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Indian Upstream Oil and Gas Industry

Additional cess on crude production credit negative for incumbents

JULY 2022

Highlights

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Crude oil prices remain elevated and are likely to stay at such high levels in the medium term. High energy prices are a positive for upstream companies and result in healthy earnings. Looking at the extraordinary earnings, the Government of India imposed a cess of Rs. 23,250 per tonne (around $40/bbl) of crude produced. This will result in a mop-up of around Rs. 51,800 crore for the Government in the current fiscal and will reduce the industry EBITDA by the same amount.

- The armed conflict between Russia and Ukraine has led to a spike in crude oil prices. A few countries, including the US, have banned Russian oil and gas imports, while some European nations have decided to phase out Russian oil and oil products by the end of the year.
- Given the elevated crude oil prices, which have remained at more than $100/bbl mark for quite some time now, the upstream companies have been generating healthy profits. Looking at this, the Government has imposed a cess of Rs. 23,250 per tonne on the crude produced.
- Domestic crude oil production has been steadily falling due to a natural decline in the mature oil fields. State-owned ONGC and OIL combined continue to dominate domestic crude oil production.
- This cess is likely to result in the Government of India collecting Rs. 51,800 crore in the current fiscal, which will be the total impact on the EBITDA of the upstream companies as the realisation from rude for these players reduce by $40/bbl.
- ICRA expects that the capex plans of the incumbents to remain largely intact owing to the still remunerative realisations of $60-80/barrel for crude, post the imposition of cess. Additionally, ICRA expects the cess to be rolled back in case crude prices decline
- A similar levy was imposed in the UK, wherein the Government charged an extra 25% corporate tax on oil and gas companies. This is likely to result in a mop-up of £5 billion in one year. Many other countries have imposed similar taxes on power generators, while some others are contemplating similar actions

