India's oldest refinery at Digboi

The Corporation's business strategy found its most eloquent expression in the willingness and ability of IndianOilPeople to quickly learn and grow.

management discussion & analysis

(Forming part of the Directors' Report for the year ended 31st March 2009)

INDUSTRY STRUCTURE & DEVELOPMENTS

Global Economy

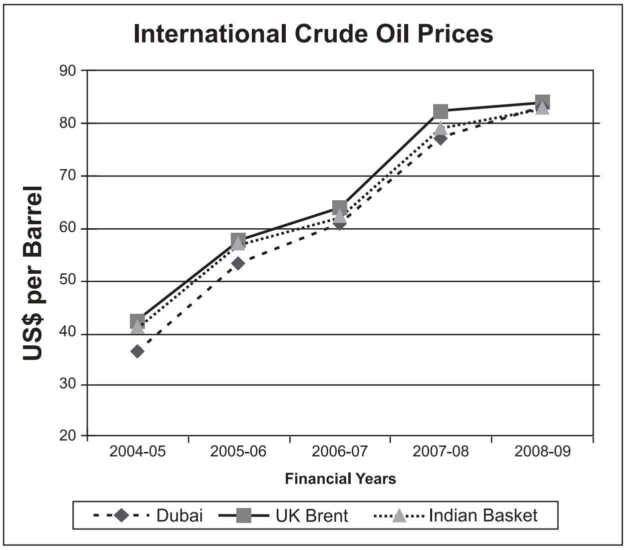
The slowdown of the advanced economies last year, was just the tip of the iceberg. Post second quarter of 2008-09, the world economy plunged further down, for the first time since the Great Depression of 1930s. The advanced economies across the globe slipped into recession, the emerging economies, which until last year were soaring, slowed down abruptly and the under-developed economies of Asia & Africa too were not spared.

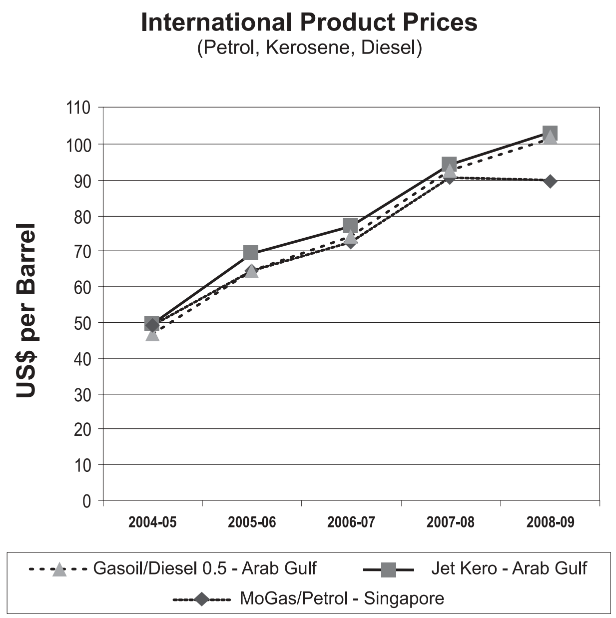
The second quarter of 2008-09 saw a significantly slow pace of world trade and financial flows. The credit markets remained cold in the wake of the deleveraging process. International commodity prices, which had peaked owing to the strong economic growth and increased investor interest in them, have fallen low post July 2008. This has sparked worries of price deflation, which could exacerbate the downturn in activity. Major fluctuations in exchange rates were also witnessed; almost every currency in the world has depreciated against the dollar, reflecting a "flight to quality" into U.S. Treasury securities.

