



Nutrient-based subsidy for urea a positive step, but impact likely to be neutral for the credit profile of gas-based urea manufacturers: ICRA

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A Group of Ministers (GoM) on fertilisers has approved the decontrol of urea prices, where in the fertiliser companies would be allowed to increase farm gate prices of urea by upto 10% in the first year, while complete pricing freedom would be provided in the subsequent years. However, clearance of this policy from the Cabinet Committee on Economic Affairs (CCEA) is still awaited. The price decontrol in urea would be a part of the proposed NBS mechanism, under which gas based urea plants would get a fixed subsidy under four sub-groups (base level subsidy of Rs. 4,000/tonne), while liquid fuel based units would continue to function under the existing subsidy mechanism until their conversion into gas by March 2013. Alongside, urea manufacturers would get natural gas at a uniform pooled price so that cost differences arising out of varying gas mix among units are evened out.

ICRA believes that the phased decontrol of farm gate prices and introduction of NBS for urea should result in lower dependence on subsidy as compared with the current dispensation and hence moderately ease the working capital position of urea manufacturers. While a 10% price increase (from the current level of Rs. 5,365/tonne) is expected in FY2012, further increases in farm gate prices resulting from higher pricing freedom FY2013 onwards would augur well for the industry's profitability. The above move is an extension of gradual reforms undertaken by GoI in the fertiliser sector beginning with price decontrol and introduction of NBS for complex (NPK) fertilisers (including DAP) w.e.f 1-April-2010. The extension of these policies to urea is also expected to establish consistency with the policy for NPK fertilisers over the medium to long term; and hence promote balanced consumption of fertilisers. In ICRA's opinion, the price decontrol for both urea and NPK fertilisers paves the way for a gradual move towards free market pricing for all fertilisers. In this regard, ICRA takes comfort from the robustness of demand, which has remained strong despite the various rounds of price increases in NPK fertilisers since the April 2010 decontrol (adding up to 25-40% post-decontrol).

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The existing NPS-III policy mechanism for urea expired on 1 April 2010, subsequent to which GoI extended it further on a provisional basis. However due to heterogeneity in the urea sector on account of use of varying feedstock, the GoI after suggestions by an expert committee, is expected to follow group wise NBS along with adoption of a sector wide gas pooling mechanism. As per the report by Committee of Secretaries, under the NBS framework, gas based urea plants would get a fixed subsidy under four sub-groups (based on their vintage and conversion history). The base level subsidy has been fixed at Rs 4000/tonne with additional subsidy of upto Rs 1800/tonne for different groups. The subsidy would be computed based on current estimated pooled gas price of \$6.6/mmbtu. ICRA expects the new subsidy levels to overcome the inadequacy of the previous policy for reimbursement of certain fixed costs. In order to move to a uniform subsidy structure, the gas based urea industry would converge to two groups by 2014-15, with base subsidy of Rs 4000/tonne and an additional subsidy of Rs 1,000/tonne for the second group. However, as a result of the regrouping, the phased subsidy reduction (by Rs 600-800/tonne in 2014-15) for three groups¹ would partly offset the initial gains made due to higher subsidy meant to compensate higher capital costs.

Under the proposed gas pooling mechanism, effectively an uniform weighted average gas price would be paid by the existing gas based urea units, except for 4 small units (RCF-Trombay, GSFC-Baroda, and two units of BVFCL). The weighted average industry level pooled price would be a function of volume of gas consumed & price applicable for cut off production levels & energy consumption norms of respective plants. The pooling mechanism would be operated by the Department of Fertilisers in such a manner that the difference between actual weighted average gas price of individual companies and the industry pooled price would be compensated/recovered by the GoI. It is noted that gas consumed beyond the cut off capacity would have to bear the actual gas price paid, as the incremental production (beyond cut off capacity) would continue to be eligible for subsidy under existing urea investment policy. However, till the cut off production level, for energy savings, the players were previously reimbursed based on a weighted average gas price of their units as compared to the proposed subsidy which would be benchmarked to industry weighted average gas price. As a result, ICRA believes units using a higher share of R-LNG and with energy savings post their debottlenecking/energy savings project, might see their upside partly eroded.

