CHAPTER VI
THE PRICING SYSTEM IN THE EARLY DAYS

In the previous chapters, the background of the various aspects of petroleum policy were analyzed. In this chapter, focus will be narrowed down to the central theme of the thesis, namely the pricing policy. Before embarking upon a study of the developments in pricing policy, an understanding of the pricing system in the early days would be essential.

Upto 1945, the pricing of petroleum products in India was based on the "World Parity Price System" or the "US Parity Price System", with the US Gulf as the basing point for pricing both crude and products. This system was born in 1928 in Achnacarry in Scotland, through an agreement signed by Royal Dutch/Shell, Standard of New York and Anglo-Persian Oil. The oil cartel of the international majors was set up as a result of this agreement. Even in the case of oil from other nearer sources such as Burmah, Persia, the Far East or Russia, although the actual freight was less, for the purpose of fixing prices the oil was supposed to have come from the US Gulf. The rationale for this system was that more than 70 per cent of the world export trade in oil was accounted for by US oil and almost no oil consuming country was in a position to do without importing a part of it. Since there could not be two or more prices for an identical commodity in the same market, the system worked well for a long time.\(^\text{[84]}\)

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Under this system, even Assam crude, refined at Digboi, was priced at par with imported products, giving undue profits to the BOC.

With the Persian Gulf becoming a major producer of oil and replacing US Gulf as the source of 90 per cent of the oil trade in the Eastern Hemisphere, Persian Gulf was adapted as another basing point in 1945, but only for the purpose of calculating ocean freight. The base price remained the high f.o.b US Gulf price irrespective of the source of the product. Still, for India, this meant a substantial saving in landed price. Even after 1948 when the f.o.b Persian Gulf crude oil prices started drifting away from the f.o.b US Gulf prices, the product prices continued to follow the US Gulf prices until 1957, when due to product imbalances created in Western Europe at prices which had no relation to the pattern of relative demand, this resulted in a surplus of gasoline and a deficit in diesel in the market and many of the independent refiners of Western Europe began selling gasoline at prices lower than those prescribed by the existing price formula. In order to correct this product imbalance, the majors began posting prices for refinery products f.o.h Persian Gulf from the middle of 1957.35

After 1959 the basing point system broke down because of the entry of the erstwhile USSR with a large volume of exports at highly attractive terms, higher refinery capacity in consuming countries and the entry of a large number of non-major international companies (independents) as competitors. The "Import Parity System"

thus came into existence, with discounts being demanded and offered off posted prices in the light of competitive conditions in the world market.

The arrival of Russian oil in the world market also signalled a price war which started in India when the majors were forced to cut prices. It hit the Arab oil producing nations, but the lead was taken by Venezuela which opposed the price cuts and goaded the other oil exporters like Iraq, Iran, Kuwait and Saudi Arabia to take a united stand against the monopoly of the cartel. On 14 September 1960 they set up the Organisation of Petroleum Exporting Countries (OPEC), the creation of which can be attributed to three factors which changed the entire structure of international oil economy. These are: (1) The apprehension among the petroleum exporting States regarding the ability of oil companies to cut prices without consulting the host governments; (2) a realisation among the most established exporters that the entry of new producers in the world petroleum market with lower prices might detract from established markets; (3) an increase in the technical knowledge and skills of the oil producing countries, resulting in demands for changes in the structure of prices and the taxing system. The primary aim of OPEC was to arrest the falling prices. In spite of the Russians 'dumping' oil in the market, they succeeded to a large extent and even reversed the trend in early 1970s, culminating in the oil crisis of 1973.

