Low return despite high capacity utilisation

Uttam Gupta

FOR QUITE some time, new urea plants have been in the thick of a controversy. Apprehending understatement of capacity by some new units, the JPC (1992) had recommended a cut-off point of 110 per cent in case of gas based nitrogenous plants, beyond which capital related charges (CRC) should not be paid.

Recently, the HPC (1998) has virtually indicated plants operating at high capacity utilisation for alleged fortuitous gains at the cost of increasing fertiliser subsidy. A number of other reports not so much in public knowledge e.g., BICP, too have taken a critical view of these plants.

The old vintage plants _ commissioned or in advanced stages of comissioning before introduction of RPS in 1977 _ are also under cloud of suspicion. This is because, in recent years, some of them have been operating at more than 100 per cent of their installed capacity.

During 1.10.1997 to 31.3.1998, the Government restricted offtake of urea to 115 per cent of proportionate installed capacity for units having retention price (RP) of Rs 7300 per tonne and above as on 1.10.1997. In effect, this meant denial of subsidy to concerned units on production in excess of 115 per cent.

Even as this restriction has been withdrawn from current year, the mindset continues to be one of punishing these plants. This is reflected in contemplated moves like re-fixing capacity at higher levels, putting a cap on capacity utilisation beyond which CRC would be disallowed or a combination of both.

At the core of it, is the impression that high capacity utilisation automatically leads to fantastic profits. No doubt, there is linkage between level of production and profit. But, to be fair to the units, we need to look at the factual position.

The RPS provides for 12 per cent post tax return on net-worth at prescribed norms in regard to capacity utilisation _ currently. 90 per cent for gas based plants and 85 per cent for plants on naphtha and fuel oil/LSHS _ and consumption of raw materials and utilities. This was fixed way back in 1977 and has since, remained unchanged.

Compared to returns available in other sectors, this, by itself, was unattractive. And yet, investment came in because it was linked to efficiency norms and any unit doing better could hope to improve profitability. That was the scenario in 80s.

In the 90s, however, things have changed. Thanks to tightening of norm -e.g., capacity utilisation norms was changed from uniform 80 per cent to 90/85 per cent for gas/naphtha based plants w.e.f. 1.4.1988-under-recovery under various cost heads and delayed payment of subsidy dues' escalation claims etc., the ability to achieve reasonable profitability has hampered.

Despite high capacity utilisation, units are not able to reach even the assured return. For instance, during 1996-97, capacity utilisation were Nagarjuna Fertilisers, Kakinanda 138.8 per cent, Chambal Fertilisers, Gadepan 112.92 per cent, KRIBHCO, Hazira 106.0 per cent, NFL, Vijaipur 109.85 per cent..

The pre-tax return on net-worth were Nagarjuna Ferts., 19.98 per cent, Chambal 20.16 per cent, KRIBHCO, 9.98 per cent and NFL, Vijaipur 16.08 per cent. These were all lower than 21.05 per cent (corresponding to 12 per cent post tax), they should have got at 90 per cent. What about likely return at 90 per cent?

For determining this, excess of actual production over 90 per cent level is multiplied by average contribution in Rs/tonne. This would be Bagarjuna Fert., 3.39 per cent, Chambal Ferts., 7,38 per cent, KRIBHCO 7.2 per cent and NFL, Vijaipur 8.03 per cent.

In view of the above, if, responding to the sensitivities of critiques, units were to decide not to produce beyond 90/100 per cent than, this would tantamount to reducing return to such low level which investors would not even look at. Even, the Government as owners of PSUs in pubic/co-operative sector, would do the same.

A major reason for low returns is the huge under-recoveries of costs under various heads viz., disallowance in project cost, impact of Rupee depreciation on repayment of foreign currency loans, repairs and maintenance, wages/salaries and other overheads, marketing and selling expenses, non-recoverable taxes and duties, to cite a few.By producing more an hereby, increasing realisation from CRC and other fixed cost, units try to off these to the extent possible. Some of them are not able to fully neutralise; that is why, in examples cited above, the units don't even reach 12 per cent post tax despite high utilisation.

Even as under-recoveries go unnoticed, a mountain is made out of gains from increasing production beyond the normative level. A glaring manifestation of this is available in HPC (1998) Reports. In its zeal to show that units must be getting away with fantastic profits. HPC didn't even realise that its relevant computation was faulty.

In table A-III, 6 (page 100 of Report), it multiplied RP of the unit with normative/assessed production and divided resultant number by actual production (average for 1994-95 _ 1996-97) to arrive at revised RP. The excess of former over latter was thus, identified as the unintended gain. What is wrong with this?

The RP includes a substantial element of variable cost (VC) on which, there is no question of any gain due to increase in production. However, by working on RP, VC was also proportionately reduced. To give the correct picture, logical course should have been to work on CRC and other fixed cost only which do not vary with production.

It may be argued that implementation of RPS could be improved to minimise/remove under-recoveries. This is easier said than done consider, for instance, turnover tax levied by some states viz., Karnataka, Tamil Nadu etc. As per state law, manufacturer/dealer cannot pass it on to consumer. The GOI says that states should not levy it. The manufacturer is squeezed between the two. Under-recoveries continue unabated. The HPC recognised this problem, but, has ducked a solution.Because of erratic and unreliable power supply from the Grid, units have installed captive power plants (CPP) to ensure uninterrupted production and prevent damage to process plants. A substantial portion of investment on CPP is arbitrarily disallowed.

There are inordinate delays in revising RP for various pricing periods. For sixth pricing period i.e., 1.4.1991 to 31.3.1994, these were notified in January 1995. Due to this, sixth pricing was extended by three years to cover 1.4.1994 to 31.3.1997. The RP for seventh pricing w.e.f. 1.4.1997, are yet to be notified.

This really means that until revised RP is notified, payment for CRC and other fixed costs continues as per prevailing lower rate. The financing cost of the difference erodes profitability as Government does not reimburse interest on delayed payments. In addition, units face liquidity problems affecting production.

The under-recoveries are thus, a perennial feature. These cannot be wished away. For a moment, let us assume that there will be no under-recovery. This implied that units would get 12 per cent post tax return at normative production. Will the Government then, be justified in asking them not to produce beyond this level?

This is not fair as return of 12 per cent is not attractive. Moreover, in situations when, production drops below the norm -say, due to inadequate supply of feedstock, technical problems-the unit does not even reach 12 per cent or could even incur loss.

From the economy's angle too, restriction on production is unjustified. Given the shortfall in domestic production vis-a-vis demand, this will lead to increase in imports. Considering prevailing low price of imported urea, some of us might favour this. But, what about the scenario when, prices will be higher?

It will not be prudent to switch on and off incremental production from our own plants depending on movement in international price of urea. It is not practical also. For instance, the units will have serious problems with oil/gas PSUs in adjusting supplies of feedstock.

While, formulating the new pricing policy, the Government should take a holistic and pragmatic view taking into account the need for giving reasonably attractive return, inherent constraints in realising this -including impact of persisting under-recoveries -and ensuring optimum use of domestic production capacity.

(The author is a Chief Economist in the Fertiliser Association of India)