LIBERALISATION OF THE PETROLEUM SECTOR WITH IOC
- SALIENT FEATURES

Nihal Sri Ameresekere F.C.A., F.C.M.A.

CABINET DECISIONS

Ceylon Petroleum Corporation (CPC) had commenced a process of being restructured in terms of Cabinet Memoranda dated 13.11.2002 and 3.7.2003 submitted by the then Minister of Power & Energy and approved by Cabinet on 2.1.2003 and 29.7.2003, respectively.

Key features of the restructuring scheme had been the formation of a Company, called the 'Common User Facility Company' (CUF Company), which was to own and operate the storage and pipeline infrastructure of the CPC for petroleum products, and the formation of 3 Companies (Retail Companies) for retail operations to operate approximately 100 Filling Stations each of the CPC. The CPC operated around 350 Filling Stations, whilst about 650 Filling Stations were 'Dealer Owned – Dealer Operated' by franchise agents.

Whilst one of the Retail Companies was to be owned and operated by CPC (i.e. 'CEYPETCO'), the other 2 Retail Companies were intended to be 100% owned and operated by strategic foreign parties in the petroleum sector. The CUF Company was to be equally owned i.e. 33 1/3 % by the 3 Retail Companies.

By the Cabinet Memoranda dated 30.11.2002 and 21.5.2002 Cabinet approval had been sought and obtained by the then Minister of Power & Entergy for the selection of Indian Oil Corporation Ltd. (IOC) to be the strategic party to own 100% of the 2nd Retail Company and 33 1/3 % of the CUF Company, 'on terms to be negotiated'.

The selection of IOC had not been on a 'competitive transparent bidding process', whereas at the same time by Cabinet Memoranda dated 1.10.2002 and 4.10.2002, the then Minister of Power & Energy had sought and obtained Cabinet approval for the strategic party to own and operate the 3rd Retail Company to be selected through an 'open competitive bidding process'.

By Cabinet Memorandum of 8.10.2003 the then Minister of Economic Reform, Science & Technology had sought and obtained Cabinet approval for the acceptance of IOC's 'negotiated offer' of US $ 75 Mn. for the 100% ownership of the 2nd Retail Company and for 33 1/3 % ownership of the CUF Company.

The Cabinet Memorandum of 8.10.2003 had set out that the assessment of the US $ 75 Mn. offer by IOC, including its investment plan to invest around Rs 2 – 3 billion in upgrading Filling Stations, noting that 'this downstream investment together with the upfront consideration adds to around US $ 100 Mn.' It also stated that Ernst & Young (E & Y) were engaged as Financial Advisors of the Government for this transaction, and that the IOC's Financial Advisors were KPMG Ford, Rodhes, Thornton & Co.

The IOC offer of US $ 75 Mn. had been justified on the basis of the 'business valuation' given by E & Y of US $ 71 Mn. (US $ 40 Mn. for 33 1/3 % of the CUF Company + US $ 31 Mn. for 100% of the 2nd Retail Company of 100 Filling Stations).

E & Y had also 'added a premium upto a maximum value of US $ 30 Mn. for the market access for 'Dealer Owned - Dealer Operated' Filling Stations of franchise agents, expressing reservation that in a stand-alone negotiation with IOC that there is a risk that they may refuse to pay the full premium'.

Furthermore, Cabinet Memorandum of 8.10.2003 provided for the formulation of a 'pricing formula', where retail prices are fixed by the Government.

Making observations on 10.10.2003 on the above Cabinet Memorandum of 8.10.2003, then Minister of Power & Energy, *inter-alia,* had stated thus – 'furthermore, the purchase consideration should be in foreign currency and should not be raised through local Banks'.

SHARE SALE & PURCHASE AGREEMENT
FOR 100 FILLING STATIONS & 'SUBSIDY CLAIMS'

Consequently, a 'Share Sale & Purchase Agreement for 100 Filling Stations' had been entered into by and between the Government and Lanka IOC (Pvt) Ltd., (LIOC), a fully owned subsidiary of IOC for the payment of US $ 30 Mn. for acquiring 100% ownership of the 2nd Retail Company of 100 Filling Stations and US $ 45 Mn. for 33 1/3 % ownership of the CUF Company, i.e. a total of US $ 75 Mn., as had been approved by Cabinet.

As per the 'Share Sale & Purchase Agreement for 100 Filling Stations', the Government and CPC were not to preclude LIOC from entering into arrangements for developing and operating 'Dealer Owned – Dealer Operated' Filling Stations of franchise agents.

The Share Sale & Purchase Agreement had come into effect from 1.1.2004, and after a period of 5 years it had been intended to fully liberalise the petroleum retail market.

