Anti-Competitive Practices in

Nepal's Petroleum Sector

SAWTEE
SOUTH ASIA WATCH ON TRADE, ECONOMICS & ENVIRONMENT

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Milan Mani Sharma
Sudeep Shrestha

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Published by : South Asia Watch on Trade, Economics & Environment (SAWTEE)

Supported by : Nepal Office of the Department for International Development (DFID), United Kingdom

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Citation : Sharma, Milan Mani and Sudeep Shrestha. 2007. *Anti-Competitive Practices in Nepal's Petroleum Sector*. xii+48. Kathmandu: South Asia Watch on Trade, Economics & Environment (SAWTEE).

Design : Effect, 9851046272

ISBN : 978-9937-8038-1-6

Printed at : Modern Printing Press, Jamal, Kathmandu

Available from :

South Asia Watch on Trade, Economics & Environment (SAWTEE)
P.O. Box: 19366, 254 Lamtangeen Marg, Baluwatar, Kathmandu, Nepal
Tel: 977-1-4415284/4444438, Fax: 977-1-4444570
E-mail: sawtee@sawtee.org
Web: www.sawtee.org

Acknowledgements

The petroleum sector in Nepal has long been operating under the monopoly of the government. The state-owned Nepal Oil Corporation (NOC) exercises an absolute monopoly over the import of petroleum products. The government is seeking to liberalize the sector to end decades-long monopoly and ensure a fair and competitive environment in the petroleum market.

The government plans to open the petroleum sector to the private sector, adopt an automatic pricing system, and set up an independent authority to supervise and monitor the sector. However, the government's plan flies in the face of the political sensitivity associated with petroleum pricing, inefficiency and corruption in NOC, and anti-competitive practices of petroleum dealers, transporters and gas companies.

South Asia Watch on Trade, Economics & Environment (SAWTEE) implemented Competition Advocacy and Education Project (2004–2007) to raise the level of awareness among stakeholders about trade and competition issues and inculcate a 'competition culture' in them so as to promote fair and competitive market environment in the country. As part of this project, SAWTEE conducted a detailed study on Anti-Competitive Practices in Nepal's Petroleum Sector; this volume is an outcome of the same study.

I would like to thank Milan Mani Sharma and Sudeep Shrestha for undertaking this study. I am grateful to all government officials, NOC officials, business persons of the petroleum sector and experts for helping the researchers at different stages of the study. Special appreciation goes to Amrit Nakarmi, Bimal Wagle, Krishna Hari Baskota, Mahesh Jung Rana, Narayan Sanjel, Saroj Pandey, Shiva Prasad Ghimire, Sushil Bhattarai, Umesh Dahal and Dr Upendra Koirala. I would also like to thank Bijay Ghimire, Krishna Regmi, Prem Khanal and Sanjay Neupane for their support in conducting this study.

I would also like to extend heartfelt thanks to Kamalesh Adhikari for his valuable inputs to the study. I would also like to acknowledge the enduring support provided by Dr Dhrubesh Chandra Regmi and Neelu Thapa throughout the study. I am also grateful to Paras Kharel for editing the volume and Prakash Dahal for his editorial inputs. I also appreciate the design and layout done by Indra Shrestha to publish the study in this form. I would also like to thank the Department for International Development (DFID) for supporting SAWTEE to implement CAEP and publish this volume.

I hope this publication will be useful to the concerned stakeholders in promoting ‘competition culture’ in Nepal’s petroleum sector. Comments and suggestions on this publication are welcome.

Navin Dahal
Executive Director

Abbreviations and acronyms

DoC	Department of Commerce
DoSM	Department of Standard and Metrology
FBP	Final Boiling Point
FY	Fiscal Year
IOC	Indian Oil Corporation
IRs.	Indian Rupees
KL	Kilolitre
LPG	Liquefied Petroleum Gas
LPGDA	LP Gas Dealers' Association
MoICS	Ministry of Industry, Commerce and Supplies
MoU	Memorandum of Understanding
NKDA	Nepal Kerosene Dealers' Association
NLPGIA	Nepal LP Gas Industries Association
NOC	Nepal Oil Corporation
NPDA	Nepal Petroleum Dealers' Association
NPTA	Nepal Petroleum Transporters Association
NRs.	Nepalese Rupees
OMC	Oil Marketing Company
PDO	Purchase Delivery Order
RTP	Refinery Transfer Price
VAT	Value Added Tax

Note:

US$1 = NRs. 65.49 as of 7 August 2007

IRs. 1 = NRs. 1.6 (fixed exchange rate)

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Executive summary

Fuel shortage has become a recurrent problem in Nepal. At its heart lies the anti-competitive practices that are rife in the petroleum sector, characterized by monopoly or cartel at virtually every stage of the business. As the country imports all of its petroleum needs, the burden of such anti-competitive practices for the economy as a whole is staggering.

The monopoly begins with the sourcing of fuel, as the 1974 Memorandum of Understanding (MoU) between Nepal and India obliges Nepal to import fuel exclusively from the Indian Oil Corporation (IOC). On the domestic front, the state-owned Nepal Oil Corporation (NOC) remains the statutory fuel import monopolist. It makes headlines for all the wrong reasons. Its monthly losses run into the tens of millions and it owes IOC and domestic financial institutions billions in outstanding dues primarily because it buys dear and sells cheap. As the outstanding dues mount, IOC frequently halts or cuts supplies in an attempt to pressurize NOC and, by extension, the Nepalese government, to clear the same.

The solution seems simple enough: just adjust domestic prices to changes in international prices. But that is easier said than done. Wholesale prices are still government-administered, so the suggestion of an upward adjustment in fuel prices is a political hot potato; virtually every political

party in government is loath to adjust prices to the extent warranted by global price fluctuations. Price-hike decisions have invariably attracted the wrath of the opposition, notwithstanding the recommendations of studies commissioned by different governments for devising a politically free mechanism to revise prices in accordance with the world price trend. NOC's reluctance to recommend lowering of prices when world prices fall and predilection for distributing bonuses among its staff when it makes a windfall gain due to a decline in its import price instead of passing the gain on to consumers—coupled with the corruption and inefficiency in the corporation—make price-hike decisions all the more unpopular.

This volume attempts to dissect the Nepalese petroleum sector and throw light on the anti-competitive practices rampant in the sector and the resulting burden borne by consumers. The monopoly and inefficiency story does not end with NOC. The associations of petroleum dealers, transporters, gas companies and gas dealers, ostensibly formed to protect *entrepreneurs' interest*, are essentially nothing but cartels. They resort to various pressure tactics, stalling distribution and creating crisis in the market, to raise profit and commission margin, and transportation fares, and to acquire concessions on handling and technical losses—often the result of their own inefficiency. It is the consumers who have to bear the ultimate burden of such inefficiency. Consumers' woes are also compounded by artificial shortages created by dealers, often under the cover of supply cuts by IOC.

The volume suggests that deregulation alone does not necessarily guarantee competition in the market and its attendant benefits to consumers. The government's decision in February 2006 to adopt a wholesale pricing system and open retail oil pricing to petroleum dealers was based on the assumption that dealers would compete on prices, raise their efficiency and focus on increasing the volume of sales. However, dealers started resorting to collective price fixing, jacking up the cost components of retail pricing arbitrarily. The same is true in the case of cooking gas, where the government provides a direct subsidy but consumers are denied the full benefits of the subsidy due to collective price fixing by gas companies, which thereby earn super-normal profits. The deter-

mination of costs does not make any economic sense. The fixing of a uniform fare for transporting liquefied petroleum gas (LPG) from an Indian refinery to bottling plants located in different parts of Nepal is a case in point.

Ironically, thus, the partial deregulation only led to a significant cost variation on the higher side between dealers' retail pricing and the previous NOC pricing. In effect, monopoly was partially transferred from the State to a bunch of private players. Worse still, the government has done little to break such practice. Hence, the government should institute an autonomous Petroleum Authority without further ado. The Authority should be mandated to decide on wholesale prices in accordance with international prices and ensure that retail prices are realistic.

If the opening up of retail market operations in oil failed to provide any relief to consumers, the government's decision to allow private sector companies to import gas directly proved to be utterly premature. A number of obstacles, including the standing 1974 MoU with India that requires fuel to be imported exclusively from IOC, and the lack of a timeline for companies to upgrade infrastructure and expand storage capacity before NOC stops issuing Purchase Delivery Order (PDO), have effectively stalled the private sector's entry into direct gas import. The lack of an adequate storage capacity has meant a recurrent supply crisis.

Adulteration of fuel by authorized dealers, often in collusion with NOC staff, is another unhealthy practice in vogue in the market. This practice partly stems from the difference in acceptable fuel quality-standard in India and Nepal. Moreover, though NOC's Fuel Quality Bylaws give it full authority to take action against dealers resorting to adulteration, the corporation has not been able to carry out its market inspection function since the government opened retail market operations to the private sector, prompting dealers to interpret the decision as barring NOC from monitoring and inspecting the retail market thenceforth, and to put up a stiff resistance to any attempt at inspection. This calls for the formation of an effective market inspection mechanism/body to ensure quality control and prevent quantity theft, another rampant prac-

tice, as well as narrowing the discrepancy in inter-country quality-standard. There is no specific policy that governs the downstream petroleum business. This should change.

