Between the devil and the deep sea

By Uttam Gupta

REPORTEDLY, the Government is not favourable inclined to consider recommendations of the high powered Hanumantha Rao committee on future pricing policy for urea. Instead, it is contemplating modification in existing retention pricing scheme (RPS).

Under RPS, a fair exfactory price is fixed for each unit based on prescribed efficiency norms in regard to capacity utilisation and consumption of raw materials and utilities. This includes return at 12 per cent post tax grossed up to pretax using prevailing rate of corporate tax.

Introduced in November, 1997 based on recommendations of high powered Marathe committee, RPS was contemplated as a unit specific system. This was keeping in view wide interplant variation in respect of feedstock, vintage, location, etc. leading to unavoidable differences in reasonable cost of production.

Within the Marathe committee there were two opinions. One view supported by majority of members was for group pricing, i.e., a single price for a group of plants. The minority view favoured unitwise pricing system. The Government accepted this overruling the majority view.

The operation of RPS yielded rich dividends. The installed capacity of nitrogen increased from 4.58 million tonnes during 1980-81 to 8.15 million tonnes during 1990-91 and to 10.52 million tonnes in 1997-98. Production increased from 2.16 million tonnes in 1980-81 to 6.99 million tonnes during 1990-91 and further to 10.09 million tonnes in 19997-98.

The slow growth of capacity, in 90s, has been due to emerging uncertainty of the policy environment — frequent talk of alternatives like free market, import parity pricing (IMPP), etc., — on the one hand and fidding with RPS — tightening of pricing parameters, delayed payment of subsidy dues/ escalation claims — on the other, rendering investment unattractive.

The Rao committee has recommended discontinuation of unitwise RPS and its replacement by a system of uniform normative referral price (NRP) based on the LRMC principle for all existing units. However, the concept itself, is flawed as it assumes fertiliser to be a homogenous industry which it is not.

Moreover, the committee has used theoretical assumptions in relevant calculations. For instance, energy consumption is taken at level which even a most efficiently operated plant cannot achieve. This has led to artificially low recommended NRPs. Adoption of these will render majority of units unviable besides, causing serious interplant distortions. The Government's move to bypass Rao's package is, therefore, welcome.

Under the Department of Fertilisers, (DoF) package, existing unit specific dispensation is proposed to be continued. This is quite logical particularly considering heterogeneity of industry which has increased over the years with setting up of more and more plants differing widely in terms of investment cost, vintage, etc. The specific elements of the package are, however, a matter of serious concern.

Under it, energy cost is proposed to be reimbursed on the basis of actual energy consumption achieved by concerned unit during 1997-98. For many plants, actual for 1997-98 being lower than existing nor, they would be at a serious loss. For others, whose actual is higher than existing norm, higher actual will be protected. The proposal thus, seeks to discriminate against units who have improved efficiency in the past.

It is not clear as to how long revised norm will remain in force. However, pendency of pricing period being 3 years, it can be safely assumed that it would be that long. It could even be longer considering the thrust on stability of new policy. Thus, the better performers will be subjected to perpetual loss.

For the majority of old naphtha/fuel oil/LSHS based plants, energy cost accounts for about 75-80 per cent of reasonable production costs. Savings in energy use, thus, hold the key to achieving reasonable profits. Logically, therefore, concerned units have made extraordinary efforts in this area. Now, for the Government to take away resultant benefit will mean penalising them for these efforts.

While, these units may be told that they could further reduce energy use — over already reduced level — and thus, add to their profit margins, this is wishful thinking. There are inherent techological, process/equipment limitations and it is not possible to go beyond a certain point; unless huge investment is undertaken which will make operations unviable.

The package envisages reassessment of capacity of plants from existing 1350 tpd ammonia to 1500 tpd. While, these numbers largely pertain to units along the HBJ pipeline, reassessment for others may not be ruled out. Additionally, it is proposed to put a cap at 110 per cent of reassessed capacity beyond which, excess production will be paid at either IMPP or retention price, whichever is lower.

Reassessment of capacity also tantamounts to mopping up efficiency improvement. A majority of these plants were set up — or are at an advanced stage of commissioning — before RPS was introduced. Therefore, they cannot be blamed for having built up excess capacity.

In the initial years, they were operating at low level — in some cases, even below norm, viz., 80 per cent for ammonia plants. Over the years, they improved because normative principle under RPS provided necessary incentives. Now, to mop up the fruits of these efforts will be unfair and unjustified.

The Government mopped up gains in the past also, viz., increase in capacity utilisation norm to 85 per cent for naphtha/fuel oil based plants and 90 per cent for plants on gas from 5th pricing period commencing 1.4.1988. The same approach is being pursued even now, but through a newly found route, i.e. raising base capacity.

Even though increase in posttax returns from 12 per cent to 14 per cent has been proposed, considering the low net worth of these plants, this will give them only marginal extra contribution. Against this, loss due to reduction in energy consumption and capacity re-assessment will be monumental.

For new units particularly gas based, wherein, there may be instances of excess capacity, this could be taken care by putting a cap on capacity utilisation beyond which, some notional amount may be paid towards capital related charges (CRC) as a uniform incentive. This way, the country would get extra production at significantly lower cost i.e. about Rs 4,000-4,500 per tonne, than cost of imported urea even at present dumping price, i.e. about Rs 5,500 per tonne.

The package, however, penalises these units twice, i.e., first by reassessment of capacity and then, putting a cap on maximum permissible production. The proposed increase in return will hardly make any dent in mitigating the loss inflicted by these two major shocks.

Another proposal to include the CRC, only depreciation and return on net worth and pay interest on actuals will also be detrimental to efficiency operated plants. In contrast, this would make inefficient units complacent as their interest cost would be met in full despite low capacity utilisation.

In short, whereas the Rao package presents one extreme, i.e., tying units to uniform/group price ignoring factors beyond control, viz., location, vintage, feedstock, etc., DoF's package pursues unit specific approach to a point of discouraging efficiency and encouraging inefficiency in operations.

The Government will do well to seek advise from the founding fathers of RPS — and others who interacted with them — and formulate a policy which reinforces normative character of pricing and promotes the industry.

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