Urea prices

Why import parity makes better sense

In this reform era, when the thrust is on encouraging units that are globally competitive, the New Pricing Policy acts as a strong disincentive to the gas-based urea plants while allowing several high-cost naphtha and fuel oil-based plants to continue in production. There is an urgent need for the Government to replace the existing group concession scheme with a system linking the realisation of all manufacturers to the import parity price of urea, says **Uttam Gupta**.

AN important component of the globalisation process is the linkage of domestic prices of various products with their international prices. Since the early 1990s, the government has brought majority of the sectors within the ambit of this principle, covering even the highly sensitive petroleum products last year. In fertilisers, however, it is yet to abandon its old mindset.

Being an essential input in agriculture, the government apprehends that forging a linkage of fertiliser retail prices with their international prices could lead to a sharp price-spurt apart from making the prices unstable. This, in turn, could affect the millions of subsistence farmers. But what has prevented it from operationalising this principle in respect of the price paid to the producers?

Under the erstwhile Retention Price Scheme (RPS), the government was fixing price to the producers on a unit-specific basis using cost of production approach. Under the New Pricing Policy (NPP) introduced from April 1, 2003, it continues to follow the same approach for fixing concession (read ex- factory price). In fact, the NPP is a mere re-instatement of the RPS in a new form.

On taking a close look at the Notification dated January 30, 2003 incorporating the NPP, however, one comes across certain provisions that contain references to the import parity price (IMPP) concept. Does this mean the Government has not completely shut its doors to linkage with international prices? Or is it a case of trying to test the waters before it eventually decides to take a plunge whole hog? These questions can be answered only after we analyse the relevant provisions. At the outset, it is necessary to take cognisance of an important policy change — incorporated in the NPP — that relates to the sale and distribution of urea.

This major policy change allows manufacturers to sell a portion of production at reassessed capacity (25 per cent during Kharif, 2003 and 50 per cent during Rabi 2003-04) to the farmers freely in any part of the country. The balance portion of 75 per cent Commodities Act (ECA).

Now, let us take a look at the provisions. First, if a manufacturer is not able to sell the entire quantity of decontrolled urea (50 per cent during Rabi 2003-04) to the farmers, then, he is allowed to sell the excess to manufacturers of complex fertilisers or export. Such sales will have to be made at the IMPP of urea and will not qualify for concession support.

Second, manufacturers contemplating production in excess of 100 per cent of the reassessed capacity will be allowed to sell the incremental production to complex manufacturers or export at the IMPP. They can also supply these quantities against global tenders floated by state trading enterprises designated by the Government for import of urea.

Third, depending on the demand supply situation, the Government can direct low-cost manufacturers to supply production in excess of 100 per cent of the reassessed capacity for meeting the demand for urea under the ECA. On such sales, they would receive subsidy as per the concession rate applicable under the Group Concession Scheme (GCS).

Finally, an overriding provision allows the Government to take charge of decontrolled quantities for sale under ECA to meet shortage in any part of the country. It goes without saying that such urea will be also entitled to the applicable concession under GCS.