In the light of the state of affairs in the petroleum sector, a number of steps have to be taken to ensure competition in the petroleum market and save consumers from paying for others' inefficiencies and malpractices. The various syndicates in the market should be scrapped forthwith. There is a need to review the 1974 MoU to pave the way for Nepal to seek new suppliers, Indian and/or overseas. Necessary policy and legal frameworks should be devised to welcome the private sector into the import business, ending NOC's monopoly. At the same time, the activities of the private players should be closely monitored, since, as has been the experience, the mere presence of a large number of players is not a sufficient condition for fair competition. An effective enforcement of the laws related to competition and consumer rights is thus in order. Reforms in NOC are urgently needed, involving transparency in its operations and right-sizing of its staff by reducing the burden of non-professional and non-technical personnel.

As regards the LPG business, gas companies should be directed to expand and upgrade their infrastructure and storage capacity so that supply is smooth. The perversity of the subsidy on LPG ought to be rectified through price differentiation for domestic and commercial consumers. Likewise, the PDO system under which gas is being imported should be phased out in a time-bound manner. The country should also have a comprehensive energy policy and a Petroleum Perspective Plan, taking into account population and economic growth, energy demand, development goals and environmental considerations.

CHAPTER 1

Overview of the petroleum sector

Dependence on petroleum imports

A least developed country landlocked between China and India, Nepal finds it difficult to access international markets for the export and import of goods and services. Since the country does not have crude oil sources to meet a rapidly growing national demand for petroleum products, it depends on India for the supply of petroleum products. Until 1973, multinational petrochemicals based in India such as Exxon used to supply petroleum products through their own refilling stations in Nepal. In 1974, Nepal signed a 'Memorandum of Understanding (MoU) on Petroleum Supply' with India, which has since governed the import of petroleum products in Nepal. It has designated India as Nepal's source country, appointed India's state-owned enterprise, the Indian Oil Corporation (IOC), as the sole exporter of fuel to Nepal and the state-owned Nepal Oil Corporation (NOC)[1] as the petroleum import monopolist in Nepal (*Box 1*).

[1] NOC is a state-owned trading enterprise established in 1970 under Company Act, 1964.

Box 1: NOC and petroleum business policy

There is no specific national policy in Nepal to govern petroleum downstream business, i.e., transactions and marketing of petroleum products. The government enacted Petroleum Act 1983, but it merely deals with upstream business such as exploration, mining and distribution of crude oil from oil wells. As far as petroleum transaction is concerned, it is carried out as per the regulations and internal decisions of NOC.

NOC regulation has established the corporation as the import monopolist, stockist and supplier of fuel in the domestic market. It has authorized NOC to function as the regulatory body of the petroleum sector; empowered it with the authority to appoint dealers for retail sales; hire transporters for the transportation of fuel; set operating conditions and standards for dealers and transporters; formulate quality regulation; control quality; and monitor and intervene in the market as and when necessary.

At the upper level, the Ministry of Industry, Commerce and Supplies (MoICS) is the authority designated to oversee NOC's operations and the petroleum market. The Ministry takes policy decisions related to the petroleum sector in consultation with the Cabinet of Ministers. NOC provides policy recommendations to MoICS as and when necessary. Thus, NOC functions as the sole Oil Marketing Company (OMC) as well as the sectoral regulatory authority.

Import arrangements

According to the 1974 MoU with India, NOC has to procure crude oil from the international market and hand the same over to IOC. IOC would then supply NOC with an equivalent volume of petroleum products in different forms such as petrol, diesel, kerosene, aviation fuel and furnace oil. The MoU has also authorized IOC to review export prices (import prices for Nepal) every six months on the basis of NOC's actual import prices.

The MoU has extended certain facilities to Nepal. The Government of India has exempted Nepal's overseas petroleum imports from customs duty, with a further commitment to supplying the same on bonded facility, thus making petroleum supply to Nepal free from all forms of tax otherwise applicable in India such as excise duty and sales tax. The institutional arrangements, duty exemption, bonded supply facility and delivery system of petroleum trade under the 1974 MoU hold good till date.

However, provisions related to product exchange and pricing have changed since 28 March 2002, when NOC and IOC signed a new agreement for five years. The new supply and pricing arrangements for the import of petroleum products, as provided for in the 2002 agreement, are as follows.

Procurement of crude oil

The agreement requires NOC to provide crude oil to IOC from the international market for acquiring an equivalent value of refined petroleum products. In this regard, NOC has been asked to source crude oil from Egypt, Iraq and Yemen as IOC refineries accept crude oil only from these countries. However, Nepal has not been able to supply crude oil to IOC from the said international markets so far for two main reasons: the financial crisis of NOC and a lack of expertise to carry out international procurement (*Box 2*).

Not that it did not make any efforts to comply with this provision. A high-level delegation of the Government of Nepal visited Egypt in 2002 to conduct a procurement feasibility study. A process was also initiated to procure crude oil from Malaysia with IOC's consent. Both efforts failed. Till date, however, IOC has not withheld the supply of petroleum products citing this non-compliance. NOC continues to receive refined petroleum products and liquefied petroleum gas (LPG) from various IOC depots and refineries as it did in the past.

Box 2: NOC's limitations in procuring crude oil

Financial crisis: Since the signing of the 2002 agreement, import prices of oil have drastically increased and the Government of Nepal, due to political reasons, has not adjusted domestic prices accordingly. The disparity in import-sales prices has seriously hit NOC's financial position. The financial condition of NOC has worsened to such an extent that it has not even been able to pay its monthly import bills on time.

As of mid-August 2006, NOC's monthly losses stood at NRs. 830 million; its cumulative outstanding import account had reached NRs. 8.07 billion; and it owed NRs. 1 billion to the government, NRs. 1 billion to the Rastriya Banijya Bank, NRs. 1.05 billion to the Employees Provident Fund, NRs. 400 million to the Nabil Bank, NRs. 286 million to the Citizen Investment Trust and NRs. 99.75 million to the Agricultural Development Bank. In such a situation, procuring crude oil, which requires investments in billions of rupees, has become impossible for NOC.

Lack of expertise: Although NOC is currently operating with 510 staff, there is a dearth of technical expertise to effectively and efficiently handle the procurement of crude oil from the international market. There are only 18 engineers and three overseers.

Only a few staff have the knowledge of how the international market operates, but they lack exposure to undertake such a responsibility with confidence. Lack of know-how on the part of NOC board members, who are appointed politically, further worsens the case.

Note: Data and information are collected from different publications and sources of NOC and MoICS.

International pricing system

The 2002 agreement annulled the previous arrangement whereby IOC set prices for petroleum exports to Nepal on the basis of NOC's actual import price. It introduced an import parity pricing system, under which IOC fixes oil prices for Nepal as per international spot prices (of refined petroleum products). IOC reviews export prices of petrol and diesel every 15 days and adjusts prices for other products such as kerosene, aviation fuel, furnace oil and LPG on a monthly basis. The agreement has stipulated the Haldiya Refinery Transfer Price (RTP) as the basis for IOC to fix prices for exports to Nepal. It also requires Nepal to pay the monthly import bills by the 15th of every month.

Refinery transfer price

RTP is a price at which the Indian refineries supply petroleum products to OMCs. It is based on import parity pricing and includes cost components such as net-import cost of the product, shipment cost (up to Indian ports), transport insurance cost, basic customs duty, demurrage charges (paid at the port), quality premium charges, government's landing and service charges and refineries' service charges. To this RTP, IOC adds its internal costs such as railways freight cost, inventory cost, marketing margin and profit margin to arrive at the ex-depot prices for exports to Nepal. It, however, deducts a demurrage charge of NRs. 240 (IRs. 150) per ton if included in RTP while fixing final export prices to Nepal. It also pledges discounts on marketing margin.

Bonded facility and customs duty refund

The 2002 agreement has retained the previously pledged bonded supply facility to Nepal. That is, petroleum products exported to Nepal are exempted from all forms of duties otherwise applicable in India. In addition, in June 2003, IOC also agreed to refund NOC the basic customs duty (5 percent for diesel and 10 percent for petrol) paid for crude oil import at the Indian port. The duty is included in RTP as a cost component, and imposing it was against the 1974 agreement. However, IOC has not made any refund of the duty till date. It attributes the

delay to the protracted procedures of the Indian customs department in releasing the refund claim. IOC owes some NRs. 1.12 billion (IRs. 700 million) in customs duty refund to NOC. Once the provision is enforced, NOC is estimated to receive around NRs. 800 million in duty refund annually.

