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Saving ₹13,500 crore with a Stroke of a Pen

The government can save thousands of crores in fuel subsidy almost overnight, but why are oil companies up in arms against it?

:: Avinash Celestine

Earlier this month, a committee headed by economist Kirit Parikh put the lid on a long and contentious battle within the government over the fuel subsidy, estimated in 2012-13 at ₹1 lakh crore. On one side was the finance ministry, which had asked for changes to the way a benchmark fuel price was set. On the other side were the petroleum ministry and the entire oil industry. In the end, the oil industry won this round of the battle.

But the arcane and technical debate over what benchmark to use highlights the fact that despite over a decade of reform India's fuel price policy, and the way in which prices are set, subsidies are paid and how oil companies are compensated still remain highly complex, with the industry still standing to gain or lose several thousand crore from such decisions. But the debate also highlights the changes which the oil industry has gone through in the past decade, with India turning into a net exporter of fuel products such as diesel, even as it remains a heavy net importer of crude oil. And the debate occurs in a context where the Indian refining industry is set to become much more competitive, with heavy expansion in capacity likely in the next few years.

> DESPITE A DECADE OF REFORMS, INDIA'S FUEL PRICE POLICY, AND WAY IN WHICH OIL COMPANIES ARE COMPENSATED, STILL REMAINS HIGHLY COMPLEX

Companies such as Essar Oil have heaved a sigh of relief following the committee's proposal. "We welcome the Kirit Parikh report since it takes a holistic view of the petroleum refinery and marketing sector," says Lalit Kumar Gupta, managing director and chief executive of Essar Oil. Had the committee decided another way, he says, it would, "have put a lot of burden on OMCs [oil marketing companies] and would even threaten the survival of several refineries".

What's the Correct Price

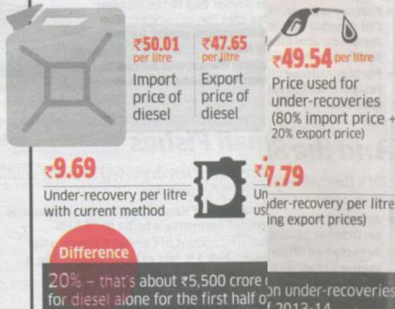
Oil companies are compensated to the extent that they suffer what the government calls 'under-recoveries' on the sale of fuel products such as diesel or kerosene.

What the Controversy is about

'Under-recoveries' calculated on difference between the international price and domestic sale price of fuel

International price assumes India is a net importer of products like diesel. But India is a net exporter of petro products

Critics say international price used should be export price, which is lower. If used, under-recoveries would fall sharply



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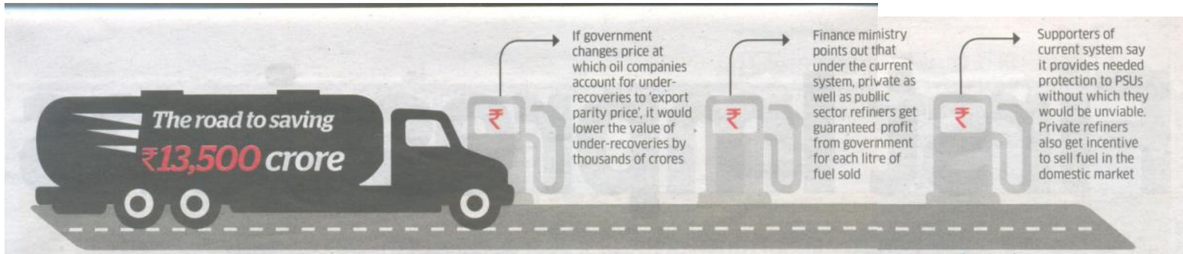

These 'under-recoveries' are not losses of the kind that a company faces when it sells a commodity below the cost of producing it. Instead, the government sets an international benchmark price of the fuel in question (say, diesel), and the under-recovery on each litre is the extent to which the price at which the refinery sells the fuel to the dealer falls short of this benchmark.

The implicit assumption is that the Indian consumer should pay oil companies this international price, with anything less being treated as equivalent to a subsidy. As of November16 for instance, the benchmark price for a litre of diesel was ₹49.54. To this are added a premium for marketing and other costs of the oil companies, taking that benchmark to ₹51.99. As opposed to this, the price charged to dealers in Delhi is ₹42.30 per litre, implying an under-recovery of ₹9.69 per litre. Total under-recoveries in diesel for the first half of 2013-14 were ₹28,266 crore, according to the petroleum ministry.

THE BATTLE OVER PRICES OCCURS IN CONTEXT OF AN EXPANSION IN REFINERY CAPACITY, WHICH IS LIKELY TO INCREASE WELL IN EXCESS OF CONSUMPTION FORECASTS

The battle between the finance ministry and the oil companies and the petroleum ministry was what this benchmark should be. Currently, the benchmark price assumes that consumers should pay a price related to that at which diesel is imported into India. Against this stand of the petroleum ministry, and supported by the Parikh committee, is the finance ministry which argues that the actual benchmark should be the price at which the fuel is exported, which is lower. The difference is about ₹1.89 per litre. Supporters of the current system claim that this disparity is small enough that it makes little difference which benchmark is used. "There is not much difference between the two benchmarks, so from a pragmatic point of view it is preferable that the current trade parity price benchmark is used," Parikh told *ET Magazine*. The trade parity price is an average of the export and import prices, with the import price having an 80% weight in the final calculation.

