

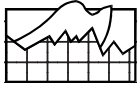
IBON POLICY PAPER  
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# Regulation of Local Oil Industry: More Urgent in the Light of Skyrocketing Pump Prices

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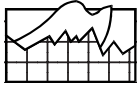
# Regulation of Local Oil Industry: More Urgent in the Light of Skyrocketing Pump Prices

The news that the Department of Energy is looking into possible collusion among oil companies in the setting of pump prices validates IBON Foundation's call for regulation of the local oil industry. Such a move is all the more urgent given skyrocketing pump-prices, which are already at historic highs.

IBON has been advocating for the repeal of Republic Act 8479, the Downstream Oil Industry Deregulation Act of 1998, to allow the government to control and regulate the activities of oil companies operating in the Philippines, particularly in terms of pricing. IBON further proposes a package of reforms, hinging on the principle that crude oil and various petroleum products derived from it are crucial to national security and industrialization. It is therefore imperative that the State declare, as a matter of national policy, that all activities relating to the downstream and upstream oil industry including but not limited to importation, exportation, re-exportation, shipping, transporting, refining, distributing and marketing of crude oil and finished oil products, should be under the full control and supervision of the State. Such State control should also extend to the exploration, development and utilization of all domestic petroleum resources.

All existing laws, executive orders, presidential decrees, and other government statutes that are inconsistent with these basic principles must be repealed to allow the State to:

1. Ensure that the country has adequate and continuous supply of crude oil and refined petroleum products under the most economic and competitive terms possible, considering all available sources of supply, including local supply;
2. Ensure that the entire petroleum industry serves the national interest and economic needs of the country;
3. Ensure that consumers enjoy reasonable prices of petroleum products and prevent price manipulation, unfair competition and other trade abuses being committed primarily by big foreign oil transnational corporations;
4. Promote local capital, labor and technology in the downstream and upstream oil industry;
5. Uphold the constitutional guarantee of full state control and supervision over the country's petroleum resources in the name of national interest and pursuit of industrialization, while maximizing whatever benefits foreign technical and financial assistance will bring in the exploration, development and utilization of petroleum products.



IBON's proposals include seven basic provisions:

1. Centralized procurement of imported crude oil and refined petroleum products;
2. Commodity swap and other non-traditional trade arrangements;
3. Establishment of a buffer fund to cushion the impact on consumers of sudden increases in oil prices;
4. Government buy-back of Petron Corp.
5. Active State involvement in petroleum refining;
6. Establishment of a mechanism to ensure reasonable pump prices.

### Centralized Procurement of Imported Petroleum

Almost nine out of 10 liters of oil sold in the Philippine market come from the Big Three (Chevron (formerly Caltex), Petron Corp.; and Pilipinas Shell), companies that have their own oil fields abroad as well as their own global network of pipelines, tankers, depots, refineries and retail stations. Such a dominant position has allowed the Big Three to impose exorbitant prices on the domestic oil market.

Deregulation, the lack of substantial government intervention in the oil industry, has given these companies more room to manipulate the price of petroleum at the expense of consumers and the domestic economy. A system of centralized procurement of imported crude oil and refined oil products is therefore necessary to ensure the steady supply of reasonably priced petroleum in the country.

Under a system of centralized procurement, the Philippine National Oil Company (PNOC) becomes the sole importer of crude oil and refined petroleum products, and refiners and retailers operating in the country will have to purchase their supplies from the Company.

Consequently, PNOC must have substantial control over the country's oil storage facilities. There are some 119 oil depots nationwide, and PNOC can initially control the most strategic among these, such as the Subic Bay terminal (the largest in the country which has a storage capacity of three million barrels). At the same time, PNOC can also utilize Petron's storage facilities and lease privately-owned depots to meet its storage requirements.

For example, under a five-year program, PNOC would import on the first year a volume that is equivalent to 20% of the country's total import volume in the past year, increasing to 40% of the import volume of the past year in the program's second year and so on until it reaches 100% in the fifth year of the program. By this time, imports may be higher or lower than the country's actual needs. In this case, the surplus will be stored as a buffer supply to meet possible shortages or extremely high global oil prices.

Based on the annual growth average in volume (-2%) and value (18%) of oil imports from 1998 to 2004, IBON estimates that in 2008, under a gradual centralized procurement program spread over a five-year period, the government would have to import 19.8 million barrels of oil worth US\$1.6 billion. By 2012, the volume would reach 100.2 million barrels worth some US\$15.5 billion. (See **Table 1**) But the cost is expected to go down as government negotiates for special terms and arrangements with potential suppliers.

