Strike when the Iron is Hot....

a Thought Leadership Paper

by Petroleum Federation of India

Executive Summary

Over the past four years and till few months back, high crude prices caused mayhem. Economies were threatened and oil importing countries had serious cause for worry when Big Oil and oil exporting countries were rejoicing. At home, public sector oil marketing companies reported losses even in the third quarter and some are expected to return losses for the fiscal on account of controlled transport fuel prices, a paradox of purpose when world-wide profits of oil majors have jumped several fold. The companies had borne very high levels of under-recoveries, and now need to regain their financial strength by avoiding making any losses during higher crude prices scenario in future. The future of marketing companies is at stake.

At the national level, oil bonds, fertilizer bonds and subsidies in the two sectors weakened the Government finances. Trade and fiscal balances have been affected severely with high crude prices in the past four years.

The consumers will continue to be burdened in such scenarios if true competition does not set-in within the Indian retail petroleum sector.

Steps to reduce transport fuel price on December 6, 2008 and the temptation to further reduce them, although may appear rational in the current low crude oil price scenario, are devoid of a lasting solution.

Commodity markets are cyclic. Petroleum industry is no exception to this. Crude prices may go up in the future and difficult times would start again. Political compulsions will never allow the burdens to be passed on deliberately. The debate over how much to pay oil companies to make up for under-recoveries would never end, and as a result oil companies would stand to lose. Why not allow competition to rule? Let the 'consumer pays' principle rule and allow the prices to be regulated by competition so that consumers are not burdened unduly.

The good times have arrived – crude oil prices have plummeted and reached a four year low. Private oil companies have begun to restart the retail operations they had closed down. Most importantly, soon there would be a newly elected government at the centre with a fresh mandate from the public. It may not be compelled to take populist decisions. Election manifestos will be drafted soon; the petroleum sector and the stakeholders would like political parties to spell out their plans on petroleum product pricing policy.

The Integrated Energy Policy also advocates rationalisation of fuel prices. The policy recommends that, as a general rule, all commercial primary energy sources must be priced at trade parity prices at the point of sale, namely the Free-on-Board (FOB) price for products for which the country is a net exporter and Cost, Insurance and Freight (CIF) price for which it is a net importer. The policy projects that the price of a product for which the country is self sufficient in a competitive market with many suppliers and buyers would fluctuate between the two depending upon the ease of import/ export and reliability of supplies. This principle, the policy claims, is extremely relevant for the petroleum sector wherein bulk of the crude oil is imported and India has become a net exporter of petroleum products.

The policy goes further to recommend to cushion domestic prices against short-term volatility of prices on the international market (FOB or CIF) by setting domestic prices on the basis of median prices over the previous month or a three month period. In conclusion the policy suggests that instead of administering prices, full price competition should be introduced.

To start, decontrolling the prices by linking them to Trade Parity Price for all – PSU as well as Private Oil Marketing companies – and providing subsidy to needy at the consumer end, would be in line with recommendation of the IEP 2006 which was recently approved by the Union Cabinet.

For the fear of consumers getting unduly burdened disallowing the above actions would be a script for failure on many accounts; we were saved just when situation was getting out of control. That was owing to global drop in crude oil price, not our action. Hence, let the failures not wait round the corner.

Do not wait. Strike while the iron is hot ……

Here is an opportunity to take actions which, in all probability, find the solution to almost all related problems –

- Decontrol transport fuel prices, and
- Let deserving domestic consumers receive subsidies instead of suppliers.

In case a similar very high crude price scenario emerges again, the Government can, as an exception and not as a rule, cap the burden on consumer and share the rest through fiscal or subsidy mechanism in future.

