

COMMENTARY

The other side of SAIL's profits

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State-owned steel giant's profits are found increasingly because of raw material subsidies and not due to real economic value addition. This only leads to wastage and poor operational management, causing higher pollution

The public sector steel giant Steel Authority of India Limited (SAIL) frequently boasts of its gargantuan profits and the Maharatna tag to brush away all criticism on its poor environmental performance levels. By claiming its '*immense contribution*' to the nation, SAIL feels they should be considered above board on pollution issues. But a deeper analysis on value added from its latest financial statements shows a degree of misrepresentation to its shareholders and the nation.

The analysis done by Centre for Science and Environment (CSE), a Delhi research institution, finds that the profit earned by SAIL is increasingly because of the free iron ore gift provided by the government, or in other words, by the citizens of the country.

As per a detailed CSE study, post independence in 1950s, the Indian steel sector was brought under the licensing system and large integrated steel plants (above 1 million tonne capacity) were reserved only for the public sector under SAIL. To get the different factories kick started, swathes of iron ore mines were given away free (*see Table 1*) along with making provisions for their rail linkages and other freebies such as water, land, etc.

Table 1: Iron ore freebies

| SAIL Plant | Mines allotted | Year of Commissioning |
|----------------------|------------------------------------|-----------------------|
| Bhilai Steel Plant | Dalli, Rajhara (both Chhattisgarh) | 1960 |
| Durgapur Steel Plant | Bolani (Orissa) | 1960 |
| Rourkela Steel plant | Barsua (Orissa) | 1960 |
| | Kalta (Orissa) | 1966 |
| | Kiriburu (Jharkhand) | 1964 |
| | Meghahatuburu (Jharkhand) | 1985 |
| Bokaro | Kiriburu(Jharkhand) | 1964 |
| | Meghahatuburu (Jharkhand) | 1985 |

Source: Raw Materials Division, Steel Authority of India Limited¹

*Green Rating Project, Centre for Science and Environment, New Delhi

1 Source: http://www.sail.co.in/pnu.php?tag=others_unit_raw_material (as viewed on November 5, 2012)

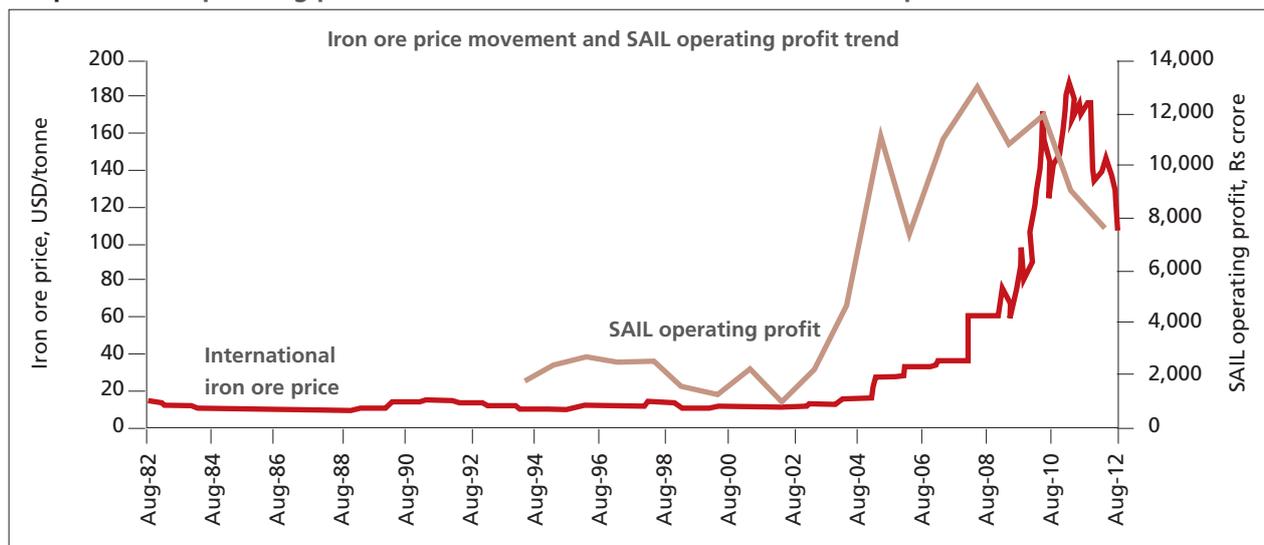
Steel price and market distribution was also stipulated by the government and hence profits of the companies remained under control. In 1991, when the government liberalised the Indian economy, steel sector was also freed². No license was henceforth required for setting steel units. However, as government feared cheaper steel imports could harm the Indian producers, it still kept import duty high at above 90%³. The import duties were then gradually brought down to 25% by 2003⁴. From August 2004 onwards, owing to heightened inflation worries, government sharply reduced duty of steel to 5% to bring it in line with the global pricing⁵.

