Senate Economic Planning Office

Policy Insights

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An Assessment of Petroleum Prices

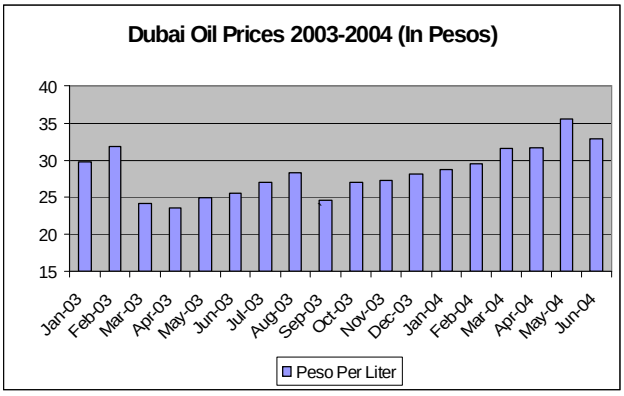
Recent Trends

Oil prices have been increasing at an alarming rate since the start of the year. From an average retail price for diesel and unleaded gas of P16.50/liter and P20.90/liter respectively in January, prices have averaged about P19.70/liter and P25.20/liter respectively as of June 8, 2004. These increases represent a jump in oil prices this year of about 20%. The 90 centavo increase in June is the seventh round of increase since January this year. The increase of one peso in May was the biggest since the P1.20 increase made in September 2000 when world crude oil prices rose by 13%.

Cause of Rising Prices

These recent increases in fuel prices have been attributed mainly to the rising world prices of crude oil. The price of oil has been steadily climbing since September 2003 and countries across the globe have been scrambling to address the apparent inequality between the supply and demand of oil. The expected higher demand for oil in China and the United States (US), due to increased economic activity in both countries, continues to drive up oil prices in the world market. Further, the Organization of Petroleum Exporting Countries (OPEC) imposed a production cut last April 2004 in order to keep price levels floating between US$25 and US$35 per barrel. Low supply levels were further compounded by a decrease in refinery output in the US in May 2004.

Figure 1. Current World Prices



Source: US Department of Energy

The price increases were aggravated by the delicate situation in the Middle East which has raised concerns over the security of oil reserves in the near-future. Prices skyrocketed to a record high US$36.22 per barrel (Dubai) after 22 people were killed in a compound housing foreigners in a Saudi oil-producing region a few weeks ago. The

escalating violence in Saudi Arabia and the US' inability to establish firm control over Afghanistan and Iraq, placed the security of existing oil supplies in jeopardy. This resulted in risk premiums which experts estimates can go as high as US$13 per barrel.[1]

Rising petroleum prices are not limited to the Philippines as shown in Table 1. The Philippines has one of the lowest prices of petroleum compared to major economies of the world. Differences in prices across countries are attributed to the different tariff rates and specific taxes applied to petroleum products. Philippine pump prices are among the lowest since petroleum taxes are lower in the country relative to other countries (Galang & Solleza, 2000).

Table 1. Global Comparative Pump Prices In Philippine Pesos

	Unleaded		Diesel	
	As of 31 December 2003	As of 8 June 2004	As of 31 December 2003	As of 8 June 2004
Hong Kong	70.96	84.41	39.54	47.54
South Korea	56.15	65.68	34.67	41.68
Singapore	40.69	48.40	22.77	27.38
New Zealand	38.84	46.55	20.91	25.14
Australia	36.61	43.55	33.51	40.29
Cambodia	27.30	31.93	19.69	23.67
USA	26.47	29.99	21.26	25.56
Thailand	20.91	25.06	16.72	20.10
Philippines	21.05	25.23	16.41	19.73

Source: Department of Energy, International Energy Agency

Impact on the Domestic Economy

The National Economic and Development Authority (NEDA) sees the country's gross domestic product (GDP)reduced by 0.5 percentage points if an increase of US$10 per barrel in oil prices prevails for as long as a year. Similar simulations made by other international agencies predict a 1.6 to 1.8 percentage points reduction in GDP if oil prices stay at between US$35 to US$40 per barrel unitl the end of the year.[2] This will occur as industries heavily reliant on oil such as transportation, chemicals, and manufacturing struggle with rising costs of production.

This situation will also increase the cost of domestic goods and services. A ten percent increase in domestic oil prices is estimated to increase inflation by 0.67 percentage points (NEDA). In May this year, inflation rose to 4.5%, higher than the targeted rate of 4.2% to 4.3%. The rise in oil prices, which has triggered similar increases in transport fares, plus the foreseenwage hikes, are estimated to cause inflation this year to exceed the high end target of 4%.

Policy Options

Consumer groups across the country have recently been clamoring for renewed government intervention in light of rising fuel costs. Should the government accede to public opinion, it will not be the first time. Prior to 1970, the domestic oil industry was a free market characterized by a highly competitive environment with the presence of six major oil companies (Shell, Caltex, Filoil, Mobil, Esso, and Getty). The international oil crisis during the early 1970s forced the government to take a more active hand in regulating the oil industry. Government intervention came through a number of regulatory offices such

[1] Different estimates made by Bloomberg, ICF, and CNBC peg the risk premium of oil between US$8-US$13 per barrel.