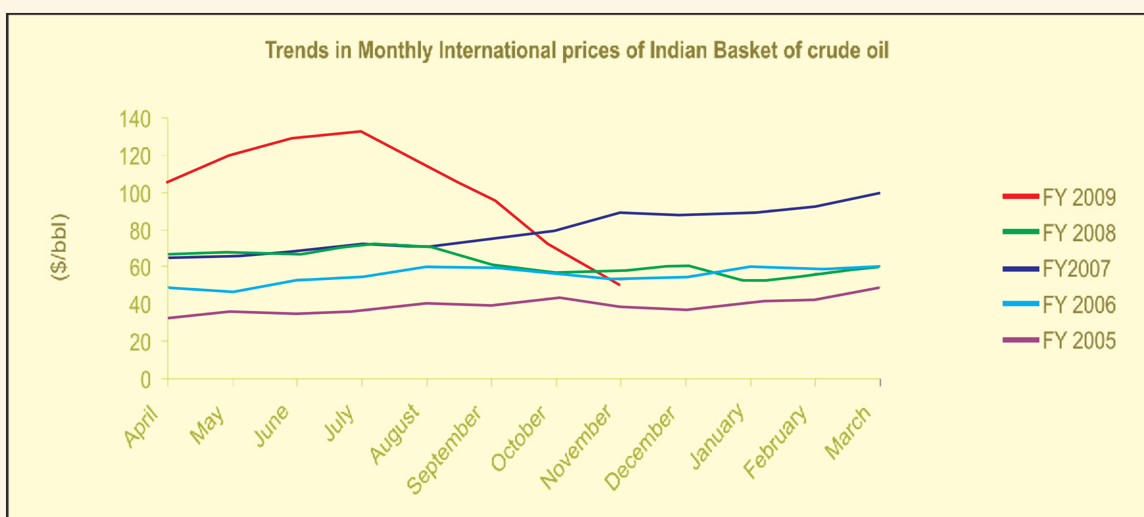
Let the opportunity not go waste.

Absorbing volatility in crude oil prices not planned

Crude oil prices have displayed extreme volatility in the last four years with NYMEX crude oil prices climbing from $37/bbl in April 2004 to $147/bbl in July 2008 and then tumbling to below $60/bbl mark within a span of three months. The average price of an Indian basket of crude oil has exhibited a whopping increase of 309 percent between April 2004 and July 2008. This upward surge in crude oil prices reversed with the prices falling to $51/bbl in November 2008.

The erratic movement in global crude oil prices cannot be explained merely by the dynamics of demand and supply. Other variables such as currency movement, speculations, sufficiency and security, geopolitical tension and even the macro-economic situation in countries like USA also contribute to international crude oil price movement. It is therefore best to plan for volatility in prices, rather than be reticent about low prices.

Figure 1: Trends in Monthly International prices of Indian basket of crude oil



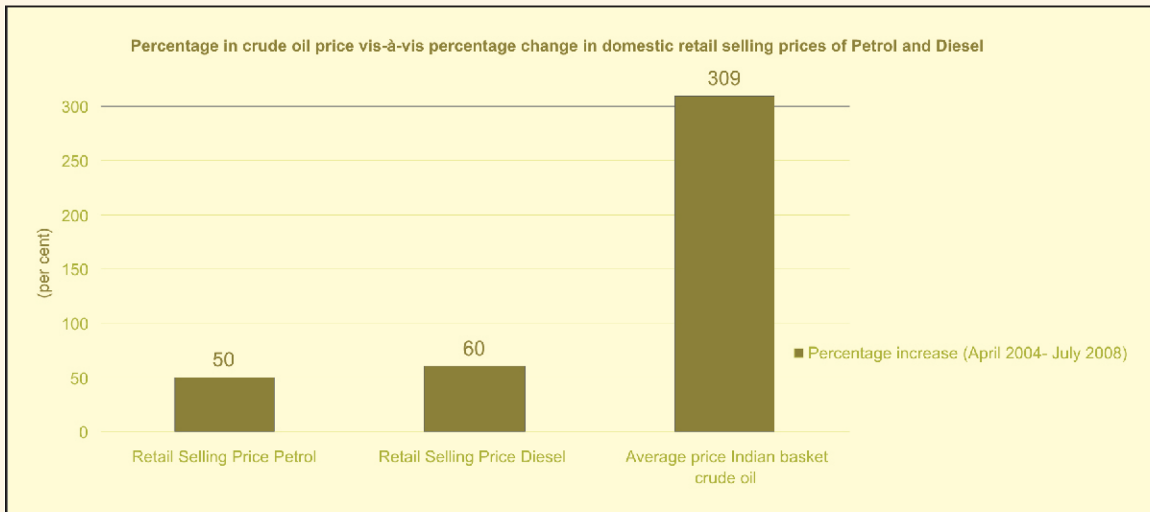
Source: PPAC-Oil Prices and Taxes, GoI (2008)

