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**PETROLEUM PRICES IN BANGLADESH**  
**A NEED FOR REGULAR & APPROPRIATE ADJUSTMENTS**

*Under-pricing of diesel and kerosene continues to cause major financial problems for Bangladesh Petroleum Corporation (BPC), which is losing over Tk 2 billion monthly. Global forecasts suggest that oil prices will continue to be over \$US 50 per barrel for the next couple of years. Bangladesh's Household Income and Expenditure Survey data for 2005 indicate that both diesel and kerosene form a very small part of the budget of the poor. One option, therefore, is to raise the price of diesel and kerosene from current Tk 33 to 41 per liter and make BPC breakeven on its trading costs. BPC's trading cost is roughly 70 percent of its total current costs; the latter includes an ever increasing interest bill, currently at Tk 4.7 billion. If the one step increase is considered difficult, a second option would be to phase the increase over a six-month period with each increase of Tk 4 per liter, possibly in sync with the 'boro' rice planting season. A major communication campaign should be launched to inform the public the rationale of the price increase. Future adjustments should be based on a formula that automatically adjusts prices—both upwards and downwards—on a regular basis.*

### **I. The Current State of Oil Prices**

Oil prices have doubled in the last three years—rising from close to US\$30 per barrel in January 2003 to US\$58 per barrel at present. Unlike the case of 1970s, when oil prices rose due to an exogenous supply shock, the present case of high oil prices is likely to persist over the medium-term. The current bout of high oil price is mainly due to a surge in global demand, which in turn is due to the fast growing economies of China and India. Moreover, there are near-term capacity constraints as well as a risk of supply disruptions due to the volatile situation in the Middle East. In view of these global considerations, most research forecasts suggest that crude oil prices are likely to be above US\$50 per barrel in the foreseeable future.

### **II. Adjustment of Domestic Petroleum Prices in South Asian Region (SAR) and Other Countries**

In South Asia Region (SAR) countries, the oil price pass-through has been partial. Domestic prices of petrol, diesel and kerosene have been inadequately and infrequently adjusted, and do not reflect the higher cost of oil imports. Most of the price burden has been borne by governments who have relied on international borrowing and their foreign exchange reserves to finance the increased import bill.<sup>1</sup>

With rising oil prices, Bangladesh's import bill has also risen. As domestic prices have only been partially adjusted, demand for petroleum products has continued to grow, and rising international prices have had virtually no impact on the quantity of petroleum imports in the past few years. Since FY03, the overall import bill has gone up by over 50 percent from US\$ 1 billion in FY04 to US\$ 2 billion in FY06. During this period, petroleum imports have accounted for a much bigger share of total imports; the share has risen from 9.2 to 13.6 percent.

The extent to which higher oil prices are passed on to consumers is a key measure of a country's response to higher oil prices. The ratio of the increase in the retail price to the increase in the international price, both measured in local currency, is known as the "Pass-through

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<sup>1</sup> For more details, see "Macroeconomic Challenges of High Oil Prices in the SAARC Region," Asia and Pacific Department, International Monetary Fund, January 2006.

Coefficient.” As indicated in Table 1 below, Bangladesh’s pass-through coefficient is the lowest among some of its comparator Asian countries.

**Table 1: Oil Price Pass-through Coefficient: Bangladesh & Other Selected Countries**

Petroleum Products	Bangladesh	China	India	Indonesia	Pakistan
Gasoline	0.79	0.71	1.25	1.2	1.98
Diesel	0.43	0.53	0.66	1.03	0.78

Note: A value of the coefficient close to 1 implies that the government has taken steps to ensure that the fiscal burden is neither increasing nor decreasing noticeably, given that the volume of consumption is unlikely to be strongly affected by the change in domestic prices.

Source: ESMAP, Coping With Higher Oil Prices, the World Bank, August 2006.

Table 2 below provides relative prices of four petroleum products—diesel, kerosene, octane and motor spirit—in five major SAR countries. As noted in Table 2, with the exception of kerosene, domestic petroleum prices are highest in India and lowest in Bangladesh. The gap between Indian and Bangladesh prices is very large. Even Nepal, which is poorer than Bangladesh, has higher fuel prices than Bangladesh.

