INDIAN OIL PRICING POLICY & PRACTICE – A CRITICAL LOOK

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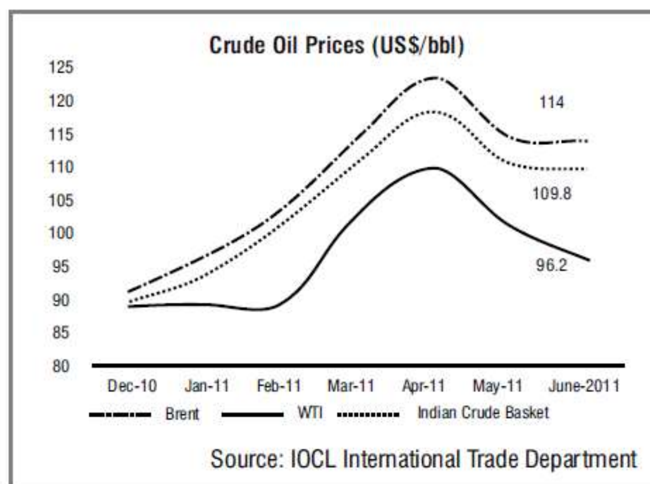
On August 15, 2011 'The Business Line' questioned the logic of Indian Refiners paying $ 23 per barrel more to their suppliers (Indian Basket) than the price of 'Brent'. To quote, "the average price of crude oil in August (till August 10) at which Indian refiners purchased has been higher than (West Texas Intermediate (WTI). While the WTI averaged $87.81 a barrel, the Indian crude basket averaged $108.63 a barrel". WTI is traded at the New York-based commodity exchange (NYMEX); a superior variety of crude oil, it is mainly available in the US market. The composition of Indian Basket of Crude, on the other hand, represents the average of Oman & Dubai for sour grades and Brent (Dated) for sweet grade in the ratio of 64:37 for 2009-10; 62:38 for 2008-09; 61:39 for 2007-08; 60:40 for 2006-07; 58:42 for the year 2005-06 and 57:43 for the prior periods, as per the explanation given in the Petroleum Product Analysis Cell – (PPAC). No clarification on the price differential as mentioned in the press report, was given in the public domain.

Given below is a graph highlighting such huge variation in price of crude in the international market.

A graph published by IOCL itself re-confirms such difference, as exhibited below:



Such difference in crude price has also existed since January 2011. Although the government-owned refiners in India are importing crude at the Indian Basket (Dubai and Saudi crude) price, WTI crude was in use in our refineries a few years back. As could be seen from the sample data given below, the difference between Indian Basket crude price and WTI crude cost us an extra payment of $**916,93,43,952 approximately.** Taking the average exchange rate, such excess payment works out to Rs.2,488.71 crore in the first six months of the fiscal year 2011-12 (estimate based on monthly average of crude import price declared in PPAC website). No one questions the rationale for refineries resorting to such practice despite the huge additional out flow of foreign exchange occurring on every import consignment of crude from Indian Basket sources.

	APRIL	MAY	JUNE	JULY	AUGUST	SEPTEMBER	TOTAL
Import of Crude in M.T	15737000	13784000	13935000	13751000	14175000	12748000	**84130000**
In barrel @ 1MT=7.33brl	115352210	101036720	102143550	100704830	103902750	93442840	**616672900**
Rate diff be-tween Indian Basket & WTI in US$	8.57	9.43	13.64	15.09	20.63	23.24	
Total excess US $ paid on Crude import	988568440	952776270	1393238022	1519635885	2143513733	2171611602	**9169343952**
Total excess Rs paid on crude import @ Rs/US$	46 45474148240	46 43827708420	47 65482187030	48 72942522480	49 10503217290	49 10640896840	**24887068030**

For clarity, the price trend on crude as published on the website of IOCL is given below:

