

# Comment & Analysis

## Assurance before investment

Fertiliser firms need to know that incentives will continue before they invest

by **UTTAM GUPTA**

ANYONE wanting to set up an ammonia/urea project needs to consider a few basic facts. Of the various feedstocks in production of urea, natural gas is the most preferred in view of its high conversion efficiency apart from low price when compared to naphtha. The supply of gas presently from ONGC/OIL - as well as its price is controlled by the government.

In future, there will be supplies from private companies too eg: Reliance - Enron combine from Mid & South Tapti, Mukta and Panna fields - Bombay off-shore etc. However, these too will be regulated by the government until it takes a conscious policy decision to deregulate the gas sector.

Due to distortions in the priorities for allocation of gas, in the 90s, leading to its diversion to other less important uses such as power, sponge iron etc., the government has no plans to give gas for new fertiliser project including expansion of existing unit. In fact, the expansion of IFFCO-Aonla and NFL-Bijaipur - both recently commissioned - were the last projects to get it. Prospective units need to look for some other feedstock.

The next best feedstock is naphtha. However, for new projects, domestic supplies - also controlled by the government - are available only at the non-concessional rate. Presently, this is Rs 6,684 per tonne ex-refinery as against the concessional rate of Rs 4,840 per tonne which is applicable only to existing units. Including excise duty 10 per cent, freight and sales tax, landed cost at the plant site on an average, will be about Rs 9,000 per tonne.

Although, the producer is free to import naphtha at zero customs duty - it is a decanalised item - at prevailing C&F cost of about \$235 per tonne, to the unit located on the coast, this would cost about Rs 9,000 per tonne and still higher of about Rs 10,000 per tonne to a plant located in the hinterland. Additionally, there are problems of handling and transportation and attendant risk of disruption in supplies. The import option is not only more costly, but, risky as well.

Imported LNG (Liquified natural gas) is another alternative. Enron which is in the process of setting up facilities to import LNG for supply to users, has reportedly hinted at a price of about \$4.0 per million Btu at the landfall point. Including transport charge, the cost to the user at the plant site would be about \$5.0 per million Btu. Although, this look better than naphtha ie, \$6.25 per million Btu (corresponding to Rs 9,000 per tonne), the supplier may even jack it up to bring at par with naphtha.

For an efficient naphtha based plant, about seven million kilo calories of energy is needed - towards feedstock/fuel and power - to produce one tonne of urea. In view of one tonne naphtha containing about 10 million Kcal, this translates to 0.7 tonnes of naphtha. At Rs 9,000 per tonne being its cost factory gate, the energy cost alone will be Rs 6,300 per tonne. It will be more if non-concessional rate for naphtha is increased.

Presently, urea is under pricing and distribution control and covered by retention pricing and subsidy scheme (RPS). At current controlled selling price of Rs 3660 per tonne, the net back after deducting freight and distribution margin (about Rs 500 per tonne) is Rs 3,160 per tonne. Against this, VC alone for the new project is substantially higher at about Rs 6,600 per tonne. If RPS continues, this excess plus fixed costs including capi-



tal related charges (CRC), will be reimbursed as subsidy. The project would thus, hope to remain viable provided all reasonable costs are fully covered.

The RPS is currently being reviewed by a high powered committee (HPC) under Dr Hanumantha Rao, former member, Planning Commission. Apart from addressing the concerns of the farmers and industry, HPC is expected to evolve a dispensation that helps in reducing fertiliser subsidy. In view of this, whatever option/system committee recommends, producers' net back is bound to come under pressure; a new unit entailing high cost could be most affected.

One scenario could be in which subsidy support is completely withdrawn and yet, the producer is expected to sell at existing price i.e. Rs 3,660 per tonne. Indeed, one leading economist has favoured such a system. This means a net back of Rs 3,160 per tonne. With VC alone being Rs

**In view, of the viability of a fertiliser project being dependent solely on the policy environment, investors need to interact with the government to know what precisely it has in store**

6,600 per tonne, as brought out above, the producer will be deep in the red from the word go.

Another scenario could be in which the government gives to all producers' a common price, based on import parity (IMPP) or cost of supplying imported urea to farmers. At prevailing C&F landed cost of \$140 per tonne, this is about Rs 6,500 per tonne. The net back on this basis, will be about Rs 6,000 per tonne which too is below the unit's VC i.e., Rs 6,600 per tonne.

Although, C&F could rise leading to higher IMPP, it may fall again - this is how world market price for urea behaves. Yet another scenario could be one of urea decontrol in which the market would decide producers' realisation. The weighted average cost of supplying urea from various units in production (34) is about Rs 6,500 per tonne. The market prices is expected to settle at this

level as domestic production accounts for about 85-90 per cent of total supply. The net back from this too is woefully inadequate for the new unit.

For the unit to remain viable, it must get a price (ex-factory) which fully covers its VC plus fixed cost including CRC. To get an idea of fixed cost, let us consider an investment of about Rs 1,600 crore for a standard plant of 7.68 lakh tonne per annum urea capacity. Take debt-equity ratio of 3:1 ie., Rs 1,200 crore loan and Rs 400 crore equity.

Interest on loan at 13 per cent per annum is Rs 180 crore, while, return on equity even at existing meagre pre-tax 18.64 per cent (linked to 12 per cent post-tax allowed under TPG) is about Rs 74 crore. And, depreciation at 6.33 per cent per annum is about Rs 100 crore. All this adds up to Rs 354 crore. Add another about Rs 50 crore towards fixed cost other than CRC eg: overheads, chemicals/stores, catalyst, repairs and maintenance etc. A total of about Rs 400 crore per annum has to be generated to meet all these obligations.

The capacity utilisation norm for a naphtha-based plant is 85 per cent. On base capacity of 7.68 lakh tonnes, this gives normative production of about 6.53 lakh tonnes. Consequently, fixed costs per tonne has to be about Rs 6,100 per tonne. Plus VS ie. Rs 6,600 per tonne, the ex-factory realisation will have to be about Rs 12,700 per tonne.

Alternatively, if the unit operates at normative level, ie., 85 per cent, it will be able to generate only Rs 157 crore leading to shortfall of Rs 243 crore vis-a-vis the requirements. Even if it foregoes return, uncovered gap would still be Rs 169 crore. At 100 per cent utilisation, the yield would be about Rs 184 crore leading to shortfall of Rs 216 crore. Without return, the gap would be Rs 142 crore. Clearly, an artificially low price will make the plant sick.

In view, of the viability of a fertiliser project being dependent solely on the policy environment, investors need to interact with the government to know what precisely it has in store. Merely knowing that RPS would continue is not enough. An assurance about full coverage of reasonable cost of production including an attractive return is absolutely necessary before the promoters venture into investing huge sums of their own and those of other shareholders, FIs including FIIs and banks.

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