As India imports more than 70 percent of its crude oil requirement, these cyclic movements in international oil prices bring to the fore challenges posed by the actual operation of the domestic pricing policy of petroleum products, besides making the domestic economy more vulnerable to oil price shocks due to higher degree of oil import dependence. Despite the dismantling of the APM regime, the Public Sector Oil Marketing Companies (OMCs) have not yet been granted freedom to revise the prices of the major petroleum products such as petrol, diesel, kerosene and LPG, which account for more than 60 per cent of the total consumption of petroleum products, in tandem with international crude oil price movements.

While average price of Indian basket of crude oil increased by 309 percent between April 2004 and July 2008, the retail selling prices of diesel were increased by only 60 percent and that of gasoline by 50 percent for the corresponding period, resulting in a low degree of price pass-through. The price pass-through ratios[1] for gasoline and diesel for the period between 2004 and July 2008 were 0.16 and 0.19 respectively. This clearly indicates that decontrolling prices of petroleum products, which was the Government intent while dismantling the APM regime in 2002, is not being implemented in principle.

[1] The price pass-through ratio for petrol/diesel is the ratio obtained by dividing the percentage change in Retail Selling Price of petrol/diesel during the period April 2004 to July2008 by the percentage change in average price of Indian basket of crude oil for the corresponding period

Figure 2: Percentage change in crude oil price vis-à-vis percentage change in domestic retail selling prices of Petrol and Diesel (2004-08)



Source: PPAC-Oil Prices and Taxes, GoI (2008); Indian Oil

Impact of domestic petroleum product pricing policy on various stakeholders

Not aligning the domestic selling prices of petroleum products with the international prices has adverse implications for government finances and development of the petroleum sector. The financial health of the public sector oil marketing companies would deteriorate; on one hand the subsidy burden of the Government would grow substantially, while the growth in revenue accruing to it from tax collections would slow down with tax rates being moderated. In such a scenario, public upstream companies and their share holders would need to continue to share their windfall profits with downstream companies and consumers of products other than diesel, petrol, LPG and kerosene would continue to cross-subsidise these products.

Impact on Private Sector Oil Marketing Companies

As crude oil prices rose sharply in 2008, private companies like Reliance Industries Limited closed down their retail outlets. They found it difficult to compete with public sector oil marketing companies due to the selling price-differentials between public and private sector retail players. The public sector oil marketing companies - Indian Oil Corporation, Bharat Petroleum Corporation, and Hindustan Petroleum Corporation are selling fuel below the production cost. While these state-owned oil retailing companies are compensated by the Government for their revenue losses, a similar mechanism is not available to private sector players. This ad-hoc price control policy has created a non-level playing field between the public and private sector.

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Thursday, April 24, 2008

Closing of petrol pumps by private sector companies

Lok Sabha

Reliance Industries Limited (RIL) has informed that the sales at their retail outlets (ROs) are negligible due to selling price differential between private and public sector ROs, leading to the closure of their ROs. Essar Oil Limited (EOL) and Shell India Marketing Private Limited (SIMPL) have not yet decided to shutdown their ROs.

The prices of sensitive petroleum products are fixed by the Public Sector Oil Marketing Companies (OMCs) in consultation with the Government. Private oil companies are not subject to pricing restrictions by the Government and are free to take their pricing decisions on commercial considerations.

