

Trimming subsidy: penalising efficiency

Though the urea industry has the capacity, the government does not wish to encourage domestic production

by UTTAM GUPTA

THE government's recent notification of trimming the subsidy level for urea plants based on the retention price and the plant capacities, is unilateral, arbitrary and lacks transparency.

The government has notified that in order to restrict the ballooning subsidy bill on urea, a decontrolled fertiliser, subsidy will be curtailed for those units having a retention price of Rs 7,000 per tonne and operating at a capacity of over 115 per cent.

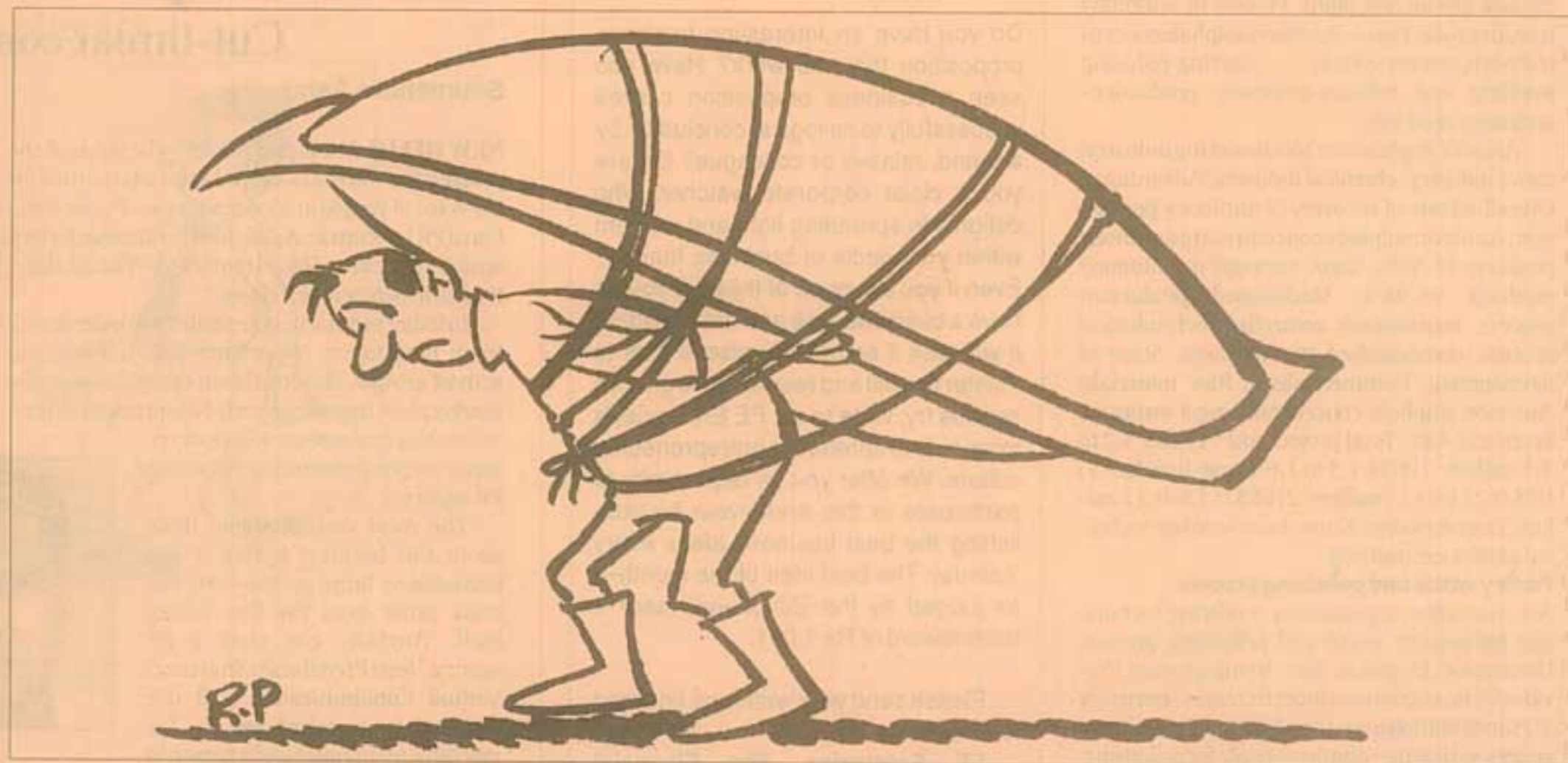
The regulation, an imperative need to restrict the burgeoning deficit, came into effect this October with a view to make urea affordable to farmers and ensure that adequate supplies reach them. But while the price is controlled at a low level, off-take and distribution is regulated under the Essential Commodities Act (ECA) on the other hand.

