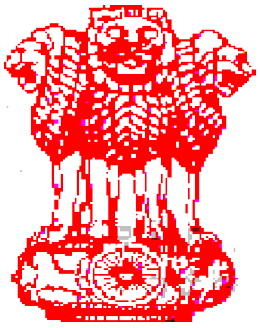

Report of the

Committee on Pricing and Taxation of Petroleum Products

February 2006

Composition of the Committee

1.	Dr. C. Rangarajan Chairman, PM's Economic Advisory Council	Chairman
2.	Dr. Kirit S. Parikh Member, Planning Commission	Member
3.	Shri Saumitra Chaudhuri Member, PM's Economic Advisory Council & Chief Economist, ICRA, New Delhi	Member
4.	Dr. Ashok Lahiri Chief Economic Adviser Ministry of Finance	Member
5.	Prof Bakul H. Dholakia Director, IIM, Ahmedabad	Member
6.	Shri M.S. Srinivasan Secretary Ministry of Petroleum and Natural Gas	Member
7.	Shri S.C. Tripathi Former Secretary Ministry of Petroleum and Natural Gas	Member until retirement on 31.12.2005

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ANNEXURES

Acronyms

AOD	Assam Oil Division, Indian Oil Corp. Ltd
APL	Above Poverty Line
APM	Administered Pricing Mechanism
ASEAN	Association of South-east Asian Nations
ATF	Aviation Turbine fuel
Bbl	Barrel
BICP	Bureau of Industrial Costs and Prices
BP	British Petroleum
BPL	Below Poverty Line
BRPL	Bongaigaon Refinery and Petrochemicals Ltd
C&F	Cost and Freight
CNG	Compressed Natural Gas
CPCL	Chennai Petroleum Corporation Ltd
CST	Central sales tax
E&P	Exploration and Production
EIL	Engineers India Ltd
ETG	Expert Technical Group
FO	Furnace oil
FOB	Free on Board
GAIL	Gas Authority of India Ltd
HPC	Hindustan Petroleum Corporation Ltd
HSD	High Speed Diesel
IBP	Indo Burma Petroleum Ltd
IEA	International Energy Agency
IIM, Ahmedabad	Indian Institute of Management, Ahmedabad
IOC	Indian Oil Corporation Ltd
KRL	Kochi Refinery Ltd
LNG	Liquefied Natural Gas
LPG	Liquefied Petroleum Gas
LSHS	Low Sulphur Heavy Stock
MDPM	Market determined Pricing Mechanism
MMSCMD	Million metric standard cubic meters per day
MMT	Million Metric Tonnes

MOF	Ministry of Finance
MOP&NG	Ministry of Petroleum and Natural Gas
MRPL	Mangalore Refinery & Petrochemicals Ltd
MS	Motor Spirit
MT	Metric Tonnes
NCAER	National Council of Applied Economic Research
NELP	New Exploration Licensing Policy
NIPFP	National Institute of Public Finance and Policy
NOC	National Oil Companies
NRL	Numaligarh Refinery Ltd
OCRC	Oil Cost Review Committee, 1984
OIDB	Oil Industry Development Board
OIL	Oil India Ltd
OMCs	Oil Marketing Companies
ONGC	Oil & Natural Gas Corporation Ltd
OPC	Oil Prices Committee, 1976
OVL	ONGC Videsh Ltd
PAT	Profit after tax
PDS	Public Distribution System
PPAC	Petroleum Planning and Analysis Cell
PSU	Public Sector Unit
R Group	Strategic Planning Group on Restructuring of Oil Industry
RBI	Reserve Bank of India
RIL	Reliance Industries Ltd
RSP	Retail selling price
SKO	Superior Kerosene Oil
TRU	Tax Research Unit, Ministry of Finance
UP	Uttar Pradesh
VAT	Value Added Tax
VSA	Valued Stock Account

Context - Need for Urgent Adjustment of Prices and Taxes

1. With the declared objective of moving towards market determined prices for petroleum products, Government announced the dismantling of the Administered Pricing Mechanism (APM) effective 1.4.2002. However, it was decided to continue to subsidize PDS kerosene and domestic LPG on the ground that these were fuels of mass consumption largely consumed by "economically weaker sections of society". The subsidy on these two products was to be continued on a flat rate basis financed from the budget and was to be phased out in three to five years. The Oil Marketing Companies (OMCs) were to adjust the retail selling prices of these products in line with international prices during this period. However, in compliance with Government directions, the OMCs did not make the necessary adjustment in prices of PDS kerosene and domestic LPG commensurately, resulting in losses on account of these two products.[1] In October 2003, Government decided that the OMCs would make good about a third of the losses on these two products from the surpluses generated by them on petrol and diesel while the balance losses would be shared equally by the upstream companies (ONGC/OIL/GAIL) and the OMCs.

2. This burden sharing arrangement began to collapse in the face of unprecedented, sharp and spiraling increase in international oil prices, particularly since late 2003, combined with sharp week-to-week and even day-today volatility. Both the prices of crude and prices of sensitive petroleum products are close to their highest levels now ($63.23/bbl for the Indian basket of crude on 1.2.2006). The impact of this global price trend on the domestic situation has been two fold. First, the burden of subsidy on PDS kerosene and domestic LPG ballooned to unprecedented levels – the current burden of subsidies is Rs.15,000 crores on account of PDS kerosene and Rs. 11,000 crores on account of domestic LPG. Second, Government took back control of

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[1] In the oil sector, under-recoveries and losses are often used interchangeably. This is not correct as they are two distinct concepts.

Refining of crude oil is a process industry where crude oil constitutes around 90% of the total cost. Since value added is relatively small, determination of individual product-wise prices becomes problematic. The oil marketing companies (OMCs) are currently sourcing their products from the refineries on import parity basis which then becomes their cost price. The difference between the cost price and the realized price represents the under-recoveries of the OMCs.

The under-recoveries as computed above are different from the actual profits and losses of the oil companies as per their published results. The latter take into account other income streams like dividend income, pipeline income, inventory changes, profits from freely priced products and refining margins in the case of integrated companies.

price setting for petrol and diesel, and restrained the 'pass-through' of the international prices to domestic consumers. this year.

3. As a result of these developments, the margins available to OMCs during 2002-04 on petrol and diesel thinned and then rapidly turned negative. The combined profits of OMCs which were healthy at Rs.10,818 crores in 2003/04 declined to Rs. 7,193 crores in 2004/05 and got totally eroded during the current year with losses of Rs. 2,898 crores in the first nine months of 2005/06 (April-December 2005). This is after upstream assistance of Rs. 9,750 crores from ONGC/OIL/GAIL and budgetary subsidy of Rs. 2,000 crores during this period. The issuance of oil bonds, which itself raises some fiscal concerns, has nevertheless helped the oil companies to tide over their financial problems

4. Since international prices are unlikely to soften in the near to medium term, an immediate adjustment of prices and subsidies is an urgent imperative. The economic and financial costs of continued inaction will be alarmingly high as the financial position of the oil companies will rapidly deteriorate. The Government will not only forfeit the taxes and dividends that it has been getting from these companies but will have financially crippled companies on its hand, which will be unable to make the much needed capital expenditure required for expansion and modernization.

Principles

5. The following principles informed the decisions of the Committee.

(i) Pricing and taxation of petroleum products should be rationalized to transmit the right price signals so as to minimize if not eliminate distortions and inefficiencies that result in misallocation of resources.

(ii) Prices of petroleum products should, as far as possible, be aligned with international prices.

(iii) Across the board subsidies result in inefficiencies and place an undue burden on an already strained fiscal situation. Subsidies should be minimal, targeted and restrained by a monetary ceiling.

(iv) To the extent the Government decides to extend subsidies, the burden should be borne entirely and transparently in the Union Budget. The oil marketing companies should be freed from the burden of subsidy.

(v) Custom tariffs on crude and products should be rationalized so as to moderate the effective rate of protection to a level that will offset the

disadvantages suffered by the domestic producers without at the same time allowing them any undue cushion. Excise tariffs should be restructured to protect the consumers from excessive volatility in prices.

6. An appropriate pricing regime which promotes efficiency needs to be evolved in relation to petrol and diesel on the one hand and domestic LPG and PDS kerosene on the other. However, it is the latter which is arguably more intractable because of the heavily subsidized prices to consumers. The issues of adjusting prices and targeting them appropriately become urgent in this context.

Analysis and Recommendations

(Specific recommendations shown in bold)

Pricing of Petrol and Diesel

7. Currently, the refinery gate prices are computed based on the import parity principle. There is need to review the pricing of sensitive petroleum products (petrol and diesel) to provide relief to consumers as also to rationalize pricing in the context of exports of the order of 20% of production of these products. **Given the global context and our refining capacity, a more appropriate pricing model for diesel and petrol will be the trade parity price. Accordingly, we recommend adopting the trade parity principle for pricing petrol and diesel which would be a weighted average of the import parity and export parity prices in the ratio of 80:20.[2] This principle of trade parity pricing will apply for the refinery gate price as well as for determining the retail price. The trade parity prices would be port specific as against weighted average import parity prices currently followed for fixation of consumer prices of petrol and diesel. The relative weights of exports and imports in estimating the trade parity price may be reviewed and updated every year.**

8. The trade parity price determined as above will operate as an indicative ceiling price. **Having established this principle of trade parity price, the Government should keep themselves at arms length from the actual price setting. The marketing companies should be allowed flexibility to fix the actual retail price subject to the indicative ceiling. This will introduce an element of competition that will be in consumer interest.**

[2] A comparative picture of the refinery gate price of diesel (HSD) under alternative pricing models based on the international prices ruling during April-September 2005 is as follows:

Pricing model	Rs/Litre
Cost plus (APM) (HPCL Refinery, Mumbai)	Rs. 19.27
Import parity (using existing tariff of 10% on products)	Rs. 20.48
Export party	Rs.18.77
Proposed trade parity (80% import parity + 20% export parity) using reduced (7.5%) customs duty on products	Rs.19.77

It may be noted that the proposed trade parity price is marginally higher than the cost plus price under the APM model. However, the APM model uses a cost build-up based on return on capital on the depreciated cost of assets. If, in fact, the replacement cost of assets had been used in the APM model, the price would be higher, and in line with the trade parity price.