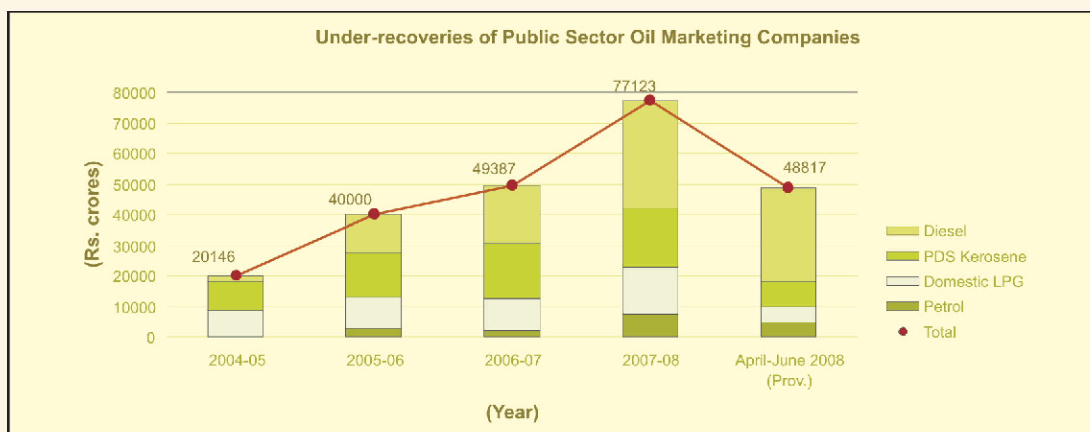
The above information given by the Minister of State for Petroleum & Natural Gas Shri Dinsha Patel in a written reply in the Lok Sabha today.

Some of the private fuel retailers, that had shut their retail outlets following a sharp increase in crude oil price, intend restarting their operations with crude oil prices declining by about one-third between July-November 2008.

Impact on Public Sector Oil Marketing Companies

The Government's influence over the retail selling pricing of petroleum products as a result of which the public sector Oil Marketing Companies end up selling products at prices dictated by the government which are lower than the import parity price has resulted in huge under-recoveries for the OMCs (Figure 3). The magnitude of under-recoveries of the Oil Marketing Companies on petrol, diesel, kerosene and LPG till November 2008 was Rs.1,50,000 crore of which the under-recovery on diesel alone was reported to be approximately Rs.1,00,000 crore.

Figure 3: Under-recoveries of Oil Marketing Companies

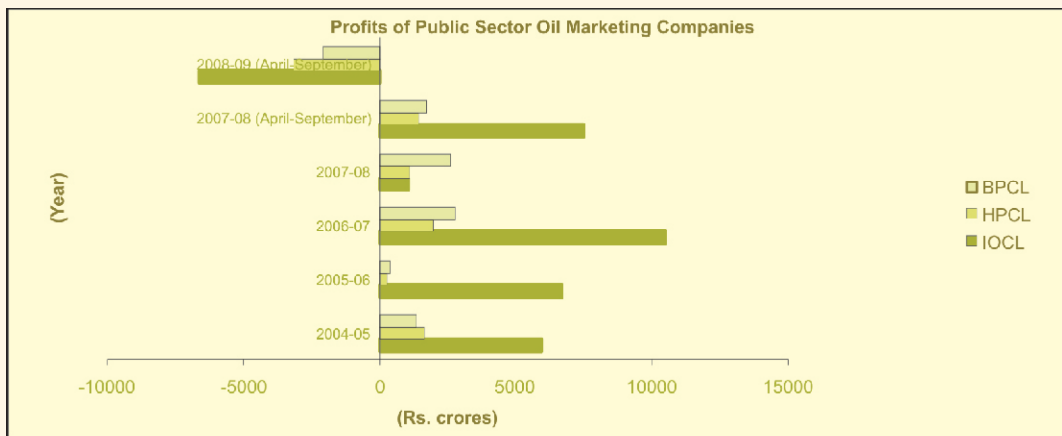


Source: PPAC-Oil Prices and Taxes, GoI (2008)

The Central Government's share of meeting the under-recoveries of Oil Marketing Companies through provision of budgetary subsidies on PDS kerosene and domestic LPG and the issue of oil bonds was 45.76 percent in 2007-08. Another 33.33 percent came from upstream companies like ONGC, GAIL and OIL. The remaining losses on account of under-recoveries were borne by the OMCs themselves 20.9 percent.