Import parity pricing

Interestingly though, at this very juncture, i.e. from 2002 onwards, the world steel market had changed. As China began ramping up its infrastructure and shifted to urbanisation, it gobbled all iron ore among other raw materials, leading to its price rise (see *graph 1*). Simultaneously, there was spurt in demand for cars and houses in the western countries fuelled by cheap credit. These factors led to rise in international steel prices.

All this while, though SAIL continued to get benefit from free iron ore, it began to sell steel at domestic market prices, which in turn closely tracked the international prices plus the import duties. For example, if international price of a particular grade of steel was 700 USD/ tonne, SAIL would sell the same grade to its Indian customers at 735 USD/tonne (considering 5% import duty) or around Rs. 36750/tonne. The pricing of product at close to import parity prices⁶ boosted its profits sharply (see *graph 1*).

Graph 1: SAIL operating profit from 1990s tracks international iron ore price



Source: Iron ore - China Import price IndexMundi.com, Operating profits - SAIL Annual Reports for the corresponding years

- 2 Source: Joint Plant Committee, Ministry of Steel <http://www.jpcindiansteel.nic.in/frame2.asp> and <http://www.jpcindiansteel.nic.in/profile.asp> (as viewed on November 5, 2012)
- 3 Source: Report of the Working Group on Steel Industry for the Eleventh Five-Year Plan (2007-2012) Annexure 4, http://planningcommission.nic.in/aboutus/committee/wrkgpr11/wg11_steel.pdf (as viewed on November 5, 2012)
- 4 Source: Report of the Working Group on Steel Industry for the Eleventh Five-Year Plan (2007-2012), Annexure 4, http://planningcommission.nic.in/aboutus/committee/wrkgpr11/wg11_steel.pdf (as viewed on November 5, 2012)
- 5 Source: Budget, Ministry of Finance, 2004-05 <http://indiabudget.nic.in/es2004-05/chapt2005/chap56.pdf> (as viewed on November 5, 2012)
- 6 Source: http://www.moneycontrol.com/news/brokerage-recos-sector-report/jpc-data-shows-weaknesssteel-consumption-nirmal-bang_768165.html (as viewed on November 5, 2012)

Extent of profits

CSE found the extent of benefit gained from differential price of iron ore (i.e. market price of ore minus cost of iron ore incurred by SAIL) was a whopping 70 percent of its operating profit in the recent years (see Table 2 below).

Table 2: Cheap iron ore now bringing in the moolah

| Parameter | Units | 2006-07 | 2007-08 | 2008-09 | 2009-10 | 2010-11 | 2011-12 |
|---|----------------|------------|------------|------------|------------|------------|--------------|
| Value of Iron ore consumed | Rs. Crores | 1488.31 | 1725.38 | 1791.95 | 1844.36 | 2337.79 | 2666.96 |
| Volume consumed | Million tonnes | 24.65 | 25.44 | 23.28 | 23.24 | 23.07 | 22.00 |
| Iron ore mined cost for SAIL | Rs./ tonne | 603.7 | 678.1 | 769.7 | 793.5 | 1013.3 | 1212.3 |
| Average market price of iron ore for the year (for NMDC ore)* | Rs./ tonne | 1629.9 | 2024.6 | 2855.7 | 2583.1 | 4287.7 | 4104.2 |
| Average market price of iron ore assuming 10% lower value of SAIL ore due to slightly poor quality compared to NMDC | Rs./ tonne | 1466.1 | 1822.1 | 2570.2 | 2324.8 | 3859.0 | 3693.8 |
| Difference between market price and SAIL cost for iron ore | Rs./ tonne | 862.4 | 1144.0 | 1800.5 | 1531.2 | 2845.6 | 2481.6 |
| Differential value in iron ore costing due to captive mines | Rs. Crores | 2126.1 | 2910.8 | 4191.8 | 3558.9 | 6564.8 | 5459.4 |
| Operating profit stated | Rs. Crores | 10966 | 12955 | 10946 | 11871 | 9030 | 7658 |
| Share of differential iron ore value as operating profit | Percentage | 19% | 22% | 38% | 30% | 73% | 71.3% |
| Net profit | Rs. Crores | 6202 | 7537 | 6170 | 6754 | 4905 | 3543 |
| Ratio of differential value of iron ore as net profit | Percentage | 34% | 39% | 68% | 53% | 134% | 154% |

Source: Analysis from SAIL Annual Reports and financial statements, Centre for Science and Environment, Delhi

*Source: NMDC ore price as per letter dated 25 Jan 2012 by Chief Minister, Orissa to Union Minister of Mines, <http://www.orissaminerals.gov.in/Download/DO-CM-reg-mineral-resource-rent-tax.pdf> (as viewed on November 5, 2012)

In other words, had the government just sold iron ore in the open market (like it does through other state owned firm NMDC Limited), it would have earned revenue of say Rs. 5459 crores in 2011-12, which is equivalent to almost 70 percent of SAIL's operating profit for that year. And this needs to be compared with SAIL's annual dividend (payout) to government of only Rs. 700 crore in 2011-12.

