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Buyback pact in urea plan is faulty

by UTTAM GUPTA

THE low international price of urea has reportedly caused lot of worry in official circles in view of its likely adverse effect on RCF and Kribhco, the two government of India undertakings, which together hold 50 per cent equity in Oman Fertiliser Company (OFC)—the rest being held by Oman Oil Company (OOC)—formed to implement the 1.5-million-tonnes per annum urea project in Oman.

The worry arises because of a provision in the agreement for buyback of the entire production from the plant at 100 per cent capacity utilisation. Under it, RCF and Kribhco are required to buy urea from the project at the prevailing international price. Since the price moves up and down depending on global demand-supply balance, realisation from sales would fluctuate against a benchmark price—reportedly about $120 per tonne—at which reasonable cost of production including a reasonable return is fully covered.

Thus, when the F.O.B. price is lower than the benchmark price, RCF/Kribhco will have to give a soft loan equal to the difference multiplied by quantum purchase. Take for instance, F.O.B. price of $30 million on a total production of 1.5 million tonnes. This would, thus, be the loan amount.

The project is expected to be commissioned about three years from now. Thereafter, as and when the prevailing international price is lower than $120 per tonne, the condition would apply. The government's worry is, therefore, understandable. But the moot question is did we not know the implications at the time of signing the agreement?

After all, in the past, prices touched lower levels—$70-90 per tonne in 1987 and $92-95 per tonne in 1993. Therefore, we need not have waited for yet another downturn to realise the folly of what was being contemplated. It is a case of having made a mistake in full knowledge of facts, and then bemoaning its inevitable consequences. The agreement is patently unjust, inequitable and discriminatory. This is because, in a reverse situation, when the international price is higher than the benchmark price resulting in a gain to OFC and corresponding loss to RCF nad Kribhco, there is no provision for compensation to the latter. For OFC, it is heads I win, tails you lose.

A review of F.O.B. prices during the last 20 years or so reveals that generally it was above $120 per tonne. Against this backdrop, most of the times, we would be paying more than the reasonable production cost. Moreover, with the latter itself going down owing to diminishing interest burden (even as the feedstock cost remains unchanged), margins of OFC will be progressively higher.

During the 90s, growth of urea capacity in India has considerably slowed down owing to policy uncertainties. These have been further accentuated by the government's reported rejection of the policy package recommended by the high-powered Hanumantha Rao Committee. Therefore, the pace of addition to capacity is unlikely to pick up. Hence, imports will further increase to meet growing demand.

With a major importer like India entering the international market to meet a substantial portion of its demand, prices are bound to shoot up. Under the buyback, thus, we shall be paying at still higher rates, in turn, adding to margins of OFC at the expense of RCF and Kribhco.

It may be argued that RCF and Kribhco being equal equity partners, they will automatically share gains with OFC. This is true, but only if the profits are distributed as dividend. Even in this scenario, only 50 per cent of extra money that we pay would flow back to RCF and Kribhco. The situation would be much worse if only a portion of profits are distributed, which is a common corporate practice.

While the clause relating to soft loan is illogical, inequitable and unjustified, we need to ponder whether the government's decision to buy urea at the prevailing international price was the right thing to do. Is it not contrary to the raison de atre for setting up a joint-venture facility at Oman?

Because of availability of cheap gas—at $0.77 per million btu, against $3.0 per million btu to gas-based plants in India along HBJ and about $5.9 per million btu for naphtha-based plants—the objective was that we could procure urea from the joint venture at a much lower cost. But linkage of purchase under buyback at the international price denies us this benefit. If only we had tried to contract for supplies at the benchmark price, that is, $120 per tonne, for the entire life of the project, we would have been much better off and also justified our going to Oman. ◆