The Financial Express January 24, 1998

Dismantling fertiliser retention pricing

Uttam Gupta

IN the context of giving shape to a new pricing policy regime for fertilisers in place of the existing dispensation that is, retention pricing scheme (RPS), various alternatives are being talked of. Prominent amongst these include, uniform administered pricing, group pricing, import parity pricing and pricing based on free market etc. While, these may vary in details, all are common in one respect. Unlike RPS, which provides for a fair ex-factory price to each unit to cover its reasonable cost of production including a margin of profit - currently at 12 per cent post tax on net-worth - any of the above mentioned alternatives, is expected to throw up a uniform number for all units or a group of units. Units producing at cost higher than this will loose, whereas, units with lower cost will gain. While, the system rewards latter, former will be under pressure to reduce cost in order to remain viable. That is what competition is all about and some of us find merit in uniform pricing for the same reason.

There is a serious danger in this approach as apart from efficiency in operations - capacity utilisation and energy use , - cost of production depends largely on cost of purchased inputs including feedstock/fuel, utilities e.g., power, water and services, Railways etc., over which manufacturers have no control. In fact, these are largely controlled by the Government. The units when set up - majority of them before 1991 - did not even have a choice as to which feedstock to use, where to locate the plant and what should be the technology. Virtually, all relevant parameters were decided by the government. For most of the units set up after 1991, too, decisions were taken under the controlled regime. Even projects on which decisions have been taken in the liberalisation era - post 1991 - choices have been seriously constrained as feedstock/fuel supplies are mostly from Government owned and controlled undertakings and all vital decisions concerning feedstock linkage continue to be taken by the Government. Thus, even if plants operate at optimum level, substantial variation in production cost could arise depending on feedstock use and location of the plant. let us first consider the impact of differences in feedstock. Compare a naphtha based plant with the one based on gas both located in say, Uttar Pradesh. The current ex-refinery price of naphtha is Rs 7624 per tonne. Including excise duty (nil), freight and sales tax, its cost at factory gate works out to about Rs 8,500 per tonne or Rs 850 per m.kcal (1 tonne = 10 m.kcal). For gas, corresponding to basic price of Rs 2150 at landfall point and after including royalty, CST and transport charge, cost at factory tap is about Rs 3400 per thousand cubic metre or Rs 400 per m.kcal (1 cubic metre = 8500 kcal).

Let us take energy use for the gas based plant to be about 6 m.kcal per tonne urea. Naptha being an inferior feedstock, its energy efficiency is about 10 per cent more or 6.5 m.kcal. With these and delivered cost of energy as above, production cost of the plant on naphtha will be about Rs 5525 per tonne as against much lower cost of the gas based unit at Rs 2400 per tonne.

To capture the impact of location, let us compare the gas based plant in U.P/Rajasthan - fed by HBJ pipeline - with another gas based unit located at landfall point (Gujarat). The delivered cost of gas to the latter is about Rs 2400 per thousand cubic metre or Rs 265 per m.kcal (1 cubic .metre = 9000 k.cal) as against Rs 400 per m.kcal (1 cubic metre = 9000 k.cal) as against Rs 400 per m.kcal to the former. The difference arises mainly due to transport charge of Rs 1150 per thousand cubic metre or Rs 135 per m.kcal (1 cubic metre = 8500 k.cal) paid by plants along HBJ. Purely on this account thus, production cost of plant along HBJ is more by about Rs 800 per tonne (135 x 6).

Amongst plants based on naphtha also, wide variations occur on account of location. The cost of naphtha delivered at factory gate is about Rs 8200 per tonne at MFL, Manali (TN), Rs 8500 per tonne at SFC, Kota (Rajasthan), Rs 9300 per tonne at ZACL Goa and Rs 9500 per tonne at IFFCO-Kalol (Gujarat). Apart from freight, these are mainly due to differences in sales tax i.e., 3 per cent in Tamil Nadu, 17 per cent in Goa and 20 per cent in Gujarat. The vintage of the plant also contributes to huge variation in cost. A new unit has higher investment cost due inflation, Rupee depreciation and attendant higher burden of taxes and duties. For instance, units commissioned recently that is, 1994/95, along HBJ have investment cost almost double than similar plants - same feedstock, size and technology, - set up in late 80s. This leads to much higher production cost of the former i.e., about Rs 2000 - 2500 per tonne. Ignoring these differences in cost - beyond control of individual units - forcing a common price on all or a group will lead to serious distortions. Much will depend on what level price is set. To illustrate, let us take two units 'A' and 'B' with cost x and y,. 'y' being more than 'x'. At 'x', 'B' will be unviable even as there is saving in subsidy (y - x). If price is set mid way between 'x' and 'y', 'B' will still be unviable and no saving in subsidy. In a third scenario, if price is fixed at 'y' to make 'B' viable, 'A' would reap bonanza (y - x) at the cost of exchequer.

While, contemplating a new system, the Government is guided primarily by the need to reduce subsidy. In view of this, it is unlikely to consider second and third alternative as these would leave subsidy unchanged as in the former or increase as in the latter. It may settle for first - indeed, high powered BB Singh Committee, in mid 80s, recommended uniform pricing on the basis of least cost units - which saves on subsidy.

This would, however, lead to virtual closure of 'B' and resultant loss of production having to be made up by imports which could be much more costly and entail higher subsidy outgo.

Before, the high powered Hanumanthha Rao Committee ventures into recommending a system that involves price fixation/setting on uniform basis, it needs to assess whether it would be possible to put various plants on a common footing in regard to cost of feedstock delivered at plant site on the one hand, and, capital cost on the other. Without necessary measures to create a level introduction of uniform pricing will only lead to closure of a large number of plants and discourage fresh investment. Such a step will not only be highly unfair and discriminatory, but also, contrary to national economic interest.

(The author is a chief economist with The Fertiliser Association of India)