Purchase delivery order

Purchase Delivery Order (PDO) is a mechanism worked out by NOC and approved by IOC for the import of LPG in Nepal. It is nothing but a delivery request slip which bears NOC's request to IOC to issue specified weight of gas to the PDO bearer. IOC supplies companies with the gas as and when they produce PDO to it.

Import points

Nepal imports petroleum products from various IOC refineries and depots. Raxaul, Barauni, Allahabad, Assam, Beitalpur, Mugalsaray, Gonda and Banthara are the major depots from which NOC receives petroleum products. LPG is imported from the Barauni, Haldiya and Mathura refineries.

CHAPTER 2

Pricing of petroleum products

Oil pricing

Import prices are determined at rates fixed by IOC. IOC reviews import prices every 15 days in line with the international trend of spot petroleum prices. Prices for local sales are, however, administered by the government; NOC has no authority to fix prices on its own. Earlier, NOC used to fix the prices of aviation fuel on its own, but the government took over the authority a few years ago. Nonetheless, NOC proposes adjustments in prices as and when necessary to MoICS. The Cabinet of Ministers, on the recommendation of MoICS, decides on fuel prices. Thus, the Cabinet of Ministers holds the ultimate authority to decide on petroleum pricing. MoICS enforces the Cabinet decision, while NOC executes it.

On receiving the Cabinet's approval, NOC discloses the wholesale prices of petroleum products. The wholesale prices are ex-depot prices and vary from depot to depot due to differences in transportation cost. Retail-level pricing of petroleum products has been opened for NOC-

appointed dealers to decide on. Petroleum dealers acquire products from NOC depots at wholesale prices and add their cost of transportation, insurance, technical and handling losses, administrative expenses and profit margin to fix the retail prices. In the case of aviation fuel, the retail price is fixed by the government.

Earlier, the government used to cross-subsidize kerosene by fixing petrol prices on a higher side. The government also used to fix dual prices for kerosene to provide subsidy to the poor, the marginalized and other targeted groups such as students. But those measures suffered from weak administration and distribution problems, and were hence withdrawn. Although there is no direct subsidy or cross-subsidy on oil at present, indirect subsidy persists as the government has not brought domestic prices into line with international prices.

Oil pricing is a politically sensitive issue in Nepal. The government, no matter which party it represents, tends to refrain from taking price-hike decisions due to the political uproar it creates. Parties in the opposition invariably contest such decisions. There are numerous instances of Commerce Ministers resigning due to the pressure coming from the street. People refuse to accept price-hike decisions due to politicization of the matter as well as lack of awareness. So much so that people have even lost their lives protesting price hikes.

Unjustifiable increases in transportation fares and commodity prices when international prices go up, and a very few cases of price cuts when world prices go down have also contributed to making price-hike decisions unpopular. High-level studies commissioned by the government have unanimously warned of serious economic consequences of the politicization of fuel pricing and have stressed the need to do away with the practice. On its part, the government lately has made commitments to introducing reforms in the petroleum sector—both to evade undue fiscal pressure and liberalize the sector.

Going by the recommendations of high-level committees on petroleum products, the government in 2005 took a decision to allow NOC to decide on oil prices. However, it also directed NOC not to change

the prices without the Cabinet's approval. This condition ensured the government's continued control over pricing decisions.

Intense politicization of pricing has left oil prices in Nepal out of sync with the international price trend. For instance, oil prices in Nepal were not changed for 15 months, from mid-May 2003 to mid-August 2004, whereas international prices during the period had soared by as much as 65 percent. Such inactions are common. They have piled up pressure on the economy and subsequent governments. They have also created situations necessitating sharp hikes in prices, of which there are numerous examples. As a case in point, to compensate for the inaction of 15 months, the government raised oil prices thrice between August 2004 and January 2005. No wonder, the rate of increment was sharp.

Inaction regarding price adjustment is in evidence not only in the case of price rises in the international market, but also in the case of declines. The government appears to be reluctant even to transfer the benefits of international price declines to consumers. NOC engages in intense exercises to jack up prices to rein in its losses, but maintains a conspicuous silence when its profit margin rises on account of a fall in world prices. It prefers to retain the windfall gains for itself and distribute the same among its staff rather than transferring them to the consumers at large (*Box 3*). For instance, in Fiscal Year (FY) 1999/2000, NOC earned a net profit of NRs. 2 billion due to a decline in international prices and a lack of a concomitant adjustment in the domestic prices. It distributed bonus equivalent to 28 months' salary (NRs. 174 million) to its staff in 1999.

Introduction of wholesale pricing system

The Government of Nepal has been undertaking some reform measures in the petroleum sector since 2004. On 17 February 2006, the government adopted a wholesale pricing system. Under the system, NOC is required to announce wholesale prices, while retail-level dealers are allowed to fix retail prices for petrol, diesel and kerosene. The new system scrapped the earlier arrangement of dealers operating on commission from NOC, and allowed them to include their profit margin in the retail prices.

Box 3: NOC distributes huge bonus

Charges that NOC prefers to enjoy robust profits and distribute handsome bonus to its staff instead of slashing prices when international prices go down are not merely an allegation. In 1999, NOC distributed bonus worth NRs. 174 million among its staff, which amounted to 30 months' salary. The cumulative annual salary of the corporation's staff then was NRs. 75 million.

From October 1997 to February 1999, international petroleum prices fell to US$10 per barrel from US$23 per barrel due to an increase in production carried out to cope with the South-East Asian economic crisis. But instead of adjusting domestic prices, which would have relieved the consumers greatly, NOC kept the prices same, thereby raking in NRs. 2 billion in profits.

The distribution of bonus was not done against the regulations though, as the Bonus Act allows state-owned entities to distribute bonus of up to 6 percent of their profits. The only concern is that the corporation could have transferred the benefit to the consumers, but it did not do so. That is not the end of the story, however. The corporation's staff also enjoyed additional perks which came through the Employees' Welfare Fund. As per the Act, NOC contributed an additional 4 percent of its profits to the fund.

Source: The Kathmandu Post (2005)

The aim behind taking such a decision was to prepare the ground for deregulation of prices by giving a message to consumers that they should not expect respite with respect to prices forever, as pricing is a commercial decision. The aim was also to orient the private players to liberalization and promote competition among market players. The government argued that the decision would enable and encourage private players (dealers) to cut back their profit margins and compete on end prices to attract consumers, thereby ensuring voluminous sales. It assumed that competition would not allow dealers to compromise on quality, and

expected that the move would, instead, give consumers the upper hand in the petroleum market.

To ensure an unhindered supply and facilitate dealers in receiving oil from the nearest NOC depots, NOC also disclosed 10 sets of wholesale prices, one for each of the 10 depots located in different parts of the country. The prices for depots located far from customs points (points of entry) were kept slightly higher (due to additional transportation cost) than for depots closer to customs points (*Table 1*). NOC also made the announcement of adjusting wholesale prices to changes in import rates every month. But that has not been implemented.

Although the government opened retail oil pricing to dealers, it has not devised a mechanism to check whether the prices fixed by them are realistic. No policy and institutional arrangements have been made to monitor possible deviations in pricing components, leading to the earn-

Table 1: Wholesale prices* *(NRs. per KL, inclusive of VAT)*

NOC depot or customs point	Petrol	Diesel	Kerosene
Biratnagar	63,656.76	50,101.44	45,354.29
Birgunj	62,791.96	49,317.07	44,495.64
Amlekhgunj	62,878.48	49,403.60	44,572.21
Kathmandu	63,949.13	50,474.25	45,519.70
Pokhara	63,827.05	50,352.17	45,411.66
Bhairahawa	63,866.10	50,231.77	45,309.34
Nepalgunj	63,937.58	50,532.92	45,454.85
Surkhet	64,803.86	51,399.20	46,221.47
Dhangadi	64,290.47	50,922.74	45,665.16
Dipayal	66,101.38	52,733.65	47,267.74

** Announced on 21 February 2006*
Note: The table's data are collected from monthly pricing tables and statistics of NOC.

ing of undue profits by dealers. There is no regulation on how the government should treat dealers if they resort to price cartel.

Components of retail pricing of oil

Import price

Import price is the rate at which NOC buys oil from IOC. It occupies the largest weight in retail prices. On 1 May 2006, import prices made up 70.74 percent of NOC's wholesale prices in the case of petrol and 97.70 percent in the case of diesel. In the case of kerosene, however, import prices exceeded wholesale prices by 3 percent.

Customs duty and taxes

Customs duty and taxes stand as the second largest component of retail pricing. This includes import duty, customs service charge, local development tax, special duty, road maintenance tax and value added tax (VAT). Taxes levied on the import of different petroleum products are tabulated in *Table 2*.

Transportation cost

Transportation cost accounts for 2 to 4 percent of retail prices. This cost is incurred at two levels: while importing oil from IOC depots to NOC depots; and while transporting it from NOC depots to dealers' refilling stations. At the first level, NOC has fixed the transportation cost at NRs. 1,463.24 per KL of fuel. At the second level, dealers and transporters have fixed it at NRs. 1,092.82 per KL.

