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Excise Duty Cut on Fuels

GoI's FY2022 revenue loss from excise cut on fuels pegged at Rs. 440 billion; states may forego similar amount of VAT

NOVEMBER 2021

Highlights

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ICRA estimates GoI's revenue loss from excise duty cut at ~Rs. 440 billion

Impact of excise duty cut on GoI's fiscal deficit pegged at modest ~0.2% of GDP

Net impact of VAT cuts by states/UTs (including cascading effect of excise cut) is tentatively placed at a similar ~Rs. 440 billion

Excise duty cut by the GoI may shave off 30-35 bps from Nov 2021 CPI print

- The average international crude oil price, in Indian basket terms, surged to US$82.0/bbl in Oct 2021 from the low US$20.5/barrel in Apr 2020, and recorded a 30% rise relative to US$63.3/bbl in April 2021, on the back of buoyant global demand and restrained supply.
- In view of rising crude oil prices, the Government of India (GoI) announced a cut in the Road and Infrastructure Cess (RIC) component of central excise duty, by Rs. 5/litre on Motor Spirit (MS) and Rs. 10/litre on High Speed Diesel Oil (HSD) w.e.f. Nov 4, 2021.
- Factoring in the impact of the excise duty cut, and our expectations for mobility and the economic recovery with the rising Covid-19 vaccine coverage, we forecast the year-on-year (YoY) rise in the consumption of MS and HSD in FY2022 at 14% and 8%, respectively, on the low base of FY2021.
- We peg the gross and net revenue loss to the GoI from the excise cuts at Rs. 440 billion each in FY2022, since RIC is not shared with the states. This is likely to widen the GoI's fiscal deficit in FY2022 by a modest ~0.2% of GDP.
- Since most states levy Value Added Tax (VAT) on an ad valorem basis, the excise cut will lower their VAT inflows by ~Rs. 90 billion. Subsequently, VAT cuts on fuels have been announced so far by 25 states and Union territories; we tentatively place the impact of this at Rs. 350 billion.
- We estimate the direct impact of the reduction in central excise duty on MS and HSD on the Nov 2021 CPI inflation print at ~30-35 bps. The second order impact is likely to be muted as tentative demand had limited the pass through of higher fuel prices to other goods.
- The tax cuts will soften the inflation trajectory, staving off any early repo or reverse repo hikes by the MPC and the RBI, respectively. Moreover, the tax cuts are likely to ease the pressure on disposable incomes that had been restrained by elevated fuel prices, bolstering demand.

Crude oil prices on an uptrend with rising demand and limited supply; prices to remain elevated in H2 FY2022

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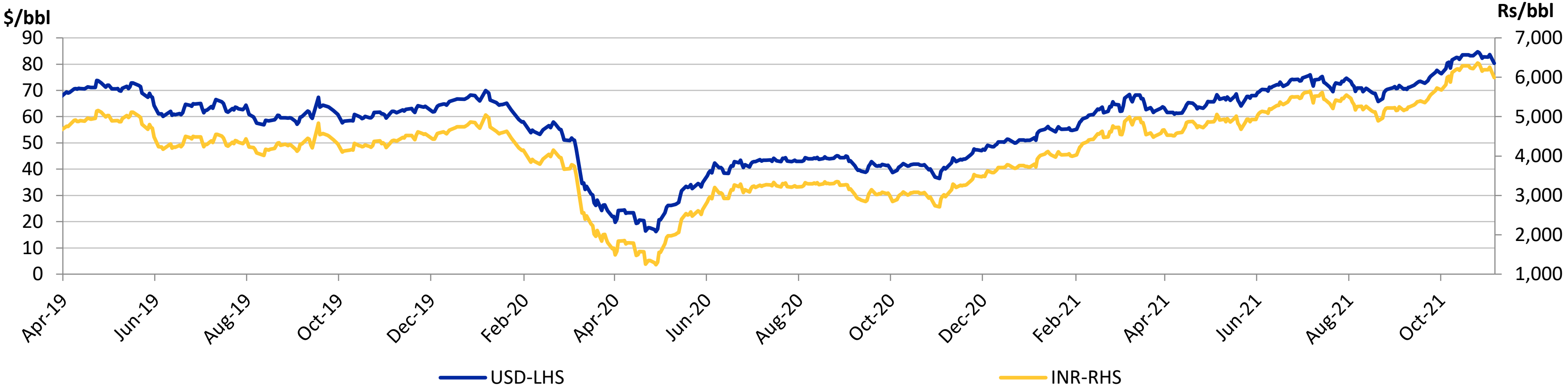
EXHIBIT: Crude Oil Price Movement of Indian Basket

