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# CRISIL Opinion

## PSU OMCs to benefit in the near term with fuel de-regulation

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# PSU OMCs to benefit in the near term with fuel de-regulation

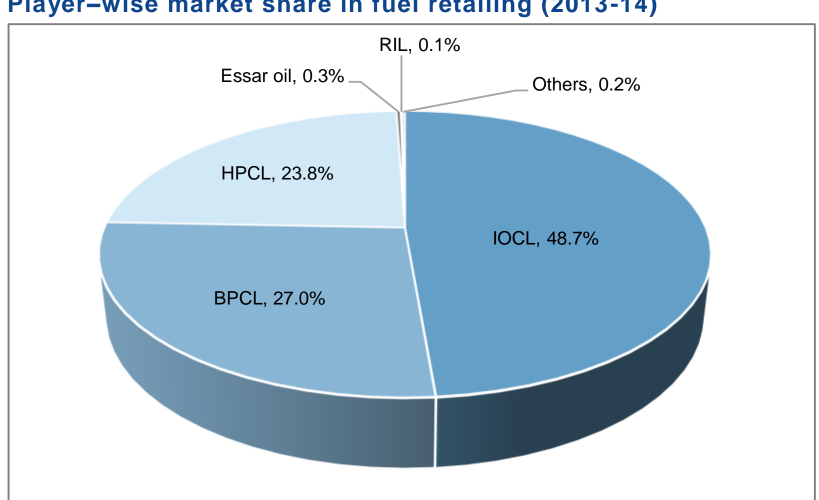
## Marketing margins of PSU oil marketers to expand by 30-40 paise/litre in 2 years, contract there after

*Deregulation of diesel price, announced last October, has set the stage for re-entry of private entities in fuel retailing. However, it is unlikely these players will expand aggressively, at least in the medium term, until they are convinced the government won't do a policy flip-flop and intervene in pricing like it did in 2005. So the big three public sector oil marketing companies are unlikely to lose more than 3-5% market share over the next 2 years. What's more, OMCs' marketing margins will expand by 30-40 paise a litre and their profitability will improve by Rs 38-43 billion in the next 2 years. In the long run, however, marketing margins will decline as competition intensifies due to expansion and aggressive pricing strategies by private players. Private players are likely to capture 10-12% market share by 2018-19 with 7-8% share in fuel retail outlets.*

## Diesel decontrol to bring back private companies…

Deregulation of diesel prices last October (petrol prices were deregulated in 2010) has set the stage for private players to once again challenge, after nearly 9 years, the dominance of the Big Three oil marketing companies (OMCs) – Indian Oil Corporation Ltd (IOCL), Bharat Petroleum Corporation Ltd (BPCL) and Hindustan Petroleum Corporation Ltd (HPCL) – all of them public sector undertakings.

**Player–wise market share in fuel retailing (2013-14)**




**Source: Industry**

Until October 2014, private participation was minimal to non-existent in the domestic liquid fuel (petrol or motor spirit, and high-speed diesel) retail industry, worth about Rs 6.2 trillion ($100 billion) in 2014-15. Petrol and diesel together account for around 50% of overall domestic petroleum product consumption (100 million kilo litres in 2014-15); diesel accounts for an overwhelming 80% of retail fuel sales.

A mere 5% market share in the fuel retailing segment, at marketing margins of Rs 0.7/litre and Rs 1.1/litre for diesel and petrol respectively, translates to a profit of Rs 4 billion. The return of private players into fuel retailing,

in spite of having burnt their fingers once before due to the government's policy flip-flop, is, thus, unsurprising (*see box on page 8*). Even some domestic standalone public sector undertaking (PSU) refiners are keenly eyeing the segment.