The government can use its earnings from the corporate income tax from the oil companies and import duties on crude and refined oil to partly finance PNOC's centralized procurement. Additional funds may also be sourced from royalties and taxes that the government earns from petroleum exploration and production, and government revenues from corporate income

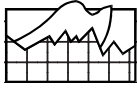


Table 1. Projected Volume & Value Oil Imports

Year	Volume (MB)	Value (\$ bn)
2008	19.8	1.60
2009	42.6	3.79
2010	62.6	6.7
2011	81.8	10.55
2012	100.2	15.56

*Source:* IBON estimates based on DOE data

tax being collected from the oil companies. In Malampaya alone, for example, government is expected to earn US\$400-\$500 million a year in royalties.

As State imports of oil increase, prices will go down since government will no longer impose tariffs or duties on its own imports even as it continues to charge such levies on private-sector importers. With government as a major (and eventual exclusive) importer of oil and a leading refiner and distributor (through a 100% state owned Petron) at the same time, ordinary consumers and industrial users of petroleum will be assured of more reasonable pump prices. This will also give minor Filipino oil firms the leverage they need to be able to effectively vie for the local market against the Big Three. Meanwhile, the country can diversify its import sources, considering that at present Saudi Arabia and Iran already account for more than 85% of total crude oil imports.

In addition, government can utilize various means of procuring imported petroleum unlike in the current system wherein local units of TNCs are supplied by their own mother units,

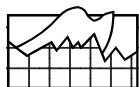
making oil artificially expensive through transfer pricing (the practice of bloating the price of a product as it is being transferred from one unit to another of the same corporation until it reaches the end-consumer). For example, PNOC can bid out supply contracts to prospective suppliers of crude oil and refined oil products, giving preference to state-owned oil companies (See **Table 2**), to be able to purchase petroleum products at the cheapest prices.

Another option is for the government to pursue bilateral agreements with the national governments of oil producing countries. As an official agreement between sovereign states, the Philippines can push for special terms in exchange for equally favorable concessions to the exporting country. One model the country could adopt is the deal between Venezuela and Cuba, wherein Venezuela supplied 100,000 barrels of subsidized oil a day in exchange for medical aid in the form of 17,000 Cuban doctors and dentists stationed in Venezuela.

### Commodity Swap

Government could also pursue commodity swaps with crude oil exporters. Under this trade practice, the parties involved swap products instead of buying each other's exports with foreign exchange. (See **Table 3**) This would help minimize the impact of fluctuations in the peso-dollar exchange rate on the price of oil.

The major imports of the country's main sources of crude oil include food and agricultural goods, which the Philippines already promotes for exports. The government can also negotiate for a bilateral agreement wherein the country would purchase petroleum imports using the Philippine peso, which the oil exporting country can use in the future to pay for their imports from the Philippines.

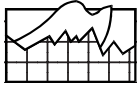


Company	Country
Saudi Aramco	Saudi Arabia
NIOC	Iran
PDV	Valezuela
Pemex	Mexico
Sonatrach	Algeria
KPC	Kuwait
Adnoc	UAE
Petronas	Malaysia
NNPC	Nigeria
LibyaNOC	Libya
INOC	Iraq
EGPC	Egypt
QP	Qatar
Pertamina	Indonesia
SPC	Syria
Socar	Azerbaijan
Ecopetrol	Colombia

*Source:* Energy Intelligence Group, Top 100 2007

	Share to RP crude oil imports %, 2005	FOB Value of Total imports from RP (\$ thousand) 2005	Main imports from Philippines
Saudi Arabia	56.31	39,366	Food stuff
Iran	25.33	39,615	Food stuff
Malaysia	7.27	2,452,777	Food
UAE	3.7	117,956	Food

*Source of basic data:* 2006 Philippine Statistical Yearbook



## Buffer Fund

Another important element of regulation of the oil industry is the establishment of an oil price buffer fund. This fund would be different from the Oil Price Stabilization Fund (OPSF) set up during the Marcos regime. The OPSF was not used as a buffer fund in the strictest sense, but merely served as a mechanism to protect the profits of the Big Three oil firms during price shocks.

Under the old mechanism, oil companies replenished the OPSF when their pump prices were higher than world prices and withdrew from it when the opposite happened. To ensure that the OPSF did not dry up, government delayed rollbacks even if world prices fell. Thus, the burden of replenishing the OPSF and ensuring TNC profits was passed on to consumers.

Unlike the OPSF, IBON's proposed buffer fund would be used exclusively to mitigate the effects of sudden increases in world prices and would be replenished by whatever savings government will accumulate from its centralized procurement system. The buffer fund would also be supported by a buffer supply. It would be managed by the Department of Energy with the Department of Finance, with a strong set of guidelines drawn up on when the fund can be drawn upon, in order to discourage corruption. The DOE must compute a trigger price that will determine when the buffer fund can be used.

During the transition period to full centralized procurement, when government savings are still minimal, a portion of the national budget would be allocated for the buffer fund. If unutilized during the previous year, it would be carried over to the next year until such time as the PNO is already implementing full centralized procurement and is able to replenish the fund.