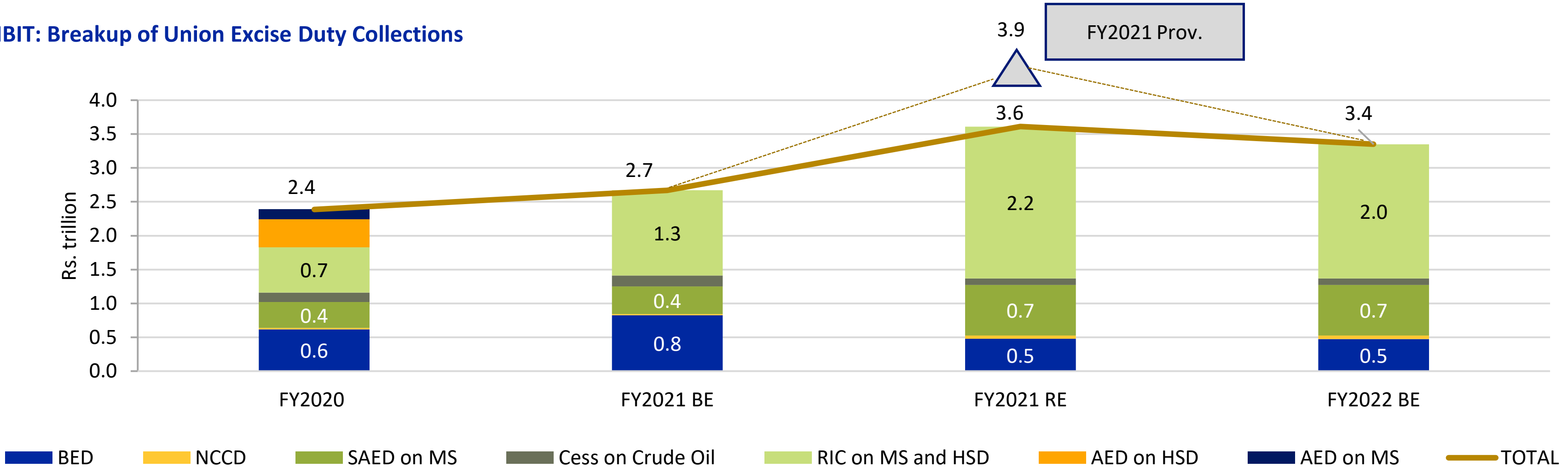


Source: PPAC; ICRA Research

- The average international crude oil price, in Indian basket terms, quadrupled to US$82.0/bbl in Oct 2021 from the low of US$20.5/barrel in Apr 2020, while recording a 30% surge relative to US$63.3/bbl in April 2021, on the back of buoyant global demand and restrained supply.
- Despite the global economic recovery and expected pickup in demand in the winter months, OPEC and its allies, in a meeting held on November 5, 2021, decided to retain the extent of increase in the oil output by 0.4 mn barrels per day (bpd) from December 2021 onwards.
- Accordingly, the crude oil prices are likely to remain elevated for the next few months, unless OPEC+ nations raise the monthly quantum of increase in supply. We expect the Indian basket of crude oil to average ~US$80/barrel in H2 FY2022.

