

EXHIBIT 1: Breakup of Union Excise Duty Collections



*BED: Basic Excise Duty; NCCD: National Calamity Contingent Duty; RIC: Road and Infrastructure Cess; AED: Additional Duty of Excise *AED on MS and HSD has been replaced with RIC;* ***Source****: CGA, Ministry of Finance, GoI; CEIC; ICRA research*

EXHIBIT 2: Excise Duty Structure of Motor Spirit and High Speed Diesel Oil



Source*: CBIC; GoI; ICRA research*

The provisional data for FY2021 released by the Controller General of Accounts (CGA) has pegged the aggregate union excise duty collections at Rs. 3.9 trillion, surpassing the FY2021 RE by 7.9%, and indicating a sharp YoY expansion of ~62% relative to the FY2020 Actuals (Rs. 2.4 trillion). The breakup of excise duty collections is not available in the provisional data for FY2021. We estimate the revenues from the various cesses imposed on MS and HSD at Rs. 3.2 trillion in FY2021, forming the bulk of the union excise duty collections of Rs. 3.9 trillion.

[1] After the duty hikes between March-May 2020, the cumulative cess levied on MS and HSD stood at Rs. 32.9/litre and Rs. 31.8/litre, respectively.

In the Union Budget FY2022, the GoI had forecast a decline of 7.2% in the union excise duty collections to Rs. 3.4 trillion in FY2022 BE, relative to FY2021 RE, of which, the inflows from RIC and SAED on petrol and diesel were together pegged at Rs. 2.7 trillion (YoY decline of 8.7% relative to FY2021 RE). In addition, the GoI had imposed Agriculture Infrastructure and Development Cess (AIDC) on MS and HSD for this fiscal and reduced the BED and SAED rates by an equivalent amount to keep the impact on consumers unchanged[2] (refer Exhibit 2). Accordingly, the cumulative cess levied by the GoI remained unaffected at the elevated Rs. 32.9/litre and Rs. 31.8/litre, respectively, on MS and HSD, which will continue to garner healthy revenues in the current fiscal, even if the uptick in consumption levels is moderate.

Retail Fuel Prices at Record-High Levels, fanning inflationary pressures and impinging upon disposable income: The strengthening of demand and favourable prospects of a global economic rebound brought on by the vaccine rollout optimism, have resulted in a nearly uninterrupted increase in the international crude oil prices since January 2021. In particular, the crude oil price, in Indian basket terms, averaged US$71.6/barrel during June 1-24, 2021, similar to April 2019 (refer Exhibit 3). Given a weaker INR, the price of the Indian crude oil basket stood at a modestly higher INR 5,252/barrel in June 1-24, 2021, relative to INR 4,938/barrel in April 2019.

In addition to the cess hikes by the GoI, many state governments had modified the rates of VAT that they levy on fuels in 2020. Moreover, the levy of VAT magnifies the impact of the excise hikes on retail fuel prices, resulting in a cascading structure of taxation.

Reflecting the weaker INR, higher cesses and VAT rates, the average RSPs of petrol and diesel in the four metro cities have increased to record-high levels of Rs. 99.54/litre and Rs. 92.03/litre, respectively, as on June 25, 2021. On average, the prices of petrol and diesel have risen to Rs. 98.0/litre and Rs. 90.7/litre, respectively, in June 2021 (up to June 25, 2021) from Rs. 75.5/litre and Rs. 68.4/litre, respectively, in April 2019 (refer Exhibit 4), despite the US$ price of the Indian crude oil basket being at similar levels in these time periods.

