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An alternative to RPS?

An analysis of the budget document proves that the subsidy money on urea goes not to the industry but oil companies, says **Uttam Gupta**

THE much-maligned retention pricing scheme (RPS) continues to remain in vogue despite persistent demands for its discontinuation. The critics attribute this to incessant lobbying by the industry, which they believe is the prime beneficiary of subsidy. The fact is that this argument has no valid basis.

Here is an industry in which despite high capacity utilisation and efficiency of input use, primarily energy, producers are not getting even the so-called guaranteed return of 12 per cent post tax which they should have got at normative production level. Had they operated just at the norm (90 per cent capacity utilisation for gas-based plants) the return would have been meagre or even loss in some cases. Clearly, the benefit of subsidy does not accrue to the industry. For any meaningful debate on the issue, we need to address some fundamental queries. Which factors contribute to increase in subsidy and to what extent? Where exactly the subsidy money is going? Is there any alternative to the RPS?

As per budget documents, subsidy on domestic urea increased by Rs 6,595 crore from Rs 2,075 crore in 90-91 to Rs 8,670 crore in 99-00. Out of this, the increase purely due to the rise in production (about 7 mt from 12.8 mt in 90-91 to 19.8 mt in 99-00) was Rs 1,127 crore. The rise in prices of feedstock/hydrocarbons like naphtha, fuel oil and gas led to a cost push of about Rs 8,000 crore (rise in cost per tonne urea multiplied by quantum of output during 99-00). After deducting from this, extra realisation from rise in selling price of about Rs 3,500 crore on a net basis, the subsidy rise due to feedstock price hike was about Rs 4,500 crore. The rise in equated freight consequent to the rise in rail/road freight charges accounted for about Rs 300 crore. The contribution of above three factors adds up to a total of Rs 5,925 crore. The remaining Rs 670 crore was due to the rise in conversion cost and capital related charges. Increase in prices of hydrocarbons alone accounted for about two-thrids of the subsidy rise. Where did all these money go? Obviously, to the companies in the petroleum and gas sector. And since, bulk of the supplies are from oil PSUs, it actually came back to the government as surpluses of these undertakings. Similar is the case with the rise in rail freight.

As regards production, it cannot be anybody's case that the industry should not produce more. And since consumer price is artificially pegged at a level lower than reasonable cost of supply, entailing a subsidy, increase in production is bound to lead to higher total subsidy payments. Only about 10 per cent of total increase was contributed by increase in CRC and conversion cost. A substantial portion of this was the outgo towards servicing of loans, rise in wages and salaries, expenditure on other overheads and higher cost of repairs/maintenance. After all this, the money left for profits was insignificant.

Notwithstanding these hard facts, based on the flawed perception that the industry is the prime beneficiary, various adverse changes have been made under pricing, affecting producers bottomlines without, at the same time, making any dent on the subsidy bill. For instance, interim re-assessment of capacity effective from April 1, 2000 may save only about Rs 500 crore out of the total subsidy of Rs 8,000 crore on urea.

In its report to the finance minister, the Expenditure Reforms Commission has recommended RPS dismantling and its replacement by a system of group pricing, a uniform price for each of the proposed five group of plants (the pre-92 gas-based plants, post-92 gas-based plants, naphtha-based plants, fuel oil-based plants and plants using mixed feed). The ERC used an elaborate method to determine price under each group.

The ERC has recommended that these prices should take effect in Stage-I beginning next year. In Stage-II (1.4.2002 to 31.3.2005), it has proposed slash in these prices based on reduction in energy intake and CRC for various groups. In Stage-III (1.4.2005-31.3.2006), prices/concession for plants on naphtha and mixed feed are further reduced on the basis that they will switch over to LNG. In Stage-IV (1.4.2006), five groups will be reduced to just two groups — naphtha based plants having switched over to LNG/new plant on LNG on one hand and all other plants on the other.

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A close look at the ERC package would reveal an obsession with reduction in subsidy by resorting to arbitrary changes in energy consumption norms, reduction in the CRC, suppressing prices of feedstock/fuel on import parity (despite the fact that producers aren't allowed to import naphtha), assumed switch over to LNG without even assessing its availability etc. Its adoption will only lead to closure of majority of the plants and compromise on continued self-sufficiency in fertilisers.

The ERC has also recommenced adoption of coupon system for targeting subsidy or giving directly to the farmers. Under this, while the manufacturer sells at the markets price, the farmer will get coupon of a value equal to the difference between this and the subsidised price. The impression that a change over to this system will drastically reduce subsidy is a myth. In a decontrolled situation, the market price will be significantly higher than the existing controlled price of Rs 4,600 per tonne. This is in view of current high cost of supply (even imported urea has a subsidy of about Rs 7,500 a tonne) and no credible steps in sight for reducing cost of feedstock. And yet, if the government is keen to ensure supplies at low price, subbsidy is inevitable.

Unlike RPS, in which payments are made to a handful of companies, implementation of proposed system will involve issue of 105 million coupons twice a year. That is almost like making arrangement for holding general elections. Besides, the cost of printing, handling and distribution of coupons will be mindboggling. ERC has shown significant saving in subsidy due to adoption of coupon scheme, which however was due to a revamp on specified quantities.

The government is well aware of the pitfalls in any alternative policy. And if, RPS despite so much contempt for it has not been discontinued, it is for want of a viable alternative. That the industry has no role in this longjam is also clear from its submission early this year seeking immediate decontrol. Undoubtedly, the government has a tough job ahead.