

Making NFL privatisation work

UTTAM GUPTA

FOLLOWING the lukewarm response to the Government offer for divestment of 51 per cent of its equity holding in the National Fertilisers Limited (NFL) the Union Minister for Chemicals and Fertilisers, Mr S. S. Dhindsa, has reportedly renewed his demand for postponement of the divestment process in NFL. His arguments are:

- A time-frame of two years is needed to assess the full impact of the New Pricing Scheme (NPS) for urea on the viability of the plants operated by NFL.

- There is a possibility of the private operator taking some drastic steps in regard to the three fuel-oil-based plants — Nangal, Bhatinda and Panipat.

- The anticipated global demand-supply situation does not warrant the Government relinquishing control over strategic plants in the NFL fold.

How new pricing regime works

The Government controls the selling price of urea at a low level unrelated to the cost of production. Until March 31, 2003, the manufacturers were compensated for the excess of the latter over the former under the Retention Price Scheme (RPS) on a unit-specific basis.

From April 1, 2003, under the NPS, a weighted average approach is adopted for determining the reimbursements. There are six groups: pre-1992 gas, post-1992 gas, pre-1992 naphtha, post-1992 naphtha, fuel oil/LSHS and mixed feed. Within each group, the weighted average retention price for all the units put together will be computed. Units whose

RP is higher or lower than the weighted average by 20 per cent are treated as outliers. The weighted average (WA) price is re-computed after excluding outliers. Subsequently all units in a group will get either the WA or their original retention price, whichever is lower.

An outlier on the higher side will get WA plus a special allowance equal to 50 per cent of the difference between its RP and WA. This allowance is available only in Stage I — from April 1, 2003 to March 31, 2004.

How NFL units stack up

To understand how NFL will be affected, one needs to know which groups its plants are positioned and how do their RP compare with the WA of the respective group. Vijapur I (Madhya Pradesh) is pre-1992 gas; Vijapur II in post-1992 gas and remaining three plants i.e., Nangal (Punjab), Panipat (Haryana) and Bhatinda (Punjab) are in fuel oil/LSHS.

The RP of Vijapur I is higher than WA of its group. Vijapur I will get lower WA and thus suffer loss.

The RP of Vijapur II is lower than the WA of its group. Being an expansion unit, it entails lower investment cost than a majority of other grass-roots plants in the group. Still, it will not gain as it gets a lower RP.

In the fuel oil/LSHS group, the three NFL plants sit in the company of GNFC, Bharuch; NLC, Neyveli; and FCI, Sindri. Of these, NLC, Neyveli is an outlier on the higher side

and GNFC Bharuch an outlier on the lower side. Therefore, WA is computed by taking RP of three plants of NFL and Sindri.

The RPs of Panipat and Sindri are significantly lower than those of Nangal and Bhatinda. While, Bhatinda and Nangal will get the lower WAs, Panipat will get a lower RP.

Under the NPS thus, while Vijapur I, Nangal and Bhatinda will lose, there will be no gain for Vijapur II and Panipat. On the whole, NFL will suffer a substantial loss in Stage I — that is, 2003-04.

In Stage II — April 1, 2004 to March 31, 2006 — the Government proposes to reduce the concession on account of tightening of the energy consumption norms besides reducing capital related charges (CRC). The conversion cost will remain frozen at the level of Stage I.

Vijapur I and Vijapur II will be affected by reduction in the CRC. On the other hand, tightening of energy consumption norms will affect all the

