

Fossil Fuel Subsidies in India: *The Case for Rationalizing Petroleum Product Prices**

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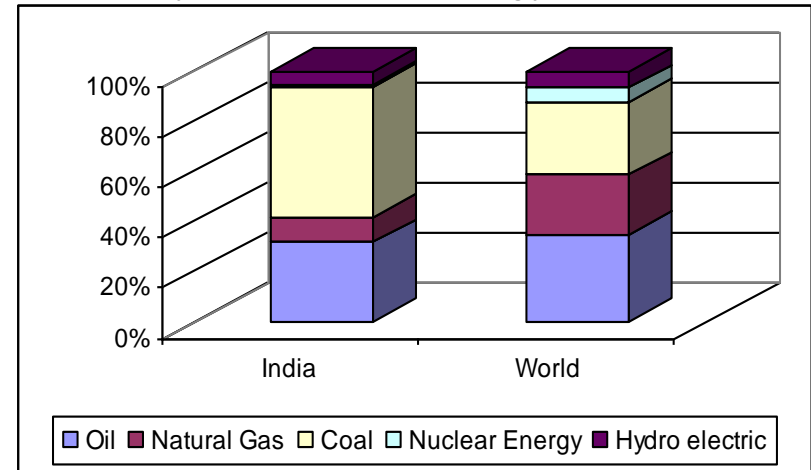
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** This presentation is a summary of a larger policy paper being prepared by the Centre for Research on Energy Security, The Energy and Resources Institute*

Introduction

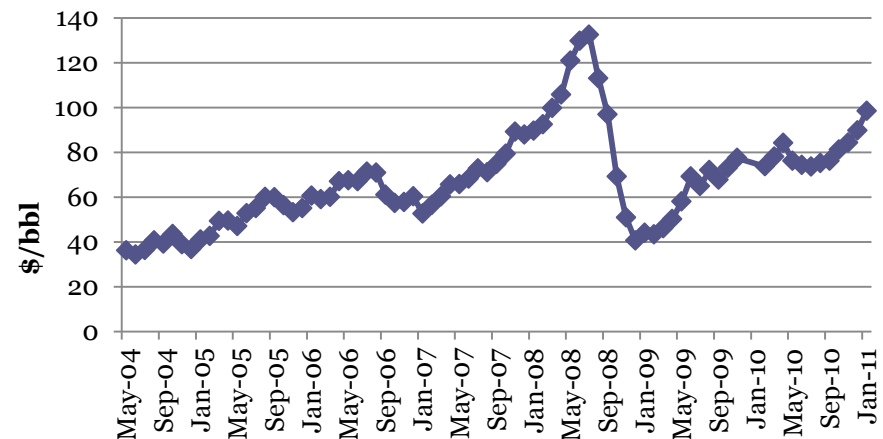
- Petroleum accounts for almost 35% of the world primary energy consumption.
 - In India – it accounts for 32% of the total primary energy consumption (BP, 2010)
- Crude oil import dependence is 80% and is projected to rise to 91% by 2030.
- Given the dependence on imports, international oil prices affect the oil import bill
- Increase in the prices of oil in the recent months
- This affects economic indicators – current account, GDP and inflation rate

Primary Commercial Energy Mix



Source: British Petroleum

Prices of Indian Basket of Crude Oil



Source: Indian Oil Corporation Ltd.

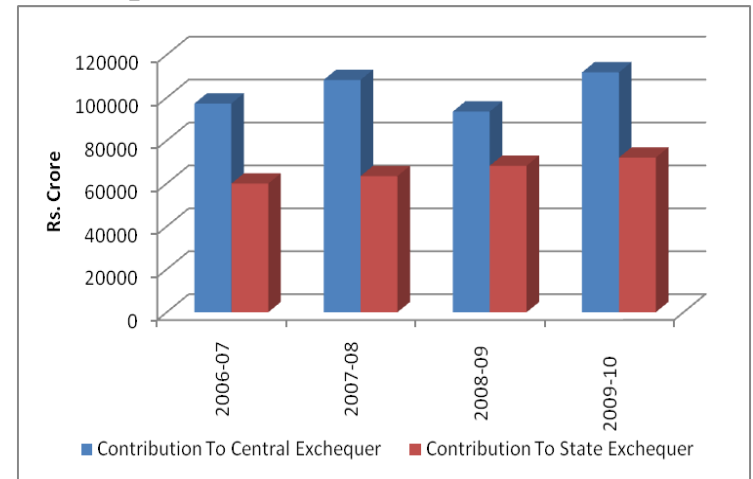
Indian Petroleum Sector - A Snapshot

- Consumption in 2009-10
 - 193 MMT of crude
 - 138 MMT of petroleum products
- Largest consumed products: HSD (41%), LPG (10%), MS (9%)
- Imports
 - 159 MMT of crude
 - 15 MMT of products
- India is a net product exporting country
 - 51 MMT of products were exported in 2009-10
- Value of imports
 - Rs. 420 thousand crores (30.5% of the total imports)
- Origin of imports
 - Middle East (67%)
 - Africa (20%)

