Pakistan Refinery and OMC Sectors

Pakistan Oil Refining and Marketing Policy 2020 formulated

20-Jul-20

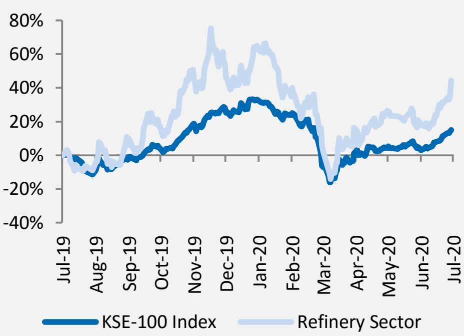
Sector Performance

Absolute %

	1M	3M	12M
Absolute %	19.4	24.1	44.2
Relative to KSE %	9.6	10.4	29.2

Relative to KSE %

Refinery Sector vs. KSE-100 Index



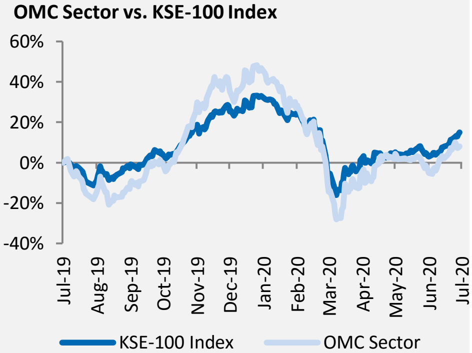
Sector Performance

Absolute %

	1M	3M	12M
Absolute %	9.6	15.2	8.1
Relative to KSE %	(0.1)	1.4	(6.9)

Relative to KSE %

OMC Sector vs. KSE-100 Index



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REP 039

- **Ministry of Energy has drafted Pakistan Oil Refining and Marketing Policy 2020, outlining incentives for both oil refinery and marketing sectors.**
- **The policy offers a number of incentives, including tax and duty exemptions, for investment in Deep Conversion Refinery of minimum 100,000bpd within 5yrs from announcement of the policy.**
- **For the OMC sector, the policy proposes relaxation storage capacity requirement for retail expansion, which would bode well for smaller OMCs.**
- **OMC and dealer margins deregulation is to take place in a phased manner, whereby till deregulation is complete, the margins will be increased in line with inflation.**
- **For refinery sector, given the substantial amount of investment (PKR336bn) required to set up a plant, it is unlikely that any single company in the sector would be able to reap the benefits of the policy and it seems to be geared towards attracting FDI.**
- **For OMCs, the relaxation of storage capacity requirement is positive for smaller OMCs such as HTL but may result in volume attrition for larger OMCs such as PSO and APL. Deregulation of OMC margins is poised to be a positive event for all OMCs, which would help expand bottomlines.**

New policy drafted: Ministry of Energy has drafted Pakistan Oil Refining and Marketing Policy 2020 and it is expected to be notified after approval from ECC and Cabinet. We discuss the proposals under the policy and their impacts on the sectors.

A) Oil Refinery Sector

Incentives for Deep Conversion Refinery offered: The policy outlines incentives for investment in the refinery sector which have been classified in 2 categories: i) Category A (all new deep conversion oil refinery projects of minimum 100,000bpd) or ii) Category B (expansion/upgradation projects of existing oil refineries by a minimum of 100,000bpd).

For new projects, the policy provides duties waiver and taxes exemptions on property, machinery, equipment are applicable on new state of the art equipment. The incentives for expansion/upgradation are time-bound to 5yrs of this policy and offer a 20yr tax holiday. Furthermore, the policy outlines that the incentives are only applicable on the new plant to be set up under the policy and not on the existing units.

The incentives for investment in the refinery projects are as follows:

- Exemption from the application of the Companies Profits (Workers' Participation) Act 1968 and Workers' Welfare Fund Ordinance 1971.
- Exemption from withholding tax and all other duties, taxes, surcharges and levies for foreign contractors for EPC, commissioning, operation, maintenance and repair of the refinery. Furthermore, this exemption will also be applicable to temporary imports of all machinery, vehicles, plant and equipment, other materials and spares in connection with engineering, procurement, construction, commissioning, operation, maintenance and repair of the refinery.

