The Pathfinder Economic Alert

Government in Petroleum Trade---*Is it Really Necessary?*

Since nationalization of the petroleum import and distribution trade in 1961 successive Sri Lankan Governments have continued to carry the burden of operating this business. During the past four decades, the political and economic burden became evident with the drastic increase of prices, partly due to the cartel exercised by OPEC. This has meant that price increases as well as product and service quality have been key issues for Opposition political parties in leveling criticism against any government that was in power. In the recent past too, we have seen the Government being criticized on petroleum trade related issues.

Why invite problems?

Notwithstanding the exceptionally favourable economic conditions that prevail even the present government is being dragged into unnecessary and sometimes unjustified controversies and allegations of corruption and financial mismanagement. The highly publicized hedging deal and 'substandard' petroleum imports are the latest cases in point. For example, hedging is a well accepted market instrument that is used to minimize losses incurred through fluctuations in the prices of commodities, such as petroleum. In general, private sector players in the market use this type of instrument to take positions on both the upside and downside to reduce uncertainties and losses. In the case of Ceylon Petroleum Corporation (CPC), the de facto monopoly for importing petroleum, the hedging instrument was utilized when unprecedented oil price increases were projected in the world market. In order to mitigate risk, the CPC used the hedging instrument tocover only the upside movement of prices without taking a position on the possible ramifications of a downward movement. The high cost of hedging against the downside seems to have led to this decision. The general consensus at that time was that prices were unlikely to fall. However, when the markets went against the consensus the CPC hedging deal came under fire. The government had to bear the brunt of all the allegations of possible corruption, lack of financial acumen etc, as the CPC was a fully state-owned enterprise.

Similarly, recent emergency import & distribution of petroleum resulted in the so called 'diluted' petrol being distributed, resulting in breakdown of a couple of thousand vehicles. Then the supporters, opponents of the government as well as politicians across the wholespectrum found fault with the government, the Minister and the Ministry in charge of the CPC. Many suspected corruption and conspiracy. When party politics crept into the analysis, everyone was blinded and did not see why the government had to bear responsibility for purely international trade-related transactions and deals.

This raises the question as to why this government, as well as all its predecessors, has been getting involved in monopolizing petroleum imports to Sri Lanka, since the nationalization of the downstream petroleum industry. Is there are a way for this government and future administrations to get away from these unnecessary controversies and unwarranted allegations?

A way out and way forward

Of course, the way forward is to open up petroleum imports, distribution and retailing to other private sector enterprises in competition with the CPC or other government or semi – government institutions willing to enter into the business. The current downstream petroleum sector legislation provides for entertaining one or more parties entering into the field under similar conditions that were applicable to the Indian Oil Corporation (IOC).

In 2002, the UNP administration, as well as its successor, failed to act within the specified time-frame to permit the entering of the third player (i.e. Sinopec Corporation) into the market.
By introducing other players into the downstream petroleum market, the consumers and the government are bound to benefit in many ways.The current duopoly, with CPC playing a dominant role, results in the line Ministry and the Cabinet of Ministers being at the receiving end for controversies related to price increases, delays in shipment of petroleum and other procedural issues.
The first round of petroleum sector reforms that were undertaken during the 2001/2002 period included unbundling of the CPC into storage and distribution/retailing units. In the process, the IOC became an independent operator distributing and retailing petroleum. There seems to be a strong case for the government to proceed- with the next round of reforms whereby new entrant/s will be entertained.Furthermore, as envisaged in the current legislation-, the petroleum regulatory function should be assigned to the Public Utility Commission (PUC). The PUC was established with the objective of introducing an independent regulator for electricity, petroleum, potable water resources and other infrastructure services.

With regard to the downstream petroleum sector, the PUC's function, as the regulator, should include introduction of a pricing mechanism, quality and standard assurance and in the final analysis establishing a level playing field for the players irrespective of the nature of ownership.

In such a restructured sector, what should be the role of the line Ministry? It can be an independent watchdog protecting the consumer interest and creating an environment conducive for further investment in the sector.

After the restructuring / reorganization of CPC it is advisable to list its shares in the Colombo Stock Market, preceded by allocation of a substantial number of shares among the workers and retailers who have made a considerable contribution to the business.

Maintaining Strategic Reserves

An important aspect of petroleum trade in countries such as Sri Lanka is to ensure maintenance of strategic reserves for use during any disruption of international supply.This has, for some reason, never been discussed in local policy circles. Many countries in the world, including our neighbour India, maintain such strategic petroleum reserves through the Government or private sector owned enterprises. In case of Sri Lanka too, the line Ministry, through CPC or even other players, could maintain strategic reserves to cover any emergency. The Government would need to bear the cost of maintaining such reserves to avoid imposing an undue burden on the enterprises concerned,whether State-owned or otherwise.

Subsidizing the Needy Not the Greedy

The losses incurred by the CPC at present amount to billions of rupees. They are caused by non-transparent subsidies and cross subsidies. Generalised subsidies (non pass-through of international prices) benefit both users of kerosene oil, who include the poorest of the poor and three wheeler drivers, as well as gas-guzzling luxury cars and SUV's. As the Ministry and the government are mandated to provide a safety-net for the less privileged, a well-targeted fuel subsidy or an income transfer scheme to the needy could be developed. Such policy action would mean that subsidies are properly targeted and individual enterprises such as CPC and IOC are not compelled to incur losses. In the case of CPC, it loses billions of rupees through subsidising the thermal electricity generation by another government-owned loss-making enterprise, the Ceylon Electricity Board (CEB).

Benefits for consumers and the economy

In an environment where profit-seeking public and private enterprises are in competition, imports (refined or crude petroleum) are likely to be based purely on price and quality considerations. In addition to these market-based compulsions, the PUC, as well as the line Ministry can also ensure that the players are not colluding or under/over invoicing so that consumers are further protected.

If the petroleum sector is made more efficient through greater competition, it will benefit all sectors of the economy through its impact on the costs of energy and transport. The proposed reforms are also likely to trigger much-needed improvements in other institutions, particularly the CEB.

In this context, highly integrated government-held monopolies, such as the CEB, too will be compelled to restructure by unbundling different stages and processes of producing, transmitting, distributing and retailing electricity. Irrespective of the nature of ownership, different government entities can be identified as cost or profit centres and measures could be taken to improve their efficiency in order to minimize losses and wastage.

This is the twelfth in the series of Economic Alerts issued by the Pathfinder Foundation.

Readers' comments via email to pm@pathfinderfoundation.org are welcome.