Crude prices retain upward bias

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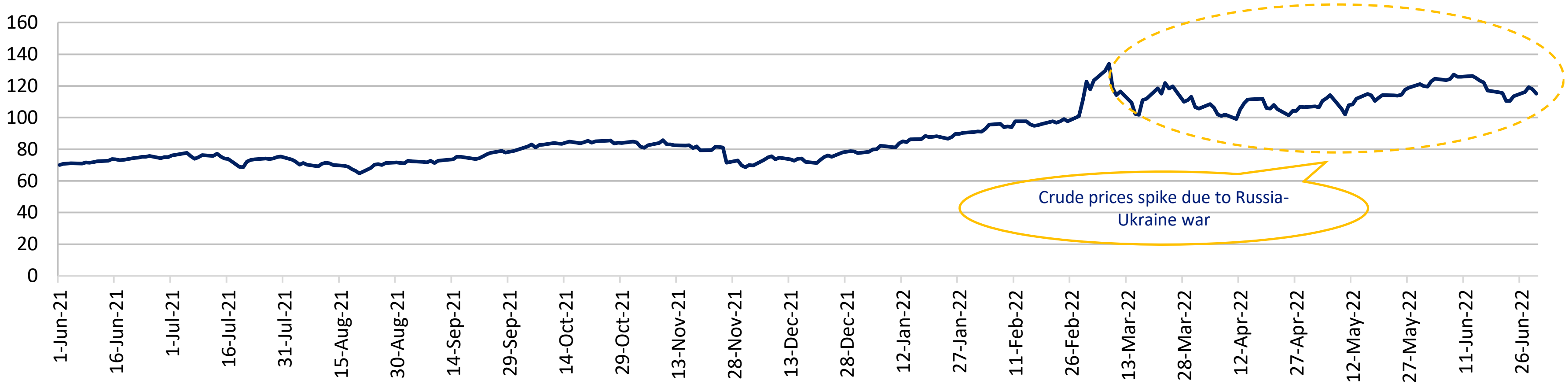
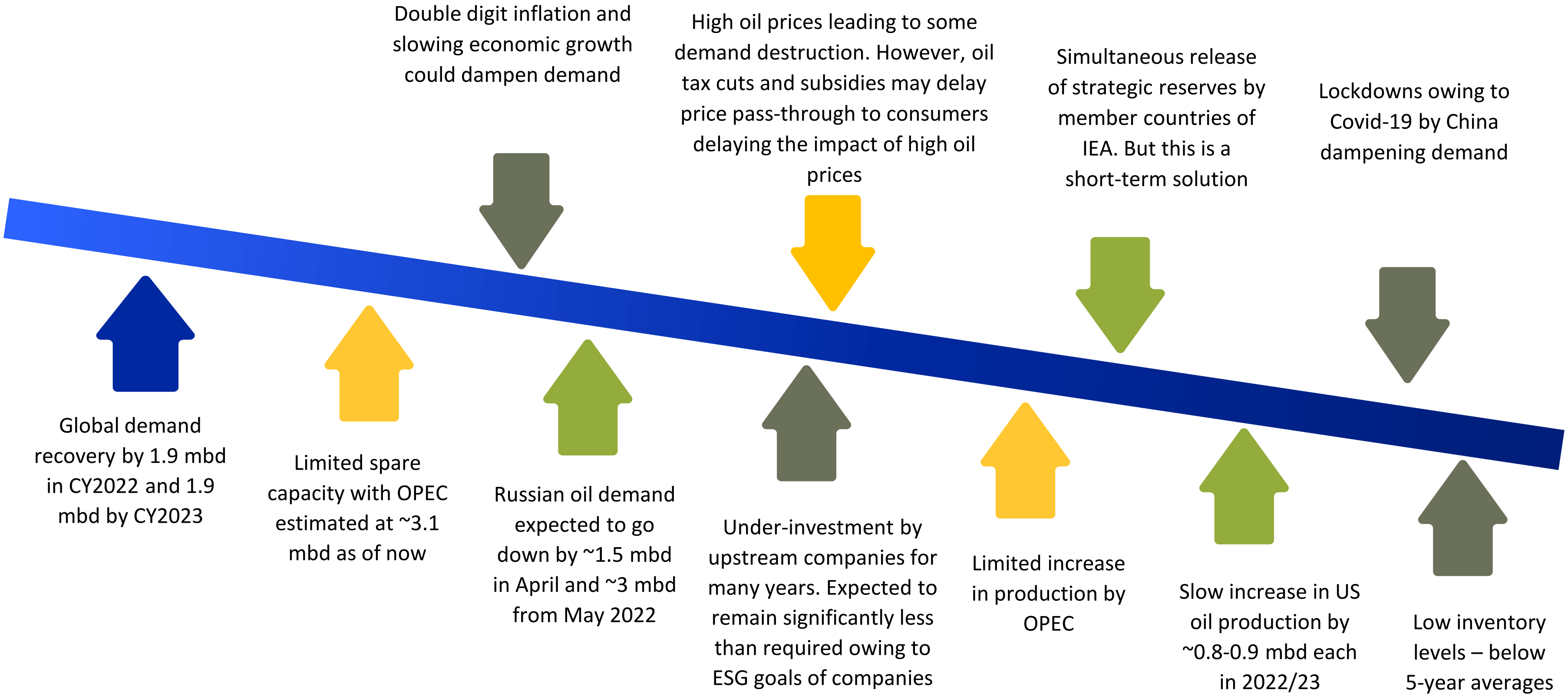
Exhibit: Brent crude price trend ($/bbl)



Source: Bloomberg, ICRA Research

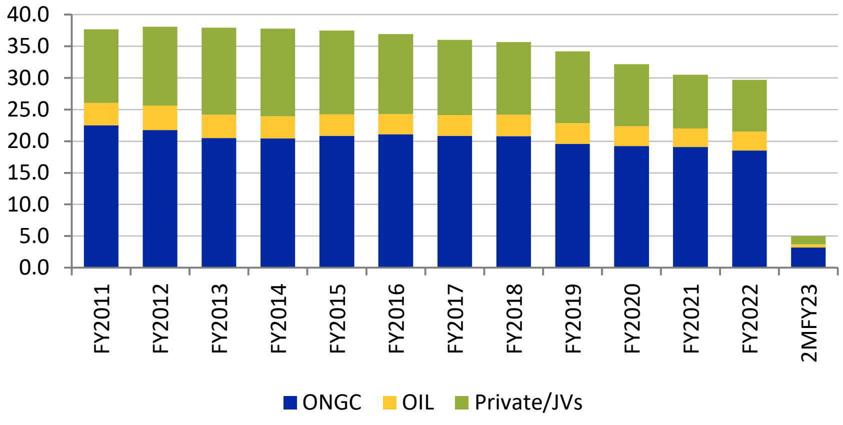
- Oil prices have remained elevated since the start of the Russia-Ukraine face-off. While the prices have come off from their highs of around $135/bbl, they still remain elevated at around $110/bbl.
- Inflationary pressures, coupled with pressures on economic expansion, could dampen global oil demand.
- The possibility of an Iranian nuclear deal could lower oil prices. But Iran is a much smaller oil producer and cannot replace the loss of Russian oil.