The financial performance of the Public Sector OMCs is very telling. The three OMCs (IOCL, HPCL and BPCL) taken together have posted aggregate pre-tax losses of Rs.11,870.14 crore during the period April-September 2008 for the financial year 2008-09 as against profits before tax of Rs.10,624.12 crore for the corresponding period during the last fiscal (Figure 4). As a result, downstream marketing companies will face severe liquidity crunch and encounter problems in meeting their day-to-day expenditure due and severely impact the investment plans. A weakened petroleum sector would lead to dampening of investment sentiment and this could lead to a very negative situation for a growing economy like India.

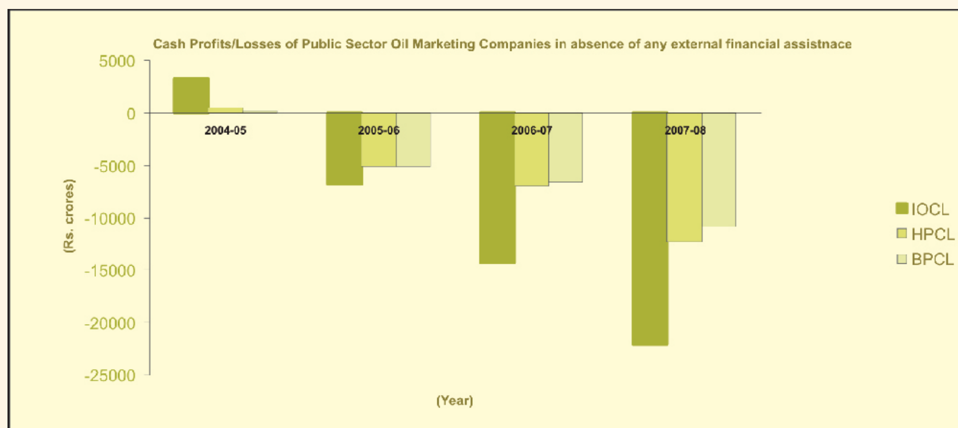
Figure 4: Profit before tax of Public Sector Oil Marketing Companies



Source: Company Annual Reports

When viewed in retrospect, the picture could have been really dismal for the OMCs had it not been for the external financial assistance extended to them by the Centre and the E&P companies. The OMCs would actually have posted huge losses or record lower profits in last four years as a result of single-handedly shouldering the financial burden of unprecedented increase in under-recoveries (Figure 5).

Figure 5: Cash profits / losses of Public Sector Oil Marketing Companies in absence of any external financial assistance



Source: BK Chaturvedi Committee Report, 2008

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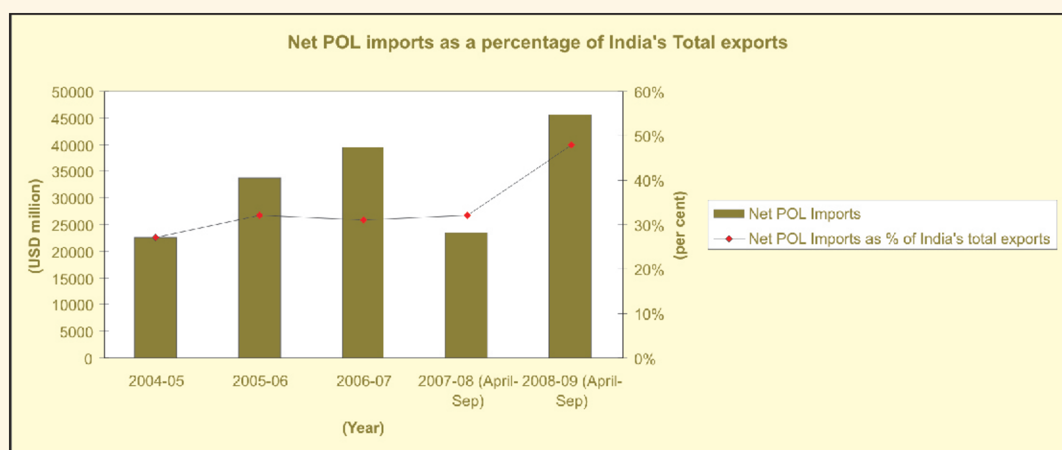
Macro-economic impacts

The crude oil price increase over the last four years has significantly impacted the country's Balance of Payments situation. For the period April-September 2008, the net Petroleum Oil and Lubricants (POL) imports were almost half of India's total commodity exports, as against 32 percent for the corresponding period in 2007-08, thereby implying that a sizeable chunk of export earnings is used to finance import of petroleum products (Figure 6).