Month Year	**Brent**	**Dubai**	**Indian Basket**	**Oman**	**WTI**
September, 2011	113.13	106.31	108.79	106.65	85.55
August, 2011	110.37	105.02	106.94	105.35	86.31
July, 2011	116.89	109.99	112.37	110.41	97.28
June, 2011	114.04	107.77	109.85	107.90	96.21
May, 2011	114.56	108.38	110.65	108.89	101.22
April, 2011	123.49	116.01	118.46	116.56	109.89
March, 2011	114.60	108.71	110.72	109.00	103.03
February, 2011	103.76	100.24	101.62	100.60	89.57
January, 2011	96.54	92.52	93.87	92.66	89.38

As per the latest recorded data in the PPAC of Petroleum Ministry, the trend still exists, as shown below for 2011, 2012 and for 2013 up to March:

Month Year	**Brent**	**Dubai**	**Indian Basket**	**Oman**	**WTI**
March, 2013	108.37	105.55	106.45	105.56	92.87
February, 2013	116.29	111.10	112.68	111.10	95.28
January, 2013	113.01	107.94	109.55	107.94	94.74
December, 2012	109.36	106.34	107.28	106.34	88.23
November, 2012	109.11	107.26	107.87	107.27	86.57
October, 2012	111.61	108.87	109.79	108.90	89.45
September, 2012	112.86	111.22	111.77	111.31	94.45
August, 2012	113.37	108.59	110.07	108.90	93.99
July, 2012	102.59	99.15	100.34	99.43	87.80
June, 2012	94.84	94.44	94.52	94.49	82.32
May, 2012	110.20	107.31	108.13	107.37	94.62
April, 2012	119.54	117.30	118.04	117.44	103.35
March, 2012	125.33	122.47	123.61	122.92	106.31
February, 2012	119.56	116.17	117.67	117.15	102.29
January, 2012	110.58	109.80	110.47	110.83	100.35
December, 2011	107.84	106.43	107.20	107.28	98.55
November, 2011	110.66	109.00	109.62	109.35	97.17
October, 2011	109.44	103.95	106.11	104.76	86.45
September, 2011	113.13	106.31	108.79	106.65	85.55
August, 2011	110.37	105.02	106.94	105.35	86.31
July, 2011	116.89	109.99	112.37	110.41	97.28
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Thus, India is incurring an additional foreign exchange outflow for the past few years over and above what would have been incurred had the WTI crude been imported and used in our refineries, as in the past, rather than importing crude at the Indian Basket rates.

The Petroleum Ministry blissfully ignores such variation in prices of different brands of crude oil and continues to allow import only at the from Indian Basket rate, which is almost ten to twenty dollars more per barrel than the rate of WTI crude, which is much better crude in terms of the refined produces therefrom. No reasons nor supportive justification for this is given in the public domain.

On the contrary, even the slightest fall of value of the Indian Rupee vs. US dollar, prompts the Oil Marketing Companies (OMCs) to clamour about 'under-recoveries' and raise the prices of petroleum products based on the variations occurred in the exchange rate during the previous fortnight. What is the explanation for the government's ignorance on this front?

If a proper investigation is done as to why OMCs have switched over from the WTI source of supply adopted earlier and why they still continue to buy the crude oil only at the Indian Basket rate, despite such vast variation in prices, the exact reason will come to light. The CAG can take up this matter for a special audit and bring out the truth behind such policy change, which is, in all probability, not in the 'public interest'.

The extract below from the published Financial Statement of IOCL for the year ended on 31st March, 2013, refers to "canalising commission" being paid by the OMCs to some agency in the import of crude oil. May be this is the reason for such imports at the Indian Basket rate rather than the WTI rate. This possibility needs to be investigated.

"Crude oil imported against canalising commission on behalf of CPCL, a subsidiary Company, hitherto accounted for as purchase / sales, is now accounted on agency basis ; in order to make previous period figures comparable, such transactions relating to (the) quarter ended 31st March, 2012, Rs.11,161.19 crore, and (the) year ended 31st March 2012, Rs.36,030.91 crore, have been recast. Accordingly, the previous quarter / year figures have been re-grouped".

If an estimate is made based on difference in price of crude between WTI and Brent (from where 67% of the crude import was/is being made) and also Dubai

(where from the remainder was/is being imported), instead of Indian Basket rate, the excess payment may go up still higher.