Trade Parity Pricing - What is it and Why?

Import parity pricing has been a commonly used approach in a regulatory context or in making a case for tariff protection. The argument in support of this approach is that in a situation where there is no domestic manufacture of a product, the cost of supplying it in the domestic market will be the landed cost which is the import parity price. However, even in a situation where there is domestic manufacture, import parity price can be taken as the international competitive price that sets the ceiling for the domestic price. When domestic refiners are given the import parity price, they enjoy a rent which is equivalent to the differential in ocean freight and associated costs as between crude and products. In such a situation, there is case for mandating the refiners to share the rent with public interest.

The fact that a part of the domestic production is exported indicates that domestic refiners, or at any rate domestic refiners with modern technology and locational advantage, are not at a disadvantage compared to foreign refiners. Using this as an argument for pegging the domestic price to the export parity price for all refiners will be unrealistic.

It is in the light of the above considerations that the Committee felt that trade parity pricing which is a weighted average of import and export parity prices should be used as a guide. Such trade parity pricing also provides some degree of protection to domestic refineries.

9. In the computation of import parity prices, the principal elements are the FOB price, customs duties, ocean freight and a few other associated items. These elements, except for the FOB price, are not relevant in computing export parity prices. **In the interest of transparency, the OMCs should be required to disseminate the details of the pricing model adopted by them by putting it on their website as well as through other means.** A committee of technical experts may be constituted to examine the costing details from time to time.

Freight Equalization

10. Currently, prices of petrol and diesel include a component of equalized freight for all locations across the country. This is economically inefficient and leads to misallocation of resources. Also its impact is iniquitous across local refineries operating only in coastal areas and companies operating on an all-India basis.

11. **We recommend terminating the principle of freight equalization.** This will not only provide a level playing field but also transmit the right price signals

specific to each location. On the aggregate, this will result in lower prices in coastal areas and higher prices at inland locations. Illustratively, while the price of petrol will go up by Rs.0.51/litre in Delhi, it will go down by Rs.0.45/litre in coastal locations such as Mumbai and Chennai. The details of price variations across important locations in the country consequent to terminating the freight equalization principle are given in Attachment 1. **Since the price increase will be larger in remote and hilly areas, the Government may want to consider some other way of softening the impact of freight in these areas**.

Rationalization of Customs Duties

12. Currently, the customs duty on crude oil is 5%. There is no customs duty on domestic LPG, PDS kerosene and fertilizers inputs (naphtha and LSHS) thereby putting these products under a regime of negative effective protection. The customs duty on petrol, diesel and other products is 10% which translates to an effective rate of protection as high as 40% for these products.

13. There is a case for allowing some effective protection to domestic refineries for several reasons. First, refining is a cyclical industry characterized by very volatile prices. The spread between crude and product prices fluctuates widely. There have been instances in the past, for example, when the spread between international prices of diesel and the Indian basket of crude was less than a dollar per barrel, and on occasion even turned negative. Second, providing some level of protection and thereby adequate refining margins is necessary for encouraging investment in expansion, and more importantly in modernization of our refineries. Failure on this front can impede our quest for energy security.

14. Furthermore, there is need to offset the burden of irrecoverable taxes such as octroi/entry tax on crude oil. However, the burden of such local irrecoverable taxes is different on different refineries and affording effective protection as high as 40% to all of them uniformly results in disparities in margins and profitability. Since effective protection cannot be calibrated differently for different refineries, the solution lies in reducing effective protection across board, and selectively compensating refineries that suffer irrecoverable local taxes on crude.

15. Effective protection can be reduced by raising the duty on crude oil or by lowering the duty on products or by a combination of both. Raising the customs duty on crude is inadvisable in view of the Government's declared policy of aligning customs duty to ASEAN levels and of standardizing customs tariffs on bulk commodities at 5% .

16. **Accordingly, the customs duty on crude may be retained at 5%. The customs duty on petrol and diesel should be reduced from the existing rate of 10% to 7.5%. This will reduce the effective rate of protection for refining these two products from the present 40% which is high to a more**

reasonable rate of 20%. Given that PSU refineries are required to produce PDS kerosene, domestic LPG and specified fertilizer inputs, on all of which there is no customs duty, the aggregate effective protection for the refining business as a whole will be less than 20%. Customs duty on industrial products other than petrol and diesel may be retained at 10% in order to protect domestic producers who suffer sales tax as compared to direct importers. However, customs duties on the industrial products should also be reduced to 7.5% if any additional duty is introduced to neutralize the incidence of state level taxes.

17. To compensate refineries that suffer irrecoverable local taxes (referred in para 14 above), the first best solution is to persuade the concerned sate governments/local bodies to withdraw such levies in view of their distortionary impact. If that option fails, the second best option is to encourage the state governments/local bodies to replace the entry tax/octroi by a surcharge on sales tax on finished petroleum products. To the extent the current impost is octroi levied by a local body, the state government can compensate the local body out of the surcharge it collects. It is important to calibrate the surcharge to be equal to the entry tax/octroi so that consumers are not unduly burdened. We reiterate that the most desirable option is to eliminate all such duties.

Restructuring of Excise Duties

18. Currently excise levy on petrol and diesel is a combination of ad-valorem and specific rates. The excise duty on petrol is 8% + Rs.13/litre while the excise duty on diesel is 8% + Rs.3.25/litre. This is inclusive of the cess for road construction. There is an education cess of 2% on top of this. The contribution of the petroleum sector to the total net excise revenues of the Government is of the order of 40%. Moreover, taxes (including sales tax/VAT) and duties constitute a significant proportion of the retail prices - about 55% and 34% of the retail prices of petrol and diesel respectively in Delhi.

19. The wisdom of imposing ad-valorem duties during a time of persistent price increases is debatable. Not only do ad-valorem levies exacerbate the burden on the consumer, but they also result in the Government willy-nilly benefiting through higher tax yields making it vulnerable to the criticism of 'profiting at the expense of consumers'. There is, therefore, need for both softening and smoothing the impact on the consumers of international price variations and for the Government sacrificing 'windfall gains' in revenue. This clearly suggests the need for shifting from the current mix of specific and ad-valorem levies to a pure specific levy.

20. **Accordingly, excise levies on petrol and diesel (inclusive of road construction cess) should be made specific. The indicative levies (rounded off appropriately) at the currently prevailing prices in Delhi work out to Rs.14.75/litre for petrol and Rs.5.00/litre for diesel (details in Attachment 2).**

Education levy, if any, will be on top of this. The rate of specific levy may be reviewed every year as part of the budgetary exercise.

21. Customs and excise levies on petroleum products contribute about 40% of the total customs/excise collections of the Government. This has led to the common refrain that the revenues raised by the Government through levies on petroleum products are high. This, however, has to be seen in the context of the overall revenue requirements of the Government. Taxation of petroleum products lends itself as a convenient means of raising revenues because of the limited scope for leakage. Also high levels of taxation have been advocated as a measure of restraining the consumption of petroleum products and encouraging conservation. In determining the overall taxes on petroleum products, particularly the excise levy, a balance has to be struck across several objectives.

Restructuring Sales Tax

22. Although this report addressed only the issue of excise duty which is a central levy, state level taxes too have been responsible for the pressure on prices of petroleum products. Sales tax collection from oil sector have consistently been contributing to a third or more of the total sales tax collections of the states thereby burdening the consumers as well as building an undesirable dependency at the state level too for revenues on a single sector. Moreover the rates of taxation vary widely – from a minimum of 20% to a maximum of 34% in the case of petrol, and from a minimum of 9% and a maximum of 38% in the case of diesel. Coming on top of what is considered a large incidence of excise duties, heavy sales tax levies lead to a high degree of cascading. The Empowered Committee of State Finance Ministers deliberating on the implementation of VAT should also be entrusted with the task of evolving a uniform policy on sales tax levies on petroleum products.

Petrol and Diesel - Required Price Adjustment

23. The increase in international prices since the last price revision (September 2005) warrants an upward adjustment in the retail prices of petrol and diesel. The required increase for Delhi computed as per the methodology so far used is Rs. 1.67/litre in the case of petrol and Rs. 2.65/liter in the case of diesel. However, the required increase will be lower if the recommendations as above are implemented, Rs. 1.21/litre for petrol and Rs. 1.96/litre for diesel. This will be so as the impact of the first three measures, i.e. shift to trade parity pricing, reduction in customs duty and adjustment of excise duty is to reduce the price. The impact of the withdrawal of the freight equalization arrangement will vary depending on the location.