Figure 6: Net POL imports as a percentage of India's Total Exports



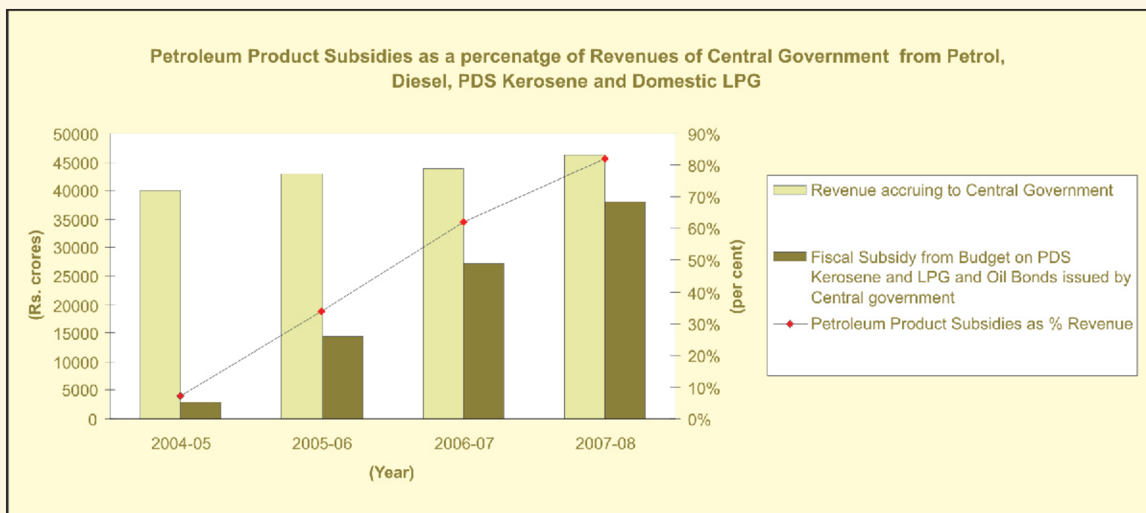
Source: Petroleum Planning and Analysis Cell (PPAC) - Oil Prices and Taxes, GoI (2008); Ministry of Commerce, GoI (2008)

Decontrolling the petroleum product prices will attract huge investments in the refineries. The high crude oil prices will result in significantly higher margins for these refineries. Increased earnings from exporting the value added by these refineries can compensate for the rising oil import bill and make the BoP situation more favourable.

The government's continued failure to gradually adjust domestic oil prices to international realities is expected to result in a burgeoning fiscal deficit. In the present system the transfer of oil bonds to OMCs is off the budget. It does not affect the fiscal and revenue deficits of the central government at the time of transfer as the issue of oil bonds is not accounted for in the Government budget.

However, the petroleum product subsidies, which is the aggregate of subsidies on PDS kerosene and Domestic LPG provided from the Government budget and the implicit subsidies provided through issue of oil bonds as a percentage of the total revenue collected by the Central Government through excise duties and levies on petrol, diesel, PDS kerosene and domestic LPG, have increased to 82 percent in 2007-08 from a meagre 7 percent in 2004-05 (Figure 7).