It is understood that the WTI crude is far superior to, and yields better refining margin to the refineries than, the Dubai crude. To quote from a published source:

"*Generally, lighter and sweeter crudes are considered higher quality and will trade at a premium relative to heavier and sourer crudes. This is mainly because they yield higher volumes of refined petrol and diesel and are therefore less costly to process on a unit basis into high-value refined petrol products such as petrol and diesel, compared with heavy crudes that are more suited for production of low-value products such as fuel oil. The lower levels of sulphur in sweeter crudes mean that they do not need as much processing to meet environmental standards".*

During 2011, the price of petrol was raised from Rs.63.70 per litre to Rs.66.84, an increase of Rs.3.14 on September 16. The earlier price rise was on July 1, 2011. Depreciation of the rupee against the US dollar was given as the reason. More recently and for similar reasons, the price of petrol has been raised on June 15, 2013.

However, the Economic Times, Bangalore Edition reported on October 14, 2011, quoting a source in the oil Industry, that import of crude was through the "buyer's credit" system and thus, despite the fall in rupee value noticed then, the actual cost of crude import must work out cheaper because of such 'buyers credit' working out lower than the base rate of most banks. S K Joshi, former Director (Finance) BPCL, confirmed to ET "since buyer's credit is a cheaper route for funding short-term capital, marketing companies are resorting to this product". Earlier, before the RBI had introduced the base rate regime in July 2011, barring banks from lending below base rate, these companies increased their dependence on buyer's credit; the interest on buyer's credit, with the rupee at 49 for the dollar then, worked out cheaper by two to two and a half percentage points to most banks' base rates. Buyer's credit, normally for six months and up to a year in certain cases, is a product linked to the London Interbank Offered Rate (LIBOR) available under external commercial borrowing norms. If this is true, was such rise in petrol

price allowed by the Union government in the public interest? Or were OMCs misleading the government in getting approval for the rise in price?

Again on October 15, 2011, the ET Bangalore Edition reported that the Oil Companies made a margin of Rs.4.52 per litre on sale of diesel despite the much talked - about under-recoveries the calculation of which includes expenses not actually borne by the oil companies, like port charges and customs duties. It listed Rs.1.54 as conversion gain, Rs.0.70 as gains by including the ocean charges, port dues and customs which are absent in domestic product and sale of diesel, Rs.1.52 gain as the difference between the global and refinery gate price and Rs.0.76 margin – together making up the net margin of Rs.4.52 per litre. However, the 'under-recovery', per litre claimed is Rs.6.90 per litre, that is, instead of declaring only Rs.2.38 per litre as under-recovery OMCs project Rs.6.90 per litre as under-recovery on sale of one litre of diesel. Again, does it mean that the government was not aware of such misleading data or had the OMCs suppressed such data for getting the nod of the government for approval of the price hike in diesel? Proper explanation is needed from all concerned.

According to data in www.indexmundi.com, during the five year period up to 2009, India's annual consumption of crude was about 2813 million units of which on an average 685 million units were produced indigenously, thus reckoning the percentage of import and indigenous crude at 76% and 24% respectively. That means, for the 24% of crude which was processed by our refineries, there was no market fluctuation as in international crude price, no ocean freight and handling charges, no import duty, etc. However, when the Rangarajan Committee recommended the Trade Parity Price (TPP) for transfer of petroleum products from the refineries to OMCs, 80% weightage was given to the import cost of the relevant petroleum products which included the ocean freight, handling charges, import duty, education cess, etc. Further, in calculating the so called 'under-recoveries', the OMCs did not calculate the actual average import price of the relevant petroleum product, taking into account different ports for the import depending upon the location of refineries. This is much against the specific recommendation of the Rangarajan Committee. The companies took the FOB price at the Arab Gulf of Gasoil (Diesel) BS III equivalent and added ocean freight from the Arab Gulf to

