

# FUEL PRICING POLICY SUBSIDIES AND OTHER ECONOMIC IMPACTS

## FROM FUEL SWITCHING

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### INTRODUCTION

The pricing policy before the nationalization of petroleum fuel supply, distribution and marketing had been based on cost of supply. The cost of supply in this instance could be taken as cost of imports, taxes, local handling and distribution cost. The same system continued soon after nationalization and as controls on pricing was taken over by the state an element of cross subsidy was introduced by attempting to keep the retail price of kerosene at a politically acceptable level by subsidizing kerosene at the expense of petrol.

The refinery was established in 1969 and when it started to produce all requirements of petroleum fuels, that gave the Ceylon Petroleum Corporation (CPC) some flexibility to price products differently as against costing based on import parity prices. For instance this permitted the ex refinery price of kerosene to be reduced at the expense of petrol or any other product while costing individual products as all products as produced simultaneously.

### IMPORT PARITY PRICE OR REFINERY GATE PRICE

The name plate capacity of the refinery was 2.0 million tons per year and the local demand for all products was less than 1.2 million tons by the year 1990. The demand has continued to increase in the last decade and demand reached nearly 3.0 million tons by year 2000. The forecasted demand has now reached 3.4 million tons for the year 2003. So in the last decade we have become net importers of Petroleum products, at Singapore based market related prices.

Singapore is a large refining centre with exportable surpluses and able to supply the requirements in the region. As we have become a net importer, based on posted prices at Singapore it will be natural that we would have to determine retail prices in Sri Lanka based on posted prices. If that is taken as the starting point to determine retail selling prices then we have to add on other costs such as handling, freight and insurance and port charges to get at the landed cost before tax. This is taken as surrogate ex-refinery gate price.

### TAXES ON PETROLEUM PRODUCTS

There were minimal taxes imposed on petroleum products imported or produced locally prior to 1986. The 5% import duty on crude oil prices following the abandonment of crude oil pricing strategy adopted by Organization of Petroleum Exporting Countries (OPEC). With high import duties on crude oil and the intention of the government in power to keep retail price of kerosene low, the retail petrol prices had to be kept much above cost of supply to enable the CPC to cross subsidize kerosene for the benefit of the poor households. The taxation policy further exacerbated the issue of pricing when crude oil was taxed at 35% while imported kerosene and fuel oil was taxed at 10% in 1992. This virtually meant that locally produced kerosene and fuel oil was more costly than that could be imported. This meant even fuel oil had to be cross subsidized with petrol.

### RETAIL PRICING OF PETROLEUM

As per the Petroleum Corporation Act No. 28 of 1961 and clause 66, the Minister had the power with the concurrence of the Minister of Finance

by a Petroleum price order to specify or determine any one or more of following:-

- a. Maximum spot price or rate
- b. Minimum spot price or rate
- c. Spot price or rate
- d. The maximum amount or percentage of discount or rebate
- e. The formula fixing the price

Based on the above from time to time retail prices have been adjusted to ensure profitability of CPU while not looking at any specific profit target to get a Return on the Investment or any predetermined return based on turnover.

The policy followed right through has been to ensure kerosene, which was used mainly for lighting in rural areas and to some extent for cooking in Urban areas was kept low and taxes and duties due to the state from import and sale of petroleum fuels are recouped from the consumer and CPC does not become unprofitable and the Treasury does not have to plough back any state fund to subsidize CPC operation.

The above policy continued until end 2001 when following a study conducted by the Asian Development Bank, a pricing formula for Retail Pricing of petroleum products was proposed to the Government. The retail pricing formula proposed was accepted by the Government and implemented as from February 2002. The retail price at the pump for petrol, kerosene, diesel and furnace oils (all grades) have been adjusted monthly based on posted prices of the above products at the Singapore market as quoted in PLATTS GLOBAL ALERT on working days. The prices quoted daily have been averaged to determine the retail prices for the following month. As these prices are quoted in US\$ per barrel FOB, the average exchange rate of Sri Lanka Rupees

to US dollar as published by the Central Bank is used to determine the equivalent rupee price for each of the products. To the above FOB price the average freight rate, insurance and loss are included to give a CIF price. To this CIF price is added on Port Development charges and Bank Charges and pipeline charges levied by the Sri Lanka Ports Authority to give the landed cost in Rupees per litre.

