

Modified RPS

Stick to basic pricing tenets

Uttam Gupta

FOR more than two decades now, the nitrogenous segment of the fertiliser industry — primarily urea — has been governed by the retention pricing scheme. The RPS is now under review. The High-Power Fertilisers Pricing Policy Review Committee (HPC) of 1998 recommended its abandonment and replacement by a system of uniform normative referral price (NRP) based on LRMC principle for all existing units.

Considering the serious adverse impact on the health and growth of the industry, the Government has not favoured the uniform NRP. At the same time, it sees certain anomalies/distortions in the RPS and has, therefore, put it under a microscope with a view to bring about far-reaching changes even while retaining its unit-specific character.

The ammonia/urea plants vary widely in respect of all critical parameters — feedstock, technology, location, vintage and so on. The majority of the units were set up under the controlled regime of the 1970s and the 1980s. For several plants commissioned in the 1990s, decisions were taken in the 1980s. Consequently, the reasonable cost of production varies from unit to unit and is beyond control of individual firms. In view of this, emphasis on unit-wise pricing is logical. But what about the modified RPS?

In this context, media reports talk of re-assessment of the installed capacity, ceiling on capacity utilisation beyond which capital related charges (CRC) are proposed to be disallowed or to be allowed at substantially reduced rates, allowing interest on long-term loans on actual basis, revision of energy consumption norm on actual and so on.

A brief look at the manner in which the retention price (RP) is fixed. The RP is expected to cover the reasonable cost of production of the unit including a reasonable margin of profit currently at 12 per cent post-tax on the networth. Broadly speaking, the production cost is made up of fixed costs (FC), including CRC and variable cost (VC) that covers the energy cost apart from those for water, bagging and so on.

For determining the rate for FC, that is, Rs./tonne, the allowable cost in Rs. crores is divided by the annual production. Likewise, for arriving at the rate for VC, the delivered cost (at factory gate) of relevant input in Rs. per tonne is multiplied by the conversion factor, that is, tonne of naphtha/gas needed to produce a tonne of urea.

The Government fixes the norms in regard to both the production and conversion efficiency. For instance, for arriving at normative production for a gas-based plant, the installed capacity is multiplied by a factor of 90 per cent. For plants based on fuel oil/LSHS, this is 85 per cent.

During the initial years of operation since its introduction in November 1977, the RPS was fundamentally normative. Thus, by operating above the normative production level, a unit could increase its realisation from CRC and other fixed costs, thereby improving profitability. Similarly, by achieving consumption of feedstock and other inputs lower than the norm, it could affect savings in the VC and, thus, improve returns.

Conversely, units which could not come up to the norm were penalised by way of lower returns than the assured level or, even losses depending on the shortfall. This is amply demonstrated by

the huge accumulated losses of the FCI and HFC group of plants which have been operating all through at extremely low levels due to certain inherent design and equipment limitations, besides power and labour problems.

Prior to the RPS, a number of existing efficiently-running plants were operating at low capacity utilisation. Given the incentive linked to actual performance, they made unstinted efforts to improve it by better maintenance, timely repairs/replacement of critical equipment, better control of process parameters, and so on. The RPS also induced fresh investment as it was possible to improve profitability by working at efficiency levels higher than the norm.

In short, the RPS provided a conducive environment, and laid the foundation for a healthy and efficient industry. This is reflected in a sharp increase in the installed capacity of nitrogen from 4.586 million tonnes in 1980-81 to 8.282 million tonnes in 1991-92. Production increased even more sharply from 2.164 million tonnes in 1980-81 to 7.301 million tonnes during 1991-92.

Unfortunately, beginning the fifth pricing period — April 1, 1988 to March 31, 1991 — various measures were implemented to mop up the benefits of improvements in efficiency. For instance, from April 1, 1988, the capacity utilisation norm was revised from uniform 80 per cent for all the plants to 90 per cent

Fertilisers				
	93-94	94-95	95-96	96-97
Production				
Nitrogenous Fertiliser	'000 tonnes			
Target	7800	8115.50	8632.50	9800
Actual	7231	8115.50	7950.00	8777
Installed capacity				
Public sector				
Viable units	3308	2572.8	2618.0	2694.0
Loss-making units	1011	374.5	308.5	333.1
Total	4319	2947.3	2926.5	3027.1
Co-operatives				
Private sector	2268	1681.0	1659.3	1803.8
Total	3910	2624.6	3338.0	3946.1
Total	10497	7231.2	7945.5	8777.0

for gas-based plants and 85 per cent for naphtha/furnace oil based plants.

The norm for depreciation was tightened to 15 years basis thus, entailing reduction in the allowable depreciation from 10.56 per cent to 6.33 per cent. For plants set up between 1982 and April 1, 1998, the methodology resulted in still lower rates of allowable depreciation.

The norms for consumption of raw materials and utilities were initially fixed on the basis of actual performance during a few selected reasonably long periods of operation at high capacity utilisation and making standard allowance towards unproductive consumption during shut-down/start-ups. However, during the Fifth pricing period, these were also tightened based on actuals of the units.

The RP is fixed for three years, commonly known as pricing period. Specifically, CRC and other fixed cost — these are computed with reference to the cost year (generally, one year before the commencement of the pricing period) — remain unchanged during the period.