Indian ports to arrive at C&F price and further added import charges (insurance/ ocean loss/LC charge / port dues) before adding the 2.58% customs duty (2.5% plus 3% cess), to arrive at the import parity price of the product. The export parity price (EPP) was arrived at, on the basis of FOB price of product plus advance licence benefit for export (details are absent in the published details of the Oil Ministry), while by giving 80% weightage to Import Parity Price (IPP) and 20% to EPP, the refinery gate price was arrived at. In fact, the Rangarajan Committee had recommended that such parity percentage should be fixed periodically depending upon the production of petroleum products by the Indian refineries; whereas, the OMCs for their part are conveniently adopting the same percentage as in 2006. The government is also ignores this factor totally and allows periodical rise in the prices of petroleum products. The price build up details from the PPAC website are given below for appreciation of the calculations done by OMCs in claiming the 'under-recoveries':

Price Build-up of Diesel at Delhi

Sl. No.	Elements	Unit	Effective 1st Nov'11
1*	FOB Price at Arab Gulf of Gasoil (Diesel)BS III equivalent	$/bbl	125.06
2*	Add: Ocean Freight from AG to Indian Ports	$/bbl	1.49
3	C&F (Cost & Freight) Price	$/bbl	**126.54**
OR Rs./Litre 38.84			
4*	Import Charges (Insurance/Ocean Loss/ LC Charge/Port Dues)	Rs./Litre	0.37
5*	Customs Duty @2.58% (2.50% + 3% Education cess)	Rs./Litre	1.01
6*	Import Parity Price (at 29.5º C) (Sum of 3 to 5)	Rs./Litre	40.22
7*	Export Parity Price (at 29.5º C)	Rs./Litre	38.39
8*	**Trade Parity Price** (80% of (6)+20% of (7))	**Rs./Litre**	**39.85**
9*	**Refinery Transfer Price (RTP) for BS-III Diesel** (Price Paid by the Oil Marketing Companies to Refineries)	Rs./Litre	**39.85**
10	Add: Premium recovered for BS-IV Grade over BS-III	Rs./Litre	0.04
11*	Add : Inland Freight and Delivery Charges	Rs./Litre	0.73
12*	Add : Marketing Cost of OMCs	Rs./Litre	0.65
13*	Add : Marketing Margin of OMCs	Rs./Litre	0.77

14	**Total Desired Price** (Sum of 9 to 13)-Before Excise Duty, VAT and Dealer Commission	Rs./Litre	**42.05**
15*	Less: Under-recovery to Oil Marketing Companies	Rs./Litre	8.58
16	**Price Charged to Dealers (Depot Price)** (14-15)**-** Excluding Excise Duty & VAT	Rs./Litre	**33.47**
17*	Add : Specific Excise Duty @ Rs.2.06/Litre (Rs.2.00/Litre+ 3% Education cess)	Rs./Litre	2.06
18*	Add : Dealer Commission	Rs./Litre	0.91
19*	Add : VAT (including VAT on Dealer Commission) applicable for Delhi @ 12.50% and Air Ambience Charges @ Rs.250/KL less rebate of Rs.375/KL.	Rs./Litre	4.46
	Retail Selling Price at Delhi (Sum of 16 to 19)	Rs./Litre	**40.91**

Such calculations were neither scientific nor as contemplated by the Rangarajan Committee. The Committee had recommended that the **actual import data relating to the particular petroleum product to be aggregated to find out the average cost of such import,** perhaps taking into account the cost involved in import in **all the ports** through which such imports take place and taking into account the exchange rate fluctuations. When the refineries produce the BS IV products, there is no question of adding value again.

In fact, as has been pointed out by the Standing Committee on Petroleum & Natural Gas (2004-05) (fourteenth Lok Sabha) - Ministry of Petroleum & Natural Gas - Pricing of Petroleum Products (presented to Lok Sabha on 04.08.2005 and Rajya Sabha on 04.08.2005), while calculating the Import Parity Price, particularly when 24% of the crude consumed is indigenously produced, there was no reason why all import cost should have been added instead of adding only 76% to arrive at the IPP. The Committee had recommended:

"This, the Committee understand, allows ONGC and OIL to charge import parity prices for the crude produced in India, by linking the prices to international crude prices. Components like ocean freight, insurance, customs duty, ocean loss, port dues, etc. are added to the Free on Board (FOB) price of the respective marker crude in the international market to calculate the import parity price of domestic crude. In the opinion of the Committee such factors which are in no way connected to domestic crude production should not go into calculating the price of domestic

crude. The Committee, therefore, recommend that the Government should peg the price of domestic crude to the Free on Board (FOB) price of the respective marker crude in the international market".

