Analysing the Parikh Committee Report on Pricing of Petroleum Products

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The Parikh Committee's recommendations on pricing of petroleum products are bad for the country and worse for the *aam aadmi*. The committee's recommendations do not address the problems of petroleum pricing in their entirety and appear to be driven by the desire to give private sector refiners, originally set up for export of products, an entry into the domestic market under the garb of liberalising price of petrol and diesel. The petroleum sector in India needs tax rationalisation and not tax increases. The high incidence of taxes on the petroleum sector, relative to the gross domestic product, has a negative impact on issues such as access to energy services and development.

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Since the release of the 2006 Integrated Energy Policy (IEP), three committees have been set up to look at pricing of the four sensitive products namely, petrol, diesel, kerosene and liquiefied petroleum gas (LPG). None of these reports deal comprehensively with the distortions that plague not only the oil sector but the entire energy sector. None of these reports deal with the issue of taxes/levies imposed on the petroleum sector. None of these reports look at how unmet demand and lack of access to modern commercial energy have an impact on inclusive development, and its core components such as gender equality, health, education, infant and maternal mortality and livelihoods. Greater access to commercial energy remains essential to each of the foregoing elements of inclusive development and an improved Human Development Index (HDI).

Despite a period of high sustained gross domestic product (GDP) growth, India's HDI has slipped eight notches to 134 among 180 countries. Any reform in pricing energy or petroleum products must necessarily address taxation of petroleum products and the need to raise access.

In different ways all these three committees propose to free up pricing of petrol and diesel and to gradually reduce subsidies on kerosene and LPG. This note will demonstrate that the entire basis for this age-old recommendation is questionable. This recommendation stems from the basic inability of these committees to conceive of an effective scheme for targeting subsidies and not from demonstrating the absence of a need for such subsidies. Let me ask if free pricing of these four petroleum products will help solve the issues of access. About 500 million Indians are living without electricity, about 700 million are dependent upon biomass as their sole or primary energy source for cooking and about 400 million are living in poverty. We have effectively priced and taxed modern commercial energy outside the reach of this segment of our society. How is freeing prices and reducing subsidies going to help these unfortunate Indians? And if market-based pricing is such a good idea within India's energy context, then why not allow electricity, coal and natural gas prices also to be freed and determined through markets?

India is an energy deficient country. Per capita commercial energy consumption in India is under 5% that of the US, under 26% that of China and under 22% of the world average. I support reforms and well regulated competitive markets operating on a truly level playing field. The question is whether India's energy sector or the petroleum sector is sufficiently mature with a healthy supply-demand balance to deliver such markets. Reforms, in the Indian context, should ensure lifeline levels of access to modern commercial energy for all irrespective of their capacity to pay. This core and bold recommendation of the IEP is ignored by all the three subsequent committees on pricing petroleum products.

What Are Under-recoveries?

Several arguments of the Parikh Committee revolve around the issue of rising "under-recoveries". It is important to understand that under-recoveries are not losses. They are the difference between the actual price realised and a notional price called the import parity or trade parity price (incorrectly, I might add) that includes custom duties and still has some elements of the old Administered Price Mechanism (APM) such as freight pooling, ocean loss and other provisions relevant to the actual import of products. Trade parity price if correctly applied can only be the export realisation for all products with net export on balance. Such a computation entailing removal of notional (not actual) costs and taxes, and correction for the quality of the end product would substantially lower the incorrectly estimated ("claimed") under-recoveries. Suffice it to say that despite huge "claimed" under-recoveries that are only partially funded by government of India; no oil company showed a loss till 2008-09. Technically, the National Thermal Power Corporation (NTPC) or Coal India could also claim under-recoveries against the price of freely traded power or freely traded coal.

Are the Four Products Subsidised?

It is my contention that there are no net subsidies in the petroleum sector even inclusive of the erroneous "claimed" under-recoveries. Contrary to the tenor of the Parikh Committee report, the total tax collected from the petroleum sector by the central and state governments is a multiple of the combined fiscal subsidies and the claimed under-recoveries. So any price liberalisation must also address oil sector taxation. The Parikh Committee fails to even highlight this issue.

Table 1 gives the total take of the state and central governments from the oil sector. Table 2 gives the fiscal subsidies and the claimed under-recoveries for the same years. The state and central taxes/levies alone exceed the fiscal subsidies and the "claimed" under-recoveries by far.

