

## Deregulation of urea sector

# Tackle inter-unit cost differences first

Before proceeding with the contemplated plan of phased deregulation of the urea segment of the fertiliser sector, the Government should make a serious effort to minimise the inter-plant variations in cost. And before that, the feedstock cost to all the units should be brought more or less on a par, says **Uttam Gupta**.

**T**HE GOVERNMENT is contemplating a long-term fertiliser policy involving phased deregulation of the urea sector. Under a three-phase action plan, it has mooted a modified normative retention price scheme (MNRPS) in the first phase; subsidy at uniform rate for all the units in the second, and total deregulation in the third.

The emphasis in all the three phases is on standardising various items of cost. In the first phase, even as unit-wise dispensation is proposed to be retained, it would appear that certain items of cost would be standardised.

In the second phase, a single price will be given to all the units, whereas, in the third, the price will be market-driven; the latter too, would be broadly uniform subject to small variations depending on freight and local taxes.

Considering the vital importance of the fertiliser industry in supplying essential plant nutrients for increasing production of foodgrains, serious implications of the contemplated move on its health and growth need to be carefully evaluated before taking a plunge. First, a look at the present dispensation — the unit-wise retention price scheme (RPS).

Under the RPS, the reasonable production cost is allowed on the basis of prescribed efficiency norms in regard to capacity utilisation and consumption of raw materials and utilities.

For instance, in respect of the ammonia plant — prime intermediate in the production of urea — the utilisation norm of 90 per cent of the assessed capacity is taken for gas-based plants in respect of production from the second to the tenth year; from the eleventh year onwards, this is 80 per cent. Likewise, norms are prescribed for consumption of inputs, including feedstock (for example, 'x' cubic metres of gas needed to produce a tonne of urea).

The above norms when applied to expenditure in various segments give the corresponding component in the overall production cost. For instance, the cost of servicing the capital — return, depreciation and interest (in Rs. crores) when divided by the normative production level will give its contribution (in Rs. per tonne).

Likewise, the delivered cost of the concerned input, that is, Rs. per cubic metre gas when multiplied by the norm in cubic metre will yield its contribution in Rs. per tonne. The system is, thus, a combination of norm and actuals; norm for efficiency, which is under the unit's control, and reasonable actual for investment/cost of input which is beyond.

Contrary to the impression in some quarters that the RPS is a cost-plus system, this is normative. In other words, if the unit operates below the prescribed efficiency norm, it would stand to loose whereas, if it does better than the norm, it would gain. Unfortunately,

in the euphoria over the so-called cost-plus, this fundamental point is often missed.

Even when production cost goes up due to an increase in the cost of input over which it has no control, often the industry is blamed. A quick analysis of the increase in the production cost of urea between 1980 and 1999 would reveal that it went up by a monumental Rs. 9,600 crores purely because of the hike in the price of various hydrocarbons — naphtha, natural gas, fuel oil/LSHS (while this calculation is based on basic/ex-refinery prices, taking into account the delivered cost at plant site which includes cascading effect of taxes/duties, the impact will be much more).

During this period, even as extra realisation from increase in selling price was about Rs. 3,300 crores, the uncovered gap of Rs. 6,300 crores got reflected in increased subsidy. It would be illogical and highly improper to attribute this to the alleged inefficiency or a bonanza to the industry.

A pertinent question is: Why is the delivered cost of inputs allowed on actual? This is because there are significant inter-plant variations in respect of feedstock, location, technology, and so on.

For instance, currently, the cost of feedstock to a naphtha-based plant at about Rs. 1,100 per million Kcal is more than double the cost to a gas-based plant along HBJ pipeline at about Rs. 500 per million Kcal. Even within any given feedstock category, differences arise due to local taxes which vary from as low as 5 per cent in UP to 17-20 per cent in Gujarat/Goa.

Against this backdrop, if, in price fixation, the input cost is taken as uniform, a unit paying for these at a higher rate will be unjustifiably penalised, whereas another unit paying less will get a windfall.

While seeking to protect the producing units from exogenous shocks, such as increasing price of feedstock and other inputs, the existing dispensation requires them to work at fairly high levels of efficiency to achieve reasonable profitability. It contributed remarkably to the rapid growth of the industry particularly in the 1980s. In the 1990s, the pace slackened primarily due to frequent fiddling with the RPS by way of tightening of norms, denying/delaying payments of reasonable cost, and so on.

As a result, despite operating at high capacity utilisation, units are not able to achieve even the 12 per cent post-tax return allowed under pricing which, by itself, is unattractive compared to the much higher returns available in other sectors. This has also affected fresh investments.

Against this backdrop, we need to be careful as to what modification is aimed at in the first phase. Whether or not there is need for rationalisation of the norms for capacity utilisation/nor-



native production, consumption of feedstock, utilities and so on, is a debatable point.

However, a view on these has to be taken in a holistic and coordinated manner to ensure that reasonable profitability and cash flows of the efficiently performing units are not affected. But, more important, it would be a serious mistake to take delivered cost of inputs on a uniform basis! The pitfalls of this approach may be seen by looking at the following facts.

Given the feedstock cost of Rs. 1,100 per million Kcal to a naphtha-based plant and Rs. 500 per million Kcal to a gas-based plant along HBJ (as mentioned above), if, in price fixation, cost is taken at a uniform Rs. 800 per million Kcal (average of the two) then,

would seriously erode margins of efficiently-run units.

The prescription for uniform subsidy for all producing units in the second phase is a logical extension of the normative approach contemplated in the first phase to provide for a single price realisation (selling price plus subsidy) for all the units.

So long as there are wide inter-unit variations in cost over which units have no control, this would lead to far more serious distortions as this dispensation tantamounts to imposing uniform cost in all areas (unlike the first phase wherein the approach could be selective). Even in a market-based regime (the third phase) which will also generate uniform price realisation, the implications will be broadly similar.

In view of the above, before proceeding with the contemplated plan of phased de-regulation, the Government should make a serious effort to minimise the inter-plant variations in cost. And before that, the feedstock cost to all the units should be brought more or less at par.

This would require bringing down the cost of naphtha and fuel oil/LSHS, besides further reducing the price of gas from the existing \$2.5 per million BTU (British thermal unit). We should aim at a uniform price of no more than \$1.5-2 per million BTU for all feedstock.

Currently, plants along the HBJ are burdened with transport charge of Rs. 1,150 per thousand cubic metre, which translates to about \$0.8 per million BTU. This, by itself, is artificially inflated, as pointed out by JPC (1992) which recommended its lowering to reasonable levels.

Furthermore, there is need for equitable sharing of the burden by all units including those located near the source of gas. In a limited way, such a dispensation is already in operation in as much as all plants along HBJ are charged the same rate irrespective of location; this approach needs to be broad-based to cover all units.

Urgent steps need to be taken to enable new plants to tide over the burden of high capital cost. Towards this end, the Government may give a one-time capital subsidy; alternatively, a portion of the loan liabilities from the financial institutions (FIs)/banks may be extinguished. This would enable such plants compete with old/depreciated plants on equal footing.

Only if all these pre-requisites are put in place within a reasonable time-frame, should the Government venture into a uniform pricing system leading to eventual market-based regime. At that stage, when, free import of urea is also contemplated, duty at an appropriate level should be introduced to afford protection to the domestic industry.

Even as the duty may vary depending on the cost of imports *vis-a-vis* reasonable cost of supply from domestic units, the bound rate (the maximum permissible) under WTA, should be declared at a reasonably high level to allow for extreme situations (such as at present) of imported urea coming at throw-away prices.

(The author is Chief Economist, Fertiliser Association of India, New Delhi.)