**Table 2: Retail Prices of Petroleum Products in SAR Countries**

(in Taka per liter as of November 2006)

Countries	Diesel	Kerosene	Octane	Motor Spirit
Bangladesh	33	33	58	56
India	54.8	14.3	80.7	72.1
Nepal	44.7	37.9	NA	65.1
Pakistan	44.1	40.1	73.8	65.6
Sri Lanka	43.0	30.8	66.7	64.8

Source: World Bank Energy Database.

**Some Governance Implications.** A major implication of the price differential with India is the incentive to smuggle petroleum products, especially diesel and kerosene, out of Bangladesh and sell them in bordering towns in India. This results in a significant net loss to the economy, as a large chunk of the subsidy on diesel and kerosene is enjoyed by Indian consumers. This has also become a major governance issue as smuggling of petroleum products has proven to be extremely difficult to control, and is allegedly undertaken with the connivance of border officials. The GoB has identified 13 major sea and river routes by which fuel was being illegally transported out of the country, and has stepped up patrols to combat smuggling. So far there seems to be little impact on the smuggling activity, given the powerful incentives faced by weakened border agencies. A major consequence of such smuggling activity last year was an acute shortage of diesel available to Bangladeshi farmers in key agricultural districts to fuel tube-wells during the harvest season, with consequences for farm output.

### III. Past Price Adjustments in Bangladesh

The Bangladesh Petroleum Corporation (BPC), a state-owned enterprise, imports oil and oil products in the country and sells them to both public and private agencies. BPC purchases most of its petroleum products in refined form as it has very limited refining capacity.

In response to rising oil prices, the Government of Bangladesh (GoB) has raised domestic petroleum prices in a number of incremental steps during July 2003 to June 2006. These increases are detailed in Table 3. While the international crude oil price has increased by over 100 percent, the domestic prices of diesel and kerosene have increased by around 34 and 62 percent, respectively, when converted in dollar terms at the prevailing exchange rates. A notable feature of these adjustments is that when measured in dollars they have been much less as compared to the taka adjustments as the taka has been consistently depreciating against the dollar. In terms of quantity, diesel and kerosene account for roughly 60 and 14 percent of the petroleum imports, respectively.

**Table 3: Petroleum Price Adjustments in Bangladesh – May 2004 through June 2006**  
(in Tk/liter, US\$/liter and % changes)

Month/Year	Kerosene	Diesel	Petrol	Octane	Crude Oil
	Taka/liter [US\$/liter]				US\$/barrel
January 2003	17 [.29]	20 [.35]	33 [.57]	35 [.61]	<b>27.93</b>
May 2004	20 [.34]	20 [.34]	33 [.55]	35 [.59]	<b>34.12</b>
	<i>17.6 [17.2]</i>	<i>0.0 [-2.9]</i>	<i>0.0 [-3.5]</i>	<i>0.0 [-3.3]</i>	<i>(22.2)</i>
December 2004	23 [.38]	23 [.38]	33 [.54]	35 [.58]	<b>31.73</b>
	<i>15.0 [11.8]</i>	<i>15.0 [11.8]</i>	<i>0.0 [-1.8]</i>	<i>0.0 [-1.7]</i>	<i>(-7.0)</i>
May 2005	25 [.39]	26 [.41]	35 [.55]	35 [.55]	<b>44.15</b>
	<i>8.7 [2.6]</i>	<i>13.0 [7.9]</i>	<i>6.1 [1.9]</i>	<i>0.0 [-5.2]</i>	<i>(39.1)</i>
July 2005	25 [.39]	26 [.41]	36 [.56]	38 [.59]	<b>51.88</b>
	<i>0.0 [0.0]</i>	<i>0.0 [0.0]</i>	<i>2.9 [1.8]</i>	<i>8.6 [7.3]</i>	<i>(17.5)</i>
September 2005	30 [.46]	30 [.46]	42 [.64]	45 [.69]	<b>55.49</b>
	<i>20.0 [17.9]</i>	<i>15.4 [12.2]</i>	<i>16.7 [14.3]</i>	<i>18.4 [16.9]</i>	<i>(7.0)</i>
June 2006	33 [.47]	33 [.47]	56 [.80]	58 [.83]	<b>62.91</b>
	<i>10.0 [2.2]</i>	<i>10.0 [2.2]</i>	<i>33.3 [25.0]</i>	<i>28.9 [20.3]</i>	<i>(13.4)</i>
<b>Current Situation</b>					
February 2007	33 [.48]	33 [.48]	56 [.81]	58 [.84]	<b>58.00</b>
					<i>(-7.8)</i>

**Notes:** Numbers in square brackets are in US\$/liter converted at the prevailing exchange rate at the time; the second line numbers (in italics) indicate percent change in--taka/liter and US\$/liter, respectively--from the last price change.

