

The background of the entire page is a large, stylized flame graphic. It is composed of several overlapping, curved shapes in shades of orange, yellow, and light pink, creating a sense of movement and heat. The flame is positioned on the right side of the page, with its base near the bottom right corner.

# **MOTOR FUEL SURROGATES: HOW DO WE BEAT THEM?**

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# SUMMARY

- The circulation of low-quality products (surrogates) in the markets for motor fuels is a problem big enough to require a solution. **In 2017, at least 0.9 million tons of low-quality substitutes for gasoline (almost 3% of the total demand for gasoline) and 8.9 million tons of low-quality substitutes for diesel fuel (almost 25% of the total demand for diesel) were in circulation on the Russian market.**
- Surrogate production is concentrated in refineries that are either inadequately equipped or even completely unequipped to carry out the secondary petroleum refining processes necessary for the production of a quality product. **In 2017, the losses sustained by the government and by fair-minded business (not only in the bulk, but also in the small-scale wholesale and retail segments), due to the turnover of surrogate fuels, amounted to 69.7 and 16.4 billion roubles respectively.**
- Surrogate production is concentrated in refineries that are either inadequately equipped or even completely unequipped to carry out the secondary petroleum refining processes necessary for the production of a quality product. **The efficiency of surrogate production at these enterprises is based on the indirect subsidy that Russian refineries receive due to the difference in duties on oil and petroleum products, and on the removal of surrogate fuels (or their components) from the burden of excise taxes.**
- High demand for surrogate diesel fuel is supported due to the fact that in Russia the fleet of vehicles, agricultural and other off-road vehicles equipped with diesel engines is largely equipped with outdated models. **Around one half of Russia's truck fleets meet the Euro 2 emissions standard, and almost 70% of agricultural machinery is over 10 years old. The engines in these vehicles do not need to run on the higher environmental classes of diesel fuel** specified for circulation on the domestic market in the Technical Regulations of the Customs Union (at present, this is only diesel fuel K5). **And in so far as surrogate fuels can be 10–20% cheaper than those specified, it is above all price which drives consumer choice.**
- **Selling surrogate fuel at filling stations is a more profitable business than retailing regulated fuel,** which in itself guarantees the presence of surrogates at the filling stations of independent retail market operators. Moreover, **trading with surrogates is often the only opportunity for independent filling stations to survive.** Such situations arose, in particular, in 2018, when the government put pressure on retail prices in an attempt to prevent fuel prices becoming too expensive for the population. In contrast to vertically integrated petroleum companies, independent operators do not have sources of funds to cover the losses they sustain

when retailing standard fuels and look to trading in surrogates as a means to that end.

- Until now, the measures taken by the state to combat surrogate fuels head on have more or less been restricted to adjustments to the Tax Code, in an attempt to impose excise taxes on all possible types of surrogates and/or their components and in so doing to make their production unprofitable. These **efforts have turned out to be ineffective, since on each and every occasion, surrogate producers have found a way to extricate their products from the taxes.**
- The state has also acted in recent years to reduce the duty on the subsidies paid to those refineries carrying out the simple oil refining (these refineries are also surrogate producers), in order to make their activities unprofitable. However, the tax reforms that were meant to contribute to this objective (the most notable of which was the introduction of a 100% duty on fuel oil) **also failed, due to the regulator's incorrect assessment of marginality in refineries carrying out simple refining.**
- The completion of the tax manoeuvre, which came into force on January 1, 2019, should completely deprive the vast majority of surrogate producers of rental subsidies by 2024. However, according to the calculations presented in the study, **this measure is unlikely to be very effective, since the surrogates (gasoline and diesel fuel) supplied to the domestic market from refineries deprived of subsidies will only reduce the total by some 0.6 million tons.** This is because the vast majority of these subsidy-deprived refineries will continue to generate positive margins by maintaining the practice of excise-free surrogate trade.
- **A solution to the problem could be the introduction of a direct excise tax on oil at the rate of 4 000 roubles/t, at the same time compensating only those refineries entitled to the repayment of excise tax, as provisioned in the completion of the tax manoeuvre.** This will increase the feedstock costs of the surrogate producing refineries to a level, at which they will be unable to withstand the price competition with refineries producing quality fuels.



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