Union excise duty collections from all sources in FY2022 were budgeted at Rs. 3.4 trillion

EXHIBIT: Breakup of Union Excise Duty Collections

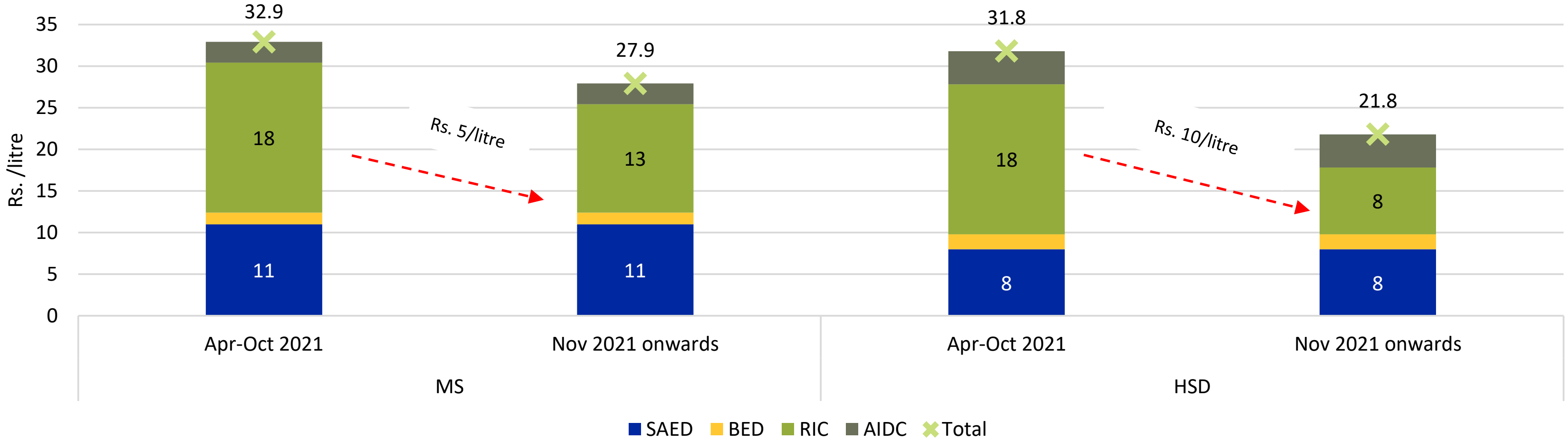


*BED: Basic Excise Duty; NCCD: National Calamity Contingent Duty; RIC: Road and Infrastructure Cess; SAED: Special Additional Duty of Excise *Additional Excise Duty of Excise (AED) on MS and HSD was replaced with RIC in FY2021; Source: CGA, Ministry of Finance, GoI; CEIC; ICRA Research*

- The revenues from the various cesses imposed on MS and HSD in FY2021 were estimated by ICRA at Rs. 3.2 trillion, on account of the higher central excise duties levied in Mar-May 2020 during the first wave of the Covid-19 pandemic. This accounted for the bulk of the union excise duty collections of Rs. 3.9 trillion in FY2021, as per the provisional data released by the CGA.
- In the Union Budget FY2022, the GoI had forecast union excise duty collections at Rs. 3.4 trillion in FY2022 BE (decline of 7.2% relative to FY2021 RE), of which the inflows from RIC and SAED on petrol and diesel were together pegged at Rs. 2.7 trillion (decline of 8.7% relative to FY2021 RE).
- In addition, the GoI had imposed 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.

