The Indian EXPRESS
NEW DELHI ■ FRIDAY ■ FEBRUARY 26, 1999

Modified RPS — recipe for disaster

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ACCORDING to recent reports, contemplated Modified Retention Pricing Scheme (MRPS) for urea manufacturers will remain in force for a period of 10 years. This is unlike the past practice of pricing period being generally three years with exception of 6th pricing period, that is, 1.4.1991 to 31.3.1994, which had to be extended by three years up to March 31, 1997 (due to delay in pricing exercises).

The 10-year pricing period implies that essential parameters of pricing would remain unchanged for that long. Even as MRPS cover a whole gamut of areas, four of them are of special significance: (i) base capacity and capacity utilisation, (ii) consumption norms for raw materials and utilities, (iii) treatment of interest on long-term loans, and (iv) basis for allowing depreciation.

In regard to base capacity, in respect of 8 plants along HBJ pipeline, a Technical Committee of the Department of Fertiliser (DoF) (November 1997) had recommended increase in capacity of ammonia plant from existing 1,350 tonnes per day (tpd) to 1500 tpd and for Nagarjuna Fertilisers, Kakinada, from existing 900 tpd to 1,050 tpd. These numbers have been arrived on the basis of best monthly production of best operated plant. Even as all pants are of identical size, actual performance varies from unit to unit and over time for any given unit, depending on both external factors, e.g. availability of gas and its calorific value, temperature, etc, and those internal to the unit. By definition, the best level cannot be sustained.

For others operating at high levels — primarily old naphtha/fuel oil based plants — capacity is proposed to be re-assessed on the basis of performance in best production year. Herein also, underlying premise that best can be sustained is highly unrealistic. In fact, due to aging, continued reliable operations at high levels cannot be taken for granted. Under RPS, from 11th year, capacity utilisation norm is reduced by 5 per cent viz, for gas based from 90 to 85 per cent, in recognition of diminished potential of plant. For units currently operating at high level, this vintage benefit is proposed to be withdrawn. Even though, through proper upkeep and maintenance, they may be doing well, inevitable impact of age cannot be wished away.

The consumption norms are proposed to be adjusted for higher re-assessed capacity. This pre-supposes that consumption of raw materials/utilities i.e., tonnes of naphtha needed for producing a tonne of urea, would decline with increase in production. While, there may be room for marginal improvement, proportionate reduction is unimaginable.

Additionally, consumption norms are proposed to be updated on basis of best performance year for concerned unit and frozen at that level for a period of 5 years. After years of continuous efforts, efficient units have reached current levels. The old plants in particular, bank on saving in energy cost to remain viable. Mopping up of these would sound their death knell.

The proposal to exclude interest on long-term loans from capital related charges (CRC) is tantamount to distortion of pricing principles. How can a major element of cost as interest be taken out and given on actual basis? This would mean that a unit which does not produce at all or operates at very low level, would get reimbursement of interest in full. On the other hand, efficient units will have little incentive to improve performance. The proposal to reduce depreciation from existing 15 years basis to 18 years reflects a totally inconsistent approach. Prior to 5th pricing period, this was related to 10 years in line with Companies Act. From 5th pricing, this was reduced to 15 years basis despite rate under Companies Act remaining unchanged.

Now, when, depreciation rate under Companies Act has been revised to 18 years basis, Government is keen to adopt same for pricing as well. If, there has to be alignment between former and latter, then, why did it deviate from this premise during last 10 years i.e., 1.4.1988 onwards? The provision for minimum CRC is a good concept as it helps old plants generate resources for funding revamp/modernisation. However, in an inflationary situation, proposed amount of Rs 1,000 per tonne is grossly inadequate. Under RPS, a number of units have already reached this level (due to capital additions over time). For them, the incentive is only academic. The MRPS seeks to put a cap on capacity utilisation at 110 per cent beyond which incremental production would be picked up at either import parity price (IMPP) or retention price (RP) including CRC of Rs.1000 per tonne whichever is lower. This is illogical.

A typical case of Heads of I win and Tails you loose. Already, due to significant under-recoveries of reasonable cost, units are not able to achieve reasonable profitability despite operating at high capacity utilisation. During 1998-99, profit before tax (PBT) of all profit making units is estimated to be about Rs 1,275 crore. This is 14.70 per cent of net-worth as against assured 18.46 per cent which, by itself, is inadequate. During 1999-2000, cash flow (post-tax profits plus depreciation minus loan repayment and capital additions) of these units is projected to be about Rs 380 crore (based on likely RPS w.e.f. 1.4.1999). Adoption of proposals under MRPS will more than wipe out entire PBT of these units and severely undermine their cash flows.

To be meaningful, pricing system should be offered as a package. Thus, while, there may be areas wherein, units gain, in others, they suffer. The MRPS focus is primarily on former with sole aim of mopping up gains. In turn, this is prompted by obsession to reduce subsidy without tackling basic causes viz., low selling price/high input prices. This is the surest way of pushing industry on brink of disaster.

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