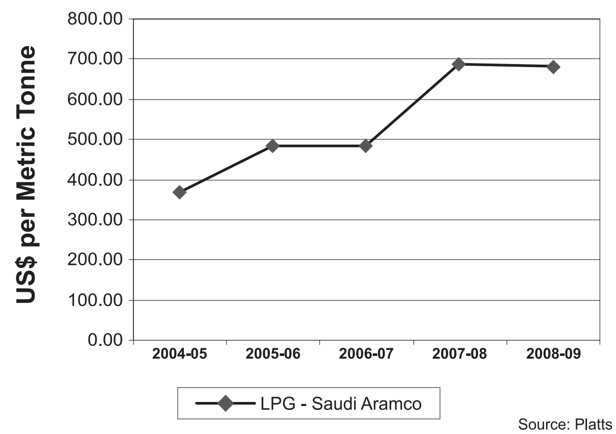
Governments across the globe have been at the helm with large scale policy interventions via monetary policy, bailout packages for the financial institutions and fiscal stimulus. These interventions have been implemented with great vigour. The fact that policy action was coordinated across developed & emerging economies through several rounds of discussions has made it more significant in speeding up the recovery process. Although the effect of some of these policy interventions is expected to be felt with elapse of time, the absence of these would have made the crisis more long-drawn and painful.

India

Indian economy too was affected by the global slowdown, despite strong dominance of domestic sources of growth. The Balance of Payments (BoP)







Source: Platts

through contraction in exports, reversal of portfolio flows and decline in long-term and short-term debt flows was the main channel of transmission. There was deceleration in growth by the third quarter of 2008-09, mainly due to varied domestic factors and an adverse external environment. In fact, the slowdown in industry was the severest, with Index of Industrial Production recording negative growth in the latter part of the year. While a sharp drop in external demand was the direct fallout of the global trade contraction, domestic demand in the form of private consumption and investment also received a jolt.

In such a crisis, monetary policy was used as the first line of defence, with cuts in major policy rates. Fiscal stimulus in the form of increased expenditure and tax cuts have provided the much needed support to aggregate demand. Even before these formally announced fiscal stimulus measures, the Sixth Pay Commission recommendations and the Agriculture Loan Waiver have provided cushion to the aggregate demand. The resultant increase in fiscal deficit raises concern about its sustainability.

On the flip side, despite a severe impact of the global turmoil, the Indian economy still fared quite well. Indian banking system & credit markets although not unscathed were not deluged. In fact, Indian banks had only limited or no exposure to malignant sub prime assets and all banks were adequately capitalized. The tight liquidity conditions that ensued were promptly managed by the Reserve Bank of India (RBI). India's strong foreign exchange reserve position, acted as a buffer and helped contain the adverse effects of the external shocks to the BoP. Confidence in India as a long-term investment destination remains unshaken with FDI reaching record levels during the year. Inflation after touching record highs in the earlier part of the year due to flared international commodity prices, in the latter part, fell and reached a record low.

The fact that the Indian economy grew at 6.7% amidst this crisis reflects the resilience of the Indian economy. In fact, most macro economists believe that while the impact of economic crisis on world economic growth will be more prolonged than earlier expected, emerging economies like India & China will lead the recovery and will return to considerable growth in the long term. The Indian economy is expected to recover early, with strong domestic fundamentals.

OUTLOOK

Global Oil & Gas Industry

It was a year of extremes for the global oil industry. The benchmark West Texas Intermediate crude price, averaged at a record $110 per barrel for 2008 (yearly base). At the back of this record average was unprecedented volatility. Crude price peaked at $ 147/bbl in July 2008 & plunged to $40/bbl at the end of the year. In the initial part of the year, tight supply-demand balance, geopolitical tensions, a weakened US dollar & overflowing money into crude futures made the crude oil price reach its historical peak. Subsequently, in the wake of the economic turmoil, the oil market found itself at cross roads, as flow of funds to crude futures dried up, demand from advanced countries as well as emerging markets (especially China, post Beijing Olympics) plummeted and dollar started strengthening. In fact, in 2008, global oil demand declined from the previous year for the first time since 1983.

The Organisation of Petroleum Exporting Countries (OPEC) & US Energy Information Administration (EIA) both project a decline in world demand of oil by 1-1.35 million barrel per day, respectively during 2009. According to the EIA, if global economic recovery begins earlier and is stronger, there is an upside risk of even higher oil prices from the current level. The Institute of Energy Economics, Japan (IEEJ)'s take on oil prices is that high level inventories at present and growing surplus OPEC production capacity can also work to weaken oil prices and pressure will grow on OPEC to reduce oil production further. Overall, the outlook for the oil market remains highly uncertain.