Ocean Freight and AFRA

Since ocean freight constitutes about 10-12 per cent of the c.i.f. prices of products in India, an understanding of the mechanism of computing ocean freight is important. The Average Freight Rate Assessment (AFRA) was the system adopted for this purpose. It was determined by a panel of six leading tanker brokers in London. This panel was established by Shell and Burmah Oil in 1949, in order to achieve stability in freight rates for determining oil prices. The assessment covered time charters, consecutive voyage charters as well as spot charters and provided a weighted average of these rates twice a year. Spot rates used to fluctuate from time to time but AFRA rates generally remained stable over long periods. However they were higher than spot rates during normal years.77

Pricing in India After Independence

The price leadership of Burmah Shell and the world parity pricing system with the Persian Gulf as the basing point continued till 1 April 1950, when it was replaced by the Valued Stock Account (VSA) formula, which was based on the import parity principle with Ras Tanura (Persian Gulf) as the basing point. This formula was applicable to all purchases made by the Government from Burmah Shell. The prices for all bulk refined petroleum products were determined by adding (i) f.o.b. Ras

Tanura price on date of loading, (ii) ocean freight from Ras Tanura to Indian port, or ports, of despatch irrespective of actual source of supply, (iii) Marine and War Risk Insurance on insurable value, (iv) Ocean loss, (v) Remuneration at 10 per cent on c.i.f. plus charges post c.i.f. (excluding duty, rent and hire on facilities, rail freight and sales tax), (vi) import duty, (vii) interest and del credere on duty at 2.5 per cent and (viii) charges from c.i.f. to ex-installation/local pump. The VSA agreement was terminable at one month's notice on either side and related to Government purchases only. Burmah Shell charged other consumers the same price as applicable under this agreement and the other companies followed the prices fixed by Burmah Shell.9

The VSA covered all major products except lubricants and greases and Burmah Shell maintained separate account for each product. To this account was debited the costs of the oil products sold, and credited the revenue earned from the sales on the basis of the agreed price formula. Burmah Shell estimated the position of the VSA from time to time and submitted to the Director General, Supplies and Disposals (DGS&D) "a certificate to the effect that the VSA for the product concerned had been prepared on the basis of the agreed price formula and that all over/under recoveries were correctly accounted for". But the account was not subject to audit by the Government. There was no incentive to the Company to improve efficiency and this naturally led to extravagance in costs. When pressure was built up on the Government, in the Parliament and outside, to explain the rationale of the price

9 Ibid., p. 161.
structure of petroleum products, the companies advanced the following reasons for not disclosing the quantum of the various post-c.i.f charges included in the VSA:

1. The Government should trust the companies.
2. The accounts were too complex for any official agency to completely examine them.
3. If the Government knew what went into the companies' costing, this would put the companies at risk in maintaining their trading secrets from one another."

In 1951 when the Abadan refinery was closed, the foreign oil companies claimed that they had to get their supplies from the Western Hemisphere at higher transportation costs. Consequently, the VSA was revised incorporating the extra ocean transportation charge (EOTC). Similar price escalations were conceded after the Suez crisis in 1956. Pakistan, Ceylon and Burma had turned down this demand, and it was soon realised that the price increase was unjustified, as crude oil continued to be shipped from the Gulf and elsewhere in the East. Still, the Government could not evoke the clause in the VSA agreement that provided for its termination after giving six months notice. Malaviya participating in Lok Sabha debates admitted:

"I want to emphasize this point (that we discover oil) and I want to make it quite clear that whatever we might like, whatever our sentiments might be, so long as we do not succeed in discovering oil in our country as we require for our use and so long as we are not able to

S.S. Khera; *Oil, Rich Man, Poor Man.* 1979, P. 59
refine the oil by refineries which are completely under our control, it will be difficult for us to say much with regard to this price factor. I also do not know much about it....It was only recently that they gave us notice that they wanted to increase the price of finished products. We were only to be consulted about it. We were consulted. There was some price increase after the Suez crisis and we had to agree to it.

Therefore, so long as we are mainly dependent on imported crude and until such time as we produce and our refineries refine the oil, as much as we need to meet our requirements, we have no other alternative but to accept the import parity basis for the petroleum products.

....It is a fact that the oil that comes to this country comes from east of Suez.

You will be glad to hear that recently we have persuaded the companies to switch on from the Gulf of Mexico price to the Gulf of Persia price. We have thus effected a saving of more than Rs.2 crores on that score.”

