Promotion of Mutual Investments between Oil Producing and Consuming Countries

Introduction

Good afternoon Ladies and Gentlemen,

It is my pleasure to be here this afternoon to share my thoughts on the topic ‘Promotion of mutual investments between oil producing and consuming countries’ with you.

It was suggested by the organizer that I speak on my company’s strategies in overseas ventures and the measures that my company adopted to mitigate risks associated with these ventures.

However, before I do that I first wish to share my views on why there is a need for mutual investments between producing and consuming countries.

Slide I

- Oil reserves are not in consuming countries

  By divine intervention, substantial reserves of oil are found mostly in remote locations, often in harsh and difficult conditions away from demand centres.

  To quote BP Statistical Review of World Energy, the Middle East for instance holds about 62% (734 billion barrels) of world’s oil reserves, but consumes only about 6% of world demand. Africa holds about 9.4% of reserves but consumes only about 3.3% of world demand.

Demand centres such as Asia Pacific, Western Europe and North America consume about 29%, 20% and 30% of world demand respectively but possess only about 3%, 1% and 5% of world's oil reserves respectively.

The Middle East currently exports about 17 million bpd of oil. This has to almost double to about 32 million bpd in 2025 to meet world's demand. Africa now exports close to 6 million bpd and it has to increase to 10 million bpd in 2025 to satisfy world's projected demand.

Asia Pacific, Europe and North America now import a total of about 35 million bpd and this will increase to approximately 60 million bpd in 2025.

It is imperative for consuming countries to invest in the exploitation of oil in producing countries and oil rich countries to ensure adequate and stable supply to feed their energy hungry economies.

- Significant investment and capabilities requirements

The world now consumes about 85 million bpd of oil. By 2025 the demand is projected to grow to about 120 million bpd which is equivalent to a cumulative annual growth rate (CAGR) of 2% per annum. In order to keep up with this projected demand IEA has estimated that the industry will require investments to the tune of USD17 trillion up to the year 2030. Oil producers in the Middle East and North Africa for example need to raise their average annual investment in oil projects to US23 billion per year from about US15 billion currently.

In producing countries about 64% of the reserves is held by NOCs. With the exception of a few, most NOCs lack the capabilities and the financial resources to develop their reserves. At the same time, the IOCs who possess the relevant technology and resources are mostly from the consuming nations, but own only 7% of the reserves. With the above factors and coupled with the high risks involved in exploration activities it is prudent for NOCs to invite foreign investors to forge partnerships to exploit these reserves.

- Value adding opportunity

I have mentioned the traditional model whereby the oil companies from the consuming countries invest in producing countries to exploit the reserves to ensure the world is supplied with adequate quantity of oil.

But we have seen state-owned companies of producing countries vertically integrating into mid and downstream projects in consuming countries. This provides opportunities for producing countries to add-value to their resources which may be limited in their own domestic market.

Examples are Saudi Aramco investments in the Philippines and South Korea and KPC investments in Europe.

This trend should be encouraged because it will also help to further stabilise the supply as the producing countries now also have a stake in the supply chain. Additionally it will help to mitigate the risks of mutual investments.

Slide II

- Common Grounds for Win-win Collaboration

  To achieve long term and sustainable collaboration between any two parties, it is critical that each party understands and appreciates the other's objectives and motivation. The consuming countries and the producing countries must, in sincerity, engage and appraise each other of their aspiration and goals. An economic relationship based on such mutual understanding and appreciation is bound to succeed and continue over a long period.

- Consumers

  - Security of Supply

Uppermost in the minds of consuming countries when they venture into far flung and unfamiliar geographies is to enhance security of supply. The American and European multinationals started to venture far and wide in the middle part of the last century in search of oil, sometimes at great peril. This scenario is being played out again today as we see the Chinese and Indian NOCs, compete aggressively to secure hydrocarbon resources. Producing countries must take cognizance of this goal during deal structuring. For instance, a service agreement, whereby the consuming country is given a fair financial return on investment but without access to physical barrels may not be considered appropriate by the consuming countries.

- Fair and stable prices

Price volatility is one of the many risks that a consumer must contend with. A sustainable stable price regime is high on the list of priorities for consumers. It not only gives manufacturers of goods and service providers a better sense of their input cost, which is vital in setting prices but will also allow these manufacturers and service providers to focus on their primary economic activity, rather than being distracted by collateral activity like hedging. The challenged faced by the airline industry now illustrates this point very well. Airlines today spend significant management time addressing the issue of high and volatile Jet A-1 price and its impact on the fare structure.

There is much discussion on fuel surcharge and how airlines should hedge Jet A-1 price.

Given the history of the oil price volatility since 1974, both consuming and producing countries are well aware that neither too high nor too low prices are sustainable. High prices that benefit producing countries and low prices that benefit consuming countries are but temporary wins, which are counter productive in the longer term. The challenge is for consuming countries and producing countries to reach consensus on the "right" equilibrium price level. Perhaps, when mutual investments between oil producing and consuming countries having equitable investment along the entire value chain in both producing and consuming markets, this dream of finding the"right" price for oil will be achieved!

o Producers

For many producing countries, the oil and gas industry is the centrepiece of their economic activity and the national economy is highly dependent on this industry. It is understandable that these oil producing countries may be very possessive of this natural resource and may be seen as reluctant to share this endowment with others. But leaving this valuable resource in the ground is not an option either. Producing countries do want to exploit this resource, with the help of consuming countries, but on fair and equitable terms.

- o Fair value of resources

As discussed earlier, the flip side of the coin where consumers are desirous of a fair and stable price of oil, producers also want a fair value for their scarce resource. Producers naturally want to factor in the scarcity value of this depleting resource as a key variable for determining fair price and would like this price to increase over time on a real basis. Hence some producers argue that the price of oil today, in 1974 dollars, is lower than its 1979 peak. Hence the recent peak of US$70 per barrel is justified. Consumers may not agree with this assessment. Nevertheless, the discussion on what is a “fair” price must continue until there is a meeting of minds.