The critic's logic on the other hand, is in line with the sea change in India's refining sector over the past decade. Since 2001, India has produced more fuel products than it has consumed, with the excess pegged by the committee at 60 million tonnes per annum for 2012-13. It is a net exporter of diesel and other products, and logically therefore it should be the export price rather than the import price which should be used.

Money At Stake

The other key change that has come over India's oil sector is the emergence of private sector oil refiners such as Essar and Reliance. The production of fuel products by the country's public sector refiners-cum-marketers falls short of domestic consumption. To make up the difference, the PSU oil marketers must buy the fuel products from private sector refiners, at the benchmark trade parity price. Thus, the private sector refiners too have been important stakeholders in this battle, since shifting over to the finance ministry's benchmark would lead to a sharp reduction in revenues for them. For the PSU companies, a reduction in the benchmark rate would mean a fall in the compensation that they receive from the government for the 'under-recoveries' they sustain.

The finance ministry points out that built into the import parity price is a 2.58% customs duty rate, as well as other costs related to shipping and insurance. When a domestic PSU oil company buys diesel from a private sector refiner, such charges are entirely notional, but they are paid anyway. "Given the fact that the OMCs or the private refiners are not actually paying the customs duty, there should be no reason that the government should be paying these notional import duties on diesel to the OMCs or the private refiners," wrote the representative of the finance ministry on the Parikh committee, in a dissent note to the report.

As of 2011-12, OMCs purchased around 14.5 million tonnes of diesel from private refiners. Assuming the current difference between trade and export parity prices (EPP) of ₹1.89 per litre applied then, the finance ministry is effectively arguing that around ₹2,740 crore worth of excess subsidies was distributed by the government to the private sector refiners in 2011-12 just on diesel. It pegs the over-compensation to OMCs and private refiners at about ₹13,500 crore annually.

But the private refiners argue otherwise. While Reliance did not respond to questions put by *ET Magazine*, Essar's Gupta says: "We had planned the refinery when the refinery sector was assured of 12% post tax return. However, later in 1997, the government decided to deregulate the sector and refineries were deregulated with clear provision for import parity pricing for the products, reasonable duty protection and freeing up the transportation and fuel retail marketing to enable private sector and joint sector refineries to get the marketing margins." He argues that 95% of the difference between the two benchmarks is anyway eaten by the company having to pay central sales taxes and 'notional coastal freight' on finished products. Incorporating these and other costs into the EPP sharply reduces the difference between the two benchmarks, though the finance ministry dissent note still points to an over-compensation of ₹1,000 crore even after this – though this is small in comparison to the overall fuel subsidy. And the dissent note points out that the central sales tax would only be payable by private refiners for sales outside the state.

Parikh in fact concedes that the export price, is, in principle the correct price to use. In a report last year done under the auspices of Integrated Research and Action for Development (IRADe), and funded partially by the finance ministry, Parikh was part of a study team which argued that "... diesel price, substantial quantity of which is exported as we have surplus refining capacity, should be set at the FOB level [effectively the export price]."

"Trade parity pricing provides some protection to domestic refineries who might otherwise make losses. And it gives incentive to private sector refiners to sell products in the domestic market"

Kirit Parekh,
Economist

"Export parity price is a sound principle to follow," Parikh told *ET Magazine*. However he supports the continued use of the current benchmark on grounds of the small difference between the two benchmarks, and the fact that the higher benchmark price provides a degree of protection to a number of public sector refineries in the country which would otherwise suffer losses. "The use of trade parity price over export parity price also provides an incentive to private sector refiners to sell the fuel in the domestic market rather than into the international market," says Parikh.

"The use of trade parity pricing plays an important part in sustaining the domestic petro refining industry," says Dilip Khanna, partner (oil and gas practice), Ernst and Young.

Bigger Changes

The battle over which benchmark price to use occurs in context of a larger expansion in refinery capacity underway in India. Current refinery capacity in the country is 215 million metric tonnes per annum. Over the next few years, this capacity is expected to rise by almost 90 million metric tonnes (40%), keeping refinery capacity well in excess of consumption forecasts even as far out as 2016-17.

As Khanna points out, one of the benefits of the fuel price reforms has been precisely to enable this expansion in capacity. "As a strategy to increase refining capacity in the country, the move to TPP [trade parity price] has worked," he points out.

And while the current benchmark may provide an incentive to private sector refiners to sell in the domestic market, companies face challenges internationally too. As a story by Bloomberg pointed out recently, new capacities are also being built in the rest of Asia and the Middle East which could weaken margins of Indian refiners such as Reliance and Essar. As Gupta told *ET Magazine*: "Basic demand has to come from domestic market otherwise refineries will become unviable Further, many refineries may have to reduce their throughput if you shift to EPP because companies will find it unviable to produce."

Little wonder then, that while the debate over whether to use export parity pricing may seem technical, the outcome has several thousand crores in profits riding on it. ■