**Source:** World Bank Energy Database.

### IV. Financial Problems of BPC: A Case for Price Adjustment

In most SAR countries, the incomplete pass-through for diesel and gasoline has led to a significant negative impact on the public finances. While Sri Lanka has been the hardest hit, the situation in Bangladesh continues to deteriorate. Until FY03, BPC had negligible financial losses. Since then, with rapidly rising oil prices and inadequate pass-through in domestic prices, BPC has

been incurring heavy losses (see Table 4 below). The GoB does not directly compensate BPC for the losses incurred by selling petroleum products at below their tax-inclusive trading cost. Instead, using “moral suasion” GoB has required the nationalized commercial banks (NCBs) to finance BPC’s losses. BPC’s liability to the four NCB's at mid-February 2007 was estimated at Tk 127.7 billion compared with Tk 117 billion at the end of June 2006. NCB’s available domestic credit has thus been diverted to finance the losses of BPC. The international capital markets have also been tapped to finance BPC losses. With BPC unlikely to repay such loans, the NCB’s have been considerably weakened. Finally, as arrears to BPC by SOEs such as Biman mount, pressures on the NCBs will continue. Needless to say, this situation is not compatible with macro-stability or growth over the longer term.

**Table 4: Bangladesh Petroleum Corporation: Deterioration in Finances**

(in Taka billion and % of GDP)

	FY04	FY05	FY06
<i>(i) Annual flows</i>			
Losses	9.58 (0.3)	23.2 (0.6)	31.8 (0.8)
Of which Interest on Loans	2.5	3.5	4.7
<i>(ii) Stock at the end of FY</i>			
Total Liabilities	73.3 (2.3)	99.8 (2.6)	138.3 (3.5)
Of which Loans Outstanding to banks	49.5 (1.6)	78.5 (2.0)	117 (2.9)

Notes: Numbers in parentheses are in percent of GDP.

Source: Bangladesh Petroleum Corporation.

Bangladesh has limited access to international capital markets, domestic savings are limited, and its revenue mobilization capacity is extremely weak. Therefore, there is a good case for increasing the extent of pass-through to the consumers based on economic efficiency and macroeconomic sustainability. Standard public finance theory suggests that since oil is a private good, it is most efficient that consumers pay the market price for oil.<sup>2</sup> This will induce them to conserve the use of oil which will also help in the long term adjustment to the reality of higher prices. So far the huge BPC deficit has been financed by borrowing from public banks and BPC has been unable to service its debt to the public banks. This will only grow further if the prices are not adjusted, unless the government provides budgetary support. The latter in turn may require expenditure cuts somewhere else, given that the budget deficit cannot simply be increased willy-nilly. Since most current spending such as wages, pensions, interest payments and subsidies are fixed in the short-term, this will require cuts in development spending at a time when development spending need to be increased to properly implement the country’s poverty reduction strategy. Alternatively, the government can raise taxes, but given the history of weak tax collection effort, this is not a practical option in the short term.

Notwithstanding the recent months decline in oil prices—as measured by the dollar price of Kuwait blend, the one relevant for Bangladesh, as most of the petroleum products are imported from Kuwait—the pass-through remains well short of that required to recover fully the rise in tax inclusive prices in domestic currency. More specifically, currently in Bangladesh while diesel and

<sup>2</sup>For a more detailed discussion see “The Economics vs. Politics of Oil Price Adjustment in Bangladesh,” by Sadiq Ahmed, 2006.

kerosene are heavily subsidized in financial terms, there is a trading surplus on Motor Spirit, Octane and Jet Petrol.<sup>3</sup>

In 2003, the administered pricing mechanism for petroleum products was abolished in principle as part of the reform of the petroleum sector towards a market based system. In theory, the downstream oil companies were free to set retail prices of all petroleum products based on an international parity pricing formula under the supervision of the energy sector regulator. Due to various political impediments, this has not been implemented yet and the government has continued to administer petroleum prices.