IOC had accordingly commenced operations in January 2004 and by 31.3.2006, i.e. a 2 ¼ year period, in respect of which period, LIOC has submitted monthly 'subsidy claims' to the Government, confirmed by its statutory Auditors, Pricewaterhousecoopers, claiming 'subsidies from the Government' totalling Rs. 9,394,829,213/- against which the Government has paid Rs. 1,700,000,000/-, with the balance claims standing at Rs. 7,694,829,213/- as at 31.3.2006.

Subsequently, a further payment of Rs. 250,000,000/- has been paid by the Government in April 2006 with a further 'subsidy claim' of Rs. 225,144,900/- made by LIOC from the Government; thereby making the total 'subsidy claims' from the Government Rs. 9,619,974,113/- upto 30.4.2006.

In the meanwhile, early 2005 the new Government decided to negotiate with Bharat Petroleum Corporation Ltd., (BPCL) for the sale of 49% ownership (change of policy of selling 100% Shareholding) of the 3rd Retail Company, together with its management rights and for 33 1/3 % ownership of the CUF Company for the total consideration of US $ 84 Mn., through an 'open competitive bidding process'.

During the ensuing discussions and negotiations with BPCL, it transpired that the 'pricing formula' in the LIOC Agreement, which reads as given below, was 'impractical', and BPCL, whose then Chairman was Mr. S. Behuria, who is now the Chairman of IOC, concurring with such position agreed that the 'pricing formula' needed to be reformulated and redefined, with a reasonable and equitable 'cap' on profits to equity plus reserves to be agreed upon negotiations, subject to the same being also negotiated with LIOC.

> "6.2 Deviations from the Pricing Formula on a Request by the GOSL
>
> At the request of the GOSL or due to any determination or order by a Government Authority or any Change in Law, if any one of the Three Players is required to refrain from the application of the Pricing Formula as setout in Annex III during the Initial Period, the loss arising from the price differential incurred by that player shall be compensated by the GOSL through the payment of a subsidy. Such Player shall make a written detailed claim for the subsidy to the GOSL certified by a firm of International Auditors based in Sri Lanka appointed by Such Player with the concurrence of the GOSL. The GOSL shall ensure the payment on the claim within a period of three (03) months from the date of submission of such claim."

Accordingly, Cabinet Memorandum dated 22.3.2005, jointly signed by then Minister of Power & Energy then Minister of Finance & Planning and the then President had been submitted for acceptance of the bid of US $ 84 Mn. of BPCL for 49% ownership of the 3rd Retail Company, together with its management rights and for 33 1/3 % ownership of the CUF Company; and this Cabinet Memorandum had further sought Cabinet Approval – 'to re-negotiate with LIOC the Pricing Formula to be on an equitable basis and the same to be applicable to all 3 Players (*i.e. 3 Retail Companies*), taking into account the interests of the Government, the consumers and the 3 Players (*i.e. 3 Retail Companies*)'.

ATTORNEY GENERAL'S & COUNSEL'S OPINION

In the context of the foregoing, the advice of the Attorney General had been sought on the issue of interpretation of the 'pricing formula' for 'subsidy claims from the Government' in the Government's 'Share Sale & Purchase Agreement for 100 Filling Stations' with LIOC, and the following Opinion dated 3.2.2005 had been given by the Attorney General.

> "The Chairman
> Public Enterprises Reform Commission
> 11-01 World Trade Centre
> Echelon Square
> Colombo 1.
>
> LANKA IOC LIMITED
>
> I refer to your letter dated 27th January, 2005 and the discussion had with you in the chamber of the Attorney General on the same day.
>
> Having considered the provisions of clause 6 read together with the part relating to Pricing Formula in Annexure III of the shares sale and purchase agreement between the Government of Sri Lanka and Lanka IOC, I am of the view that the term "the loss arising from the price differential incurred by that player shall be compensated by the GOSL through a payment of a subsidy" contemplates a situation where GOSL would only become liable for an actual loss incurred by the player for a given accounting period computed in terms of accepted accounting standards, arising from the non application of the pricing formula. In a situation where a player has incurred an actual loss for an accounting period computed in the above manner GOSL becomes liable to compensate such a loss in accordance with clause 6(2) of the Share Sales and Purchase Agreement.
>
> Therefore, I am further of the view that the GOSL will not be liable if any determination or order by the Government Authority or any change in the law does not cause any loss to a player, in this instance Lanka IOC.
>
> Parinda Ranasinghe State Counsel. — Sgd. K.C.Kamalasabayson Attorney General "

Public Officers are necessarily bound to act in conformity with the advice of the Attorney General, and a Government ordinarily would also comply and conform therewith.

