THE STORY OF OIL BONDS

The Story of Oil Bonds

– By Prof. *Simply* Simple

THE STORY OF OIL BONDS

- The most talked about subject these days is whether petrol prices will rise even further or not and if so how much more?

- Pricing of petroleum products in India is managed in a different manner as compared to other products.

- I will try and de-mystify this for your understanding…

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Understanding Oil Subsidy

- While oil prices are rising in the international markets and have crossed $142 for a barrel, an increase of 100% in one year, the price of petrol that we buy at retail stations had been the same for a long while, before being increased by around Rs. 5 recently.
- So who is financing this deficit?
- The Government and the oil companies together are responsible for keeping the prices of petrol and diesel under control and have so far guarded us from price hikes.

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But how do they do it?

- To begin with oil cos. such as IOC, BPCL and HPCL purchase crude at a higher price and sell it in the market at a lower price.

- For the sake of understanding, let us assume that they are purchasing crude for Rs. 100 per unit and instead of selling it at Rs. 120 per unit and making a profit of Rs. 20 they are actually selling it for Rs. 80 per unit at a loss of Rs. 20 per unit.

- They are doing this as the Government controls the pricing of petroleum products and under its instructions, the pricing is finalized which the oil cos. have to follow.

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So what happens now?...

- The oil companies have several problems due to this policy.
  - First they are losing money for every unit at the rate of Rs. 20
  - Hence the more they sell, the more they lose
  - But since the prices at the retail levels are not being raised, the people at large are unaware of rising prices and their demand for petroleum products does not decrease and in fact may even go up
- The oil cos. approach the government to compensate them for their losses.
- The government therefore pays them to fund this subsidy on petroleum products.

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Seems fine. So what is the problem?

- **The problem is that the government does not pay cash to the oil companies to meet their deficit.**
- **Instead it gives the oil companies ‘Oil Bonds’ in lieu of the cash.**
- **Now, a bond is a promise to pay at a later date.**
- **Thus, although the oil cos. are paying money upfront for purchases, they are being compensated by means of oil bonds which is a deferred payment.**

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Therefore…

- **The oil companies' cash flow gets adversely impacted. What is the point of getting money at some future date if it is badly required today?**

- **So what can the oil cos. do to fund their working capital like new purchases, salaries, selling and marketing expenses etc?**

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So…

- **They sell the oil bonds in the market. But these bonds may not be in demand.**
- **So, they have might have to be sold at a discount (currently around 12-15%) For example, a Rs. 40 per unit oil bond might recover only Rs. 34-36. This means that the oil cos. do not achieve their price targets.**
- **Further, oil companies can sell only 25% of the bonds in a given quarter, thus posing huge financial challenges for the companies.**
- **Thus, oil bonds, that are long term in nature, are being used to finance immediate expenses.**

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Are only oil companies affected?

- **Besides the oil companies' losses, the Government too has to pay up the money at the end of the stipulated time period.**
- **What these bonds are doing is just postponing the losses, which have to be repaid some day.**
- **And somewhere, at some point in time, the promised doles met out earlier will also eat into the Government's revenues, thus adding to the fiscal deficit.**

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To sum up…

- **The Government is slowly realizing that raising petroleum product prices to increasingly reflect the hard facts of global scarcity could be a better option than just depending on oil bonds.**
- **This would explain the largest fuel price hike that we have witnessed in recent memory.**
- **Thus, a change in approach to this administered price control mechanism will subsequently auger well for the economy.**

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Hope you have now understood the concept of Oil Bonds

Thinking of Investment

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