

Fertiliser industry — I

Why the investor is still interested

THERE is a sudden burst of interest to set up ammonia/urea projects. While many of the relatively new private sector units — the Birla's Chambal, the Tatas' Babrala and the Osvals' Shahajahanpur — are contemplating expansion at existing sites, others — the R. P. Goenka group and the Paharpur Cooling Towers — plan to set up greenfield projects.

The cooperative/public sector companies too have substantial greenfield expansion plans (IFFCO at Nellore) and of expanding existing locations (IFFCO at Aonla, NFL at Bijaipur and KRIBHCO at Hazira).

With the industry delicensed in July 1991, anyone could set up a fertiliser unit, subject to locational and environmental restrictions. Only the entrepreneur had to enter into a long-term supply contract with government-controlled corporations such as IOC, ONGC, and GAIL for uninterrupted supply of the feedstock, critical to the running of an ammonia/urea plant.

Natural gas is the most preferred feedstock in terms of energy efficiency and cost effectiveness, apart from being environment friendly. This was why a majority of the plants set up in the 1980s and the early 1990s ran on gas.

Now, except for the IFFCO-Aonla and NFL-Bijaipur expansions, no other new project (including expansions) has been allowed this route mainly because of the limited availability and the distortions in allocation priorities, leading to its diversion to other sectors such as power and sponge iron.

The Petroleum and Natural Gas Ministry took a policy decision recently to not make domestic naphtha (the next best alternative) available to the new projects at the concessional rates applicable to the fertiliser industry. So, the industry would have to import it at the market price, which is determined by the uncertainties of the global market.

Also, with so many plants planned, off-take had to be ensured. In 1995-96, of the total urea consumption of about 18 million tonnes, 15.8 million tonnes were indigenously produced, the balance being imported.

In 1996-97, the projected consumption is

Modern production processes and the incentives available under pricing linked to performance may make the fertiliser industry attractive to investors. But they must analyse the mechanics of the retention pricing, the subsidy scheme, the experiences of the existing plants, and the likely policy environment when projects see the light of day, says Uttam Gupta.

18.5 million tonnes, with local production touching 16.3 million tonnes, leaving a gap of 2.2 million tonnes to be met through imports.

Assuming that the demand continues to grow at the same pace as in the recent years — 7,00,000-8,00,000 tonnes per annum — the augmented supply after the commissioning of all the planned projects will far exceed the demand.

Adding to the excess supply situation would be the 1.5 million tonnes per annum Oman urea project being commissioned with Indian partners (RCF and KRIBHCO), which have a 100 per cent buy-back arrangement, and likely to be commissioned by 1999-2000.

A further dampener could be if the Government decides to raise urea prices to keep the subsidy burden under control and achieve better balance *vis-a-vis* the prices of decontrolled P and K fertilisers; the selling price of urea remained unchanged through the 1980s, and was raised only by a small margin during the first half of the 1990s.

Though for the time being, the pressure to decontrol urea has eased, in case of a serious balance of payment crisis, *a la* 1991, forcing India to approach the International Monetary Fund/the World Bank for assistance, decontrol may well be forced on the country as a conditionality.

In the event of decontrol, the urea selling price would shoot up by almost 100 per cent, leading to a further fall in consumption, as happened in the case of phosphatic fertilisers following their sudden decontrol in August 1992. In such a situation, if the existing urea producers would be hit, the

new projects would be devastated.

So with all these uncertainties, why is the investor interested in the fertiliser industry? Under the control regime, the manufacturer/importer is compensated, as subsidy, for a reasonable cost of production (C&F landed cost, in case of imports), distribution and profits. For the domestic producers, the Government runs what is called the retention pricing and subsidy (RPS) scheme.

Under the RPS, the reasonable cost of production (or the retention price) is allowed to the producer on the basis of the prescribed efficiency norms taking into account the capacity utilisation and consumption of raw materials and utilities.

For gas-based units, a capacity utilisation norm of 90 per cent for the ammonia plant from the second to the tenth year is assumed, whereas it is 85 per cent for plants based on naphtha or fuel oil/LSHS. From the eleventh year, these norms are 85 per cent and 80 per cent respectively.

In allowing for the cost of servicing the capital, the investment cost and the actual financing pattern are taken as the basis. The investment cost is accepted after careful scrutiny and making suitable disallowances for the time and cost overruns in implementing the project.

The system allows for a return of 12 per cent post-tax on networth. This was fixed in 1977, based on the Cabinet's guidelines, corresponding to the then 9 per cent interest on term deposits in banks, and a risk factor of 3 per cent. This return rate has remained unchanged, though the bank's term deposit rates have been scaled up to 12 per cent.

The returns available in other industries

are significantly higher. For instance, in the power sector, the Government guarantees 16 per cent post-tax return at 68.5 per cent capacity utilisation (plant load factor) and an additional incentive of 0.7 per cent for every 1 per cent increase in the PLF beyond 68.5 per cent.

Being a normative system, the returns are not guaranteed. To earn 12 per cent post-tax, the fertiliser manufacturer is expected to operate the plant at the prescribed efficiency norms.

If the actuals fall short of the norm, the returns may not only be short of the 12 per cent level, but the producer may make a loss, depending on the shortfall. Of course, if the actuals exceed the norm, the returns would be higher.

With state-of-the-art plants and the use of modern technology and production processes, the investor would expect the plants to operate at a high capacity utilisation and achieve energy efficiency.

This, together with the incentive available from the pricing linked to performance, no doubt makes the investor optimistic of getting good returns and, hence, the virtual flood of proposals to set up urea plants.

But the investors would do well to study the mechanics of the RPS and its implementation, draw useful lessons from the experiences of the existing plants, and analyse the likely policy environment when the projects see the light of day.

Although, initially, the system was implemented in a fair and equitable manner, upholding its normative philosophy since the late 1980s, unfortunately, it has been unjust and unfair to the efficient units.

Because of this, despite operating even above 100 per cent capacity utilisation, the manufacturers have not been able to achieve the 12 per cent post-tax return. At the normative levels — 90 per cent for gas-based units — the returns would have been much lower and some of them would have even made losses.

(To be concluded)

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