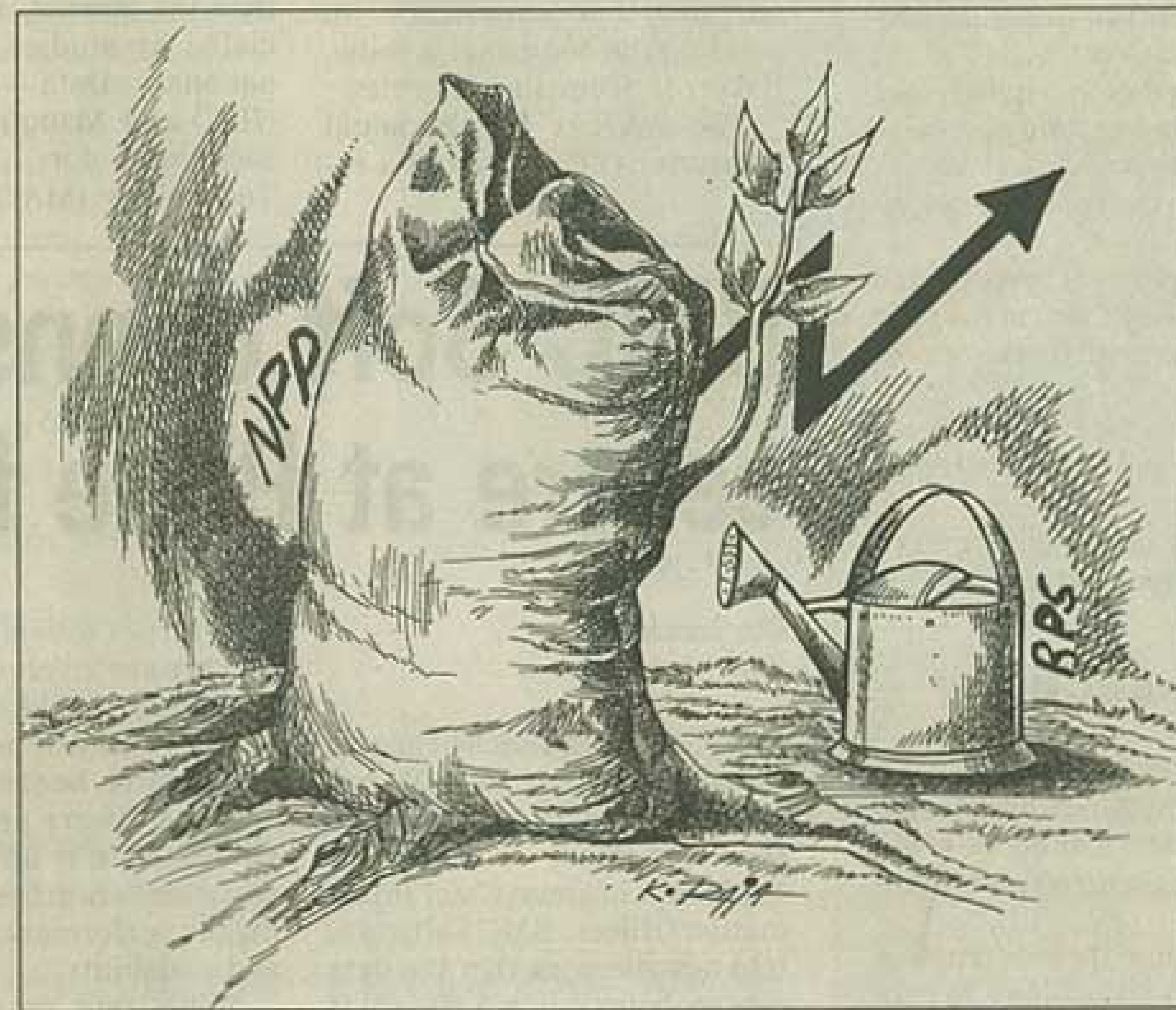
On the face of it, the first and second provisions appear to give low-cost manufacturers (these are gas-based plants whose production cost is generally lower than IMPP) the benefit of higher IMPP. But this becomes redundant when seen in juxtaposition with the third and fourth provisions.

These allow for compulsory mop-up of the decontrolled quantities as well as production in excess of 100 per cent level for meeting the demand under the ECA. And to the extent this happens, the quantum of free urea available for sale to complex manufacturers or export will be reduced.

And in case the entire surplus from the decontrolled quantities/above 100 per cent production is encroached upon by the Government for sale under ECA (the keenness to save on subsidy tage of the first and second provisions.

In regard to sale of surplus urea (if any, after the mop up), even as the January 30 notification gave a free hand to the manufacturers, a spate of notifications issued by Department of Fertilisers thereafter have virtually taken away this freedom.