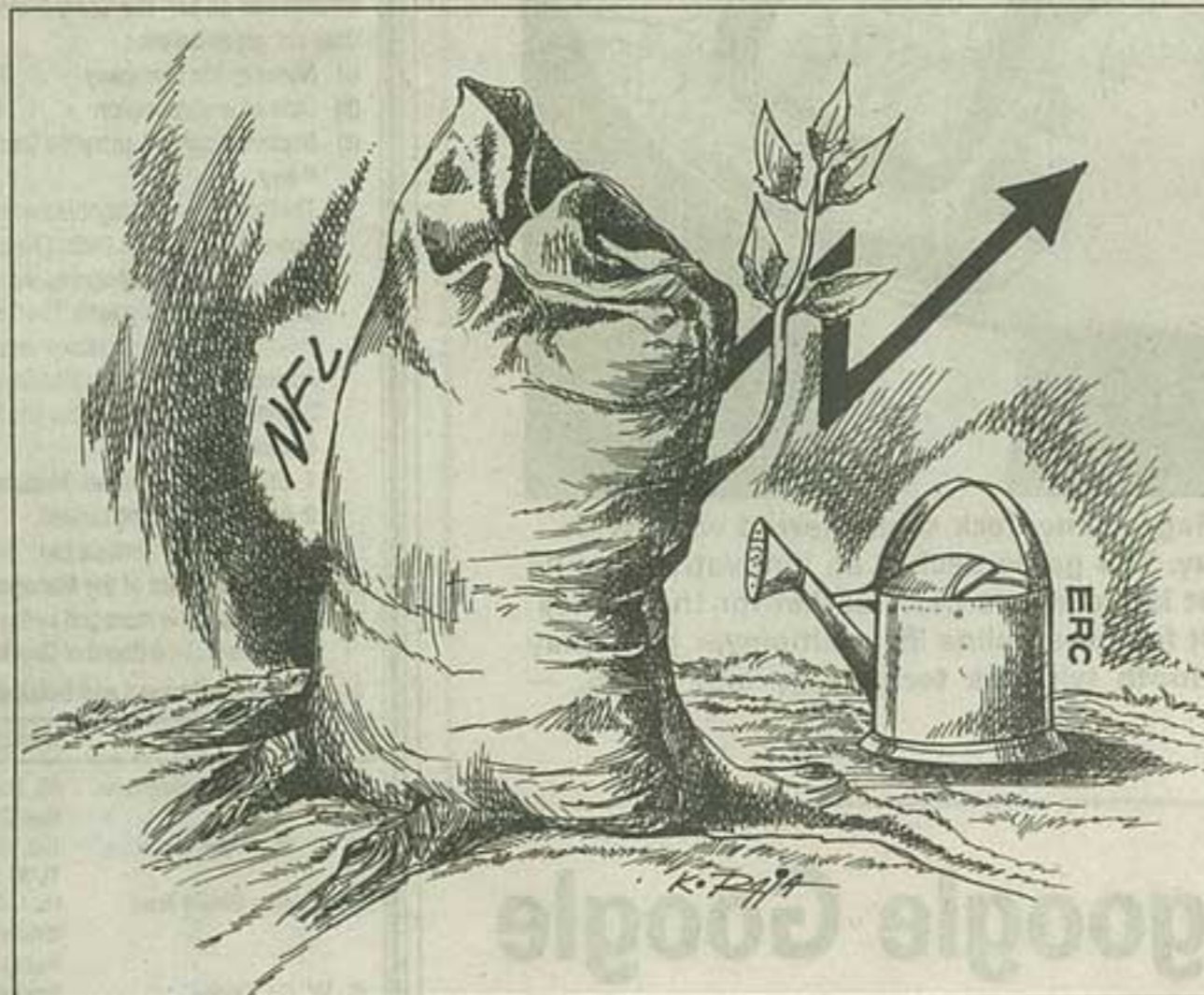
foreseeable future. Besides, we can source supplies from joint ventures (JV) in countries where feedstock is available in plenty and cheap.

Instead of letting politics dictate the fate of NFL privatisation, the Government should address the fundamental issue of why the response was lukewarm and what can be done to get a better response next time and improve the price realisations.

Repairing the flaws

Under the NPS, the very approach of taking the weighted average or the actual, whichever is lower, for determining the concession is flawed. The underlying premise of taking an average is to give incentive to a low cost unit. This is defeated if its realisation is pegged at its lower production cost, which the NPS seeks to do.

The above results in an anomalous situation. While Vijapur I, Nangal and Bhatinda, whose RP is higher than the WA, incur loss, Vijapur II and Panipat, whose RP is lower, are denied the opportunity of benefiting



five plants. The units will also be affected on account of freezing the conversion cost, which is prone to increase in an inflationary situation. On the whole, NFL's losses will be aggravated in Stage II.