Factors impacting crude prices



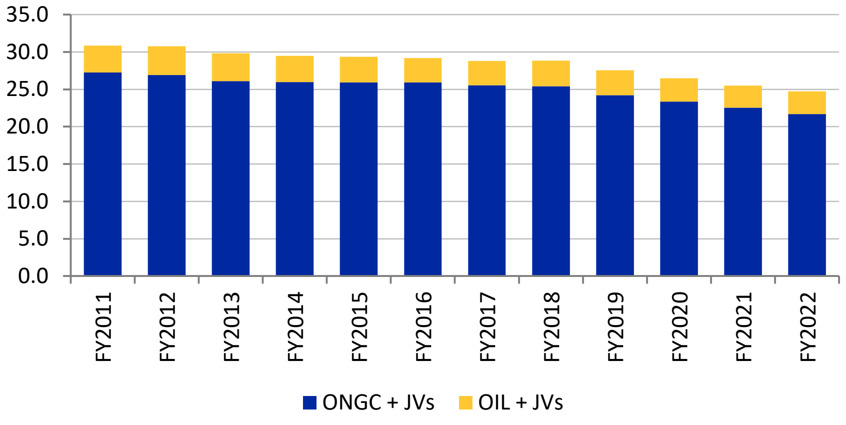
Domestic crude oil production on a declining trend

EXHIBIT: Domestic crude oil production (MMT)



Source: PPAC

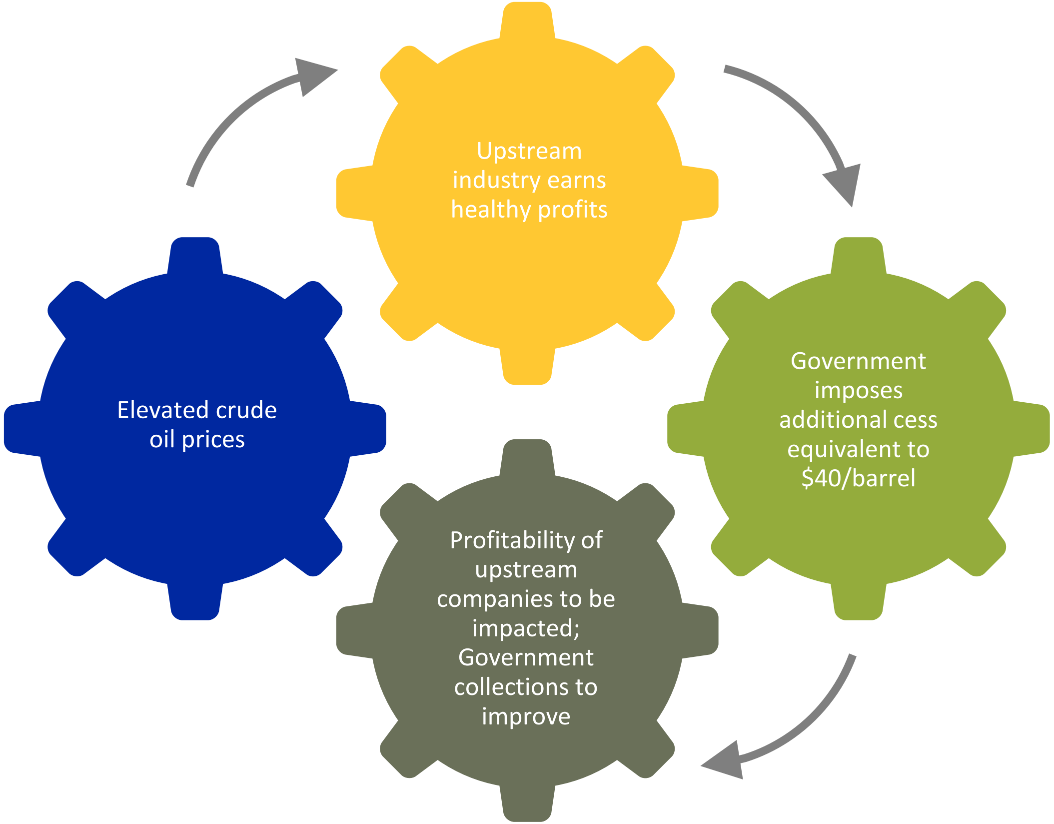
EXHIBIT: Crude oil production – OIL and ONGC (incl. JVs) (MMT)