Malaviya was referring to Clause 7 of the agreement which provided that

(i) the Government would permit the foreign oil companies to establish the prices of the refinery products, from time to time, at any level, subject to conditions;

(ii) that the level should not be higher than that at which the foreign oil companies sold or could make available for sale equivalent imported products; and

(iii) before oil companies altered the prices of any refinery products they should consult the Government.

“Lok Sabha Debates, 13 August 1957, pp.8317-8318
The System of Posted Prices

The prices of crude and products are reported in the Platts Oilgram Press Service, a daily bulletin published in the USA. These "posted prices" were not real market prices, but higher rates charged by the majors from the independents. Discounts were given by the majors while transferring crude among themselves. Posted prices were charged even when crude was transferred from a producing affiliate to the refining affiliate of the same major. This ensured higher royalty payments to the oil producing countries, which was necessary to act as an insurance against nationalisation or adverse Government policy in areas where the majors had made large investments. This also helped the majors in reducing their tax liability in their countries of origin. This system worked well till 1959 when the USSR appeared as an important crude oil supplier, particularly to Italy and Japan.

In January 1959, for the first time in the world, Standard Vacuum allowed 10 per cent discount on Persian Gulf posted prices to its Japanese affiliates in order to meet the Soviet challenge and also to secure a larger foreign exchange allocation - which was based on the f.o.b. prices - from the Government. Throughout this year, most of the Japanese refiners were able to secure their crude at 20 cents below posted prices from the Middle East. Japan could force even the majors to deliver crude at lower prices, by cutting down foreign exchange allocations for relatively more expensive crudes, and by accruing priority to cheaper crude. Japan also
had the advantages of having many more independent refiners and marketers, greater knowledge of the industry and oil pricing and greater economic strength.

It was logical to allow a similar discount in India, where the refineries set up by the majors had started processing imported crude from 1954 onwards, but no discounts were given till June 1960. The refinery agreements provided that the purchases were to be made at world market prices for which the Government were to provide foreign exchange. The onus was therefore on the Government to keep itself posted with the latest price trends in the world oil market and ensure that the companies actually availed the discounts. Even after the Talukdar Committee (See Chapter 7) recommended rates of discounts, the refineries continued to show lesser discounts. They even claimed much higher tanker rates than CRL for which the Philips Petroleum, acting as agent, could enter into a more favourable tanker contract. Since the Government had adopted a rather restrictive policy towards refinery expansion and private foreign investment in general, the companies had no incentive in pleasing the Government by conceding the discounts. Their major concern was the repatriation of maximum profits in the shortest possible time as they always feared that the Government might go back on the promise against nationalisation.

Biplab Dasgupta in his study titled "Oil Prices and the Indian Market, 1886-1964" found that between 1956 and 1960 Burmah Shell alone accounted for 60 per cent of the total outflow of foreign dividends from all sources. Remittances were at the rate of Rs. 80 million a year for the oil companies compared with Rs. 30 million
for all foreign manufacturing firms in India. Had a discount of 20 per cent been allowed between 1955 and 1961, Rs.473 million would have been saved. Thus his conclusion was that foreign refineries did help India's foreign exchange problem in the short run but were expensive in a rather short longer run. Against a net inflow of Rs.48.3 crores of foreign capital into petroleum during 1956-60, the net outflow from petroleum was Rs.41.2 crores out of a total outflow of Rs.71.3 crores.41

Although the Government was bound by the refinery agreements against nationalisation of the refineries, there was no such agreement against the nationalisation of marketing companies. Even this step was not taken on account of an assurance given by the Government to Burmah Shell in 1951 that the Government "at present" had no intention to nationalise it. The Government opted for the next best step - setting up its own marketing organisation.