In the earlier decades till 1980s, the iron ore gift never translated into windfall gains as government controlled the market price of steel. So, the noticeable difference of this benefit is only visible in the recent years, due to reasons mentioned above. In essence, this implies that SAIL's profit over the recent years is increasingly because of the citizens' gift of free iron ore and not because of its own internal value addition.

Opportunity costs not accounted

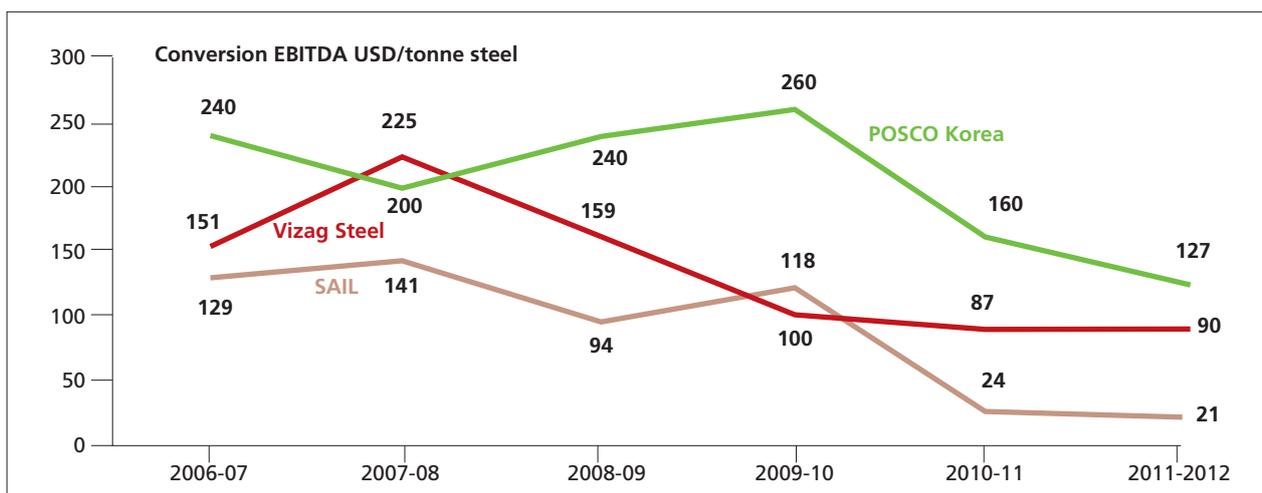
In economics, this concept of substitute value is called as ‘opportunity cost’. It is defined as value of a foregone activity when another alternative is chosen (*see box below for details*). Opportunity costs are hidden monetary value and do not appear in the balance sheet of a company. So in this case, the opportunity cost for the government had it sold iron ore in the open market has increased from 19% of SAIL’s operating profit in 2006-07 to an astounding 70% in 2011-12.

Opportunity costs: This cost involves trade-offs between two options by weighing costs and benefits. Opportunity costs are not the amount one actually transacts and hence are not costs in the traditional accounting sense. But they should be given due consideration in decision making. The term opportunity cost is normally used in natural resource economics to weigh financial option of say, mining in a forest land vs revenue generated from the forest. Nevertheless, they are vital in managerial decision making, in particular for resource planning and distribution.

For example: If a person has to choose between task A that earns him Rs. 100 and another task B of free leisure activity, then the opportunity cost of the leisure activity is Rs. 100 and not zero as per the traditional accounting sense.

In finance too, the concept is called as earnings before interest tax depreciation and amortisation (EBITDA) due to conversion, or simply ‘**Conversion EBITDA**’. This concept is normally used by financial analysts and investment banks such as Standard Chartered⁷ to measure whether a company is really adding value, over and above any subsidies, such as free raw materials, it receives. The Conversion EBITDA of SAIL was just USD 21 (or Rs. 1050)/ tonne steel in 2011-12 as against USD 100-150/ tonne steel for international producers such as POSCO Korea who do not own captive iron ore and coal mines. Even the other public sector Vizag Steel, which does not own any iron ore or coal mines, exhibits healthy Conversion EBITDA of USD 87-100/ tonne steel in the last two years (*see graph 2*).

