Frank Notes

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Urea Industry is in Crisis

India built large production base for fertilisers very systematically over three decades of 1970s to 1990s. Policies for the sector were designed and implemented in a manner which encouraged investment in fertiliser plants by ensuring fair return on capital investment. A large number of plants were built throughout the country in all sectors of economy *viz*. public, cooperative, private and joint sectors.

Urea being the most convenient product to transport, store and apply, emerged as the main source of nitrogen application in Indian agriculture. The production of urea touched 19.6 million tonnes and India became self-sufficient for urea in 2000-01. The distortion in policies started in 1990s when government's main objective became to reduce fertiliser subsidy without addressing the underlying factors for increasing subsidy. There was continuous inflationary push in cost of production. However, the controlled selling price of urea did not keep pace with increasing cost of production. This resulted in ever increasing gap between cost and sale price of urea.

In its anxiety to reduce subsidy, government started tightening the consumption norms and denying legitimate costs in calculating cost of production for each urea unit. Policy and payment procedures were made more and more cumbersome increasing the difficulty in doing business for the producers. This discouraged investment in the sector and no new urea plant was commissioned during 2000-2017. Situation has only worsened in recent years. We enumerate here a few most important issues affecting the viability of urea units.

Indian Urea Industry remains the most regulated industry in the world. Production, distribution and sale of urea are regulated through the urea pricing and subsidy policy. Retail price of urea is fixed by the Government under the Essential Commodities Act (ECA) at levels much lower than the cost of production to make it affordable to the farmers. The cost of production is also regulated by the government and the difference between cost of production and the retail price to farmers commonly known as Maximum retail Price (MRP) is reimbursed by the Government which is termed as subsidy. The freight cost of urea distribution is also reimbursed under uniform freight policy.

The cost of production has two major components *viz*., variable cost and fixed cost. Variable cost is updated every quarter while the fixed cost remains fixed for a pricing period. A pricing period was conceived to be generally of a three year, after which the fixed cost also used to get revised. This was to make the computation simple and the Government ensured 12% post tax return on networth at a capacity utilisation level of 80% while computing the cost of production.

The variable costs comprise cost of raw materials – feed, fuel, utilities, purchased power and water. Cost of bags is also a variable cost which is revised annually based on three-year moving average cost. All other costs are categorised under fixed cost under the urea pricing and subsidy policy. This *inter-alia* includes capital related charges, conversion charges and marketing & selling expenses. Capital related charges include interest on borrowed funds, return on networth and depreciation. Conversion costs include salaries & wages, contract labour, catalyst, chemical & consumables, repairs & maintenance, non-plant power & water, overheads (factory, administration & social overhead), insurance, etc. Marketing & selling expenses include salaries of marketing staff, warehousing, insurance, publicity, loading/unloading outside the factory, etc.

Thus, the elements of so called fixed cost, as provided under the policy, do not remain fixed in real sense and need periodic revision. Many of these elements are inflation linked and keep increasing in line with inflation. Particularly, cost components like salaries & wages, contract labour, chemicals & catalysts, overheads, marketing expenses, such as loading, unloading, warehousing, etc. are subject to annual increase. Similarly, the component of capital related charges also changes due to additional investments made for improvement in operational efficiency like reduction in energy consumption per unit of production and maintaining health of the plant. Most urea plants are old with vintage varying from 18 to 50 years. Significant amount of additional investments are needed just to maintain the existing levels of efficiency and ensure safety and reliability of the plant operations. If the fixed cost component is not revised periodically for a long time, the increase in these components results in under recovery of the cost and severely impacts the viability of these plants.

The fixed cost component of Indian urea units have not been revised for almost past 15 years. It continues to be reimbursed to industry based on the cost data for 2002-03. Urea pricing and subsidy policy has changed significantly after 2002-03 starting with stage-I of New Pricing Scheme (NPS) from April 2003, Stage-II from April 2004 and Stage-III from October, 2006. This was

followed by New Urea Policy 2015 w.e.f 1st June 2015.

The amount of fixed cost has more than doubled for almost all urea units since 2002-03. Even, the cost inflation index has increased by 151% from 105 in 2002-03 to 264 in 2016-17 as per government data. This indicates the general trend of increase in various cost items. Non-revision of fixed cost for almost for 15 years is resulting in under-recovery of cost and seriously impacting the viability of Indian urea plants. More than, 50% of domestic urea units are incurring losses. The return on networth for entire urea industry based on data from 25 operating urea units for 2014-15, 2015-16 and 2016-17 was minus 4.43%, minus 1.44% and minus 0.73% respectively.