24. The optimal solution is to make full adjustment in prices and taxes as above. **Should the Government, however, decide not to make the full adjustment on prices, the burden should be borne by it.**

Impact of Suggested Measures on Prices of Petrol and Diesel

Based on international prices prevailing during the period 29.12.2005 to 27.1.2006, the retail selling price in Delhi and Mumbai will need to be adjusted as under:

Product	Price under import parity model	Prevailing price	Proposed price under trade parity model	Required increase if trade parity pricing implemented
	Rupees			
Delhi (without freight equalization)				
Petrol	NA	43.49	44.70	1.21
Diesel	NA	30.45	32.41	1.96
Delhi (with freight equalization)				
Petrol	45.16	43.49	44.37	0.88
Diesel	33.10	30.45	32.08	1.63
Mumbai (without freight equalization)				
Petrol	NA	49.16	49.47	0.31
Diesel	NA	37.57	38.77	1.20
Mumbai (with freight equalization)				
Petrol	50.96	49.16	50.01	0.85
Diesel	40.73	37.57	39.47	1.90

The above calculation factors in the effect of (i) shift to trade parity on an 80:20 import parity/export parity basis; (ii) reduction of customs duty from 10% to 7.5%; (iii) adjustment of excise duty to specific rates; and (iv) termination of freight equalization arrangement. It may be noted that while the impact of the first three measures, i.e. shift to trade parity pricing, reduction in customs duty and adjustment of excise duty is to reduce the price, the impact of the withdrawal of the freight equalization arrangement will vary depending on the location.

Adjustment of Subsidy on Kerosene

25. There is overwhelming evidence, both documented[3] as well as anecdotal, that the policy of giving kerosene at subsidized prices under the PDS to all consumers regardless of their economic status is resulting in waste, leakage, adulteration and inefficiency. **We therefore recommend restricting subsidized kerosene to BPL families.** This will reduce the quantity of PDS kerosene going through the subsidized route by about 40% from the present level.

26. Some states have estimates of BPL households which are higher than those of the Planning Commission. **In computing the quantum of subsidy entitlement of states on PDS kerosene, it is appropriate to use the BPL households estimates of the Planning Commission as it will imply uniform criteria and estimation methodology across states. The subsidy entitlement thus calculated can be passed on to the states at an aggregate level allowing the states flexibility to fine-tune their own subsidy schemes.** It has been reported that states are unwilling to accept this arrangement and are agitating for subsidy entitlement based on their own higher BPL household estimates. There is no case for acceding to this plea as states have already accepted this principle of calculating subsidy entitlement for PDS foodgrains.

27. Restricting subsidized kerosene only to BPL households inevitably implies dual pricing which, as experience shows, is easily amenable to misuse, leakage and diversion, and consequent growth of vested interests. The Ministry of Petroleum is working on several solutions to arrest, or at any rate minimize, these malpractices. Such measures include different fuel colours for PDS and non-PDS kerosene, different sizes and types of packaging etc. These efforts should be pursued.

28. However, the only fool proof mechanism for preventing leakages and diversion is to move towards a system of a single price at the point of retail sale for all consumers with the subsidy being passed on to BPL consumers through alternate mechanisms. Suggestions in this regard have included cash transfers to eligible beneficiaries through coupons or bank transfers or delivery of subsidy through smart debit cards. Each of these options has its strengths and weaknesses. The coupon system would require the establishment of well-defined entitlements and sound systems to ensure that the system is not open to frauds. Bank transfer of subsidy is a neat arrangement in theory but could be complex in practice considering the number of accounts to be serviced, the logistics of servicing so many accounts and the transaction costs to beneficiaries in managing their accounts. Moreover, the system of bank transfers de-links the consumption of kerosene from the claim of subsidy. Smart cards are a technology option which will aid not only disbursement of subsidy but also maintenance of a data bank on the beneficiaries, their consumption patterns and

[3] A recent report of NCAER estimates that 38% of the PDS kerosene is diverted for non-PDS use. “Comprehensive Study to Assess the Demand and Requirement of SKO”, NCAER, October 2005.

transaction histories. However, the main inhibiting factor will be the logistics of technology back-up support.

29. Even as there are technology and governance issues in operationalizing a suitable mechanism, they are not insurmountable, and efforts must be made to evolve a suitable scheme. A substantial portion (estimated at 60%) of PDS kerosene is used for lighting. In view of the enhanced programme for rural electrification (Rajiv Gandhi Grameen Vidyuthikaran Yojana), the need for subsidizing kerosene over the medium term needs to be reviewed.

Rationalizing Price of Domestic LPG

30. The subsidy regime in domestic LPG is by far the most egregious and distortionary of all the subsidies in the oil sector. The issue price of domestic LPG is Rs. 236/cylinder (corresponding to retail price of Rs. 294/cylinder) as against the cost price of Rs. 407/cylinder implying a subsidy of Rs. 171/cylinder. This translates, at the aggregate level, to a subsidy of over Rs.11,000 crores. Moreover it is estimated, albeit heuristically, that BPL households constitute only about 10% of the total domestic LPG consumers. Providing subsidy of this order to what is overwhelmingly a non-poor segment of the society, especially in the context of fiscal stringency, is clearly indefensible.

31. Removing the subsidy on domestic LPG is an urgent imperative. **We recommend an immediate one-time upward adjustment in the price of domestic LPG by Rs.75/cylinder.** This will reduce the annual burden of subsidy by Rs.4,500 crores. Beyond this one-time increase, it is necessary to gradually increase the price of domestic LPG so that the retail price adjusts completely to the market level eliminating the subsidy altogether. It needs to be emphasized that currently there are no central taxes or duties levied on domestic LPG.

Revised Burden of Subsidy

32. If the trade parity prices for petrol and diesel are allowed to operate (i.e. without being repressed as is being done now), there will be no subsidy burden on their account. Restricting the subsidy on kerosene to BPL households will reduce to subsidy burden by Rs.6,315 crores, and increasing the price of domestic LPG by Rs.75/cylinder will reduce the subsidy by a further Rs.4,414 crores.

33. The annual gross subsidy on kerosene and LPG is Rs. 26,604 crores (at 2005/06 prices). This will go down to Rs. 15,875 crores on account of the measures suggested in para as per details in paras 25 and 31 as per details below:

Table 1: Revised Burden of Subsidy on Petroleum Products

Item	Domestic LPG	PDS Kerosene	Total
Gross annual subsidy burden under the current scheme	11,276	15,328	26,604
Reduction in subsidy on account of restricting subsidy on PDS kerosene only to BPL	-	(-) 6,315	(-) 6,315
Reduction in subsidy on account of increase in prices of domestic LPG by Rs. 75/cylinder	(-) 4,414		(-) 4,414
Balance burden of subsidy	6,862	9,013	15,875

Burden Sharing

34. The next issue is funding subsidy of the order of Rs. 15,875 crores. Since oil marketing companies should be freed of the burden of subsidy, the other avenues open to funding the subsidy are budgetary support from the Government and support from ONGC/OIL.

35. So far as the Government is concerned, the quantum of budgetary support should be explicit and transparent. **The cost of subsidy should be met through current provisioning without any recourse to oil bonds. The practice of issuing oil bonds is strictly inadvisable as it does not resolve the problem; it only postpones the resolution while compounding the economic and financial costs.**

36. So far as ONGC/OIL are concerned, they are currently bearing the burden of subsidy through two routes. First, it is paying a cess levied under the provisions of the OIDB Act at the rate of Rs.1,800/MT which yields revenue to the Government of the order of Rs.5,000 crores. Second, ONGC/OIL are contributing Rs.13,000 crores as upstream subsidy to the oil companies. Requiring ONGC/OIL to make 'upstream contributions' is not a neat arrangement as it runs counter to both PSU autonomy and accounting for tax purposes. Fiscal integrity demands that all the support required to be borne by ONGC/OIL should come as cess, be accounted for in the consolidated fund and then allocated for funding the subsidy. **It will therefore be appropriate for the Government to determine the quantum of subsidy to be borne by ONGC/OIL up front and collect it by suitably adjusting the rate of cess.** By showing a one to one correspondence between the receipt of levy from ONGC/OIL and allocation of the same for meeting a part of the subsidy, the Government will be able to establish the necessary nexus between levies and subsidies and protect itself from criticism that funds meant for the oil sector have been diverted for other uses.

37. The proposed scheme of financing the subsidy will be as follows:

Table 2: Burden Sharing of Subsidy

		Rs crores
(i)	Cess from ONGC/OIL routed through the budget	12,975[4]
(ii)	Explicit subsidy from the Government	2,900
	Total	15,875

Impact of Burden Sharing

38. The net impact of the above scheme of funding will be as follows:

39. So far as the Government is concerned, the cash subsidy from its own account will be Rs. 2,900 crores, exactly the amount provided for in the budget for 2005/06. The Government is presently collecting cess of Rs. 5,000 crores from ONGC/OIL (@ Rs. 1,800/MT) which is pooled in the consolidated fund without explicitly being allocated for meeting oil subsidy. The Government will forfeit the benefit of this as this amount is now subsumed under the increased cess from ONGC/OIL under item (i) in Table 2 above.

[4] This amount of Rs. 12,925 crores subsumes the cess of Rs. 5,000 crores presently being paid @ Rs. 1,800/MT.

40. The comparative position of ONGC/OIL will be as follows:

Table 3: Net Impact on ONGC

(Rs crores)

		Present	Proposed	Gain/Loss
(i)	OIDB cess	5,000	12,975	(-) 7,975
(ii)	Upstream contribution	13,000	-	(+) 13,000
		18,000	12,975	(+) 5,025

41. As indicated above, ONGC will see its burden of subsidy reduced by Rs. 5,025 crores. The above arrangement will also imply raising the cess from ONGC/OIL from the present rate of Rs. 1,800/MT to Rs. 4,800/MT.

