The Surplus Principle of Price Fixation

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The author examines the principle of price fixation adopted in the case of steel, coal, sugar and electricity undertakings. He is unable to find any uniformity in them.

He also finds it frustrating that the manner in which the statistical data is presented in the Tariff Commission reports or in the report of the Coal Price Revision Committee does not enable a research worker to form an opinion about the principles adopted for price fixing,

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THERE are three norms of price fixing broadly speaking, namely, (a) Price = marginal cost of production, (b) Price = average cost of production, and (c) Price = average cost of production (in. eluding normal profit) *plus* some Surplus'. This last norm is the surplus principle of price fixation for the purpose of this note.

Economists have discussed the first two norms in great detail since 1930's in the context of nationalised enterprises, particularly the public utility undertakings. About surplus principle very little has been written. However, it is this norm o£ price fixing which is particularly important for an under-developed country which is in need of internal resources for planned development.

The main problem which one faces in fixing price on the basis of surplus principle is: what should be the criterion to determine the 'surplus' element to be included in price? This, it appears from the Tariff Commission's reports, depends on the amount of resources needed for rehabilitation, expansion and development of the industry in question. Once this is determined, we have still to decide what part of these required resources can be met 'from funds available from outside i e, from borrowing or issue of fresh capital. The balance has to be raised by the industry or company from internal sources i e, by increasing the price of its product (by increasing the depreciation allowance or the rate of return).

Element of Surplus in Steel Prices

Since 1956, the Tariff Commission have been following the surplus principle of price fixation in the steel industry in order to ensure the desired rate of growth in the plans of big steel produoers. They revised the principles of price fixation on November 30, 1955. It was laid down that "the prices should be such as would enable .... the companies to obtain a portion of the capital requirements of their current and additional expansion programmes from internal sources and to raise the balance from outside" (Tariff Commission, Retention Prices of Steel Produced by the Tata Iron and Steel Company and the Indian Iron and Steel Company Ltd: Report, Bombay 1956, p 3.) To achieve this aim the Commission proceeded as follows: "We have taken into account the total capital funds required....... and the amount which they may reasonably be expected to raise from outside and have determined on this basis the amount which they should obtain from internal sources. The internal sources consist partly of depreciation and partly of return". "We propose to include in the new retention prices depreciation at the rate of 6\ per cent oh the estimated additions to the block as at the beginning of each year from 1955-56 to 1959-60, in addition to normal and special depreciation" *(ibid.* However, it is not clear from the tables given on the next page as to what was the method of estimating the gross block and to what portion of this gross block the depreciation was calculated.) After providing for this, the rate of return is determined. The above procedure can be illustrated by means of an actual case considered by the Tariff Commission in the above report.*

In order to determine the level of prices which would enable IISCO to obtain a surplus of Rs 4.82 crores for capital expenditure over the five years from 1955-56, the Tariff Commission estimated its probable works cost and other current charges during this period. "On the basis of the....estimates of depreciation, given (overleaf), the other expenses expected to be incurred by the company and its receipts otherwise than from the sale of steel, we find that an average retention price of Rs 393 per ton will enable the company to earn the necessary surplus of Rs 4.82 crores over the entire period of price fixation. (Tariff Commission, n2 p 11),

Coal and Sugar

For the coal industry, however, the surplus principle of price fixing is not so clearly laid down. Here the profit element, unlike in the steel industry, includes only that amount which is sufficient to permit payment of a reasonable dividend after providing for taxes. Thus no adeojuate provision has been made for the creation of internal resources for development. True, something is added to 'depreciation and development'. (Coal Price Revision Committee *on* the Bengal-Bihar Coalfields: Report. Delhi, 1959. pp 22-3.) This provision "should be equal to the average capital employed (about Rs 16 per ton) plus 25 per cent of that capital divided by the average useful life of the complex of assets of different kinds constituting an average colliery", *(ibid* p 211 This on the face of their statement "In our opinion the price structure should he such as would enable the industry not only to keep the plant and equipment in efficient functioning, but also to permit of further development," is very strange since the provision for internal resources for