The Committee's recommendation to ensure that the fuel price rise, especially for diesel, is kept as low as possible is not being adhered to. Its advice reads:

"Considering the fact that increase in fuel prices, especially diesel, would have a cascading effect on the prices of various essential commodities affecting the common man at large, the Committee recommend that the increase in prices of such products should be kept at the minimum".

The same Committee indicted the Central government for not transferring the funds collected for the Oil Industry Development Board (OIDB) set up in 1975 in order to provide financial assistance for the development of oil industry. The annual cess collection was nearly Rs.5400 crore and up to 31-3-2005, the Central government had collected about Rs.55,966.81 crore as cess. Out of this, however, only Rs.902.4 crore was received by OIDB till March 2005. The Committee, by dismissing the argument that the expenditure on "oil industry" had exceeded the cess collections, and by citing the earlier strong objections expressed in the First and Fourth Reports (14th Lok Sabha) reiterated the need to utilize such huge funds collected for the creation of a Price Stabilization Fund (to bring stabilization in the prices of petroleum products). It also recommended use of a part of it to fund the subsidy on PDS kerosene and LPG. It is not clear whether the Union government had complied with such advice from the Committee. If it had, there would have been a lessening of the burden of the Oil Ministry, thus helping the government to avoid to some extent the periodical hikes in the price of petroleum products that had contributed to the current inflationary trend. CAG may look into such lapses while conducting its performance audit of the Petroleum Ministry as well as the OMCs. The Lok Sabha secretariat should also take note of such glaring lapses and ensure that the recommendations of the earlier committees are unfailingly complied with.

In addition to the accumulated cess of Rs.55,966.81 crore, as reported by the Committee up to 31st March 2005, as per the PPAC published data, another

Rs.76,896 crores has been collected as cess and its disposal or otherwise, in terms of the above direction of the Standing Committee, is not known to the public. Hopefully, subsequent Standing Committees would have examined this aspect. The Lok Sabha Secretariat should also enquire into this seriously and bring out corrective proposals for submission to the Parliament. In the meantime, is it not prudent for the Central government to utilize the accumulated cess collections for the intended purposes?

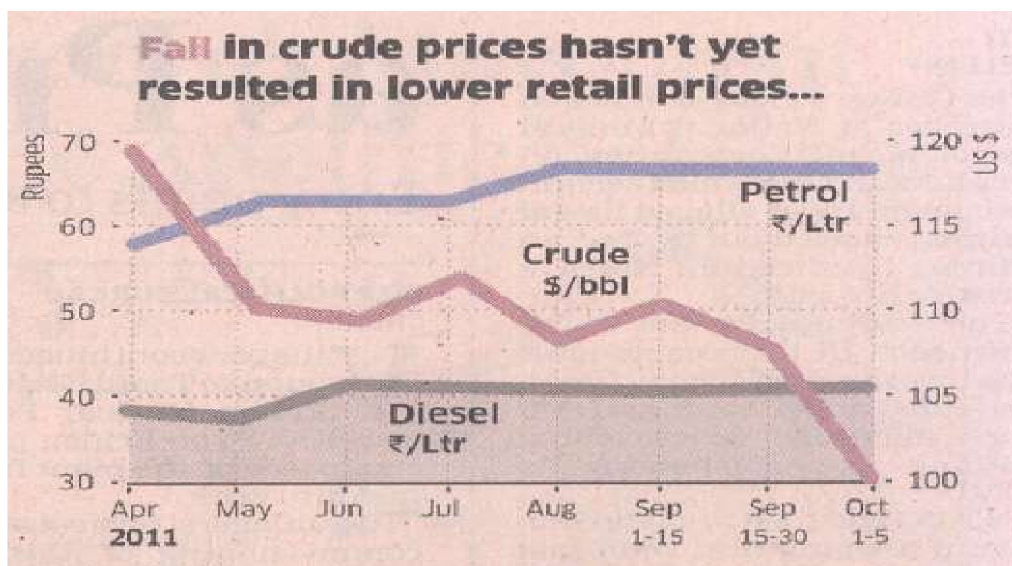
It was a surprise to everyone when the price of petroleum products was raised immediately in the wake of the crude price rise in the international market during July 2008; (Even now, such periodical raise is the order of the day); but there was no reduction of prices when the crude price went down subsequently; all other countries had brought down the selling price of petroleum products corresponding to the down pricing of crude in the international market.