Source: ONGC and OIL Annual Reports

- Domestic crude oil production has been declining steadily, primarily on account of a natural decline in the mature oil fields
- While the production for both ONGC and OIL (along with its JVs) has been following a declining trajectory, their combined share in the total production remains high at around 83%

Imposition of additional cess



On July 1, 2022, the GoI imposed a cess of Rs. 23,250 per tonne of crude, translating into $40 per barrel. This largely stems from elevated crude prices and the windfall gains made by the crude producers

Details of the cess and its impact

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Details of the Cess

Imposition of Cess

A cess of Rs. 23,250 per tonne (equivalent to around $40/bbl) has been imposed on domestic crude producers w.e.f. July 01, 2022

Sunset Clause

There is no sunset clause as such, however this is likely to be a temporary cess and should phase out when crude prices ease to normal levels

Exemptions

Small producers, whose annual production of crude is less than 2 million barrels, will be exempted from this cess. Additionally, no cess will be imposed on the quantity of crude that is produced in excess of last year's production by a crude producer.

Impact Assessment

Realisations

The realisations of crude oil producers to fall to around $60-$80 per barrel now from more than $100 per barrel

Impact on Margins

With the fall in realisations, the margins and cash accruals will be impacted, although the same are likely to remain healthy

Capex Impact

Even at these levels of crude, the capex plans are not likely to materially slow down for the domestic upstream industry

Impact assessment

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	Assessment	Impact meter
Impact on Government collections	The Rs. 23,250/tonne of cess, which is being stated as windfall tax, will result in the Government collecting around Rs. 51,800 crore this fiscal (cess effective from July 1, 2022) and will partially offset the excise duty cuts on petroleum products done earlier	High
Impact on realisations of upstream players	The upstream industry was having a dream run as the realisation of crude was consistently above $100/bbl mark since March 2022 and this cess will lower the net realisations of the companies by $40/bbl	High
Impact on margins of upstream players	With the fall in realisations, the margins and cash accruals of the industry will also be impacted. Considering the current production levels, ONGC’s EBITDA will be lower by around Rs. 35,000 crore, while for OIL it would be around Rs. 5,400 crore in FY2023.	High
Impact on capex plans	The capex plans of the incumbents would remain largely intact owing to the still remunerative realisations of $60-80/barrel for crude post the imposition of the cess. Additionally, ICRA expects the cess to be rolled back in case crude prices decline	Low

Drawing a parallel with UK's windfall tax

On May 26, 2022, the UK Government imposed an Energy Profits Levy of 25% on its domestic oil and gas industry, thereby taking the total corporate tax rate on oil and gas to 65% from 40% earlier. While this has a sunset clause till December 2025, the same is likely to be phased out when crude oil prices return to normal levels

The total collection for the Government is expected to be around 5 billion pounds in the next one year. This amount is likely to be used to pay for schemes to assist households with sky-high energy bills

This move can impact the attractiveness of the investments in UK, especially at a time energy security is in question. While oil majors (likes of Shell and BP) have committed 20-25-billion-pound investments each over the next 8-10 years, the additional levy has the potential to impact quantum

India levied the cess on a per tonne basis and is equivalent to 40$/bbl, and it does not have a sunset clause

The total collection in the current fiscal is expected to be around Rs. 51,800 crore, which on annualised basis comes out to around Rs. 69,000 crore

While definitely this levy is a dampener, the same is not expected to impact the capex plans of the crude oil producers materially

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Thank You!