

ARE OIL PRODUCERS TO BLAME FOR HIGH PETROLEUM PRICES?

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The Federal Antimonopoly Service (FAS) again blames petroleum producers for undue prices for petroleum products. Oil producing companies argue that domestic prices are set through a market mechanism of smoothing international and internal trade.

Russia has been exporting increasingly small amounts of gasoline abroad in the past years, therefore exports as a rivaling sales channel should be viewed with caution.

Table 1: Gasoline production and exports

<i>million tons</i>	2004	2005	2006	2007	2008
Production	30,5	32,1	34,4	35,1	35,8
Exports to far abroad countries	3,3	4,9	5,1	4,6	2,5
Share	11%	15%	15%	13%	7%

Sources: Russia's Federal Customs Service, InfoTEK

Exports decline because Russian-produced gasoline does not meet increasingly high car fuel standards operating in EU and other countries. Russia's petroleum products are sold as semi-finished products for further refining.

Table 2: Car gasoline standards operating in EU

	Euro-3	Euro-4	Euro-5
Valid in EU from	2000	2005	2009
Research octane number, min	95/98	95/98	95/98
Aromatic hydrocarbon content, max	35%	30%	30%
Sulfur content, ppm, max	150	50	10

Source: DOE

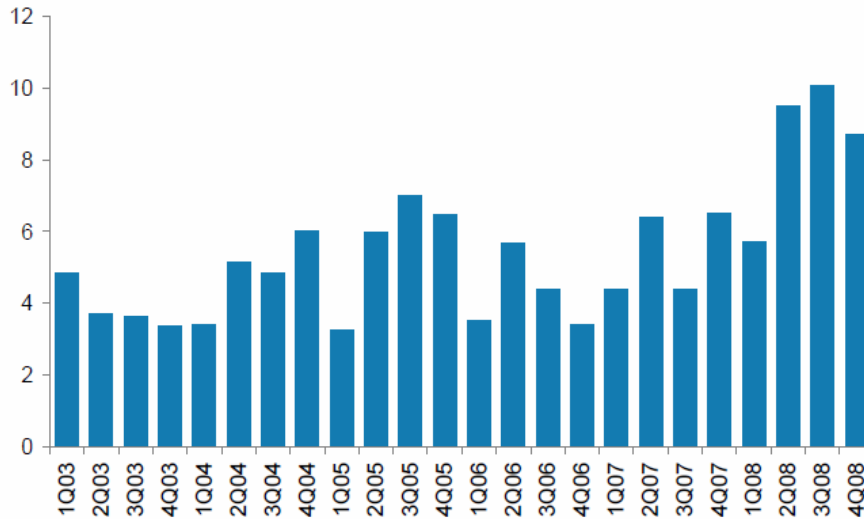
With its ancient motorcar fleet and slow development of the oil processing industry, Russia lags behind the western standards. Domestic ecological requirements could be toughened stepwise, though (starting from big cities).

The main point of petroleum pricing is that, knowing international prices (normally, market rated) and the costs of transportation, internal net-back prices can be calculated. As soon as prices can change during transportation, companies amend their calculations as to reflect their forecasts and risks. These amendments can have great impacts on final prices, and they are hard to be evaluated from outside of the business. Companies' desire to gain more is understandable, and their appetites should be curbed by competition and buyers' flexibility in choosing means of transportation. What we see in the domestic petroleum market is just the reflection of the global petroleum market trends whereby consumers agree to pay \$40 per barrel but can afford as much as \$140 per barrel.

If we study the pricing mechanism in more detail, we can distinguish two key factors, namely refining margin in Europe and the fiscal system (in particular, export taxes on petroleum products).

High refining margins point to unbalanced demand and supply and can be used to finance the sector in the long term. Car fuel standards have seen drastic changes in the US and Europe over the past years, which has partly set the trend of generating high profits from oil refining.

Figure 1: Refining margin, Northwest Europe



Source: Bloomberg

All else being equal, a higher margin in Europe should cause the same petroleum products to be sold in Russia at higher prices, too.

Export taxes are the other important factor that influences domestic prices.

Vertically integrated oil companies that possess stakes in oil extraction and oil refining businesses can choose between exporting crude oil and paying export taxes or exporting finished petroleum products and thus paying lower duties.

Let us study a model of an oil refinery situated near the border, in the vicinity of an operating crude oil export channel. To make it simple, let us assume that the refinery has an ordinary distillation still to extract 360°C boiling-point light-end products. Let us also assume that the plant's output is as follows: light-end products/heavy-end products/losses – 50%/47%/3%. Then products are transported over the border, mixed and sold as petroleum. In fact, even a simple technology like this can bring profits.

Table 3: Oil refinery efficiency

	Urals price dollars/barrel			
	40		60	
	export	oil refineries	export	oil refineries
gains	40	38,8	60	58,2
export tax	13,75	7,28	26,75	14,16
losses		3%		3%
refinement costs		2		2
fiscal effect	26,25	29,52	33,25	42,04
margin		3,27		8,79

Source: IFS estimates

Furthermore, if an oil refinery owner decides to enhance black oil refining, he will find out that higher export taxes are imposed on light-end products. As a result, there is no stimulation of deep oil processing which is clearly seen in the customs service statistics.

Table 4: Black oil exports

<i>million tons</i>	2004	2005	2006	2007	2008
exports to far abroad countries	38,3	45,5	46,9	54,2	59,8
share in the petroleum products basket	49%	49%	48%	52%	56%

Source: Federal Customs Service data

Until mid-2004, export duties on petroleum products were undifferentiated and corresponded to 90% of export taxes on oil. Then, due to several reasons, mostly related to low efficiency of the oil processing sector, taxes imposed on petroleum products were cut to 65% and later differentiated.

Each stage of the reform lessened the tax burden which enabled the oil-processing industry to gain almost \$30 billion on exports between 2004 and 2008.

Table 5: Amount saved due to lower export taxes on petroleum products

<i>billion dollars</i>	2004	2005	2006	2007	2008
amount saved					
from reducing export taxes on petroleum products from 90% to 65% of petroleum export tax	0,8	3,1	5	5,7	6,5
from differentiation		0,8	1,5	2,1	3,2
total	0,8	3,9	6,6	7,8	9,6
amount invested in refining	1	1,3	1,5	2	<i>n.d.</i>

() – without 2008 data*

Sources: Federal Customs Service data, IFS estimates

Investments in oil refining just covered the inflation faced by the industry.

In the crisis petroleum companies cut investments in the oil refining sector.

To sum it all up, the government regulation of this industry is extremely ineffective. Development of oil processing is not stimulated and low taxes cause domestic prices for car fuel to grow.

Meanwhile, to shore up the oil sector, the government could take a few simple steps:

- differentiate export taxes on petroleum products by quality (sulfur content, ecological standards) and the degree of correspondence to the finished product;
- raise the maximum export tax on petroleum products from 65% to 90%. By law, the government is entitled (but not obliged) to set maximum duties. This change can make regulation more flexible;
- to avoid overstocking, the government could create strategic petroleum product reserves by buying in low-price periods and selling in high-consumption periods.