NOC's overhead cost

The administrative cost of NOC makes up 0.5 to 0.8 percent of consumer prices. At present, NOC's administrative overhead cost is NRs. 347.15 per KL of oil. That is, about NRs. 0.35 realized from the sale of every litre of oil goes into NOC's operations.

Table 2: Duties* on petroleum imports *(NRs. per KL)*

Particulars	Petrol	Diesel	Kerosene
Customs duty – fixed	15,250.00	2,100.00	800.00
Customs service charge (@ NRs. 50/12 KL)	4.17	4.17	4.17
Local development tax (@ 1.5%)	739.47	781.42	789.09
Special duty (NRs. 0.50/L)	500.00	500.00	500.00
Roads maintenance tax	1,000.00	500.00	0.00
VAT (13%) – at NOC depots	8,789.86	7,337.88	0.00

** Based on 1 August 2006 pricing*
Note: The table's data are collected from monthly pricing tables and statistics of NOC.

Technical losses

The volume of petroleum products shrinks when they are transported to colder places. Such losses are called temperature losses. Likewise, pipeline leakages, spills and evaporation-caused losses are collectively termed working losses. Given that temperature and working losses are unavoidable, they are together called technical losses. Previously, NOC used to cover such shrinkage losses by supplying an extra 0.6 percent petrol, and 0.4 percent diesel and kerosene to the dealers. Under the new system, the dealers include the losses as a retail cost component. They have raised the rate to 1 percent.

Handling losses

Losses incurred during the process of unloading, storage and sale of fuel are called handling losses. Earlier, NOC was supplying an extra

0.15 percent fuel to cover this loss. However, following the introduction of the new pricing system, dealers have raised it to 0.60 percent. In the case of kerosene, a drum depreciation of NRs. 163.22 per KL is also added to the consumer prices.

Profit margin

The profit margin of dealers currently stands at 3 percent.

Transportation

Transportation of petroleum products is carried out through private tanker operators. NOC enjoys complete authority over the processes and terms of appointment of private tanker operators. It signs contracts with transport operators, binding them within set terms and conditions. Thus, the petroleum transportation business, like petroleum importation, is also regulated by the State.

Transportation of fuel is carried out through a network of some 1,115 tankers operated by independent private entrepreneurs. In addition, petroleum dealers also possess 39 tankers. NOC also owns seven specialized refuelling tankers of 12 KL, 16 KL and 27 KL capacity, but they are operated at airports only to supply aviation fuel.

The overall fuel transportation function is conducted in two tiers: transportation of fuel from IOC depots to NOC depots, where it is unloaded for storage purpose; and transportation of fuel from NOC depots to the dealers' refilling stations. Tankers of 12 KL, 14 KL, 20 KL and 25 KL capacity are used for transporting oil from IOC depots to NOC depots. Tankers of 8 KL, 12 KL, 14 KL and 20 KL capacity are used for transporting fuel from NOC depots to dealers' refilling stations.

In the past, NOC was responsible for carrying out both tiers of the transportation function, except in the case of LPG. But since the Cabinet decision of February 2006, NOC's responsibility has been limited to the first tier. NOC discharges its transportation function by hiring trans-

porters through open bidding, binding them in its terms and conditions. The same decision shifted the responsibility of second-tier transportation from NOC to retail-level dealers.

There are no specific government policy guidelines or working manuals on fuel transportation. It is governed by the internal policy and regulations of NOC. The corporation publishes bid notices to hire transporters. The terms and conditions, and fares are fixed through undisclosed negotiations, although a formal contract is signed between NOC and transporters for official purposes. Dealers, on their part, hold separate negotiations with transport operators to hire them for retail-level transportation.

All the tankers function under a syndicate of operators known as the Nepal Petroleum Transporters Association (NPTA), an association formed to protect the 'interests of transporters'. 'Business for all', 'protection of investment' and 'no unfair play and undue competition among members' are some of the major policies of NPTA. Therefore, it does not allow operators to compete with each other on services and fares. It fixes fares for the operators and requires NOC to accept those rates. There are numerous examples of NPTA going on strike in order to force NOC to agree to its rates as well as fulfil its other demands, e.g., 'business for all'. Such practices have reduced efficiency and stifled competition in the fuel transportation business, besides adding to the cost of NOC operations.

Distribution

Retailing of petroleum products is executed through the appointment of private sector dealers. NOC appoints the dealers. It sets the terms and conditions for such appointments as per the NOC regulation and does not allow dealers to deviate from its set operating guidelines. Thus, the State controls the retail oil business as well.

There are 850 NOC-authorized dealers that operate petrol and diesel refilling stations across the country. In addition, there are 1,046 old and 600 new kerosene dealers. NOC mobilizes this network of 2,496 dealers to supply petroleum products in the country. However, the standard

operating terms and working manuals set by the corporation do not mandate competition among dealers at the retail level.

NOC appoints dealers through internal decisions. The appointment process is not transparent. The lack of a transparent mechanism for granting dealership has also bred corruption and nepotism in NOC. In the past, dealers worked on a 3 percent commission (guaranteed profit margin) from NOC. Dealers were just required to place orders at NOC depots and NOC used to deliver the supplies bearing all the risks and costs up to the retail premises. Thus, dealers functioned merely as retail-level refilling outlets of NOC.

However, since 17 February 2006, the dealers have had to collect the supplies themselves, make all the necessary logistical arrangements for bringing the products to their premises and run the retail-level business on their own. All petroleum dealers function under a syndicate of the Nepal Petroleum Dealers' Association (NPDA). There is also an association of kerosene dealers known as the Nepal Kerosene Dealers' Association (NKDA). NPDA is a powerful national-level association, whereas NKDA is an association of dealers operating in the Kathmandu Valley only. Both these associations, in the name of 'protecting investment' and 'business interests', promote cartel and collective price fixing. Competition in the petroleum retailing business is completely absent. As a result, consumers remain deprived of the benefits they should have got from the presence of a large number of promising retail players.

LPG import and pricing

Although NOC is the import monopolist, it does not import LPG itself, but allows gas companies, numbering 23 in all, to collect the gas directly from IOC refineries in Barauni, Haldiya, Mathura and Assam. That is, NOC functions as a regulator and not as an importer in the case of gas. It regulates imports through the issuance of PDO. The gas companies need to acquire PDO from NOC, while IOC supplies them with gas on the basis of PDO.

Gas marketing functions such as transportation (both from IOC refineries to bottling plants and from bottling plants to company-appointed gas retailers), storage, bottling and distribution are also carried out by the companies themselves. NOC bears the customs duty and other tax liabilities incurred at customs, however. As with other petroleum products, the Cabinet of Ministers decides on the price of LPG. But unlike other products, subsidy exists in the case of LPG. NOC provides a direct subsidy to the companies by issuing PDO at lower rates than import prices. The PDO rate is fixed through negotiations between LPG companies and NOC.

This subsidy is perverse in nature because the LPG price is the same for household and commercial consumption. Hotels, small- and medium-scale industries and transporters, mainly those that operate three-wheelers and micro-buses, constitute the bulk of the commercial consumers of LPG. With no price differentials, the subsidy meant for household consumers is enjoyed by commercial ventures as well.

Moreover, the gas companies have formed an association called Nepal LP Gas Industries Association (NLPGIA) for the purpose of collective bargaining and protecting their business interests. Some of the companies own a few gas transporting bullets, too. Nevertheless, they all hire gas transporters for transporting gas. The companies negotiate the rates with transporters separately. NOC is not involved in the negotiation.

The arrangement of PDO pricing guarantees a definite profit to the companies, irrespective of the profit or loss situation of NOC. For example, the government-fixed consumer price of cooking gas in mid-August 2006 was NRs. 900 per cylinder (of 14.2 kg capacity). To enable the companies to sell the product at that price, NOC issued them with PDO at NRs. 718.72 even though the actual cost of importing a cylinder of gas was NRs. 986.39. Thus, at the consumer rate of NRs. 900, NOC was incurring a loss of NRs. 267.67 per cylinder of gas. The companies, on the other hand, had their transportation costs, overhead expenses, dealer commissions and profit margins covered at that rate. They were earning a profit of NRs. 21 per cylinder (*Table 3*).

Table 3: Components of consumer pricing of LPG

Components	Rate (NRs./Cylinder)
PDO Price	718.72
Barauni-Kathmandu transportation cost	63.00
Dealers' commission	20.00
Companies' overhead expense	39.00
Local transportation	17.00
Profit	21.00

Note: The table's data are collected from monthly pricing tables and statistics of NOC.

There is no separate institution to monitor and verify whether the State-sponsored cost, determined through negotiations, is realistic and not generating extra profit for the companies. The gas companies distribute refilled cylinders through their own network of authorized dealers. The companies set the terms and conditions for the operation of those dealers. The dealers are paid commission for the sales and managing the retail gas market.