The present scenario of volatility in the crude oil prices coupled with falling oil revenues has ramifications for the future of oil markets. Conservative investment policy could be a major fallout of this due to the uncertainty involved in assessing the future market scenarios and future revenues. The natural gas market, which, like the crude oil experienced a run up of prices followed by a precipitous decline on the back of similar factors is vulnerable to capacity additions.

Indian Oil & Gas Industry

More than 80% of India's crude oil requirements are met through imports. Liquefied Natural Gas and other imported natural gas are also catering to the demand. Moreover, India in recent years had also emerged as a major exporter of petroleum products. Sooner or later, the turbulences of the international oil & gas market were bound to hit the Indian hydrocarbon sector. In fact, the industry in many respects, found itself operating in an uncharted territory.

The Indian basket of crude oil touched $ 142.04 per barrel on 3rd July 2008 before plunging to $ 35.83 per barrel on 24th December, 2008. Although there was a steady fall in international oil prices since August 2008, the average price of the Indian basket during 2008-09 was still high at $ 83.57 per barrel, against the average price of $ 79.25 per barrel in 2007-08.

The domestic consumers were shielded from the spiralling crude oil prices in the initial half of the year. However, when the crude prices fell, the government reduced the prices of petrol and diesel twice, by Rs.5 per litre and Rs. 2 per litre respectively on 6th December, 2008 and 29th January, 2009. Further, domestic LPG prices were also reduced by Rs.25 per cylinder effective 29th January, 2009.

All segments of the industry, upstream companies, refiners and Oil Marketing Companies (OMCs) were affected by the high volatility in the international crude oil prices. The margins of upstream companies and refiners, having gained from rising crude prices, were hit by falling crude prices. The result, overall marketing margins turned positive, and average crude oil price was high. Additionally a depreciating rupee that accompanied falling crude oil prices neutralized to some extent, the reduction in input costs.

The economic slowdown in the country affected petroleum product demand. Moderation was witnessed in the consumption growth of petroleum products. Growth rate of petroleum products in the domestic market decelerated to 3.5% from 6.8% in the previous year. Total domestic sales excluding gas stood at 133.4 MMT and the crude throughput of the Indian refineries was at 160.8 MMT. On the external front, exports of petroleum products turned out to be lower in both quantity and value, compared to that in 2007-08.

During the year, Indian refining capacity rose to 177.9 MMTPA with the commissioning of 29 MMTPA refinery at Jamnagar in December, 2008. Of the country's total refining capacity, 105.5 MMTPA is in the control of the Public Sector and the balance 72.5 MMTPA rests with the Private Sector. Production of crude petroleum was at a level of 33.5 MMT, showing a decline of 1.8% in 2008-09. Gas production, which had declined during 2007-08, picked up during 2008-09 by 1.4% with a production of 32.8 billion cubic metre.

The gas supply scenario in the country has improved with the flow from Krishna Godavari (KG) Basin in April 2009. The New Exploration Licensing Policy(NELP) of the government has been the main catalyst in improving the domestic supply. After seven rounds of NELP, the area under exploration has progressively increased more than four times to 48% of Indian Sedimentary Basin area from the 11% before implementation of NELP. The Hydrocarbon reserves accretion has been more than 600 Million Metric Tonne of oil equivalent (MMTOE). In the latest NELP-VIII, 70 exploration blocks comprising 24 deepwater blocks, 28 shallow water blocks and 18 onland blocks are on offer.

On the policy front, the intended medium term reform measures of the government particularly, for energy sector, indicate a thrust on some areas viz. gradual removal of subsidies and market distortion, increase competition, encourage private sector entry and promote renewable resources especially solar energy as a means of removing energy poverty.

