Editorial

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Urea: Proposed uniform pricing scheme

Ensure parity in feedstock prices, first

Uttam Gupta

AFTER the Government announced — in the 2001-02 Budget — its decision to replace the existing unit-wise retention pricing scheme (RPS) for urea by a scheme of group-wise uniform concessions and determination of concession rates on the basis of prevailing import parity prices (IMPP) of respective feedstock, consultations have been going on at the inter-ministerial level as well as with other stakeholders — oil PSUs, fertiliser manufacturers, and others — to evolve appropriate strategies and arrangements for ensuring supply of feedstock at 'low' and 'uniform' IMPP-based prices.

Irrespective of the underlying policy dispensation — the administered pricing regime (APR) until end August 1997 or price fixation on the basis of prevailing IMPP thereafter — the prices of all liquid hydrocarbons — naphtha, fuel oil and LSHS — have been maintained at prohibitive levels all through the 1990s. Whereas, before September 1997 (when the IMPP-based regime was introduced), prices used to be fixed through an administrative order issued by the Government, thereafter, under the so-called market-based regime, there has been lack of transparency in their determination by the oil companies. A close look will reveal several anomalies in fixation of ex-refinery prices.

At the outset, it is important to note that instead of taking the f.o.b. price minus port charges which would be the realisation to oil companies if they were to export the feedstock, they adopt the import parity route for determination of the ex-refinery price. In other words, the price is arrived at by taking the CIF price plus a host of charges which include port charges, marketing margins, marketing cost, zonal movement charges, Customs duty and so on. While, there is need for a detailed study to unravel the extent of padding, the methodology as such suffers from certain flaws.

A glaring anomaly relates to inclusion of Customs duty on import of naphtha at 5 per cent on the CIF price. This is despite the fact that naphtha imported for use in production of fertiliser is fully exempt from levy of customs duty. The oil companies' argument that imported crude, which is used in the manufacture of naphtha, attracts Customs duty at 10 per cent, thereby leading to increase in production cost, is not valid. In the current approach of price fixation on the basis of the prevailing international price of the feedstock, any reference to the cost-plus basis of pricing is illogical.

The marketing margin is nothing but a euphemistic description of refineries' profits. Considering that in the IMPP approach to pricing, profit/returns from operations have to logically come out of the prevailing international price, there is no justification for making a separate provision for this. Inclusion of profit margin or Customs duty, which could be justified only under the cost of production approach (followed under the erstwhile APR until end-August 1997), is merely an attempt to artificially jack up the price taking advantage of the utter lack of transparency in these exercises.

The oil companies also load on to the price what is termed as 'zonal movement charges', ostensibly to take care of the additional cost of transportation consequent to change in the source of supply (this is often necessitated by inadequate availability of the material at the refinery to which the unit is linked). Ensuring adequate and uninterrupted supply of feedstock as per the Agreement is the responsibility of the oil companies. Consequently, additional cost contingent on shuffling of the refinery source, if any, should logically be borne by them. An attempt to pass it on to the hapless consumers by using sophisticated nomenclature is patently unjustified.

If, the above mentioned charges — Customs duty, marketing margins and zonal movement charges — are excluded, and other components such as port handling charges and marketing costs 'realistically' determined, this will result in substantial reduction in the price of feedstock over the levels currently charged by oil companies.

> Consultations are on at the inter-ministerial level as well as with other stakeholders — oil PSUs, fertiliser manufacturers, and others — to evolve strategies to ensure feedstock supply at 'low' and 'uniform' import parity prices to urea manufacturers, as the basis for putting in place a group-wise uniform concession scheme, replacing the retention pricing scheme. But there are several anomalies in the price fixing method adopted.

In this context, a broad calculation reveals that for a plant located in Gujarat, if the manufacturer were to undertake direct import of naphtha, the cost of such supplies at the factory gate would be about Rs 3,500-4,000 per tonne lower than the corresponding cost of procuring it from domestic refineries (this includes savings in sales tax which is not levied on supplies from imports).

Another problem in the context of implementation of the policy changes announced in the Budget arises from the wide variation in the cost of feedstock to various plants depending on their location. These variations are caused primarily by differences in ex-refinery prices and the differential effect of freight and local taxes — mainly sales tax. The difference between the minimum and the maximum price of naphtha can be as high as about Rs 2,500 per tonne.

