

Another Oil Shock

Oil is a major source of energy the world over. When energy (read oil) is available at low prices, the outlook towards growth is optimistic and vice versa. Crude oil prices have been rising continuously since 1998, when the price was \$10 a barrel then. Non-OPEC countries have now been thrown into a dilemma with the oil price within kissing distance of the \$100 mark.



The main reason, for the oil price hike, is surge in global oil consumption. As developing countries keep improving their standards of living and automobiles remain a symbol of aspiration, there is only one way where the oil price is headed: upwards.

Let us study what other factors that have contributed to the recent oil price spikes.

▶▶ The oil cartel

The Organisation of Petroleum Exporting Countries (OPEC)* has been acting as a swing oil producer of the world. That is, OPEC produces only to fill the gap between global oil demand and production by non-OPEC countries.



Over the years, this arrangement resulted in OPEC having a lot of idle capacity and helped them to gain control over oil prices. Whenever the inventory level of oil stocks in industrialized nations went up, OPEC reduced output.

This artificial scarcity that OPEC manages to create did not allow oil prices to fall.

The same idle capacity has been used to pump extra oil into the market to prevent dramatic price rises during times of unexpected supply disruptions.

But that situation seems to be changing now, with OPEC unable to control the surging global oil prices. OPEC members have been pumping oil as fast as they can with hardly any idle capacity left. Though there is no shortage of crude oil, the fact that there is no safety net, has made the oil traders jittery. This has led to them demanding a risk premium and so the high price.

▶▶ Oil prices up, Dollar down

Lately, the dollar has been making a lot of news too. Oil prices have risen, while the dollar has simultaneously plummeted against the euro.

Oil producing OPEC countries sell their products in dollars. These dollars are used by them to purchase other goods in international markets. As the dollar is losing its value precipitously in recent times, oil producers can now buy less in international markets with their dollars due to reduction in buying power. To compensate for this loss of buying power, they may have raised the dollar price for oil.

How India is dealing with the price hikes - Oil Bonds

Every rise in price of crude oil is not always correspondingly



matched by a price rise of fuels in India. This is so because, the government wishes to insulate the citizens from frequent oil price shocks and to avoid a sudden inflationary impact.

Therefore oil companies are not allowed to raise prices in tandem with the international prices. Till the time the government aligns domestic prices of transport and cooking fuel to the level of increasing import prices, oil marketing companies are making a loss of Rs 120-160 crores per day. This is, however, largely offset by the government mechanism of oil bonds.

The government issues oil bonds under its petroleum subsidies program, to state owned oil firms such as Indian Oil Corporation, Bharat Petroleum and Hindustan Petroleum to compensate them for their losses on sale of petroleum products.

Thus, the oil marketing firms continue to sell petrol, diesel, cooking gas and kerosene below profitable prices and the shortfall is compensated by means of oil bonds issued by the government.

Oil bonds therefore play a two-fold role:-

▶▶ Temporarily eases the price-rise situation by passing the fiscal burden to future budgets (oil bonds are typically of 15, 17, 20 yrs. duration)

▶▶ Helps oil firms tide over liquidity problems which otherwise restrict their ability to undertake fresh imports.

This year the government plans to issue fresh oil bonds worth Rs 23,457 crores. These bonds have maturities ranging from 15 to 20 years and therefore do not address the immediate liquidity issues that these companies face. Thus oil marketing companies like the Indian Oil Corporation have been selling these bonds at discounted prices in the market to offset their market borrowings.

Already, the government subsidy bill for petroleum and fertilisers is expected to balloon to Rs 1,00,000 crores, which is 117% more than the initial Rs 46,000 crore estimate for fiscal 2007-08. Official estimates put the petroleum subsidy bill for this fiscal at current prices at Rs 68,640 crore.

Appreciation of the rupee – a boon for oil marketing companies



Though Indian exports have been hit by the 12% appreciation of the rupee vis-à-vis the dollar this year, it has proved to be a boon for oil imports. The oil import bill for April-September this year was \$31.4 billion, only 8.26% higher than \$29 billion for the corresponding period last year.

Although there has been much debate over the strengthening of the rupee and its implications on our exports, one must realize that had the rupee not strengthened our situation with regards to energy imports would have been a lot worse.

The road ahead

Yet, experts say that the government cannot indefinitely defer a decision on raising domestic prices as Indian crude oil demand has been witnessing over 5% annual growth. Or else, in a few years, people will have to pay a higher price in the form of taxes or face the prospect of lower government investment in social sectors such as agriculture and infrastructure.



The time has now come to focus on finding renewable or alternate energy sources** thereby reducing dependence on oil derived fuels. In the year 2000, there were about eight million vehicles around the world that ran on alternative fuels, indicating sustainability of this resource. Wide spread use of this resource will reduce the demand for conventional fuels and may lower prices.

Is this the possible solution to an imminent energy shortage and our energy independence? Time alone will tell.

***Organization of Oil Producing Countries (OPEC)**

The Organization of the Petroleum Exporting Countries is an intergovernmental organization made up of thirteen oil producing nations. These countries are Algeria, Angola, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, the United Arab Emirates, Venezuela, and Ecuador (which rejoined OPEC in November 2007).

OPEC's mission is to coordinate and unify the petroleum policies of Member Countries and ensure the stabilization of oil markets in order to secure an efficient, economic and regular supply of petroleum to consumers, a steady income to producers and a fair return on capital to those investing in the petroleum industry.

****Alternate Energy Sources**

Alternate energy is also termed 'renewable energy' as opposed to non-renewable energy sources such as fossil fuels. Alternate energy is renewable as it can be replenished unlike petroleum which is a non-renewable source of energy.

Renewable energy effectively utilizes natural resources such as sunlight, wind, tides and geothermal heat, which are naturally replenished. Renewable energy technologies range from **solar power** (solar cells), **wind power** (wind turbines), **hydroelectricity** (tidal power through turbines) to **biomass** (dried manure, plant matter) and **biofuels** (ethanol, biodiesel) for transportation.