A component of Table 5 below notes the required price adjustments for petroleum products, if the Import Parity Price (IPP) formula (see Annex A for details) is applied. The table also notes the implications for price adjustments, if the current overcharging of octane, motor spirit and petrol continues.

**Table 5: Domestic Prices: Implied by IPP Formula and With Cross-subsidy**

(Tk per liter unless noted otherwise)

Products	As per IPP Formula			With cross-subsidy		
	Price (in Jan. 2007)	Required Price	% change	Recommended Price	% change	Surplus/Deficit (in Tk million in January 2007)
Diesel	33.0	43.3	31.1	41.0	24	-521.13
Kerosene	33.0	44.5	34.9	41.0	24	-188.3
Octane	58.0	41.1	-29.0	58.0	0	238.85
Motor Spirit	56.0	45.2	-19.3	56.0	0	196.52
JP-1	56.0	45.2	-20.0	56.0	0	274.07

Source: World Bank Staff Estimates.

The prices implied by the application of the formula vis-à-vis the actual prices in January 2007 are shown in Table 5. The actual price of Motor Spirit (petrol), octane and JP-1 (Jet fuel) are well above the required prices while diesel and kerosene are heavily under-priced. By definition, if prices are changed according to the above, BPC will fully recover the trading costs and their flow problem will be partially resolved until import parity prices change again. It is important to note that BPC will still be incurring huge operating losses because the pricing formula does not include interest costs, which in FY06 amounted to Tk 4.7 billion (Table 4), accounting for nearly 15 percent of its total loss in that year. The reason for such high interest cost is the accumulation of large debt in the past necessitated not just by under-pricing but also by BPCs inability to

<sup>3</sup> The current administered retail prices of diesel and kerosene are fairly close to import parity prices as measured at C&F Chittagong. The economic subsidy therefore is only about Tk 1 per liter covering the selling and distribution cost. The users of diesel and kerosene do not pay any of the current Tk 11.2 per liter of duties and taxes. Since the decisions on diesel and kerosene use are taken in the private sector, it is important that their prices reflect fully their social and environmental opportunity costs. Taxes on oil products are needed to reflect the negative externalities that they create in terms of pollution.

collect revenues from SOEs and ministries.<sup>4</sup> Thus, the stock problem—huge debt accumulated during recent years—will still remain. This needs to be dealt with separately.

Since the prevailing prices of Motor Spirit, octane and JP have been accepted by the public, there is no compelling reason for lowering them. Instead, the extent of the increase in the prices of diesel and kerosene can be contained, benefiting from the surplus generated by the other three items. The cross subsidy reduce the required increase in diesel and kerosene prices respectively from 31.1 percent and 34.9 percent to 24 percent, implying an increase in diesel and kerosene prices by Tk 8 per liter. One option is to adjust this price in one step and allow BPC to breakeven on its trading costs. If the one step increase is considered difficult, it could be phased over a six-month period with each increase of Tk 4 per liter. GoB needs to provide additional support to BPC, preferably through budget so that the latter could clean its previous accumulated losses of about Tk 120 billion.

## V. Potential Macroeconomic Impact of Petroleum Price Adjustments

There is often the apprehension that raising petroleum prices will trigger inflation. A rise in petroleum prices has a direct effect on consumer prices as well as an indirect effect through increased transportation and other business costs wherever petroleum products are used as inputs. In most cases, a prudent monetary policy response of tightening credit in the economy could check inflationary pressures. In this context, two recent examples are noteworthy:

- In countries where adjustment to oil prices has been delayed (as is the case of Bangladesh), there could be potential balance of payment and other economic problems, when eventually a bigger adjustment is made. A case in point is Indonesia, where in response to higher oil prices domestic retail prices were (inadequately) raised by 30 percent in March 2005.<sup>5</sup> This was the first significant adjustment since oil prices started to rise in 2002. Later in October 2005, the Indonesian Government raised gasoline prices by 90 percent and kerosene prices by 200 percent in one single day to counter a potential balance of payment crisis. At the same time, monetary policy was tightened to counter inflationary pressures and a program was designed to compensate the poor. The rise in price checked the demand for oil which dropped significantly. These actions may have also contributed to a slowdown of economic growth.
- In the past several years the Indian economy is growing at 8 percent plus rate. The likely growth for FY07 is estimated at 9.2 percent. At the same time inflation has also crept in and has reached a two-year high of 6.73 percent. In addition to the recent credit tightening—there have been several rounds of rate increases over the past year and the Reserve Bank of India has just increased the Cash Reserve Requirement for commercial banks—the Government of India has also lowered the price of gasoline and diesel this past week. Reduction in petroleum prices when the fiscal deficit continues to be very high and off-budget liabilities have been increasing due to the issuance of the oil bonds, is perhaps not the best policy response. Nonetheless, the Indian situation is different from Bangladesh. Many observers feel that Indian economy is overheating and therefore such a response is justified; no such situation exists for Bangladesh.