With rising crude oil prices, the GoI and 25 states/UTs have reduced the excise duty/VAT on MS and HSD

EXHIBIT: Central Excise Duty Structure of unbranded Motor Spirit (MS) and High Speed Diesel Oil (HSD)



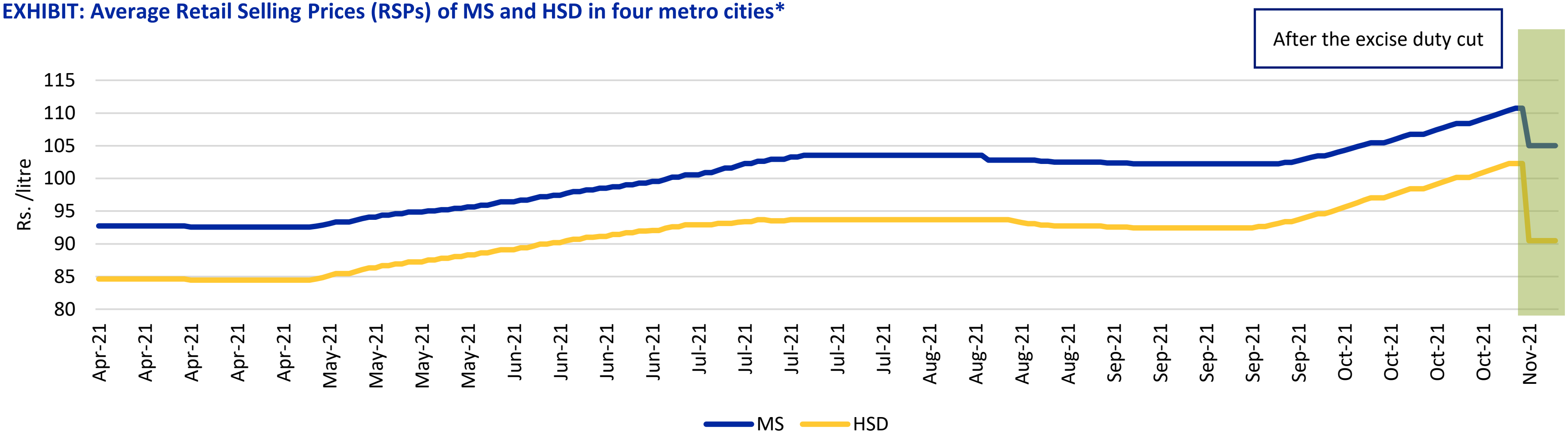
Source: CBIC, GoI; ICRA Research

- During Apr-Oct 2021, central excise rates had remained unchanged at an elevated Rs. 32.9/litre and Rs. 31.8/litre, respectively, for MS and HSD*, in line with the rates that were in effect since May 2020 amidst the first wave of Covid-19.
- The GoI has now announced a cut in the RIC component of central excise duty, by Rs. 5/litre on MS and Rs. 10/litre on HSD w.e.f. Nov 4, 2021. Effectively, the total cesses levied on MS and HSD by the GoI stand at Rs. 27.9/litre, and Rs. 21.8/litre, respectively.
- Subsequently, VAT cuts on MS and/or HSD have been announced by 19 states and six UTs (in terms of specific unit tax and/or ad-valorem basis) as on Nov 8, 2021.

**As per the Union Budget for FY2022, the imposition of AIDC on MS and HSD by Rs. 2.5/litre and Rs. 4/litre, respectively, was offset by the equivalent reduction in BED and SAED rates.*

Ad valorem VAT structure magnifies impact of excise cut

EXHIBIT: Average Retail Selling Prices (RSPs) of MS and HSD in four metro cities*



**Namely, Delhi, Mumbai, Chennai and Kolkata; Source: PPAC; ICRA Research*

- The average RSPs of MS and HSD in four metro cities declined by 5.2% and 11.5%, respectively, to Rs. 105.0/litre and Rs. 90.5/litre as on Nov 8, 2021, after having reached all-time high levels in Oct 2021.
- In absolute terms, the reduction in average RSPs in such cities was Rs. 5.75/litre for MS, and Rs. 11.79/litre for HSD, higher than the quantum of the central excise cut of Rs. 5/litre and Rs.10/litre, respectively, on account of the cascading impact of the cut in excise duty given the ad valorem structure of VAT levied by most states on fuels.