The LPG market is city-centric, confined to a few cities and urban centres. The Kathmandu Valley alone accounts for 60 percent of the gas market in Nepal. As a result, companies are aggressive about showing their presence in these pocket markets. While the number of players is large, companies mostly resort to unfair business practices to capture and retain the market.

CHAPTER 3

Anti-competitive practices

Anti-competitive practices exist in many forms in the petroleum market. While most of them have mainly been spawned by a state-bred monopoly, others have surfaced due to lack of systemic policy, laws, institutions and mechanisms to check unfair practices.

Monopoly at source

Anti-competition in the petroleum business in Nepal starts from the very stage of sourcing fuel. The MoU of 1974 has designated IOC as the sole supplier of petroleum products to Nepal, establishing its monopoly in the Nepalese market. The MoU was signed considering that India is the most viable and reliable country for sourcing petroleum products. But the MoU has principally barred Nepal from sourcing petroleum fuel from third country as well as other Indian oil companies.

Nepal cannot unilaterally open up the importation of petroleum products, including LPG, so long as the agreement exists in its current form. This directly hinders liberalization of the petroleum market and prevents competition in the import and marketing of the products.

Monopoly on import

The 1974 MoU has also established NOC's monopoly on the import of petroleum products in Nepal. NOC also enjoys a monopoly in the wholesale market and controls downstream business. The government has designated it as the authority to oversee the operations of the petroleum market. Although the government in 2006 opened gas imports to the private sector, the decision remains unimplemented, meaning NOC's monopoly on gas importation continues. Due to its monopolistic rights, NOC is under no compulsion to effect structural and managerial reforms within it and in the downstream market. Political intervention and lack of reforms have spawned inefficiency in the corporation, which is transmitted into the market and ultimately shifted to consumers. The Report of the Taskforce on Petroleum Supplies and Pricing (2004) estimated such burden at NRs. 26.30 per annum. The report stated that restructuring and other reforms can cut NOC's administrative cost by 10 percent and save consumers NRs. 26.30 million annually.

NOC's inefficiency also manifests itself in the form of oil shortages in the market. NOC lacks the capacity to pump out a sufficient supply of oil in the market when demand rises. This prolongs the span of shortage. Moreover, in order to control losses and pressure the government to raise prices, it even cuts supply, creating shortage in the market, as demonstrated in August 2006.

Cartel

Cartel is the most common anti-competitive practice that plagues the Nepalese petroleum market. Business associations opened in the name of protecting entrepreneurs' interest such as NPDA, NPTA, NLPGIA and LP Gas Dealers' Association (LPGDA) work against basic competition norms and consumers' interests to serve vested business interests. There are numerous examples of these associations launching strikes, withholding distribution and creating crises in the market in order to raise transportation fares and commission (profit margin), and to acquire concessions on handling and technical losses, among others. These associations compel all the players in the respective fields

to become their members. They impose decisions on members and do not tolerate any deviation from the associations' official stance. Thus, members (private players) are not allowed to operate independently. Such practices have largely checked efficiency in the respective sectors, and hit efficient and able players. Ultimately, consumers are compelled to bear the cost of their inefficiency. They suffer from short supply, adulteration (substandard quality of supply), undue price burden and quantity theft, among others.

Collective price fixing

Cartel-induced collective price fixing is another major unfair practice that ails the sector. The government, when it adopted the wholesale pricing system and opened retail oil pricing to dealers in February 2006, had expected that dealers would compete on prices, raise efficiency and focus on doing voluminous sales. However, dealers are neither focusing on raising efficiency nor competing on prices. Instead, NPDA started fixing prices for diesel, petrol and kerosene for retail sales, and imposing the same on its members. Dealers willing to do business at lower rates (compared to the association's rate) received various threats from the association.

NPDA raised the prices of petrol, diesel and kerosene to NRs. 68, NRs. 54 and NRs. 48 per litre, respectively, in Kathmandu as soon as the government lifted administered pricing at the retail level. Some of the dealers, initially, showed signs of defiance and fixed prices at lower rates. But the association pressured them (by issuing warnings such as excluding them from its protection net) to refrain from competing with fellow member dealers. Consequently, dealers of Bagmati zone signed a memorandum agreeing to fix the selling prices of petroleum products at the same level throughout the zone. This was followed in other zones and districts as well. Currently, retail prices of petroleum products are the same throughout the Kathmandu Valley, and the situation is same in other cities as well. The government has done nothing to break this practice.

Likewise, NLPGIA has fixed uniform fares for transporting gas from the Barauni refinery to bottling plants. This is not realistic, for gas com-

panies are based in different parts of the country: some are close to the border point, while others are hundred of miles away from it. They have also fixed a uniform commission for dealers, overhead cost, and transportation fare for retail-level transportation. This is happening although companies operating with differing investment level, staff size, plant capacity, market share and sales volume have sufficient room and can afford to compete on prices.

Unfair pricing

Higher profit margin

In the past, petroleum dealers used to work for a 3 percent dealership commission from NOC. But since February 2006, they have been allowed to fix their profit margin on their own. The government had hoped dealers would compete on prices by reducing their profit margin. But they continue to work with a 3 percent profit margin. Worse, they calculate the margin above the final price inclusive of VAT. This has made the profit margin higher than the previous level in monetary terms. Moreover, fixing profit margin above final retail rates derived after adding VAT is illegal.

Inflated cost

Contrary to the basic assumptions of liberalization, NPDA has also inflated dealers' operating costs while fixing consumer prices. It has inflated the rates of technical loss, transportation cost, insurance cost and working loss compared to what NOC operated with (*Table 4*).

In the past, NOC provided additional supplies to the petroleum dealers to cover shrinkage loss resulting from changes in temperature. Such flat concessions were fixed at 0.9 percent for petrol and 0.7 percent for diesel and kerosene. That is, NOC used to supply an additional 108 litres for every KL of fuel supplied to dealers in order to offset losses caused by a change in temperature by a degree centigrade. Later, NOC slashed this flat concession to 0.6 percent for petrol and 0.4 percent for diesel and kerosene. This was done after a study by the Department of

Hydrology showed that, on an average, the difference in temperature between Kathmandu and Amlekhgunj is 6 degrees centigrade throughout the year.

Other studies have pointed out that even this amount was high—higher than what NOC had fixed for itself. The Report of the Taskforce on Petroleum Supplies and Pricing (2004) states: "The NOC provides an additional commission to dealers to cover technical losses. The rate of that commission is higher than the rate at which NOC incurs losses itself…If this is cut down by 25 percent, NOC can save NRs. 40 million annually." Following the introduction of the new pricing system, the dealers, however, have further raised the rate of this loss to 1 percent.

Drum depreciation in kerosene supply

Earlier, NOC used to provide drum depreciation for kerosene dealers at the rate of NRs. 163.22 per KL of supply. Studies suggest that the NOC-pledged depreciation was more than the actual depreciation rate. "Rationalization of this rate can relieve consumers of a price burden of NRs. 53 million in a year," according to the Report of the Taskforce on Petroleum Supplies and Pricing (2004).

Table 4: Cost variation under NOC pricing and dealers' retail pricing

Items	NOC rates (per KL)	Dealers' rates (per KL)
Insurance	0.12%	0.43%
Technical loss	Petrol: 0.6%; diesel and kerosene: 0.4%	Petrol, diesel and kerosene: 1%
Transportation	NRs. 950.28	NRs. 1092.82
Working loss	0.15%	0.6%
Commission	3%	3%

Note: The table's data are based on monthly pricing tables and other statistics of NOC, and various statements issued by NPDA.

Under the new system, kerosene dealers can reduce this component of their pricing and afford to supply kerosene at lower rates. But they continue to retain drum depreciation at the same level. Thus, dealers have preferred to reap more profit out of the retail price liberalization rather than transmit benefits to the market and consumers as a whole. This situation has emerged because of the lack of a mechanism to cross-check and monitor the prices fixed by dealers.

While liberalizing the retail market the government did not consider that the country's petroleum market was an imperfect market lacking a self-corrective mechanism. It ignored that syndicates at all levels would work to sabotage the reform initiatives. The reform initiatives also came as an *ad hoc* step because it was introduced without chalking out a comprehensive long-term liberalization plan and without laying down policies and institutions necessary to ensure proper market operations and facilitate further liberalization. Such loopholes created a space for anti-competitive practices, which are neither benefiting the consumers nor helping the players in terms of long-term growth.

Margin theft in gas supply

The gas companies have jointly negotiated cost components covered by State subsidy on a higher side. This has cost both the State and consumers dear, and created a hidden profit margin for the companies. For instance, the companies have negotiated the commission rate for their dealers at NRs. 20 per cylinder, whereas in reality, they pay NRs. 15 only.

Likewise, the companies have fixed the cost of transporting gas from Barauni to Kathmandu at NRs. 63 per cylinder. But in reality they pay a lower rate to transporters. Also, the fixing of a same fare for transporting gas from Barauni to Kathmandu and from Barauni to Birgunj is not justifiable. It has helped the companies based closer to the border make more profits than others. The local transportation cost, which is fixed at NRs. 17 for transporting a cylinder of gas from refilling plants to dealers, is also high (*Table 3*). Thus, although the gas companies project their profit margin at a mere NRs. 21 per cylinder, their actual profit is much more.

