Report on the Downstream Oil Industry Deregulation Act of 1998

Independent Review Committee

January 2008

The **IRC**

Scenario in Mid 2005

- Gas Price P 29 (12)
- Diesel Price P 26 (8)
- Exchange Rate P 55
- Crude $ 47

*** We thought the roof was reached ***

CLAMOR: REPEAL DEREGULATION LAW – Primary Cause

Independent Review Committee – to review Deregulation Law

Six Members:	Labor	Business Executive
	Academe	Hauling
	Dealer	Retired Consumer

The IRC

Two Months of Intensive Work

- Cram course on the Oil Industry
- Interview of Stakeholders – refiners, marketers, dealers, users
- Analysis and Conclusions
- Recommendations

Written Report Submitted

Presentation of Report to Congress / Senate Committee

On Prices: Major Conclusions

- The main cause of oil price increases was the effect of major peso devaluations and increases in the international price of oil especially since we import practically all our oil product requirements.
- Subsidy is not a viable solution because it will cost government excessive amounts of money.
- There is no evidence of price cartels.

On Prices: Recommendations

- On Pricing:
  - The DOE should not support or initiate any change in the Policy of the State in the Downstream Oil Industry Deregulation Act of 1998 (RA No. 8479).

On Prices: Recommendations

- On Pricing:
  - Because we are practically 100% dependent on imported oil for our requirements, the DOE should accustom the public that we are now in a regime of high prices. As such, the DOE should continue its efforts to:
    - Encourage exploration and development of indigenous energy resources including oil and gas;
    - Encourage the use of alternative energy sources; and,
    - Promote programs for the conservation of energy and avoidance of wastages in the use of oil products (e.g., stricter enforcement of laws governing colorum vehicles).

On Prices: Recommendations

- On Pricing:
  - The DOE, working though the government's representatives in the Petron Board, should continue to urge the Company to act as "price moderator." In a deregulated market, price is often set by the low cost producer. Petron, being a refiner and a market leader, suits the role. The action of price moderator should not be done just during price rollbacks but also during price increases.

On Prices: Recommendations

- On Subsidy:
  - The DOE should not propose or support any program that leads to any subsidy. On the other hand, the committee recognizes the need to alleviate the poorest sectors of society and some social action needs to be made. However, this is a function of other government agencies and not the DOE's.

On Prices: Recommendations

- On Price Movements:
  - While at present there is no hard evidence that cartels exist, the DOE should always be alert that in the future, cartels may be practised and that the DOE should be prepared to prosecute erring companies.

On Prices: Recommendations

- On Pricing:
  - It is interesting to note that the land transport group and the sea transport group have different views on oil deregulation. Land transport is still regulated while the latter is deregulated. The DOE should look into an automatic fare setting mechanism or formula that can adjust fares quickly in response to both increases and decreases in fuel prices.

