CHAPTER I

INTRODUCTION

Petroleum is a very important source of energy for the primary, secondary and tertiary sectors of the economy as well as for the household sector. From a mere 1.2 per cent in 1950-51, the contribution of oil and gas to total primary commercial fuel production in India has increased to 33 per cent in 1990-91. The percentage share of oil and gas in the commercial energy consumption, on the other hand, was as high as 43.4 in 1990-91, the gap being filled through large scale imports. Oil is also the direct source of asphalt, waxes and lubricants and is the raw material for thousands of chemicals which find their way into our daily lives in the form of medicines, cosmetics, paints, plastics, fertilizers, insecticides, etc.

Unlike the other major sources of energy, namely, solid fuels (coal and firewood) and primary electricity, the supply-demand mechanism for oil is highly sensitive to international developments. Considerable proportion of India's oil consumption is met by the import of both crude oil and finished products. The import bill of petroleum and petroleum products during 1993-94 was Rs. 17,730 crores which was about 25.5 per cent of India's total export earnings and about 13.5 per cent of the Union Government's annual budget. Although in terms of percentage of total export earnings, there has been significant improvement over the years, the absolute value of the oil import bill has been steadily rising. Therefore, any fluctuation in the
international prices of oil or any policy shift by the oil exporting nations is likely to have a substantial impact on India's economy.

On the international scene, oil is perhaps the single most important economic commodity. It accounts for the greatest share of world trade, provides the mainstay of the world's largest companies, is the dominant force in the determination of energy prices and plays a major part in international power politics. Because of these very factors, the oil industry is also subject to the highest degree of uncertainty. But, in spite of the important place oil holds in the Indian economic scene, successive Governments at the Centre have seldom attempted to formulate a meaningful long term policy on Petroleum. There is urgent need for formulating such a long-term policy taking into account the international politics of oil, India's own production potential, socio-economic considerations involved in the pricing of various products, need for oil conservation, etc. Economic logic requires that the Government adopt pricing policies that ensure optimum utilization of the resource, but political compulsions often tend to result in a pricing policy at loggerheads with economics. Successive committees of experts have recommended modifications in the right direction, but the Government tend to defer pricing reforms till they run out of options. Presently, attempts are being made by the Ministry of Petroleum and Natural Gas to open up the oil sector and to use pricing as a means of sustaining economic growth in a competitive environment, care being taken to ensure that the deprived sections of society are not further burdened by these reforms. This is an arduous task fraught with serious socio-political repercussions.
Ramesh Bhatia in his address to the Tata Energy Research Institute Workshop on Energy policy issues (July 1984) stated the problem in a nutshell thus:

In a free-market economy, energy prices act as an allocative mechanism by providing appropriate signals to the consumers and producers. In a developing country, the role of prices may depend on a number of stated policy objectives and the special characteristics of energy demand and supply. The objectives of energy pricing are related to the goals of macro-economic policy and goals of energy planning. The objective of economic development would require that pricing policy should promote economically efficient allocation of resources. It would require that the relative fuel prices should influence the pattern of consumption in the direction of least-cost mix of energy resources to meet future demands. However, there may be other socio-economic objectives which may suggest deviations from economically efficient prices. One such objective may be to meet the basic energy needs of the poor sections of society at prices which they can afford.....Some other objectives may be control of inflation, encouragement of domestic resource-use, security of supply, profitability of public sector units and environmental considerations. ¹

In their eagerness to meet the multiple objectives, the Government have to adopt different policies at different points of time. Some of them may stand the test of time, some may turn out to be harmful to the economy. In India, at the time of independence, there was a need for the Government to exercise strict controls on this very important natural resource, but it took more than a decade for the nascent nation to come to grips with the complexities of the industry and start exercising controls. Over the last few decades, with the Indian petroleum industry and the Indian private enterprise coming of age, the situation has changed. Presently, there is perceived need for opening up the sector for private investment including foreign capital and

¹ Thukral & Pachauri (Eds.); Energy Policy Issues, 1985, p.112
technology. Of all the policy instruments available to the Government, pricing is perhaps the most efficacious as it directly affects investment decisions, producer-consumer relations and the state of the economy. In this context, a comprehensive study of the various issues related to the petroleum pricing policy of Government of India assumes considerable significance.

