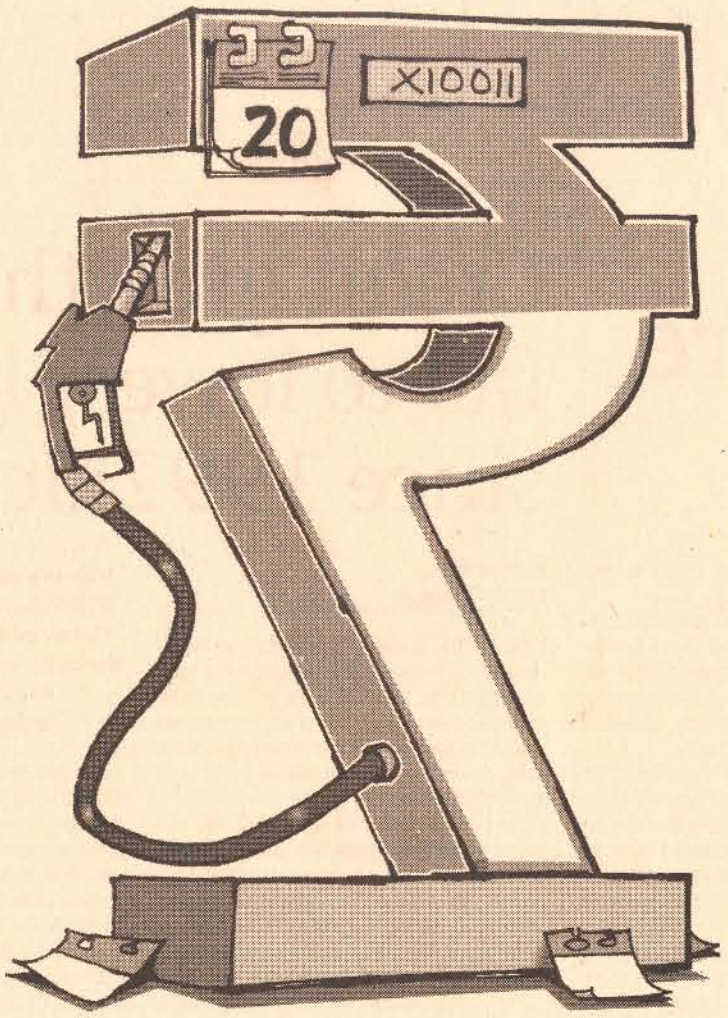

ILLUSTRATION: ROHNIT PHORE

CHANGING FUELSCAPE

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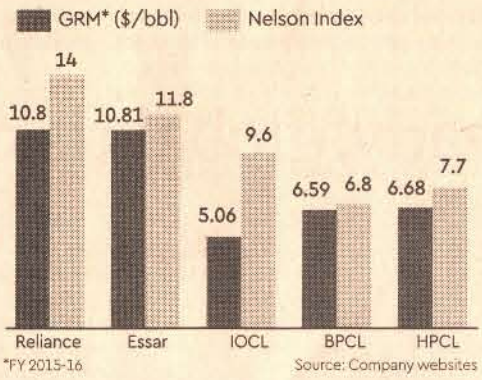
An approach towards dynamic fuel pricing

The daily fuel price revision aligned with global markets will not only improve the competitiveness of the economy, but would also bring in transparency in fuel pricing and incentivise investments in the oil sector

Global retail fuel revision frequency

US	Daily
Japan	Daily
Australia	Daily
Germany	Daily
Russia	Daily
Mexico	Weekly
UK	Weekly
Malaysia	Weekly
Thailand	Weekly
Korea	Weekly
Brazil	Monthly
South Africa	Monthly

Gross refining margins vs Nelson Complexity Index for Indian refineries



*FY 2015-16

Source: Company websites

STARTING JUNE 16, 2017, the prices of transport fuels, i.e. petrol and diesel, are subject to a daily revision across the country—at almost 58,000 petrol pumps—in sync with international oil prices. With this, we have joined the select club of developed countries such as the US, Japan, Australia, Germany and Russia. It means the state retailers will reset the price of petrol and diesel each day, rather than wait for a fortnightly revision, which has been the norm so far. On a broader note, this move will align the retail pricing of crude products in line with price changes in the international markets, and bring in transparency in the pricing of crude products.