SCENARIO TODAY: 2008

■ Gas Price	P 46
■ Diesel Price	P ___
■ Exchange Rate	P 41
■ Crude	$ 100

*** PRICES REALLY GOING THROUGH THE ROOF! ***

Our Hypothesis

RECOMMENDATIONS OF 2005 STILL VALID TODAY

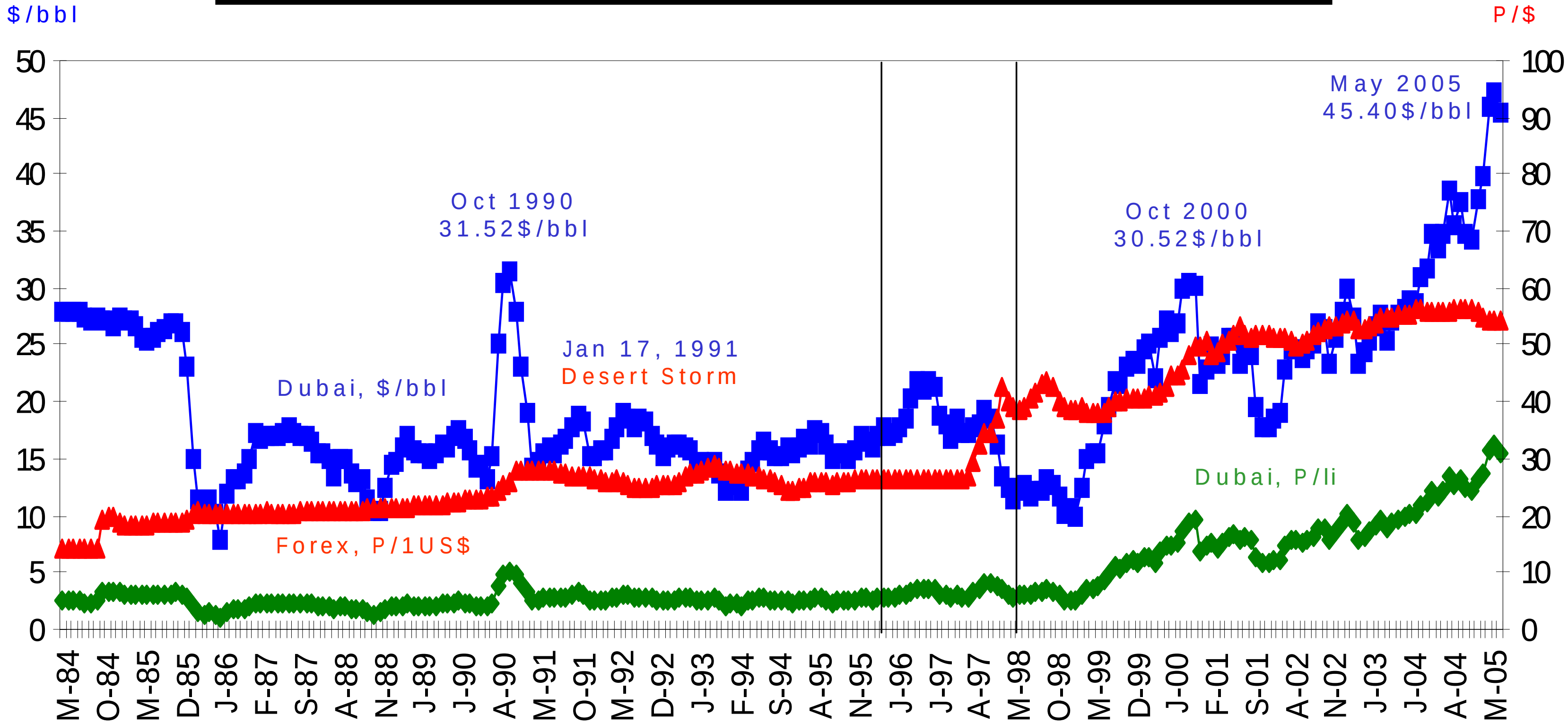
Reasons:

1. Interpolation of 2005 figures projected to the present
2. Facts gathered in 2005 still remain facts of today

On Prices - 2005

- What is the main cause of the present high level cost of gasoline and other oil products? Is it the Oil Deregulation Law?

DUBAI CRUDE PRICES/FOREX
Mar 1984 – May 2005



This shows that peso/dollar rates increased over 200% against the US dollar/ Crude oil prices which increased more than 300%.

Fact: Peso cost of crude component in oil products increased over six times (forex/crude multiple = 6 times).

On Prices - 2005

- The Philippines imports practically all our oil requirements because our own TOTAL PRODUCTION is less than one half of the country's needs for half a day.
- Any changes in international oil prices directly affect pump prices.

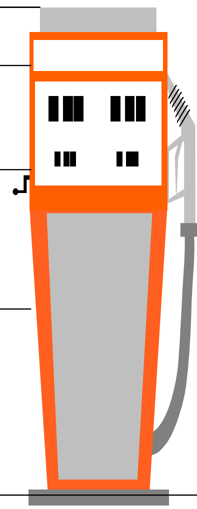
On Prices - 2005

- What do we pay for at the pump price for
  - Gasoline
  - Diesel

2005

WHAT DO WE PAY FOR IN A LITER OF GASOLINE?