Consumption of MS in FY2022 to exceed pre-Covid volumes, whereas that of HSD is likely to trail FY2020 level

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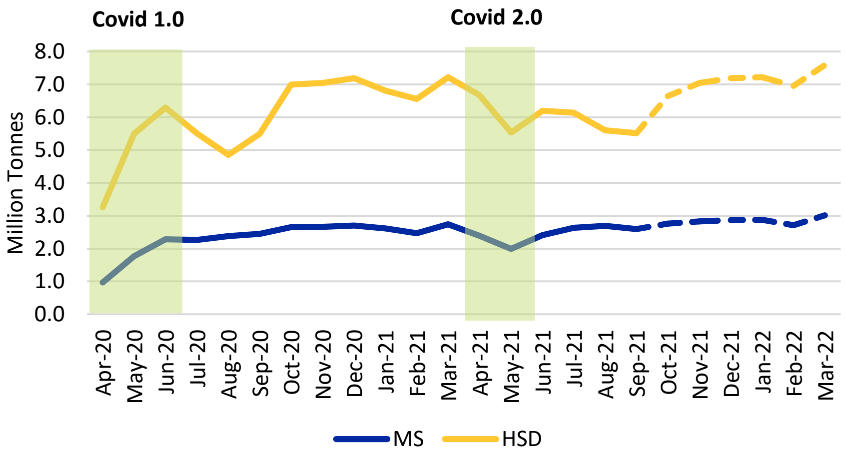
EXHIBIT: Monthly Fuel Consumption and ICRA's estimates for H2 FY2022



Source: PPAC; referred to preliminary sales data by state fuel refiners for Oct 2021; ICRA Research

EXHIBIT: ICRA's Estimated Consumption of MS and HSD 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	31.8	+14%	+6%
HSD (2)	82.6	72.7	78.3	+8%	-5%
Total (3=1+2)	112.6	100.7	111.0	+9%	-2%

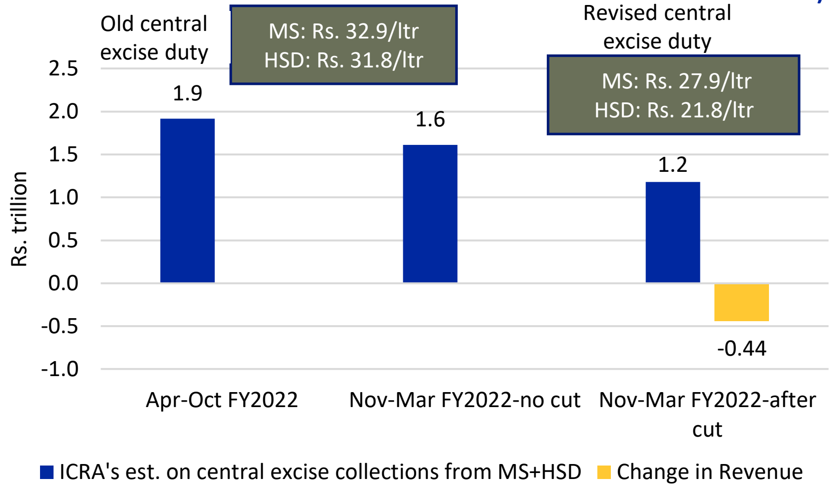
Source: PPAC; ICRA Research

- In H1 FY2022, the consumption of MS and HSD posted a YoY expansion of 21.4% and 15.4%, respectively, on the back of a subdued base especially during nationwide lockdown (-20.9% and -25.3%, resp., in H1 FY2021). Relative to pre-Covid volumes of FY2020, HSD consumption sharply trailed that of MS, partly reflecting some shift in freight movement towards railways with surging transportation costs.
- Factoring in the impact of the excise duty cut, and our expectations for mobility and the economic recovery with the rising Covid-19 vaccine coverage, we forecast the YoY expansion in the consumption of MS and HSD in FY2022 at 14% and 8%, respectively, on the low base of FY2021 (-6.8% and -11.9%, resp.).
- Relative to FY2020, consumption in FY2022 is likely to be 6% higher in the case of MS, and 5% lower in the case of HSD.

