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New formula for reducing fuel costs

What is the issue?

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Union government, to reduce the retail prices of petrol and diesel can work on with cost plus formula.

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What are the issues with trade parity?

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- At present, the government is following the trade parity formula for pricing the fuels, which is based on international markets.
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- By this, price for a commodity or service is pegged to another price or to a composite average of prices based on a prior selected period.
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- The formula based on trade parity fixes the landed cost of petrol and diesel at a level that is slightly higher because of the inclusion of customs duty in it.
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- The logic of an 80 % weight in favour of imports in the formula is questionable, with negligible imports of petrol and diesel taking place at present.
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- It also discourages oil refining companies from achieving greater operational efficiency since their cost of petrol or diesel is pre-determined by a formula irrespective of their actual refining costs.
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What is cost plus pricing formula?

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- It is now necessary to move away from the pricing formula based on trade parity and embrace a cost-plus pricing system.
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- Cost plus pricing is a cost-based method for setting the prices of goods and services.
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- Under this approach, one can add together the direct material cost, direct labour cost, and overhead costs for a product, and add to it a mark-up percentage (to create a profit margin) in order to derive the price of the product.
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- Cost plus pricing is a relatively simple mechanism and easy to understand.
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- It will also introduce transparency and help reflect a more reasonable and correct picture of the oil companies' under-recoveries.
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- It, in turn, could help reduce the government's subsidy bill and even reduce retail fuel prices.
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Source: Business Standard

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