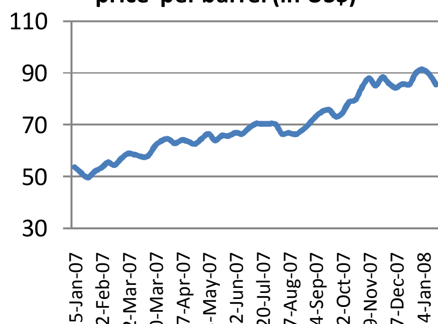
Policy Brief

SENATE ECONOMIC PLANNING OFFICE

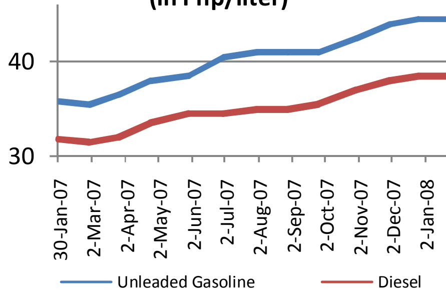
January 2008 PB-08-01

Chart 1:
Dubai Crude, weekly average price per barrel (in US$)



Source: www.med.govt.nz

Chart 2:
Average retail prices of gasoline and diesel, Jan 2007 to Jan 2008 (in Php/liter)



Source: Department of Energy

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Addressing the Oil Price Increase

I. Introduction

1.1 Oil prices in the world market have increased dramatically in the last few months. The price of the benchmark Dubai crude rose 67.4 percent, from US$ 48.8 per barrel in January 2007 to US$ 92.6 per barrel in January 2008.[1]

1.2 The steep rise in oil prices is already starting to put upward pressure on the prices of consumer goods. For instance, as the Mean of Platts Singapore (MOPS) and Dubai Crude prices reflected a fourth straight month of increase in November 2007, inflation rose to 3.2 percent from 2.7 percent in October 2007. In December, it further rose to 3.9 percent. The increase would have been even higher if not for the mitigating effect of the peso appreciation.

1.3 Domestic pump prices of unleaded gasoline and diesel have also risen, albeit at a slower rate. The average domestic retail price of gasoline increased by 24 percent, rising from Php 35.75/liter in January 2007 to Php 44.45/liter in January 2008. Meanwhile, the average domestic diesel prices grew by 21 percent over the same period, from Php 31.75/liter in January 2007 to Php 38.45/liter in January 2008.

1.4 As a response to the said situation, the Executive branch came up with an oil tariff adjustment mechanism which allows for a one percentage point (ppt) reduction in oil tariffs. The Senate, for its part, filed three bills, all of which, aim to ease the impact of the oil price increase. This *Policy Brief* presents the major issues pertaining to the said policy responses and offers other alternatives and/or supplementary measures which the government may take.

[1] As of January 4, 2008.

Table 1: Trigger Prices (US$) and Corresponding Tariff Rates		
Tariff rate	**Crude Price/barrel**	**Diesel Price/barrel**
At 2%	83.37	105.00
At 1%	92.41	110.00
At 0%	103.25	115.70
Source: Dept of Finance		
Note: *For Jan 2007 to Jan 2008, average CIF price of crude oil was US$92.75, average price of diesel was US$114.27, and exchange rate was Php41 = US$1.*		

II. Policy Responses

Reduction of import duties on oil

2.1 The Executive branch has come up with an oil tariff adjustment mechanism through Executive Order (E.O.) 691, which was signed on January 10, 2008. The mechanism allows for a 1 ppt reduction in oil tariffs whenever pre-determined crude and diesel prices have been breached (so-called trigger prices).[2]

2.2 As the first and second set of trigger prices have already been breached last November 2007 and January 2008, respectively, the incoming shipments of petroleum products will be slapped with an import duty of 1 percent starting February 1, 2008.

2.3 Estimated revenue foregone will amount to Php10.66 billion. However, according to the Department of Finance(DOF), the mechanism has been designed to be revenue-neutral as the resulting revenue loss will be offset by the increasing value of oil imports.

2.4 The DOF estimates that every 1 ppt reduction in oil tariff would result in across-the-board reduction in pump prices by 0.23 centavos per liter. Moreover, if oil companies allot the savings from the tariff reduction towards diesel alone, the pump price of diesel is estimated to decrease by 0.50 centavos per liter.

2.5 The impact of this measure, however, may not be significantly felt by the public. If the price of oil continues to increase, the slash in import duties may not even be reflected in pump prices. That is, market forces will still determine by how much and when pump prices will change. Hence, the effect on pump prices of lower oil tariffs may be viewed as, at best, positive but negligible.

Suspension of VAT on oil products/Exemption from VAT of oil products

2.6 Senate Bill (SB) 1962 filed by Senator Mar Roxas proposes to suspend the imposition of the 12 percent VAT rate on petroleum products for a period of six (6) months. On the other hand, SB 1977 filed by Senator Miguel Zubiri offers to exempt petroleum products and the sale or importation of coal and natural gas from VAT.