Graph 2: Conversion EBITDA unravels many hidden truths



Source: CSE analysis, Note: Vizag Steel 2011-12 figure based on advanced estimates

⁷ Source: Standard Chartered Equity Research, 25 November 2010
http://www.myiris.in/shares/research/SCR/STEAUTIA_20101125.pdf (as viewed on November 5, 2012)

Maharatna tag - a misnomer

Given these facts and accounting insights, even the 'Maharatna' tag of SAIL needs to be questioned. The tag granted by the Government of India through its Department of Public Enterprises (DPE) is for state owned entities with certain eligibility criteria, and allows greater financial and operational autonomy in decision making. Among other criteria, a company should meet average annual net profit of over Rs 5000 crores during the last three years⁸ for being granted the tag.

So with SAIL's profit being artificially inflated by free government (read citizens) subsidy of iron ore on one hand and by import parity pricing of its products on the other, it is able to meet the annual net profit criterion. Thus, the company should owe the Maharatna tag to its citizens and not because of the operational efficiency of its management.

In fact, with its current state of affairs and even with all these freebies, it may lose its Maharatna status if it continues to underperform in FY 2012-13 as the average net profit for three years is expected to slip below Rs. 5000 crore (*see Table 2 above*).

Meanwhile, for the new proposed mining bill, the union ministry of steel claims it wants reservation of iron ore mines for state owned entities, pleading "largely public interest" and claiming the entities are modeled on "sustainable and holistic development".

Overall, it is found that the government through its citizens is increasingly grandfathering SAIL. This only leads to extravagance by the company management, wasteful expenditure, frequent breakdown of equipments, wastage of raw materials and resources and poor supervision (*see box below*). All these eventually manifest in higher plant level resource use and pollution. If opportunity cost is taken into account, the citizens of the country are taking care of the company's management and employees, an unfortunate situation in a liberalised economy.



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Iron ore mine in Orissa

8 Source: Department of Public Enterprises guidelines 19th May 2010
http://dpe.nic.in/sites/upload_files/dpe/files/glch0931.pdf (as viewed on November 5, 2012)

EQUIPMENT HEALTH AFFECTS PRODUCTION

1) News: Production at SAIL's Bhilai Steel Plant dips

Raipur, April 11, 2012: Production at the public sector Bhilai Steel Plant dipped in the 2011-12 fiscal from the previous financial year, the management said, blaming the aging coke oven batteries for the fall.

"The health of some aging coke oven batteries posed a big challenge from early on in the year, affecting coke production and gas availability for the reheating furnaces of the mills," it said in a statement.

The flagship unit of Steel Authority of India Ltd (SAIL) located in Durg district, some 30 km west of Chhattisgarh capital Raipur, produced 5.13 million tonnes (MT) of hot metal, 4.90 MT of crude steel and 4.29 MT of saleable steel in the just ended financial year.

The plant had in fiscal 2010-11 had posted a record production of 5.71 MT of hot metal, 5.33 MT crude steel and 4.57 MT of saleable steel. It was expected that the plant would further consolidate its production in year 2011-12 but the production dipped.

Source: <http://www.sarkaritel.com/production-at-sails-bhilai-steel-plant-dips> (as viewed on November 5, 2012)

2) SAIL crude steel production dips in 2011-12

CSE note: Even while the domestic steel market is growing, SAIL's crude steel production dipped 3.6% year over year (yoy) in 2011-12. Profit margins are also falling. A major reason was the faltering coke oven batteries, among many other reasons.

Statement from the 2011-12 Annual Report of SAIL, page 9: "Lower availability of Coke Ovens at Bhilai Steel Plant, Durgapur Steel Plant and Bokaro Steel plant and resultant Coke Oven gas shortage, however, affected production during the year adversely".

Source: <http://www.sail.co.in/pdf/areport-2011-12.pdf> (as viewed on November 5, 2012)

How could this be remedied?

In the short term, starting from this financial year (2012-13), all concerned public or private sector companies which receive subsidies from the nation, should report Conversion EBITDA along with past five year performance, as per CSE recommendation. This will make all stakeholders aware of whether the subsidies are really being used for the welfare of the citizens, or only for the welfare of handful of owners, management and employees. The DPE also needs to overhaul its Maharatna eligibility criteria considering Conversion EBITDA.

Secondly, over a period of time, non-renewable natural resources should never be awarded free to any **public or private** sector enterprise. It is important to break them down to different business entities (like that in power sector where coal mining, power generation, transmission and distribution are separated) to bring in efficiencies of free market pricing.

Ignorant of these apparent fallacies, the Indian government continued to freely handover SAIL the Rowghat mines in 2009. It's time the government, planning commission and citizens wake-up to the other side of SAIL's profits so as to bring about not only economic but also environmental benefits.