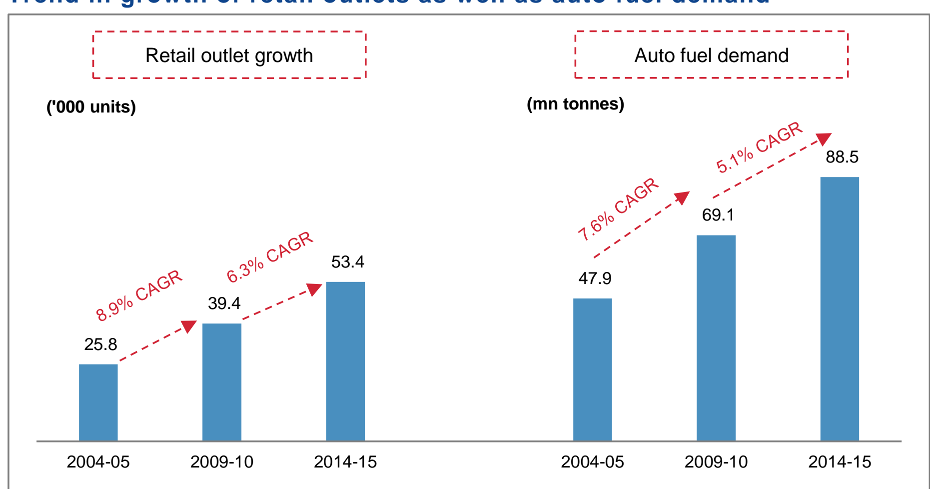
### …but on a cautious footing, in the medium term

Unlike in 2002, when deregulation of retail fuels sparked off aggressive expansion by private players, we expect companies to be more cautious this time around with their growth plans. In the medium term, companies are unlikely to make significant investments until they are sure the government won't change its mind yet again.

Second, PSU OMCs are far better prepared this time around to tackle emerging competition; they have already replicated most of the customer engagement strategies (improved service quality, fleet cards for transporters, offering discounts, higher number of dispensing units per outlet to reduce wait time, providing truck stops) that private players had rolled out – strategies that yielded higher throughput per outlet – during their ill-fated, previous foray.

Third, impeding private player expansion in the near term will be lower throughput per outlet and high retail penetration. This is because, in the past 10-11 years since private players first entered the segment, PSU OMCs have expanded aggressively; the number of PSU retail outlets has gone up by over 2.5 times (from around 19,000 in 2002-03 to over 50,000 in 2014-15).

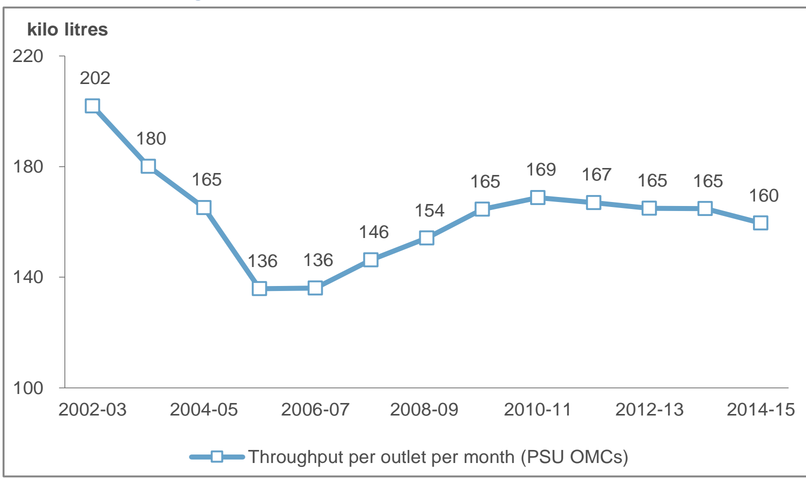
**Trend in growth of retail outlets as well as auto fuel demand**




**Source: PPAC**

Apart from high retail penetration, the growth in number of outlets has outpaced retail fuel demand growth. As a result, throughput per outlet is currently below 170 kilolitres per month compared with over 200 kilolitres per month in 2002-03.

**Trend in throughput per outlet for OMCs**




**Source: PPAC, Industry, CRISIL Research**

In the long term, of course, if private players are convinced of policy stability, they can be expected to speed up their expansion plans and also implement attractive pricing strategies to lure customers, resulting in greater competition and, consequently, lower marketing margins.