ICRA believes that as with NPK fertilisers, NBS in urea would mark a change from the erstwhile **fixed MRP-variable subsidy** regime to a **fixed subsidy-variable MRP** regime. As a result, any increases in gas prices and other costs would have to be passed on to the farmers in the form of higher prices, as the subsidy levels would remain fixed. However, unlike in the case of DAP/NPK, the raw material price for urea (i.e. gas) remains relatively stable (on a year-on-year basis), which along with the relatively stable subsidy levels (till 2014-15), should bring down the need to revise retail prices frequently. This would also result in relatively stable profitability for the urea business.

ICRA expects efficient urea manufacturers such as Chambal Fertilisers & Chemicals (CFCL), Indo Gulf Fertilisers (IGF) and Nagarjuna Fertilisers & Chemicals Limited (NFCL), to be marginal gainers once the NBS policy is implemented. Also, these players would continue to enjoy import parity linked realisation for their post-debottlenecking incremental production (beyond cut-off production quantity), which has significantly contributed to their profitability in the recent past on account of firm global urea prices. Further, ICRA also believes that given the higher pricing freedom over the medium term, branding initiatives would assume higher importance as companies with stronger brands and established farmers relationship initiatives can adjust prices in accordance with market conditions

ICRA notes that the liquid fuel (naphtha, LSHS/FO) based urea manufacturers such as GNFC, NFL and ZIL would get subsidy in line with the existing policy till their conversion into natural gas. The units are expected to convert before the official deadline of 31-March -2013, as the projects have been on track as per schedule. However, there could be delay in gas connectivity to a few naphtha based units such as MFL, SPIC and MCF. However, since gas connectivity is beyond their control, GoI is likely to extend the deadline in such a scenario. While post conversion, naphtha based manufacturers are likely to be provided subsidy on a par with gas based manufacturers, the FO/LSHS based units are likely to remain outside the purview of NBS till the medium term as they have been promised special fixed cost reimbursement per tonne post five years of their conversion. Nevertheless, post their conversion, ICRA expects the competitiveness of liquid fuel based units to be lower in general due to their relatively higher energy consumption. As a result, many of these players are likely to undertake energy efficiency measures in order to protect their profitability, which may however impact their return on capital employed.

¹ Post 1992 gas based units, those units which already switched over to gas (pre & post 1992) & mixed fuel units

Overall, ICRA sees the phased price decontrol of urea and the introduction of a nutrient-based subsidy (NBS) mechanism as a positive step towards market-linked farm gate pricing. The mechanism would also establish consistency with the policy for NPK fertilisers, thereby promoting balanced nutrient consumption. As for the impact of NBS on the credit profiles of the existing gas-based urea manufacturers, that should be largely neutral; however post-conversion, naphtha/FO/LSHS based players could be at a slight disadvantage against the existing gas based players because of their higher energy consumption.

August 2011

ANNEXURE**Table 1: Portfolio of ICRA Rated Urea Companies**

Company	Products	Ratings Outstanding
Aditya Birla Nuvo Limited (ABNL)^	Urea	LAA+/A1+
Chambal Fertilisers & Chemicals Limited	Urea	[ICRA]A1+
Gujarat Narmada Valley Fertilizers Company Limited	Urea, Complex fertilisers	[ICRA]AA-(Stable)/[ICRA]A1+
Rashtriya Chemicals & Fertilizers Limited	Urea, Complex Fertilisers	LAA-(Stable)
Zuari Industries Limited	Urea, DAP, Complex Fertilisers	LA+(Stable)/A1+ (rating watch with developing implications)

Note: ^: ABNL is a diversified company with interests in carbon black, viscose filament yarn (VFY), flax yarn and linen fabric, garments, fertilisers and insulators.

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