Before commencement of each crop season, the ministry of agriculture (MOA) prepares a supply plan after consulting state governments and the industry and lays down norms as to where each manufacturer will sell and how much.

In a parallel exercise, the department of fertiliser (DOF) in the ministry of chemicals and fertilisers, approves production plan of each unit and sends it to the ministry of agriculture for supply linkage under the Essential Commodities Act. Selling urea at controlled price, currently Rs 3,660 per tonne, yields - after paying margin to distributors at controlled uniform rate of Rs 140 per tonne - a net-back of Rs 3,520 per tonne. Since, the reasonable cost of production, this varies from unit to unit depending on feedstock, vintage, location etc., is higher than this, the difference is paid as subsidy under the retention pricing and subsidy scheme (RPS). The producers' claim subsidy from the central government on monthly dispatches. Invariably, entire production of unit during any given season is covered by supply plan and is eligible for subsidy at applicable rate. If, however, a portion remains uncovered or cannot be sold due to inadequate/unanticipated drop in demand, the same becomes part of the opening inventory and gets adjusted while deciding allocation for the next season.

The present decision is, however, a conscious move not to allow concerned manufacturers to sell production beyond 115 per cent level during October 1, 1997 to March 31, 1998. By itself, this does not make sense. However, preface to operative part of relevant notification emphasises on need to contain outgo on subsidy to restrict budget deficit. Viewed in totality, the hidden message is that no subsidy will be paid on excess production. Will they be paid subsidy on this during next fiscal? This is also ruled out because compulsion of keeping subsidy under check would remain. In fact, it will be even greater due to full impact of recent steep hike in feedstock prices with effect from September 2, 1997 for naphtha/fuel oil/low sulphur heavy stock (LSHS) and gas with effect from October 1, 1997 on production cost and consequently, subsidy outgo. The government could perhaps, extend this policy to 1998-99 or even beyond.

Let us now look at the likely impact of the move. On every tonne produced and sold above 115 per cent level, all that manufacturer would get is Rs 3,520 per tonne. Considering that the retention price - this represents reasonable cost of production at prescribed efficiency norms - is substantially higher i.e., Rs 7,000 per tonne or above, he



would be doing so at a loss. But, why look at retention price which is sum total of variable cost (VC), fixed cost including capital-related charges (CRC), marketing and selling expenses etc.

And, since fixed cost is expected to be fully recovered at prescribed capacity utilisation norm e.g., 90 per cent for gas-based plant, we may consider only variable cost for production above proposed ceiling. So long as, net-back from selling exceeds variable cost, manufacturer will have an incentive to continue production. That does not hold for majority of naphtha/fuel oil based plants. For a naphtha based plant using fuel oil/coal in off-site facilities, variable cost alone is a minimum of about Rs 6,300 per tonne going up to as high as about Rs 7,500 per tonne, latter due to substan-

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tially higher delivered cost of naphtha/fuel oil (largely due to higher sales tax). With a net-back of Rs 3,520 per tonne, and no subsidy, there is absolutely no question of such plants continuing production beyond the ceiling.