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Cash and debt positions as at 31st Mar'20

PKRmn	Cash	Debt
ATRL	13,198	8,809
NRL	867	21,557
PRL	2,007	19,377
BYCO	1,019	37,852

Source: Company Accounts, BIPLS Research

- Exemption from sales tax and excise duty on supply of locally manufactured building and construction material, equipment and services for setting up of refinery.
- Provision of a pricing mechanism which shall be no less favorable than the prevailing mechanism.
- Facilitation in project infrastructure such as Single Point Mooring (SPM), jetties, subsea/land pipelines etc. in coordination with various concerned Ministries/Government entities.
- Waiver of applicable Development Surcharge on the value of exports under the EPZA Rules 1981 in case the refinery project is set up in an Export Processing Zone.
- In case of establishing a project in upcountry locations, the imported crude oil transportation pipelines and its storages will be an integral part of the refinery project and will also be eligible to avail all incentives.
- In case of projects in upcountry locations, imported crude pipelines and their storages will also be eligible to avail the above incentives.

The above incentives are expected to attract the much needed investment in the upgradation of the refinery sector. To highlight, the refinery sector has been operating under a lower throughput since the past 2yrs as a result of lower demand of FO by the power sector in the country. A deep conversion refinery produces a lower amount of FO (2%-3%) as compared to ~25% produced by the local refineries.

Expected cost of a deep conversion refinery of 100,000bpd is ~USD2.0bn (PKR336bn). Since the scope of the project is massive, it is unlikely that a single refinery will be able to undertake the project alone. Only possible way for the current refineries is through entering into a Joint Venture, either with existing players or new investors. Even in such a scenario we expect companies to rely on external debt and/or rights issue to finance the project.

B) OMC Sector

Relaxation of storage requirement: The policy has proposed removal of storage capacity requirement for retail expansion implemented by OGRA. To highlight, OGRA currently restricts expansion of OMC's retail networks if they do not have 20 day storage capacity in the region. As a result of this policy, OMCs have been unable to expand their retail footprint in the country. OMCs, upon approval of new policy, will have to formulate their storage development plans on regional and national coverage. Furthermore, OMCs and their dealers will have to maintain an online inventory system which would allow monitoring of stock levels at depots retail outlets, whereby OGRA will develop a suitable policy in consultation with the industry. We expect this development to be positive for smaller OMCs, such as HTL, who have been unable to expand their retail footprint due to the storage constraint, which may in turn lead to attrition of volumes from the larger players (PSO, APL).

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Deregulation to continue in phased manner: Deregulation of OMC margin is expected to continue in a phased manner, whereby till complete deregulation is notified, OMC and dealer margins shall be reviewed in line with the inflation rate. With regards to deregulation, the following steps are expected in the next phase:

- Deregulation of margins on kerosene oil/JP-1/JP-8 and light diesel oil.
- Deregulation of ex-refinery prices and margins of HSD/MS for local refineries and OMCs in a phased manner.
- Phasing out of IFEM system with the completion of pipeline from Karachi to Peshawar, which would allow multiproduct movement.
- Allowance of marketing and import of differentiated products subject to approval by a competent forum on case to case basis.

Deregulation of OMC and dealer margin would be a positive event for the sector and could help contain the inventory losses for the companies. However, we would like to highlight that deregulation has been under consideration since 2017 but little progress has been made on this front.

Investment perspective: Pakistan Oil Refining and Marketing Policy 2020 is likely to generate interest in the refinery sector. However, since the capital required for a Deep Conversion Refinery is substantial (USD2.0bn – PKR336bn) it is unlikely that any single existing refinery will be able to set up a plant on its own. The policy it seems is geared towards attracting investment through FDI.

For OMCs, the easing of restriction for retail expansion is positive for smaller OMCs such as HTL, whereby the company's major bottleneck has been the storage requirement by OGRA. The expansion of retail footprint by smaller OMCs may result in volume attrition for larger OMCs such as PSO and APL. Deregulation of OMC margins is poised to be a positive event for all OMCs, which would help expand bottomlines and enable OMCs to pass on the impact of unfavorable movements in price. To highlight, deregulated product, HOBC's price did not decline as much as other products. However, we would like to highlight that deregulation has been under consideration since 2017 but little progress has been made on this front.

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The rating system

Rating Definition	
Buy	Total stock return ≥ 15%
Hold	0% ≤ Total stock return < 15%
Sell	Total stock return < 0%

* Total stock return = capital gains + dividend yield

Valuation Methodology

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