Artificial shortage

Artificial shortage is another major anti-competitive practice that characterizes the petroleum market, much to the dismay of consumers. The petroleum dealers resort to it whenever possible to serve their short-term business interest. Supply crisis hits the market whenever there is a political stir, shutdown or strike. Fear of short supply shoots up demand, and dealers take advantage of the situation. An artificial crisis also emerges when the rumour of a price hike spreads. Effective calculation and hoarding at such times generate higher profit margin for dealers.

The problem of artificial shortage is worse in the case of LPG. Frequent shutdowns of the Barauni refinery and the subsequent short supply offer an additional opportunity for gas dealers to make extra money. The consumers' general impression of the market is: no matter how severe a shortage is, they can always get hold of gas if they pay more. The readiness of commercial consumers of gas to pay more than the normal price further encourages gas suppliers to create artificial shortage.

The century-old Barauni refinery, the major source of LPG for Nepal, suffers from leakage in its pipeline and other technical problems now and again. In such events, IOC slows down the supply and, at times, even closes down the refinery for maintenance, not to mention the annual shutdown for regular maintenance. Furthermore, when the demand for gas rises in India, IOC cuts supply to Nepal in order to fulfil the local demand, which leads to LPG shortage in the Nepalese market.

Though there are 20 gas bottling companies and three additional suppliers of gas for automobiles, none of them have a capacity to store gas enough for more than seven days' supply. This supply-side bottleneck has spawned anomalies in the market. Gas companies themselves acknowledge that they slow down production whenever they have to source gas from the Mathura refinery, which is located some 2,600 km away from Kathmandu, when the Barauni refinery, located just 1,200 km away, is shut down. Moreover, it takes three days more to receive supply from Mathura than from Barauni. All this raises the transportation cost and

squeezes the profit margin. Additional transportation days also call for extra-managerial requirements on the part of the gas companies, which again impinge on the profit margin. Thus, they would rather put the supply in jeopardy than compromise on profit margin. Such a practice creates panic in the market and consumers are compelled to bear the brunt.

Every company complains that there is a dearth of fair and healthy competition in the gas market, more so when the supply situation worsens. But they still have not done anything to increase their storage capacity, upgrade infrastructure, expand business network and enhance efficiency in market management. Such a reluctance of the companies to build a sufficient storage capacity and maintain adequate buffer stocks for a longer period is also an outcome of cartel.

Nepal's LPG industry, thus, is a classic case which demonstrates that the presence of a large number of companies alone does not ensure competition and efficiency in the market.

Adulteration

Adulteration of fuel by the authorized dealers themselves is another unhealthy practice in vogue in the market. The practice of mixing a cheaper product (kerosene) with expensive ones (petrol/diesel) is common. It generates handsome profits for dealers. Market inspection by the Department of Commerce (DoC) has shown that dealers mix up to 40 percent kerosene in petrol and 80 percent kerosene in diesel. The Report of the High-Level Petroleum Products Study Committee (2002) shows that the misuse of kerosene fetches wrongdoers NRs. 1.5 billion annually. The report states: "It is due to this misuse that dealerships that are unviable are also operating in profit. The money from such misappropriations reaches people at all levels of the NOC management."

The act of adulteration is carried out along the route of transportation of fuel from border areas to NOC depots, and also at the dealers' level. The lack of a specified duration for tankers to reach NOC depots from customs points has left sufficient room for anomalies. NOC has a record of tankers taking as much as one week to cover the 36-km

distance between the Birgunj customs and the Amlekhgunj depot. Much of the adulteration is done on this 36 km stretch. Dealers located along the way operate in nexus with transporters. The presence of 84 petrol pumps on this stretch indicates the anomalies.

Not that there are no quality control regulations and mechanisms in place. The point is: they are largely ineffective. The Quality (Standard) Handbook of the Department of Standard and Metrology (DoSM) and the Fuel Quality Bylaws of NOC are the major legal documents that deal at length with the quality of petroleum products and the inspection of fuel in the market. The quality standard of fuel is specified on the basis of the density of petroleum products and their final boiling point (FBP). In the case of petrol, the higher the FBP, the lower is the quality, as FBP rises with adulteration.

The accepted standard for petrol at present is 215 degrees centigrade FBP. For diesel, it is 2.0 to 5.0 centi-stock of oil viscosity. In terms of density, the accepted density standard for petrol is in the range of 0.720–0.770 at 15 degrees centigrade, whereas for diesel it is 0.820–0.860 at 15 degrees centigrade.

The Fuel Quality Bylaws make it mandatory for NOC to inspect dealers regularly—at least once a month—in order to ensure the quality of supply. Existing regulations also designate NOC as the sole authority that can penalize dealers compromising on quality by imposing fines, suspending fuel supply and scrapping the operating licences of the dealers. Besides NOC, DoC also holds the authority to inspect the quality of fuel in the market. The market inspection team of DoC conducts market inspections at regular intervals. However, since the team has to monitor the quality, standard, pricing and supply situation of all consumable items, it cannot remain focused on fuel quality inspection alone. It lacks technical expertise to determine the quality of fuel; nor does it possess the authority to punish errant dealers. Therefore, it includes NOC staff in its team whenever it inspects the fuel market. DoSM also inspects the market as per its regulations, but its inspection is confined to the tampering of scales and weighing machines. Inspection of quality is never done in the case of LPG in Nepal.

Why adulteration?

- The presence of a large number of dealers within a short distance means the volume of their sales is distributed. Their overhead cost, however, remains high. In the absence of wrongdoing they would simply fail to survive. Even high-level government committees constituted in different periods to study the status of the petroleum sector have acknowledged this fact. The Report of the High-Level Petroleum Supplies Recommendation Committee (2005) states: "The number of petroleum dealers is high when compared with the total volume of transaction…Low sales and little business prospect mean dealers tend to focus more on extracting more commission from whatever business they do…40 percent of the existing dealerships are financially unviable and operating without business prospect. This is one major reason behind rising adulteration."

- The difference in the accepted quality-standard of IOC and NOC has also encouraged adulteration. Normally, IOC supplies petrol of 170–180 degrees centigrade FBP. The accepted standard for petrol in Nepal, according to the standard set by DoSM, is up to 215 degrees centigrade. Transporters and dealers take advantage of this difference. This loophole in quality-standard has made adulteration an apparently 'risk-free' business.

- The collusion of NOC staff in the wrongdoing and the adulteration in NOC depots themselves are no less a factor (*Box 4*). In fact, market players and experts say that adulteration cannot be done unless the NOC staff are involved in the game.

- Syndicates are in favour of adulteration. NPDA protects its members practising adulteration. Although it denies the charge in public, NPDA resists the quality inspection efforts of NOC as well as DoC. It reportedly even goes to the extent of influencing the minister concerned to order to make NOC stop its market inspection function. This practice became glaring when the government opened retail pricing to dealers. Dealers interpreted the

Box 4: Adulteration rife in government's own backyard

The government has long been beating drums that dealers are solely responsible for fuel adulteration and has vowed to tighten its grip on the dealers. But the revelation of a highly concealed and thrilling adulteration saga in a depot of NOC has exposed how NOC itself supplies heavily adulterated oil to the dealers.

The long-suspected anomalies on the corporation's own premises surfaced when a special inspection team from DoC conducted a sudden, albeit in-depth, test of oil stored at NOC's Pokhara depot and found an alarming result: a 47 percent kerosene content in petrol. The report of the first-ever laboratory test of a sample from the NOC's own depot states: "The final boiling point of NOC's sample was found to be 227 degrees centigrade against the acceptable limit of 215." If the standard of DoSM means any thing, the supply from the depot itself was not consumable. The DoSM's regulations prohibit the distribution of petrol with over 215 FBP.

NOC acquires petrol with a FBP ranging from 170 to 180 degrees centigrade from IOC. The gap of FBP between the IOC's supply and the NOC's supply reveals that some degree of adulteration has been institutionalized by NOC. Worse, NOC has been reportedly trying to conceal the case and even ignoring the direction of DoC to take immediate action against the officials engaged in irregularities.

Source: The Kathmandu Post (2004)

government's decision to pull NOC out of retail market operations (retail pricing and retail-level transportation) as implying that NOC cannot monitor and inspect the retail market henceforth. They severely resisted NOC's inspection teams and issued threats to stall distribution if NOC continued to 'terrorize' them. Pointing at the adulteration occurring at NOC depots, they demanded a separate inspection body to inspect such depots as well. Following such resistance, NOC stopped inspecting the quality of

fuel in the market. The Fuel Quality Bylaws, which give full authority to the NOC to take action against dealers resorting to adulteration, make it mandatory for the corporation to inspect the market once a month. NOC's easy exit from the inspection function despite the authority has raised questions about its authority. For it helped adulteration flourish, eroded dealers' credibility and left consumers cheated.