Medium Term Issues

42. Two medium term issues in promoting efficiency in oil refining and use that need to be addressed are the following:

- Historically, there has been a wide variation in the excise duty on petrol and diesel in our country. For example, the current excise duty is Rs.14.64/litre on petrol and Rs.4.97/litre on diesel. This is contrary to world wide trends where the excise levies on both products are more or less equal. Indeed, in some countries, diesel is costlier than petrol. The contrarian trend in our economy leads to inefficient substitution of one fuel for another.

- Some of the PSU refineries, particularly those in the east and the north-east, are of uneconomic size and have outdated technology. Their viability is critically dependent on tariff protection and fiscal concessions. Our policy framework over the medium term must be designed to encourage investment in modernization and optimal location.

Summing Up

43. The recommendations made in this report can be divided broadly into three groups.

44. The first set of recommendations relating to pricing of petrol and diesel are the following: (i) shift to a trade parity pricing formula for determining refinery gate as well as retail prices; (ii) Government to keep at arms length from price determination and to allow flexibility to oil companies to fix the retail price under the proposed formula; and (iii) reduce effective protection by lowering the customs duty on petrol and diesel to 7.5%. This set of recommendations should be implemented as an integrated package as selective implementation will create more distortions.

45. The second set of recommendations relates to pricing of domestic LPG and PDS kerosene, viz: (i) restrict subsidized kerosene to BPL families only; (ii) raise the price of domestic LPG by Rs. 75/cylinder; (iii) discontinue the practice of asking ONGC/GAIL/OIL to provide upstream assistance, but instead collecting their contribution by raising the OIDB cess from the present level of Rs. 1,800/MT to Rs. 4,800/MT; and (iv) Government meeting the balance cost of subsidy from the budget. The 'PDS Kerosene and Domestic LPG Scheme 2002' will have to be suitably amended for this purpose. This set of recommendations should also be implemented as an integrated package as partial implementation will not yield sustainable results.

46. The third set of recommendations relates to restructuring excise duties from the present mix of specific and ad-valorem to a pure specific levy and calibrating the levies at Rs. 5.00/litre of diesel and Rs. 14.75/litre of petrol.

47. We urge the Government to take immediate action to implement all three sets of recommendations. We want to reiterate what we said earlier that should the Government decide not to implement any of the measures recommended here, the burden thereof should be borne by the Government without shifting the same to the oil sector. If no action is taken, and the Government is unable to provide the required subsidies, the financial position of the public sector oil companies will deteriorate rapidly, jeopardizing the country's energy security and compromising our prospects for growth.

Attachment 1

IMPACT OF WITHDRAWAL OF INLAND FREIGHT EQUALIZATION ARRANGEMENT ON PRICES AT LOCATIONS ACROSS THE COUNTRY

	PETROL	DIESEL
NORTH		
NEW DELHI	0.51	0.55
AMBALA	0.69	0.75
CHANDIGARH	0.75	0.79
DEHRADUN	0.53	0.63
JAIPUR	0.14	0.15
JULLUNDER	0.72	0.72
JAMMU	0.89	0.97
LUCKNOW	0.15	0.16
SHIMLA	0.97	0.98
SRINAGAR	1.60	1.62
EAST		
KOLKATA	(0.20)	(0.24)
AGARTALA	0.17	0.19
AIZWAL	0.35	0.34
BHUBHANESWAR	(0.43)	(0.53)
GANGTOK	0.36	0.31
GUWAHATI	(0.44)	(0.51)
IMPHAL	0.43	0.32
ITANAGAR	0.29	0.29
KOHIMA	(0.19)	(0.25)
PATNA	0.03	0.01
PORT BLAIR	(0.36)	(0.46)
RANCHI	(0.21)	(0.25)
SHILLONG	(0.25)	(0.31)
WEST		
MUMBAI	(0.45)	(0.59)
AHMEDABAD	(0.15)	(0.19)
BHOPAL	0.20	0.23
PANJIM	(0.14)	(0.19)
RAIPUR	(0.16)	(0.20)
SOUTH		
CHENNAI	(0.45)	(0.55)
BANGALORE	(0.27)	(0.31)
HYDERABAD	(0.46)	(0.52)
PONDICHERRY	(0.41)	(0.51)
TRIVANDRUM	(0.27)	(0.34)

Attachment 2

SHIFTING EXCISE TO PURE SPECIFIC LEVY

STATEMENT SHOWING EXISTING PRICE BUILD UP		
DELHI	**Petrol**	**Diesel**
	Rs./KL	
Assessable value	20,423.14	21,448.46
Excise duty @ 8%+Rs 13/Ltr	**14,633.85**	
Excise duty @ 8%+Rs 3.25/Ltr		**4,965.88**
Education cess @ 2%	292.68	99.32
Delivery charges from depot to retail outlet	44.00	44.00
Sales tax @ 20% / 12.5% (incl. on commission)	7,248.33	3,383.33
Dealers commission	848.00	509.00
Retail selling price	43,490.00	30,449.99
Retail selling price (Rs./Ltr.)	43.49	30.45
MUMBAI	**Petrol**	**Diesel**
Assessable value	21,344.97	21,773.77
Excise duty @ 8%+Rs 13/Ltr	**14,707.60**	
Excise duty @ 8%+Rs 3.25/Ltr		**4,991.90**
Education cess @ 2%	294.15	99.84
Delivery charges from depot to retail outlet	44.00	44.00
Sales tax @ 30% / 34% + Re 1/Ltr	11,917.22	10,149.23
Dealers commission	848.00	509.00
Retail selling price	49,155.94	37,567.74
Retail selling price (Rs./Ltr.)	49.16	37.57

Note:

The burden of excise duty under the current structure of ad-valorem and specific rates implicit in the retail selling price at Delhi is given below:

	Incl. Education cess	**Excl. education cess**
	Rs per litre	
Petrol	14.93	14.64
Diesel	5.07	4.97

These are the indicative specific levies rounded of to Rs 14.75/litre and Rs 5.00 /litre on petrol and diesel respectively.

Acknowledgements

The Committee wishes to place on record its appreciation for the following officials who assisted it in its deliberations and in the drafting of the report.

Ministry of Petroleum and Natural Gas

Shri Prabh Das	Joint Secretary
Shri V.P.Joy	Director

Ministry of Finance

Shri R. Sekar	Joint Secretary (TRU)
Shri K.L.Prasad	Additional Economic Adviser

PPAC

Shri Ram Singh	Director
Shri Rajiv Bakshi	Additional Director
Shri K Rajeswara Rao	Additional Director

PM's Economic Advisory Council

Dr. D. Subbarao	Secretary
Shri T.R. Meena	Director

Annexures

Annexure I

Terms of Reference and Meetings of the Committee

1. The Government on 26th October 2005 had set up a committee to look into the various aspects of pricing and taxation of petroleum products with a view to stabilizing/rationalizing their prices, keeping in view the financial position of the oil companies, conserving petroleum products, and establishing a transparent mechanism for autonomous adjustment of prices by the oil companies. The composition of the expert committee was as follows:

1.	Dr. C. Rangarajan Chairman, PM's Economic Advisory Council	Chairman
2.	Dr. Kirit S. Parikh Member, Planning Commission	Member
3.	Shri Saumitra Chaudhuri Chief Economist, ICRA	Member
4.	Dr. Ashok Lahiri Chief Economic Adviser Ministry of Finance	Member
5.	Prof Bakul H. Dholakia Director, IIM, Ahmedabad	Member
6.	Secretary Ministry of Petroleum and Natural Gas Shri SC Tripathi (till 31st December 2005) Shri MS Srinivasan (from 1st January 2006)	Member

2. The committee was required to submit its report within six months.

3. Based on the deliberations in the meetings, the following three areas were identified by the committee for detailed study in order to meet the objectives set out in the terms of reference:

1. Alternative models for pricing of petroleum products
2. Taxes and duties on crude oil and petroleum products
3. Subsidies on PDS kerosene and domestic LPG

4. The committee also met with all the major oil companies, namely IOC, HPC, BPC, ONGC, OIL in the public sector and Reliance Industries, Essar Oil

and Shell (India) in the private sector on 26th December 2005. The Committee also met the All India LPG distributors Federation and Shri Dipankar Mukherjee, MP on 31st January 2006. Besides these meetings, the committee had a number of internal deliberations.