Thus, prima facie, there is no justification for such continued price increases after July 2008. The crude price was at its peak at $145.29 per bbl in New York Mercantile Exchange on July 4. Thereafter, the price never reached such peak rate till mid 2011 (or even until now); it only went down drastically to $106.89 on September 26, striking an average of $118.88 for the quarter ending September 2008; again down to $57.88 as average price per bbl for the last quarter of the same year. In 2009, the average price was down at $47.83 per bbl and in 2010 the average went up to $84.51. During 2011, up to June, the average price was slightly up at $91.53 per bbl[1]. On September 16, the price was only $87.91 per bbl. However, the Indian prices of petrol and other petroleum products were not brought down corresponding to the crude price lowering trend during this period. The price of Rs.50.62 per litre on July 16, 2008 in Delhi was brought down only on December 6 to Rs.45.62 per litre and again on January 29, 2009 to Rs.40.62; but it was raised again on July 2 to Rs.41.72 per litre; similar raise was made in other petroleum products also[2].

1 Crude Price trend of NYME available in the website of NYME

2 Historical price of Petroleum Products placed in the website of IOCL, PPAC

During 2011, this trend was re-confirmed as reported in the Economic Times:



As can be seen from the chart, the prices of petroleum products have been raised periodically. Contrariwise, there was always reluctance on the part of the government in bringing down the prices of petroleum products corresponding to the subsequent down trend in crude oil price.

If the claim of OMCs and the Oil Ministry about the 'under-recoveries' as periodically reported and recorded in PPAC website was true, it was not clear as to how the companies registered continuous profits in these same years and how they have been contributing substantial amounts to the central exchequer. As recorded in PPAC, the year wise contributions of oil companies to the central exchequer in the form of customs duty, cess on crude oil, excise duty, royalty on crude oil and natural gas, corporate and dividend tax and other charges including service tax have been as follows:

2006-07	Rs.	97,264 cr
2007-08	Rs.	1,08,286 cr
2008-09	Rs.	93,513 cr
2009-10	Rs.	1,11,779 cr
2010-11	Rs.	1,36,497 cr
2011-12	Rs.	1,19,850 cr
2012-13	Rs.	1,17,422 cr

Thus, it is clear that the so called 'under-recoveries' by OMCs have not at all affected their continued profit making trend and that they have continued to contribute huge revenues to the central exchequer, besides more or less equal contributions to the states' revenues as well. All utterances of senior politicians that unless the OMCs are compensated for such huge 'under-recoveries' from petroleum products, they are going to incur heavy losses would appear to be without any well founded support of statistics from their own publications.

If we look at the share values of these OMCs in the Stock Exchange, their performance has been highly rated and valued, with the value of their assets going up in sizable measure. The central government is the indirect beneficiary of such excellent performance of the OMCs. Thus, their claim of loss due to continued artificial "under recoveries" needs to be addressed properly by the authorities concerned or by the CAG.

The foregoing details would show that the Petroleum Ministry and OMCs have been misleading the nation by exaggerating the 'under-recoveries' in support of their proposals for price rise. Recklessness in raising the prices of petroleum products has contributed much to the price rise across the board of all commodities – a rise in the price of diesel leading to rise in transport costs and production costs of various consumable products, all of which leading to demand for higher wages and salaries as well.