## Reclaiming Petron

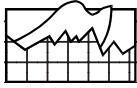
To further strengthen its position in the downstream oil industry, government must also reclaim a majority share of Petron. Effective state control over a company that accounts for one-third of the downstream market would allow government to check the unscrupulous practices of private oil corporations in implementing oil price hikes.

Although government may claim that it lacks resources to reverse Petron's privatization, in fact its share of Petron's profits would be more than enough. For example, if government were to buy back 11% or 900,000 shares of Petron, it would only need P6 million based on the selling price of P6.70 as of Oct. 26. This amount could easily be covered by the P2.38 billion the government would earn from its share of Petron's P5.94 billion net sales in 2006.

But the ultimate objective is not just to gain a majority share but to acquire full control over Petron. Government's centralized procurement system would be less effective if it would not have a substantial participation in refining and distribution of petroleum products to the end-consumers. At present, more than 80% of the downstream market is under the domination of oil transnationals, thus these foreign corporations would still have considerable influence on the retail price of oil products if government would not be involved in all aspects of the industry.

## Active State Involvement in Refining

Refining is another component of the downstream oil industry that government must actively engage in to ensure a secure and



affordable supply of oil products. Full state control over Petron is critical since it accounts for 180,000 of the 290,000 barrel per day refining capacity of the country (Shell accounts for the remainder).

PNOC must take the lead in providing new investment to generate additional refining capacity to meet the country's growing needs. But to lessen financial pressure on the state-owned firm, Filipino investors must be encouraged (and given priority over foreign investors through incentives) to pour investments into oil refining. Government must also ensure local investors of a captive market through its centralized procurement system.

Active state involvement in petroleum refining would also make certain that domestic petroleum resources would be fully maximized. Under the present system, the country could not utilize Malampaya oil and condensate because existing refineries, which are under the effective control of foreign corporations, supposedly do not have the facility to process them. Apparently it is not profitable for them to upgrade their refineries to suit the local petroleum market. However, in the face of escalating world oil costs, the issue is no longer simply commercial viability but the national interest.

### Ensuring Reasonable Prices at the Pumps

To further promote transparency and fairness in pricing, the DOE must require oil companies to file for a petition every time they intent to raise prices. The petition must justify the need to increase pump prices by detailing how increases in world market prices impact on the various components of their pump price. The DOE shall have the sole authority to grant or reject any petition for a price hike after an exhaustive public consultation.

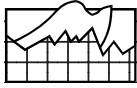
Meanwhile, with PNOC's centralized procurement system and substantial state participation in refining, the government would be in a better position to ensure that pump prices would reflect the reasonable cost of oil. The energy, justice and trade departments must also mobilize independent consumer groups to monitor prices at gas stations nationwide to guard against overpricing.

### State Control Over Local Petroleum Sources

Parallel to State efforts to regulate the downstream oil industry must be efforts to institute important reforms in the upstream level of the industry. Presently, government is using the Service Contract system, sanctioned by Presidential Decree 87 or the Oil Exploration and Development Act of 1972. Under this arrangement, it is assumed that government retains ownership of petroleum reserves in the country as required under the Constitution even as it hires the services of foreign private-sector contractors for the exploration, development and utilization of such resources.

The Service Contract system has in fact stripped the government of effective control and supervision over domestic oil resources, as seen in the case of Malampaya. It is therefore necessary for PD 87 to be repealed and replaced with a system that would uphold the people's ownership over the country's petroleum resources and ensure effective state control, while maximizing foreign technical and financial assistance. Such alternative must guarantee that:

1. All petroleum extracted from the Philippine territory must not be exported until such petroleum has been fully utilized for domestic consumption;



2. The State will play the decisive role in determining what areas need to be developed for petroleum exploration and production, and that foreign companies will not be able to hold the country hostage to their interest.
  3. There is equitable distribution of benefits from petroleum exploration and development projects. Net distribution (excluding taxes) should at least be 60% for the State and 40% for the companies based on the assumption that we own the resources that are being exploited and that the corporations will eventually recover their investment and reasonable profit.
  4. There are no unnecessary perks that may undermine the benefits that the State will gain from the project, and that 100% profit and foreign exchange repatriation will be disallowed.
  5. The rights and welfare of communities affected by exploration and development projects will be given due regard at all times.
- All these initiatives should form part of a long-term program that envisions a nationalized Philippine oil industry. Oil is too important a commodity that any government seriously pushing for industrialization cannot risk to completely put into the hands of profit-oriented TNCs.
- To achieve this, a major overhaul of the national economic framework, which is too dependent on foreign technology and capital, must be first initiated. In the meantime, the executive and legislative branches of the government have the doable and urgent option to regulate the various aspects of this vital industry. (12/07) ■