	REGULATED	DEREGULATED	
	3/01/98	4/11-15/05	
	Industry	Industry	Importer
Dealer/Hauler Take	6%	3%	3%
Oil Company Take	23%	16%	8%
Duty & Taxes	38%	17%	17%
Crude/Product Cost	33%	64%	72%
Pump Price	11.62 P/li	31.18 P/li	



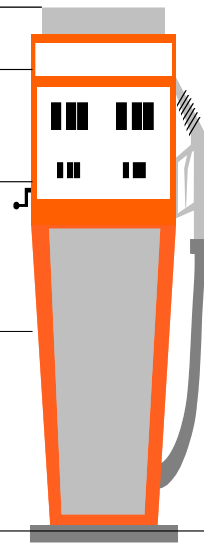
Crude based on March 2005 Dubaii
Product based on April 11-15, 2005 MOPS

Import dependence: 50%

2005

WHAT DO WE PAY FOR IN A LITER OF DIESEL?

	REGULATED	DEREGULATED	
	March 1998	April 11-15 2005	
	Industry	Industry	Importer
Dealer/Hauler Take	8%	3%	3%
Oil Company Take	24%	9%	(2%)
Duty & Taxes	21%	10%	10%
Crude/Product Cost	47%	78%	89%
Pump Price	8.10 P/li	27.31 P/li	



Crude based on March 2005 Dubaii
Product based on April 11-15, 2005 MOPS

Import dependence: 55%

On Prices 2005

- Let's analyze the pump prices of gasoline and diesel in terms of pesos using the previous tables after imputing the forex/crude multiple of 6.
- The information on pump prices is condensed to show only the portion of crude oil cost and company take.

2005

		Gasoline		
	Regulated		Theoretical Deregulated	
Oil Company Take	23%	P2.67	16%	P5.74
Others	44	5.12	20	7.18
Crude Cost	33	3.83	64	22.98
	100%	11.62	100%	35.90
Actual Deregulated Price				**31.18**

2005

		Diesel		
	Regulated		Theoretical Deregulated	
Oil Company Take	24%	P1.94	9%	P2.63
Others	29	2.35	13	3.81
Crude Cost	47	3.81	78	22.86
	100%	8.10	100%	29.30
Actual Deregulated Price				**27.31**

On Prices - 2005

- The theoretical prices of oil products are much higher than the actual pump prices.
- The share of other components have dramatically reduced.
- Conclusion: Oil product price increases were mainly caused by the peso devaluation and the increase in the world price of Dubai crude; not deregulation.

On Prices - **2008**

Extrapolated Mathematics

	2005	2008	% Inc / Dec
Crude Price	$49	$100	204%
PHP : USD	55	41	(25%)
CombinedFactor (CF)			152%

Applying CF on 2005 Prices (All others no change)

	2005	CF	2008
Oil Company Take	P 5.74		P 5.74
Others	7.18		7.18
Crude Cost	22.90	152%	34.81
Derived Price	35.90		47.73
Actual Pump Price	31.08		46.00+

CONCLUSION - **2008**

Same as FOR 2005:

Oil product price increases caused mainly by world price of crude (increases) and peso exchange rate (improvement).

NOT BY DEREGULATION

On Prices

- There are two ways that prices could be reduced:
  1. Ask oil companies to reduce prices
  2. Provide subsidy.

On Prices - 2005

- Are oil companies making too much money?
  - Under the regulated regime, they were guaranteed a fixed rate of return (8% of rate base).
  - Financial statements in the deregulated regime show that most oil players (importers) lost money.
    - Total loss of about P2 billion for Total
    - Total loss of about P5 billion for PTT

On Prices - 2005

- Are oil companies making too much money?
  - Only Shell and Petron made some money.
  - Financial data show that the two oil majors make less than the 91-day T-bill rate

PILIPINAS SHELL PETROLEUM CORPORATION

(Amounts in Million Pesos unless indicated otherwise)

