Editorial

9 January, 1997

THE HINDU BUSINESS LINE

Fertiliser industry — II

Choose a policy and stick to it

Under the decontrolled regime, new urea units have found the going tough *vis-a-vis* the old plants considering their substantially higher production cost because of the much higher investment cost. For the new entrants things have not changed much as even now, under the retention pricing and subsidy (RPS) scheme, the policy environment is unfriendly, says Uttam Gupta.

WHILE there have been numerous instances of distortions in the implementation of the retention pricing and subsidy scheme (RPS) with regard to the fertiliser industry, a look at some of the major areas which the new projects would be ignoring at the cost of jeopardising their viability.

With effect from April 1, 1988 (the beginning of the fifth pricing period), the depreciation and capacity utilisation norm was tightened. The basis for allowing depreciation on plant and machinery was changed from 9 to 15 years, which translates to 6.33 per cent per annum against 10.56 per cent earlier. The capacity utilisation norm was raised from 80 per cent for ammonia units to 90 per cent for gas-based plants and 85 per cent for units using naphtha/fuel oil as the basic feedstock.

Norms on feedstock consumption, utilisation and so on were progressively tightened since the beginning of the fourth pricing period, April 1, 1985, using the actual operating levels, thus taking away the benefit of efficiency improvement. Commenting on the state of affairs, the Joint Parliamentary Committee said that as long as the manufacturers are covered by the RPS, they should not be unjustifiably subjected to norms tightening. The industry also suffered due to the inadequacy/non-compensation of the various costs legitimately and necessarily incurred by the units. Broadly, the cost under-recoveries fall into four categories.

One, delayed and inadequate compensation for escalation claims. While the manufactures have to pay for the increases in the prices of various inputs arising out of the Government's administrative decisions from day 1, the necessary adjustment in the RPS takes long. Apart from causing liquidity problems, this leads to a heavy loss of interest as the Government does not reimburse interest cost on delayed payments.

Often, the Government and its agencies increase the charges for user-services such as water, electricity and municipal taxes with retrospective effect. In some cases, the hikes are high, forcing manufacturers to seek relief through various forums including the judiciary, which takes time. The battle is fought on behalf of the exchequer as bringing the rate down to a reasonable level will help reduce the subsidy outgo. In the event of the court upholding the hike in full or in part, the Government does not fully reimburse the increase in cost.

Two, even the payment of normal subsidy dues — related to notified retention prices — are delayed mainly due to underprovisioning in the Budget. This too results in a substantial loss of interest and a corresponding erosion in profitability. Three, finalisation and notification of retention pricing for each pricing period by itself takes a long time. The retention pricing for the sixth pricing period — April 1, 1991-March 31, 1994 — was notified in January 1995, long after the pricing period ended. Consequently, all these years, the units were paid conversion and capital-related charges based on the 1986-87 (the costed year for the fifth pricing period April 1, 1988-March 31, 1991) scale, resulting in huge under-recoveries and loss of interest.

Moreover, the sixth pricing period was extended by another three years to cover 1994-95, 1995-96 and 1996-97. This has led to further losses as fixed charges for these years continue to be related to 1989-90 (the costed year of the sixth pricing period) instead of 1992-93, which should have been the benchmark for updating costs in the normal course.

New units are paid subsidy on the basis of *ad hoc* retention pricing, which is significantly lower than the price determined on a realistic basis based on the cost data of the units concerned. Consequently, liquidity problems and interest loss are unprecedented. Some units thus have a tough time meeting even their loan repayment obligations to the financial institutions.

Four, there are several elements of cost — such as turnover tax, additional sales tax, repairs and maintenance, capital additions during the pricing period, the impact of rupee depreciation on servicing foreign currency loans, and the impact of interest rate hikes — which are either completely disallowed or allowed only partially. This cuts deep into the unit's limited profit margins.

Notwithstanding these adversities, if the manufacturers somehow manage to keep their heads above water, it is mainly due to the sole incentive of improving profitability by operating at higher capacity utilisation. For the new plants, benefits from various tax concessions during the initial years, available to all industries including those not covered by administered price controls, help improve their internal generation, crucial to servicing the debt and equity.

Contrary to popular belief, the bonus the plants get by way of savings in fixed cost, including capital-related charges on production above the normative level, is not a gift. Operating the plant above the normative capacity utilisation requires extra efforts by way of improved maintenance, optimising the stream days by encroaching even on the 35-day period usually available for shut down, straining all critical machinery and equipment, managing environmental aspects better and, above all, motivating and gearing the workforce to achieve higher efficiency standards.

Notwithstanding all these, the Government is contemplating denying capital servicing charges to the plants working above a certain capacity utilisation level. This will result in penalising the manufacturer for efforts to improve efficiency and inevitably force the unit to restrict production to the prescribed ceiling. This can demoralise the workforce and the management alike.

Also, the Government plans to disallow a part of the cost incurred by the new units in investing in captive power and steam generation plants. Prior to the 1980s, the urea plants' performance suffered because of their dependence on State electricity boards for power supply, which was unreliable and erratic. Now that on government instructions all the plants have captive power units, the move to disallow a significant portion of the cost incurred on them will defeat the objective.

These measures, if implemented, will be the proverbial last straw on the industry's back and undermine completely the viability of the units. Specifically, the proposal to mop up capital-related charges on higher production will affect seriously even the old plants and hamper their ability to generate adequate funds, needed to support their timely revamp and modernisation programmes.

Hence, irrespective of whether the controls on urea and the RPS remain or not, the new projects face a serious threat to their viability. While under the decontrolled regime the new plants' substantially high production cost due to the much higher investment cost *vis-a-vis* the old plants made them unviable from the word go, even under the RPS, the policy environment is unfriendly. Some of the vital areas likely to affect them most include: (i) Delays in fixing and notifying the final retention pricing; (ii) disallowing of a portion of the capital cost; (iii) delays in recognising the various escalation claims; and (iv) disallowing of capital-related charges above a certain capacity utilisation.

The promoters, in the interest of the financial institutions/banks and the thousands of shareholders in India and abroad, whose funds will be tied up in these projects, and their own, should sit face-to-face with the Government and decide on all the vital parameters under the RPS having a bearing on the project's viability. The Government should also state categorically the contemplated changes in the policy or the parameters of price fixation. For instance, if it intends to adopt the concept of normative capital cost, or disallow capital charges above a certain capacity utilisation, let it inform the promoters in advance; it will be illogical and unfair to tell them about this after the project goes on stream.

Any such change should not be given retrospective effect as the existing units, including those commissioned in the last few years, would have been set up on the basis of the pricing parameters existing at the time of the project's commissioning and any adverse retrospective change will violate the *promissory estoppel* principle and go against natural justice.

The uncertainty of the urea pricing policy continues due to the frequent talks of replacing RPS with other mechanisms such as free market or pricing based on import parity. The Government should put an end to this by categorically stating that controls and the RPS would continue for a reasonably long period, which should be clearly spelt out. The basic parameters of price fixation should be indicated in advance and the entire exercise made transparent.

Moreover, the various distortions in the RPS' administration should be removed by bringing it in line with the normative philosophy that its founding fathers planned for and that which was strictly observed during the initial phase of implementation, leading to the industry's rapid growth in the 1980s and the resultant reduced dependence on imports.

The cost of not rectifying these anomalies will be monumental not only by way of huge investments in capacities going down the drain, but also by way of unprecedented loss of domestic production, leading to huge imports at a much higher cost entailing correspondingly higher subsidy outgo, apart from an additional foreign exchange burden.

(Concluded)

(The author is Chief Economist, The Fertiliser Association of India, New Delhi.)