* It is very strange that an item like sales tax is also included in the estimated capital requirements without giving any justification whatsoever. Presumably this is a tax on machinery purchased; otherwise there is no point in including this item under capital requirements,

development provided for appears lo he quite inadequate. However, this is only a *prima facie* view he-cause detailed figures for the costs-depreciation arid profit provisions are nol given in the Report, though it appears that such infomation was collected (vide forms VI. VIII. IX. IX-A and X in the Report)*

The surplus principle of price fixing is even less apparent in the case of the sugar industrv. As is well known. sugar is a highly regulated industry and the 12 per cent rate of return allowed to it by the Tariff Commission will according to the (Commission, provide "sufficient funds for each unit to meet its commitments under bonus and gratuity, interest on borrowed capital and debentures. dividends on pre ference shares, managing agent's commission and income-tax and finally leave a residue to a large majority of the units in all the regions to declare reasonable divi. dends." Tariff Commission, Cost Structure of Sugar and fair Price Payable to Sugar industry Report. Bombay 1959. p 51), There is thus no provision for rehabilitation, development and reserves. The Commission, however, admit "Rehabilitation is no doubt essential in a growing industry, but has to be met mainly from depreciation provisions made in past years.... After the needs of rehabilitation are met. the surplus funds, if any. should be applied for purposes of expansion and if they are not adequate for the projected expansion, additional resources should be raised either by issue of fresh capital or by raising long-term loans." (ibid p 65) On the face of this statement if appears that the Commission have allowed very narrow margin For the rehabilitation (and expansion) of this industry. It is only fair that neces sary provision is made in the price of sugar to increase the rate of return. One can. however, raise the point thai if the sugar industry is given an adequate return on capital which should be higher than that allowed by the Tariff Commission. it may affect the interest of the consumers. It may be pointed Out in this connection that if anything is done which adversely affects-the industry now. it will, in the long run, harm the interests of the consumers themselves. For. any impairing of efficiency of the industry will either raise its costs or reduce the total production or both.

* In view of the tentative target of 97 million tons aimed in the Third Plan, this margin is insufficient and should be re-examined. This view has also heen expressed by the President of the Indian Colliery Association in the 28th General Meeting that "the present margin of profit in coal teas wholly insufficient to attract fresh capital or plough back enough money into the iiuhis try to complete the developments and programmes in the Plan/' He thought that it would he wise and realistic to create a financial cor poratinn to assist the coal industry. besides, it appears strange that the method of estimating of and providing for capital requirements tor development of coal industry is different from that followed in the steel industry.

Electricity Undertakings

Contrary to the usual belief about public utility concerns, the Delhi Slate Electricity Undertaking has been earning net revenue. In 1956-57 it amounled to Rs 29,04,148 and in 1957-58 Rs 35,71.548. Delhi State Electricity Board. *Sixth* and Seventh Report and Accounts, for 1950-57 and 1957-58, Statement No IX.) This may mean that the Delhi Stale Electricity Undertaking (the former D S E B) is following the surplus principle of rate making instead of running the undertaking on a no profit, no loss basis. The amazing thing is that many other State Electricity Boards show a loss.

Table 1 : Indian Iron and Steel Company's Estimated Capital Requirements (1955-56 to 1959-60)

(Rs lakhs)

1	1953 Extensions			
	Total	28.75		
	Less expenditure upto 31-3-55	1.62	27.12	
2	Subsidiary Expenditure			
	Land	15		
	Housing	1.50		
	Sales Tax	26		
	General	2.86		
		1.77		
	Less expenditure upto 31-3-55	36	1.41	
3	1955 Extensions		14.00	
4	Total capital expenditure			42,53
5	Provision for replacements, renewals and improvements @ 10 per cent of the estimated allocations to the Depreciation Fund			3,69
6	Repayments due in 1958-59 and 1959-60			
	I B R D	1.92		3,00
	Government	1.08		49.22

Table 2 : Estimation of Resources for Table 1.