	1998	1999	2000	2001	2002	2003	2004	7-Year Average
A. Net Income After Tax (NIAT)								
Per Audited Statements	1,191	2,062	(1,067)	2,762	2,698	2,587	2,971	1,886
Adjustments for:								
-Appraisal Depreciation (estimate)	(1,125)	(1,113)	(1,089)	(1,077)	(1,070)	(1,064)	(1,056)	(1,085)
Adjusted NIAT	66	949	(2,156)	1,685	1,628	1,523	1,915	802
B. Equity (Average)								
Per Audited Statements								
-Current year-End	16,635	17,008	14,170	15,440	16,064	16,647	17,033	
-Previous Year-End	15,733	16,635	17,008	14,170	15,440	16,064	16,647	
-Average	16,184	16,822	15,589	14,805	15,752	16,355	16,840	16,049
Adjustment for:								
-Appraisal Surplus (estimate)	13,874	12,749	11,636	10,547	9,470	8,400	7,336	10,573
Adjusted Equity (average)	30,058	29,571	27,225	25,352	25,222	24,756	24,176	26,623
C. Return on Equity (ROE)	0.2%	3.2%	-7.9%	6.6%	6.5%	6.2%	7.9%	3.0%

Notes:

a. Appraisal Surplus and Depreciation were based on estimated appraised value of assets acquired in 1997 and earlier. Such estimate of appraised values were based on actual appraisal done by Asian Appraisal in 1997 plus provision for effects of price changes up to 2002 (P/$ at 53.60). No appraisal estimates have yet been provided for assets acquired from 1998 to 2004. New asset appraisal is currently in progress (expected to be completed end-June 2005). We would update the figures as soon as available. We, however, estimate that the updated numbers will further depress the ROE.

b. Income or loss on exports are not currently available or extremely difficult to establish/isolate. These can be provided as soon as these can be reasonably determined. However, they are not expected to materially affect the ROE levels for these years.

PETRON CORPORATION
RETURN ON EQUITY (ROE)
(Amounts in millions)

PETRON (Based on restated figures)

		1998	1999	2000	2001	2002	2003	2004	AVERAGE
A.	Net Income After Tax (NIAT)								
	Per Audited Statements	3,763	2,362	(2,549)	1,224	2,921	3,114	3,425	2,037
	Adjustments for:								
	- Appraisal Depreciation (estimate)	(2,265)	(1,018)	(1,167)	(853)	(673)	(582)	(479)	(1,005)
	Adjusted NIAT	**1,498**	**1,344**	**(3,716)**	**371**	**2,248**	**2,532**	**2,946**	**1,032**
B.	Equity (Average)								
	Per Audited Statements								
	- Current Year-End	18,550	19,110	16,070	17,303	18,821	19,670	21,224	18,678
	- Previous Year-End	14,235	18,550	19,110	16,070	17,303	18,821	19,670	17,680
	- Average	16,393	18,830	17,590	16,687	18,062	19,246	20,447	18,179
	Adjustment for:								
	- Appraisal Surplus (estimate)	8,528	14,652	11,440	10,352	10,090	8,827	4,655	9,792
	Adjusted Equity (average)	**24,921**	**33,482**	**29,030**	**27,038**	**28,152**	**28,073**	**25,102**	**27,971**
C.	**Return on Equity (ROE)**	**6.01%**	**4.01%**	**-12.80%**	**1.37%**	**7.98%**	**9.02%**	**11.74%**	**3.69%**

91-day T-bill rate 1998-2004

Year	**Rate**
1998	14.27%
1999	10.20%
2000	9.86%
2001	9.86%
2002	5.43%
2003	6.03%
2004	7.43%
Average	6.97%

On Prices – **2008**

Updated Data

	T-Bill Rates	Petron ROE
2005	7.53	.43%
2006	6.20	2.99%
2007	3.71	2.91%

On Prices - Subsidy

- What about subsidizing oil prices and instituting something like the OPSF?
  - OPSF was created as a buffer fund to absorb cost increases and minimize frequent price changes.
  - OPSF was wiped out during large spikes in the cost of crude during the Kuwait invasion of Iraq.
  - There was some mismanagement of the fund. Government subsidy reached P15 billion.