Indian Petroleum Sector - A Snapshot

- This sector is one of the largest contributors to the exchequer (11% of the central government receipts in 2009-10)

Contribution of the sector to the exchequer



Indian Petroleum Industry

Exploration

- Major Players
 - ONGC, OIL RIL, EOL
- From nominated blocks to NELP
- Increased foreign participation in the sector post NELP

Refining

- Major Players
 - IOCL, BPCL, HPCL, RIL
- Massive increase in refining capacity in recent times
- Installed capacity – 185 MT
- Supply > Domestic Demand

Marketing

- Major Players
 - IOCL, BPCL, HPCL, RIL (Exports)
- Government control over pricing of major products

Evolution of Pricing

1960s

- Import Parity Pricing

1976
onwards

- Following the oil-shock of 1973-74
- Cost-plus pricing
- Largely Administered Pricing
- Absence of competition and lack of capacity addition

2002

- Partial abandonment of APM
- Four year long phased dismantling of the mechanism (1997-2002)
- Prices of all products other than LPG and PDS Kerosene would be market determined

Evolution of Pricing (2)

2004

- Increase in International prices of crude oil
- Price-band mechanism
- Increasing prices – abandonment of price-bands

2005-06

- Appointment of the Rangarajan Committee. Suggestions:
 - Trade Parity Pricing for all products at both levels
 - Limiting subsidies to the BPL households
 - Restructuring the duties
- Only refinery prices brought to TPP levels

2006-08

- Introduction of the subsidy burden sharing formula – Upstream companies, government, OMCs
- Increase in prices by 2008 – unsustainable under-recoveries
- Appointment of Chaturvedi committee

Evolution of Pricing (3)

2008

- Slump in prices
- Decline in under-recovery burden

2010

- Kirit Parikh committee report
- June – removal of control from petrol prices
- October- November – increase in crude oil prices

2011

- Government decision to not increase the prices any further
- No changes in diesel, kerosene and LPG prices
- Increasing under-recoveries for oil companies

Current Pricing Regime

Most products prices are market determined

Four *sensitive* products – petrol, diesel, PDS kerosene and domestic LPG – not determined in the market

These products constitute 66% of the total domestic product demand in the country

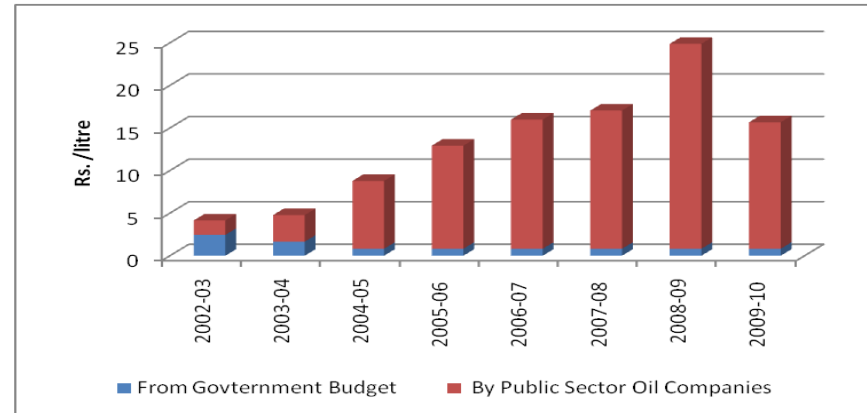
Since June 2010, oil marketing companies determine the prices of petrol

Diesel prices are controlled by the government (but no fiscal subsidy is provided on diesel)