Some of the major industry specific announcements of Budget 2009-10 are:

- Reduction in customs duty on bio-diesel from 7.5% to 2.5%
- Full exemption of excise duty of petro-diesel blended with bio-diesel
- Extension of tax holiday to commercial production of natural gas
- Expansion of LNG infrastructure and proposal to develop a blueprint for National Gas Grid
- Introduction of investment linked tax incentives for laying and operating cross country natural gas, crude and product pipelines on common carrier principle

RISKS AND CONCERNS

Uncertain oil and gas markets and venture risks have compounded in the backdrop of the financial crisis and the global economic slowdown.

The sudden switch from a high price to a low price regime and uncertainty in price have dramatically affected the economics of the industry through out the value chain. Management of short and long term risks and thinking ahead of the curve with an eye on the future is pertinent. As a result of falling crude oil prices, inventory valuation losses were also significant for the company during the year.

In the wake of the financial crisis, the trend of strengthening of rupee was reversed. Given the large scale foreign exchange transactions of the Corporation, the instability of foreign exchange markets constantly poses risk to the Corporation.

Sharp interest rate fluctuations are an area of concern for the Corporation in the context of raising debts for projects as well as for raising money through sale of oil bonds. In the first half of 2008-09, flaring inflation hardened the interest rates. The deepening financial crisis, further created a severe liquidity crunch. To cope with this, expansionary monetary policy was adopted by RBI and there were widespread interest rate cuts.

The extant pricing policy of the Government, especially with reference to the retail selling prices of Diesel, Petrol, LPG and Kerosene acts as a major constraint on the Corporation. The tradition of using retail oil pricing policy as a subsidy tool to subsidise has many a time endangered the financial health of the OMCs. Such a policy environment, only accentuates the risks associated with uncertainties of international oil market. The oil bonds issued by the Government to compensate for the under recoveries have their own limitations. The delay in issuance of oil bonds leads to interest loss for the Corporation. To meet its cash requirements, often the Corporation has to sell these bonds. Their relatively lower demand (one of the reasons being their non-SLR status) gets them sold at a discount. This practice which is beyond the control of the management has a significant impact on the financials of the Corporation despite a sound physical performance. To address this, the Government constituted a committee under the chairmanship of Sri B.K.Chaturvedi, Member, Planning Commission during the year. The terms of reference for the committee, amongst others, were to examine the impact of increases in oil prices on the financial position of the oil companies, revisit the concept of 'under recoveries', estimate the financial needs of the refiners and OMCs, besides examining the available options for burden sharing.

The global economic slump has affected the demand for petroleum products in the country. In the short term, until the economy improves, petroleum products are expected to register a slower rate of growth in sales. Slow growth in sales is further exacerbated by the private players planning to enter the market and raising the competition levels.

Strong product demand and high crude oil prices had kept Gross Refinery Margin (GRM) at a higher level for the last few years. However, with fluctuating prices of crude oil and dwindling demand of petroleum products in the foreseeable future, refinery margins will be uncertain.

The Corporation's Exploration & Production(E&P) business portfolio has increased steadily over the years. A few discoveries have already been made and the risks normally associated with such investments will continue to linger till they are commercially viable. Until now the Corporation was making investments in E&P as a non-operator, through the consortium mode. However, during the year the Corporation was awarded 2 (two) 'S' type blocks as an operator with 100% participatory stake. With this the Corporation has entered an altogether new field, where the returns are high but the risks are high as well.

CHALLENGES AND OPPORTUNITIES

The critical, complex and high level of global integration of energy sector make it full of challenges and opportunities.

While material costs (especially crude) are beyond the control of the Corporation, and price realisation for the high volume products is administered; minimising operational costs is a key challenge for the Corporation for maximisation of margins. In this context, the Corporation constantly strives to optimise its refining process, logistics and supply chain management, timely execution and safe commissioning of projects & retention of skilled manpower.

