

# Management Discussion and Analysis

## Industry Structure and Developments

The Indian economy continues to grow at over 7%, driven by domestic demand. Consequently, the manufacturing sector has seen sharp growth after many years, with new manufacturing units being set up and with aggressive capacity expansions by existing units. The prognosis is that going forward this demand led growth will sustain for a few years.

The overall growth, be it in manufacturing or IT enabled services and even agriculture, has put immense pressure on demand for electricity. Reforms in the Power sector have unfortunately not yet resulted in any concrete relief on the ground and no substantial change is expected over the next five years or so. Shortage of power could be the single most crucial impediment in economic growth. The decentralised generation solutions of the Company represent an important way of addressing such power shortages.

The Shipping industry, which is the other area of interest for the Company, has seen some remarkable growth. The Indian shipyards are now very busy with orders and many have ambitious expansion plans. Indian ship owners as well are acquiring more vessels as it is expected that the boom in the shipping business will last globally for at least another 3 to 5 years or so.

## Business Outlook, Opportunities and Threats

The policy makers including the Planning Commission have strongly recommended decentralised generation as a more efficient way to move ahead. The Planning Commission

has also suggested that the treatment of all power plants, irrespective of size and fuel, should be similar and all should be accorded equal benefits. Many regulators are compelling State Utilities to first ensure that they provide power to all, all the time, rather than resort to load shedding in order to curtail costs. Such an approach where the primary obligation of the Utility would be to provide power to all, all of the time, would benefit our business as then, short gestation peaking power plants would require to be set up.

Since the inception of Wärtsilä in India in the mid 1980s, the Company has focussed its efforts predominantly on providing sustainable power plant solutions particularly to industry. In 2005, the Company took concrete steps to diversify its business interests in order to exploit the potential of the fast growing Indian economy.

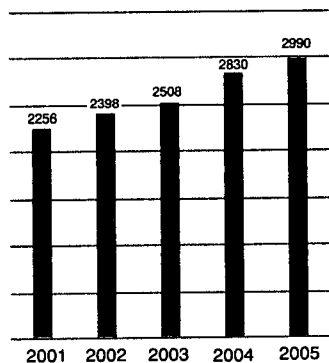
A 100% EOU was set up at Khopoli with the objective of manufacturing marine reduction gear boxes of the size 500 KW to 2500 KW. These gear boxes would be exported back to the Wärtsilä Group. It is proposed to further expand the manufacturing activities at the EOU in the years to come.

The Company has stepped up efforts to expand its presence in the Ship Power business including the service and maintenance activities related to Ship Power.

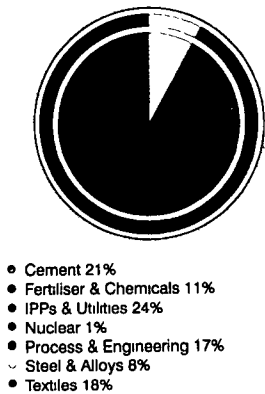
The Wärtsilä Group has decided to set up a Sourcing cell in India that will identify potential suppliers for components for the Wärtsilä Group's factories around the world.

The Company has further diversified its expertise in operations and maintenance of power plants and now successfully runs a 15 MW coal-based plant.

Cumulative Deliveries  
(MW)



Industry-wise Power Plants  
(2990 MW)



The Company also provides Project Management services for various activities including erection and commissioning of power plants located all over the world.

The Company sees another area of opportunity in rural electrification, where it has been widely acknowledged that the decentralised generation model would be most effective. Wärtsilä has products that can run on 100% bio-oil which in turn ties in very well with rural needs. The Company is in active discussion with the Government to set up a pilot plant based on 'Jetropha' for decentralised electricity in rural areas.

While the sharp increase in fuel prices and delayed availability of Gas is an area of concern having an adverse impact on the Company's business, the sheer shortage of power also offers an opportunity.

## Performance

### Power Plants

With the strong growth of the economy, the aspirations and lifestyle of people continue to consume increasing amounts of electricity, and propel a demand for power generating plants.

The Electricity Act, 2003 was expected to bring in the much needed reform in the sector, thereby providing an impetus to investments and growth in generation, transmission and distribution. However, the expected growth has not yet materialised and as a consequence, the gap between demand and supply continues to widen.

