Editorial

12 July, 2002
THE HINDU **BUSINESS LINE**

DoF proposals on long-term urea policy

Flaws in merit-based pricing

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FOR almost two years now, the Expenditure Reforms Commision-based group-wise uniform concession scheme has been at the centrestage. In his Budget speech for 2001-02, the Finance Minister had even announced the Government's decision to implement it with effect from April 1, 2001. The proposals by the Department of Fertiliser (DoF) (these are now with the GoM) have also been formulated within the framework of the ERC. The GoM too has been told not to deviate from this.

In a recent article "ERC/DoF proposals on uniform concession scheme: Putting cart before horse" (*Business Line*, June 25), I had stated that in the absence of a level-playing field for the producing units in terms of the 'uncontrollable' factors of cost, implementation of the scheme will lead to serious distortions within the industry. I had suggested that the scheme should be implemented only after achieving 'uniformity' in the cost of energy to plants under each group.

On the other hand, the Planning Commission has not given any reasons for rejecting the uniform group-wise concession scheme? Does it have any alternative? Will it adequately meet the requirements of a viable fertiliser policy? From media reports, it appears that the Commission is in favour of adopting a system of the so-called 'merit-based pricing' (reportedly, this view is also shared by Mr Ved Prakash Goyal who is a member of the GoM).

The concept of merit-based pricing involves encouraging production from low-cost units and discouraging production from high-cost units. Thus, unlike the existing dispensation under which production from 'all' units irrespective of the reasonable production cost is 'fully' covered at 100 per cent of the respective assessed/reassessed capacity, in the proposed system, the Government will pick up production only from the low-cost units.

Theoretically, the Government could invite bids from the manufacturers, determine the lowest price from among the various quotes and ask all of them to supply the full requirements at this price. However, this is not practical. The current total production capacity of about 20 million tonnes per annum comes from '32' plants whose retention prices vary widely. Now, if a low-cost unit offers to supply at, say, Rs 5,000 per tonne, it is 'unimaginable' to expect that all other units will supply at this price.

A more realistic option may be under which the Government decides a benchmark price, say, based on the import parity price (IMPP) of urea and covers production from all those units whose reasonable cost of supply is less than this price. This, however, presupposes that these units will be able to increase production beyond their respective assessed/reassessed capacity to compensate for the loss of supply from plants whose reasonable production is higher than the IMPP.

This option will inevitably lead to 'permanent' closure of the high-cost plants. The 'mandarins' in the Planning Commission have suggested a flat compensation for these plants to cover their essential fixed cost — wages and salaries, overheads and maintenance expenses, besides a reasonable return. Apart from serious doubts about the 'adequacy' of the compensation, one wonders whether, giving such dole to a unit 'not in production' will be politically feasible!

An alternative may be to restrict the production of high-cost units only to the level of normative capacity utilisation. However, considering the fact that under the policy package for seventh and eighth pricing recently approved by CCEA, the capacity utilisation norm has been fixed at fairly high level — 95 per cent for plants based on gas and 90 percent for plants on naphtha and fuel oil, this will involve substitution of production to a very limited extent. The GoM may not be impressed with the results of this exercise in terms of small savings in subsidy.

The idea of merit-based pricing has been floated with the two-fold objective of promoting a low-cost industry on the one hand and bringing about reduction in subsidy on the other. These objectives cannot be achieved by taking a policy decision based merely on the existing retention prices. We need to find out the root causes behind the high production cost of certain plants and low production cost of others.

An overriding reason for these differences is the huge differential in the cost of various feedstock. Currently, the cost of gas is $1.9-2.5 per million Btu as against much higher price of naphtha at $6.5-7.5 per million Btu. This indeed is the predominant reason for the significantly lower retention prices of plants based on gas than those of plants based on naphtha. The Government should endeavour to remove these differences instead of seeking closure of plants based on naphtha and fuel oil simply because, currently, these units are made to pay a high price for the feedstock. The concept of merit-based pricing will become meaningful only when all the units have access to feedstock/fuel at a uniform price. Until we reach that stage, all efficiently operated plants meeting the prescribed standards of physical performance should be given an opportunity to continue in production. This is important as once the feedstock handicap is removed, even the plants on naphtha and fuel oil will have production cost lower than the IMPP.

Let us now turn attention to the farmers. The ERC had recommended an increase of 7 per cent per annum in the selling price of urea, beginning 2001, leading to complete decontrol in 2006. It also proposed that for purchase of quantities up to 80 kg, the farmers will continue to pay the original price — prior to 2001 or Rs 4,600 per tonne. The differential would be taken care by issue of subsidy coupon.

The ERC prescription rests on the premise that foodgrains production resulting from application of 80 kg of urea (together with the target dose of other fertilisers) will be enough to meet the requirement of a family of 'four' at the subsistence level. And, since, increase in fertiliser use beyond this level will result in incremental/surplus food for sale in the market place, this need not be subsidised.

In view of the above, the Government will be able to restrict the benefit of subsidy to the poor farmers only without having to really identify them. This sounds great! We should however, not be oblivious of the serious difficulties in implementation.

The GoI will have to make arrangements for printing, processing/handling, transporting and distributing millions of coupons to cover all the cultivating households.

Arrangements will also have to be made for exchange of these coupons for cash. Normally, one would expect that the seller/dealer accepts the coupons from the farmers. In case however, the former refuses to cooperate and insists on payment of the entire amount in cash, then, the onus of converting the coupons into cash will be on the latter. This would lead to even greater problems for the farmers. The cost of feedstock is a major component of the production cost of fertilizers. After the dismantling of the administered pricing mechanism for petroleum products from April 1, the prices of feedstock and fuel (sans gas) are linked to their respective import parity price (IMPP). These prices are prone to wide fluctuations and are being revised at least once in a fortnight.

Against this backdrop, and ERC recommendation for passing on the impact of increase in IMPP of feedstock to the farmer "once in every season", fresh coupon for the incremental amount will have to be issued to protect the in-quota sale up to 80 kg. The Government will have to gear up to this monumental task at least twice in a year. From 2006 onwards, when, the price will be market-driven, this exercise will have to be repeated as and when the IMPP increases.

The scheme is not intended for the rich/better off farmers, but they will get the benefit as every farmer is entitled to 80 kg at the subsidised price. Moreover, it is not difficult for them to corner bulk of the coupons meant for the poor. Even those poor farmers who actually have access to coupon/cash may use it for purposes other than buying fertilisers. The very objective of targeting subsidy will be defeated. To get an idea of the likely results of introducing a scheme of targeting subsidy, let us look at the following. In August, 1991, when, the GoI had increased the selling price of all fertilisers (except ammonium sulphate, CAN and ammonium chloride which were decontrolled in July, 1991), it exempted the small and marginal farmers from the hike.

sThe Centre gave Rs 400 crore to the State governments for subsidising the target farmers to the extent of the price differential. In reply to question in Parliament, the Government admitted that only 3.5 per cent of the target farmers benefited!

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