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THE HINDU BUSINESS LINE

Urea: RPS and NPS

Six of one, half-a-dozen of the other

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The New Pricing Scheme for urea manufacturers is hardly an improvement over the Retention Pricing Scheme, whose anomalies it purports to correct. It neither provides an incentive to reduce cost and improve efficiency nor does it help all plants uniformly to face competition from imports. And unlike the ERC, it gives no clue whatsoever, whether we will at all move towards decontrol.

IN its report on agricultural subsidies submitted in September 2000, the Expenditure Reforms Commission (ERC) had given its recommendations on phasing out fertiliser subsidies. The Government announced it decision to implement the ERC recommendation in the Budget for 2001-02.

In October 2002, a Group of Ministers (GoM) under the Chairmanship of Mr K. C. Pant, Deputy Chairman, Planning Commission, gave its proposals within the framework of the ERC recommendations. Based on the GoM's recommendations, the Government notified the New Pricing Scheme for urea manufacturers (NPS) on January 30, 2003.

The introduction of NPS has been branded as a major step forward in reforming the fertiliser sector in India? In order to assess the veracity of this claim, we need to address three basic questions.

First, does NPS provide incentives for reducing cost and improving efficiency?

Second, will it enable domestic units compete with imported urea?

Third, does it lay down a road map for achieving full decontrol of urea?

Under the Retention Price Scheme (RPS) — the predecessor of NPS in vogue for two and a half decades — each unit was allowed its production cost in full. The cost was determined by using input consumption norms and financial parameters (capital cost and other fixed cost) that were unit-specific.

Even though, the norms for capacity utilisation were common (95 per cent for gas-based plants and 90 per cent for plants on naphtha and fuel oil under 8th pricing period), the installed capacity was unit-specific.

This meant that even the normative production (95 per cent/90 per cent of installed capacity) used for arriving at the per tonne fixed cost was unit-specific.

In view of the RPS being unit-specific and cost-plus, it did not give the required incentives to improve efficiency and reducing cost. Under the 7th and the 8th pricing periods (July 1, 1997-March 31, 2000 and April 1, 2000-March 31, 2003), various norms were tightened. However, the unit-specific character of the RPS and its attendant deficiencies remained.

Does the NPS remove the above deficiencies? It purportedly lays emphasis on a group concession approach. Under it, the urea units are divided into six groups — pre-1992 gas, post-1992 gas, pre-1992 naphtha, post-1992 naphtha, fuel oil/LSHS and mixed feed (gas-based plants using alternative fuel by more than 25 per cent).

For each of the above groups, a weighted average (WA) of retention prices (RP) as on March 31, 2003 (as computed under 8th pricing parameters) is calculated. But the WA is not adopted as the concession for all plants in the group, a logical course for the scheme to be consistent with the principle of uniformity. Instead, the NPS proposes the following.

For plants whose RP is higher than WA, WA is assigned as the concession. The plants whose RP is higher than WA by more than 20 per cent (nicknamed 'outliers') are given the WA plus a special allowance equal to 50 per cent of difference between their RP and WA. Finally, plants whose RP is lower than WA, get the lower RP.

For plants in the 3rd category, the concession continues to be unit-specific and is none other than RP as determined under the erstwhile dispensation.

For plants in 2nd category also, the special allowance (RP – WA/2) brings the concession closer to their RP. Even for the 1st category, the *prima facie* impression of moving towards a uniform WA for all such plants withers away the moment we consider the following.

The NPS allows escalation/de-escalation in price of feedstock and fuel as per the method under RPS. Under RPS, this was computed by multiplying the 8th pricing unit-specific norm for consumption of inputs by increase/decrease in their delivered cost.

With this, the effective concession (base concession adjusted for escalation/de-escalation) even for first category is unit-specific.

In view of the above, despite the much bravado about moving towards a group-based uniform pricing dispensation, the NPS continues to be unit-specific. Under it, each plant gets a concession specific to it. Indeed, there are as many concessions as the number of plants. The position is virtually the same as under the erstwhile RPS and the incentive to reduce cost is still missing.

If, units whose RP is lower than WA continue to be compensated on the basis of RP, then, where is the incentive for being a low-cost unit? If units with RP higher than WA get covered for escalation on higher unit-specific norm, then will this not ease the pressure on them to reduce cost?

Likewise, if an outlier on higher side gets an amount substantially higher than WA (by virtue of special allowance), will it not tantamount to covering up its inefficiency?

