Price hikes are working, time for a Rs 3-4 diesel hike

Given that the combination of a hike in global prices of crude oil and the 12% fall in the value of the rupee since January have negated the impact of whatever the government has done by way of price reforms, the government has no option but to go in for a sharp hike in at least diesel prices once the Parliament session is over—under-recoveries rose from Rs 389 crore a day in January to R454 crore in February, fell to Rs 252 crore in May before the rupee began its sharp descent, and are up to around R389 crore today. While there will be the usual howls of protest, it is useful to keep in mind the government's earlier moves have already borne fruit. Though kerosene prices have not risen from Rs 14.96 in March—with an under-recovery of Rs 34 per litre then—thanks to lower government releases each year, partly the result of greater spread of LPG, consumption has been falling steadily. From 9.5 million tonnes in FY07 to 8.2 million tonnes in FY12, consumption further fell to 7.5 million tonnes in FY13—and from a monthly average of 6.2 lakh tonnes in FY13, consumption was down to around 5.9 lakh tonnes in the first few months of FY14. Kerosene under-recoveries comprise around a fourth of the total for all petroleum products.

In the case of diesel, though the overall numbers don't suggest it, the decline is equally dramatic. When price of diesel rose sharply in January—rates for bulk users that comprise a fifth of total consumption were linked to market prices immediately—consumption fell dramatically, from 6.1 million tonnes in December 2012 to 5.8 million tonnes in January 2013. As prices went up further, consumption in February fell further to 5.4 million tonnes. Thereafter, while prices went up regularly, the markets took the hike in their stride and consumption rose again. One of the reasons, though a one-to-one correlation with price hikes and consumption—or a reduction in under-recoveries and a fall in consumption—is not always visible, the real impact can be seen in the case of furnace oils, or the lower quality fuels burnt to keep furnaces going in manufacturing units. Given the dramatically high under-recovery in diesel, units are using diesel instead of furnace oil—this has been happening for years, but has gotten worse in recent years. Furnace oil consumption fell from 12.7 million tonnes in FY08 to just 9.3 million tonnes in FY12 and to an even lower 7.7 million tonnes in FY13—from a monthly average of 6.5 lakh tonnes in FY13, FY14's monthly average is around 5.1 lakh tonnes. In the case of LPG, from an average of 15.6 million tonnes in FY13, FY14 consumption is likely to be around 14.8 million tonnes based on Q1 trends, given that subsidies have been curtailed—once DBT kicks in, and fake owners are weeded out, this could fall much further.

Apart from the obvious reforms signal it sends would-be investors, the other advantage of a sharp hike in diesel prices—diesel accounts for 40% of all subsidies—is what it does for the budget. Based on the budget numbers, the government can afford just R178 crore of daily subsidies, leaving around R200 crore to be borne by the oil PSUs (based on today's numbers). Assuming a 30% corporate tax rate and a price-earnings ratio of even 10, this means a loss of over R5 lakh crore in market cap, about two thirds of which accrues to the centre given the current levels of PSU holdings. Indeed a sharp diesel hike will do a lot more for the beleaguered government and its twin deficits than any of the measures taken by RBI over the last month.