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CUTTING PETROL AND DIESEL PRICES: UPTO HOW MUCH AND HOW?

We believe finding a lasting solution to current increase in oil prices is a delicate balancing act. Our analysis shows that at the current crude prices, and extending our analysis to 19 states (overall consumption share is 93% both in petrol and diesel), the states could have gained at least an additional Rs 18,728 crores of revenue / Rs 2675 crore additional revenue over and above the budget estimates of states revenue for every $1/barrel increase in oil prices.

Given that these revenue if foregone will not impact states fiscal position, we estimate that on an average, states can cut petrol prices by Rs 2.65 /litre and diesel by Rs 2/ litre, if the entire revenue gain was to be neutralised. This is the most plausible scenario under the current circumstances.

Additionally, one suggestion to further rationalise the petrol and diesel prices is to consider a pricing mechanism where VAT is imposed on base price only by states and not on prices inclusive of Centre's tax. If this was the case, diesel prices could further reduce by Rs 3.75 /litre and petrol prices by Rs 5.75/ litre. However, if this was to happen, the state will have to forego Rs 34,627 crores of tax revenue / 0.2% of consolidated fiscal deficit of states.

However, if the Centre cuts the excise by Re 1, the loss of revenue will be to the tune of Rs 10,725 crore for every Re 1 cut in Central Excise. This will push up the deficit of Centre, unlike states.

We strongly believe that the revenue collected by the Centre on oil through excise duty has helped it to significantly step up capex expenditure from the levels of FY14. Road building has jumped by 2.3 times over 4260 km in FY14 and Railways capex by 2 times from Rs 67,432 crores in FY14 and provision of financing social sector programmes and MSP support programme in FY19 budget.

Hence, the states could cut oil prices more than the centre. The VAT rates across states could also be rationalised to count for divergence.

We strike a point of caution even as oil prices have started to retreat. We believe oil prices might decline meaningfully only in 2019 for 3 reasons. First, Saudi Arabia lists its oil company Aramco in 2019. Second, Russia may not be able to increase its production as it access to finance is cut through sanctions. Finally, if material changes occur in the EU and Japan on demand side for battery operated cars, the oil prices will possibly decline in late 2019.

SURGE IN OIL PRICE AND ITS IMPACT ON STATE REVENUE

- There is both good news and bad news surrounding oil prices. First the bad news. The recent hike in oil prices is reflecting on the prices that consumers are shelling out for petrol and diesel. With deregulation, petrol and diesel prices across the country are now market linked on a daily basis since June 2017. When the crude prices were benign, the customers did not feel the pinch. However, as the prices started climbing up due to various geo-political factors and reduction in the worldwide supplies, the petrol and diesel prices have started burning a hole in the average customer's pocket.
- With this the clamour has started for cutting the Central Excise on petrol and diesel. The Centre charges a fixed excise duty of Rs 19.48 per litre on petrol and Rs 15.33 per litre on diesel. However, a big part of the price rise comes from the State side. States impose ad-valorem taxes on petrol and diesel consumption. This ranges from a low of 16.62% in Goa to an highest rate of 39.27% in Maharashtra for petrol. All India average comes to 26.34%. Interestingly, 17 states have a ad-valorem rate above the national average. Similarly, for diesel also there is significant diversity among the States. The average comes at 18.58% and the highest rate is in Andhra Pradesh at 28.47%.
- Apart from this, there are transportation costs, commission costs and other charges that are levied on the input price. On top of these, the state tax/VAT is levied. Though this is the convention, this system of tax on tax pinches the customer even more. For example, in Maharashtra the state tax is 39% for petrol. So on a Rs19.48 excise, the customer has to pay Rs 8 tax on tax.
- Interestingly, States are getting the benefits as the average price of India's crude oil basket has surged up to $72 per barrel (on an average) in this FY19 from the average price of $57 in FY18.
- Our analysis shows that at the current crude prices, and extending our analysis to 19 states (overall consumption share is 93% both in petrol and diesel) , the states could have gained at least an additional Rs 18728 crores of revenue, based on an average crude oil basket of around $72 / barrel for FY19. This translates into an Rs 2675 crore additional revenue over and above the budget estimates of States revenue for every $1/ barrel increase in oil prices.
- Given that these revenue are deficit neutral, we estimate that on an average, states can cut petrol prices by Rs 2.65 /litre and diesel by Rs 2/ litre, if the entire revenue gain was to be neutralised. This is the most plausible scenario under the current circumstances, as it will not impact states fiscal position.
- Additionally, one suggestion to further rationalise the petrol and diesel prices is to consider a pricing mechanism where VAT is imposed on base price only by states and not on prices inclusive of Centre's tax. If this was the case, diesel prices could further reduce by Rs 3.75 /litre and petrol prices by Rs 5.75/ litre. However, if this was to happen, the State will have to forego Rs 34,627 crores of tax revenue / 0.2% of consolidated fiscal deficit of states. This will be a permanent loss of revenue to states.

Arithmetic of States Revenue from Oil (Rs crores)			
	Diesel	Petrol	Total
Current revenue Gain (Rs crore)	12979	5749	18728
For every 1$/barrel increase in Crude Oil Price (Rs crore), states gain	1854	821	2675
Maximum permissible average cut in prices across states to exactly nuetralise the additional Rs 18728 crore revenue	Rs 2.00	Rs 2.65	-
If States impose VAT on Base price (Crude oil + Commission+Transport Cost), Consumer will gain by	Rs 3.75	Rs 5.75	-
Memoranda: If states impose VAT on Base Prices only instead of Tax on Tax, states stand to lose Rs 34,627 crores on both petrol and diesel / 0.2% of fiscal deficit			
Source: SBI Research			

Excise Cut by Centre: Impact on Revenue Collections (Rs Crore)		
	Excise Cut by Re 1	Excise Cut by Rs 2
Petrol	2618	5235
Diesel	8107	16215
Total	10725	21450

Source: SBI Research

- However, if the Centre cuts the excise by Re 1, the loss of revenue will be to the tune of Rs 10725 crore for every Re 1 cut in Central Excise and the amount will become twice if it cuts the excise duty by Rs 2. This will push up the deficit of Centre, unlike states.
- Now we come to the good news. Oil prices have started sliding down and historically also there has been evidence that oil prices come down in the second half of the calendar year after picking up in the first year. Rupee is also expected to stabilize. With evidence of asynchronised growth happening around the globe it is expected that the oil rally could move in the downward direction.
- However, a point of caution regarding the good news of oil prices declining on a sustainable basis. We believe oil prices might decline meaningfully only in 2019, once Saudi Arabia lists its oil company Aramco in 2019. This is needed to balance the Saudi Budget and will stabilize the kingdom in political transition and ease resource to undertake complex reforms. Also, Russia may not be able to increase its production as it access to finance is cut through the US sanctions. Finally, if material changes occur in the EU and Japan on demand side for battery operated cars, the oil prices will possibly decline in late 2019.

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ABOUT US

The Economic Research Department (ERD) in SBI Corporate Centre is the successor to the Economic and Statistical Research Department (E&SRD). The latter came into being in 1956, immediately after the State Bank of India was formed, with the objective of "tendering technical advice to the management on economic and financial problems in which the Bank has interest and which required expert analysis".

After the first reorganization of the Bank, when specialized departments like Management Science, Management Information Systems, Planning and Market Segment Departments took over the statistical work of E&SRD, the Department was renamed as ERD.

However, with the ERD team now taking on multidimensional functionalities in the area of risk management, corporate analytics, strategy and so on, who knows, the time may have come to rename it again!

DISCLAIMER

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