Oil companies need to set house in order to cope with reforms

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PETROLEUM companies are looking for concessions from the Union Government, now that they are saddled with excess stocks of petroleum products, like naphtha, fuel oil, diesel etc. They want the so-called level playing field for importing diesel, but in the case of naphtha, fuel oil and LSHS, independent power producers (IPP) have been told that they can only secure supplies from refineries in the country in a directive issued by the ministry of power.

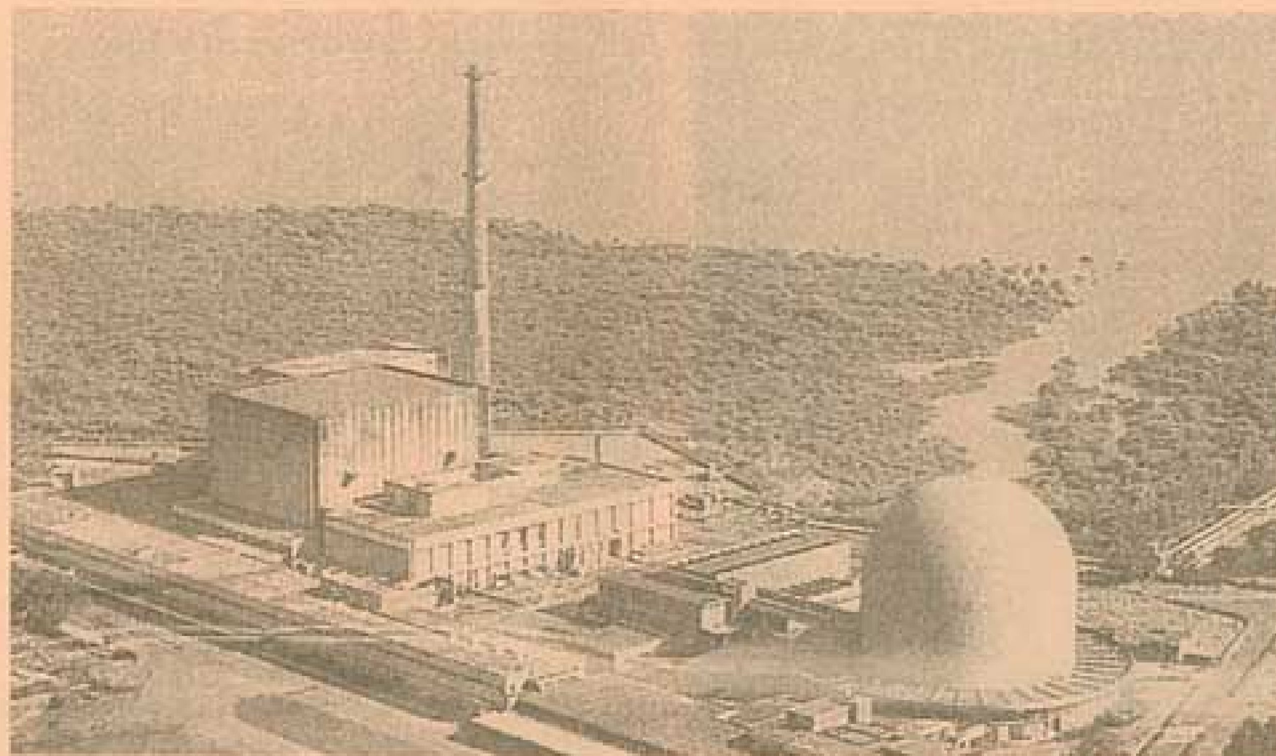
Instead of taking recourse to such desperate moves, petroleum refineries need to address a basic question: How did they get into this mess in the first place ?

The unprecedented addition to refinery capacity in recent years has already created a situation of excess supplies and petroleum product stocks are building up. This has affected the monopoly of the public sector undertakings in the oil sector. The users, particularly industries at coastal locations, also have the option of sourcing their requirements from overseas, since naphtha, fuel oil and LSHS imports were decanalised in April 1998. The customer in this case, is clearly the king and would prefer to buy from the cheaper source.

As per the principle approved in 1997, oil companies are required to fix ex-refinery (or refinery gate) prices on an import-parity basis. In actual practice, they flout this norm with impunity. Instead of taking the free on board (FOB) price as the basis for the domestic price (which, incidentally, would be their realisation if the product was exported), they take the cost and freight (C&F) cost, adding on handling charges at port and marketing margins. The system artificially inflates the price of petroleum products refined at home.

The delivered cost of the product at factory gate further increases on account of sales tax, which is charged by some states at prohibitive rates. Gujarat for instance, levies sales tax at the rate of 20 per cent on naphtha and 22 per cent on diesel. In Maharashtra, the sales tax on diesel is even higher at 33 per cent.

The tax structure is responsible for the exceptionally high price of petroleum products refined within the country. For a plant located in Gujarat, for instance, the cost of naphtha works out to about Rs 15,500 per tonne (of which sales tax alone accounts for roughly Rs 2,500 per tonne.) In sharp contrast, imported naphtha is cheaper by about Rs 3,000 per tonne, shorn of the marketing margins and sales tax loaded onto



petro-products refined within the country. Thus, if power units were to import naphtha instead of taking it from oil companies, they would be able to reduce their generation costs by nearly 40 paise per unit. Fertiliser units would be able to cut down their production costs by Rs 1,500 for every tonne of urea produced. The oil companies need to set their house in order. It would be totally illogical for them to fix the ex-refinery price of their products at any thing higher than the cost of import (ie, the C&F landed cost plus port handling charges). Ideally, they should peg their product prices to the FOB price prevailing in the global market, which is the price realisation refineries abroad get and would be the net realisations of oil companies if they were to export.

The state Governments too should provide the requisite support by reducing sales tax. In fact, a rate higher than 4 per cent is not advisable. The Centre should do its bit to help oil companies, without flouting proprieties.

A strong case does exist for a significant decrease in the customs duty on imported crude, in the light of skyrocketing international prices of crude oil and the depreciation of the rupee. Lower duties on crude imports will help refineries reduce their production costs, thereby enabling them to price their products competitively.

The Government may also consider exempting diesel, used for power generation, from excise duty, just as naphtha supplies to fertiliser plants are exempt from customs duty.

The oil companies should also take note of developments in the gas sector. Consequent to its impending decontrol next year, the possibility of industries switching over to the use of gas is not ruled out. Gas replacing liquid fuels is a strong possibility, because gas is likely to prove cheaper than naphtha in the years ahead.

Even after linking domestic natural gas prices 100 per cent with a basket of internationally traded fuels (compared to 75 per cent now), gas prices are likely to be about $4 to $5 per million BTU and will still be lower than the cost of naphtha at $7 to $8 per million BTU. Gas will also prover cheaper than fuel oil, at prices of about $6 per million BTU.

The impending challenge from imported liquefied natural gas (LNG) cannot be brushed aside either. Already, a spate of projects for supply of LNG are currently under implementation and are likely to be commissioned in three to five years from now.

Some of the major consortia eg, Petronet LNG, have indicated that LNG will be available at a price significantly lower than naphtha. This will have ominous repercussions on the refineries.

The oil majors should see the writing on the wall. The days of monopolistic and exploitative pricing are over. They are facing competition from within as well as imports. The competition will intensify in the years ahead.

Hence, there is an urgent need for removing all aberrations in the pricing of petroleum products and to bring these down to realistic levels, based on sound principles.

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