Editorial

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THE HINDU BUSINESS LINE

Fertiliser pricing policy

Deterrent to urea projects?

Following the recommendations of the Hanumantha Rao Committee, several companies have put on hold their plans to set up ammonia/urea projects: ***Uttam Gupta.***

THE High Powered Fertilisers Pricing Policy Review Committee, under the Chairmanship of Dr. C. H. Hanumantha Rao, former Member, Planning Commission, which submitted its report to the Government on April 3, recommended a positive policy to attract new investment and, thereby, ensure that, over a period of time, the level of self-sufficiency already reached is not eroded to unacceptable levels.

To realise this goal, the Committee recommended a guaranteed price for a period of 15 years of production by new units — to be announced well in advance — related to the long run marginal cost (LRMC) principle for projects based on most efficient feedstock and operating at attainable efficiency.

Under the LRMC method, the Committee computed the long run average cost (LRAC). This involves calculation, in stage-1, of the weighted average cost of servicing the capital — interest on loan/working capital (WC) and return on shareholders' funds — over the life of the project taken as 15 years.

In stage-2, the rate thus computed is used for discounting streams of investment, WC, operating cost (energy/bagging, conversion) (OC) and projected production. The sum total of the discounted values of investment, WC and OC divided by the sum total of discounted values of production gives LRAC. The projected LRAC levels are Rs. 6,938 per tonne for projects based on the use of domestic gas and Rs. 8,299 per tonne on LNG.

Though the Committee computed LRAC for plants based on naphtha and fuel oil (FO) as well, these are not relevant as it has clearly recommended that in view of these being inferior feedstock, the future growth of the industry will have to be either on domestic gas or LNG. In fact, through another recommendation, the Committee would like even existing naphtha/FO-based plants to switch over to domestic gas/LNG.

A new project coming on domestic gas is ruled out due to supply constraint. As a matter of policy, the Government has denied supply of gas for setting up new fertiliser projects. Ironically, due to shortage of gas, even existing units along the HBJ pipeline do not get their full requirement to run the plant at optimum load. In fact, the recently commissioned expansion projects of IFFCO, Phulpur (December 1997) and Nagarjuna Fertilisers, Kakinada (March 1998) are entirely on naphtha.

The only option then is LNG. While several projects are being talked about by various MNCs, either alone or jointly with Indian companies — primarily in the public sector — it is doubtful whether LNG would see the light of the day five years from now. Assuming, for a moment, that such projects fructify within a reasonable timeframe, considering the huge investment involved in setting up LNG supply and distribution infrastructure, the expected price delivered at factory tap would be at least about $5 per million BTU.

At this price and taking energy consumption of 24 million BTU needed to produce a tonne of urea, the energy cost alone will be $120 per tonne or about Rs. 5,040 per tonne (at the current exchange rate of $1 = Rs. 42). Add bagging about Rs. 250 per tonne, the variable cost (VC) will be about Rs.5,290 per tonne. Other operating costs (conversion cost, marketing cost and working capital) (OOC) would account for another about Rs 800 per tonne.

Thus, VC and OOC alone will take away Rs. 6,090 per tonne out of the recommended LRAC of Rs. 8,299 per tonne. Consequently, the amount available for capital-related charges (CRC) will only be Rs. 2,209 per tonne. On production of 0.768 million tonnes (at 100 per cent load), this would generate about Rs. 170 crores per annum.

Against this, for a new project having an investment of about Rs. 1,600 crores with debt-equity ratio 2:1, the interest on loan at 16.5 per cent and repayment over eight years, money needed for servicing the debt alone would be about Rs. 310 crores per annum. The return on the equity at 18.46 per cent (12 per cent post-tax allowed under RPS — grossed up for the prevailing rate of corporate tax, that is, 35 per cent) will account for another about Rs. 100 crores.

Clearly, the generation of funds at the recommended price of only Rs. 170 crores will fall short of the required funds towards CRC by a whopping Rs. 240 crores. The project will not only be unviable, but, get into an unprecedented liquidity crisis from day one. The continuation of the shortfall year after year will eventually turn them sick.

It is often argued that fertiliser plants generally have the capability of producing more than the declared capacity. And, that by exploiting this hidden potential, they can generate extra funds. How far a plant can go beyond 100 per cent utilisation is a question that needs to be addressed only in terms of the underlying factual position, taking into account all relevant technical factors/information, avoiding sweeping generalisations. But it may be worthwhile to get an idea of the extra production that would be needed to fully recuperate this huge shortfall.

On every tonne of urea produced beyond the 100 per cent level, the unit will get additional contribution of Rs. 2,209 towards CRC. Add another about Rs. 300 towards other fixed costs which do not increase with production. Overall, the unit will get Rs. 2,509 per tonne. In view of this, the incremental production required to fully make up for uncovered gap of Rs. 240 crores will be 0.956 million tonnes. In other words, the plant will have to produce a total of 1.724 million tonnes. An impossible task indeed!

It is also argued that the unit should strive to improve efficiency to remain viable at the offered price. Again, it is necessary to assess what is possible. The reduction in energy consumption by one million BTU per tonne urea yields a saving of $5 or Rs. 16 crores per annum. For plugging the uncovered gap of Rs. 240 crores, the required saving in energy use will have to be 15 million BTU. In other words, the plant will have to achieve energy consumption of about nine million BTU (24-15). This is an unattainable number to say the least.

If the recommended LRAC of Rs. 8,299 per tonne for a new project on LNG is adopted, no investment will be attracted for setting up of fresh capacity. The price is unviable mainly because in the relevant computations: the LRAC has been artificially suppressed by using totally unrealistic/theoretical assumptions with regard to critical parameters — energy consumption norm, delivered cost of LNG, investment cost, and so on.

For allowing energy cost, the energy consumption for producing a tonne of urea is taken as 5.07 million K. cal, which is clearly unattainable. The allowance is further lowered artificially by taking the delivered cost of LNG as Rs. 6,666 per thousand cu.m at CV of 9,250 K.cal, which translates to about $4.2 per million BTU as against the likely reasonable cost of $5 per million BTU.

The investment is also kept artificially low at Rs. 1,425 crores. In fact, this is close to the capital expenditure incurred by a unit commissioned about three years ago. The assumed level is, thus, significantly lower than the reasonable actual of about Rs. 1,600 crores. Already, following the recommendations, several players have put on hold their plans to set up ammonia/urea projects till the Government finalises its stand. If it is really serious about attracting investment in this vital sector linked to food security, then, the LRAC levels need to be reworked using realistic assumptions.

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