The Attorney General's Opinion had been further buttressed by the Opinion dated 9.3.2005 from Mr. K. Kanag-Isvaran P.C. and Dr. Harsha Cabral. This Opinion is given separately in a 'box'. Mr. K. Kanag-Isvaran P.C. and Dr. Harsha Cabral rendered such professional service *pro-bono publico.*

In the given circumstances, the Government constituted a Committee of Officials on 11.5.2005 to negotiate with LIOC, with a view to reaching a mutually acceptable equitable solution, without undue loss and hardship, and without unjust enrichment, particularly moreso, in that, this involved enormous volumes of public funds. Consequently, discussions were had before the Attorney General with LIOC.

RELEVANT ISSUES & QUERIES ARISING

In the foregoing context LIOC's published accounts, both quarterly and annual, were subjected to review and scrutiny, and several cogent issues / questions arose requiring clarification:

- Had IOC brought in US $ 75 Mn. in foreign exchange to the country in compliance with the premise upon which the Government had entered into agreement with IOC, even without an 'open competitive bidding process' ?

- LIOC accounts revealed that IOC's equity investment had been Rs. 4000 Mn. i.e. US $ 40 Mn. and not US $ 75 Mn.

- LIOC accounts also revealed that as at 31.3.2004 Rs. 3,469,772,727/- had been shown as a Loan obtained by LIOC from IOC, as at which date the Share Capital of LIOC had been stated to be Rs. 4,000,000,000/-. This Loan obtained from IOC has been shown as 'Nil' as at 31.3.2005, raising the question, as to whether such Loan had been repaid to IOC from local bank borrowings ?

- If LIOC had borrowed from local banks and made the investment of US $ 45 Mn. for the 33 1/3 % ownership of the CUF Company, then this would be contrary to the express direction that had been given by the then Minister of Power & Energy by Memorandum dated 10.10.2003, based upon which Cabinet approval had been obtained.

- Consequently, also would arise the interest cost on such bank borrowings charged to the LIOC income statement in arriving at net profit. Cost of such interest would be the cost of a part of investment that IOC had agreed with the Government to make in foreign exchange, raising the question of its incidence in reckoning net profits / 'losses' for Government 'subsidies', and reckoning the 'return on capital employed'.

- In November 2004 in a highly successful public issue, apparently due to its reckoned high profitability, LIOC raised Rs. 3,578,307,300/- by way of a public issue of which Rs. 1,325,299,000/- had been accounted as 'Share Capital', whilst the balance Rs. 2,253,008,300/- had been accounted as 'Share Premium'. The cost of such public issue would have an incidence, when charged in the income statement, if one is to reckon 'losses' for Government 'subsidies'.

- LIOC has expanded to around 170 Filling Stations (- *vide LIOC Annual Report 2005*), acquiring about 70 Filling Stations from 'Dealer Owned – Dealer Operated' franchise agents, whereas the Government's Agreement with LIOC had been specifically titled as "Share Sale & Purchase Agreement for 100 Filling Stations", thereby raising the question of applicability of the 'pricing formula' for subsidy claims from the Government in respect of these additional Filling Stations of 'Dealer Owned – Dealer Operated' franchise agents ?

- The 'Dealer Owned – Dealer Operated' Filling Stations of franchise agents in their own right had no entitlement to receive 'subsidies' from the Government for any 'losses'; thereby would it not raise the issue of infringement of the fundamental rights of 'Dealer Owned – Dealer Operated' Filling Station franchise agents, who are thus denied the right to equality, by creating a 'special privileged category of persons' ?

- In addition to acquiring the 'Dealer Owned - Dealer Operated' Filling Stations of franchise agents, LIOC as it lawfully might, have developed into other areas of businesses, such as the sale of lubricants, the operation of 'mini-super markets' at the Filling Stations, etc.

- The question of applicability of operational costs and overheads in respect of the above lines of businesses, and any renovation costs charged to the income statement would also arise, including also in respect of the Oil Tanks at China Bay, Trincomalee, if one is to ascertain the 'loss' incurred for Government 'subsidies', as a consequence of retail prices being fixed by Government on specifically 5 products, and also in reckoning a 'fair return on capital employed'.

- In the light of the following example, some of the cost parameters of the 'pricing structure' used for the 'pricing formula' attracted re-consideration. The 'marketing and distribution costs' for the period ended 31.3.2004 is reckoned to be around Rs. 3.1Mn. (*quarterly average from the year to 31.3.2004*), for the year ended 31.3.2005 had been reported to be Rs. 10.2 Mn., and for the 9-Month period ended 31.12.2005 to be Rs. 26.0 Mn., whilst the 'subsidy claims from the Government' included in respect of this 'marketing and distribution costs' item has been Rs. 31.7 Mn., Rs. 230.9 Mn., and Rs. 187.7 Mn., respectively. The 'pricing structure' provides for regular review for some items of costs i.e. insurance, losses due to evaporation, etc.