[2] The Association of Southeat Asean Nations estimates a decline of 1.6 percent in the Philippine economic growth should oil prices stay above US$35 per barrel and Interntaional Energy Agency projects a 1.8 percentage pionts reduction from the country's GDP growth should prices stay at US$40 per barrrel until the end of the year.

as the Oil Industry Commission (now known as the Energy Regulatory Commission) and the Philippine National Oil Corporation (PNOC). Their primary roles were to ensure domestic oil supplies and stabilize rising oil prices. The OIC fixed prices of petroleum products taking into account the dollar cost of imported crude oil and the foreign exchange rate. The Oil Price Stabilization Fund (OPSF) was created with an initial P5 billion budget in order to subsidize fluctuations in international crude oil prices by automatically absorbing any price change incurred by oil companies from importing crude oil (Caparas, 2000). The OPSF was maintained using import duties collected from crude oil and finished petroleum products.

While the OPSF succeeded in keeping domestic pump prices stable, government regulation was not without cost. The public deficit shot up to maintain the OPSF as it struggled to protect domestic consumers from rising fuel costs resulting from international market volatility.

Goverment intervention stifled competition and growth of the industry, as the number of market players was reduced from six to three (Shell, Caltex, and Petron[3]). The inefficient environment brought about by regulation was not sustainable in the long run and calls for deregulation were soon heeded.

The Oil Deregulation Act of 1998 (RA 8479) paved the way for the liberalization of the petroleum industry. Deregulation was done in two phases. First, partial deregulation was implemented when the importation of oil was liberalized and the Automatic Pricing Mechanism (APM) was put in place to enable the domestic price of petroleum products to approximate and promptly reflect the price of oil in the international market. After the four month transition period, there was full deregulation with the OPSF and similar price-setting controls abolished (Galang & Solleza, 2000). In order to boost foreign investments in the industry, various fiscal and capacity-building incentives were also offered to potential investors. These efforts have proven to be effective in improving competition and industrial efficiency. A significant number of new players entered the industry as shown in Table 2. New market players began and continue to eat into the Big Three's (Shell, Caltex, and Petron) market share.

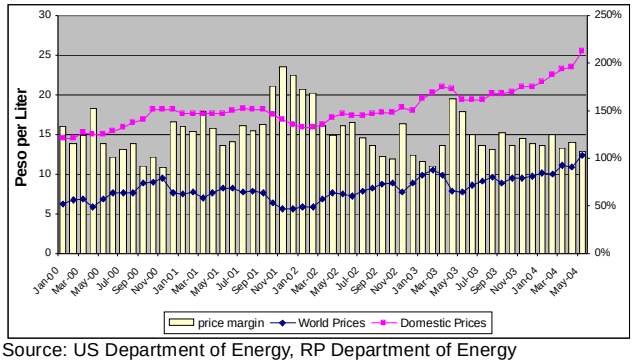
Table 2. Market Composition of the Oil Industry

	Percent Share	
	Big Three	New Players
1998	95.7	4.3
1999	91.3	8.7
2000	89.8	10.2
2001	88.6	11.4
2002	85.9	14.1
2003	85.3	14.7

Source: Department of Energy

In terms of pricing, prices of petroleum products have generally fluctuated together with world crude oil prices. The price margin between retail prices and world prices has also been generally decreasing.

Figure 2. World Prices vs. Domestic Prices



Source: US Department of Energy, RP Department of Energy
All Countries Spot Price FOB Weighted by Estimated Export Volume ($/bbl) were used for world prices. Price margin is equivalent to domestic price over world price.

[3]Petron Corporation was established when PNOC acquired Esso Phils. Inc. and renamed it Petrophil Inc. in 1973. A year later, Filoil was consolidated under Petrophil in order to integrate marketing functions (Galang & Solleza, 2000).

It has been suggested that the government consider adjusting tariff rates on imported crude oil and refined petroleum products in order to bring retail prices down. However, this option will only serve to be a short-term solution and will have serious long-term effects on the public deficit (Galang & Solleza, 2000). The government stands to lose P33.5 billion[4] in annual revenues should it decide to stop collecting tariffs and excise taxes on petroleum products. The OPSF (or any similar form of industry-wide subsidy) cannot be reinstated for the same reasons. Estimates based on current pump prices show that a subsidy of just P1.00 per liter of diesel fuel would cost the government an additional P6.3 billion annually.[5] A government subsidy therefore cannot be considered at this point given the present fiscal health of the country. Further, it would be unwise for the general public to subsidize even the consumption of the rich. The current move of the government to subsidize public transport is more acceptable.

Prospects

In the final analysis, it may be best if the government allowed market forces to dictate the normal price of oil. Current data show that rising market prices are only temporary and will revert to normal levels once oil supply levels match the current global demand.[6] Short-term oil prices are seen to fall below US$40 as the OPEC has already pledged to increase oil quotas in an effort to stop high prices from curbing global economic growth. Dubai crude oil prices have fallen to an average of US$33.43 in June 2004. However, global oil prices are expected to float between US$30-US$40 per barrel for the remainder of the year as uncertainties surrounding the peace and order situation in the Middle East are expected to persist. Without such premium, oil prices would go back to the September to December 2003 levels of US$27 per barrel. The establishment of a regime of peace and stability in the Middle East is therefore deemed crucial to the stability of world oil prices.

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- *This policy brief also used extensive inputs from various studies and reports from the Deparment of Energy, National Economic and Development Authority, International Energy Agency, and Bloomberg News Agency.*

This paper was principally prepared by Harry Pasimio, Jr. of the Microeconomics Group, under the supervision of its head and the SEPO Director General.

[4]Average annual excise tax collections for petroleum products were pegged at P22.3 billion, while average annual tariff collections were estimated at P11.2 billion (Sources: BIR, BOC).

[5]Based on average 1993-2002 consumption levels. Demand for oil is generally considered as price inelastic because of the absence of close substitutes.

[6]Several reports on current trends in the petroleum industry conducted by Bloomberg and ICF among others were extensively used as references.