Annexure II

Structure of the Petroleum Sector

Present domestic scenario

1. The Indian Oil and Gas industry can broadly be divided into three sub-sectors:-
   1. Oil and Gas Exploration and Production
   2. Oil Refining and Marketing
   3. Gas Transportation and Marketing

2. The major players in each of these sub sectors are detailed below.

Oil and Gas Exploration and Production

3. Oil and Natural Gas Corporation Limited (ONGC) and Oil India Ltd. (OIL), the two national oil companies (NOCs), apart from private and joint-venture (JV) companies like Reliance, Cairn Energy, British Gas, Essar Oil, Videocon, Prize Petroleum (HPC has a 50% stake in Prize Petroleum) etc, are engaged in the exploration and production (E&P) of oil and natural gas in the country. ONGC Videsh Limited (OVL) which is a wholly owned subsidiary company of Oil & Natural Gas Corporation Ltd. and IOC-OIL JV are undertaking overseas projects for exploration and production of hydrocarbons in order to augment the oil security of the country. Details of domestic crude oil and natural gas production during the current year and last 3 years are given in the table below:

Crude oil Production

(Unit: Million Metric tonnes)

Company	2002-03	2003-04	2004-05	April-Dec'05
ONGC	26.04	26.03	26.63	18.22
OIL	2.95	3.03	3.21	2.46
Pvt./JV	4.09	4.31	4.30	3.36
Total	33.08	33.37	34.14	24.04

Natural Gas Production

(Unit: Million metric standard cubic meters per day)

Company	2002-03	2003-04	2004-05	April-Dec'05
ONGC	66.42	64.61	62.97	46.28
OIL	4.78	5.17	5.49	4.67
Pvt./JV	14.81	17.78	18.58	15.06
Total	86.01	87.56	87.05	66.01

Source: PPAC/MOP&NG

4. This shows the dominant share of ONGC in the crude oil production which has remained stagnant.

Oil Refining

5. At present, there are 18 refineries operating in the country, 17 in Public Sector and 1 in Private Sector, the latter belonging to Reliance Industries Limited. Details of the installed capacity of refineries as on 1.2.2006 are given below:

INSTALLED CAPACITY OF REFINERIES

Unit : Capacity Million metric tones per annum (MMTPA)

No.	Refinery	Capacity
IOC Group		
1.	Guwahati	1.0
2.	Barauni	6.0
3.	Koyali	13.7
4.	Haldia	6.0
5.	Mathura	8.0
6.	Digboi	0.65
7.	Panipat	6.0
8.	CPCL-Chennai	9.5
9.	CPCL-Narimanam	1.0
10.	Bongaigaon	2.35

No.	Refinery	Capacity
BPC Group		
11.	BPC-Mumbai	12.0
12.	KRL-Kochi	7.5
13.	NRL-Numaligarh	3.0
HPC Group		
14.	HPC-Mumbai	5.5
15.	HPC-Visakh	7.5
ONGC Group		
16.	MRPL-Mangalore	9.69
17.	ONGC-Tatipaka	0.08
Total PSU		99.47
18.	RIL-Jamnagar	33.0
Grand Total		132.47

Source: PPAC

6. The private sector's share of refining capacity, at 26%, is quite significant and stands at about 26%. The domestic refining industry has been able to cater to the demand for all products except for Liquefied Petroleum Gas (LPG). In fact, the availability of products like petrol, diesel and Aviation Turbine Fuel (ATF) was in excess of the domestic requirements and such products were exported during the year. The details of imports and exports during 2004-05 are given below:

IMPORTS AND EXPORTS

Million Metric Tonnes (MMT)

	Crude Oil Import	Products Import	Gross Imports	Product Exports	Net Imports
2004-05 (Total)	95.861	8.827	104.688	18.211	86.477
-Public Sector	64.508	3.806	68.314	7.961	60.353
-Private Sector	31.353	5.021	36.374	10.250	26.124

Rs. '000 Crore

	Crude Oil Import	Product Import	Gross Import Bill	Product Export	Net Import Bill
2004-05 (Total)	117.00	14.89	131.89	29.93	101.96
-Public Sector	81.86	7.13	88.99	12.33	76.66
-Private Sector	35.14	7.76	42.90	17.60	25.30

Source: PPAC

7. As may be observed from the above table, significant amount of imports and exports are to the account of the private sector.

8. The refineries sector is facing challenges on account of substantial investments for meeting new environmental norms, technology up-gradation and high import dependency of about 76% on crude oil.

Oil Marketing

9. At present, there are four PSUs namely, IOC, HPC, BPC and IBP (subsidiary of IOC) marketing oil products in the country. In addition, certain private players like Reliance, Essar and Shell have also been granted marketing rights for transportation fuels. Their marketing presence today, however, is not significant and is limited to about 1370 outlets out of total retail outlet strength of about 29,380 as on 1.11.2005. Some additional players like ONGC, who have also been granted marketing rights for transportation fuels, are in the process of setting up retail outlets to integrate across the entire hydrocarbon value chain. The company-wise market share in sales is tabled below:

MARKET SHARE

Company	Market Share (Percentage) (April-Dec'05)
IOC/AOD	42.2
IBP	4.0
IOC Group	46.2
BPC	18.6
HPC	16.5
Other PSUs	2.2
Total PSUs	**83.5**
Private	16.5
Total	**100.0**

Source: PPAC

10. It is evident that the share of the private sector in meeting total consumption of refined petroleum products presently stands at around 15%. This proportion is however, expected to grow significantly in the coming years.

Gas Transportation and Marketing

11. GAIL (India) Limited, is primarily a Natural Gas company, focused on all aspects of the gas value chain including exploration, production, transmission, extraction, processing, distribution and marketing of Natural Gas and its related processes, products and services. Some of the major joint Ventures Companies of GAIL are Mahanagar Gas Limited (supplying piped gas to domestic consumers, small commercial/ industrial consumers and supplying CNG to

vehicles in Mumbai), Indraprastha Gas Limited (supplying piped gas to domestic consumers, small/large commercial consumers and CNG to vehicles in Delhi).

12. LNG terminals have been set up at Dahej in Gujarat by Petronet LNG and by Shell at Hazira in Gujarat. There are plans for further augmentation of LNG terminals in the country.

Evolving future scenario

13. The total investment in exploration now stands at about US $5 billion. Twenty exploration blocks have been awarded under the fifth round of NELP. However, a large part of sedimentary area of the country is yet to be explored. Even as private participants partner in the exploration process, a very large part of the effort will continue to devolve on ONGC and OIL and they will need to have the financial resources to develop oil assets both at home and abroad.

14. Refining in the private sector is already substantial and is expected to increase in the future with capacity additions in Reliance refinery and commissioning of new grass root refineries at Jamnagar in Gujarat by Essar group and at Cuddalore in Tamilnadu by Nagarjuna Group. There are plans to set up a refinery at Bhatinda by HPC-BP JV, Bina by BPC and Paradeep by IOC. In order to encourage efficiency and investments in the sector and to ensure a fair price to consumers, it is necessary to move price formation towards a competitive market structure.

15. On the marketing front, the participation of the private sector is expected to become significant with the grant of marketing rights for automotive (transportation) fuels to Reliance, Essar, Shell etc. This would call for rational pricing policies for major petroleum products like petrol and diesel so that private investment and competition is encouraged.

Annexure III

Recent changes in Pricing and Taxation of petroleum products

1. The trend in the international prices of Indian basket of crude oil and sensitive petroleum products for the years 2002-03, 2003-04 and 2005-06 compared with increase in domestic prices is depicted below:

Trend in the international oil prices & domestic prices

Period	Crude oil (Indian Basket) $/bbl	Petrol $/bbl	Diesel $/bbl	Kerosene $/bbl	LPG $/MT
March 2002	23.31	26.43	23.27	23.65	194.00
2002-03	26.66	30.15	28.93	29.33	280.40
2003-04	27.96	35.03	30.48	31.19	278.45
2004-05	39.22	49.01	46.91	49.50	368.52
2005-06 (upto 15/2/06)	55.36	63.83	63.94	69.01	480.09
Percentage Increase in international prices in 2005-06 over Mar'02	137.5%	141.5%	174.8%	191.9%	147.5%
Percentage Increase in current retail price over Mar'02 ***(Delhi retail prices considered)***	-	63.9%	83.5%	0.8%	22.6%

Note: Indian basket comprises price of Brent (dated) and Oman/Dubai average in the ratio of 43:57 upto 2004-05 & 42:58 for 2005-06.

2. With the import dependence of domestic refineries as high as 76% for their crude oil requirement and with the dismantling of APM for petrol and diesel and shift over to import parity pricing in April 2002, the impact of rising international prices were not fully reflected in domestic selling prices. Despite the increase in the international prices, the selling prices of petrol and diesel were not revised by the oil marketing companies (OMC's) in line with international prices during January to June 2004. Similarly, the basic prices of domestic LPG and PDS kerosene remained largely unrevised since 2002, despite the steep increase in crude prices.

3. While passing on the entire impact of the steep increase in the oil prices to the consumers would have resulted in steep increase in the domestic prices, the Government took certain measures in favour of vulnerable sections of the

economy, by ensuring that the burden was shared between Government, the oil marketing companies (OMC's), and consumers:

4. Reduction/Changes in Central taxes

- The excise duties on petrol were scaled down from 30% to 26%, on diesel from 14% to 11% and on LPG from 16% to 8% effective June 16th 2004.
- Effective 19th August 2004, further reduction in excise duties on refined products was given effect to. The applicable excise duty on petrol was lowered from 26% to 23% and that on diesel brought down from 11% to 8%. This was combined with reduction in the customs duty on petrol and diesel from 20% to 15%. Similarly, excise duty on PDS kerosene was scaled down from 16% to 12% and customs duty on LPG and Kerosene from 10% to 5%.
- Effective 1st March 2005, the customs and excise duty on PDS Kerosene and LPG for domestic use were reduced to zero.
- Effective 1st March 2005, the customs duty on petrol and diesel were reduced from 15% to 10% and that on crude oil brought down from 10% to 5%. The customs duty on aviation turbine fuel (ATF), furnace oil (FO) [for general use], low sulphur heavy stock (LSHS) [for general use] and bitumen were reduced from 20% to 10%. Customs duty on Naphtha, FO and LSHS for fertilizer use continued to remain NIL. The resultant loss of tax revenue was neutralised by way of increase in the excise duties on petrol and diesel. Accordingly, the excise duty on petrol was revised from 23% plus Rs.7.50 per litre to 8% plus Rs.13.00 per litre (from Rs 12.07 per litre to Rs 14.59 per litre) and on diesel from 8% plus Rs.1.50 per litre to 8% plus Rs.3.25 per litre (from Rs 3.15 per litre to Rs 4.80 per litre)

Price band mechanism for petrol and diesel

5. Greater flexibility to OMC's to allow for autonomous adjustments in prices of petrol and diesel were sought to be provided. Effective 1st August 2004, the revised methodology, allowing oil companies limited freedom to revise the prices of petrol and diesel within a reasonable price band was put in place. The concept of price band was based on the principles of rolling average prices of these products in the international markets. Accordingly, oil companies were permitted to carry out autonomous adjustments in prices within a band of +/- 10% of the mean of rolling average C&F prices of last 12 months and last quarter, i.e. three months. In case of breach of this band, the OMCs were to approach the Ministry of Finance through MOP&NG to modulate the excise duty rates so that the spiraling prices prevailing in the international markets do not cause undue hardships to the consumers. However, consequent to further rise in the international prices the price band approach was given up.

