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Pakistan Market

## Carbon tax, refineries and bottom-line

MORNING BRIEFING



KSE100 Index: Closing 7023.48 ↓ (-33.78)

With the introduction of carbon tax from July 1st, government ability to promote environment friendly fuel will definitely increase, as government is aiming to collect over Rs122bn through carbon tax and reinvest in the refinery sector. The work in progress to produce Euro-II (diesel with low carbon content) is already underway and refineries are bound to produce it by 2012.

To offset the huge cost of expansion, currently, refineries are entitled to get deemed duty @ 7.5% on diesel, which they believe is not enough to implement Euro-II. To speed up the implementation of Euro-II desulphurization plant, ECC sub-committee has recommended an additional Rs1.2 per liter on diesel for refineries over an above existing 7.5% deemed duty. If the additional Rs1.2 per liter benefit is recognized as income, the profitability of the listed refinery sector is likely to increase by 25-30%. Company wise, per share annualized earnings impact would be Rs10.2 for PRL followed by Rs8.4 for NRL and Rs5.5 for ATRL. On the other hand, if this benefit is treated as a grant, it will be neutral for the refineries.

### Euro-II up gradation an overview

**Objective:** The primary objective of the project is to ensure compliance with the government's requirement of Euro-II diesel specification i.e. 500 parts per million (ppm) sulphur. Local refineries which produce 80-82k barrels per day of diesel would need to install the desulfurization of the same capacity to produce Euro II diesel. As per our discussion with industry experts, the total project cost is estimated at Rs42-45bn (or US\$6,500-7100/barrel).

**Financing:** At current rate of deemed duty (7.5%), refineries on the whole is collecting Rs10bn per annum, which they believe is not sufficient to finance and finish Euro-II on time. However, question would be raised on refineries past year deemed duty receipts and status, which is currently stuck up with inter-corporate debt. Experts believe that refining sector earnings are cyclical and risky, as their margins are calculated on the basis of deemed duty currently fixed at

7.5% is part of the refinery margins in addition to the prevailing spread between the international crude oil and diesel price. At prevailing exchange rate and oil prices, the absolute value of this duty is Rs2.5 per liter. Assuming oil prices to stay at current levels, refineries could generate Rs10bn per annum i.e. Rs30bn in 3 years- not sufficient to fulfill deadline on time. Therefore, refineries are pushing for higher deemed duty from 7.5% to 10.0%.

We believe the government will decide against it, as Supreme Court has already taken a notice on the existing oil price mechanism. However, on the recommendation of ECC sub-committee government is actively considering to provide some additional relieve through passing on Rs1.20/litre of diesel to refineries from carbon tax it will collect. This measure will keep the prices of diesel intact without putting extra burden on consumers. With this, refineries will be able to generate Rs4-5bn annually (Rs15bn in 3-years).

### What could be the likely accounting treatment?

It depends. While no concrete details are available, our understanding suggests that the additional Rs1.2 per liter would be treated as a government grant for de-sulphurisation project in accordance with the provisions of IAS-20 "Government grants and government assistance".

The Standard requires grants related to assets to be treated as deferred income (long term liability) amortized to P&L over the depreciable life of the asset. In this particular case as the development of the de-sulphurisation plant would take 3-years, refineries would continue to recognize carbon surcharge as deferred income while capitalizing the plant expenses as Work in Progress (Non current assets) on the Balance Sheet. Hence, the surcharge would carry no material impact on the P&L. Upon completion of the plant, the accumulated deferred grant income would be amortized over the depreciable life of the plant. This implies that the grant income would serve to dilute the impact of the depreciation expense on P&L.

If the additional Rs1.2 per liter benefit is recognized as income, the profitability of the refinery sector is likely to increase by 25-30%. On a company wise basis, per share annualized earnings impact would be Rs10.2 for PRL followed by Rs8.4 for NRL and Rs5.5 for ATRL. On the hand, if this benefit is treated as a grant, it will be neutral for the refineries. We maintain 'market-weight' stance on refineries and suggest investors to 'Buy' ATRL and NRL at current levels which are trading at PE of 5.7x and 4.6x, respectively on one year forward earnings.

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