(Rs lakhs)

A	Funds already available			
1	I B R D (assuming that the closing date would be extended)		12.20	
2	Funded interested on I B R D Loan		1.91	
3	Government special advance			
	Total	10.00		
	Less drawn upto 31-3-55	1.20	8.80	
4	Government Loan			
	Total	5.00		
	Less drawn upto 31-3-55	3.34	1.66	24.57
B	Funds expected to come from outside sources (by way of borrowings or issue of fresh capital)			8.00
C	Funds expected to come from internal sources			
1	Depreciation (rounded)	9.23		
2	Plant Rehabilitation Fund (special depreciation)	2.60		
3	Returns after providing for the current charges (such as debenture interest, debenture sinking fund, managing agency commission, profit sharing bonus, dividend, etc.)	4.82		16.65
				49,22

Source : This table is compiled from the figures in the Tariff Commission Report.

Table 3 : Financial Results of Some State Electricity Boards

State	Year	Profit as % of Capital
Assam	1959-60	- 0.59
Bombay	1957-58	- 1.11
Kerala	1957-58	- 0.44
Madhya Pradesh	1955-56	1.74
Punjab	1959-60	0.78

Source : Prof V V Ramanadham's paper on Pricing in public sector read at the seminar on Public Enterprises held in Osmania University. Hyderabad -7. February 13-15. 1961.

This might be because there is already shortage of electricity supply in Delhi and to remove the shortage, the DSEU has undertaken extension and development programmes which it aims to finance from internal sources and hence it is making profit. If this is the motive. our would welcome this principle of charging electricity rates on surplus basis.

From the above, it is clear that in the industries we have chosen for examination, no uniform principle of price fixing is followed. In the steel industry we find that the Tariff Commission have started following surplus principle recently, whereas in the sugar industry it is not so clearly spelt out since the Commission disallowed the "rehabilitation charges" demand of the industry. In coal also, the surplus principle is not the basis of pricing. Though the Price Revision Com mittee allowed some provision for development. it is doubtful whether it is at all sufficient. It is only in a public utility concern viz Delhi State Electricity Undertaking that surplus principle of price fixing is being followed in some degree. It would be interesting to know the reason or reasons for the divergence in the principles and procedures of price fixing for rate making) in these industries. It may be that the principles of price fixation in these industries have been influenced from time to time by the specific problems of the industries and not by the general requirements of the economy as a whole. For example, the Tariff Commission have been fixing prices of various industrial products, on special terms of reference from the Government. One may comment why we should have different principles of price fixation for different industries and that. too. varying from time to time. Why should we not have a general principle for one sector of the economy ? For example, we may follow the surplus principle in one sector (say, consumer goods sector) and reap profits. These profits may be ploughed back not in that sector but in another sector or sectors (say. producer goods sector) and thus allow development not in the particular industries making surplus profits hut in the economy as a whole. This is only a tentative suggestion which we are putt. ing forward in order to invite discussion whether such a policy is feasible under Indian conditions or not.

Import Control Organisation

DURING the half year ending September 30, 1961. the Import Trade Control Organisation received 2.14,204 applications for import licences, as compared to 1,89.509 during October, 1960-March. 1961 period. Despite the increase in applications, their disposal kept pace with the intake and at the close of the licensing period, only 2.006 applications which worked out to 0.9 per cent, were pending.

In addition to applications for import licences, the Organisation also dealt with a very considerable volume of correspondence on questions of policy, interpretation of rules and regulations, appeals etc, from the trade and various chambers of commerce and trade associations. The number of such communications during the period reached the figure of 7.57 lakhs. The Repeat Licensing Scheme which had been introduced earlier was continued. A large number of quota holders benefited from the Scheme and obtained licences within three days of the presentation of their applications.