The lowdown on rising fuel prices

The prices of petrol and diesel in Indian cities have risen to their highest level since late 2013. This has come as a surprise to many since the price of crude oil, a major ingredient in the production of domestic fuels, is now significantly lower than what it was in late 2013. It is notable that Brent crude oil was trading at over $100 a barrel in 2013, compared to its current price of $75.

Even when international crude oil prices fell steeply in 2014 and 2015 — as low as $30 — domestic fuel prices failed to come down as much. Whenever crude oil prices have increased, the prices of domestic fuels have been raised steadfastly.

There is no strict rule that lower international crude oil prices must lead to lower domestic fuel prices. This is because, under a free pricing regime, petrol and diesel are priced according to what consumers are willing to pay rather than based on input costs. At the same time, there are other ways in which input costs can indirectly influence the retail price.

When the price of crude oil is high, oil companies are forced to cut down on their supply to the retail market in order to drive up the prices to competitive levels. It is worth noting that crude oil prices have been on an upward trajectory ever since January 2016 when it hit rock bottom; the agreement between members of the Organisation of the Petroleum Exporting Countries (OPEC) to cut down production in late 2016 has added to its momentum.

High taxes are another factor that can discourage producers from bringing enough supply to the retail market, leading to higher prices. This has predominantly been the case in India. When crude oil prices fell drastically in 2014 and 2015, for instance, the government increased the amount of taxes by more than Rs. 10 a litre on both petrol and diesel. While this increased the amount of revenue collected by the government, it prevented retail fuel prices from falling as much as international crude oil prices.

The rising prices of petrol and diesel increase the burden on citizens, affecting to some extent the government's popularity. It also quite often brings into question the government's policy when it comes to taxing basic fuels. More than half of the money that is paid by the consumer goes to the government in the form of taxes. Some have speculated that the government might compromise on its fuel deregulation policy, which allows oil marketing companies (OMCs) to price their output freely.

Not surprisingly, the shares of the government-owned OMCs have witnessed a sharp fall in recent weeks. The current price rise will thus act as a litmus test for the government's commitment to reforms in the energy sector. Further, to the extent rising fuel prices have to do with the decreasing supply in the world market, it has a negative impact on economic growth.

The price of domestic petrol and diesel going forward is likely to depend on the price of crude oil in the international market as well as the policy preferences of the government as it heads into a series of elections in 2018 and 2019. While rising geopolitical tensions have been used to explain the rise in crude oil prices this month, where oil prices are headed next is anybody's guess.

The oil bulls believe that OPEC countries will drive oil prices even higher in order to meet their increasing revenue needs. The sceptics of the recent rally, on the other hand, expect American shale oil producers to rein in any further rise in oil prices quite soon. If international crude oil prices fail to stabilise or fall, the government may decide to look at either reducing taxes on these fuels or forcing OMCs to incur losses by selling at lower prices.

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