The bottom line is that while an increase in petroleum prices has a potential to increase inflation, the government could always use a prudent monetary policy stance to check inflation. Financing

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<sup>4</sup> As a result, BPC had to borrow to service its debt, which means it is in a debt trap in the form of paying interest on interest.

<sup>5</sup> This Indonesian example has been taken from “Macroeconomic Challenges of High Oil Prices in the SAARC Region,” Asia and Pacific Department, International Monetary Fund, January 2006.

the deficit created by oil subsidy through bank borrowing, as is the present day case in Bangladesh, could be more harmful for inflation than an increase in diesel and kerosene prices.

## **VI. Likely Impact on the Poor and Farmers**

As is common in SAR countries, kerosene in Bangladesh is used for lighting and cooking by the poor. Therefore, any increase in kerosene prices could hurt the poor. Besides being used as an input for transportation, diesel is used for irrigation pump sets in Bangladesh. A price increase in diesel could therefore also hurt farmers. The question is: What portion of the budget of the poor (urban and rural) is spent on kerosene and diesel? This would indicate the extent to which they will be worse off as a result of the price increase.

These social equity issues associated with raising petroleum prices were analyzed in a recent World Bank study.<sup>6</sup> Using Household and Income Survey (HIES) data from 2000, the study came up with the conclusions given below. These conclusions largely hold true when the newly available HIES 2005 data are used.

### I. The current low prices of kerosene and diesel mostly benefit the better-off population

- The current generalized price subsidy on kerosene, petrol and diesel, operating through household expenditures on fuel and public transport, largely benefits the better-off section of the population. This is because expenditures on public transport, electricity and gas increase with consumption/income. In 2005, the poor (bottom 40 percent of the population) accounted for only 17 percent of total expenditure of the whole population on public transport, 9 percent on electricity and 4 percent on gas. In rural areas kerosene is used almost universally due to lack of availability of electricity and gas and hence the subsidy on kerosene is less regressive than that of diesel. According to HIES 2005, the poor (bottom 40%) account for 37 percent of total expenditure on kerosene.

### II. Impact of a price increase of kerosene and diesel on the poor

- The direct impact of an increase in kerosene and diesel prices—in terms of the effect on household consumption and welfare—is likely to be quite small for the poor.<sup>7</sup> This is because spending on kerosene and public transport account for a small share of a poor household's budget. Estimates using HIES 2005 data show that expenditures on kerosene and public transport account for 1.3 and 1.9 percent, respectively, of the average household budget of the poor.
- The direct impact of any increase in prices of electricity and cooking gas (which results from a petroleum price increase) on consumption of the poor is also likely to be very small. According to HIES 2005, expenditure on electricity and gas constitute 0.5 and 0.1 percent respectively of the average household budget of the poor.
- The above results refer only to the first-round effects of fuel price increases. What about second and third-round effects, such as when the increase in fuel prices raises transport (and other) costs which, in turn, raises utility prices further, raising transport costs even higher? A preliminary analysis with the Bangladesh Social Accounting Matrix that calculates multiple-round effects of a hypothetical 50 percent increase in the average utility price shows that the

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<sup>6</sup> World Bank, "Impact of Fuel Prices on Bangladeshi Households: Evidence from Household Data," February, 2006.

<sup>7</sup> Given that 40 percent of the population in Bangladesh in 2005 was below the poverty lines, the bottom two quintiles by consumption are defined to be poor. The expenditure shares of kerosene and public transport for the bottom two quintiles in 2000 were almost identical -- 1.3 and 1.7 percent, respectively.

impact on consumer prices faced by poor agricultural households is 0.5 percent. For wealthy urban households, it is 1 percent.