It has been estimated for a while now that the country would need to add at least 10,000 to 12,000 MW of power every year for the next

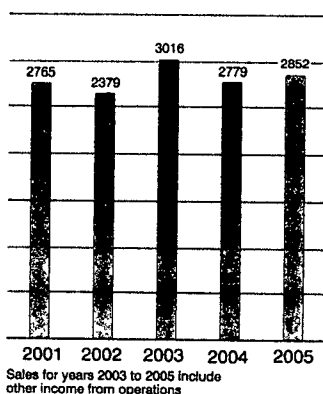
ten years to be able to catch up with existing demand, to meet the growing needs of the future and support GDP growth projections of 7-8%. India has so far added capacity at an average rate of 4500 MW to 5000 MW annually. Further, the country would also need substantial transmission facilities to ensure that power can be wheeled from where it is produced to where it is consumed. Unfortunately not much of action can be seen on the ground in transmission either.

As more than 50% of the cost of generation is based on the cost of fuel it is important to examine the various energy options available to India. Coal continues to be a dominant fuel of choice as it is abundantly available and also because it is one of the cheapest forms of energy. Despite the abundance of coal, the mining of coal is still rather inefficient and a shortage in the availability of domestic coal is forecasted for the next few years.

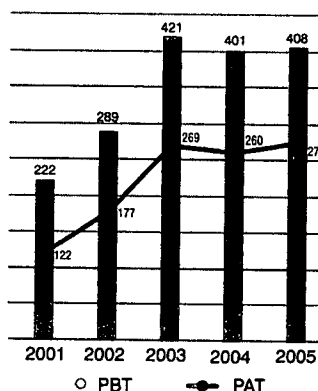
Natural gas, of which substantial reserves have been found both on the East as well as the West coast, has yet to be made available for commercial use. The infrastructure for the distribution of gas is still not in place and is likely to take anything between 3-5 years to make a meaningful impact on the consumption of gas. Further, the price of natural gas has been the topic of much debate as it has been argued that if gas is priced beyond a level of about \$4 per MMBTU, it would not be economically viable to generate electricity. The current international price of natural gas in the USA for example, is in the range of \$8-9 per MMBTU, which is also the price at which LNG is available on the western coast in India.

Heavy fuel oil, on which most of the Company's business has thus far been

**Sales**  
(Rs Million)



**PBT & PAT**  
(Rs. million)



based, has seen a dramatic increase in price from a level of \$170/MT to near \$300/MT. This sharp increase in the price of heavy fuel has also resulted in some of our customers finding the cost of self-generated power to be expensive and who would have therefore shifted to generation based on cheaper fuels such as coal. Coal based generation is however not an option available to all customers due to reasons of environmental pollution, size, water availability, distance from coal mines, etc.

The above in itself spells out a very mixed picture, where on one hand the demand for electricity has sharply increased, but there has not been enough capacity addition that has taken place and at the same time the cost of fuel has also increased sharply. In the present economic situation, both industry as well as the common man would be willing to pay more provided they get reliable and assured supply of power.

Lastly, the consumption patterns of people have normalised, thereby increasing the demand for peaking power. Unfortunately in the area of peaking power solutions, there are no plans a-foot to set up specific peaking generation capacity, which in turn will continue to result in shortages and load-shedding during specific times of the day.

The Company expects that the utilities would be compelled to install peak generation capacity as quickly as possible in order to meet the ever growing demand. Peaking power generation capacity cannot be set up effectively using coal and therefore, would have to be based either on liquid fuel like HFO or natural gas. The Company has a wide range of products that can utilise these fuels effectively.

During 2005, the Company delivered a 90 MW gas-based power plant in the South,

which has been set up under the scheme of Group Captive Power envisaged in Electricity Act. This is the largest gas engine based power plant in the country. Earlier in 2004, the Company had commissioned a similar gas engine based project, though of 18 MW size which has been performing extremely well.

The Wärtsilä Group continues to invest substantially in research and development which means that the Wärtsilä brand continues to be associated with the most efficient and environmental-friendly available products in the market.

The Company has taken significant steps to strengthen its position as a complete solutions provider by providing a range of service solutions to the customer. These solutions include products that could improve operational efficiency as well as bring down the operating costs of power plants, in short to maximise asset utilisation and minimise operating costs.

