

Naphtha deregulation move — I

Who is subsidising whom?

GIVEN the widespread and substantial use of naphtha in the fertiliser industry, its pricing and supply are bound to have far-reaching effects on the operations and the cost-competitiveness of the industry. About 27 per cent of the urea production capacity, which translates to about 4 million tonnes, is based on the use of naphtha as basic feedstock. Significant quantities of naphtha are also used in the manufacture of ammonia that goes into the making of complex phosphatic fertilisers, including DAP. More recently, as a result of the unilateral curtailment in the supply of natural gas, plants based on this feedstock have been forced to use naphtha for steam generation and captive power facilities. The majority of the plants being old and depreciated, and considering the predominance of the feedstock cost, the planned decontrol of naphtha assumes significance.

Under the existing administered pricing arrangements for various hydrocarbon feedstocks (this excludes natural gas which is priced independently) the fertiliser industry is supplied at rates lower than those charged for other industries. While the ex-refinery price of naphtha for fertiliser units is Rs. 3,723 per tonne, it is Rs. 6,076 for the latter category.

Moreover, even on excise duty, a concessional rate of Rs. 5 per kilolitre is applicable on supplies to the fertiliser industry, whereas it was a high of Rs. 2,255 for other industries, until about three years ago. However, since 1992, it is being levied at 20 per cent *ad valorem*.

While the cost to individual plants, at the factory gate, will depend on the distance from the refinery, resultant freight and sales tax (varying among states), on an average, the concession to the fertiliser industry is about Rs. 4,500 per tonne.

It must clearly be understood that a lower price charged on supplies to the fertiliser industry is not a concession to the industry. This is because, in view of the control on the selling price of urea to the farmers at a lower level, the price charged for various inputs, including naphtha, gets adjusted in the fertiliser subsidy under the retention price scheme (RPS).

For complex phosphatic fertilisers, including DAP, this was the position until August 1992 when these were decontrolled. Even thereafter, low administered price of inputs must be viewed in the context of maintaining the selling price to farmers at low levels. In either case,

Even as substantial cuts in the supply of natural gas and its unrealistically high pricing are causing tremors in the fertiliser industry, the contemplated removal of pricing and distribution controls on naphtha has the potential to push the segment of the industry based on this feedstock to sickness. If the move comes off, even gas-based plants can be affected further. The Government must tread carefully and consider the implications before going ahead with the move, says Uttam Gupta.

the low price of naphtha is to subserve the overall macro-economic objective of either keeping the subsidy burden low, as in the case of urea, or the selling price to the farmers low in respect of complex phosphatic fertilisers.

It has been argued, in some quarters, that supplying naphtha at concessional rates to the fertiliser industry too involves subsidy. So, why not the government pay subsidy directly to the fertiliser units instead of routing this through the oil companies? But two critical points are missed in this argument.

First, why and, on what basis, can it be said that at Rs. 3,723 per tonne, the supplies to the fertiliser industry are subsidised? Is it simply because the oil companies are getting a much better price from non-fertiliser segments? This does not stand to reason. What other industries are paying represents their capacity or the willingness to pay which has no relationship to the cost of production. It may well be that at Rs. 6,076 per tonne (ex-refinery), the refineries are making super normal profits and that at Rs. 3,723 per tonne charged for the fertiliser industry, the cost to the refinery, including a profit margin, is fully covered.

So, where is the question of oil companies subsidising the fertiliser industry? The former are taking advantage of the lack of transparency on costing of POL products to unjustifiably build up a case for treating the present pricing to the latter as subsidy. Needless to say, they do so by choosing an artificial benchmark, that is, the price charged to non-fertiliser users.

Second, without prejudice to the above and assuming for a moment that concessional supply to the industry is, in fact, the so-called subsidy, it would be more economical, from the national angle, to give this at the input stage,

that is, through the oil companies. This is because there is no one-to-one relationship between the incremental revenue realisation contingent upon an increase in the naphtha price to the Government, as owners of oil companies, on the one hand, and additional subsidy having to be paid to the fertiliser manufacturers under the RPS, on the other.

The mismatch, in turn, arises in view of the fact that while the additional revenue is on the higher ex-refinery price, reimbursement to the fertiliser units under the RPS is on the basis of the increase in the landed cost at the factory gate which also includes the effect of sales tax and other local taxes levied *ad valorem*. Additionally, the subsidy increases further on account of the consequential higher cost of working capital due to the higher naphtha price.

On a net basis, thus, purely from the revenue angle, the exchequer would stand to lose if higher price is first allowed to the oil companies and, then, much higher subsidies on account of taxes and duties and working capital, is paid to the fertiliser industry.

Apart from the net drain on the exchequer, the industry too suffers a serious loss. This is because as and when the administered prices of inputs are raised, which enhanced rates the manufacturers start paying from the word go, the Government reimburses the additional cost under the RPS after substantial delays (for instance, compensation for the Gulf surcharge levied in October 1990 was paid after more than 18 months).

Already, during the 1990s, under the controlled dispensation, the price of naphtha has been raised steeply by about 100 per cent, leading, in turn, to higher subsidies on fertilisers on the one hand and increasing financial

problems for the manufacturers on the other. Deregulation of naphtha, which means removal of pricing and distribution controls, will make matters worse. The immediate impact will be the withdrawal, by the oil companies, of the concession on supplies to the fertiliser industry. This is imminent in view of the categorical recommendation of the Soundararajan Committee on Restructuring of the Hydrocarbon Sector and the endorsement of the same by the R-Group set up by the Ministry of Petroleum and Natural Gas.

At the prevailing rate, thus, the ex-refinery price applicable to the fertiliser plants will be Rs. 6,076 per tonne against the present Rs. 3,723. In this situation, even the excise authorities are likely to take a different view and will, in all probability, withdraw the concessional rate of excise duty, leading to substantial increases in the excise burden as well. At the existing rate, that is, 20 per cent *ad valorem* — the non-concessional rate — this alone would work out to about Rs. 12,000 per tonne. The burden of sales tax (levied on a percentage basis) will also multiply on account of both the increase in the basic price and in the excise duty.

For a plant located in Gujarat, where the sales tax is 18 per cent plus a surcharge of 25 per cent and even assuming nil freight (considering plant location next to the refinery), the unit will have to pay, on landed cost basis, an exorbitant Rs. 8,900 per tonne. This would mean a Rs. 4,400 per tonne increase over the existing corresponding concessional rate of about Rs. 4,500 per tonne. In other States, the sales tax may be lower, but that is likely to be offset by the higher transportation charges as also the further cascading effect on magnitude of the sales tax. Consequently, for those locations also, the resultant price increase will not be different.

On an average, about 0.6 tonne of naphtha is needed to produce a tonne of urea. On this basis, the increase in the naphtha price by about Rs. 4,400 per tonne would raise urea production cost by about Rs. 2,600 per tonne. On a total production of about 4 million tonnes, the consequential increase in the subsidy outgo will, thus, be about Rs. 1,050 crores.

(To be concluded)

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