Table 1: Taxes and Other Government Receipts from Petroleum Sector (Rs crore)

	2006-07	2007-08	2008-09
State			
Sales tax	53,949	56,445	63,349
Other levies	6,006	7,000	4,937
Sub total	59,955	63,445	68,286
Centre			
Custom duty	10,043	12,626	6,299
Excise duty	58,821	61,685	60,875
Other levies	8,284	10,010	9,803
Sub total	77,148	84,321	76,977
Total taxes/levies collected	1,37,103	1,47,766	1,45,263
Total government receipts	1,57,219	1,71,731	1,61,798

Source: Petroleum Planning and Analysis Cell.

Table 2: Fiscal Subsidy Burden and Under-recoveries (Rs crore)

	2006-07	2007-08	2008-09
Fiscal subsidies centre			
PDS kerosene	970	978	974
LPG	1,554	1,663	1,714
Sub total	2,524	2,641	2,688
Under-recoveries			
PDS kerosene	17,883	19,102	28,225
LPG	10,701	15,523	17,600
Sub total	28,584	34,625	45,825
Under-recovery on diesel	18,776	35,166	52,286
Under-recovery on petrol	2,027	7,332	5,181
Total subsidy and under-recoveries	51,911	79,764	1,05,980

Source: Petroleum Planning and Analysis Cell.

It is also important to understand how the subsidies and the claimed under-recoveries are funded (Table 3). The public sector oil companies absorb a significant share of the under-recoveries. The Parikh Committee, however, wants the up-stream public sector companies to pay even more.

To justify its key recommendations of freeing petrol and diesel prices and reducing subsidies on kerosene and LPG; the committee raises the spectre of ever increasing under-recoveries based on the peak prices achieved by crude oil in the recent past. Table 3 highlights the fact that average prices paid for imported crude on a year to year basis have been within a far more reasonable range. In fact, in real terms average import prices in recent years have been lower than crude prices in the early 1980s. Importantly, the Committee does not question the basis of estimating the erroneous "claimed" under-recoveries.

Table 3: How Subsidies and Under-recoveries Were Funded (Rs crore)

Item	2006-07	2007-08	2008-09
Oil bonds	24,121	35,290	71,292
Fiscal subsidies	2,524	2,641	2,688
Under-recoveries absorbed upstream	20,507	25,708	32,000
Under-recoveries absorbed downstream	4,759	16,125	0
Total	51,911	79,764	1,05,980
Actual price of crude imports $/barrel	59.2	76.2	79.1
Reference price (Indian crude basket) $/barrel	62.5	79.5	82.7

Source: Petroleum Planning and Analysis Cell.

Table 4: Comparative Current Prices of Diesel and Petrol (US$/Litre)

Country	Diesel			Petrol		
	Base Price	Taxes PPP	Total Price	Base Price	Taxes PPP	Total Price
US	0.63	0.12	0.75	0.61	0.11	0.72
Japan	0.75	0.36	1.11	0.71	0.60	1.31
United Kingdom	0.64	0.76	1.40	0.62	0.95	1.57
Germany	0.70	0.97	1.67	0.69	0.98	1.67
India	0.54	0.67	1.21	0.51	1.52	2.03

1 US$ = Rs 45.5. The Indian petrol and diesel are of lower quality but no correction is made for this.
PPP calculation based on IMF factors.
Source: Base Data from Petroleum Planning and Analysis Cell.

Do Indians Pay Less for Petrol and Diesel?

This is yet another myth that permeates the Parikh Committee and indeed most government discourse. Petrol and diesel prices are made up of the base price for the fuel and the taxes/levies imposed by the central and the state governments. I agree with the Parikh Committee that the international price of a traded commodity such as oil and oil products should prevail. My problem is that the committee completely ignores the fact that the taxes, that are domestically imposed, must reflect the purchasing power parity (PPP) of the host country.

Table 4 compares current prices across some countries using PPP for correctly assessing the tax component. It is pointed out that the quality of Indian petrol and diesel is well below the quality of these products in the countries listed but no correction is made for this. It is clear that Indian consumers are paying the highest price for lower quality petrol and more for lower quality diesel when compared to the US and Japan – the two most vociferous proponents of removing fuel subsidies. Also, Japan and the UK and, indeed, several other countries tax diesel at a lower rate.