[2] Oil imports are currently slapped with a 3% tariff rate.

Table 2: National Government (NG)Fiscal Position			
	Revenue *(in P million)*	**Expenditure** *(in P million)*	**Surplus/ (Deficit)** *(in P million)*
2003	639,737	839,605	(199,868)
2004	706,718	893,775	(187,057)
2005	816,159	962,937	(146,778)
2006	979,638[a]	1,044,429	(64,791)
2007[c]	1,044,298[b]	1,031,693	12,605

Source: BTr

Note: a Of which 76,887 = VAT as of December 2006
b Of which 69,470 = VAT as of September 2007
c As of November 2007

2.7 According to the National Economic and Development Authority (NEDA), the passage of SB 1962 would result in a 0.16 ppt reduction in the GDP whereas inflation is expected to decline by 0.285 ppt from the baseline assumption of 4.0 percent, all other things constant.

2.8 Both proposals are likely to result in significant reduction in pump prices - Php4 reduction per liter of diesel; and Php65 per tank of LPG. Assuming that each jeepney driver consumes an average of 30 liters of diesel per day,[3] this translates to a daily savings of P120 per driver.

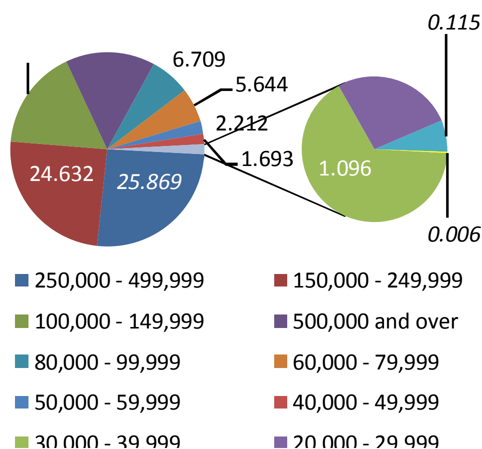
2.9 A troubling issue raised by both proposals is the resulting revenue loss. The Department of Finance (DOF) estimates an outright revenue loss of Php54 billion annually, or a 2 percent decline in expected tax revenues. But as the amount saved by consumers is translated to an increased consumption of other VAT-able goods, potential revenue loss may be lower, amounting to Php30 billion.

2.10 The national government registered a surplus as of November last year. However, this has been achieved through the reduction in public spending, specifically from savings in interest payments. Moreover, revenue targets have not been met. Revenue collection would have even been lower if not for the substantial increase in privatization proceeds. Tax effort as of the third quarter of 2007 dropped to 10.3 percent from 14.3 percent in 2006. Further reduction in VAT revenues by suspending or exempting petroleum products from VAT could hence, aggravate the government's revenue predicament.

2.11 Since 40 percent of VAT revenue is allocated towards infrastructure and social services, a decrease in VAT collection could also curtail the social benefits obtained from these programs. Also, it is worth noting that growth of public construction significantly contributed to the increase in capital formation (7.5 percent) and government spending (11.7 percent), and was thus a big growth driver in 2007.

[3] According to Pagkakaisa ng mga Samahan ng Mga Tsuper at Opereytor Nationwide (PISTON), a national federation of public transportation associations, a jeepney driver consumes an average of 30 liters of diesel per day.

Chart 4:
VAT Paid for Petroleum Products, by Family Income Groups (in %)



Source: Dept of Finance; Raw data 2003 FIES
Note: Figures show the share (%) of each income group's VAT payment to total VAT payment amounting to Php30 billion.

Table 3:
Proposed excise tax rate of SB 1977
(Php/liter)

Product	Pre-RVAT	Under RVAT	SB 1977
Regular gasoline	4.80	4.35	4.80
Kerosene	0.60	0.0	0.60
Diesel	1.63	0.0	1.63
Bunker fuel oil	0.30	0.0	0.30

Table 4:
Electricity Consumption by Income Bracket

Total Family Income	Electricity *(in Php)*	% Share
under 10,000	119,411	*0.002*
10,000 - 19,999	4,131,729	*0.055*
20,000 - 29,999	17,624,243	*0.235*
30,000 - 39,999	51,435,717	*0.686*
40,000 - 49,999	90,584,900	*1.208*
50,000 - 59,999	126,096,807	*1.682*
60,000 - 79,999	342,673,749	*4.571*
80,000 - 99,999	440,648,644	*5.878*
100,000 - 149,999	1,167,125,649	*15.570*
150,000 - 249,999	1,848,156,675	*24.655*
250,000 - 499,999	2,083,221,920	*27.791*
500,000 and over	1,324,122,667	*17.665*
Total	**7,495,942,111**	***100.000***