The NPS merely takes cognizance of outliers on the lower side. These are plants with RP lower than WA by more than 20 per cent.

If, a unit is able to produce urea at an exceptionally low cost (frankly such plants ought not to be given a unhealthy description of an outlier) then, it deserves some reward for this. But the NPS does nothing of that sort. The Scheme clearly discriminates against a highly efficient and least cost plant!

For Stage II — April 1, 2004 to March 31, 2006 — a Committee under the Chairmanship of Mr A. V. Gokak (former Secretary, Fertilisers) recommended the adoption of group energy norms.

But, the Government has adopted these only for plants whose unit-specific energy consumption is higher. Others get their lower unit-specific consumption. Here again, there is no incentive for better performers.

Let us take up the second question. Due to low price of gas and high energy efficiency, the production cost of gas-based plants in India is lower than the cost of imported urea. This equation will not change even after impending increase in the gas price recommended by a Group of Ministers under Mr K. C. Pant.

Even after complete deregulation of gas price, these plants will be able to compete with imported urea with suitable increase in import duty currently at 5 per cent. Under the WTO, at present, urea is unbound. Therefore, the Government should not face any problem in raising the duty to the desired level. In view of above, clearly, the gas-based plants will stand to gain under a regime based on the import parity price (IMPP) of urea. But, far from gaining any benefit, the more efficient / low-cost producers among them do not even get the benefit of higher WA of their respective group (as they are tagged to their lower RP).

The NPS allows low-cost producers to sell surplus urea (quantities that are not absorbed by farmers) to complex manufacturers, or export or supply to designated State Trading Enterprises (STE) against import at IMPP.

But they are required to surrender 50 per cent of gain (difference between IMPP and applicable concession) to the Government.

Thus, even on sale of limited quantities (quantum of surplus urea may not be more than 5-10 per cent of total production), low-cost, gas-based units are denied the full benefit of IMPP.

Besides, the manufacturers are required to take prior approval of the Department of Fertilisers before undertaking these transactions. This could even result in total loss of opportunity.

The production cost of plants based on naphtha and fuel oil / LSHS is higher — in fact, substantially higher — than the cost of imported urea. Under an IMPP-based scenario, they would be completely wiped out.

They can bring down their cost and compete with imported urea only if they switch over to use of gas. But there is no policy on how they will be treated after the switchover!

The NPS thus gives rise to an anomalous situation where the gas-based plants that excel in imported urea are being denied the opportunity of consolidating on their inherent advantage. Some of them may even be pushed into an unsafe zone due to squeeze on various cost items under pricing that continues to be unit-specific.

On the other hand, plants based on other feedstock such as naphtha and fuel oil are not given the necessary signals to restructure their operations and prepare for competition with imports.

As regards the third question, the NPS has brought in partial removal of controls on urea distribution. Thus, a manufacturer is free to sell 25 per cent / 50 per cent of production at reassessed capacity during Kharif 2003 and Rabi 2003-04 respectively.

It must not, however, be forgotten that the Government will continue to control the selling price of urea for the entire quantity sold to the farmers. This, in turn, means that it will continue to pay concession/subsidy even on the decontrolled quantities. This would necessarily involve policing — continued controls — in the distribution chain.

From April 1, 2004, the NPS has hinted at complete removal of distribution control. But this has been made conditional on the concurrence of the Ministry of Agriculture (MOA). This means continued uncertainty in regard to full decontrol from Stage II.

As regards achieving full decontrol (covering both price and distribution), the NPS is far from it, to say the least.

It merely states that the policy for the period beyond Stage II — from April 1, 2006 onwards — will be announced after reviewing the implementation of Stage I and Stage II.

Under NPS, the Government will continue to control (i) the selling price of urea (ii) realisation of manufacturers virtually on a unit-specific basis (iii) distribution to the extent of 50 per cent and (iv) sale of surplus urea to entities other than farmers. All this implies that the legacy of RPS will continue.

If the Government is really serious about reforms in this vital sector then, it should implement the ERC recommendations in toto. The ERC had recommended

(i) 'uniform' concession for all plants in each group and escalation on 'group' energy norms;

(ii) progressive reduction in concession in various groups leading to eventual elimination and uniform concession only to plants based on LNG;

(iii) appropriate incentives for naphtha/fuel oil-based plants to switch over to gas;

(iv) complete removal of distribution control from the Day One, and removal of price control by 2006.

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