In a circular issued on April 23, 2003, the Fertilisers Department required manufacturers to take its prior approval for undertaking sale of decontrolled urea to complex manufacturers or for exports. For production in excess of 100 per cent, it directed them to furnish the necessary information only. Vide a circular dated July 4, 2003 even on these quantities, the Department insisted on prior approval. The July 4 notification also provided for sharing of proceeds from such sales with the Government. Thus, in respect of decontrolled urea, manufacturers were required to surrender 50 per cent of difference between realisation from sale at IMPP and applicable concession (including sales tax).



On production of over 100 per cent, it allowed the manufacturer to retain 40 per cent of difference between realisation from sale at IMPP and variable cost (including sales tax). Through another notification dated September 22, 2003 the retention amount by the manufacturer was cut to 35 per cent.

A manufacturer can get optimum results from sale only if he is allowed to operate freely. This will be seriously undermined if he is required to take prior approval. Further, by asking him to surrender a portion of the difference between IMPP and applicable concession (variable cost in case of production of over 100 per cent), the Government is denying him the full

importer. In this backdrop, situations may arise when the realisation is lower than the applicable concession, resulting in a loss. There is no provision under the NPP to compensate for this loss. Why should the Government, then, mop up the gain when the IMPP is higher?

Under the GCS, several units whose retention price is higher than the group average and, therefore, get lower group average as concession, suffer a loss on sales to the farmers. Against this backdrop, any gain from sale to complex units or exports at IMPP merely offsets this loss. Then, to take away a portion of the former would be unfair.

The method of working out gain from sale of urea in excess of 100 per cent assumes that fixed cost has already been fully recovered on output up to 100 per cent.

This assumption is not correct as while computing applicable concession, a significant portion of the fixed cost (conversion cost and capital related charges) is disallowed. Against this backdrop, the use of variable cost alone would artificially increase the computed gain and, in turn, the recovery. The exclusion of cost of bagging from variable cost (this is illogical, as bagging is very much a part of variable cost) — as envisaged in the July 4 circular — for computing the gain also results in excess mop-up from the manufacturer.

There could be other ways by which the quantum of gain from sale could be artificially inflated, leading to excess mop-up. For instance, if for arriving at the realisation, the selling and distribution expenses are not deducted from IMPP, this would unjusti-

clear that under the NPP, only small quantities of urea — that is, the surplus decontrolled quantities that are not sold to the farmers and production in excess of 100 per cent — are sought to be brought within the ambit of the IMPP principle. Further, only a part of the above will be available for sale to complex units or exports due to compulsory mop-up by the Government for fulfilling ECA requirements.

And, even in respect of this very limited quantity, the Department officials decide their disposal and the realisation from such sales.

Needless to say, such decisions would be taken in a manner that would virtually deny the low-cost manufacturers the benefit of IMPP. There would be no incentive for them to undertake exports or sell to complex units despite their ability to compete against global players.

In this era of reforms, when the overriding thrust is on encouraging units that are globally competitive, the NPP acts as a strong disincentive to them while at the same time, it allows several high-cost naphtha and fuel oil-based plants (these account for about a third of total production) to continue in production.

There is an urgent need for a paradigm shift in the policy for the urea industry. The Government should replace the existing GCS (as already stated, this is a mere reinstatement of the erstwhile RPS in a new garb) by a system of linking the realisation of all manufacturers to the IMPP of urea.

The announcement should be made right now — say, at the beginning of fiscal 2004-05. However, the changeover should be made effective from April 1, 2006. This will put the naphtha and fuel-oil-based plants on notice and give them adequate time for switchover to use of cheaper feedstock — gas — and thereby survive under the IMPP-based regime.

In such a scenario, the oil companies will be forced to drastically slash the prices of naphtha and fuel oil from their present high levels. At present, due to an assured market (facilitated by high subsidy support to fertiliser plants using these feedstock), such pressure simply does not exist.

This would help reduce costs as, even after switchover to gas, the use of naphtha cannot be completely eliminated due to the limited supply of gas, on the one hand, and technical reasons, on the other (for instance, the use of gas alone does not generate enough carbon dioxide required for manufacture of urea).

The above policy dispensation will also be in line with the roadmap prescribed by the Expenditure Reforms Commission for adoption of the IMPP principle for all urea manufacturing units in 2006.

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