### III. The impact of higher diesel prices on farmers

It is also widely believed that the increase in fuel prices can negatively affect agricultural production through increase in prices of agricultural inputs, especially irrigation. However, the facts appear to contradict such perceptions. The HIES 2005 data show that 29% of poor rural household incur some irrigation related expense. Even if it is assumed that all irrigation related expense relate to diesel costs (a ‘worst case scenario’), this constitutes only 3% of the budget of the poor. If one then raises diesel prices by 25% and assume demand remains constant, this price change would result in a net loss for these poor households of less than 1% of their budget/real income – a minimal impact. At the same time, since the impact on agriculture production is a sensitive and complex issue in Bangladesh, more comprehensive and detailed analysis is needed to fully measure the effects.

## VII. Conclusion

In spite of higher oil prices, kerosene and diesel continue to be under-priced in Bangladesh. While there are convincing reasons to believe that one needs to take into account social equity and inflation concerns, they both can be managed by other sensible policy interventions. Inflation can be checked by a prudent monetary policy stance. If required, a targeted subsidy could be provided to the poor though the merits of doing so would need to outweigh administrative costs. As higher oil prices are likely to stay in the near future, the cost of delaying adjustments could be much higher.

If subsidies are retained and higher oil prices do not recede further, the fiscal costs will continue to mount. Although the poor rely on diesel indirectly through transportation, the benefit from diesel subsidy goes mostly to non-poor. This happens because of both monopolistic control over distribution of diesel and regulatory failure. Dealers at the Upzilla and village level reportedly charge as much as Tk 42 per liter for diesel and kerosene.<sup>8</sup> Part of this difference between the administered price and the price charged by dealers is perhaps justified in terms of transportation, storage and the opportunity cost of the dealers’ time. But the presence of such large premium certainly signals the presence of large monopoly rents. If the diesel distribution system at the local level becomes more competitive, the increase in administered price will be absorbed by a reduction in dealers’ profit rather than an increase in local prices.

The case for eliminating kerosene and diesel subsidies in Bangladesh is strong. Otherwise, with each passing day, week and month, the financial burden on BPC will continue to grow. The delayed adjustments have the potential to cause major economic problems.

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<sup>8</sup> While this is only anecdotal, there is little doubt that diesel and kerosene prices paid by the end-user outside urban areas are much higher than the administered prices.

## **Annex I. A Framework for Adjusting Prices<sup>9</sup>**

In 2003, the administered pricing mechanism for petroleum products was abolished in principle as part of the reform of the petroleum sector towards a market based system. In theory, the downstream oil companies were free to set retail prices of all petroleum products based on an international parity pricing formula under the supervision of the energy sector regulator. Due to various political impediments, this has not been implemented yet and the government has continued to administer petroleum prices.

### **I. Import Parity Pricing (IPP)**

International petroleum prices change on a daily basis, and it is virtually impossible to predict what prices will be in one week time, not to speak of three months. There is often considerable measure of uncertainty about how long higher prices are likely to endure. This generally commends a measured response, which can be reversed without incurring large costs. The practice adopted so far implied the fixation of “ex refinery prices” over long periods, in a way wholly unrelated to the market. This has resulted in BPC incurring huge losses when international prices are high, and windfall profits when they were low. Furthermore, governments have only adjusted prices upwards, irrespective of international trends, i.e. without letting consumers know the underlying rationale.<sup>10</sup>

Pending the introduction of a competitive market, the decision in 2003 was that Import Parity Prices (IPP) for oil products be determined as maximum prices (referred to as caps), on a fortnightly basis based on previous 15 days Platt’s<sup>11</sup> averages, a reasonable margin for freight, insurance and port fees. Should any importer be able to import at a lower cost, the benefit would be his. Ex-refinery prices for local products will also be capped at IPP, thus giving ERL an incentive to optimize its crude purchases in relation to the products slate, and be made more efficient.

As stated, IPP would change every fortnight. In competitive markets, prices change on a daily basis. A system of fortnightly caps was re introduced in Pakistan (after an experimentation with quarterly adjustment) and contrary to earlier anticipations, has been generally accepted by the public, as prices increase but also decrease in tune with the market.

### **II. Prices Implied by the Application of the Formula**

The prices implied by the application of the formula vis-à-vis the actual prices in January 2007 are shown in the Table 5. The actual price of MS, octane and JP-1 are well above the required prices while diesel and kerosene are heavily under-priced. By definition, if prices are changed according to the above, BPC will break-even and their flow problem will be resolved until import parity prices change again. The stock problem—losses accumulated during recent years due to under-pricing—will still remain. This needs to be dealt with separately.

