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Incitec Pivot Limited
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Incitec Pivot Limited (ASX code: IPL) has announced that it will proceed with the construction of a A$935 million ammonium nitrate (AN) complex at Moranbah in Central Queensland. This makes the project significantly more expensive than was originally announced by Dyno Nobel in February 2007. What has changed to now make the project economic and how have you sought to ensure it stays within budget?

CEO Julian Segal
While the strategic rationale for the project has not changed, the cost of the project and its value proposition have changed significantly under our ownership.

Clearly our cost estimate of A$935 million is significantly up on Dyno Nobel's original project cost guidance of A$520 million, although I note that at the time the project was abandoned, Dyno Nobel said it was unable to estimate cost to completion.

We've taken a bottom up, clean sheet approach to evaluating the project. Importantly, we've included in our estimate all the costs that will be incurred in constructing the plant and bringing it to beneficial operation.

Capital costs are split into two categories. The first is the United Group Alliance costs which are estimated at A$683 million. This includes the engineering, procurement and construction costs. The scope of works has increased as, for example, costs in constructing the emulsion plant and product storage facilities were not included in the original estimates. In addition basic input costs, such as the cost of steel and concrete, have increased significantly.

The second category is what we've called "IPL managed costs" of A$252 million. The equivalent costs were largely excluded in the original Dyno Nobel analysis. The costs include start-up commissioning, project management and key engineering resources, establishment of a fully resourced operations team including writing plant operating procedures and training, initial plant fills such as catalyst charge, capital spares/stores and the provision of accommodation for the permanent workforce.

In assessing this opportunity, we recognised that it was vital to develop a fully inclusive capital cost estimate. To improve confidence in the capital cost we've involved two industry experts, Uhde Shedden, the lead contractor on the QNP AN project that was commissioned in 2000, and Independent Project Analysis, a global project engineering benchmarking consultancy, to review the project scope, implementation and risk management plans.

In terms of delivery of the project, the formation of the United Group Alliance has effectively rationalised contractor interfaces from around 20 to one. The alliance comprises United Group Resources, Bilfinger Berger Services and BCG Contractors which are jointly accountable for delivery of the project. We've incentivised the alliance to bring the project in on budget and on time via a A$44 million risk/reward regime. We've also established a comprehensive project management plan. The majority of our executive team is directly involved in overseeing the construction, commissioning and operation of the project, and is accountable for the delivery of the financial returns.

Offsetting the capital cost increases are several positive factors. Under our ownership there are far more flexible marketing options for the plant output, which means we'll be able to sell out the plant from day one. Not only will the plant service the explosives industry, but it will also service liquid fertiliser demand on the east coast through our Australian fertiliser distribution business.

The outlook for AN demand in the North Bowen Basin has also improved. The demand for metallurgical coal combined with the debottlenecking of key infrastructure, mean our customers are looking to secure key inputs to facilitate their own growth plans. We estimate that the Queensland market will be in balance from 2013, allowing us to access improved manufacturing margins far earlier than originally contemplated.

We're also in a far better contractual position now, with AN prill contracts down to 39 percent of the plant's volume. This means more of the planned output can be priced based on "spot" and be leveraged to the step change in AN pricing that has occurred over the last few years. This is consistent with what we've seen in fertiliser markets.

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You've indicated the project will meet IPL's 18 percent RONA and 15 percent IRR hurdles. What assumptions are you basing your assessment on? Do the

returns take into account the A$300 million already sunk into the project by Dyno Nobel or the liabilities associated with the tonnage already committed under Dyno Nobel's legacy contracts?

CFO James Fazzino

To understand our numbers you need to set aside what has previously been said about the financial metrics of this project and take a clean slate, as we discovered there were significant issues with the completeness of the original capital estimate and the accuracy of the financial model itself.

We've taken a first principles analytical approach and have based our calculations on a total project cost of A$935 million, plant depreciation over 30 years and a three yearly shutdown cycle commencing 2013. We've assumed plant output at a nominal 330,000 tonnes pa of AN solution, with no benefits from debottlecking and/or other efficiency programs.

In terms of revenue, we've assumed 9 percent growth in AN demand in Queensland and have been conservative in assuming that all excess AN from the plant will be sold at export parity until demand in the Queensland market matches supply. We see this occurring by 2013, but under more bullish growth scenarios it could occur at around commissioning date in 2011. From 2013 we assume import parity pricing on non-contracted tonnes.

Export parity pricing assumed in our model is around A$580 per tonne compared with longer term import parity pricing of A$700 per tonne. The current spot price is around A$821 per tonne so arguably we've been conservative on price also. We've assumed annual price growth at 100 percent of Australia CPI.

Dyno Nobel abandoned the project in December 2007. The A$300 million spent on the project was subsequently written down to a scrap value and does not form part of our investment analysis. The Dyno Nobel acquisition assumed that the project wouldn't proceed and accordingly we've taken up only the scrap value of the plant in our acquisition accounting.

We've modelled the project on a stand-alone basis in arriving at an un-geared IRR in excess of 15 percent. This is more than 50 percent above our cost of capital, which highlights the significant shareholder value that will be created by the project.