## Competition in fuel retailing to intensify in the long term

While private players are unlikely to be aggressive in the near term, the situation may change in the long term in the event of policy stability. In the near term, asset light model and dealer caution will limit expansion of private fuel retailers.

Most private retail fuel outlets follow the dealer-owned, dealer-operated (DODO) model in which the lion's share of investments is made by the dealer and not the marketing company. Inevitably, under this model, throughput per outlet has to be high enough for the dealer to consider investing. As current dealer commissions and throughput per outlet go, if a dealer sets up a fuel retail outlet under the DODO model on a national highway (investment required is Rs 14.5 million excluding land cost), the average return on investment would be just 8%.

Further, dealers will also be wary of private retailers in light of their bitter experience with fuel price decontrol in the past. After 2005-06, private retailers stopped selling retail fuel to their outlets because the government reversed policy. Consequently, dealers suffered huge losses after making huge investments in setting up retail outlets; many of them did not get any return on their investment. Since the outlets were leased for a minimum period of 20 years to private players, the dealers were also not able to monetise the space for anything else.

Consequently, mammoth expansion by private retailers does not appear to be on the horizon in the medium term.

However, the scenario is expected to change 2-2.5 years down the line. Private players will most likely seek to increase the number of outlets and embark on different strategies to snatch market share from the Big Three PSUs.

The process appears to have already begun, albeit in a small way. Reliance, through its trans-connect scheme, has introduced volume-based discounts nationwide to bulk consumers; the higher the consumption per month, the higher the benefit.

Reliance is offering discounts ranging from 25 paise per litre to 80 paise per litre depending on monthly consumption. Customers in Gujarat (where its refinery is located) and Maharashtra (along the coast) are being offered higher discounts as the benefit of higher realisations due to trade parity pricing as against export parity pricing (for products exported) is passed on to the consumers.

Apart from volume-based pricing, new players are also likely to implement location-based pricing in the long term. Certain locations may have lower prices due various reasons like proximity to refinery, higher throughput per outlet, higher competition.

Private companies may also be willing to pursue company owned dealer operated (CODO) and company owned company operated (COCO) models (where investment required is significantly higher than DODO model) if the dynamics prove to be viable.

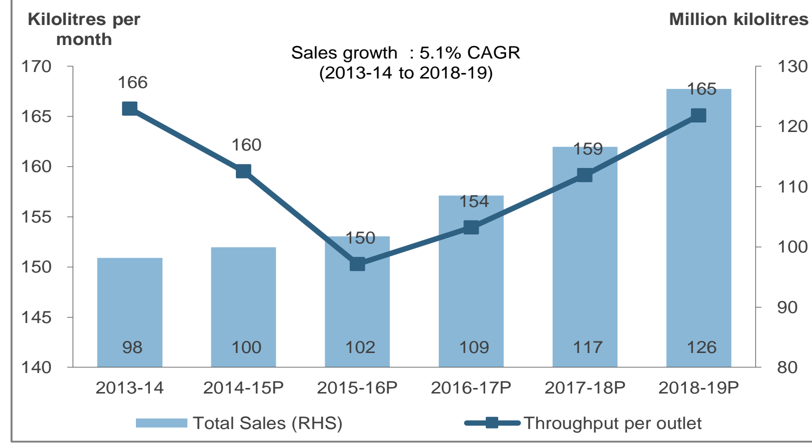
## Private fuel retailers to capture 10-12% share in the next 4-5 years

We do not expect PSU OMCs to resort to aggressive expansion because of the entry of private players as they have already increased their outlets significantly over the last 10-12 years; if they continue to expand aggressively, it will lower their throughput per outlet and impact their profitability.

We estimate that PSU OMCs will open about 13,000-13,500 (5% CAGR) new outlets by 2018-19. The pace of expansion of their retail outlets will be slower than that seen in the previous 5 years (around 14,500 outlets) as penetration levels are already high. On the other hand, we expect total number of operational outlets by private players to reach 5,000-6,000 (~8% of total outlets) by 2018-19 from ~1600 in 2014-15.