EXHIBIT 3: Crude Oil Price Movement of Indian Basket

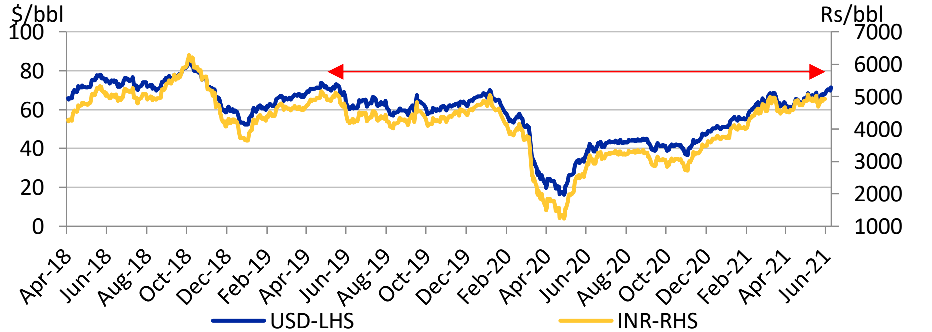
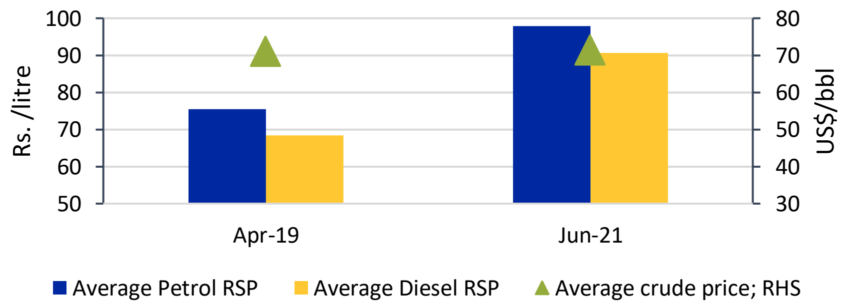


EXHIBIT 4: Monthly Average Crude oil and Retail Selling Prices* of Petrol and Diesel



*In four metro cities; **Source:** PPAC; ICRA research*

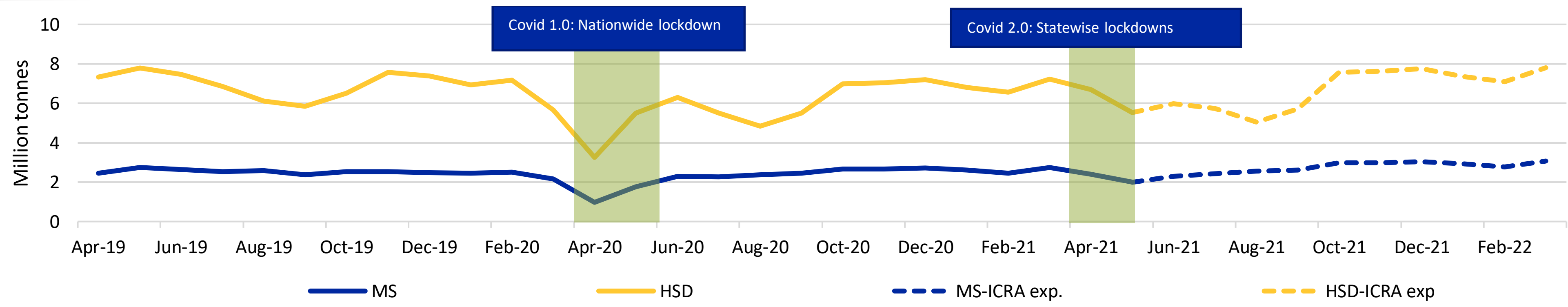
[2] The GoI has imposed an additional cess, termed as Agriculture Infrastructure and Development Cess (AIDC) on MS and HSD of Rs. 2.5/litre and Rs. 4.0/litre, respectively, for the current fiscal, offsetting the equivalent reduction in the basic excise duty (BED) and SAED on the same (BED: Rs. 1.0/litre each; SAED: by Rs. 1.5/litre and Rs. 3.0/litre, respectively) to keep the impact on consumers unchanged.

Given the current scenario where domestic sentiment demand has been singed by the impact of the second wave of Covid-19, the all-time high retail prices of fuel are weighing upon disposable incomes and consumption. Moreover, higher fuel prices are feeding into inflationary pressures, both through a first round and second round impact. For instance, in the CPI, the petrol and diesel index of vehicles were higher by 25.1% and 28.5%, respectively, in May 2021 relative to February 2020[3]. Higher fuel prices have contributed to the rise in the CPI inflation to 6.3% in May 2021, exceeding the upper threshold of the Monetary Policy Committee's (MPC's) medium term target of 2-6%. In the last three Monetary Policy reviews (Feb 2021, Apr 2021 and June 2021) the MPC has highlighted the inflationary pressures created by the higher cesses and VAT rates announced by the Centre and the state governments last year, and the need to unwind the same to ease the cost push pressures. **A reduction in fuel prices generated by a cut in the cesses imposed, would help dampen the inflationary pressures, and prevent inflationary expectations from getting entrenched at a higher level, thereby affording Monetary Policy continued space to support a revival in growth. Lower fuel prices would also ease the pressure on disposable incomes, allowing for a modestly faster revival in consumer sentiment and spending.**

At the same time, a cut in cesses would result in a revenue loss for the GoI. In the next section, we have constructed the potential revenue of the Centre based on our expectation of fuel consumption in FY2022, and the associated cess collections.