For the recently commissioned gas-based plants along the HBJ pipeline having a retention price of above Rs 7,000 per tonne, energy cost alone works out to about Rs 3,200 per tonne. This includes Rs 2,300 per tonne towards gas used in main process plant and Rs 900 per tonne on account of naphtha used in captive power and steam generation. It will be even more for a plant using high cost naphtha in main process due to inadequate gas supply. Including bagging, variable cost would be about Rs 3,500 per tonne or even more which leaves virtually no contribution

or negative in some cases, towards fixed cost. Therefore, such plants will also not produce above the ceiling.

Clearly, the government does not wish to encourage domestic production even though industry has the capacity. Why? Is it because we do not need extra output? This cannot be as India continues to be deficit in indigenous supply and there is heavy imports. Or is it because our production cost is high? Therefore, it is better to import which is cheaper and thus, save on subsidy.

On the face of it, the argument may appeal but, we need to be cautious. Whether to import more or less, on this, a view cannot be taken purely on the basis of prevailing import price. Currently, this is low mainly because China is absent from international market. The situation is likely to change in a couple of months when the big bull will re-enter.

Only two years back we paid C&F US\$245 per tonne entailing farmgate cost of about Rs 10,000 per tonne. Against this, weighted average cost of supplying domestic urea was about Rs 6,000 per tonne. In case, C&F cost shoots up again thus, making imported urea costlier than indigenous, then, on the same logic, the government will have to ask industry to produce more.

You cannot pick and choose. The policy should give incentive to produce on a sustained basis. After all, even if the industry were to switch on and off on asking by government, it may not be able to do it as IOC/GAIL would not agree to adjust supplies of naphtha/gas depending on when government wants more or less production from manufacturers.

Dislike for high cost supplies from domestic production is but natural. But, instead of changing track and going the wrong way, we need to ask as to why this is high? The main reason is high price of feedstock/fuel. The recent steep increases alone have raised production cost of urea by a minimum of about Rs 1,500 per tonne and a high of about Rs 2,400 per tonne. So much so, at current feedstock/fuel prices, in several cases, energy cost alone exceeds Rs 7,000 per tonne.

The focus should be on bringing down feedstock/fuel prices to reasonable levels which will automatically make indigenous production

cheaper than imports. The government cannot have the cake and eat it too i.e., give more revenues to oil companies and to itself (latter by way of surplus in the oil pool account (OPA) to be utilised for redeeming oil bonds) and, at the same time, get low cost urea.

Could government have done it to discourage so called gold-plating? This is a very narrow reading of underlying facts. Majority of naphtha/fuel oil based plants which have retention price above Rs 7,000 per tonne, were set up before the retention price scheme (RPS) was introduced. They could not have built-in capacity cushion in anticipation of a scheme which did not exist. No doubt, over the years, they have improved capacity utilisation. This is, however, the result of their efficiency factor for which they need to be rewarded and not penalised.

Being depreciated and due to low net worth, contribution towards CRC is low i.e., in the range of Rs 500-800 per tonne. As it is, this limits profitability and internal resources constraining their ability to undertake timely revamp and modernisation. Somehow, they are managing to survive by operating at high capacity utilisation. Imposition of ceiling will even jeopardise their survival.

For new gas based plants also, generally, due to fixation of retention price at inadequate level and under-recoveries in various cost heads, at normative production level, manufacturers would have posted returns less than the permitted under-pricing or could have even incurred loss. By operating at higher capacity utilisation, they are able to offset it and achieve reasonable level of profitability. The ceiling could come in the way of such efforts.

Could proposed ceiling of Rs 7,000 per tonne be indicative of shape of things to come? Is the high-powered Hanumantha Rao Committee, currently examining fertiliser pricing options, contemplating a uniform administered price of IMPP basis? Before, all this, it ought to ask a basic question as to whether, at prevailing energy cost and capital cost which vary widely from unit to unit - largely beyond their control - will it be possible for industry to remain viable despite high efficiency?

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