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Oil Pricing: Should There Be a New Direction?

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One of the critical issues facing General Chatichai Choonhavan's Government is the Oil Price Stabilizing Fund ("the Oil Fund") reserve that is being rapidly depleted and which will soon run out. This could mean that the government might have to increase the retail price of domestic oil. However, the government will probably consider any move to adjust the oil price carefully as, historically, the public's reaction against oil price increases is very strong.

In Thailand, the government strictly controls oil prices at every oil transaction stage: (1) weekly, the government announces the ex-refinery and imported oil product prices; and (2) the government also determines taxes, the Oil Fund levy, and oil company marketing margins. The sum of the supply price, taxes, the Oil Fund levy, and the margin makes up the controlled ex-Bangkok retail price. Then, a (controlled) transportation allowance is added to the Bangkok price to obtain the upcountry retail oil price.*

Since the controlled retail price, taxes, and the marketing margin are infrequently changed, the Oil Fund levy acts as a balancing factor, absorbing the impact of weekly supply-price changes, and according to the existing oil-pricing structure, a "neutral" stage is reached when the average netback price of imported crude is about $18 per barrel. At this price level, there would be no movement in the Oil Fund reserve because the amount of the Oil Fund levied on certain products (like gasoline) is exactly matched by the subsidy (or negative levy) given to some oil products (like diesel and cooking-LPG). However, if the average (CIF) price of imported crude exceeds $18 per barrel, which is currently the case, the amount of subsidy exceeds the levy, draining the Oil Fund Reserve.

As of the end of October, 1989, the monthly Oil Fund levy (imposed on gasoline, automotive-LPG, and bitumen) was 138 million baht, while the subsidized amount (given to diesel, kerosene, cooking-LPG, and fuel oil) was 614 million baht. This resulted in a net monthly Oil Fund Reserve outflow of 476 million baht, and the amount left at the end of October was estimated at approximately 800 million baht. Thus, at the current outflow rate, the Reserve will run out in December 1989.

What has the Government done about oil pricing? When General Chatichai's Government took office in August 1988, the world energy situation was favorable; the world oil price had been gradually falling from $17-18 per barrel (in late 1987) toward a $10 per barrel level (in October 1988). As a result, the Oil Fund inflow over that period was relatively healthy, as most oil products did not require subsidization in order to maintain existing (1987) levels. In fact, the net inflow to the Oil Fund was 586 million baht a month in October 1988, and the total Reserve was about 5 billion baht. So, the Chatichai Government decided to pass the "benefits" on to consumers in November 1988 with a general oil-price reduction.

However, as it turned out, the world oil price began to strengthen in December, as the OPEC countries agreed on production quotas. By March 1989, the price went back to its previous $16-17 per barrel. As a result, of course, several local oil products required subsidization in order to maintain their prices at October 1988 levels. Then the Oil Fund registered a net monthly outflow of 0.5 and 1.1 billion baht in April and June, respectively. At this outflow rate, the June Oil Fund reserve (of 3.7 billion baht) would be depleted in approximately four months.

Thus, it came as no surprise in July that the government policy was to maintain the domestic oil price level. To slow down the Oil Fund outflow, the government reduced the excise tax level by 3 to 10 percent. This measure was achieved easily because the two items are adjustable components in the retail oil price. In other words, the government decided to subsidize the oil price from both its General Revenue Fund and from the Oil Fund. The tax reduction cost the government 200 million baht a month in lost revenue.

Further, the July tax cut was clearly insufficient to slow down the drain on the Oil Fund. As it turned out, the huge Oil Fund outflow was not only a result of the stronger world oil price, but also a function of the extraordinarily high growth in domestic oil consumption, which increased 18 percent during the first half of 1989. And this growth in consumption was partly a product of the government policy to maintain the domestic oil price in the face of rising world price levels.

Pressed by the huge Oil Fund outflow, the government made a second-time excise tax cut by 12-13 percent in September. And this resulted in an additional government revenue loss of 440 million baht per month. However, despite the two tax cuts, the Oil Fund continues to drain quickly and will probably be depleted by year-end. Then what will the government do?

Several previous governments had faced the same situation and had adopted various measures to prolong price increases or to minimize the impact of an oil price adjustment on consumers. Table 1 highlights some of the measures adopted by governments since the Second Oil Crisis. General Kriangsak Chomanan's Government first allowed gasoline consumers to shoulder the price increase when it raised the oil price in 1978. Due to continuing world oil price rises, the government subsequently raised domestic oil prices across the board. Since the Oil Fund reserve at that time was not firmly established and since the government showed a budgetary deficit throughout this period, the Kriangsak Government raised the price five times—each time including a tax increase.

In early 1980, shortly after the last oil price adjustment, the Kriangsak (4) Government was pressured to resign and was replaced by General Prem Tinsulanonda's Government. To combat the continuing world oil price hike, the Prem Government adopted two oil pricing measures. First, the government levied a higher price increase on gasoline and automotive-LPG than on diesel, kerosene, fuel oil and cooking-LPG. Price gaps between gasoline, diesel and kerosene began to widen and by 1982, the price of premium gasoline was 82 and 120 percent higher than for diesel and kerosene, respectively. Prices were also differentiated between LPG for cooking and non-cooking uses. Second, the government used the Oil Fund Reserve—the proceeds of which came from gasoline levies—to partially subsidize the price of diesel, kerosene, fuel oil and cooking- LPG. However, the subsidized amount from the Oil Fund was much greater than the levy collected, and the Reserve quickly ran out in late 1980. Nonetheless, the government continued to subsidize oil prices by allowing the Reserve deficit to be as high as 4 billion baht by the end of 1981. Much of the deficit consisted of money the Government owed the oil companies through withholding their subsidy payment. The rest of the deficit was financed by borrowing from government banks.