Among all the positives, first, this move is believed to crystallise the outlook for oil marketing companies' marketing margin—or the difference between the cost of procurement and the price charged by retailers—and therefore raise confidence over the overall sustainability of this broad deregulation initiative. Shorter time lag between crude purchase and products sales will collapse, thus allowing prices to reflect cost and avoid artificial distortions. It may also enhance OMCs' ability to pass the prices into the economy more effectively.

If we compare volatility of prices that have come out of these methods of pricing, we can see that the dynamic pricing had a daily volatility of 0.23% (May 2017, Chandigarh), whereas the fortnightly pricing had an average daily volatility of 0.8% (January-May 2017, Delhi), suggesting a lower volatility component that may kick in with the implementation of the daily price revision. This is largely due to the daily pass-on of prices than accumulating it to be passed on.

What is the daily factor?

Given that the purchasing of crude happens on a contractual basis, and refining cost and fiscal features like taxes remains fairly constant for a certain period, the major daily fluctuating factor for OMCs in pricing of petroleum products remains the currency risk. Depending on the movement of the rupee, OMCs will be able to pass on this daily currency risk to the consumer in a dynamic pricing environment.

However, in case of a shift in oil fundamentals or major geopolitical events that may affect the international prices of oil, the increase or decrease in fuel prices can be smartly managed by OMCs, with short spectrum purchasing capabilities to pass on competitive prices to the consumers.

Therefore, we can say that the retail fuel prices are expected to be more aligned to market dynamics.

Additionally, since OMCs now have flexible options to lift short-term contracts or buy crude with no contract obligation (like West African crude) from global markets when prices are lower, it can provide them an additional way to boost profitability. Alternatively, hedging their petroleum products ahead of time will provide relief to OMCs in passing on their risk from oil price or exchange rate movements and, therefore, bring stability to refining margins.

Global experience shows that the current dynamic pricing of fuel has the potential to attract participation of private players in fuel retailing and several downstream opportunities, thus exposing the downstream and marketing to best practices and modern technology in refining. For successful fuel retail participation across a large country like India, private players will need to have better policy environment right from land acquisition to an efficient licensing regime.

In addition, the government can look beyond canalisation in their current fuel import policy and enable firms other than the government-owned Indian Oil Corporation Ltd (IOCL) to import motor fuels, a practice recently enabled by the government of Mexico. This will also help to lay the foundation needed for coping with the expected increased demand for specific refined products in the upcoming years. For example, according to a report by BMI, a Fitch Group company, India is expected to turn into a net importer of petrol from 2020, driven by solid economic growth despite an increase of 1 million barrels per day (bpd) refining capacity.

A liberalised retailing regime may also expose the PSUs into an intensive competitive scenario. Currently, Indian oil PSUs are lagging behind domestic private oil companies in refining margins as they fall back in refining technology, particularly in secondary conversion units like catalytic cracking, coking, hydrocracking, etc. The accompanying table compares the Nelson complexity index and gross refining margins of Indian oil PSUs versus domestic private refiners. The Nelson index is a measure of the complexity of an oil refinery and is an indicator of its efficiency; a high Nelson index for a refinery or a firm implies a higher probability of the refinery or the refining firm to generate a high refining margin.

The Nelson index as per the accompanying clearly indicates that PSU refineries are lower in terms of their refining margins compared with Reliance or Essar. In technical terms, it indicates that PSU refiners are missing on the opportunity to process lower quality cheaper crude into premium refined products and achieve higher margins. One of the ways in which this can be achieved would be through possible merger of all PSU oil companies into single large oil conglomerate, as proposed in the latest Union Budget, thereby pooling in their resources to improve their access to modern technology, enhance their purchasing capacity, reap the benefits of economies of scale, and create value for the stakeholders as envisioned by the policy-makers. In the long-run, the merger of PSU OMCs will enable the proposed monolith to not only withstand any volatility in international oil prices in an efficient manner by diversifying into various upstream activities abroad, but would also enable the country's emergence as a significant player in the competitive global oil markets, setting Indian markets on the path of being a 'price-setter' in the region, if not at the global level.

At a time when global oil prices and exchange rates are becoming increasingly market-oriented, transparent and disseminated almost instantaneously, dynamic fuel pricing will make the demand elasticity of the consumers reflected well in the markets as the price and sales data will be available in public for the market participants to reflect the same. Also, the proposed daily fuel price revision aligned with global markets will not only improve the competitiveness of the economy overall, but would also bring in transparency in fuel pricing and incentivise investments in the oil sector. This sector is vital to the Indian economy, which is heavily dependent on oil—constituting about 22% of India's imports worth $82.2 billion during FY16.