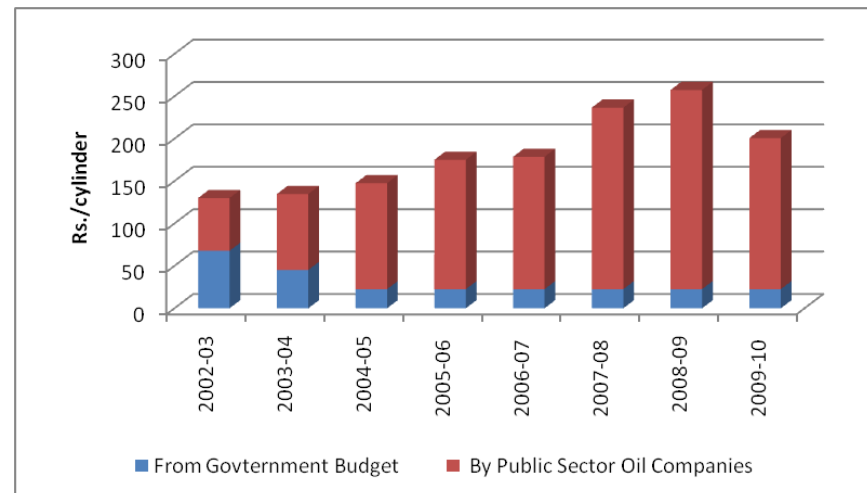
Current Pricing Regime (2)

- Fiscal subsidy is provided on PDS kerosene and domestic LPG
- This subsidy is only a small percentage of the actual loss on the sale of the product (5% in case of kerosene and 11% in case of LPG in 2009-10)
- The government share in subsidy was to be reduced by one-third each year beginning 2002-03
- Since 2004-05 the subsidy level are constant:
 - 82 paise/litre for PDS kerosene
 - Rs. 22.58/cylinder for Domestic LPG

Subsidy sharing on PDS Kerosene



Subsidy sharing on Domestic LPG



Effective Subsidies*

- Gauging the fiscal subsidies is not sufficient – these constitute less than 10% of the actual under-recoveries
- Actual level of subsidy = Difference between the refinery gate price and the retail selling price
- Subsidy shared by
 - Upstream oil companies – selling crude at discounted rates
 - Downstream oil companies
 - Government

Effective Subsidies - Impact

The costs of selling petroleum products below market prices affect:

- Government
 - Direct fiscal subsidy
 - Impact of oil bonds – interest burden and future redemption costs
- Economy
 - Consumption of petroleum products
 - Penetration of clean fuels
 - Malpractices – leakage of subsidy
- Oil Industry
 - Impact on the financial performance of oil companies
 - Impact on investments
 - Effect on competition – level of private sector participation

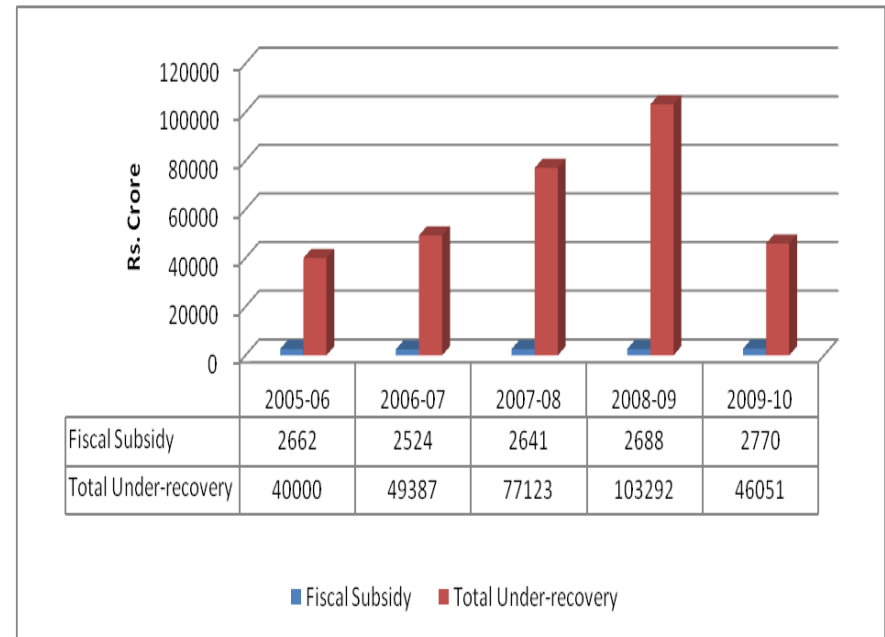
Impact of Subsidies

- Intention behind having subsidies (desired impact)
- Actual Impact
 - On the economy (macro and micro)
 - Budgetary implications
 - Exploitation and over-use of fuels
 - Adulteration
 - Absence of trickle down to the poor
 - On the oil industry
 - Poor fundamentals of the OMCs
 - Lack of private sector participation