The early Prem Government's oil pricing policy later led to severe consumption distortion and oil product adulteration. When the world oil price began to soften in 1983, the later Prem Government implemented policy measures that gradually reduced the distortion. Taxes were imposed on fuel oil and LPG, and the price gap between substitute fuels—like gasoline and diesel—was narrowed. These measures continued to be carried out by the Chatichai Government after it took office in August, 1988.

By most accounts, the oil pricing situation facing the current Chatichai Government is relatively "mild" compared to the situation its predecessors had encountered. Although there is an impending need for the Chatichai Government to act on the oil price, the circumstances surrounding the oil situation now are significantly different than those during the previous oil crises. Following is a summary of the differing circumstances:

(1) The current world oil price situation is much less volatile than it was during the last oil crisis. Oil price increases are now relatively modest, and there have been periods in recent months where the prices declined. More importantly, however, predictions are that the world oil price will grow steadily at a moderate rate in the short- to medium-term, and the supply is expected to be readily available. On the other hand, the oil price outlook during the Kriangsak and the early Prem Governments was very poor, and the availability of the oil supply was highly uncertain.

(2) The country's economic performance during the Chatichai Government is much stronger than it was during the economic recession of the Second Oil Crisis. The average income of consumers has significantly increased since that time.

(3) The current 5 to 6 percent inflation rate is relatively modest compared to the 13 to 19 percent rate experienced during the late Kriangsak and the early Prem Governments. Furthermore, the current inflationary pressure is caused by excessive spending in the economy, which has been booming.

(4) The Chatichai Government is experiencing a 60-billion-baht government budgetary surplus, whereas the Kriangsak and early Prem Governments had a deficit ranging from 21 to 25 billion baht throughout the crisis period.

(5) The Chatichai Government is not pressed to subsidize economic fuels like fuel oil, since only 10 percent of total EGAT power generation has come from fuel oil. On the contrary, during the Second Oil Crisis, about 80 percent of energy generation came from fuel oil, and the government needed to subsidize fuel oil in order to prevent a price rise in electricity.

(6) Oil trading has become highly competitive in recent years, both in Bangkok and in the upcountry regions. Coupled with a significantly improved road network in rural areas, oil availability has become widespread. Most villages are now accessible by roads; as a result, most villages in the country are well supplied with oil from both formal and informal retail outlets. Improved oil transportation methods have led to a significant cost reduction of transportation in rural areas, resulting in increased price competitions in oil trading in most parts of the country.

Given these relatively favorable conditions, the Chatichai Government should be able to effectively handle the current oil pricing problems. It is possible that the government will continue to maintain the existing price level, and the tool that it will probably first use is a further tax cut. Currently, the taxes are 3.33, 2.32 and 0.2 baht per litre for gasoline, diesel and fuel oil, respectively. A 0.3 baht per liter tax cut for gasoline and diesel would slow down the Oil Fund drain by 300 million baht a month, and a 0.5 baht per liter tax cut would stop the Oil Fund drain, given the October level world oil price. As mentioned earlier, cutting the tax is equivalent to subsidizing oil consumers by using the government's General Revenue Fund.

Second, the government might decide to hold the existing tax level and allow the Oil Fund Reserve to go into deficit. The deficit could be financed by the oil companies (by withholding their subsidy payment, as was partly done during the Prem Government), or it could also be financed by borrowing the money from government banks. Third, the government could cut the oil companies' marketing margin (when this was attempted by the Kriangsak (1) Government and which lasted about one week). Considering the substantial budgetary surplus, the government is not likely to pursue the second and the third options. Fourth, the government could change the reference for the domestic ex-refining price from "averaged" Singapore posting to "minimum" Singapore posting, which could partially slow down the Oil Fund drain. (In effect, local refineries would have to share the oil pricing burden with the government). Finally, the government could take steps to "float" the oil price.

Although the first four measures are popular politically, they are economically undesirable. Keeping the oil price below its opportunity cost will only encourage the uneconomic utilization of oil—over 90 percent of which is imported. Furthermore, after decades of the government interference with the oil price, the public's perception is that the government determines the price. Thus, it has become the government's duty to maintain the oil price in order to protect the interest of oil consumers. The public perceives that it is the Thai government—not OPEC or any other oil producers—who would be held responsible for a domestic oil price increase. Subsidizing the oil price from tax revenues would only strengthen the public's perception.

It is more desirable that the government begins to take steps to allow some fluctuation in the domestic oil price. The proposed "semi-float" oil pricing scheme—in which the price is allowed to fluctuate within a narrow band—should be seriously considered. The scheme maintains the Oil Fund Reserve, but allows it to be "triggered in" only if the oil price fluctuates beyond the band. The domestic oil price would become more responsive to world price fluctuations, and oil would be utilized more efficiently. Furthermore, the small price movements would not be harmful to the inflation level. In fact, an oil price increase will probably help to alleviate inflationary pressure in the country which has been caused by excessive demand.

In summary, the current economic situation and the projected world oil price are conducive with the proposed oil pricing scheme. The government should take the first step toward the development of a more desirable oil pricing policy. The public's perception that the government should control the oil price through subsidization must be changed. It is the government's responsibility to allow some fluctuation in the price of domestic oil. Keeping the oil prices artificially low no longer serves the interests of the country's economy and in the long term, could harm the overall economic situation.