Revival in consumption to boost cess collections in FY2022: The low base of the nationwide lockdown (refer Exhibit 5) boosted the YoY expansion in the consumption of petrol and diesel in Apr-May FY2022 (+59.6% and +39.7%, respectively), although both trailed the pre-Covid levels i.e. Apr-May FY2020 (-15.8% and -19.2%, respectively) given the widening state-level restrictions. Subsequently, the provisional data provided by state refiners reveals that sales of petrol and diesel declined by 3.5% and 7.5%, respectively, on a YoY basis in the first half of June 2021, despite the phased unlocking by some states, which may partly reflect the impact of elevated prices and some shift in freight movement towards railways.

EXHIBIT 5: Monthly Consumption of MS and HSD from April 2019-May 2021, and ICRA's expectations for June 2021-February 2022



Source: PPAC; ICRA research

3 The YoY CPI inflation for petrol and diesel for vehicles cannot be compared given the unavailability of detailed version of the CPI data during March-May 2020, owing to the limited transactions of products in the months of nationwide lockdown.

Benefitting from the anticipated rise in mobility and economic recovery aided by an acceleration of the coverage of Covid-19 vaccines, we expect the consumption of MS and HSD to grow by 7% and 4%, respectively, in Q2 FY2022, before rising to 12% and 8%, respectively, in H2 FY2022. Based on this, we have forecast the YoY expansion in their consumption in FY2022 at ~14% and ~10%, respectively, on the low base of FY2021 (-6.8% and -11.9%, respectively; refer Exhibit 6). Our forecasts suggest that consumption in FY2022, relative to the pre-Covid level of FY2020, will be 6.7% higher in the case of MS, and 3.3% lower in the case of HSD.

EXHIBIT 6: ICRA's Estimated Consumption of fuel in FY2022

Million Tonnes	FY2020- A	FY2021- B	ICRA's exp. for FY2022- C	YoY growth (C/B)	Growth in C relative to A
MS (1)	30.0	28.0	32.0	~14%	+6.7%
HSD (2)	82.6	72.7	79.9	~10%	-3.3%
Total (3=1+2)	112.6	100.7	111.8	~11%	-0.6%

Source: *ICRA research*

Assuming that the total cesses on unbranded MS and HSD remain unchanged at Rs. 32.9/litre and Rs. 31.8/litre, respectively, the aggregate revenue from such duties on these two fuels is projected by ICRA to expand by ~13% or Rs. 0.4 trillion to Rs. 3.6 trillion in FY2022 from Rs. 3.2 trillion in FY2021 (refer Exhibit 7).

We have calculated how much cess can be reduced per litre of MS and HSD, if the GoI chooses to forego this additional revenue of Rs. 0.4 trillion. **Based on the actual volumes in April-May 2021 and the expected level for June 2021, we estimate the GoI's cess revenues from MS and HSD in Q1 FY2022 at Rs. 0.8 trillion. To maintain the total cess revenues in FY2022 at the estimated level of Rs. 3.2 trillion for FY2021, collections of Rs. 2.4 trillion are required in the remaining three quarters. Our calculations suggest that the expected consumption of fuels can generate revenues of this magnitude in the next nine months, with a reduction in the cesses on petrol and diesel by Rs. 4.5/litre each.**

EXHIBIT 7: ICRA's estimated Excise Collections on fuel and expected rate cut on petrol and diesel

	Prevailing Central cess rates on MS and HSD*		FY2021- (A)	ICRA's exp. FY2022- (B)	YoY growth	Variation (B- A)	ICRA's exp. Q1 FY2022- (C)	Amount required in 9M FY2022 to meet FY2021 level	Central cess rates at which D revenue can be achieved		Extent of cut in cesses on MS and HSD	
	Rs./litre (F)		Rs. trillion			Rs. Trillion		(D=A-C)	Rs./litre (E)		Rs./litre (F-E)	
Central excise duty revenue on MS and HSD	MS: 32.9	HSD: 31.8	3.2	3.6	~13%	0.4	0.8	2.4	MS: 28.4	HSD: 27.3	MS: 4.5	HSD: 4.5

Since May 2020;* ***Source:* *ICRA research*

Such a revenue neutral cut in cesses on fuels would shave off a modest ~10 bps from ICRA's forecast of 5.25% for the headline CPI inflation for July 2021, in terms of the first round impact with a similar second round impact likely with a moderate lag. To make a larger dent on inflation, some revenue would have to be foregone, unless crude oil price decline appreciably in the near term, which appears unlikely.