Impact on Government

- Under-recoveries not paid for via budgetary allocation
- Not much direct impact on the budget deficit

Sharing of Under-recoveries by direct government subsidy

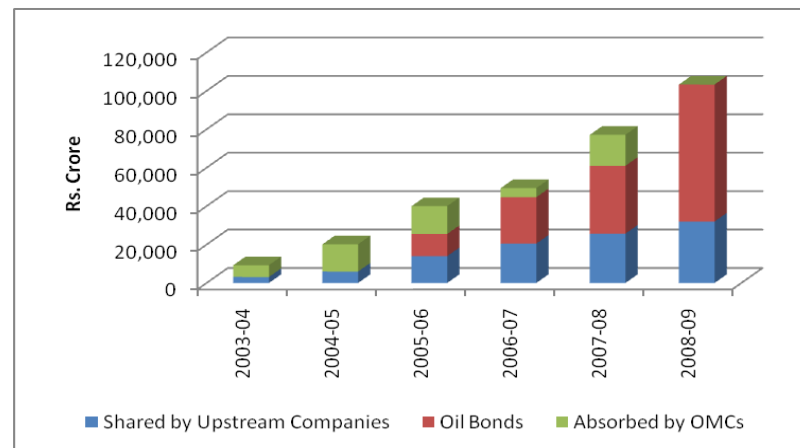


Source: PPAC

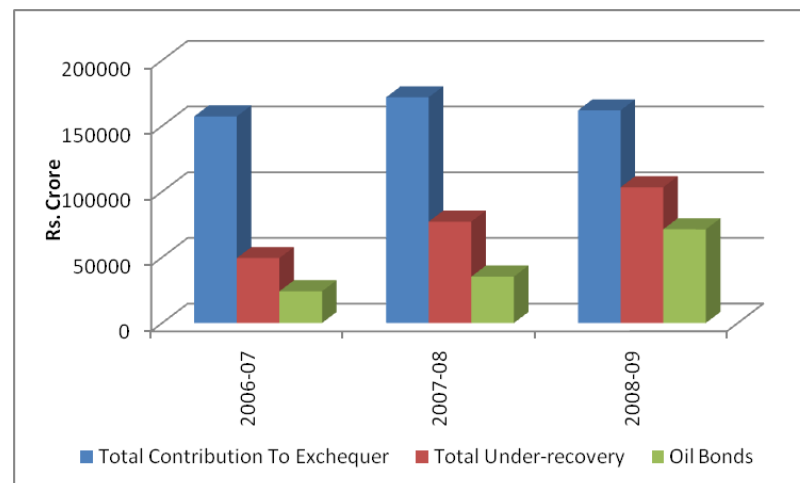
Impact on Government (2)

- Increase in the use of oil bonds by the government
- Characteristics of the bonds:
 - Partially tradable
 - Interest rate – 6 to 8%
 - Typically 5-7 years of maturity
 - Do not have SLR status
- Future costs imposed on the government
- Rising interest payments due for the government
- Push towards further rounds of debt issuance to meet the rising under-recoveries
- Under-recoveries increasingly eating into the revenues earned by the government from the sector

Absorption of Under-recoveries



Revenue from the petroleum sector and Under-recoveries



Impact on the Economy

- Falling sovereign ratings. S&P rated India:
 - BBB minus - long term
 - A-3 - short term
- This adversely affects the capacity to raise funds in international finance markets
- High future costs of financing the subsidies via oil bonds
- Unsustainable increase in demand of petroleum products
- Lack of penetration of clean fuels
 - Only 9% of the rural households use LPG for cooking
 - 85% households still depend on firewood and dung cake
 - Only 4% increase in households using LPG in rural areas
 - Penetration in urban areas is higher at 62%
 - Kerosene is primarily used for lighting in rural areas (39%)

Impact on the Economy (2)

- Use of firewood – adverse health impact (Indoor Air Pollution), waste of time in collecting the resource
- Leakages in the subsidy mechanism
- Diversion of PDS kerosene:
 - 35% PDS kerosene gets diverted*
 - This negates the investment made by refiners in improving the quality of diesel
- Price differential across borders - smuggling of kerosene to neighboring countries