IndianOil believes in running its operations responsibly today to build a dependable and sustainable energy system for tomorrow. Development of techno-economically viable and environment-friendly products and services for the benefit of its consumers is another challenge for the Corporation. To this end, energy conservation, hydrocarbon loss reduction, water & waste management and auto fuel quality improvement projects are underway at our various locations. Significant investments have been made in various quality upgradation projects at all our refineries. Presently, quality improvement projects are underway at the Corporation's refineries to meet Euro-III/IV fuel quality norms, which will become effective from April 2010.

In the long term, climate change concerns and a shift favouring renewable energy in the policies of major consuming countries will act as a major challenge to the traditional oil and gas industry. The Corporation with the vision of diversification across the energy sector and commitment to sustainable practices, views renewables as an area of immense opportunity. Already, it has made headway into some of these. IndianOil has a well laid out plan for its bio-fuels business. During the year, it formed a joint venture company for its bio-fuels activity in Chhattisgarh. Also the Corporation commissioned a 21 MW wind power project and ventured into solar energy business.

Servicing the rural sector has been a priority for the Corporation. The network touches the remotest corners of the country and specially designed Kisan Seva Kendras cater to the rural fuel demand. It also provides non-fuel conveniences to the rural population. The Corporation views the rural market as an area of enormous opportunity and innovation. The structure of the rural economy is changing, the share of industry and services in the rural income has been rising and huge sums are being spent by the Government for development of rural infrastructure. Today, many private sector manufacturers are entering the rural market. The resilience exhibited by rural India in face of the global economic crisis raises our confidence further in its potential.

The Corporation in the recent years has been making efforts to tap opportunities across the entire value chain of oil & gas business. It has forged strategic alliances in the E&P and gas sector. Having successfully entered the petrochemicals sector, it has ambitious plans for the future. Challenges and opportunities both abound in these new fields. The availability of skilled E&P professionals in the market is low, as we expand our E&P portfolio, meeting our manpower requirements will be a big challenge. In the present international scenario of gas business both high prices and low availability pose a major challenge. Moreover, getting into long-term gas sourcing agreements has become increasingly difficult in recent times.

The global petrochemicals industry is going through a down-cycle and this has coincided with the global economic meltdown. However, the Indian market has remained somewhat insulated, though the situation has warranted a revision in growth projections. The Indian market is expected to grow faster and further.

FINANCIAL REVIEW

Turnover

The turnover (inclusive of excise duty) of IndianOil for the year ended 31st March, 2009 was Rs.2,85,337 crore as compared to Rs.2,47,457 crore in the previous year. The total sales of petroleum products (including natural gas) for 2008-09 were 66.17 MMT as against 62.62 MMT during 2007-08.

Profit Before Tax

The Corporation's Profit Before Tax was Rs.4,329 crore during 2008-09 as compared to Rs.10,080 crore in 2007-08.

Provision for Taxation

a) Current Tax

An amount of Rs.1,285 crore has been provided towards current tax for 2008-09, considering the applicable income tax rates, as against Rs.3,084 crore provided during 2007-08.

b) Fringe Benefit Tax

An amount of Rs.44 crore has been provided towards fringe benefit tax for 2008-09, as against Rs.28 crore provided during 2007-08.

c) Deferred Tax

An amount of Rs.50 crore has been provided towards deferred tax in the current financial year, as against Rs.5 crore provided during 2007-08.

Profit After Tax

The Corporation has earned a Profit After Tax of Rs.2,950 crore during the current financial year, compared to Rs.6,963 crore in 2007-08.

Depreciation & Amortisation

Depreciation for the year 2008-09 was Rs.3,038 crore as against Rs.2,708 crore for the year 2007-08.

Interest(net)

Interest Expenditure (net) of the Corporation for the current year was Rs.2,560 crore, as against Rs.404 crore during 2007-08.

Borrowings

The borrowings of the Corporation as on 31st March, 2009 were Rs.44,972 crore as compared to Rs.35,523 crore as on 31st March, 2008. The Total Debt to Equity ratio on 31st March, 2009 works out to 1.02:1 as against 0.86:1 as on 31st March, 2008 and the Long Term Debt to Equity ratio stands at 0.36:1 as on 31st March, 2009 as against 0.28:1 as on 31st March, 2008.