- A comparison of the income statements in the LIOC accounts for the 9-Month period to 31.12.2004 and the 12-Month period to 31.3.2005 had revealed 'unexplained' discrepancies between the 12-Month figures *vis-à-vis* the 9-Month figures, with the comparison showing a 'gross loss' of 9.13% for the 3-Month period to 31.3.2005, whereas there had been a 'gross profit' of 14.24% for the 9-Month period to 31.12.2004, when for comparison credit is taken for the full 'subsidy' claims from the Government for such period. As per the LIOC accounts for the 9-Month period to 31.12.2004, Rs. 2061 million has been accounted for as 'subsidy', as against Rs. 3652 million claimed as 'subsidy' from the Government upto 31.12.2004 of which Rs. 351 million has been in respect of the 3-Month period to 31.3.2004; and as per the LIOC accounts for the year to 31.3.2005, the full 'subsidy' claims from the Government of Rs. 4639 million has been fully accounted for.

- The Government had agreed to 'subsidise losses' in terms of Clause 6.2 of the 'Share Sale & Purchase Agreement for 100 Filling Stations' in respect of specifically the following 5 products, retail prices of which have steeply increased during the 2 ¼ year period under review, as given below:

Prices per Litre as at

	30.12.2003 Rs.	30.9.2005 Rs.	31.3.2006 Rs.	31.5.2006 Rs.
Super Diesel	37/30	55/30	55/30	63/30
Auto Diesel	32/-	50/-	50/-	58/-
Kerosene Oil	25/50	30/50	30/50	38/50
Petrol 90	53/-	80/-	80/-	88/-
Petrol 95	56/-	83/-	83/-	91/-

- Hence the 'profit margin' in the 'pricing structure' used for the 'pricing formula' for 'subsidies from the Government' being related to value, would be very much more for the 'same volume' of fuel handled, at such price differentials.

In such circumstances, the Secretary, Ministry of Finance by Letter dated 1.8.2005 stated that – "As per the formula 5% profit margin of the base price is provided for the petroleum companies to recover their investment …. this ad-valoreum margin was recognised when the prices were varying at around US $ 30 – 35/bbl …. the market thinking at that time was that the prices would decline to a range of US $ 22 – 28 /bbl soon after the Iraq war was over …. The negotiations with the LIOC for retail distribution were conducted with the assistance of Ernst & Young …. However, since the conclusion of the transaction, market prices have been continuously moving in an upward direction. Therefore, I consider it is necessary to revisit this pricing formula ….. the international prices have exceeded US $ 55/bbl (*today around US $ 70/bbl*) giving large margins which were not expected by LIOC ….. there is an additional windfall of around Rs. 1/50 to Rs 2/- per lt. of fuel from the formula price …. since there is no decision in securing a third player, there has been a hidden protection. Therefore, I am of the view that this pricing formula should be revisited with a cap on the 5% profit margin. I urge your early attention to this matter"

In conclusion, the following citations from Judgements of Lord Denning MR perhaps would be pertinent in the context of diplomatic influences and nuances, *vis-à-vis*, this matter. *(1977) 1 All - ER @ 892*

> "If the dispute brings into question, for instance, the legislative or international transactions of a foreign government, or the policy of its executive, the court should grant immunity if asked to do so, because it does offend the dignity of a foreign sovereign to have the merits of such a dispute canvassed in the domestic courts of another country; but if the disputes concerns, for instance, the commercial transactions of a foreign government (whether carried on by its own departments or agencies or by setting up separate legal entities), and it arises properly within the territorial jurisdiction of our court, there is no ground for granting immunity" – *Rahimtoola v Nizam of Hyderabad*

> "….. a foreign sovereign has no immunity when it enters into a commercial transaction with a trader here and a dispute arises which is properly within the territorial jurisdiction of our courts. If a foreign government incorporates a legal entity which buys commodities on the London market, or if it has a state department which charter ships on the Baltic Exchange it thereby enters into the market places of the world, and international comity requires that it should abide by the rules of the market" – *Thai–Europe Tapioca Service Ltd. v Government of Pakistan*

On the other hand, could a sovereign government be subjected to threat and intimidation, akin to that normally posed by labour unions, that too *vis-à-vis* a foreign direct investment of US $ 40 Mn. ? Public utility services, when privatised or on a public-private partnership basis, warrants a 'step-in clause' as is the accepted international norm and practice, for a government to 'step-in' and ensure the uninterrupted continuity of a public utility service to the people, particularly as vital as in this instance.