Repayment of Special Bonds issued to Public Sector Oil Marketing Companies (OMCs) due for FY2022 is muted, indicating room for excise rate cuts: As per the Union Budget for FY2022, the balance outstanding on account of GoI Special Bonds issued to the Public Sector OMCs in lieu of cash subsidy[4] stood at ~Rs 1.3 trillion, as of March 31, 2021. These bonds were issued during 2005-2010. An amount of interest of Rs. 99.9 billion has been paid on such bonds each year during FY2016-FY2021. In FY2022, two securities are due for repayment worth Rs. 50 billion each (8.13% GOI special Bonds, 2021 and 7.75% GOI special Bonds, 2021), of which one will be repaid on October 16, 2021 and other on November 28, 2021. We have estimated the amount of interest to be paid in this fiscal year (on the remaining bonds as well as interest for some months for bonds that are getting matured in H2 FY2022) at ~Rs. 95-96.5 billion. **Accordingly, the GoI needs ~Rs. 0.2 trillion to service the principal and interest related to the oil bonds during FY2022. If this debt servicing is to be offset through the additional revenues collected through fuel cesses, then the extent of the potential duty cut would be restricted to Rs. 2/litre each on MS and HSD in the current fiscal.**

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4 These bonds were issued by the GoI between 2005-2010 to the oil marketing companies (Indian Oil Corporation, Bharat Petroleum Corporation Limited and Hindustan Petroleum Corporation Limited), for the under-recoveries (the difference between the administrative price and the cost) that they had incurred when selling petrol, diesel, kerosene and domestic cooking gas, below their cost. Officially, these bonds are referred to as special securities issued to oil marketing companies in lieu of cash subsidy.

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- Provide intermediaries with a tool to improve efficiency in the funds raising process.

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Business Contacts

Mr. L. Shivakumar
E-mail: shivakumar@icraindia.com
+91 22 6114 3406 / +91 98210 86490

Mr. Jayanta Chatterjee
E-mail: Jayantac@icraindia.com
Tel: +91 80 4332 6401/ +91 98450 22459

Media and Public Relations

Ms. Naznin Prodhani
E-mail: Communications@icraindia.com
Tel: +91 124 4545 860

Registered Office

B-710, Statesman House 148,
Barakhamba Road
New Delhi-110001
Tel: +91 11 23357940-45

Corporate Office

Building No. 8, 2nd Floor,
Tower A, DLF Cyber City, Phase II,
Gurgaon - 122 002
Tel: +91-124-4545300

Ahmedabad

1809-1811, Shapath V,
Opp: Karnavati Club,
S.G.Highway, Ahmedabad - 380015
Tel: +91 79 4027 1500/501

Bengaluru 1

'The Millenia', Tower B Unit No. 1004,
10th Floor, 1 & 2 Murphy Road,
Bengaluru - 560 008
Tel: +91 80 4332 6400

Bengaluru 2

2nd Floor, Vayudooth Chamber
15-16, Trinity Circle, M.G. Road,
Bengaluru - 560 001
Tel: +91 80 4922 5500

Chennai

5th Floor, Karumuttu Centre
634, Anna Salai, Nandanam
Chennai - 600 035
Tel: +91 44 4596 4300

Hyderabad 1

4th Floor, 'Shoban'
6-3-927/A&B. Somajiguda
Raj Bhavan Road,
Hyderabad - 500 082
Tel: +91 40 4067 6500

Hyderabad 2

No. 7-1-58, 301, 3rd Floor, 'Concourse',
Above SBI-HPS Branch, Ameerpet,
Hyderabad - 500 016
Tel: +91 40 4920 0200

Kolkata

A-10 & 11, 3rd Floor,
FMC Fortuna 234/3A,
A.J.C. Bose Road,
Kolkata -700 020
Tel: +91 33 7150 1100/01

Mumbai

3rd Floor, Electric Mansion
Appasaheb Marathe Marg,
Prabhadevi,
Mumbai - 400 025
Tel: +91 22 6169 3300

Pune

5A, 5th Floor, Symphony, S. No. 210
CTS 3202 Range Hills Road,
Shivajinagar, Pune - 411 020
Tel: +91 20 2556 1194

Email: Info@icraindia.com
Helpdesk: 9354738909
Website: www.icra.in/ www.Icraresearch.in