Capital Assets

Gross Fixed Assets (including Capital Work in Progress) increased from Rs.66,002 crore as on 31st March, 2008 to Rs.80,531 crore as on 31st March, 2009.

Investments

Investments, including advances for investment, as on 31st March, 2009 were Rs.32,250 crore as compared to Rs.21,546 crore as on 31st March, 2008. The changes in investments during the year are mainly on net increase in Government of India Special Oil Bonds. The aggregate market value of the Quoted Investments as on 31st March, 2009, i.e., investments made in ONGC, GAIL, Chennai Petroleum Corporation Ltd., Petronet LNG Ltd. and Lanka IOC Plc., is Rs. 15,319 crore (as against the cost price of Rs. 2,705 crore).

Net Current Assets

Net Current Assets as on 31st March, 2009 were Rs. 9,177 crore, as against Rs.18,350 crore as on 31st March, 2008.

Earnings Per Share

Earnings Per Share for the year 2008-09 work out to Rs. 24.30 as compared to Rs.58.39 in the previous year. Cash Earnings Per Share for the current year work out to Rs.49.32, compared to Rs.81.10 in the previous year.

Earnings in Foreign Currency

During the year, IndianOil earned Rs.14,963 crore in foreign currency mainly due to export of petroleum products, against Rs.11,454 crore in 2007-08. This includes Rs.6,014 crore received in Indian currency out of repatriable funds, as against Rs.3,522 crore in the previous year.

SEGMENTWISE PERFORMANCE

The segmentwise performance for the current year is given below:

(Rs. in Crore)

	Sale of Petroleum Products	Other Businesses	Eliminations	Total
External Revenue	2,76,564	28,884	-	3,05,448
Inter Segment Revenue	1,424	459	-	1,883
Total Revenue	2,77,988	29,343	-	3,07,331
Operating Profit	7,012	(49)	13	6,950

Notes:

(a) Segment Revenue comprises Turnover (net of excise duty), Subsidy & Grants from the Government of India and other income (excluding interest income, dividend income and investment income).

(b) Other business segment comprises sale of imported Crude oil, sale of Gas, Petrochemicals, Wind Mill Power generation, Oil & Gas Exploration activities, and explosives & Cryogenic businesses.

INTERNAL CONTROL SYSTEMS

The Corporation has adequate internal control systems, commensurate with the size and nature of its business. In addition, there are detailed manuals on various aspects of the business activity, accounting policies and guidelines. Further, your Corporation has a full-fledged independent Internal Audit Department, which carries out extensive audits round the year covering each and every aspect of business activity so as to ensure accuracy, reliability and consistency of records, systems and procedures. An Audit Committee comprising independent Directors constituted by the Board of Directors reviews the recommendations and observations of the Internal Audit Department regularly.

HUMAN RESOURCES / INDUSTRIAL RELATIONS

The industrial relations climate in the Corporation generally remained harmonious and peaceful during the year, although the Officers had struck work for 3 days . This was in response to a call given by the Officers' Association on issues related to pay revision, which were beyond the jurisdiction of the Corporation and needed redressal by Government of India.

IndianOil continued its efforts to promote employees' participation in various activities by way of information sharing, suggestion scheme, rewards, recognitions, etc. HR Index, which was designed with an objective to facilitate effective implementation of HR policies and practices and to create an environment of belonging and team work at the operating units, has contributed in ensuring corrective action / improving HR climate in the locations / units. The employee strength of IndianOil as on 31st March, 2009 was 33,998 including 13,716 officers.

CAUTIONARY STATEMENT

Statements in the Management Discussion & Analysis describing the Company's focal objectives, expectations or anticipations may be forward looking within the meaning of applicable securities, laws and regulations. Actual results may differ materially from the expectations. Important factors that could influence the Company's operations include global and domestic supply and demand conditions affecting selling prices of products, input availability and prices, changes in Government regulations/tax laws, economic developments within the country and factors such as litigation and industrial relations.