Loss Sharing with Upstream PSU companies

6. A larger share of the losses of public sector OMCs on account of domestic LPG and PDS kerosene, petrol and diesel were passed on to be absorbed by upstream companies, namely, ONGC, OIL and GAIL.

7. Upward adjustment in retail selling prices

- Effective 16th June 2004, the OMCs were allowed a moderate increase in prices of petrol by Rs 2.00/litre, diesel by Re 1.00/litre and LPG by Rs.20 per cylinder. This was coupled with reduction in excise duties.
- Effective 1st August 2004, the retail price of petrol was increased by Rs 1.10 per litre and for diesel by Rs 1.42 per litre.
- Effective 5th November 2004, the price of domestic LPG was increased by Rs 20 per cylinder, the price of petrol was increased by Rs 2.19 per litre while the price of diesel was increased by Rs 2.12 per litre.
- Effective 21st June 2005, the price of petrol was increased by Rs 2.50 per litre while the price of diesel was increased by Rs 2.00 per litre.
- Effective 7th September 2005, prices of petrol and diesel were increased, by Rs 3.00/litre and Rs 2.00/litre at Delhi.
- The selling price of Kerosene (PDS) has remained untouched since 2002.

Financial repercussions

8. In consequence of the non-revision of petrol and diesel, and even more so of PDS kerosene and domestic LPG, the profitability of oil companies were eroded in 2004/05 and 2005/06. In the current financial year (2005/06) the financial position of the PSU oil refining and marketing companies have come to such a pass that they would make huge losses, were it not for transfers from upstream companies and subsidies from the Government. This is evident from the data on profit after tax given below:

Profit After Tax from Financial Years 2001-02 to 2004-05 and April-Dec'05 – PSUs

					(Rs/Crore)
Company	**2001-02**	**2002-03**	**2003-04**	**2004-05**	**2005-06**
					April-Dec'05
UPSTREAM OIL COS					
ONGC	6197.88	10529.30	8664.40	12983.05	11344.89
OIL	525.22	916.73	949.70	1061.70	1354.53
GAIL	1185.83	1639.00	1869.34	1953.91	1900.81
Sub Total	**7908.93**	**13085.03**	**11483.44**	**15998.66**	**14600.23**
INTEGRATED OIL COS.					
IOC	2884.66	6114.89	7004.82	4891.38	889.66

					(Rs/Crore)
Company	**2001-02**	**2002-03**	**2003-04**	**2004-05**	**2005-06**
					April-Dec'05
HPC	787.98	1537.36	1903.94	1277.33	-1607.78
BPC	849.83	1250.03	1694.57	965.80	-1658.60
IBP	195.79	87.75	214.66	58.87	-520.83
Sub Total	**4718.26**	**8990.03**	**10817.99**	**7193.38**	**-2897.55**
STAND ALONE REFINERIES					
KRL	68.77	456.00	555.09	842.12	220.60
MRPL	-492.48	-411.81	459.42	879.76	401.10
NRL	122.98	174.63	214.95	409.15	273.65
CPCL	63.71	302.89	400.05	596.97	451.70
BRPL	-198.61	178.45	303.74	478.30	144.11
Sub Total	**-435.63**	**700.16**	**1933.25**	**3206.30**	**1491.16**
TOTAL- PSU	**12191.56**	**22775.22**	**24234.68**	**26398.34**	**13193.84**

9. The oil companies have reported their financial distress in terms of "under-recoveries" with respect to the import parity formula that has been in use ever since the end of the APM regime.

Reported "under-recoveries" of the PSU-OMC

As per import parity formula and prevalent customs duties

Unit: Rs in Crore

Product	**2003-04**	**2004-05**	**April-Mar'06 (Est.)**
PDS Kerosene	3,751	9,480	14028*
Domestic LPG	5,523	8,362	9,676*
Total on PDS Kerosene and Domestic LPG	9,274	17,842	23,704*
On petrol and diesel	nil	2,304	16,000
Total	**9,274**	**20,146**	**39,704**

Note: Gross under recoveries before considering upstream & refinery discounts but after netting out subsidy provided in Union Budget. * Gross subsidy (before fiscal subsidy) is Rs 15,328 crore and Rs 11,276 crore for PDS kerosene and domestic LPG respectively amounting to a total of Rs 26,604 crore. *Source:* Provided by MOP&NG

10. The upstream oil companies have been contributing large sums under the extant arrangement of loss-sharing evolved by Government. The year-wise contribution from 2004/05 onwards is below:

*Uni*t: Rs in Crore

	2003-04	2004-05	2005-06 (Apr-Dec) (Provisional)
Upstream oil companies			
ONGC	2,695	4,104	8,549
GAIL	428	1,137	526
OIL	nil	706	676
Total	**3,123**	**5,947**	**9,751**

Source: Provided by MOP&NG

11. In addition, the oil marketing companies have sought to obtain discounts on the import parity price (i.e. obtain lower prices) for sensitive petroleum products supplied by the refineries including private refineries. These are, however, *ad hoc* measures and may not be sustained over a longer period of time.

Annexure IV

Evolution of the Pricing Mechanism

1. Regulation of oil prices was first attempted in India when the Valued Stock Account (VSA) procedure was agreed between the Government and Burmah Shell in 1948. In the 1960's, various committees namely the Damle Committee, 1961, Talukdar Committee, 1965 and the Shantilal Shah Committee, 1969 were appointed by the Government to recommend the pricing modalities for petroleum products in India. These committees recommended prices to be determined on principles of import parity. Ceiling selling prices were recommended for various petroleum products. Subsequently, in 1974, the Government appointed an Oil Prices Committee (OPC) headed by K. S. Krishnaswamy. This committee recommended discontinuation of the import parity basis and a shift-over to determination of the prices of major petroleum products on "cost plus basis" which came to be commonly known as the Administered Pricing Mechanism (APM). The regime recommended by OPC was amended by Oil Cost Review Committee (OCRC), 1984 headed by J. S. Iyer wherein the basis of compensating return was amended from a flat rate on the capital employed to 12% post tax return on net-worth and weighted cost of borrowings. The main features of the APM were as follows:-

   (a) National crude oil producing companies namely ONGC and OIL were allowed operating cost plus 15% post tax return on capital employed for indigenous crude oil production. Capital employed represents the sum total of net fixed assets (gross block of fixed assets less depreciation) and normative working capital.

   (b) Oil refineries, pipelines and marketing companies were allowed operating cost and return on capital employed. Capital employed was bifurcated into net-worth and borrowings. Net-worth was taken from the balance sheet as the sum total of equity capital and free reserves. The balance capital employed was considered as borrowings. On the net worth portion, return @ 12% post tax was provided whereas the average actual rate of interest was provided on the borrowings.

   (c) Subsidisation of consumer prices of certain products like Kerosene for public distribution and Domestic LPG by cross-subsidisation from certain products like Petrol, Aviation Turbine Fuel (ATF), etc., and indigenous crude oil.

   (d) Uniform prices of each administered petroleum product at all refinery locations by equalizing all costs like cost of crude oil, freight, margins to oil companies etc.

   (e) It ensured stable prices so that the domestic market is insulated from the volatility of prices in the international market.

2. The above objectives were achieved through the operation of the Oil Pool Account which was used to adjust the variation in various elements of costs. The Government in January, 1995 had appointed a Strategic Planning Group on Restructuring of the Oil Industry ('R' Group) comprising eminent experts from the Public Sector and Private Sector, distinguished energy experts and academicians to make recommendations to meet the policy objectives and initiatives required for restructuring the oil industry. The 'R' Group had recommended the gradual phasing out of APM and introduction of free marketing mechanism due to following reasons:

- APM can not generate sufficient financial resources required for investments in the upstream and down stream sectors.
- Private Capital as well as foreign direct investment would not be forthcoming in view of the inherent regulatory controls imposed by the government.
- APM does not provide strong incentives for investments in technological upgradations or for cost minimization.
- APM has not been completely successful in achieving the primary objective of ensuring a consumer friendly and internationally competitive vibrant petroleum sector capable of global presence to provide energy security to the country.
- Since all costs are reimbursed, there is no incentive to make profitable investments. Therefore, cost plus formula breeds inefficiencies.
- With the entry of the private sector, the cost plus formula will encourage 'gold plating' of the plant and inflate costs which the consumer would have to bear.
- The subsidies and cross subsidies have resulted in wide distortions in the consumer prices and do not reflect economic cost of petroleum products, which are not being passed on to consumers automatically. This in turn has led to inefficient use of precious fuels and large-scale misuse of highly subsidized products.