It is neither politically feasible nor necessarily socially desirable to change prices strictly in line with the above. Since the prevailing prices of MS, octane and JP have been accepted by the public, there is no compelling reason for lowering them. Instead, the extent of the increase in the prices of diesel and kerosene can be contained, benefiting from the surplus generated by the other three items. The cross subsidy reduce the required increase in diesel and kerosene prices

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<sup>9</sup> This section is based on World Bank, Considerations on Energy Pricing, 2003.

<sup>10</sup> In the long term, hedging instruments could be used by OMCs to moderate the fluctuations in the international petroleum markets.

<sup>11</sup> A widely read daily publication providing world wide crude oil and petroleum product prices.

respectively from 31.1 percent and 34.9 percent to 24 percent, implying an increase in diesel and kerosene prices by Tk 8 per liter. This increase could be done in one step, or, if that is considered difficult and sensitive, in two steps over six months.

The balance sheet would require the government to provide additional support either through budget or through other means to BPC for it to recover its previous losses of about Tk 120 billion. BPC has borrowed funds from various financial institutions. Increasing diesel and kerosene prices by about 24% will not provide BPC with additional funds to repay those loans using sound means.

### III. The Institutional Framework

In the long term, the Petroleum Downstream Marketing (PDM) activity should be fully competitive, and hence there would be no need for price regulation. Ideally, new interim pricing policies can be introduced in tandem with modifications in the institutional framework to prepare the industry for the competitive mode. Among others, this will require transferring the present functions of BPC such as importing crude, importing products, ensuring tax payments etc. to Eastern Refinery Limited and the Oil Marketing Companies (OMC) which in due course could be privatized. Under such circumstances, in addition to determining its tax requirements, the role of the Government would be confined to:

- Setting products specifications;
- Ensuring a competitive framework through the establishment of a Competition (anti-trust) Authority;
- Ensuring that the petroleum installations meet basic safety standards;
- Ensuring that the strategic storage facilities and stock levels comply with national requirements.

However, until a competitive framework is in place, the state could adopt, in addition to new pricing policies, a number of liberalization measures including facilitating entry of new OMC to the market, enabling ERL to import directly its crude requirements,<sup>12</sup> promoting competition among retail outlets particularly in peri-urban and rural areas, together with converting common infrastructure to common carriers enabling third party access.

As the price of petroleum products fluctuates daily, delay in adjusting petroleum prices could create financial stress on BPC's account. Therefore until the Bangladesh Energy Regulatory Commission (BERC) is staffed adequately, the Energy Division of the Ministry of Power Energy and Mineral Resources along with BERC should review the difference between the prevailing price and the required price of petroleum products on a monthly basis and adjust the prices on a semi annual basis. In case the review indicates that the difference between the price and recognized costs are more than 5% in any given month then that could be adjusted immediately. This would reduce build up of BPC losses, which afterwards can only cause additional burden on government budgets.

### IV. Need for Public Awareness of the Pricing Policy

A communication campaign should immediately be launched to inform the public of the new policies and their rationale. The adoption of the new framework would de-politicize the pricing

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<sup>12</sup> It is generally recognized that the arrangements for crude transport are sub-optimal, and were designed *inter alia* to support the Bangladesh Shipping Corporation, another SOE. Thus 100,000 t crude tankers discharge at an offshore location (some 40 km from the coast), at which point smaller BSC tankers unload the cargo and bring it to shore. By changing the arrangements unloading could be reduced from 7 to 4-5 days, i.e. a saving of some \$300,000 per cargo.

process. Prices would be revised (upwards and downwards) every fortnight, appropriate signals would be given to the consumers on a timely basis, and the activity would no longer be affected by artificial cash shortfalls (i.e. no short-term financing would be required). Whereas the government would be relieved from day-to-day operational matters and the resulting contingent liabilities, it could focus more appropriately on the policy matters and other sector externalities. Because of the price chain becoming consistent, GoB could expect predictable tax receipts from the consumption of petroleum products. Lastly, it is anticipated that the pricing framework would act as a catalyst for fostering new investments (largely private-sector) in the development of infrastructure facilities.