To this landed cost is added any Customs Duty applicable to give the price ex-port in Rupees per litre. At the moment customs duty is zero. When petroleum products are imported a special tax of 1.0% of the value is paid to the Western Provincial Council.

Excise Duty levied by the Customs on products have to be paid at the time of import to the Sri Lanka Customs before the products reach the bulk storage terminal at Kolonnawa. The price of Petroleum products are adjusted further when the products leave Kolonnawa terminal to include operating cost of terminal and the finance charges of the working capital employed, which gives the wholesale price of each product. When products are picked up from Kollonnawa terminal or from any other regional depots and distributed to the final retail point we have to add on the retail and marketing costs that include transport costs and in addition Value Added Tax (VAT), Dealer Turn Over Tax and dealer margins are added on to arrive at the final retail price at the pump.

### **POLICY ON COST ALLOCATION**

Pricing of petroleum products will be based on import parity prices. All costs in relation to supply and distribution will be recovered. Minimum of such costs will be allocated to industrial fuels including that used for power generation. There will be no direct subsidies to any products.

In the fuel pricing, a policy decision was made that financial costs which include interest on working capital and foreign exchange loss resulting from import, holding and storage and supply of petroleum products is recovered from petrol and diesel only. Neither Fuel Oil or kerosene is charged this component of financial costs. In pricing of Heavy Fuel oil 380 Cst. Only about 1/3 of the price charged on other products is charged for storage and handling as there is less handling involved for Heavy Fuel Oil. No marketing charge is levied on Heavy Fuel Oil while only about 50% of marketing costs charged on other products like petrol, kerosene and diesel is charged from furnace oils grades of 180 Cst and below.

At the moment as directed by the cabinet there is no profit margin from sale of petrol kerosene and diesel. This will change when the market is liberalized and competition starts.

The earlier mechanism of ad valorem excise duty levied on all products except fuel oil was done away with and replaced with a fixed excise duty component which was introduced to ensure that the total tax collection does not vary with FOB price of petroleum products. Hence excise duty which was 25% on CIF price of petrol, kerosene and diesel was replaced with fixed excise duty component of Rs. 21.00 per litre of petrol, Rs. 1.25 per litre of kerosene and Rs. 3.00 per litre of diesel. Therefore the present price is devoid of any direct subsidies. However, there is some element of indirect subsidy on kerosene and furnace oils as the finance costs are recovered from the transport sector fuels only. Again diesel supplies for thermal power generation by CEB are also devoid of any excise duty and the full finance charge based on stocks carrying costs and others working capital requirements.

## **ECONOMIC IMPACT OF FUEL SWITCHING**

As fuels are today priced based on market related prices there are no major economic impacts from fuel switching to the economy if you take foreign exchange outflow into consideration. In recent years the costliest petroleum fuel (disregarding high-octane petrol) at the Singapore market has been kerosene because of its use as an aviation fuel. If retail pricing of kerosene does not reflect the true international price vis a vis diesel and petrol and if kerosene is adulterated to petrol and diesel then there is an economic loss to the country. Further there is a loss in revenue to the General Treasury as the high excise duty component specially in petrol is replaced by a fuel using a low excise duty. Similarly if LPG replaces petrol there is also loss to the country in foreign exchange and also to the General Treasury in taxes. In June the landed cost of a ton of LPG was around US\$ 278 per ton against US\$ 268 per ton for 92 RON petrol. In addition the state, loses the full excise duty of Rs. 21 per litre levied on petrol as no such duty is levied from LPG when used as a motor vehicle fuel. Those advocating this switch only speak of the marginal environmental benefits. In recent years the benefit or loss from fuel switching has been marginal to the country as import parity price differentials have narrowed due to supply / demand balance at the international market place.

## **CONCLUSION**

Formula based pricing has been recognized and implemented to adjust retail price of petroleum products on a monthly basis. As the petroleum sector is being liberalized and free market competition will come to play in the not too distant future the retail prices may get adjusted on a daily basis as is the case in developed countries. The consumer is expected to benefit in the long run from these developments.