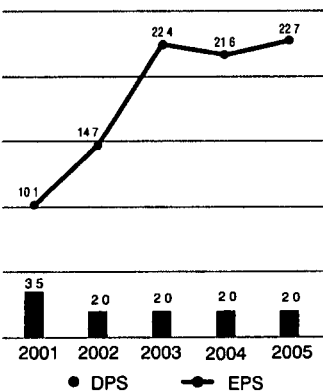
The Company continues to see growth opportunities in the O&M field. The experience in operating the first steam turbine based power plant has thus far been good. The Company is also likely to further diversify into operations of power plants burning other fuels.

### Ship Power

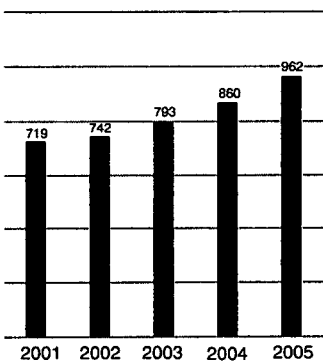
The shipping industry continues to grow globally and even more so in India. The Wärtsilä Group bagged some sizeable orders from Indian shipyards and Indian ship owners during 2005.

The Indian Navy, which has substantial expansion plans, continues to offer good opportunities for the Ship Power business. The ability of the Company to offer comprehensive

Earnings & Dividend per Share  
(Rupees)



Employees  
(Numbers)



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After-Sales service and maintenance is of particular interest to the Indian Navy.

The Wärtsilä products such as the Dual Fuel engine, are of particular relevance to Indian ship owners who are engaged in LNG transportation and the Company continues to see substantial opportunities in this area.

The ship repair industry is also poised for extensive growth and the Company proposes to exploit these opportunities, the plans for which will be rolled out during 2006.

## Risks and Concerns

The primary risks to which the Company is exposed pertain to technological changes, impact of rising fuel prices and financial risks. The strong research capability of Wärtsilä Group and its emphasis on cutting edge products, help the Company to eliminate the risks emanating from technological changes. The main financial risks that the Company is exposed to are forex risks and credit risks. While the exports and imports undertaken by the Company provide a natural hedge thereby mitigating the forex risks to some extent, the balance forex exposure is suitably covered on an active basis. Internal controls and continuous focus on monitoring of customer profiles and outstandings help the Company to mitigate credit risks.

The Company has adopted a 'Risk Assessment and Management' Policy covering business risks, financial risks, Legal and Regulatory risks and Information Technology risks. The management team reviews the implementation of the strategy and financials periodically and attempts to mitigate the perceived risks.

## Internal Control Systems and their Adequacy

The Company has an internal control system commensurate with its size and nature of business. The Company's assets and resources are adequately monitored through strong Internal Control systems. Clear policies have been laid down for financial authorisations, purchases, sales, capital expenditure, domestic and international travel.

Accounting and reporting tasks are carried out by trained and experienced personnel. Specific responsibilities are laid down to ensure that all stipulated accounting policies, procedures, practices and guidelines are

adhered to. Accounting estimates, judgements etc. used for the preparation of the financial statements e.g. revenue recognition, provisioning for expenses and liabilities, revaluation of assets etc. are periodically reviewed by the management.

The internal control system of the Company covers the following areas:

- Optimum utilisation of resources
- Accurate and prompt recording of transactions
- Safeguarding and protecting assets
- Ensuring compliance with the acts, laws, rules and regulations as applicable
- Efficient Management Information System
- Preventing financial loss on account of frauds and misappropriation of funds.

The Company has also appointed an independent firm of Chartered Accountants to carry out the periodic Internal Audits. The scope and areas to be covered in internal audit is discussed and approved by the Audit & Investors' Grievances Committee annually. The internal audit assignments cover all the key areas of activities. The reports of the Internal Auditors together with the responses on observations are placed before the Audit & Investors' Grievances Committee.

## Cautionary Statement

Statements in this Report describing the Company's activities, projections, estimates, expectations may be 'forward looking statements' within the meaning of applicable laws and regulations. These statements are based on certain assumptions and expectations of future events. Actual results differ materially from those expressed or implied. Important factors that could make a difference to the Company's operations include economic conditions affecting global and domestic demand and supply, finished goods prices in the domestic and overseas markets in which the Company operates, raw-materials cost and availability, changes in Government regulations, tax regimes, economic developments and other factors such as litigation and industrial relations. The Company assumes no responsibility to publicly amend, modify or revise any forward looking statements, on the basis of any subsequent developments, information or events.