Retail fuel demand is estimated to grow at 5.1% CAGR to 126 million litres during 2013-14 to 2018-19. During the same period, retail fuel outlets (including private players) are also forecast to grow by around 5% CAGR to 63,000-64,000 outlets. Throughput per outlet will decline in 2015-16 as a significant number of private players' existing non-operational outlets (around 3,000) are expected to re-open quickly.

**Throughput per outlet to decline in 2015-16**




Source: CRISIL Research

So, unlike 2005-06, when private players snatched nearly 8% market share in just 1 year, the shift in market share will be more gradual; private companies are expected to garner about 10-12% share of the fuel retail market over the next 4-5 years. Even after losing market share, absolute sales volumes of PSU OMCs in 2018-19 will still be 11-13% higher than 100 million kilolitres in 2014-15.

Private players such as Reliance Industries and Essar Oil are already present in the fuel retail segment and will, therefore, have an edge over other standalone refiners such as MRPL or international players such as Shell. Before diesel de-regulation in October 2014, both Essar Oil and Reliance had around 1,400 retail outlets each (operational and non-operational) in the country; even Shell has a presence (79 outlets). But these numbers are still very small to pose a threat to PSU OMCs. Private players are likely to reopen their existing outlets before conceiving new ones.

**Present stated position of various players**

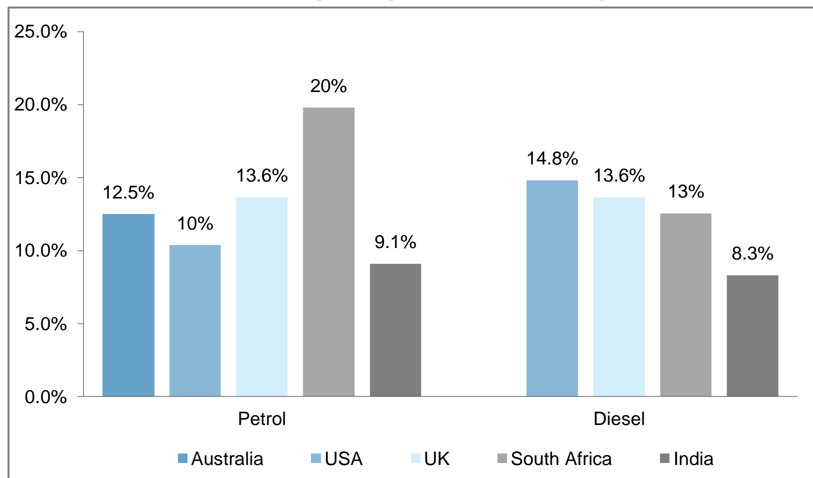
| Name of the company | Current position | Expansion plan |
|---|---|---|
| Essar Oil | Current outlets : 1,400-1,500 | To open additional 1,400 outlets over the next 2-3 years |
| RIL | Current operational outlets : 300 -350 | To open all non-operational outlets (1,400) by end of 2015-16. No further plan disclosed |
| OMCs (BPCL, HPCL, IOCL) | Current operational outlets : ~51,000 | Advertised setting up of over 35,000 outlets across India |
| MRPL | No outlet currently | Has license to operate 500 outlets. Announced setting up of 100 outlets in first phase |
| ONGC | No outlet currently | Has license to operate 1,100 outlets. No plans announced. |
| Shell | Current operational outlets :75 | Has license to operate 2,000 outlets. No specific plans disclosed |

## OMCs’ marketing margins to expand in next 2 years…

Due to decontrol of petrol and diesel prices, marketing margins of OMCs are expected to increase by 30-40 paise per litre over the next 2 years. This is because retail fuel marketing margins are lower in India compared with other countries where fuel prices are deregulated. This is despite significantly higher competition in those countries.