Chinese data for July 2009 shows that diesel and petrol was sold at $0.82/litre in nominal terms. If one removes the price of diesel and petrol prevailing in the international market in July 2009 and ascribes the entire balance to taxes, it is seen that in PPP terms China, at most, taxed diesel and petrol at $0.70 and $0.66 respectively to yield an effective price of $1.13 and $1.11 per litre for diesel and petrol respectively. It is worth noting that this simple exercise overestimates the tax component and hence the total effective price in China because the base price is typically higher than the traded international price for bulk petrol and diesel. What is clear, nevertheless, is that while China taxes diesel, at most, at about the same level as India, China's taxes on petrol are much lower than those in India.

Other Fallacies

The Parikh Committee report talks of limiting LPG subsidies to below the poverty line (BPL) households. How many BPL households do use LPG? In any event are all above the poverty line (APL) families so prosperous that they can do without subsidies?

The report talks of compensating higher diesel prices for the agriculture sector through higher support prices. What about the small and marginal farmers who have no surplus to sell? Has the Parikh Committee not heard of farmer suicides even in Punjab – the granary of India? The report talks of electrification of BPL households when the truth is that about 44% of the country's population has no electricity. So till we can learn to target subsidies and ensure access, we will need to be more innovative than simply removing/reducing subsidies as suggested by the committee.

While arguing that diesel engines are more energy efficient, the Parikh Committee suggests a flat Rs 85,000 excise on all diesel cars. First, a uniform tax makes no sense as some of the smaller diesel vehicles give twice as much mileage as the sport utility vehicles. Further, this proposal overlooks the fact that diesel vehicles are already priced up to Rs 1,00,000 more than the petrol versions of the same vehicles by car manufacturers. The higher up-front cost of diesel cars almost completely negates the benefit of a lower diesel price for a typical small domestic car that runs about 8,000 kilometres in a year.

Impact of Freeing the Domestic Market

India is dependent on imported crude oil to the extent of 80% even to meet domestic needs. Yet, India has promoted surplus refining capacity that exceeds domestic demand by some 35%. The report admits that value addition in refining is minimal with raw material (imported crude oil) accounting for over 90% of the product price. The surplus refining capacity was created on the back of multiple subsidies disbursed selectively. The surplus refining capacity was justified on the pretext of promoting export-oriented refineries. And indeed petroleum products have emerged as India's largest export in recent years. What, may I ask, is India's marginal advantage in refining imported crude – an activity known for yielding small, and sometimes, negative margins? What we have been exporting is not added value but the subsidies to the refiners funded by Indian taxpayers.

The report talks of taxing pre new exploration licensing policy (NELP) concessions and taxes on windfall profits of the Oil and Natural Gas Corporation (ONGC). First, ONGC is already shouldering a major share of the claimed under-recoveries and, second, why not also tax the oil product exporters with windfall profits derived from exporting subsidies they received from Indian taxpayers. The Parikh Committee further rewards the export-oriented refineries that earlier received benefits for export-oriented units in special economic zones, by allowing them freedom to sell in the domestic market, on terms identical to public sector refineries, in the name of a level playing field.

The public sector capacities were not created on a level playing field when compared with the export-oriented refiners. And while going forward a level playing field is desirable; creating such a level ground requires a far more elaborate exercise over time, if one is to avoid a situation where the public sector refineries lose market share and are forced to run at less than capacity. One possibility could be to rationalise product mix, defer new refinery capacities, and allow full competition only when domestic demand catches up with the surplus capacity already in place. If the process is not managed, the public sector refineries will be unable to compete with the more

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How Was the IEP 2006 Different?