New Urea Policy 2015 provides that production above 100% of reassessed capacity will be entitled for their respective variable cost of the unit plus a uniform per tonne incentive equal to the lowest of per tonne fixed cost of all indigenous urea units subject to import parity price (IPP) plus weighted average of other incidental charges which the government incurs on imported urea. But, since the government is yet to reimburse minimum fixed cost of Rs.2300 per tonne of urea as provided in the Modified NPS-III Policy, these units continue to be reimbursed fixed cost based on the minimum fixed cost of Rs.1285 per tonne. This is impacting the viability of additional production beyond re-assessed capacity.

A large number of plants made investment in projects for debottlenecking capacity and these are capable of producing additional urea. Quantity in question is about 3 million tonnes. Policy for this additional production is supposed to provide win-win situation to both government and producers. Government in any case under the policy will not reimburse cost exceeding the import parity price. Producers are incentivised to get some extra contribution towards fixed cost. But, by putting artificial ceiling of Rs. 1285 per tonne for reimbursement of fixed cost has rendered the extra production unattractive for the producers. It may also be highlighted that all producers are incurring extra interest cost on entire production due to delay in payment of subsidy. If this extra production is not realised, it will increase the import dependence of the country. Level of import dependence is very high even for other products. For example, we import almost fifty per cent requirement of Diammonium Phosphate (DAP) and 100% of Muriate of Potash (MOP).

It is contingent upon the government to address the issues of increase in conversion (fixed) cost and energy consumption norms immediately, in order to pull back the urea industry from the brink of sickness.

Stage-I New Pricing Scheme (NPS) implemented in 2003 was a group based pricing scheme breaking away from the earlier system of unit wise Retention Pricing Scheme (RPS). The NPS provided that after commencement of Stage-I and also beyond Stage-II, there shall neither be any reimbursement of the investment made by a unit for improvement in operations nor any mopping up of gains of the units as a result of operational efficiency.

In spite of the above provisions, the capacity utilisation norms were increased at successive stages of the policy thereby mopping up the operational efficiency improvements. The improvement in energy efficiency has also been mopped up by reducing the energy consumption norms under policy for Stage-II & Stage-III of the NPS Policy and New Urea Policy 2015 (NUP 2015) w.e.f. 1st June 2015. Further drastic reduction in energy norms has been proposed from 2018-19 onwards. Surprisingly, no provision was made either in Stage-II and Stage-III policy for NPS nor any window has been provided under the New Urea Policy 2015 for recovery of the additional capital investment needed for energy improvement projects for achieving such a level of energy efficiency.

The industry plea to postpone implementation of reduction in energy norms proposed for 2018-19 onwards for a few years to allow the industry to implement energy improvement projects is also pending with the government. Implementation of energy reduction from 2018-19 onwards will further squeeze the industry margins. Some units may not be in a position to achieve such level of energy efficiency and may result in closure of such capacities which are providing urea at lower than the import cost. Thus, instead of encouraging domestic production under 'Make in India' initiative, the proposed reduction in energy norms will discourage domestic production and encourage import at much higher cost.

As per conservative estimates, implementation of proposed energy reduction from 2018-19 onwards is likely to result in subsidy saving of about Rs. 2000 crore per annum. The proposed energy norms will severely impact existing domestic production of about 7-8 million tonnes which would result in proportionate higher imports and also increase in international prices of urea. Government may have to pay increased international price on entire import including the level of existing import and the increased import due to affected domestic production. The Government may end up paying more than Rs. 4000 crore per annum as additional subsidy on imported urea.

The fate of urea industry hangs in balance. Almost half of 31 urea units are making net losses. These units will be pushed further into red and more units will join their ranks. Any closure of units and loss of production will result in higher imports of urea. This will push up the international prices which are already higher than domestic cost of production. Closure of domestic urea units will be ironical because we pay higher prices to foreign suppliers in advance and deny the legitimate cost to our own producers. It is contingent upon the government to address the issues of increase in conversion (fixed) cost and energy consumption norms immediately, in order to pull back the urea industry from the brink of sickness. ■