The Financial Express February 26, 2001

Uniform pricing may spell doom for many urea plants

UTTAM GUPTA

IN its report presented to the finance minister in September 2000, the Expenditure Reforms Commission (ERC) recommended immediate removal of distribution controls on urea. At the same time it recommended continuation of control on selling price and the regime of concession/subsidy to compensate manufacturers for excess of their reasonable cost of production and distribution over this.

There is merit in not favouring sudden removal of price control. This will lead to a steep increase in price from the existing Rs 4,600 per tonne to at least about Rs 8,500 per tonne (being the reasonable cost of supply from all producing units on a weighted average basis). Consequential substantial reduction in consumption of urea will lead to precipitous decline in foodgrains production and, therefore, threaten continued food security.

While, retaining control on the selling price, the ERC has, however, recommended an increase in it by 7 per cent per annum beginning 2001-02, for a period of six years. On this basis, the projected price in 2006-07 will be Rs 6,900 per tonne. The price will, therefore, continue to be lower than the reasonable cost of production and distribution. Consequently, there is no escape from continuing the system of price support to producers to compensate them for the differential.

For giving support to producers, ERC has recommended a urea concession scheme which provides for uniform concession under each of the five groups (i) gas-based plants set up before 1992; (ii) gas-based plants set up after 1992; (iii) plants based on naphtha; (iv) plants based on fuel oil/LSHS; and (v) plants based on mixed feedstock. These rates are determined on the basis of weighted average of retention prices under the existing unit-wise dispensation. The ERC hopes that the scheme will ensure continued viability of efficiently run plants and maintain a reasonably high level of self-sufficiency on the one hand and protect small and marginal farmers on the other. Besides, it will result in substantial saving in subsidy—about Rs 2,000 crore in stage-I i.e., 2001-02 (this is over and above savings resulting from increase in selling price).

Fertiliser is a highly heterogeneous industry with plants varying widely in respect of critical parameters viz., feedstock, location technology, vintage and so on, leading to unavoidable differences in reasonable cost of production and distribution. Under RPS, these are taken care by fixing unit-wise RP, based on norms for physical efficiency parameters viz. capacity utilisation, energy consumption etc., but, actuals for cost which are beyond units control.

The ERC too is conscious of the unique character of the Indian industry. But for this, it would not have recommended adopting five groups carved out on the basis of feedstock and vintage. But, it stops at that perhaps, because of the obsession to show some advance in the direction of moving away from the unit-wise system. However, the fact is that even within any given feedstock-group, there are wide variations in cost of energy.

PERSPECTIVE

The delivered cost of naphtha varies from Rs 14,885 per tonne for Mangalore Chemicals & Fertilisers, Mangalore to Rs 17,759 per tonne for Iffco, Kalol as on December 1, 2000 (this is largely due to sales tax in Gujarat being 20 per cent against 4 per cent in Karnataka). Likewise, for gas, plants along the HBJ pay transport charge of Rs 1,150 per 1,000 cubic metre to GAIL which is not incurred by those located at landfall point (or those using onshore gas). Differences in sales tax cause further variations in cost of gas at factory tap.

Further differences arise on account of factor of vintage and technology. For instance, plants using old technology have higher energy consumption. Even after modernisation, these will not be able to come up to the energy use level achieved by newer plants. Some plants are dependent on supply of power from SEBs which puts them at a disadvantage vis-a-vis others having captive power.

Notwithstanding these differences, implementation of the scheme will lead to serious distortions within the industry. Specifically, this will cause closure of plants whose RP is higher than the weighted average. Resultant significant loss of production will defeat the objective of maintaining self-sufficiency in fertiliser production.

What about the objective of reducing subsidy? On this, the ERC's claim about saving Rs 2,000 crore in Stage-I, resulting from restructuring of the price scheme is incorrect. By taking a weighted average, overall subsidy payments remain unchanged, and merely result in re-distribution of money from units having RP higher than weighted average to those with lower RP. Yet, savings are largely due to the assumed important parity price (IMPP) of various feedstock resulting in reduction of concession amount.

The assumption of IMPP is flawed as under the Exim policy import of naphtha is not even permitted. Even if the policy is amended to allow this, it will be quite some time before the manufacturer will actually be able to import right now as they do not have the necessary infrastructure.

That apart, IMPP prices assumed in calculations are highly theoretical. Taking into account these realities, if computations are redone to reflect realistic price levels, the savings would disappear. The ERC has shown further savings by tightening energy consumption norms in stage-II and assuming switchover of naphtha-based plants and plants on mixed feed to LNG in stage-III. Having been squeezed in stage-I, the units will not have money to invest for modernising and restructuring. That apart, given the uncertainties surrounding LNG projects, there is no guarantee that it would be available on D-day. Therefore, savings shown by ERC will be at the cost of making the units unviable.

What about the impact on farmers? The increase of 7 per cent in selling price may not be painful. But, the impact of a parallel recommendation in regard to treatment of variation in feedstock price needs serious thought. Thus, whereas, reduction in it will be adjusted by reducing the concession amount, an increase will be passed on to the farmer. Hence, the ERC package will neither take care of farmers nor the industry. Nor will it make a dent on the subsidy bill. The crux of the problem is that the ERC wants to introduce a uniform pricing regime without tackling the causes of heterogeneity. It wants to reduce susidy without addressing the real factors leading to its increase.

For a uniform pricing regime and a subsidy-free environment, the government would do well to make some proactive moves like fixing ex-refinery price on uniform basis, introducing uniform sales tax, and a system of freight equalisation. There is also an urgent need to take steps to bring down the cost of feedstock from the existing high levels.

Until these issues are tackled there is no escape from continuing with a unit-wise dispensation. Since QRs on imported urea are being removed in April 2001, the government will also have to make sure that the policy dispensation is compatible with our WTO obligations.

(The writer is chief economist, Fertiliser Association of India)