Source of raw data: 2003 FIES

2.10 Moreover, the rich stand to gain more from the suspension of VAT on oil than the poor. A DOF study based on the 2003 Family Income and Expenditure Survey (FIES) showed that higher income groups accounted for the largest share of the Php 30 billion VAT payments on petroleum products. Specifically, Php 36.2 million (or 0.1 percent) is paid by families earning Php20,000 every year and below, while Php 12.2 billion (or 40.7 percent) is paid by families earning Php 250,000 and above. Hence, suspending the VAT on oil is tantamount to providing "subsidy" even to those who do not need it. *(Chart 4).*

Scrapping of VAT on electricity

2.11 SB 1361 filed by Senator Enrile and SB 1977 seek to exempt from VAT the generation, transmission and distribution of electricity. SB 1977 further seeks the exemption from VAT of the importation of machinery and equipment (including spare parts) used directly in the generation, transmission and distribution of electricity. In lieu of VAT, SB 1977 seeks to restore the 2 percent franchise tax on electric utilities and to amend the excise tax rates of petroleum products, reverting back to the pre-RVAT rates. *(Table 3).*

2.12 The DOF estimates a net revenue loss of Php 8.6 billion (projected electricity VAT collection amounting to Php12.4 billion minus estimated franchise tax collection amounting to Php3.8 billion).

2.13 According to the Department of Energy, exempting electricity from VAT will result in a reduction of 0.592 centavos per kwh. If a household consumes an average of 100 kwh per month, this means a monthly saving of P59.20, a rather considerable amount especially for a poor household.

2.14 However, not only poor households will benefit from this measure. Not unlike the impact of SB 1977 and SB 1962, scrapping VAT on electricity will benefit the higher income groups as they are the heavy users of electricity. As revealed in the 2003 FIES, lower income groups (families earning less than 100,000 a year) account for less than 15% of total electric consumption.

III. Alternative measures

3.1 A better alternative to simply scrapping the VAT on electricity is for the government to increase the subsidies given to households availing of lifeline rates. Lifeline rates refer to the subsized rates given to low-income electricity consumers who cannot afford to pay at full cost as prescribed by the Electric Power Industry Reform Act (EPIRA). Lifeline rates vary depending on the distribution utility and are set by the Energy Regulatory Commission (ERC).

3.2 At present, households in the Meralco franchise area consuming 50 kwh or less are given a discount of P0.11/ kwh. These households however, are being subsidized by other households. It would be more favorable to consumers if government were to carry the burden of these subsidies. Another option is to expand the coverage of the lifeline rates from households consuming 50kwh to 100 kwh. This intervention will have a relatively smaller impact on public finances while ensuring that government assistance is given to those who need it.

3.3 Another more direct, sector-specific approach is to provide discount coupons to public transportation. While currently being implemented by oil companies on a voluntary basis, the discounts being offered are too small, ranging from P0.50 to P1. The discount should at least be equal to the VAT (or P4) and should be provided by all gas stations. In return, oil companies can be given tax credits for the discount they provide.

3.4 The scrapping of royalties on indigenous energy can also be explored. At present the government collects a 60 percent share of the net proceeds of natural gas development, 60 percent of the net proceeds of geothermal energy development, and 30 percent of the net proceeds from indigenous coal. These add up to the cost of electricity. Rough estimates by the Department of Energy show that there will be a reduction of Php0.16/kwh from the elimination of natural gas royalties.

The impact of such measure however, will not be immediate since the government presently uses the royalties to pay for the excess energy being delivered by the Malampaya natural gas operations. Because of the take-or-pay agreement governing the Malampaya operations, the government has to pay the full amount of energy delivered by Malampaya regardless of whether this energy is utilized or not. Furthermore, estimated consumer savings are smaller relative to other proposed measures.

3.4 Intensifying government's effort to curb smuggling will definitely help in easing the impact of oil price increase. However, the welfare-enhancing benefits to be gained from this policy may take some time to materialize as strong political will is required to implement this much-needed economic/regulatory measure.

3.6 Over the long term, there is a need to reduce the country's dependence on imported non-renewable fossil fuels. Because it is a finite resource, it should come as no surprise that the price of oil will continue to rise over the years. As a long-term response, there is a need for a law that will encourage the development and utilization of new sources of energy. Adoption of renewable and indigenous sources of energy would help reduce the cost of fuel and power as well as reduce emissions of greenhouse gases. The passage of the Biofuels Act was an important first step in adopting alternative fuels for the transport sector. The next step is for the passage of the Renewable Energy Bill which seeks to promote the development and utilization of alternative energy sources such as wind, solar, biomass and ocean energy for electric power generation in the country by providing a package of fiscal and non-fiscal incentives to developers of renewable energy and imposing a minimum purchase requirement for all electricity suppliers.

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Materials from the Joint Public Hearing of the Committee on Ways and Means and the Committee on Energy. January 23, 2008. Senate of the Philippines.

This Policy Brief was prepared by Acting Director Maria Cristina Pardalis, Kathreena del Rosario, and Peter Turingan under the supervision of Director Merwin H. Salazar and the overall guidance of Officer-in-Charge, Executive Director Ronald R. Golding.

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