LPG and kerosene

Few gains from notional decontrol

The current woes of the oil companies are the result of the Government's mindset of wanting to have the cake and eat it too. It cries itself hoarse about the increasing subsidy outgo on LPG and kerosene but does not lower the rates of taxes/duties. If only these are brought down, the consumers will have access to the products at affordable prices, even without subsidy, says Uttam Gupta.

DURING 2002-03, the first year after dismantling of the Administered Price Mechanism (APM) for petroleum products with effect from April 1, 2002, oil companies in the public sector are reported to have suffered a loss of about Rs 5000 crore on the sale of LPG and kerosene. This calls for a close look at the mechanics of their pricing.

Under the APM, the Government controlled the prices of all petroleum products. While the prices of LPG, kerosene and diesel were fixed at levels below the cost, in respect of petrol, diesel, ATF and supplies of naphtha, fuel oil/LSHS to non-fertiliser users, the levels were set higher than the cost. The surpluses generated from the sale of the latter were used to meet the deficit on the former.

The above inflows and outflows were handled through the mechanism of the Oil Pool Account (OPA). The OPA was self-sustaining and no explicit financial support from the Government was needed to provide subsidy cover on sale of LPG, kerosene, etc.

The dismantling of the APM logically meant that the Government would not regulate the prices. In LPG and kerosene however, fearing a steep increase in the price, it decided to influence it — albeit indirectly — by giving subsidy at a certain pre-determined level. This was in sharp contrast to the earlier dispensation, wherein the subsidy was open-ended.

Now, if, the subsidy amount is fixed, any increase in the cost of supply — resulting from increase in the international price of these products or crude — has necessarily to be absorbed by corresponding increase in the selling price. In case this is not allowed, the oil companies will suffer a loss. This is precisely what happened in 2002-03.

For LPG, the budgetary allocation for reimbursement to oil companies was made with reference to the international price of $185 per tonne as on April 1, 2002. Despite a sharp increase during the year (in the last quarter, it scaled a peak of $350 per tonne), the Government did not allow any increase in the retail price. The case of kerosene was broadly similar.

The situation is unlikely to change during this year. Based on the international price of $230 per tonne (April 2003), the cost of LPG exceeds the retail price by Rs 80 per cylinder (14 kg). But the Government capped the subsidy at Rs 45 per cylinder. Likewise, on kerosene, the payments will be at Rs 1.6 per litre, against an estimated shortfall of Rs 2 per litre.

The current woes of the oil companies are the result of the Government's mindset of wanting to have the cake and eat it too. The latter is keen to limit the subsidy outgo on LPG and kerosene to the level dictated by its overall budgetary compulsions and, at the same time, maintain the prices of these politically sensitive products at a level of its choice.

This mindset is reminiscent of the approach adopted by Government towards the fertiliser sector under similar circumstances. It may be worthwhile to recall some important milestones in this regard.

Before August 25, 1992 all phosphatic fertilisers were covered by the retention price scheme (RPS). Under RPS, the Government controlled the selling price of fertilisers at a low level and compensated the producers for the excess of the cost of production and distribution over this by way of subsidy.

As in case of LPG and kerosene under the APM, the subsidy on fertilisers was open-ended. Thus, even as their selling prices were, by and large, inflexible (these were changed only when the Government took a conscious decision based on the overall socio-political scenario), the cost escalations were absorbed by corresponding increases in the subsidy amount.

On August 25, 1992, all phosphatic fertilisers were decontrolled, and the RPS abolished. From October 1, however, the Government re-introduced subsidy under a new incarnation — concession support.

This was a fixed amount, and the manufacturers were expected to suitably reflect this in the retail price. The States which were initially authorised to disburse subsidy, started regulating the retail price as well.

From April 1, 1997 the Government appropriated to itself the role of regulating the retail prices. And since it was fixing the concession amount as well, the manufacturers had virtually no control over the realisation from sale. Ironically, both the components were being fixed in a manner such that the proceeds fell short of the cost of the sales, thereby denting profit margins and even leading to loss in some cases.