Adulteration control on paper

On 5 November 2004, NOC unveiled a plan to enable customers to test adulteration in petroleum products. It announced that dealers throughout the country would be asked to keep quality-testing 'filter papers' at their refilling stations, so that customers could test the quality of the supply if they wished. It even asked dealers to comply with the announcement within two months. But dealers have not complied with it even till date. The corporation also has not seriously acted to enforce it. With the plan to check adulteration being largely confined to paper, the 'mobile inspection van' of NOC, equipped with a modern laboratory to test fuel quality, has remained unused for the last 10 years. The market inspection teams used to utilize it extensively till FY 1995/96, but not anymore.

Quantity theft

Theft in the quantity of supply by tampering with scales is another common unfair practice. While tampering with the flow meter of refilling stations and measurement jars is in vogue, the staff at fuel-dispensing pumps also resort to the practice of stopping supply before the meter reads the specified volume of purchase (*Box 5*).

Though DoC, in the course of market inspection, has reported numerous cases in which it seized tampered scales, it has not focused much on the tampering of flow meters.

On receiving an increasing number of complaints of quantity theft, NOC, on 5 November 2004, also asked dealers to arrange for a sepa-

Box 5: Dealer robs customers

A DoC inspection team found a petroleum dealer in Bhaktapur to be tampering with the scale and selling 30 millilitres less petrol on every litre of the product. Of the five refilling stations the team investigated during 26–28 May 2006, Ganesh Oil Store of Nalinchowk, Bhaktapur was found to be resorting to quantity theft. At the price of NRs. 67 per litre, the dealer was unduly pocketing NRs. 2.10 on the sale of every litre of petrol from customers.

Source: Nepal Samacharpatra (2006)

rate scale of a litre so that consumers could check the quantity of supply if they have any doubts. However, this decision was never implemented.

The problem of quantity theft is more apparent in the case of LPG. DoC has on a number of occasions taken action against gas companies for supplying less than the specified weight (14.2 kg) of gas. Gas companies in Nepal refill cylinders manually, and it is mainly the negligence of their staff that results in low-quantity supply. Gas companies have not made arrangements for consumers to check the quantity of supply. Dealers, who work as retail outlets for the companies, do not cooperate with consumers wanting to weigh the supply. Moreover, neither do the companies disseminate crucial information of consumer interest in the market. For instance, when the temperature falls in winter, LPG in the cylinder freezes at times. This blocks the flow of gas. If warmed (e.g., by placing the cylinder in a hot-water tub), the gas regains its form and can be used again. But lacking awareness, the consumers tend to believe that increased consumption in winter emptied their cylinders rapidly and thus send a substantial quantity of gas back to the company.

Also, gas dealers do not readily agree to exchange gas cylinders, while companies do not intend to compensate consumers in case of leakages, which mainly happen due to wear and tear of the cap of the cylinder. Although the companies are responsible for such wear and tear, they still have not made any arrangements to exchange refilled cylinders. The

Report of the High-Level Petroleum Supplies Recommendation Committee (2005) states: "…companies are compelling consumers to bear the brunt of their inefficiency. …Consumers are shouldering all the cost of their (of the companies) survival in the market by compromising on price as well as quantity of supply".

Transporters' syndicate

NPTA is the syndicate under which petroleum transporters operate. The syndicate is strong and, by issuing threats of strikes, compels NOC and dealers to bow down to its terms, particularly on hiring and pricing. It maintains a firm grip on its members. In the name of 'protecting members and investment', it imposes a 'business for all' policy and compels NOC to hire all the tankers in rotation.

There are numerous instances of the association resorting to strikes and stalling transportation to compel NOC to accept its terms. NPTA's decision to raise fares by 15 percent immediately after the government opened retail-level transportation, and petroleum dealers' endorsement of the new fare also demonstrate how strong the syndicate is. It also proved wrong the government's assumption that private sector dealers would be able to deal with private sector transporters better than did NOC. Instead, while entering into the retail transportation deal, NPTA hiked the service charge to NRs. 1,092.82 from NRs. 950.28 for transporting fuel from Amlekhgunj to Kathmandu. That added an upward pressure on final consumer prices.

Besides, dealers that resort to different forms of anti-competitive practices to reap benefits from the loopholes in the system and the market imperfection have a strong nexus with transporters. The fact that fuel adulteration and market manipulation cannot be done without transporters' assistance indicates that dealers and transporters have to work in close cooperation. And there is no official monitoring and regulatory mechanism in place to ensure that a given business deal and pricing structure is fair. Under such circumstances, the government's assumption that transporters will automatically compete with one another on pricing and services in an open regime has proved wrong.

The operation of NPTA has invariably stymied competition among transporters, hit efficient operators and raised transportation fares. Its focus has always been to ensure sound returns to its members irrespective of the quality of their services, rather than facilitating able and efficient transporters to undertake voluminous business. Hence, although the number of transportation service providers in the market is large, benefits have not been transmitted to consumers. Moreover, the appointment of more than necessary transporters has eroded the efficiency and added to the cost of NOC, which ultimately has to be borne by consumers. The Report of the Taskforce on Petroleum Supplies and Pricing (2004) has shown that if NOC can only appoint a limited number of tankers for its transportation purpose and select them through an open bidding among the operators (rather than bowing down to NPTA's pressure for 'business for all'), it can effectively cut transportation fares by 15–20 percent.

Distortion of competitors' market

The anti-competitive practice of distorting competitors' market is more prevalent in the LPG industry. While companies exhibit strong unity when it comes to jacking up profit margins, they engage in equal foul play to damage the credibility and distort the market of competitors. Companies mainly replace the cylinders of rival companies with their own, and collect and dump them. The companies mobilize their dealers to carry out the exchange. Similarity in colour and shape, and negligence and lack of awareness on the part of customers make it easy for dealers to exchange cylinders of different companies without the customers' consent.

Moreover, when the problem of short supply appears, the customers readily exchange their cylinders for other companies' cylinders to get hold of gas. Companies that have a low market share and new companies wishing to penetrate the market mainly resort to such measures. The story of Baba Gas penetrating the market of the Kathmandu Valley by collecting and dumping cylinders of Nepal Gas is famous among gas marketers. In addition, companies even go to the extent of refilling rival companies' cylinders with less gas than the specified volume and

circulating the same in the market to erode the rivals' credibility. This is mainly practised during normal supply situation.

In situations of severe crisis, the companies bring out and circulate rival companies' cylinders in the market to mount pressure on the competitors and create consumers' disenchantment towards them. To check such unhealthy practices, the government has barred a gas dealer from dealing with the cylinders of two or more gas companies. But the implementation, again, is weak. Numerous dealers continue to deal on behalf of two or more gas companies. Although DoC has issued a circular to check the practice, it has not been enforced effectively.

Reform initiatives

As per its commitment to introducing reforms in the petroleum sector, the government in 2004 initiated the liberalization process in the petroleum sector. The vision of the government, under the liberalization initiative, was to set up an independent authority to oversee the petroleum sector and market operations, open the sector, including the import business, to private players, promote competition, and let the market operate freely. To initiate that process, the Cabinet approved the Petroleum Act drafted by MoICS and tabled it at the House of Representatives for approval in October 2006. However, so far there have been no broad, national-level consultations and comprehensive exercises on how the liberalization of the petroleum sector will be carried out. Burgeoning oil-induced deficits, failure to break the pricing impasse and politicization of the sector have also derailed the reform initiatives.

In a bid to do away with the existing constraints, and reform and liberalize the gas market, the government in 2006 took a decision to allow the private sector to import gas, ending NOC's import monopoly. The decision has paved the way for private companies to independently deal with Indian as well as third country suppliers for importing cooking gas. Following the decision, two companies have been registered with DoC for importing gas independently. But they have not come into operation so far.

The government's liberalization decision was a hurried one largely guided by a motive to relieve NOC of the losses it incurred from the gas business. Coming as it did without the necessary homework and policy framework in place, it proved futile due to several reasons.

First, it did not address the provision of the 1974 MoU which binds Nepal to import the product from IOC alone. Without reviewing the MoU, implementing the decision was not possible as the private sector cannot deal with third parties to import gas.

Second, the decision remained silent on the issue of deregulation of gas prices. If NOC is to continue providing price subsidy on gas, no private players can compete with its product in the market.

Third, the decision positioned NOC as one of the multiple importers in the market and thereby, in effect, annulled its regulatory function (after all, a company cannot function as the sectoral regulator in an opened market having multiple players). But it was silent as regards who will monitor the market to ensure smooth supply, check possible distortion in pricing and distribution, maintain fair competition and protect consumers' interest.

Fourth, the decision did not lay down the conditions of physical infrastructural requirements for the companies. It did not deal with basics such as storage capacity, security arrangements, availability of gas transporting tankers, and other infrastructural and logistical requirements for companies willing to import gas on their own. Addressing those basics was important because companies operating in the market so far are functioning as bottling plants and marketing institutions only. They do not possess infrastructure and logistics to support bulk imports.