In regard to the ex-refinery price, prior to April 1999, these were fixed on a uniform basis, irrespective of whether the supplies were from port location or an inland refinery. The change-over to differential pricing may have been prompted by the introduction of pricing on IMPP basis which essentially implies benchmarking of ex-refinery price to the cost of imports.

While, under this approach, it may sound logical to load the cost of transport from port to the inland location, the argument cuts both ways — that is, if exports were to be made from an inland refinery, then, the realisation will be lower by the same amount! On balance, therefore, it is only fair that the oil companies revert to the earlier practice of fixing ex- refinery price on a uniform basis.

In regard to freight, on the basis of a rational supply plan covering supplies to all fertiliser units and taking into account the optimum inter-modal mix as well as the average lead of movement, this can be worked out on an equated basis. In fact, under the RPS for urea, such a dispensation is already in vogue, under which freight cost is reimbursed on a uniform basis taking into account quantities dispatched to various destinations, optimum rail-road mix and average lead.

In regard to sales tax, it may be recalled that at the Chief Ministers' conference in New Delhi in early 2000, the State governments had agreed to re-structure their respective sales tax regimes to achieve uniformity in the sales tax rates for various commodities, including fertilisers and various raw materials including feedstock used in their production. Despite this, differential rates persist, with some States maintaining very high rates; for instance, in Gujarat, sales tax at 20 per cent continues to be charged on naphtha, in sharp contrast to a low of 4 per cent in Karnataka.

Reportedly, the Government has exhorted fertiliser manufacturers to enter into purchase arrangements/agreements with oil companies in such a manner that on feedstock supplies from domestic refineries, they are required to pay only 4 per cent CST.

This is impractical as the benefit of lower CST can be availed of only when the sale is made on inter-State basis, which does not make sense for a unit sourcing supplies from a refinery located in its home State. Any attempt to somehow show these supplies as inter-State transaction in a bid to circumvent higher local tax is bound to be resisted by the State government concerned. Besides, this could also lead to legal complications.

Instead of putting the onus of procuring all supplies — irrespective of the source — at a uniform sales tax of 4 per cent on the manufacturers, which opens up a Pandoras Box, the Government should vigorously pursue with the State governments the urgent need to honour their commitment by introducing uniform sales tax on all feedstock — naphtha, fuel oil, LSHS and gas — at a rate which equals the current CST of 4 per cent. Needless to say, that harmonisation of the sales tax with CST is also an essential requirement for facilitating the smooth transition towards the system of VAT which the Central and State governments have agreed to put in place by April 2002

Implementation of the above measures would help generate a level playing field for manufacturing units under each of the five groups — pre-1992 gas-based plants; post-1992 gas- based plants; naphtha-based plants; plants based on fuel oil; and plants based on mixed feedstock, for which uniform concession has been recommended by the ERC.

In such a scenario, it would be quite fair and logical to test individual units for their cost competitiveness on the strength of their respective efficiency in operations. In case, however, no credible effort is made to remove/minimise the differences and yet the ERC package or any other form of uniform pricing is implemented, this will only lead to fortuitous gains for some units and loss for others unrelated to efficiency in operations.

Recently, the Government constituted a Group of Ministers (GOM) under the Chairmanship of the Finance Minister to finalise the new fertiliser policy. The fact that this has followed the Budget announcement of its decision to implement the ERC-based uniform concession scheme in replacement of the RPS is indicative of a change of the official mindset.

It would appear that the adverse consequences of implementing a uniform pricing scheme 'immediately' disregarding the ground realities are beginning to agitate the minds of the policy-makers. This is also evident from a recent statement of the Minister for Chemicals and Fertilisers — a member of the GOM — expressing his discomfiture over the concept of uniform pricing.

The recommendations of the GOM in regard to the new fertiliser policy will be known only at the start of the monsoon session of Parliament when it has been asked to submit its report. It is, however, hoped that this time the Government will not act in haste (unlike at the time of presenting the Budget, when far-reaching changes were announced without carefully evaluating the consequences and despite protests from several State governments on the ERC recommendation) and refrain from introducing a scheme of uniform pricing until such time a semblance of uniformity is achieved in respect of the major factors impinging on production cost.

(The author is Chief Economist, Fertiliser Association of India. The views expressed are personal.)