ICRA estimates GoI's revenue loss from excise duty cut at ~Rs. 440 billion

Trend in Apr-Oct FY2022	ICRA's exp. Trend for Nov-Mar FY2022	Revenue loss to GoI as per ICRA's estimates
Based on the actual fuel consumption in H1 FY2022 and the expected level for Oct 2021, we estimate the GoI's cess revenues from MS and HSD in Apr-Oct FY2022 at Rs. 1.9 trillion, a YoY expansion of 17% benefitting from improving mobility, low base and economic recovery after second wave.	Based on our projection for fuel sales during Nov-Mar FY2022, the cess collections from MS and HSD were estimated at Rs. 1.6 trillion, if no duty cuts were announced. However, after the RIC cut in MS and HSD by Rs. 5/litre and Rs. 10/litre, we now peg the revenues from these two sources at Rs. 1.2 trillion during Nov-Mar FY2022.	Accordingly, we estimate the revenue loss to the GoI from the RIC cut on MS and HSD at Rs. ~440 billion. Overall, the combined cess collections from these fuels is projected at Rs. 3.1 trillion in FY2022.

EXHIBIT: Excise Collections on Fuels and Revenue loss to the GoI (ICRA's est.)



Source: ICRA Research

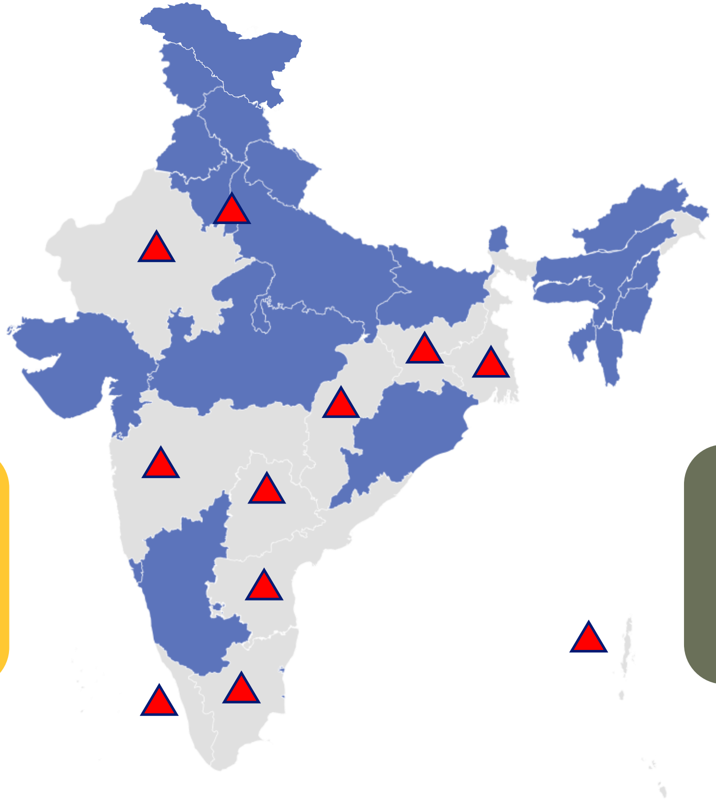
- Impact of excise duty on GoI's fiscal deficit likely to be modest at ~0.2% of GDP in FY2022.