Immediate impact

In view of the above, one does not really have to wait for two years to know what the impact of the new policy will be. For the current year and the next two years, the impact is crystal clear and is known right now.

As regards apprehensions about what the bidder will do to the three plants based on fuel oil/LSHS (after acquiring majority stake), one has to proceed on plain economic logic. If NPS renders plant operations unviable, how can the acquirer continue production? By the same logic, how could the Government behave differently?

A related argument that the closure of these three plants would lead to a shortage situation does not cut ice. The International Fertiliser Industry Association (IFA) — based in Paris — projects a fairly comfortable global demand supply situation in the

from higher WA. If the principle of taking the WA were to be applied uniformly, irrespective of the RP levels, the overall financial position of NFL would have been better.

In Stage I, the very act of taking a weighted average involves averaging of the unit-specific energy consumption norms (applicable to eighth pricing period). This means that a plant whose eighth pricing norm is higher, takes a beating by being pegged to the implicit weighted average energy norm. Against this backdrop, a further reduction in Stage II is unwarranted.

The reduction in CRC for a plant such as Vijapur I is unjustified. Commissioned way back in 1988, the plant has been in operation for 15 years. To remain healthy, it will have to incur capital expenditure. While this would require increase in CRC, the Government has reduced it. Freezing of conversion cost — and, that too, at the 1999-2000 level — in an inflationary situation is illogical.

The new policy provides for partial decontrol of urea in Stage I (25 per cent during kharif 2003 and 50 per cent during rabi 2003-04). On the

decontrolled quantities, however, the Government has reduced freight by Rs 100 per tonne. This is ad hoc and arbitrary.

Making NFL attractive

To meet the challenges under the NPS' particularly tight energy norms, NFL needs money. On finalisation of policy parameters under seventh and eighth pricing, it received about Rs 400 crore as dues for the past period. However, the Government mopped up a substantial portion of this amount by way of special dividend!

As formulator of the fertiliser policy as well as the owner of NFL, the Government should endeavour to remove the above deficiencies and anomalies. However, this by itself will fail to generate the desired interest among investors. For this to happen, they need to be told — right now — what the policy environment will be like beyond the end of Stage II — that is, by March 31, 2006.

In this context, it may be pertinent to note that the Expenditure Reforms Commission (ERC) had recommended complete decontrol of urea from April 1, 2006 and wanted all domestic gas-based plants to maintain their production cost within the overall ceiling set by the import parity price (IMPP).

For plants based on imported LNG (liquefied natural gas), it recommended a FDCR (feedstock differential cost reimbursement) of Rs 1,900 per tonne. The ERC proposal for FDCR was based on the assumption that imported LNG will be costlier than domestic gas. However, from the emerging trends, it appears that the prices of gas from the two sources will converge.

A probable scenario is, therefore, one in which all domestic plants are expected to survive at the projected IMPP of urea. Therefore, the prospects of NFL should be assessed in this scenario. While Vijapur I and Vijapur II (both based on gas) will be comfortably placed, the remaining three plants based on fuel oil/LSHS could face difficulties. They have no option but to switch over to gas if they are to remain competitive in a decontrolled environment.

While this will require substantial investment in the switchover, the resultant gains would more than offset the extra CRC (particularly in view of prevailing low interest rates). The Government should initiate work on the necessary schemes immediately.

Concurrently, efforts should be made to ensure that gas reaches these plants by the time the switchover is completed.

In a nutshell, if the Government can take the following steps — remove the anomalies in the NPS; announce complete decontrol of urea from April 1, 2006; undertake restructuring of the three fuel oil/LSHS based plants for switchover to gas; and facilitate putting gas — domestic gas or LNG — on tap by 2006, it will be able to fetch a very good price from the sale of its equity in NFL.

(The author, an economist, is an expert on fertiliser policy. Feedback may be sent to uttamgupta2003@yahoo.co.in)