Impact on the Industry

- Pricing of products below market prices impact the oil industry across the entire value-chain
- Upstream companies – sell crude oil to refineries at discounted rates (Rs. 32,000 crore paid to downstream in 2008-09)
- Refiners and OMCs are integrated companies and indirect subsidization of product prices affects their financial position

Impact on the Industry - OMCs

- Profit levels
 - The net profit (after tax) has declined for all three PSUs
 - Not severely affected as the companies have other sources of income – dividend, refinery incomes
- Cash flows
 - Falling net cash flows
- Working capital financing
 - Oil bonds have long term maturity
 - Cannot be sold in the market since these are only partially tradable and non-SLR
 - Companies take loans to finance the short term working capital needs

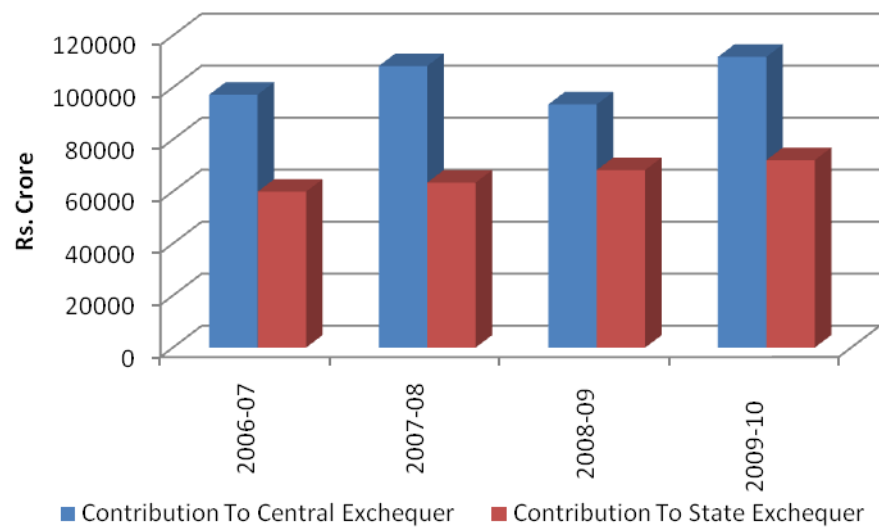
Impact on the Industry - OMCs (2)

- Rising interest costs
 - Rising borrowings
 - Rising interest payments
- Investments
 - Despite the burden of subsidies and declining financial position investments have not been curtailed
 - Increased capacity addition and greenfield investments in new refineries by PSUs
- Lack of competition
 - Absence of private sector participation due to control on prices