Objectives of the Study

The primary objective of the study is to trace the historical evolution of the pricing policy of crude petroleum and petroleum products adopted by the Government of India after independence and to critically evaluate the various aspects of the policy from an administrative and economic point of view. The study aims to examine the alternatives that were available to the Government at different stages of this evolution, culminating in the present era of economic liberalisation and globalisation. The facets of petroleum pricing policy sought to be included in the study are:

1. Pricing policy at the time of independence and the changes brought about as a result of the recommendations of successive oil price committees,
2. The impact of pricing policy on the consumption of oil products, its effect on demand-supply imbalance,
3. The impact of international developments on oil prices,
4. Product pricing mechanism followed at present,
5. Economic principles of pricing of crude oil, natural gas and finished products,
6. The current thinking on pricing policy, and
7. Alternative approaches to pricing and recommended choices.

The study also aims to briefly examine the salient features of the Government policies relating to exploration and development, refining, marketing and distribution, imports, oil conservation and natural gas as these also have a direct or indirect bearing on the oil pricing policy.

**Scope and Limitations**

The present study focuses on one of the most important aspects of oil policy, namely the pricing policy and makes an attempt to evaluate the reasons that led to the policies adopted by the Government of India at different points of time and their impact on the national economy. The study also makes an earnest effort to identify future policy options. Since any policy that determines the price of oil and oil products is influenced by policies governing exploration, refining, marketing, import-export and petroleum conservation, this study also analyses these policies in so far as they have a bearing on the pricing policy. Due to limitations imposed by the magnitude of each aspect of Petroleum policy, the study has not tried to cover all these aspects in detail. Maintaining its focus on pricing policy, efforts have been made to trace the evolution of the petroleum policy of Government of India from 1947 till date, the factors both national and international that influenced these policies, possible
alternatives that were available to the Government and the consequences of the choices made by the Government. Critical analysis of such policy decisions both from administrative and economic points of view has been attempted. These analytical studies have been made in the light of the world oil scenario existing at the relevant time.

Methodology

The data for the study were collected primarily from secondary sources. It was supplemented by data collected from primary sources such as reports of Parliament Committees, Parliament debates, private communications from officers of the Government of India and the oil industry and unpublished reports with the Petroleum Ministry. Data were also collected from the senior functionaries of the Government of India and the public sector oil companies using a questionnaire (Appendix I). Then an interview was conducted among the selected officers who were involved in policy making.

Scheme of the Study

The thesis is organized under 13 chapters. The first chapter gives an introduction to the study. It describes the relevance, objectives, scope and limitations of the study and the methodology adopted. The second chapter presents a brief review of the relevant literature on the subject. The third chapter presents the historical
outline of the growth of petroleum industry in India. This Chapter also outlines the developments in exploration, production, refining, marketing and distribution of oil products, imports, production and distribution of natural gas and oil conservation. Chapter four is on the consumption of petroleum products. It analyses the growth trends of petroleum in India and the demand projections. Chapter five discusses the demand-supply imbalance. It contains a historical outline of the expanding gap between demand and supply of petroleum products, with special emphasis on the problem of middle distillates and the contribution of the pricing policy and subsidies on the imbalance. Chapter six explains the pricing system in the early days. It gives the background information on world parity pricing, OPEC, pricing in India after independence, the system of Valued Stock Account, the system of posted prices and discounts and finally highlights the options before the Government. Chapter seven gives a brief account of the early oil price committees. It analyses the recommendations of the Damle Committee, Talukdar Committee, Shantilal Shah Committee and Krishnaswamy Committee. It also describes the genesis of the Oil Crisis of 1973 and its effect on India. Chapter eight explains the later modifications in the pricing system and the present pricing mechanism. It deals with the effect of the oil crises of 1979-81, 1986 and 1990, the limitations of pricing mechanisms and the concept of retention pricing. It describes the present mechanism of price build-up in a step-by-step fashion and explains the salient features of the Administrative Price Mechanism and the Oil Pool Accounts. Chapter nine explains the pricing of crude oil and natural gas. It elaborates the Hotelling Rule and its limitations, the concept of Long Run Marginal Cost (LRMC), and outlines the computation of gas development.
cost by Julius and Mashayekhi. The present pricing mechanism of natural gas is also
-described here. Chapter ten analyses the objectives of oil pricing policy. It explains the
-considerations of economic efficiency, financial viability and social equity in relation
to oil pricing as well as the considerations involved in LRMC calculations. Chapter
eleven is on alternative approaches to pricing. It explores the alternative approaches
such as Integrated Energy Pricing and alternatives to the present form of subsidies.
Chapter twelve discusses free market pricing. It delineates the options before the
Government in the context of the recommendations of the Oil Industry Committee and
the Strategic Planning Group on Restructuring of Oil Industries (R-Group). It assesses
the possible scenarios and suggests a petroleum pricing policy suitable to the present
economic situation in the country. Chapter thirteen presents the summary and
recommendations of the study.