On Prices

- What about subsidizing oil prices and instituting something similar to OPSF?
  - If OPSF were continued to this day:
    - Subsidy would be about P18 billion if diesel were pegged at P18.70 when the LTFRB granted fare increases in May 2004.
    - Subsidy would be about P1.5 billion for the first 4 months of the year if the government bore the P1/liter discount for diesel.

On Prices

- What about subsidizing oil prices and instituting something similar to OPSF?
  - There is danger when there are too many players.
  - OPSF is only good when few players exist and are willing to stay in business when they have to contribute to the fund.
  - There are “hit and run” players.

On Prices

- Can the government subsidize oil prices?
  - Subsidy is a system when someone other than the direct user pays a portion of the cost.
  - OPSF was sort of a subsidy but it was eventually wiped out.

On Prices

- Can the government subsidize oil prices?
  - Subsidy in other countries:
    - Indonesia – reached $7 billion
    - Malaysia – reached up to $1.5 billion for diesel
    - Thailand – reached $2 billion for gasoline and diesel; discontinued in June 2005
  - Can the Philippines afford subsidies of this magnitude?

On Prices

- Can the government subsidize oil prices?
  - Subsidy is viewed as unsound fiscal practice – ADB and UNESCAP
  - Subsidy has negative effects as it:
    - Distorts relative prices
    - Discourages fuel conservation and efficiency in transport
    - Encourages overuse of subsidized items

On Prices

- Can the government subsidize oil prices?
- Conclusion: Subsidizing oil prices (something like the OPSF) does not work in an era of rising crude prices because it would entail government resources that it cannot afford.

On Prices

- If we accept for argument's sake that the oil players were not overcharging:
  - Why were increases in oil prices very frequent?
  - Why didn't they reduce prices right away when there was a decrease in international crude prices?