In India, marketing margins as a percentage of retail petrol price (excluding taxes) was about 9% in 2013-14 versus 10-20% in the US, South Africa, Canada, and Australia. Even in diesel, the ratio is much lower for India (8%) compared with other countries (13-15%).

**Comparison of marketing margins as percentage of petrol prices in various countries**



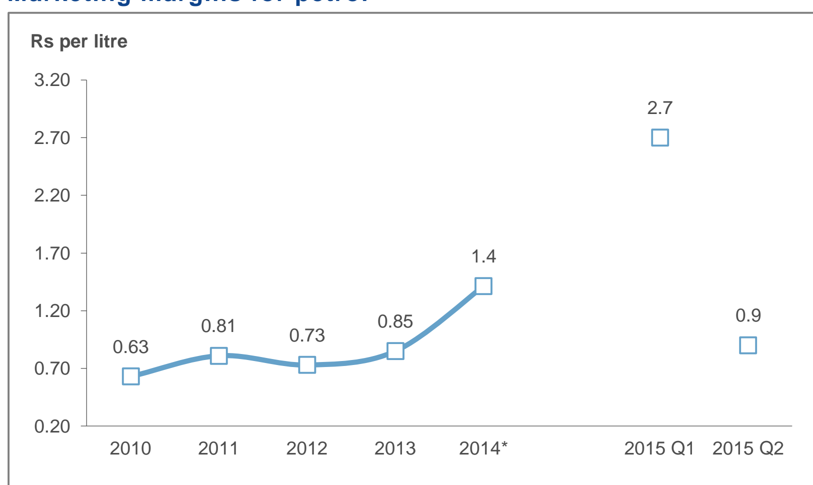

Note: As diesel is largely sold in Australia in bulk through commercial contracts and not retail outlets, it has not been considered, marketing margins calculated are on gross basis

**Source: PPAC, Industry, CRISIL Research**

Interestingly, marketing margins are higher globally despite more number of players operating in the segment. There are only 5-6 players (three players with more than 95% share) in fuel retailing in India compared with nearly 20 players in the US and the UK and 10-15 players in Australia and South Africa. CRISIL Research believes that, even with the influx of new players, marketing margins will improve in India as they have historically been low due to price regulation.

The experience with petrol corroborates this. The marketing margin on petrol increased from 63 paise per litre in 2010 to an average Rs 1.40 per litre in 2014 after price de-regulation.

**Marketing margins for petrol**




Note: * Average marketing margins for 2014 were skewed by significantly higher margins during November-December 2014 when oil prices declined sharply. Excluding the last 2 months, average margins stood at Rs 1.10 per litre. Same was the case in Q12015 after which marketing margins have come down to Rs 0.9 per litre with rise in oil prices.

**Source: Oil marketing companies, CRISIL Research**

Even if we consider Rs 1.10 per litre margin for 2014 (and ignore the spike in November-December 2014), the hike in marketing margins by 50 paise per litre during 2010-2014 is much higher than the 20 paise increase during 2006-2010. To reach margins in other countries, marketing margins for petrol in India have to improve by 30-40 paise from Rs 1.10 per litre. Even in diesel, we expect marketing margins to climb by 30-40 paise over the next 2 years, to Rs 1.00-1.10 per litre.

## …so will their profitability

IOCL, BPCL, and HPCL will benefit from diesel decontrol, as marketing margins for retail fuels are expected to rise over the next 2-3 years. A 40 paise increase in marketing margins on petrol and diesel will increase their PBIT by Rs 38-43 billion (on retail consumption of 100 million kilolitres). This is nearly 26% of their combined PBIT in 2014-15. Other things remaining constant, a 40 paise jump in marketing margins for petrol and diesel will boost their profitability by 40-50 basis points.

