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India's oil-price folly

By Kunal Kumar Kundu

Moves by the Indian government to reduce fuel subsidies remain more a paper fiction than hard reality as it continues to prevent state-controlled oil suppliers charging prices that reflect the international rates they must pay for fuel.

The average basket of prices for oil imported by India has surged by nearly 50% since January but, after a long hiatus, and only after results of this month's assembly election in five Indian states were announced, the government allowed petrol prices to be raised by only 5 rupees (about 11 US cents) a liter, with Indian Oil Corp, the nation's biggest refiner, increasing gasoline prices on May 15. State-run refiners face losses of around US$44 billion in revenues this fiscal year, Bloomberg reported last week, citing an unidentified oil ministry official.

The gasoline price increase is not enough to remove the shortfall between international and local prices. Oil marketing companies (OMCs) are still losing 5.5 rupees a liter, and the prices of diesel (the fuel used for transportation) and kerosene (used primarily by the poor and less affluent) continue to be held at the old rates for fear of a public backlash against any increases at time of high and rising inflation. Consumer prices rose around 8.7% in April from a year earlier.

Diesel and kerosene prices may rise after a June 8 meeting of ministers led by Finance Minister Pranab Mukherjee to discuss the issue.

This particular government cannot solely be blamed for its opportunistic behavior, as every ruling party in the country has followed the same way of thinking.

Yet, while the OMCs have been losing money as international oil prices have surged, the important question is whether domestic oil prices should be as steep in India as they are. Retail oil prices in India are exorbitantly high, despite subsidies. The following table shows the price of a liter of oil in neighboring countries.

Country	Oil price per litre (in INR)
Bangladesh	46.63
Sri Lanka	62.50
Pakistan	46.78

Source: Internet sources

In comparison, in Delhi the cost is 63.37 rupees per liter of petrol, in Mumbai 68.33 rupees, and in Bangalore as much as 71.05 rupees.

Why so?

International crude oil prices at present are about $115.31 per barrel. Effectively a barrel of oil costs approximately 5,210 rupees at current exchange rates. Each barrel contains about 158.99 liters. This translates into a crude oil price of about 32.75 a liter. While it is difficult to calculate the refining and transportation cost, it is safe to assume the same to be around 13 per liter. Add to that an approximate dealer commission of 1 rupee a liter and the final petrol prices come to around 46.75 rupees a liter.

The retail price of petrol in India is higher on an average by about 20 per liter. The difference clearly lies in huge taxes imposed in the country.

Taxes	Quantum
Excise duty	Rs.14.35/litre
Customs duty	7.50%
Sales tax	10-20%
Entry tax*	5%

Source: Internet sources

Clearly the government's appetite for revenue as it fails to manage its profligate ways has to take a lot of blame for this state of affairs, with taxes accounting for roughly about 45% of oil prices.

It is important to note that, with most of the taxes being charged as a percentage of the oil price, the tax component in absolute amount goes up as oil prices go up, adding to the burden on the companies and the consumers.

With such taxes being sacrosanct, the under recoveries are hurting the oil companies where it matters most - their bottom line. That is because the government, though it is expected to undertake the subsidy burden because of its questionable policies, passes the buck - not the money but the burden. (Under recovery is the difference between the actual cost of oil, or say petrol, and the price received by the oil companies for the petrol sold.)

According to available information, the subsidy paid out by the government in the financial year to March 31 was close to 410 billion rupees (US$9 billion), while the total under recovery was of the order of 780 billion rupees. In effect, the government is enjoying all the benefits of rising prices (through rising tax revenue), while it pays out only a little more than 50% of the total subsidy that it should ideally have paid out.

The solution? The government recently mandated that upstream oil companies (involved in exploration and recovery of crude oil) should pay directly to the OMCs (that is, it is not a tax in the conventional sense of the term) 260 billion rupees. The remaining amount of the total 810 billion rupees total under recovery will be absorbed by the OMCs themselves.

This is a blatant misuse of power by the government as a majority shareholder in these companies - upstream and downstream - and a trampling of the rights of the minority shareholders - including retail investors, many of whom invest in these companies simply because these are government-owned and hence perceived to be safe. One consequence is the damping of share prices.

Not only do these subsidy burdens directly impact the bottom lines of these companies, thereby disproportionately pulling down their valuations; their debt burden also goes up substantially as their working capital requirement increases.

The loss in market capitalization of these companies then, crucially, results in a substantial reduction in the value of the government's share in them. As a result, government disinvestment targets also take a hit.

Talk of confused governance ...

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