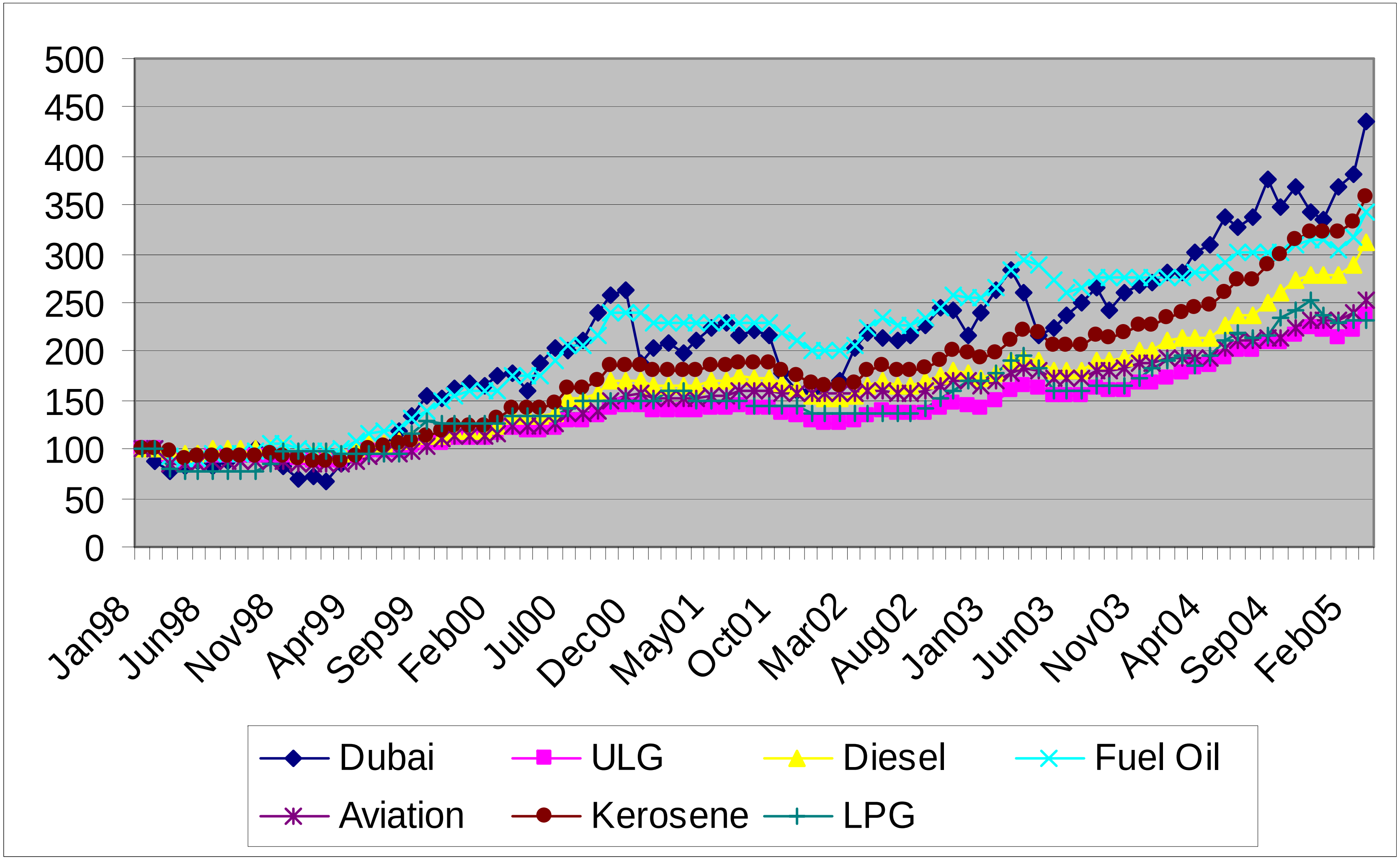
COMPARATIVE PRICE INCREASES

	April 2005		Mar 1998		%Change	
	Local	Int'l	Local	Int'l	Local	Int'l
ADO	27.21	23.39	8.10	3.91	236	498
ULG	31.10	21.07	11.62	4.27	168	393

Prices in P/liter; International price are MOPS-based

DOE's price monitor shows that the local oil companies are not able to adjust their prices as fast as MOPS.

Dubai vs. Local Prices



Dubai benchmark reached 4.35 times its Jan 1998 level, in contrast unleaded gasoline and diesel were about 2.37 and 3.13 times respective in Mark 2005. For the refiners, their raw material cost went up faster than their selling price.

On Prices

- Price Catching Up
  - Small but frequent adjustments.
  - The DOE secretary asked for the cooperation of local oil companies to increase prices on a staggered basis rather than in one big jump.
  - This resulted in weekly P.50 increases on March 7, 15, 19, 27 and April 4.

On Prices

- Parachute Phenomena
  - Since oil companies cannot keep up with price increases, they try to recover when there are price decreases.
- Conclusion: Frequent price increases resulted from government suasion in spreading major price increases over a longer period.

On Prices

- Why do oil companies seem to raise prices at the same time?
- Do cartels exist?
  - Nature of the product – interchangeability
  - Competition is involved
  - Market share is the name of the game
- Basic economics should consider that under these conditions, we should expect prices to go up and down together which is an indication that market forces are working; not necessarily that cartels exist.

On Prices

- Conclusion: When products are interchangeable, when market share is the “name of the game,” and competition is in full swing, we should not be surprised, but rather expect, that oil companies’ prices will seem to rise and fall at the same time.

On Prices: Major Conclusions

- The main cause of oil price increases was the effect of major peso devaluations and increases in the international price of oil especially since we import practically all our oil product requirements.
- Subsidy is not a viable solution because it will cost government excessive amounts of money.
- There is no evidence of price cartels.

On Prices: Recommendations

- On Pricing:
  - The DOE should not support or initiate any change in the Policy of the State in the Downstream Oil Industry Deregulation Act of 1998 (RA No. 8479).

Report on the Downstream Oil Industry Deregulation Act of 1998

Independent Review Committee

January 2008