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WINDFALL TAXES AND EXPORT DUTY HIKES

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OVERVIEW

The imposition of the windfall taxes and export duty evoked considerable debates across the development spectrum. The basic justification for the windfall taxes and export duty tax on petrol, diesel and Aviation Turbine Fuel (ATF) hikes imposed on July 1, 2022 stems from the fact that some oil refiners were raking in "phenomenal profits" while domestic supplies were bleeding. Small producers whose annual crude production in the previous fiscal year was less than 2 million barrels were excluded from this cess. Domestic petroleum product pricing remained unaltered by this cess.

Indian measures are similar to the Chinese action. Refinitiv Eikon reveals that Asian refining margins of diesel rose over 192 per cent post the Ukraine war amid a global shortage and changes in trade flows, while the gasoline cracks have more than doubled on tight supplies and recovering demand. Given this asymmetric and uneven level playing field, the Government of India rightly stepped in to remedy this completely unacceptable situation.

The government also framed new rules requiring oil companies exporting petrol to sell in the domestic market, the equivalent of 50 per cent of the amount sold to overseas customers, for the fiscal year ending March 31, 2023. For diesel, this requirement was 30 per cent of the volume exported. These export restrictions were also aimed at enhancing domestic oil supplies while curbing diesel and gasoline exports.

In view of the high price differential, it is no wonder that private refiners were increasingly taking the export route rather than doing local sales. These well-conceived measures would thus help to boost domestic supplies of petrol, check abnormal profits of a few firms, reduce sectoral arbitrage and the inherent asymmetry in the system.

Given the severe fiscal crunch, which was exacerbated by the Central Government's slashing of fuel taxes, subsidised gas cylinders, capped sugar exports and permitted duty free import of 20 lakh tonnes of crude soya-bean oil and sunflower oil in late May to check the inflationary spiral (estimated to cause a hit of over ₹1 lakh crore to public finances), this measure is expected to generate close to $12 billion (₹ 94,800 crore) for the government in this financial year. Hence it would almost offset the hit caused by reduced fuel taxes.

In sum, the government's move was aimed at correcting an anomaly in the system, boost tax collections and moderate the northward movement of prices (sticky CPI inflation, which rose for the seventh successive month from 7 per cent in March 2022 to a 95-month high of 7.8 per cent in April 2022; 15 per cent WPI inflation, the highest in 3 decades, breached the MPC mandated threshold of 4 per cent +/-2 per cent).

This measure would thus have a wholesome effect on the twin current account deficits (record monthly trade deficit of $24.3 billion in May 2022) and fiscal deficit and achieve both the avowed objectives.

It has sometimes been suggested that given the crude import bill this year (estimated at well above the last year's level of 212 million metric tonne worth $120 billion), this move does not jell with the need to incentivise higher domestic output and the Cabinet Committee on Economic Affairs' decision to provide greater pricing power to domestic oil producers to enable market-determined price discovery.

This issue also assumes significance in the wake of the steady decline in domestic crude production from 38.1 mmt in FY12 to 29.7 mmt in FY22.

An analysis by the Petroleum Planning & Analysis Cell revealed that production at 5 mmt till May 2022 remained almost constant from the levels during the corresponding period in FY 22 because of reasons, such as, declining output from old and marginal fields, inadequate technological capability for deep water exploration, a conspicuous absence of major hydrocarbon discoveries of late, rising expenditure on seismic surveys of domestic hydrocarbon assets.

India has 26 sedimentary basins covering an area of 3.3 million square km, of which only seven Category 1 basins have established commercial production of oil. The issue of incentivising prospecting the remaining areas is a tall order and necessitates, inter-alia, an accent on resources and technology to raise the harnessing of the sedimentary basin, which rose modestly to 10 per cent in an attempt to reach the ambitious target of 30 per cent.

This move would adversely impact global fuel supply modestly because global fuel supplies shrank in the aftermath of the Russia-Ukraine war. It would also disrupt the oil market and debilitate the incomes, profits and profitability of some Indian companies, e.g., Reliance Industries Limited (RIL) and Oil and Natural Gas Corporation Ltd (ONGC), which would be required to shell out ₹ 6 per litre (around $12.2 per barrel) on exports of petrol and ATF, and ₹13 per litre (around $26.3 per barrel) on exports of diesel. This is starkly reflected in the fall of RIL's share by 8 per cent and ONGC's share by 20 per cent.

Simultaneously, upstream producers will have to pay taxes of ₹ 23,250 per tonne (around $38.2 per barrel) of crude oil produced in India. Import of crude oil would not be subject to this cess. But the credit quality of RIL, ONGC Vedanta Ltd., and Nayara Energy is unlikely to deteriorate significantly because their margins still continue to be healthy.

The refiners or the downstream companies export oil products at high global prices and gain windfall profits. But this does not apply to State owned upstream national oil companies (NOCs) like ONGC, who in turn have exclusive MoUs to sell their crude production in domestic market only. Their prime buyers are the state run refiners like IOC, BPCL, HPCL, etc. There is, however, no such compulsion on private entities like Reliance to sell their crude only to state owned refiners.

At the macro level, these innovative, out of box measures would reduce export receipts but higher customs duties on gold imports would help to contain the current account deficit within manageable proportions.

India's foreign exchange reserves ($593.323 billion during the week ended 24 June, 2022) are quite healthy in terms of accepted benchmarks. To be sure, India's foreign exchange reserves could take a hit because of rising repayment of external debt. But there is no reason for concern-much less alarm-in this sphere.

These windfall taxes and/or the export tax hikes certainly make sense because of the stark ground level realities and the evolving macro-economic situation. What is contextually significant is the fact that the government will review these measures every two weeks based on international oil prices (Asia's third largest economy imports about 85 per cent of its annual oil requirements), inflation, external balances and currency depreciation (the Indian rupee has depreciated by 6 per cent against the US dollar during FY 23 because of the strength in the US dollar and investors pulling out an unprecedented US$28 billion from the domestic share markets).

This depreciation is, however, modest relative to other emerging market economies (EMEs) and even major Advanced Economies (AEs)).

Movements of Indian Rupee and EME Currencies against the US Dollar			
Currency	Beginning of war	13-Jul-22	Change %
Indian Rupee	75.7	79.7	5.3
Euro	0.9	1.0	11.2
Japanese Yen	115.3	137.1	18.8
British pound	0.7	0.8	12.2
Russian Rouble	87.3	61.8	-29.2
Brazilian Real	5.1	5.4	6.3
Malaysian Ringgit	4.2	4.4	5.4
Chinese Yuan	6.3	6.7	6.2
Thailand Baht	32.8	36.3	10.6
Indonesian Rupiah	14391	14984	4.1
South African Rand	15.5	17.0	9.8
(+)Depreciation and(-)appreciation			
Dollar Index	97.1	108.2	11.3

In the event of crude prices crashing because of a synchro=nised prolonged global slowdown, windfall gains will cease and there could conceivably be a rollback of these creative measures.