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India's reliance on imported energy threatens long-term recovery

By Victor Mallet in New Delhi

Crisis over? The sharp recovery of the Indian rupee over the past week and the return of foreign investors to the stock market suggest that fears of an Indian balance of payments crisis were overblown.

Yet India's biggest underlying financial problem, according to business leaders and economists, is not the imminent change in US monetary policy that triggered an investor exodus from India and other emerging markets last month. Rather, it is India's own heavy and growing dependence on imported energy.

The figures are stark. More than half of India's $191bn trade deficit in the financial year to March – $109bn – was made up of oil, with India importing 82 per cent of its oil needs, mostly from the Gulf.

Those imports contribute to the current account deficit that worries investors and that the government of Manmohan Singh has pledged to reduce. They also leave India highly vulnerable to price spikes prompted by the Syrian civil war or other events in the Middle East.

Official attempts to curb the deficit, led by Palaniappan Chidambaram, the finance minister, and Raghuram Rajan, the new central bank governor, assume an Indian imported oil price of $104 a barrel, but the price of the "Indian basket" recently peaked above $114 and was this week at $110. Every one-dollar increase in the price over a year adds $1bn to the net import bill.

"The whole mess in the current account deficit is due to the imports of both coal and oil," says Vivek Pandit, senior director for energy and the Federation of Indian Chambers of Commerce and Industry.

Deepak Mahurkar, oil and gas specialist at PwC in India, says the trend is not new but is brutally exposed when foreign direct and institutional investors become reluctant to continue financing the current account deficit, forcing India to draw down its foreign reserves, as it has since March. "Then you start feeling the pinch of it," he says.

Nor is there much hope that India will be able to decrease its reliance on imported energy. Oil import dependency, for example, is forecast to grow another 10 percentage points to exceed 90 per cent by 2031.

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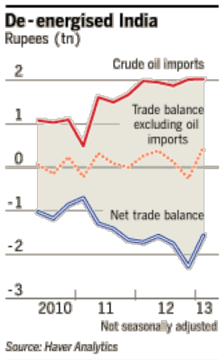
India, which is set to overtake China as the most populous nation, is already the fourth biggest energy consumer on the planet, after China, the US and Russia. Indian energy use is growing inexorably and rose 5.1 per cent last year to the equivalent of 563.5m tonnes of oil, according to the BP Statistical Review of World Energy, though per capita consumption is still less than a quarter of the level of China's.

When the investor funk about emerging markets was at its worst two weeks ago and the rupee sank to a record low against the dollar, Indian ministers floated ideas for stopgap remedies to save the currency, including a night-time ban on fuel sales and a plan to pay Iran solely in rupees for shipments of oil.

Neither made much headway. The notion of closing petrol stations smacked of panic, and the Iranian option would depend on the agreement of Tehran and on finding international companies willing to insure or reinsure oil cargoes in the face of western sanctions against Iran over its nuclear programmes.



Indian business leaders have proposed four longer-term solutions to India's deepening energy crisis: encourage domestic exploration for oil and gas; abolish fuel subsidies, which increase Indian oil demand and worsen the budget deficit; promote alternative energy; and continue diversifying India's suppliers by having the country's oil companies buy stakes in African and other non-Gulf oil and gas assets.

All of these except the last are made harder by the pressures of Indian politics and the shortage of land – reducing subsidies is particularly difficult ahead of the general election due by May 2014 – and even if pursued enthusiastically they would only alleviate and not eliminate the problem.

In depth

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Increasing exploration and domestic production of oil and gas, however, would produce significant benefits to India within a decade, not only helping to contain the cost of imports but also creating millions of jobs and boosting gross domestic product, according to PwC.

"The only the way the hydrocarbon deficit can be reduced is by domestically producing the crude oil," says Mr Mahurkar.

International oil companies have mostly shied away from India in recent years, citing unfavourable taxes, Emerging markets are taking a battering as investors withdraw at the prospect of higher global interest rates

regulations and domestic price controls. The country's coal mines are also producing far below their potential amid a political row over allegations of corruption in the awarding of coal blocks to power companies and other licensees.

BP did pay $7.2bn in 2011 for a 30 per cent stake in a Reliance Industries offshore gas block, but output there has been hit by production problems and regulatory delays, even if a new discovery in the block announced in May has raised hopes of a turnround.

"India is under-explored about 60-70 per cent," says Mr Pandit of Ficci. "We need to explore our own national basins – oil and gas reserves – and incentivise our own domestic production."

In the end, he says, future Indian governments will have no choice but to support exploration and cut consumption subsidies to avert an energy-based financial crisis. "It's a Hobson's Choice. You've got to bite the bullet either today, or tomorrow or the day after tomorrow," he says. "Nobody's looking at long-term energy security."