First and foremost, the IEP 2006 recognised the issue of universal access to modern commercial energy as being critical to India's energy security. As such, the IEP 2006 recommended that each household be entitled to lifeline levels of commercial energy (defined as 30 kWh of electricity and 6 kg of cooking gas per household per month). The IEP 2006 demonstrated that even if this entitlement was made encashable, the burden would be of the same order as the reported level of subsidies on these accounts. Second, the IEP 2006 recognised the fallacy of import parity pricing and the way it was being computed and used in claiming under-recoveries. The IEP 2006 recommended trade parity pricing that would have ensured that all products with net exports be priced no more than the FOB realisation on such exports. Finally, the IEP 2006 recognised that India's energy sector in general and the petroleum sector in particular was not ready for open market operation. The role of adjusting taxes to manage consumer prices was specifically highlighted for the petroleum sector. As a first step IEP 2006 recommended full price competition at refinery gate and retail outlets among the refineries meeting domestic demand. Such competition within the cap of the prices determined by the government would have forced these refineries to rationalise product mix and become more efficient in order to preserve market shares. That recommendation, if implemented, together with the recommendation on trade parity pricing would have enforced a far stricter discipline of financial justification for creating surplus refining capacities and their location. The market for the four products under consideration could be thrown open to full competition once a healthy demand-supply balance and the desired product rationalisation was achieved.

Budget 2010 Proposals

It is pointed out that the 2010 Budget merely reinstates duties and excise at levels that prevailed before the unprecedented spike in crude prices in the second and third quarters of 2008 and the ensuing price volatility. What is strange is that this is being done when crude prices appear to be firming around the average levels achieved in 2008-09 and the country is experiencing strong inflation. The finance minister has rightly emphasised the need to bolster government revenues. Revenues from the petroleum sector rose consistently prior to 2008-09. In 2008-09 the centre's tax collection from the petroleum sector provisionally dropped by Rs 7,344 crore.

Petroleum product prices comprise central and state taxes and levies and the price of the underlying commodity. The impact on the consumer and inflation is blind to which component of the price is increased. Even the finance minister has admitted that inflation will increase further as a result of his proposals for the petroleum sector. Higher taxation does not address the issue of under-recoveries and actually compounds the cash crunch that public sector refineries face as a consequence. It is possible that the intention is to raise prices of the underlying commodities in line with the Parikh Committee's recommendations after the budget is approved!

My own sense of the budget is that it would not be prudent to give up any revenue source without cutting an equal amount from one or more programmes included in the budget. If a reduction in expenditure is not an option, the government should explore how it can raise the same amount of revenue more equitably by raising the burden on the top 2-5% of Indians who have the capacity to absorb the higher levy. This will spare the *aam aadmi* who is already reeling under the impact of high inflation. I also believe that the petroleum sector in India needs tax rationalisation and not tax increases. The high incidence of taxes on the petroleum sector, relative to our GDP, has a negative impact on issues such as access to energy services and development. China, for example, has traditionally priced energy below the prices prevailing in India.

Summing Up

In light of the facts stated above, the Parikh Committee's recommendations are bad for the country and worse for the aam aadmi. Bad for the country because the recommendations do not address the problems of petroleum pricing in their entirety and appear to be driven by the desire to allow private sector refiners, originally set up for export of products, an entry into the domestic market under the garb of liberalising price of petrol and diesel. This would be detrimental to the public sector refiners in the current context. While I am an ardent supporter of well functioning competitive markets, I do not believe the Indian energy or petroleum sector can deliver such markets today. Such markets require that demand (including unmet demand) and supply be delicately balanced. Price reforms cannot and should not be implemented in a piecemeal manner without addressing all the underlying distortions that plague the oil sector.

The Parikh Committee recommendations are worse for the aam aadmi because inclusive development shall remain a pipe dream without ensuring access to lifeline levels of modern commercial energy for all. Barring public distribution system (PDS) kerosene, the rest of the petroleum products are currently priced outside the reach of the bottom two-thirds of Indians and the report of the committee talks of further inflationary price increases. Access to modern commercial energy in India is one of the lowest in the world and worse than in some sub-Saharan countries. Everyone among the bottom two-thirds of India does not have access and/or the capacity to pay for even the PDS kerosene. And even if one assumes that the top one-third does not consume any PDS kerosene (a completely incorrect assumption considering the amount of leakage and adulteration) the per capita allotment of PDS kerosene to the bottom two-thirds of the population is a little over one litre a month. But even this abject subsistence level of allotment (actual consumption is much lower) is not spared.

The Parikh Committee report on pricing petroleum products should be rejected outright or, in the very least, debated openly with all political parties and civil society at large. The IEP, that Kirit Parikh also chaired not so long ago, made much more meaningful recommendations on the pricing of petroleum products. The latest Parikh Committee does not propose "bold" reforms – it proposes bad reforms.