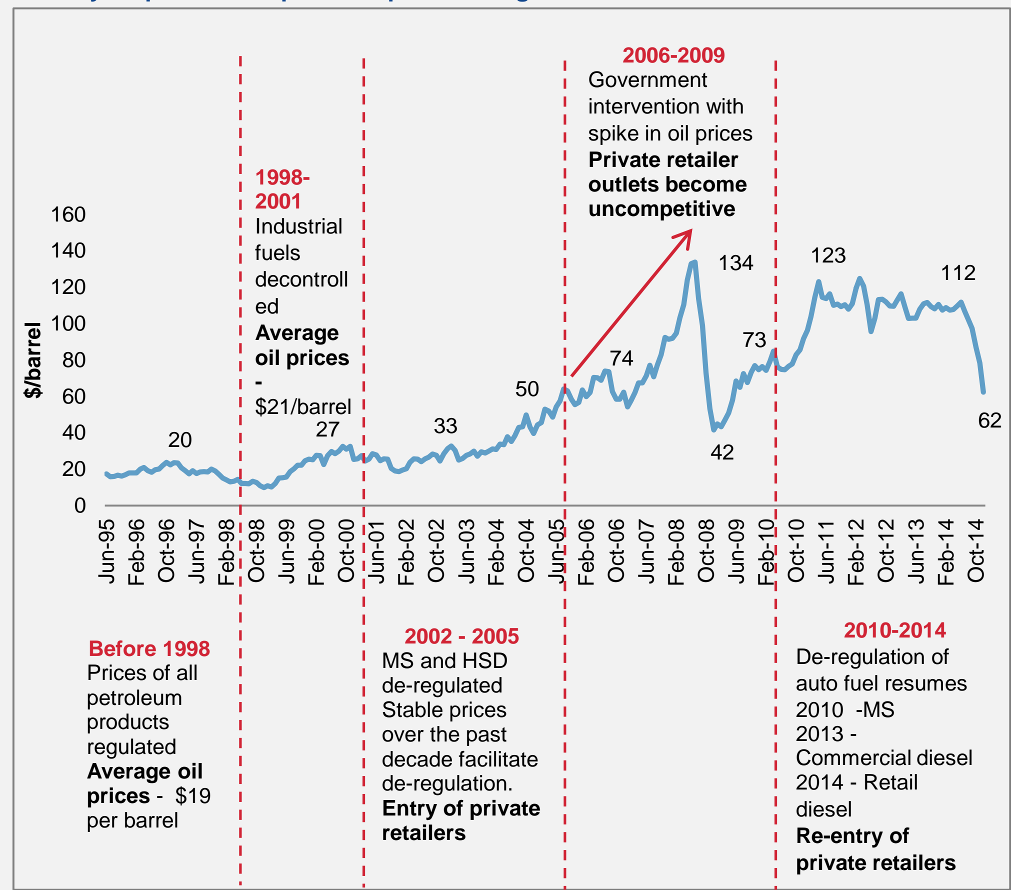
In the long run, however, marketing margins and profitability will fall as private players will increase the number of outlets and will most likely adopt aggressive pricing strategies (location based pricing, bulk discounts) to gain customers and increase their market share.

## Deregulation disaster: Or how private players burnt their hands

The last time petrol and diesel prices were deregulated (in 2002), three top private sector players – Reliance Industries, Essar Oil and Shell – gate-crashed into the segment and, within a span of three years, together accounted for around 6% of total retail outlets (30,700) in the country. They also snatched nearly 9% of the retail fuel market share from IOCL, BPCL and HPCL, the three PSU OMCs that still lord over the segment.

This swift increase in market share was led by aggressive strategies employed by private players such as opening outlets only in high-traffic areas, largely on highways; introducing fleet cards to facilitate cashless transactions for transporters; offering discounts; ensuring more dispensing units per outlet to lower wait times; and providing facilities such as truck stops (comprising parking spaces and inexpensive places to rest, eat and rejuvenate).