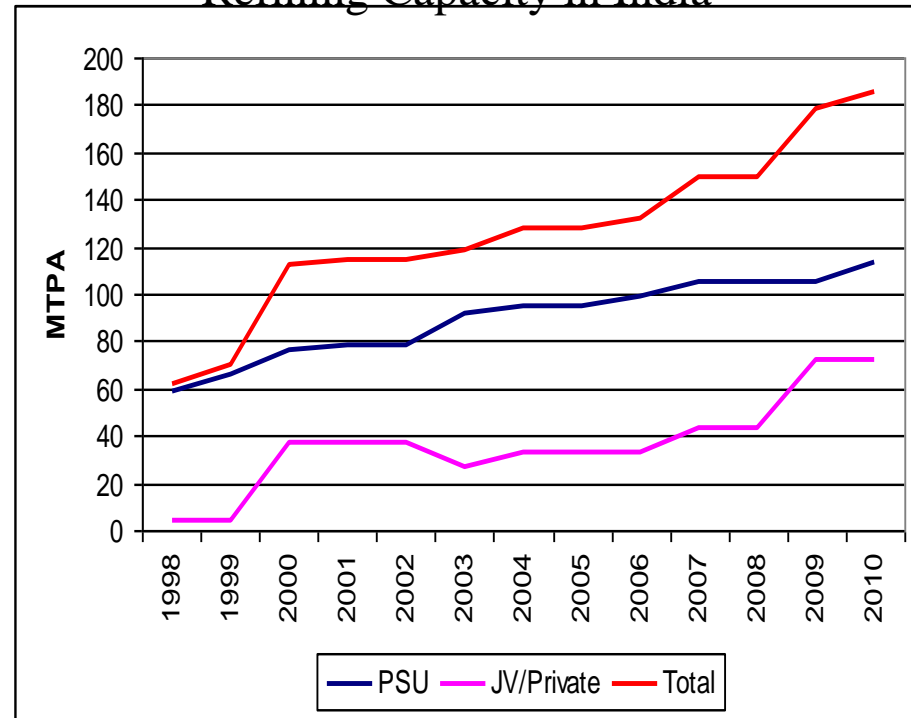
Conclusions & Recommendations

- Introduction of targeted subsidy delivery mechanism to avoid leakages
 - Introduction of cash transfers
 - Using the UID mechanism to deliver subsidy
- Focusing on investing in clean renewable technologies
- Rationalizing the taxation regime
 - Current tax regime is part ad-valorem and part specific
 - Increase in taxes with rising crude oil prices
 - Duties and taxes need to be redefined towards becoming more specific in nature

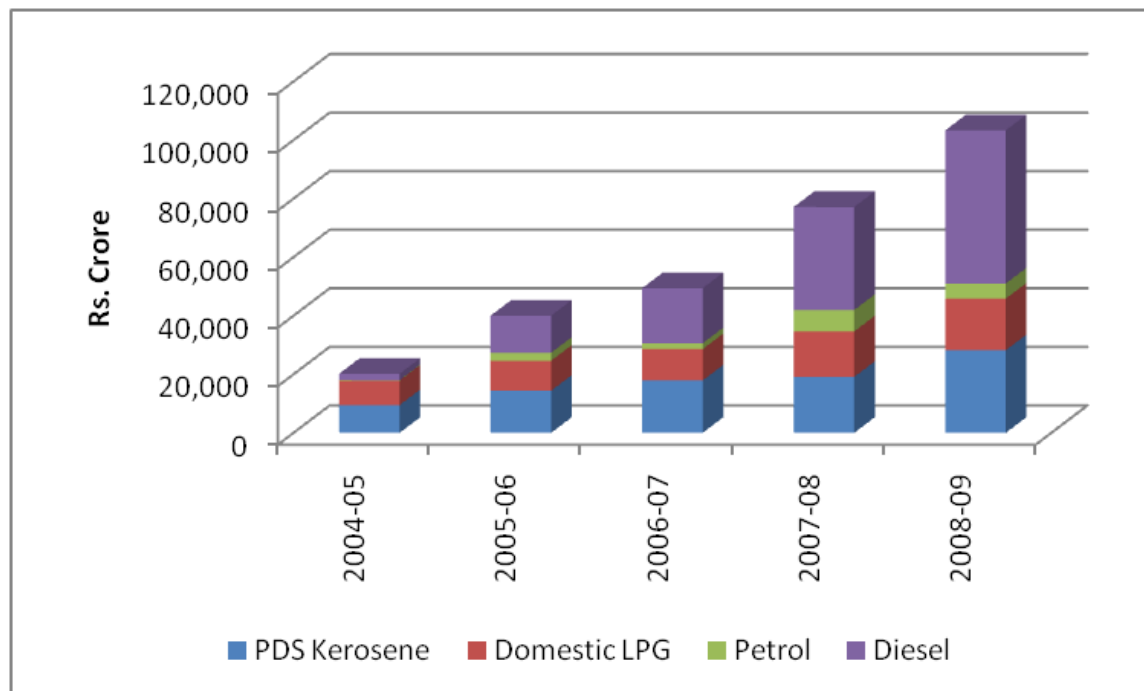
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Refining Capacity in India



Source: PPAC



OMC financial performance

		2005-06	2006-07	2007-08	2008-09	2009-10
Debt Equity Ratio	IOCL	0.9	0.78	0.86	1.02	0.88
	BPCL	0.92	1.05	1.29	1.75	1.7
	HPCL	0.76	1.1	1.59	2.12	1.84
Interest	IOCL	1022	1505	1546	3952	1526
	BPCL	247	533	673	2166	1011
	HPCL	176	423	766	2082	904
PAT	IOCL	4915	7499	6963	2950	10221
	BPCL	292	1806	1581	736	1538
	HPCL	102	292	106	178	406

Under Recoveries and fiscal deficit

	Under Recoveries	Fiscal Deficit	GDP	FD/GDP	FD+UR/GDP
2005-06	40000	239560	3540559	7%	8%
2006-07	49386.55	230432	3874632	6%	7%
2007-08	77122.687	203922	4247918	5%	7%
2008-09	103292.16	473947	4465360	11%	13%
2009-10	46050.82	597414	4807222	12%	13%