Figure 7: Petroleum Product Subsidies as percentage of Revenues of Central Government from Petrol, Diesel, PDS Kerosene and Domestic LPG



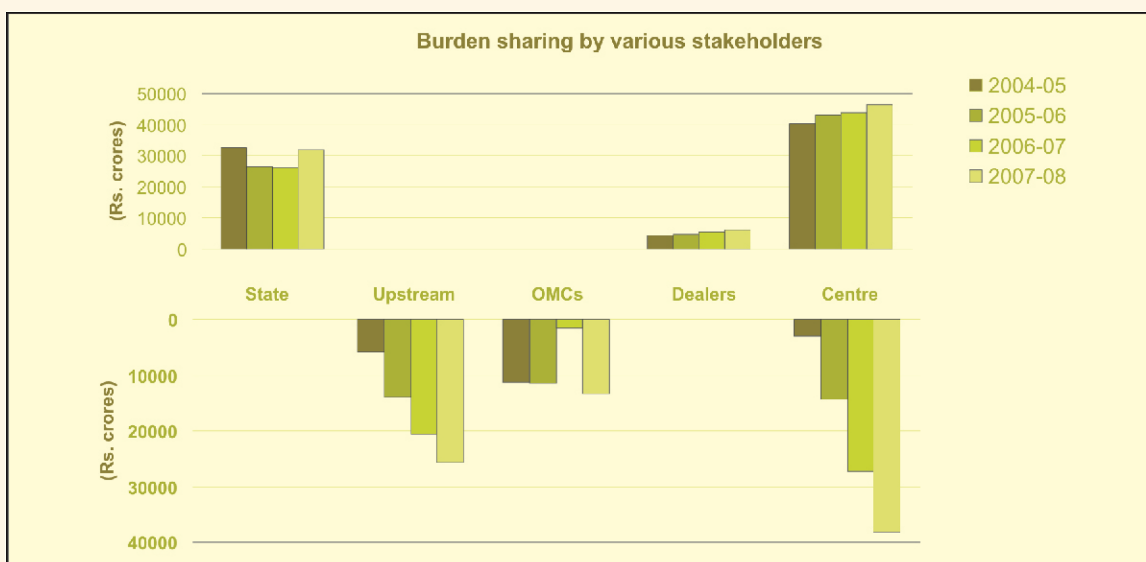
Source: Petroleum and Natural Gas Statistics 2008, Ministry of Petroleum and Natural Gas, GoI; PPAC-Oil Prices and Taxes, GoI (2008)

According to expert estimates, central fiscal deficit after taking into account implicit subsidies on petroleum products, food and fertilizer, is likely to be in the range of approximately 6 to 7 percent of GDP. Together with State fiscal deficits in the order of 2 to 3 percent of GDP, the combined true fiscal deficit is clearly going to be in the range of 9 to 10 percent of GDP.

Burden sharing by stakeholders

When a distress situation arises, the Government takes up evaluation of burden sharing amongst stakeholders. The main stakeholder remains the Central Government – the exchequer collecting taxes, the share-holder of downstream and upstream companies collecting dividends and the funding source of subsidies through budget allocations and oil bonds. Other stakeholders are State Governments who collect taxes, consumers who pay for fuel, downstream companies who have been made to bear under-recoveries, upstream oil companies who have been made to forego their profits and finally the dealers operating retail stations who are remunerated through commissions (Figure 8).

Figure 8: Burden sharing by various stakeholders



Source: Petroleum and Natural Gas Statistics 2008, Ministry of Petroleum and Natural Gas, GoI; PPAC-Oil Prices and Taxes, GoI (2008)

The debate over how much to pay the oil companies to make up for these under-recoveries would never end, and as a result oil companies would stand to lose. Various committees appointed by the Government in the past have suggested several mechanisms for sharing the under-recoveries of the oil companies, but these have not been adopted in practice by the Government. With market-determined pricing of petroleum product prices in place, the oil companies would be spared from the burden of reporting their under-recoveries to the Government every fortnight and would completely eliminate their dependence on the Government and the upstream companies for financing these under-recoveries.

Need of the hour: Decontrol pricing of petroleum products

Market pricing will encourage efficiency in the use of petroleum products, which will save money for the country by reducing oil imports. In India, the capping of prices has also led to diversion and wasteful consumption of certain petroleum products. For instance, a comparison of diesel consumption between the periods April-June 2008 shows an increase of over 11 percent over 2007-08 for same period. Due to artificially depressed prices for diesel, the demand for industrial products such as FO, LSHS, Naphtha, and LDO has been partially substituted with increased consumption of diesel by certain industrial consumers in sectors such as cement, coal, steel, mining etc. for captive power generation.