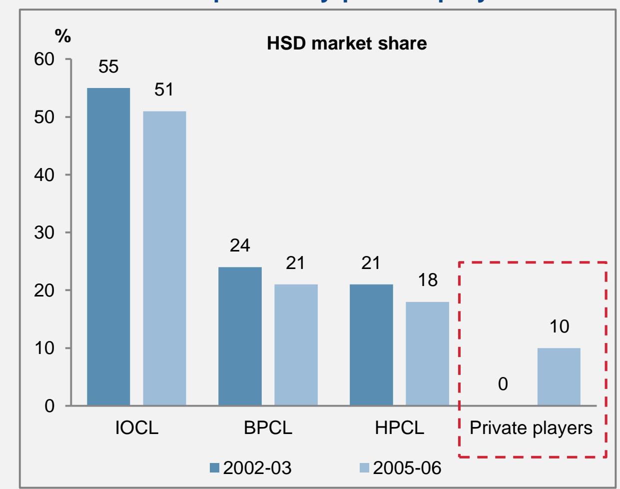
**History of petroleum product price deregulation**

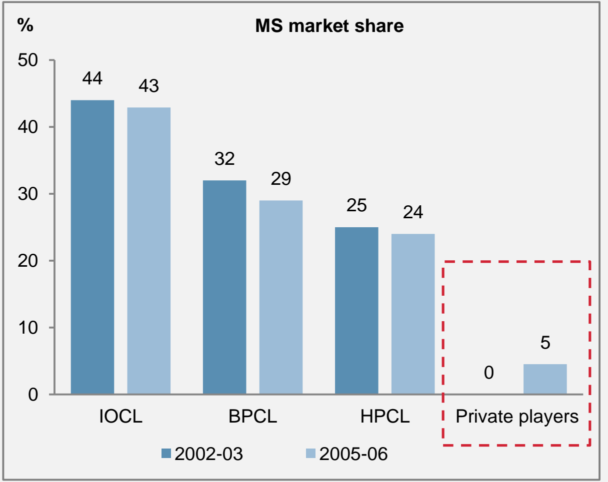



During this period, the private players garnered higher market share in diesel (10%) as they opened their outlets mostly on highways, where petrol consumption was lower.

But their joy was short-lived. The government abruptly reversed course in 2005, within three years of deregulation, and started regulating and subsidising retail fuels only to public sector OMCs, leaving private retailers with little option but to suffer losses or shut shop. Most of them chose the latter.

**Market share captured by private players between 2002-03 and 2005-06**

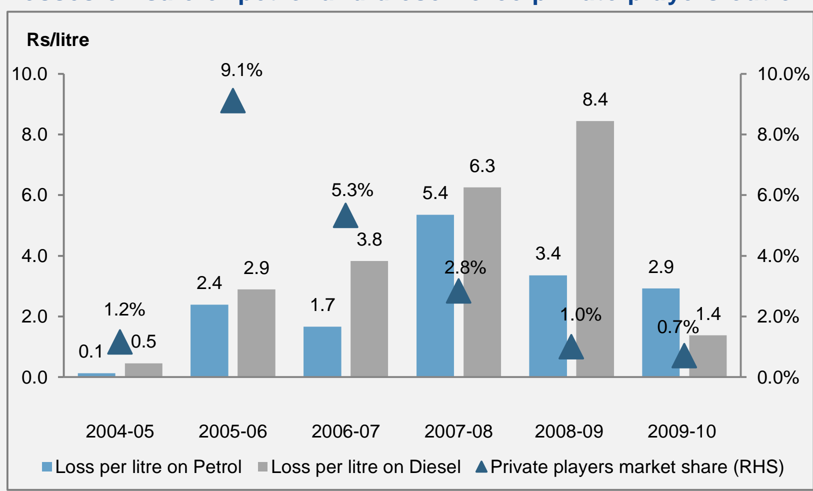



Source: MOPNG, Industry

Deregulation of fuel prices in 2002 was largely triggered by the boom in oil prices after being stable for nearly a decade. But, by 2005, oil prices had more than doubled from 2002 levels and continued their upward trajectory. Consequently, by 2009-10, the share of private players in retail fuel sales slumped to less than 1%.

**Losses on sale of petrol and diesel force private players out of business**




Source: PPAC, Industry, CRISIL Research

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