Fifth, the decision did not set a cut-off timeline for NOC to stop issuing PDO. That is, it did not demarcate a timeline for private sector companies to build capacity and start importing gas themselves. If NOC is to continue issuing PDO, guaranteeing sound profits for companies, and if a timeline is not specified for companies to build their capacity, it

is highly unlikely that private companies will venture into the gas import business, which calls for high investment and competence, and, more importantly, involves a certain degree of risk.

In order to deal with supply constraints and instigate competition in the sector, the NOC has mooted a plan to construct an LPG plant in Mahendranagar of Dhanusha district with joint investment from IOC. It has already purchased over 6.5 hectares of land there. NOC and IOC have already exchanged a draft agreement on the venture. However, the plan has not materialized mainly due to NOC's financial crisis.

CHAPTER 4

Way forward

Unfair and anti-competitive practices plague the Nepalese petroleum sector. An inefficient market chain has added to the cost of doing business for the market players and also imposed an undue financial burden on consumers. Moreover, consumers are not assured of quality supply. If the damages done to vehicles due to fuel adulteration and the resulting repair and maintenance costs are also factored in, Nepalese consumers are paying a high price for retaining a state-promoted monopoly in the petroleum market.

Institutional reforms, transparency, capacity building, modernization, price deregulation, realistic pricing, a strong market-monitoring mechanism, stringent anti-competitive measures and overall liberalization of the petroleum sector are required to ensure efficiency in the market, protect consumers' rights and promote competition in the sector. Given the importance and sensitivity of the product, reforms should be pushed only after a clear-cut plan and liberalization steps are worked out. A strong sectoral policy should be formulated, an autonomous and authoritative pricing and regulatory body set up, and private players invited to the field. Effective implementation of the competition- and consumer right-related laws is also vital to ensure fair and competitive market environment in the

petroleum sector. The country's energy policy should be comprehensive enough to manage and promote inter-fuel substitution for sustainable energy sourcing and usage. A Petroleum Perspective Plan should be developed to manage downstream petroleum business with a long-term vision. The plan should reflect the country's long-term growth and development plans, and support its socio-economic advancement.

The following recommendations are made for effectively doing away with the anomalies and weaknesses prevalent in the Nepalese petroleum sector.

Pricing

- The government should discard the administered pricing system. Prices should be adjusted in line with the international price trend. An autonomous Petroleum Authority should be constituted and it must be allowed to function independently. Pricing must be freed from politics.
- The Authority should be mandated to keep track of the international price trend and decide on wholesale prices. It should be authorized to ensure that retail prices are realistic. It should work to prevent the transfer of the burden of retailers' inefficiency onto consumers, control the inclusion of unnecessary costing in retail prices, and check the practice of earning super-normal profits. It must also determine the impact of a review of oil prices on transportation fares and make appropriate recommendations to control unnecessary fare hikes. Over time, it should be made a sectoral regulator.
- Relevant information should be disseminated regularly to make people aware of the international price trend, and the discrepancy between domestic and international prices. The socio-economic cost of deficits caused by the failure to adjust domestic prices to hikes in international prices must be explained to the people regularly.
- A clear-cut policy on subsidy should be worked out in case the government considers subsidy is necessary. Blanket and indirect

subsidy measures should be scrapped. A targeted subsidy programme and a clear-cut distribution mechanism should be devised. The subsidy should be borne by the government and not the OMC.

- The Authority should monitor whether the subsidy has reached the targeted groups. Groups not targeted should not be allowed to enjoy the concessions. Strict penalties for wrongdoers should be worked out.
- The government must segregate household and commercial consumers of LPG and adopt differential prices for them. Prices for commercial consumption should be fixed with business sense.

Import arrangement

- The 1974 MoU must be reviewed and the monopoly export rights of IOC must be scrapped in order to pave the way for the liberalization and promotion of competition in the sector. Side by side, Nepal should build the necessary capacity and start delivering crude oil to IOC. This will raise NOC's bargaining capacity vis-à-vis IOC.
- The NOC-IOC agreement should be established as an agreement between two companies and not an agreement between two countries.
- With the revision of the 1974 MoU, Nepal should explore and go for multiple sourcing of fuel.
- Nepal should ask for refinery quotas in Haldiya, Barauni and other nearby refineries of IOC—a facility which the 1974 MoU has pledged to Nepal. This will save Nepal the additional costs the refineries are currently charging. It will also exempt Nepalese oil imports from the marketing margin of IOC. Nepal can also sell by-products to domestic buyers as well as IOC. This will generate additional benefits to Nepal. "If Nepal can do so, it will save US$5 to US$7 per barrel of oil imports," states the Report of the Taskforce on Petroleum Supplies and Pricing (2004).
- NOC should push for an immediate refund of the customs duty

charged on RTP, which IOC agreed to in 2002 and the Indian government consented to in 2003. The existing refund process is complicated and protracted. NOC should seek a direct waiver of import duty to avoid the hassles it is facing at present.

- The joint venture projects currently pushed by NOC, such as the Raxaul-Amlekhgunj pipeline project, should be designed in such a way that they do not put potential new players at a disadvantage. A quota- and facility-sharing mechanism should be put in place in such projects.
- Nepal should seek and build storage units in Kolkata and Haldiya ports—a facility which India has committed in the 1974 MoU.

NOC reforms

- NOC's organization should be restructured.
- Human resource planning should be prioritized and implemented to enhance the functional capacity of NOC. The size of non-professional and non-technical staff should be reduced. Managerial skills should be developed and the size of technical human resources increased so that functions such as international procurement, quality testing and market inspection are carried out efficiently.
- Transparency must be ensured in NOC operations.
- Clear-cut and transparent policies and procedures of appointing dealers and hiring transporters should be laid down.
- Professionalism should be developed in inventory management, maintaining records and updating financial statements.
- A management information system should be introduced, and standard accounting practices adopted.
- NOC's existing infrastructure and facilities should be updated and modernized.
- Separate technical working manuals should be developed for various operations and for enhancing technical capacity in the areas of petroleum handling and storage.

Quality control

- An effective quality control and market inspection mechanism/ body should be devised and implemented.
- It should inspect the quality of imported products, products in NOC depots and at retail refilling stations.
- The parameters of quality standards such as FBP and density of fuel should be harmonized with exporters' standard. Huge discrepancies should not be created.
- The number of dealers should be right-sized. A certain minimum business opportunity and sales target must be provided to dealers. Licences of dealers failing to meet the sales target should be terminated.
- High-quality and high-octane fuel should be introduced to the market.
- Mechanisms should be put in place whereby customers can test fuel quality and check the quantity of supply.
- Quality-testing capacity should be enhanced by bringing in the latest technology and developing an efficient laboratory at the centre.
- A time limit should be fixed for transporters for delivering products from one destination to another to check adulteration on the way.
- Huge differences in the prices of different petroleum products should not be created. Prices of diesel and kerosene must be equalized to curb adulteration.

Dealers' operation

- A code of conduct for dealers should be issued and implemented effectively.
- The syndicate of dealers should be scrapped.
- Retail-level price cartel should be banned.

- Dealers resorting to adulteration should be fined and closed down promptly.

Transportation

- An effective code of conduct should be issued for transport operators.
- Clear-cut and transparent policies and procedures must be laid down for hiring transporters.
- The syndicate of transporters must be scrapped.
- Bid rigging by and price cartel of transporters should be banned.
- Transporters resorting to adulteration should be fined and never be hired again.
- Standards should be set for the technical fittings of tankers.

Gas companies

- Gas companies should be directed to expand and upgrade their infrastructure and increase their storage capacity.
- They should be encouraged to issue coupon cards to consumers to manage the crisis during short supply.
- A code of conduct prohibiting companies from collecting and dumping rivals' cylinders should be enforced strictly.
- A code of conduct for gas dealers that bars them from dealing with products of more than one company, and exchanging cylinders and hoarding gas, among others, should be enforced effectively.
- Companies should be compelled to make arrangements enabling consumers to weigh the supply they receive to guard against possible quantity theft or leakage.
- Gas companies must be encouraged to explore new suppliers, Indian or overseas. The PDO system must be phased out in a

time-bound manner and NOC must shed its function of import regulator. It can, however, import gas for its own distribution purpose.

- Gas companies should have increased storage capacity, enhanced refilling plants and effective distribution networks.
- Gas companies should be motivated to operate through a coupon card system during supply crises.

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South Asia Watch on Trade, Economics & Environment (SAWTEE) is a regional network that operates through its secreatariat in Kathmandu and 11 member institutions from five South Asian countries, namely Bangladesh, India, Nepal, Pakistan and Sri Lanka. The overall objective of SAWTEE is to build the capacity of concerned stakeholders in South Asia in the context of liberalization and globalization.

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ISBN: 978-9937-8038-1-6