Transparency is lacking in the claims of OMCs and in the support extended by the Oil Ministry, particularly in import of crude, import of petroleum products, calculation of the IPP and EPP, justification of the additional cost on account of exchange rate fluctuation, etc. In this regard, it is worth taking note of the advice given by the World Bank, in its article entitled "Government response to oil price volatility – Experience of 49 Developing Countries", by Masami Kojima, published in www.worldbank.org:

"Transparency in pricing helps create a level playing field and can indicate whether prevailing prices are broadly reasonable…… Other means of enhancing transparency include conducting price surveys and posting the results,

publishing graphs of domestic and international fuel prices for comparison, making historical and current prices public and readily available through the internet and other media, and disclosing on a regular basis the price build up for each key petroleum product (including application of rules for price determination where prices are set by the government)".

In the past, the first major policy shift in pricing of petroleum products occurred in 1976, when the government replaced the IPP of the 1960s with cost-plus pricing. This came to be known as Administered Pricing Mechanism (APM), which was applied to the entire oil sector. The objective of the government was to shield the Indian economy from the high and volatile oil prices generated by the first Oil Shock in 1973-74[3]. Now that the Indian economy is on an inflationary mode, it is worthwhile to re-consider a change from the present system of un-controlled pricing mechanism to the erstwhile Administered Pricing Mechanism (APM) as in 1976. Of course, based on our experience, there could be a proper built-in system to ensure that there is no undue hardship to the OMCs or to the Oil Companies, based on support from the central government out of the Price Stabilization Fund and also proper adjustment in the taxation policy, besides having the oil refineries share a part of the subsidy burden. The revenues of the central exchequer and the surplus available in the form of profits of both Oil Companies and OMCs could always support such a public welfare-oriented system, these companies being part of the government. Protection of their profitability alone should not be the motto of the oil pricing policy. Similarly, we cannot ignore the huge accrual of tax revenue to the exchequer while considering such policy change and extending subsidy to sections of the public on the price of diesel, PDS kerosene and domestic LPGs. According to data on the PPAC website, the subsidy on PDS kerosene and domestic LPG during 2006-7 was only Rs.2,524 cr, in 2007-8 Rs.2,641 cr, in 2008-9 Rs.2,688 cr, in 2009-10, during 2010-11 it was only 2,904 cr. When the cost benefit in ratio the form of the huge tax and other revenues accrued to the central exchequer is considered such relatively small outlay for subsidy to the consumers of kerosene and LPG should not be a matter of worry for the Central government.

3 Extract from **Overview of Government Policy on Pricing of Petroleum Products -** Rangarajan Committee Report, as placed in website of …

In conclusion, the Central government will do well to have a re-look at its oil pricing policy, particularly in view of its adverse impact on the inflationary trend and to consider the option of a return to the Administered Pricing Policy as obtained in 1976; however, while doing so, the government would need to ensure that the revised policy does not harm the oil companies. Adequate measures may be designed as part of the operation of the Price Stabilization Fund by utilizing the cess amount already accumulated, a sizeable contribution from the refineries and/or by issuing Oil Bonds. Cost plus method of arriving at the refinery gate price is bound to induce competition among oil companies in their crude procurement, and lead to increase of the oil refinery margin by process improvement, cost cutting etc. Average FOB price of crude import could also be allowed to be adopted for the indigenous production of crude without adding any significant cost. Such adoption would give them the needed cushion in increasing their refining margin. Considering the rise in crude price in the international market and to prevent the adverse effect of such rise on our economy, the tax on petroleum products and crude must be levied at specific rate only to remove the windfall gain of tax revenue to the central exchequer. Similarly, the states should also be advised to switch over to specific rates for taxation of petroleum products. As has been suggested in the World Bank review, the oil companies and the Oil Ministry must be much more transparent in disseminating the needed information by placing them in their websites and updating them periodically. Oil Ministry must also desist from the protectionist attitude favouring the oil companies and should work with the Department of Economic Affairs, Ministry of Finance in handling the pricing of petroleum products so as to ensure that its actions are not contributing to the rising inflationary trend. Clear policy and procedure must be evolved in handling the import of crude through participation in spot markets by the refineries and such action must be closely monitored by the Oil Ministry, Finance Ministry and also by the CAG, as huge foreign exchange outlays are involved in such transactions.

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