The project will generate an 18 percent RONA (EBIT/net assets) in year four or 2014. On our calculations, the plant will operate at an annualised RONA equivalent to 18 percent pa in the 2013 year, but won't reach this target for the full year because of a planned maintenance shutdown in that year which will lose us 40 days' production.

If the project didn't proceed, we'd still need to supply customers under the AN legacy contracts. We stated at the time of the Dyno Nobel acquisition that we were assuming Moranbah didn't go ahead in our acquisition modelling and that the impaired value of the contracts was a negative NPV of over A$200 million. Of course these contracts will now be supplied from the plant and accordingly we won't incur the majority of this cost. It's important to note that project IRR would climb to 17 percent if the value of the impaired contracts was added in.

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The project will be debt funded. Why have you chosen to fund Moranbah in this way? How will this transaction impact gearing levels, debt serviceability and your ability to pursue other growth opportunities?

CFO James Fazzino
The Moranbah project won't require equity for us to maintain our target debt, gearing and serviceability profile.

A separate exercise is currently underway to replace the A$2.4 billion syndicated bridge facility we put in place for the Dyno Nobel acquisition. The bridge matures on 21 May 2009 and the refinancing is on track. I'm delighted with the progress our treasury team, led by Frank Micallef, has made so far – and in fact we'll have the bulk of the long-term finance in place by our financial year end.

This refinancing exercise will result in a more diversely sourced funding mix and a more balanced refinancing profile. We'll ensure we retain adequate funding capacity and balance sheet flexibility to take advantage of the growth opportunities that are likely. It's also important to remember that our operating cash flow is extremely strong and provides significant self-generated capacity to fund new growth opportunities.

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What is the capex time line of the project? What are the key milestones prior to commissioning?

CEO Julian Segal
Currently, 90 percent of the bulk earthworks for the project is complete, as is 20 percent of the ammonia plant installation and 85 percent of the ammonia storage tank. Further, 90 percent of the 13 megawatt power plant is complete, and the construction camp, which provides temporary housing for up to 700 workers, is fully operational.

Mechanical completion is scheduled for the first quarter of calendar 2010, with beneficial operation scheduled for the first quarter of calendar 2011. Between mechanical completion and full beneficial operation, progressive commissioning of the various plant components and ramp up production will occur, including establishment and training of the operations team.

Key milestones relating to mechanical completion are completion of the ammonia plant and storage tank, completion of the nitric acid and AN reactors, completion of the utilities and construction of the prilling and emulsion facilities. The spend profile will be fairly even between now and mechanical completion and we'll keep the market informed as we progress towards completion of the project.

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What are your production expectations for the new plant? Will there be opportunity for future expansion under your current design blueprint?

CEO Julian Segal

The plant is designed to produce 330,000 tonnes pa of AN solution. Downstream production will be initially 265,000 tonnes pa of AN prill and 40,000 tonnes pa of AN emulsion for explosives markets and 25,000 tonnes pa of urea ammonium nitrate for liquid fertiliser markets.

It's likely there will be opportunities to debottleneck and expand the plant in the future. We're forecasting that the Queensland AN market will be in deficit from 2014 and so at the right time we'll look at opportunities to increase production. I would also note that the fit of the plant with our other in-house manufacturing plants at Gibson Island and Phosphate Hill will give us flexibility in sourcing feedstock ammonia for plant expansions.

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What is the plant's competitive position in terms of costs? How will you manage input costs, in particular gas feedstock, in the future?

CFO James Fazzino

The plant will be at the bottom of the global cost curve and have the lowest cash cost position delivered into the Moranbah footprint. This is consistent with our strategy of achieving the lowest cost base from our operations.

Importantly, the plant will be integrated back-to-gas and accordingly, our returns won't be subject to the volatility associated with sourcing feedstock ammonia. Gas will be supplied to the plant from adjacent coal seam methane fields owned by Arrow Energy, with which we have a 15-year contract, priced in Australian dollars with annual Australian CPI escalation. Importantly, we will have the benefit of being de-linked from global gas prices which will put us in a very competitive long-term position given increasing global energy prices. The gas contract underpins the profitability of the plant in the same way our Gibson Island facility is underpinned by its gas contract.

In addition, the plant is located in the heart of Queensland's metallurgical coal deposits and will be the natural supplier to large existing and new coal projects in the Moranbah area. This also gives us a freight advantage over supply from alternate plants in Australia. Further, the AN plant will be highly efficient, being world-scale and based on the latest technology.

Of course, once the plant is commissioned our task will be to become even more efficient and widen the competitive gap over alternative plants. We're well placed to drive efficiencies as the plant will fit comfortably with our other three ammonia plants in Queensland.

Corporate File

What are the terms and obligations for IPL under your new AN product supply contracts? What level of price increase have you negotiated over the previous contracts entered by Dyno Nobel? What obligations remain under the previous contracts?

CFO James Fazzino
The terms and conditions of the contracts are covered by confidentially clauses and in any event our policy is not to publicly discuss the commercial details of specific contacts. However, clearly we will supply all contracted tonnes in full.

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Thank you Julian and James.

For more information about Incitec Pivot, visit www.incitecpivot.com.au or call Simon Atkinson, General Manager – Finance & Investor Relations, on +61 405 513 768.

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