There have been inordinate delays in announcing the RP for various pricing periods. For instance, the revised RP for the sixth pricing period, that is, April 1,

1991 to March 31, 1994, was notified towards end of 1994-95. Due to this delay, the sixth pricing period was extended initially by two years, that is, 1994-95 and 1995-96, and eventually, to cover 1996-97 as well.

For the seventh pricing period, commencing April 1, 1997, the revised RP is yet to be notified. However, in view of 1997-98 having already passed and even 1998-99 about to end, the possibility of treating these two years as an extension of the extended sixth pricing period is not ruled out. The newly set up plants (post-1992) continue to be paid on the basis of *ad hoc*/provisional price.

In addition, there have been substantial under-recoveries of reasonable expenses under various cost heads — repairs and maintenance (R&M), overheads, selling expenses, impact of exchange rate fluctuation on servicing of foreign currency loans, normal capital additions, local taxes and so on. Besides, the delay in the payment of escalation claims and even normal subsidy dues have cost the units dearly by way of loss of interest.

During the second half of 1997-98, in respect of units having an RP of Rs. 7,300 per tonne and above, the offtake was restricted to 115 per cent of the proportionate installed capacity. This essentially meant no payment of subsidy on incremental production beyond the 115 per cent level. In turn, this squeezed the profit margins of the units concerned.

As a result, despite operating at high capacity utilisation levels, generally, the units are not able to achieve 12 per cent post-tax return which, by itself, is unattractive. This has discouraged fresh investments as well, which is reflected in a drastic slowdown in capacity build-up during the 1990s.

The addition to the installed capacity of nitrogen since 1991-92 has been only 2.236 million tonnes against an increase of 3.696 million tonnes during the 1980s. The bulk of the former came from plants conceived and planned in the 1980s. In the 1990s, no new grassroots project has been taken up for implementation. The foreign investors are not keen to invest in this important industry.

The above review points towards a drastic change of mindset that believes in penalising producers for doing better instead of rewarding them. This is contrary to the normative philosophy of the RPS. The contemplated changes merely represent a continuation of this trend. Let us get an idea of how and, to what extent, the measures could affect the units.

On re-assessment of capacity, the approach seems to be to fix it at the best production level achieved by the unit. Consider a plant with capacity of 7.68 lakh tonnes per annum. At present, the pricing is done on 90 per cent of this or 6.912 lakh tonnes. Now, assume actual production at 110 per cent or 8.448 lakh tonnes. On the difference, that is, 1.536 lakh tonnes, it is getting extra contribution which is utilised to offset various under-recoveries at 90 per cent and, thus, achieve reasonable profit.

Now, if the normative production is re-fixed at 8.448 lakh tonnes, the benefit of incremental production would have been fully mopped. The unit would be saddled with meagre returns or even losses depending on the extent of under-recoveries. In case, however, it cannot maintain production at 8.448 lakh tonnes — due to inadequate feedstock

supply or technical problems — then, it would simply go into the dumps.

Such an approach is illogical and inconsistent. This may be seen from the fact that, in the initial stages, when many units were operating at below normative levels, the RPD did not provide them any relief. Now that after having undertaken substantial investments, they have affected improvements, it would be illogical to take away the consequential benefit of higher capacity utilisation.

Likewise, a reduction in the energy consumption norm on the basis of the actuals would be illogical. Due to the very low networth and, consequently, low CRC, old plants depend heavily on saving in energy cost for increasing their internal generation to support continued operation at optimum level. If this is mopped up, they would go into the red.

Disallowing interest on actuals not only discriminates against efficient plants, but is also contrary to the principles of pricing. This can even lead to a highly absurd situation whereby, even if a unit either does not produce at all or produces just a few tonnes, it would still get full reimbursement for interest.

The Government should not proceed with the proposed changes in view of their serious adverse effect on viability of existing units and further investment. While the need to reduce the subsidy outgo may have prompted such steps, the fact cannot be ignored that various measures on similar lines implemented in the past, made no dent on the problem. The subsidy has continued to scale new heights because no serious attempt has, so far, been made to tackle the fundamental causes.

In this context, according to a study by the Fertiliser Association of India in respect of 17 urea manufacturing units — with a share of about 50 per cent in the urea production — during 1990-91 to 1996-97, the gross increase in cost was Rs. 1,316.20 crores. Of this, Rs. 780.57 crores was neutralised by upward revision in the consumer price. Thus, the net increase in the subsidy was Rs. 535.63 crores.

Out of the gross increase in cost, Rs. 1,040.57 crores was on account of the increase in the cost of raw materials, utilities and freight which are all supplied by government agencies. But for this, units would have made an additional contribution of Rs. 504.94 crores to the exchequer. Really speaking, the fertiliser subsidy is not a burden on the exchequer; it is a mere intra-economy transfer from the Budget head to its own agencies — that is, ONGC, IOC, CIL, SEBs, the Railways and so on.

And, yet, if the objective is to reduce the fertiliser subsidy *per se*, then, the focus has to be on reducing prices of various inputs, including hydrocarbons, utilities — power, water and services such as railway freight as recommended by the JPC (1992). For instance, if plants in India were to be charged for energy as applicable to joint venture in Oman, then, savings in energy cost alone and, consequently, in subsidy would be a whopping Rs. 5,800 crores per annum.

Likewise, an increase in selling price of urea by 10 per cent will result in reduction in subsidy by about Rs. 730 crores per annum. The increase may be considered in small doses, over a period of time, to prevent any adverse effect on consumption.

(The author is chief economist, Fertiliser Association of India, New Delhi.)