In late 1957, the Government tried to negotiate for the replacement of VSA by an actual cost plus reasonable profit formula. The companies took umbrage of Clause 7 of the refinery agreement relating to import parity and their exclusive right to fix prices. The Government, not willing to violate the agreement, decided to conduct probes by the Government's cost accountants into the companies' method of cost accounting in order to ascertain whether or not it was possible for the companies to

41 Quoted by Penrose, The Large International Firm in Developing Countries - The International Petroleum Industry, 1968, p.227
make available imported products for sale at lower prices. These probes revealed that
the profits earned by foreign oil companies were the highest earned on oil anywhere
in the world. In the case of Burmah Shell refinery it was found that the profit earned
in 1955, its first year of operation was 20.8 per cent of capital employed, exclusive of
debenture capital. The trading profit in 1956 was 38 per cent with and 18 per cent
without duty concessions.\footnote{This was far in excess of the 7.5 per cent the Company
had, in the course of refinery negotiations, sought from the Government. There was
an unwritten collateral understanding that, as and when the profits of the refineries
exceeded 7.5 per cent, the Government could review the duty concessions. The
Government, therefore, proposed that the refineries surrender the concessions. Burmah
Shell agreed to effect \textit{ad hoc} reductions in prices and even to suspend VSA, but the
other two companies did not agree. The Government had to resort to the threat of
invoking the Essential Commodities Act to enforce reduced prices in which case the
onus of proving that the prices were justified would shift to the companies. The
companies could not defend their position too long and an agreement was reached with
Burmah Shell on 24 May 1958 on terms accepted by the other two companies also.
Simultaneously the VSA agreement was terminated. The Government now undertook
an examination of the components of the wholesale selling price of the companies
through the Chief Cost Account Officer (CCAO) of the Government. The companies,
in anticipation of a likely suggestion for price reduction by the CCAO, agreed to make
\textit{ad hoc} price reductions, which were mopped up by the Government through the

\footnote{Kaul; \textit{K.D. Malaviya and the Evolution of India's Oil Policy}, 1991, pp.209-213}
imposition of additional (non-recoverable) excise and customs duties payable by the companies with effect from 20 May 1958.

The report of CCAO, submitted on March 28, 1959, was highly critical of the marketing expenses charged by the companies, and stated that there was scope for economy to the extent of 20 per cent in administrative, installation, and distribution expenses. The report also commented on the extraordinary income level of supervisory and managerial staff, which formed a very significant proportion of the total administrative expenses. However, the report raised no question about the “import parity principle” or its application in India.4

The oil companies refused to accept the findings of the CCAO’s report. However, they agreed with the Government on an ad hoc price arrangement, to continue up to March 31, 1961. The Price Adjustment Account for this purpose was similar to VSA with the difference that it was not permitted to show a balance of more than Rs.2 million.

By 1960 the Government had largely succeeded in getting the established majors to import crude oil rather than refined products, thus saving considerable foreign exchange. At the same time, however, the rising demand for oil in India threatened to more than offset this saving, thereby increasing the total oil import bill. Moreover, the foreign exchange position was deteriorating rapidly. Faced with this

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problem, the Government had five basic alternatives: (1) attempt to suppress the
growth in oil demand, either through the price mechanism or through limiting imports;
(2) seek to find crude oil within India; (3) force a reduction in the prices paid for
imported oil by the companies to their overseas affiliates; (4) import oil on a barter
basis, involving no outlay of hard foreign currencies; (5) obtain Western foreign aid to
purchase oil. At one point or another the Government worked along each of these
lines. Considerable effort was devoted to (3) and (4), which soon became interrelated.
Because the Soviet Union was the only practical source of barter oil, the Government
started pressurizing the companies to import Soviet oil.**

In the mid-1960s, the Government entered into an import agreement with
the USSR, which offered to supply 18 million barrels of crude oil per year or about
half of India’s crude import at that time. Despite the long haul from the Black Sea to
India, the Soviet crude oil was offered on a delivered basis at $1.81 per barrel c.i.f.
Bombay or $0.25 a barrel cheaper than the companies’ c.i.f. price. Thus the Soviets
were offering to sell oil to India at a price which would immediately save India almost
$5 million per year. Even more important, since the Soviet oil was to be paid for
completely in inconvertible rupees, the foreign exchange saving would amount to the
full cost of the displaced Western oil or some $33 million per year.*** Upto 3 mmt of
crude per annum was offered at prices ranging between Rs 62.02 and Rs 63.17 per