3. The Government constituted an Expert Technical Group in June 1996 comprising representatives from various ministries like Finance (DEA), Planning Commission, BICP etc. to examine the impact on various sectors at different levels of duty structure in case of dismantling of APM. The report of the Expert Technical Group had dealt with phased movement to Market Determined Pricing Mechanism (MDPM) and rationalization of customs tariff and excise duty rates in respect of dismantling of APM along with its impact on various other sectors.

4. In September, 1997 the Government decided "in principle" to dismantle the APM in a phased manner based on the recommendations of the Strategic Planning Group on Restructuring of the Oil Industry ('R' Group). Thereafter, in November 1997, the Government announced the details of the phased programme for dismantling of APM after taking into account the recommendations of the Expert Technical Group (ETG) which dealt with phased

movement to Market Determined Pricing Mechanism. The cost plus approach and a pre determined margin on net worth formula did not encourage oil producers as ONGC and GAIL to invest their internal resources on high risk high reward sedimentary basins, including frontier areas, to develop oil and gas reserves from marginal fields or to introduce enhanced oil recovery techniques that will maximize country's hydrocarbon wealth. In order to sustain the accelerated exploration and production efforts essential future oil security, public sector crude oil producers needed to be freed from Government controlled pricing mechanism so that they can get international prices for their production.

5. The Government had accordingly initiated the phased programme for dismantling of Administered Pricing Mechanism (APM) from April, 1998 with a view to attract investment in the Petroleum Sector to meet the growing demand, and to promote competition, efficiency and better customer service. Effective 1.4.2002, the APM has been fully dismantled. The oil companies made frequent revisions in the selling prices of petrol and diesel during 2002 and 2003 when the international prices were fairly stable. However, the years 2004 and 2005 have witnessed sharp and spiraling increase in International prices of crude oil and petroleum products. The impact of such phenomenal price increase in the International market is bound to have major impact on Indian Oil Industry which is heavily dependent on imports for crude procurement. To insulate the end consumers, it was decided that the share of burden should be equitably divided between various stakeholders i.e. Government, Oil Companies and consumers. Moderate increases in retail prices coupled with customs and excise duty reductions on Petrol, diesel, PDS kerosene and domestic LPG have been carried out.

Annexure V

Subsidies on PDS kerosene and Domestic LPG

1. In a gazette notification issued in November 1997, the Government set a timetable for the gradual phasing of subsidies on PDS kerosene and domestic LPG. The stated policy called for the retention of price subsidies @ 33.3 percent for kerosene and 15 percent for LPG for household use. The subsidy phasing was originally planned to be completed by the time of sector deregulation in April 2002. However, the Government later decided that the subsidy on domestic LPG and PDS kerosene would be provided on a specified flat rate basis from the Consolidated Fund from April 1, 2002. After providing for this subsidy, the retail prices were to vary as per changes in the international prices. These subsidies were to be phased out in three to five years, and in terms of a decision taken by the Government in March 2005, subsidy at 1/3rd of the level applicable for 2002-03 would now continue till 31.3.2007.

2. The Government however did not allow the oil companies to increase the prices of PDS kerosene and domestic LPG in tune with the international prices since 2002-03. The Government has further decided that a portion of the under recoveries on sensitive products be shared by the upstream oil companies. The upstream companies have contributed Rs 3,123 crore and Rs 5,947 crore during 2003-04 and 2004-05 respectively as discounts. While the subsidy on PDS kerosene and domestic LPG from the fiscal budget is reducing, in view of the phase-out, the subsidy bill to the account of the oil companies has increased substantially which is evident from the data given below:

SUBSIDY ON PDS KEROSENE & DOMESTIC LPG

Rs./Crore

	2002-03	**2003-04**	**2004-05**	**2005-06 (Est.)**
Fiscal Budget	4,496	6,292*	2,930	2,900
Oil companies "Under recovery"	5,430	9,274	17,842	23,704
Total	**9,926**	**15,566**	**20,772**	**26,604**

*** includes arrears of 2002-03 of Rs 2,213 crore**

SUBSIDY ON PDS KEROSENE & DOMESTIC LPG
Rs./Selling Unit

	PDS Kerosene (Rs./Litre)			
Item	**2002-03**	**2003-04**	**2004-05**	**2005-06 (Est.)**
Subsidy from fiscal budget	2.45	1.65	0.82	0.82
"Under recoveries" to oil companies*	1.69	3.12	7.96	12.14
Total subsidy to consumer	4.14	4.77	8.78	12.96
	Domestic LPG (Rs./Cylinder)			
Subsidy from fiscal budget	67.75	45.18	22.58	22.58
"Under recoveries" to oil companies*	62.27	89.54	124.89	147.74
Total subsidy to consumer	130.02	134.72	147.47	170.32

* On a gross basis before adjusting amount shared by upstream companies

3. During 2005-06, besides the initial budgeted subsidy of Rs 2,900 crore, Government is proposing additional support in the form of "Oil Bonds" to the PSU oil marketing companies to the extent of Rs 11,500 crore. Balance of "under recovery" will be borne by the PSU oil companies.

Annexure VI

Subsidies on PDS kerosene and Domestic LPG – Findings of recent studies

Beneficiaries of subsidies on PDS kerosene and domestic LPG

1. The subsidies on both PDS kerosene and domestic LPG are universally applicable to all categories of consumers of these products. The subsidized kerosene is distributed through the public distribution system (PDS) and LPG is sold by distributors working with state-owned oil companies. About 95% of the LPG market belonged to the subsidized supplies by the state owned oil companies The kerosene subsidy comes with a quantity constraint as well i.e., household are allotted quotas that vary by the state and sector they live in and whether they have an LPG connection or not. For LPG, there is no such quantity constraint.

2. A study done in June 2005 by the National Institute of Public Finance and Policy (NIPFP) titled "Modeling economic impact of oil price changes on Indian economy-Methods and applications" provide the fuel usage pattern in rural and urban India for cooking and lighting purposes, wherein an overwhelming proportion of rural households used biomass as their primary fuel for cooking. On the other hand, in urban areas the percentage of households using LPG and kerosene for cooking was much higher than the rural households. Kerosene is pre-dominantly used for lighting purposes in rural areas whereas this figure is very low in urban areas. These figures reveal two things:

- First, the subsidies for kerosene and LPG for cooking purpose, which can be termed as modern fossil fuels, predominately accrue to the urban sector.
- Second, despite subsidizing for decades, they have failed to shift the fuel consumption pattern away from biomass in rural areas.

Diversion of PDS kerosene

3. Given the price differential of PDS kerosene market kerosene and diesel, it is often believed that a sizeable portion of kerosene supplied through the PDS is illegally diverted. It is generally believed that the diverted kerosene is used to adulterate diesel on account of price differential between these two fuels. A recent study conducted by the National Council of Applied Economic Research (NCAER) titled "Comprehensive study to assess the genuine demand and requirement of Kerosene" submitted October 2005 has concluded the following:

- There is an urgent need to overhaul the monitoring system to control leakages and diversion of PDS Kerosene.
- Total Diversion is at 38.6%
    - Non-household use at 18.1%
    - Black market at 17.9% &
    - Non card holders at 2.6%

- § Kerosene demand is relatively price inelastic
- § With increase in Kerosene price, some households in rural areas may shift to other non-commercial fuels such as wood, crop waste, dung cake etc., and in urban areas to LPG
- § If change in Kerosene prices is gradual, Kerosene demand would not go down much.
- § Subsidized PDS Kerosene should only be made available to people with BPL, Annapurna, Antyodaya cards etc only. Non supply of PDS Kerosene to APL card holders would amount to 41.2% savings of current subsidy.

Impact of Rationalization of Kerosene and LPG Subsidy

4. The NIPFP in their report submitted in June 2005 have referred to a UNDP/ESMAP (2003) conducted study with the primary objective of facilitating access to clean fuels, given the significant health and social benefits of switching away from traditional biomass. This study has found the price subsidy on kerosene and LPG as ineffective in expanding the uptake of these fuels as primary household fuels among the poor, and fiscally unsustainable. This study is of the view of phasing out the price subsidies on kerosene and LPG and fostering a vibrant, open and competitive market for these fuels, given the social objectives.

5. The Ministry of Finance in their report of December 2004 titled "Central Government Subsidies in India" and NIPFP in their report of June 2005 advocated the following policy measures:

- § LPG subsidy benefits largely the higher expenditure groups in the urban areas, and may be regressive.
- § With regard to kerosene, on a per capita basis, the urban areas receive a larger subsidy. The limited availability of subsidized kerosene in rural areas biases its use in favour of lighting rather than cooking.
- § Kerosene subsidy is prone to mis-utilization with about half the subsidized kerosene supplies diverted and never reaching the intended groups.
- § LPG and kerosene subsidies are ineffective in serving the desired objectives. Therefore, the removal of LPG subsidy in a gradual manner, or at least a substantial reduction in the subsidy element, may be recommended.
- § A more cautious approach may be justified in the reduction of kerosene subsidies since about a half of the rural households use kerosene primarily to light their homes.
- § Cash transfer to the poor to compensate for the reduction or elimination of subsidy does not appear to be a suitable strategy for inducing a shift toward hydrocarbons for use as cooking fuels. The urban poor and all rural households may use more wood with enhanced incomes from a modest cash transfer.
- § An alternate approach may be to channel all sales of kerosene through the retail markets, and encourage small distributors of fuels. Coupons may be issued only to poor ration card holders with entitlement to purchase kerosene

from a retailer at the subsidized price. This would discourage direct diversion of subsidized kerosene to other sectors.