In a bid to deal with this situation, in August 1998, the Cabinet Committee on Economic Affairs (CCEA) took a decision that, henceforth, the Government would fix only the concession amount and allow the manufacturers the flexibility to fix the retail price after suitably factoring the concession amount.

The relevant notification incorporating the CCEA decision also mentioned that the concession amount as applicable to rabi 1998-99 would remain unaltered for a couple of seasons. This was in sharp contrast to the subsisting dispensation under which the rate was changed every season.

If implemented, the above decisions would not only have given manufacturers the freedom to price the products but also stability in regard to the concession amount.

But the Government reversed these decisions within a month and restored the *status quo ante* by issuing another notification in September 1998 that superseded the August 1998 circular. The position continues till to date.

Currently, the oil companies face a more or less similar situation in regard to sale of LPG and kerosene as experienced by the manufacturers of fertilisers for more than a decade now. The Government can provide much needed relief to producers in both the sectors by revisiting the Cabinet decision of August 1998.

It should give oil PSUs full freedom to fix the prices of LPG and kerosene at a level equal to the IMPP minus the pre-determined / fixed subsidy amount. This will not only be consistent with the spirit of liberalisation but also enable the oil companies maintain a reasonable level of profitability.

Because of significant under-recovery of cost on sale of LPG and kerosene, the oil companies are prompted to charge high prices (more than warranted by the underlying IMPP levels) for other products like naphtha, fuel oil, petrol etc. If, the former are priced at the right levels then, the motivation for raising prices of the latter will also cease, thereby bringing users enormous relief.

In view of the impending privatisation of two major oil PSUs — HPCL and BPCL — it is all the more necessary that the Government decides to unshackle the pricing of LPG and kerosene at the earliest. This is because without the freedom of pricing (a prerequisite for ensuring full coverage of the cost), the strategic partner may simply refuse to participate in the scheme for reaching subsidy to the consumers.

This brings us to a fundamental question: Why should LPG and kerosene be subsidised at all? The subsidy is essentially an instrument to help the poor.

But LPG is certainly not the poor man's fuel. This is used predominantly by the middle-class and the upper middle-class.

The persons belonging to these classes buy all other essential commodities at the market-based price. Under the restructured public distribution system (PDS) in vogue since 1997, the so-called APL (above poverty line) families have to pay the full economic price on their purchase of foodgrains. Against this backdrop, there is no reason why they should be treated differently when it comes to LPG.

In the LPG market, there exist two parallel supply streams — to the households at a subsidised price and to the commercial / business establishments at a significantly higher price.

This leads to large-scale diversion of subsidised supplies for profiteering and can be prevented if subsidy on LPG is abolished. This will also provide the private marketers of LPG a level playing field.

As regards kerosene, *prima facie*, this may appear to be a fuel of the poor. However, we must not be oblivious to the ground realities. Instead of finding its way to the kitchen of the poor housewife, the bulk of the subsidised supplies of kerosene are used for adulterating high priced diesel. Therefore, the real beneficiaries of kerosene subsidy are a handful of unscrupulous traders.

In view of the above, and considering that the benefit is not even reaching the poor, the Government may consider abolishing subsidies on LPG and kerosene. At the same time, it should endeavour to promote competition in the marketing of oil and gas so as to bring down the prices. This would require *inter alia* easing of the entry barriers.

The taxes and duties account for a significant portion of the cost of petroleum products. LPG and kerosene are no exception.

While, on the one hand, the Government cries hoarse about the increasing burden of subsidy, on the other, it does not bother to lower the rates of taxes/duties. If only these are brought down, the consumers will have access to the products at affordable prices even without subsidy.

Despite the above measures, a large number of poor households may still not be able to afford the market-based prices for fuel. In order to protect them, the Government may consider providing direct cash assistance. This mode of helping them would be cost-effective and much less prone to misuse.

Unlike the route of giving subsidy by way of reimbursement to the oil companies, which could be wrongly interpreted as subsidy to the producers, this approach would also be free from any hassles at the WTO.

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The Government should abolish subsidies on LPG and give oil PSUs the freedom to fix LPG and kerosene prices rationally to enable the oil companies maintain a reasonable level of profitability. — AFP