** Tanzer: *The Political Economy of International Oil and the Underdeveloped
Countries*, 1969, p. 178

*** Ibid., p. 179
tonne as against the Rs 74.32 of Standard Vacuum, Rs 76.34 of Burmah Shell, and Rs 84.55 of Caltex.

Since the Government had no refinery of its own, it asked the private refineries to process Soviet crude. The foreign companies refused and tried to dissuade the Government by arguing that the Soviet offer was politically motivated and lacked the commercial advantages of an assured and continuous supply. However, subsequent events showed that although political considerations may not have been altogether absent, economic considerations were there. Adelman showed that the allegation of the foreign companies that the prices offered by USSR were not based on economic and commercial considerations was incorrect. He pointed out that, even according to the National Petroleum Council, most of whose members were top executives of the major companies, Soviet production costs were $0.68 per barrel as compared to Soviet f.o.b. prices in 1960 ranging from $1.34 to $1.83 a barrel.

The Government did not nationalise refineries as was done by Castro in Cuba in a similar situation. Neither was it strong enough to force the oil companies to accept the Soviet crude, as was done by a small country like Finland. Instead, it broke off the agreement to purchase crude from USSR.

Kaul; Op.cit., p.263


The companies were quick to realize the need for making some adjustment in view of the Soviet competition. Accordingly, they agreed to allow a 15 cents discount off posted crude price in the Middle East. The amount of discount was increased in the following year, and the companies paid $1.57 per barrel, compared to a posted price of $1.78 per barrel f.o.b. Bandar Masur of light Iranian oil, between 1962 and 1964. From the beginning of 1965, they made a further cut of two cents per barrel in response to a request made by the Government to the oil companies in view of the precarious foreign exchange position. In July 1965, the price was further reduced under Government pressure and the f.o.b. price of light Iranian crude was $1.48.

All these developments compelled the Government to conduct a detailed examination of the basis of pricing followed by the companies. This led to the appointment of the Damle Committee on 2 August 1960.

In July 1960, following the companies' refusal to handle Soviet oil, the Indian Oil Company signed a contract to import Soviet products on a barter basis. The first consignment of Russian HSD reached Bombay in August 1961. The majors who controlled most of the marketing and distribution facilities adamantly refused to handle any Soviet products in their marketing networks; this would have been even worse than handling Soviet crude oil, since it would not only eliminate the companies' crude oil profits but also their refining profits. In addition, the Government had moved very slowly to develop its own marketing facilities. The Third Five Year Plan allocated only

$21 million for this, or about a tenth of what the private companies had invested. The majors started a new kind of price war. Since IOC had no retail outlets, it could only sell to the bulk consumers, particularly state transport enterprises. The majors, in a bid to retain their business, offered prices even lower than those quoted by IOC for its Russian products. As a result, a large part of IOC’s supply remained unsold creating storage problems. IOC was forced to offer prices below the economic level so as to secure some business. However, the price war did not last very long as the companies could not afford a conflict with the Government. The main objective of the price war was perhaps to put pressure on the Government to reject the proposals of the Damle Committee which prescribed a lower schedule of prices for imported products.

Between 1961 and 1965 India imported a total of 10 million tons of refined products of which Soviet products accounted for less than one-fourth. In value terms, it came close to $500 million, most of which had to be paid for with scarce hard currency.

The ownership of all refineries by the majors prevented the pressure of competition, which worked in Japan, Germany or Italy, from operating in India. Still the Government could force reductions in crude oil prices as the majors could not afford to alienate the Government and could not ignore a growing potential market.

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*Ibid.* p. 71

of 500 million consumers. Moreover, the possibility of nationalisation of marketing companies was a real threat. Later, foreign exchange cuts also put pressure.

The refusal of the companies to process or sell Soviet oil forced the Government of India to simultaneously take the following steps:

1. Investigating the price policies of the companies;
2. Providing increased support for an integrated state oil industry;
3. Refusing to allow the expansion of the existing refineries or the building of new refineries by the three established majors;
4. Seeking to bring newcomers into the oil industry in India.

*Ibid.* p. 192