Annexure VII

Duty Structure on Crude oil and Petroleum Products

Contribution to Exchequer

1. The oil industry contributes a substantial amount both to the Central and State exchequer in terms of duties, taxes, royalty, dividends etc. The total contribution has risen from Rs 96,751 crore during 2002-03 to Rs 1,20,946 crore during 2004-05. Item-wise details of contribution to the exchequer during the last three years is given below:

CONTRIBUTION TO EXCHEQUER

Rs./Crore

	2002-03	2003-04	2004-05
CONTRIBUTION TO CENTRAL EXCHEQUER			
CUSTOMS DUTY	7953	9552	11697
CESS	5213	4766	4891
EXCISE DUTY	32964	35364	38150
ROYALTY	1738	1620	2181
CORPORATE TAX	10249	10038	11180
DIVIDEND	5806	6320	7641
TAX ON DIVIDEND	269	1110	1513
OTHERS (includes service tax)	403	425	439
TOTAL	64595	69195	77692
CONTRIBUTION TO STATE EXCHEQUER			
SALES TAX	29166	32080	38935
ROYALTIES	1654	1643	2251
DIVIDEND TO STATE GOVT.	10	18	21
OCTROI, DUTIES (INCL. ELECTRICITY DUTY)	1253	1032	1313
OTHERS	74	408	734
SUB-TOTAL	32156	35180	43254
TOTAL CONTRIBUTION TO EXCHEQUER	***96751***	***104375***	***120946***
NOTES:			
DATA GIVEN ABOVE IS AS PROVIDED BY OIL COMPANIES.			
FOLLOWING OIL COMPANIES ARE COVERED:			
ONGC, OIL INDIA, IOC, HPC, BPC, IBP, CPCL, KRL, BRPL, MRPL, GAIL,NRL , EIL. And RIL (Petroleum Sector)			

Component of taxes in price

2. The existing incidence of taxation as a percentage of the retail price at Delhi remains significant for petrol and diesel as per details given below:

COMPONENT OF TAXES IN RETAIL PRICE

Product	Central Taxes	State Taxes	Total taxes
Petrol	38%	17%	55%
Diesel	23%	11%	34%
Domestic LPG	-	11%	11%
PDS kerosene	-	4%	4%

3. The customs and state taxes are ad valorem in nature while excise duty on petrol and diesel is a combination of ad valorem and specific rates.

International experience

4. Tax levels as a percentage of the retail price in India for petrol and diesel are similar to the levels prevailing in the developed countries (with the exception of USA) and are substantially higher than the rates prevailing in the neighbouring countries where the rates of taxes on petrol and diesel are more moderate as is evident from the data given below:

Tax as % of retail price

Country	Petrol	Diesel
France	65%	47%
Germany	66%	50%
Italy	62%	43%
Spain	54%	37%
UK	68%	60%
Japan	45%	34%
Canada	33%	25%
USA	17%	19%
Pakistan	42%	20%
Nepal	31%	22%
Bangladesh	24%	24%
Sri Lanka	37%	5%

Source: Developed countries as per IEA (Jan'06) and other countries collected from respective websites.

Central levies

5. The petroleum sector's contribution to the central exchequer represents a substantial portion of the central government revenues. Details of contribution by the oil sector in terms of customs and excise duty as a percentage to total excise/customs duties for the last five years is given below:

CONTRIBUTION OF EXCISE/CUSTOMS DUTY

Rs./Crore

Item	Customs duty	Excise duty*
2001-02		
- Petroleum	6,767	29,337
- Total	43,170	74,520
% Petroleum to total	16%	39%
2002-03		
- Petroleum	9,166	35,961
- Total	45,500	87,383
% Petroleum to total	20%	41%
2003-04		
- Petroleum	10,582	40,151
- Total	49,350	92,379
% Petroleum to total	21%	43%
2004-05		
- Petroleum	13,250	43,145
- Total	56,250	100,720
% Petroleum to total	24%	43%

*includes cess on indigenous crude oil

Note: Contribution by petroleum sector is based on information provided by TRU, MOF while total contribution has been taken from revised estimates of the Receipts Budget of Govt. of India net of refunds and rebates.

6. The above table demonstrates the excessive dependence of the central exchequer on excise duties from the petroleum sector. It may be noted from above that total revenue from customs and excise duties have increased by Rs 6,483 crore and Rs 13,808 crore respectively during the last three years. There has been a substantial increase in the excise duties revenue which is primarily on account of increase in the excise duty rates on petrol and diesel. The excise duty on petrol at Delhi which was Rs 10.53/Litre as on 1.4.2002 (at the time of dismantling of APM) is at present Rs 14.93/Litre (Rs 14.64 per litre plus education cess of Rs 0.29 per litre at 2%). Similarly, the excise duty on diesel at Delhi which was Rs 2.85/Litre as on 1.4.2002 is at present Rs 5.07/Litre (Rs 4.97 per litre plus education cess of Rs 0.10 per litre at 2%). Further, as a portion of the excise duty is ad valorem, it has a cascading impact whenever there is a revision in the retail prices.

Changes in Central taxes

7. In view of the steep increase in the international prices of crude oil and petroleum products in 2004 and 2005, the Government has taken measures to reduce to level of taxes. The details of the major changes that have taken place in the level of Central taxes since 1998 are given below:

MAJOR CHANGES IN EXCISE/CUSTOMS DUTY

EXCISE DUTY

Item	As on 2.6.98	As on 28.2.99	As on 30.9.00	As on 1.3.02	As on 1.3.03	As on 16.6.04	As on 19.8.04	As on 01.03.05
Crude	Rs.900 pmt as cess	Rs.900 pmt as cess	Rs.900 pmt as cess	Rs.1800 pmt as cess	Rs.1800 pmt as cess	Rs.1800 pmt as cess	Rs.1800 pmt As cess	Rs.1800 pmt as cess
Petrol	32% + Re 1 per litre	32% + Re 1 per litre	16% + Re 1 per litre	32% + Rs 7 per litre	30% + Rs.7.50 per litre	26% + Rs.7.50 per litre	23% + Rs.7.50 per litre	8% +Rs.13.00 per litre
Diesel	15%	16% + Re 1 per litre	12% + Re 1 per litre	16% + Rs 1 per litre	14%+ Rs.1.50 per litre	11%+ Rs.1.50 per litre	8%+ Rs.1.50 per litre	8%+ Rs.3.25 per litre
SKO (PDS)	10%	8%	8%	16%	16%	16%	12%	NIL
Domestic LPG	10%	8%	8%	16%	16%	8%	8%	NIL

CUSTOMS DUTY

Item	As on 2.6.98	As on 28.2.99	As on 1.3.2000	As on 30.9.2000	As on 1.3.03	As on 19.8.04	As on 1.3.05
Crude	22%	20%	15%	10%	10%	10%	5%
Petrol	32%	30%	25%	20%	20%	15%	10%
Diesel	32%	30%	25%	20%	20%	15%	10%
SKO (PDS)	Nil	Nil	Nil	Nil	10%	5%	Nil
Domestic LPG	12%	10%	10%	10%	10%	5%	Nil

Note: With effect from 9/7/04, an additional levy of Education Cess @ 2% has been imposed.

State sales taxes

8. As state taxes on petroleum products are mostly ad valorem, there has been a substantial increase in the contribution by the petroleum sector to the state exchequer. As is evident from the data given in para 1, the contribution of the petroleum sector to the state exchequer has gone up from Rs 29,166 crore in 2002-03 to Rs 38,935 crore in 2004-05. Moreover, there is a wide disparity in the rates of taxes across various states. On petrol, the rates vary from a minimum of 20% to a maximum of 34%. Similarly, in case of Diesel, the rates vary from a minimum of 12% to a maximum of 37.72%. This creates disparity in regional prices. The petroleum sector's contribution on sales tax to the state exchequer represents a substantial portion of the state government revenues. Details of contribution by the oil sector in terms of sales tax as a percentage to total sales tax revenue to the state governments for the last three years is tabled below:

CONTRIBUTION TOWARDS STATE SALES TAX

Rs./Crore

Item	2002-03	2003-04	2004-05
Total sales tax revenues*	86,038	97,590	115,330
Sales tax revenues from oil sector**	29,166	32,080	38,935
% from oil sector to total	34%	33%	34%

* Based on data taken from "State Finances, A study of Budgets of 2005-06" by the RBI & does not include data pertaining to Union Territories. ** Based on data provided by the oil companies

Impact of irrecoverable levies

9. Many state governments in India are also levying irrecoverable taxes on crude oil and petroleum products. In Mumbai, the two refineries of HPCL and BPCL pay an octroi @ 3% on crude oil entering the municipal limits of Mumbai. Similarly, the state governments of Karnataka, UP, Bihar, Assam and Haryana also levy entry tax on crude oil where the rates are as follows:

RATE OF ENTRY TAX ON CRUDE OIL

State	Rate of entry tax on crude oil (%)
UP	4%
Haryana	4%
Karnataka, Bihar and Assam	2%

10. Out of a total of 17 PSU refineries in the country, 10 refineries are impacted by this levy. As this is an incidence on the raw material, it cannot be recovered from product prices and leads to erosion of the refinery gross margin. It also results in non-level playing field for different refineries and they also become non competitive when they export their products. In addition, all refineries are not marketing companies and inter-state inter company transactions attract CST. This cannot be recovered from the customers in the consuming states as it would amount to double taxation. However, the incidence of CST can be removed if the movements are rationalized.

11. At a crude price of $ 60 per barrel, it is estimated that the impact of octroi/entry tax on crude oil will be an annual burden of about Rs 2,700 crore during 2006-07.