Majority of States and UTs have announced a VAT cut on petrol and diesel

EXHIBIT: 19 States and 6 UTs have announced a VAT cut on auto fuels

Several states such as Gujarat, Karnataka, Mizoram, Nagaland, Tripura, Assam, Sikkim, Goa and Manipur have reduced VAT on petrol and diesel by Rs. 7/litre each

Punjab has cut VAT on petrol and diesel by Rs. 10/litre and Rs. 5/litre, respectively, whereas Meghalaya and Odisha have reduced it by Rs. 5/litre and Rs. 3/litre each, respectively



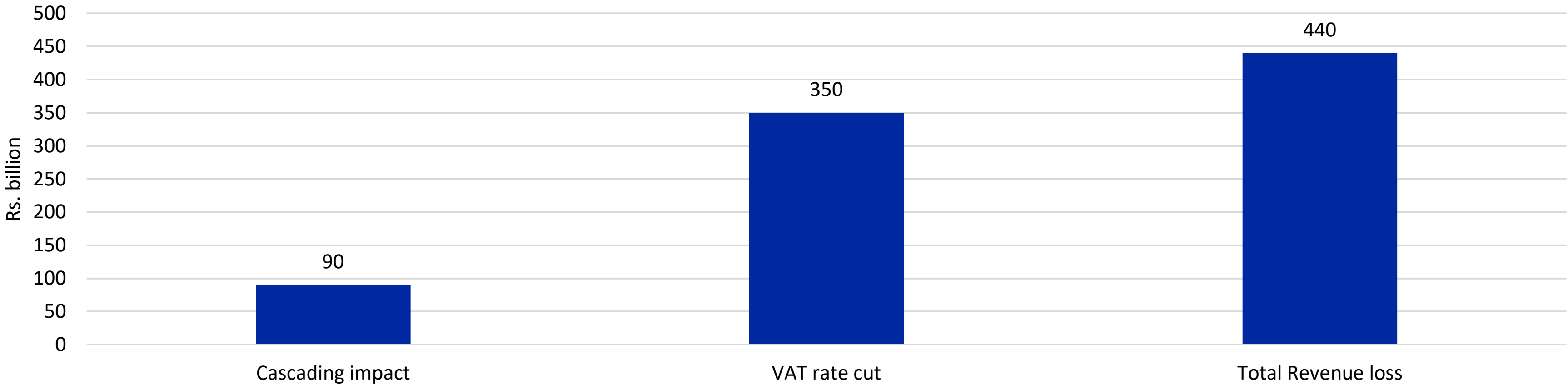
Himachal Pradesh has reduced the VAT on petrol and diesel by 7.5% and 8.0%, respectively, while Arunachal Pradesh has cut it by 5.5% each

Nine states (Andhra Pradesh, Kerala, Tamil Nadu, Rajasthan, Maharashtra, West Bengal, Telangana, Chhattisgarh and Jharkhand) and two UTs (NCT of Delhi and Andaman and Nicobar) are yet to announce any VAT cut on fuels

Source: Various News reports; Updated up to Nov 8, 2021; ICRA Research

Revenue loss to States and UTs from cascading impact of excise cut and VAT reduction on petrol and diesel, estimated at ~Rs. 440 billion as well

EXHIBIT: ICRA's projections of Revenue Foregone by the States/UTs from cascading impact and VAT rate cut on petrol and diesel in FY2022