International experience suggests that in countries with market-determined prices of petroleum products, consumers have responded to high oil price increases by reducing their consumption. In Philippines, allowing full pass-through of world market price to be passed on entirely increases to consumers along with a very active energy conservation campaign by the Government of Philippines, helped to reduce fuel consumption, achieving an eight percent reduction during the first 11 months of 2005 compared to a year earlier.

Removing the subsidy will considerably reduce the subsidy burden and subsequently the fiscal deficit of the Government thereby freeing up huge resources for it to spend on productive ventures and social sectors.

Decontrolling the prices will certainly have an impact on household expenditure directly from the higher petroleum prices and indirectly via passing on of petroleum prices to other goods and services. The impacts of such price increase can be mitigated by directly subsidizing the deserving strata of society rather than product subsidy. International experience of three countries which recently raised petroleum product prices, and key mitigating measures undertaken by them to protect the poor is as follows.

Mitigating Measures on account of price rise - Country Experience

Ghana, Indonesia and Jordan all recently raised petroleum product price. The key mitigating measures they took to protect the poor were:

Ghana

- Fees for attending primary and junior-secondary school were eliminated.
- Extra funds were made available for primary health care programs concentrated in the poorest areas through the existing Community Health Compound Scheme.
- Investment in the provision of mass urban transport was expanded and expedited.
- Extra funds were made available to expand a rural electrification scheme.

Indonesia

Indonesia has an extensive history of subsidizing certain oil products. The continuation of this policy has vastly increased total cost to Government. Eventually the Government took up the challenge of large fuel price increase, and simultaneously addressed potential adverse impacts on the poor.

- An unprecedented cash transfer program to 16 million poor families was implemented. Under the program, each family receives Rp. 300,000 (about US$30) every three months. The full annual cost of the program is estimated at nearly 0.7 percent of GDP. The identification of poor households is based on an existing approach used by the Central Statistics Bureau, which calculates a "proxy-means score" for potentially poor households based on observable household socio-economic characteristics. Beneficiary cards and receipt coupons are printed and delivered by the post office. Eligible households with access to a post office collect their cash quarterly on designated days. Those in remote areas without such access receive cash in their village.

- Some budgetary savings from reducing subsidies were reallocated to existing education, health and infrastructure programs that disproportionately benefit low and middle income households.
- Initially, the subsidy on kerosene was not substantially reduced, and its price remained at two-thirds of the world price. However, subsequent to the implementation of the transfer program, the kerosene subsidy has been substantially reduced.

Jordan

- The minimum wage was increased, as were the salaries of low-paid government employees.
- A one-time bonus was given to low-income government employees and pensioners.
- An electricity lifeline tariff was maintained at current low levels-electricity access is almost universal.
- Cash transfers were provided to other low income households.
- The government announced a plan to increase funding to the National Aid Fund as part of a program to improve the design and implementation of this national safety net program with World Bank assistance.

Source: IMF Working Paper WP/07/71

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Common Minimum Programme of UPA Government

Energy Security:

The UPA government will immediately put in place policies to enhance the country's energy security particularly in the area of oil. Overseas investments in the hydrocarbon industry will be actively encouraged. An integrated energy policy linked with sustainable development will be put in place.

Election Manifesto of National Democratic Alliance for 2004 General Elections (Agenda for Oil and Gas Sector):-

- Enhanced oil production through increased exploitation of own resources as well as purchase of ownership in oil fields overseas.
- Dependence on fossil fuels to be lessened through a concerted drive for harnessing non-conventional energy sources.
- Commercial exploitation of discovered gas fields will begin by 2005.
- The Petroleum and Natural Gas Regulatory Board Bill will be enacted. in 2007

It is high time that we get out of this highly complex and opaque pricing policy of petroleum products once for all. We should take it out from the realm of politics back to the realm of economics, so that consumers know what exactly they have to pay for petroleum products as they pay for a number of other products in a market economy.

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