FERTILISER PRICING

# Time to scrap the archaic scheme

*The present fertiliser subsidy system is doing no good to farmers or agriculture, as the huge sums forked out by the tax-payer for subsidy payments are cornered by fertiliser producers, input suppliers and others in the supply chain. The Government should dismantle the system, and soon, says* **UTTAM GUPTA**.

A few weeks back, the Fertiliser Association of India (FAI), an umbrella organisation of all fertiliser manufacturers, published an appeal to the Prime Minister to save the industry from turning sick and in turn, ensure food security.

The key issue raised was that in Budget 2007-08, the Finance Minister had provided for an allocation of only Rs 20,000 crore for fertiliser subsidy payments, against a requirement of around Rs 50,000 crore.

The problem is not new. It has long troubled the sector; only, the scale has increased. What is its genesis? Under a scheme of administered pricing — known as retention price scheme (RPS) until 2003 and group pricing scheme (GPS) thereafter — the Government reimburses to the producer the excess of his production cost over the selling price, which is controlled.

How much should be paid to the producer? To determine this, the Government adopts a formula — put in place nearly three decades ago — which is unique to the fertiliser industry.

Under the RPS/GPS, each producer is paid a price/subsidy "specific" to it, even as all farmers/users, irrespective of their location, pay a uniform price. There are adjustment factors — again unit-specific — to reflect the changes in various components of the cost.

Fertiliser production is an energy-intensive operation. Over the years, the energy price has zoomed. Other components of production cost — capital cost, overheads, etc., — have also increased, though not as much as oil. However, the selling price of fertiliser has moved at a niggardly pace.

Naturally, the gap between production cost and selling price has progressively widened, leading to corresponding increase in subsidy payments. The Finance Minister thinks the subsidy can be reined in merely by reducing the allocation. This is "wishful thinking".

The subsidy can never be reined in unless the root cause is addressed. Ironically, the RPS/GPS system is completely out of alignment with market forces. While the entire economy is in reform mode, the fertiliser sector is stuck with an "archaic" system.

### NO INCENTIVE TO CUT COSTS

In a market-driven system, the moment a company is faced with any development that has the effect of increasing its production cost, the entire team is put on alert to work out strategies and plans to combat it. But, under the RPS/GPS, all a company has to do is to prepare a revised cost-sheet that captures the impact of this development on production cost and submit it to the Government for additional subsidy reimbursements.

There is no pressure on it to move into alert mode. The system may have checks to ensure that only "unavoidable" cost increases are allowed. But how does the pricing authority decide what is unavoidable and what is not? Subjectivity is bound to creep in while taking decisions!

Why should the cost increase be reimbursed at all? A standard answer is that producers cannot increase their selling price. Are we saying that in sectors where the price is not under control, the producer is able to charge more from consumers each time he faces a cost increase?!

There may be companies which — despite the protective umbrella of RPS/GPS — would like to take cost reduction initiatives. For instance, a company may like to switch from naphtha (a prohibitively priced feedstock) to gas, which is cheaper. The system gives them no incentive for this!

This is because, after the switchover, its subsidy entitlement will be correspondingly reduced to reflect the lower cost of gas. The manufacturer could even be a net loser, as the pricing authority might not fully cover its investment in equipment/machinery to enable the switchover.

A high-input-cost environment is inherently beneficial to fertiliser manufacturers. The reimbursement of input cost is arrived at by multiplying the factory-gate cost with the specified norm for the relevant input — say, 'X' tonnes of naphtha needed for producing a tonne of urea. If the actual usage of naphtha is less by ?X, then any increase in its price by, say, ?Y will generate a bonus for the producer equal to (?X)(?Y). In recent times, naphtha prices have zoomed (thanks to the steep increase in crude prices); this would have meant a corresponding gain to concerned producers that could run into hundreds of crores!

Several committees set up during the last decade and a half have pronounced that naphtha and fuel-oil-based plants in India are high-cost, inefficient routes to fertiliser production and, therefore, must be disbanded. Yet, these survive under the GPS/RPS, benefiting the producers at the cost of the exchequer.


### WRONG SIGNALS

Committees after The existing system gives a wrong signal to all those supplying inputs/raw materials/intermediates/feedstock to the fertiliser producers. The former take advantage of the fact that whatever increase in price they seek from the latter will get compensated under the RPS/GPS.

In recent times, the price of phos acid and ammonia — imported by Indian industry for production of phosphate fertilisers — have skyrocketed. Some of us might argue that this is due to global cartel or tightening demand-supply. However, the role of above factor cannot be wished away!

Competition among producers — badly needed to drive down cost — is completely missing. This is because each one of them is required to sell at the same price and they are all enabled to recover their cost in full, irrespective of the level.

At present, 50 per cent of urea sales are under distribution controls. When, producers are allotted quotas on how much to sell and where, they need not look for strategies to increase/maintain their market shares. Sometime back, the Minister for Fertilisers even hinted at bringing all urea sales under control!

For years, the urea price has stagnated, despite rising costs. Hence, there is no pressure on farmers to optimise its use. In fact, they have resorted to excessive use of urea — because of too much subsidy — leading to imbalance in nutrient use and resultant adverse effect on the soil and the environment.

### REMOVE CONTROLS

Due to the subsidy regime, the farmers are unable to look for innovative ideas to raise their crop yield. For instance, there is huge loss of crop due to pests and disease. This can be substantially minimised by use of modern crop protection technologies (at present, only 20 per cent of cultivated area is under the crop protection umbrella).

The treatment of seeds can help in better germination and higher plant population. The Government has launched a 100 per cent seed treatment Campaign during Kharif 2007. Adequate funding of programmes such as this to make them successful will do greater good to farmers than subsidy.

The present system is doing no good to farmers and agriculture even as the tax-payer is doling out huge sums for subsidy payments that are cornered by fertiliser producers, input suppliers and others in the supply chain. The Government should scrap it sooner than later.

It must remove all controls on fertilisers — both price and distribution — and dismantle the subsidy scheme. The Government may, however, pay subsidy directly to the poorer farmers (ERC had recommended this in 2000). The amount can be credited electronically to the account of farmers holding a Kisan Credit Card.

This will force all stakeholders to change gears and get in to the right action mode. Producers who perform better (by restructuring/revamp, striking good deals for feedstock price or expanding capacity at lower cost) will be rewarded. Others will fall by the wayside.

Given the uncertainty of how new investment will be treated under pricing, there has hardly been any addition to fertiliser production capacity during the last decade or so. With decontrol, and certainty of the policy environment, substantial augmentation of capacity can be expected.

The supply scenario for gas (most preferred feedstock) is promising. By 2009, Reliance gas alone would have led to doubling of the current production. Fertiliser industry can benefit if only it is unshackled from the current policy uncertainty.

The decontrol scenario will give a big push to R&D in the fertiliser industry (this is completely missing now) and enable supply of new technologies/solution (for instance, urea impregnated with micronutrients) to the farmers. The benefits in terms of yield increase and better quality produce can be immense.

With fertilisers no longer artificially priced, farmers will focus more on optimising their use. Even so, the impact of decontrol on farmer's cost of cultivation is not so serious as is often made out. The share of fertiliser being only about 15-20 per cent, even doubling of its price will increase cultivation cost by 15-20 per cent. The impact is modest and must not deter policy-makers.

Since the reform process started over 15 years ago, the Government has liberated sector after sector from the clutches of control. Now, it has garnered the political will to do the same in sugar. It should strike at fertilisers next.

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