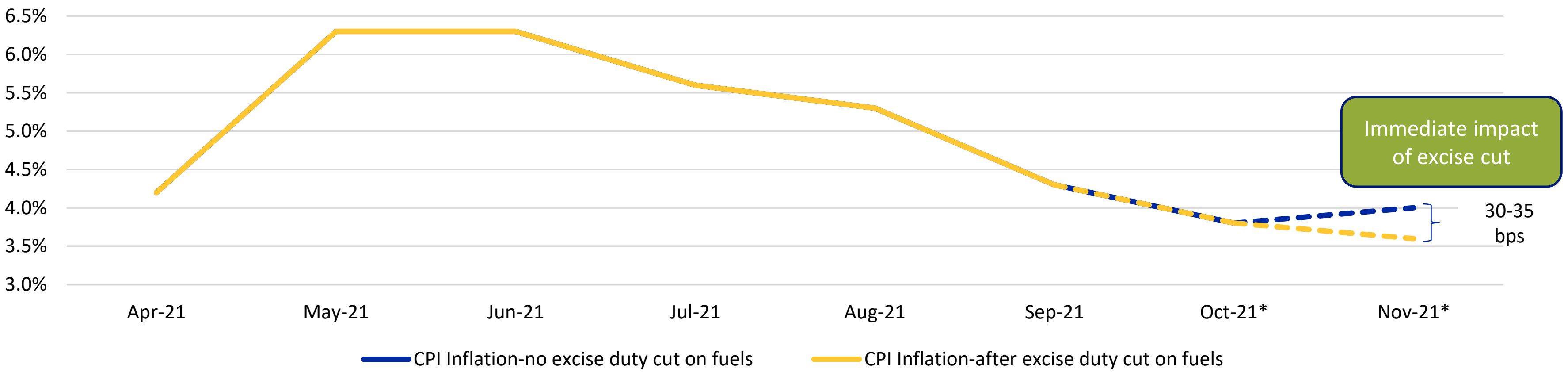


Source: ICRA Research

- There is no direct impact of the reduction in RIC on MS and HSD by the GoI, as RIC is not shared with the states.
- However, the cascading impact of this cut will be visible on the states' VAT collections, as it is typically levied on an ad valorem basis; we estimate this revenue loss at ~Rs. 90 billion.
- We tentatively estimate the revenue loss to all states and UTs from VAT cuts on these fuels at Rs. 350 billion; accordingly, their total revenue foregone is assessed at Rs. 440 billion for FY2022, in line with the expected revenue loss of the GoI.

Central excise duty cut on fuels may shave off 30-35 bps from Nov 2021 CPI print

EXHIBIT: YoY Headline CPI Inflation



**ICRA's projection for Oct-Nov 2021 with and without announcement of excise cut; Source: NSO; ICRA Research*

- A high base is expected to temporarily dampen the CPI inflation for Oct-Nov 2021 to below 4.0%, i.e. the mid-point of the MPC's medium-term target range.
- Our calculations suggest that the direct impact of the reduction in central excise duty on MS and HSD on the Nov 2021 CPI inflation print would be ~30-35 bps, with a somewhat smaller impact of the varied VAT cuts by states. The second order impact will be visible over the next three months, but is likely to be muted as tentative demand had limited the pass through of higher fuel prices to other goods.
- We expect the CPI prints in Dec-March FY2022 to range between 5.0% and 6.0%. Despite the pressures related to coal, metals and logistics costs, it is unlikely that the CPI inflation will cross 6% in the remainder of this fiscal.

Cuts in fuel taxes to allay fears of early rate hikes, bolster demand

As highlighted by the MPC in its last five reviews, the reduction in indirect tax on fuels would help in easing the exogenous shocks on the cost of transport services and overall inflation, and also prevent inflationary expectations from getting entrenched for a longer duration. The softening impact of the tax cuts on the inflation trajectory is likely to stave off any early repo or reverse repo hikes by the MPC and the RBI, respectively

The MPC is likely to change the monetary policy stance to neutral only after a durable domestic demand revival emboldens producers to raise prices, which is likely in the Feb 2022 review. We expect this to be accompanied by a 15 bps hike in the reverse repo rate by the RBI.

We expect hikes of 25 bps each in the repo and the reverse repo rates each in the Apr 2022 and Jun 2022 reviews, followed by a likely pause to reassess the durability of the growth revival as the policy support is weaned off. As a result, real interest rates are likely to remain negative over the next 12 months.

The duty cuts on fuel both by the Centre and States will boost the sentiment and ease the pressure on disposable incomes that had been restrained by elevated prices, and thereby support consumption.

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