- o Responsible exploitation of resources

One way for foreign investors to mitigate risk is to produce as much oil in the shortest possible time. This approach would enhance their cash flow. From the resource owner’s perspective however, such project philosophy would be irresponsible. The resource owner would like to see a technically optimum exploitation rate based on good oilfield practices which would preserve the reservoir over the long term. Over and above this, producing countries may also wish to control the rate of resource exploitation on a non technical basis. This would seek to balance the nation’s financial requirement now against the need of future generations. In Malaysia, we have instituted a National Depletion Policy, through which we cap the rate of crude oil production on non technical basis, taking into account the current and future needs. In Norway, the same philosophy is implemented in a slightly different way. Instead of slower depletion rate, the proceeds from the sale of oil must be deposited in a National Heritage Fund, which has been set for the benefit of future generations.

It is therefore in the self interst of both host government and foreign investor to engage in a meaningful discussion to determine the optimum rate of depletion. If the host government wishes to extend the life of its resources, then the request by the foreign investor to prolong the production period as compensation for the capital it has risked, is surely a reasonable request that must be favourably considered.

When finding and producing oil, it is the universal duty of all parties to operate in an environmentally friendly way so as to preserve nature. The consuming countries must apply the same standards they are bound to at home, when operating in the oil producing countries, irrespective of the often more lax rules and regulations in producing countries. Such positive attitude will form the basis of a long lasting relationship.

Consuming countries must also show that they are sensitive to the needs of the producing countries by making social contributions to the local population. Good corporate citizenship and corporate social responsibility will endear the consuming countries to the people of the producing countries.

- o Transfer of technology/upgrading of skills

I had earlier alluded to the situation where in many producing countries, the oil industry is the hub for the national economic activity. A significant portion of the population depends on this activity, directly and indirectly, for their livelihood. It is usually a major source of employment and it is only through this economic activity that the population can aspire to upgrade their skills. The foreign investor, however, is usually in a hurry to exploit the resources and will be more inclined to take the quick route of importing skilled manpower from developed nations. It may not have the patience to train local manpower who are starting from a low skill base. Similarly, the oil consuming countries, by virtue of their long history in the oil industry, have developed the technology to find and produce oil. Such technology is considered as proprietary and a source of competitive advantage, and therefore there is a great reluctance to share this technology with oil producing countries. Such views are self defeating as it creates a mistrust between the producing and consuming countries. Sharing technology with the producing country and upgrading the skill base of the local labour force will result in a quicker pace of economic development of the oil producing country. Economic development accompanied by a fairer distribution of wealth are the key ingredients for social stability in developing countries, which ultimately translates into lower country risk, from the perspective of the oil consuming countries.

Slide III

Petronas Business Strategy

o Growth

Petronas like any other oil company sees business opportunities in the gap between supply and the projected demand. Notwithstanding that currently Malaysia is a net exporter of oil and has the potential to remain as a net exporter, Petronas has embarked on globalisation and growth strategies since 1990 when it first ventured in E & P in Myanmar, although not successful. It had set a targe of 30% of its revenue from overseas ventures.

Despite its young age it now has interest in more than 30 countries. Petronas has grown into a fully integrated petroleum company involved in the whole spectrum of the oil, gas and petrochemical industries.

Petronas wants to continue with the supplier role and will therefore continue to invest overseas both in the upstream and downstream sectors. At the same time Petronas will continue to encourage foreign companies to invest in Malaysia, especially in the E & P sector.

- o Maximising returns to stakeholders

Petronas is a business entity with a heart. Therefore its pursuit of business activities be it in its domestic market or overseas is driven by the objective of maximising returns to stakeholders. Of course profit is important without which you cannot sustain or grow. But we believe that profit is not to be reaped solely by the shareholders but it is to be shared with other stakeholders.

In many countries where we operate Petronas provides scholarships to deserving local students to study in the Petronas University in Malaysia. After graduation they return to their countries to serve their respective governments (Thailand, Sudan, S.Africa, Vietnam). In some countries Petronas has contributed to development of infrastructure. In Sudan for example we have contributed to the building of hospital, schools and library. In Vietnam we have built shelter homes for needy children. We have also set up an institution together with the government to train up operating personnel. Whenever possible we also encourage local participation in supplies and provision of other services.

In contract negotiations we believe in a balanced terms and conditions so that both parties can share the benefits equitably. We believe in fairness and reasonableness. We emphasise on mutual success.

o Long term view

Petronas always takes a long term view of its investments and will ride through the business cycles. Because of this, we position ourselves as a partner with the host government or local companies. We do not unnecessarily impose, we do not threaten our partners, we always strive to settle issues and problems amicably and equitably.

We look for sustainable growth in the country. We respect the environment. In Sudan the water that was pumped out from the oil fields is treated and filtered through bio-remediation and the processed water is being used for irrigation and farming.

We respect the local culture and will try to integrate with the local community. Not surprising therefore that Malaysians are liked in many countries.

We respect the aspirations of the host government. In South Africa for instance, even before the government enforced the BEE Charter, Petronas sold off 20% of its equity in Engen to a black group.

We want to grow with the nation and its people. And we want to contribute to the country's economic development because we believe that economic development can help in the stability of the country which in turn provides more business opportunities.

o Alliance with credible partners

Another strategy adopted by Petronas is alliancing with credible partners either through incorporated or unincorporated joint ventures. Petronas has many successful joint ventures. Reasons for alliancing are several :

1. risks mitigation
2. access to market
3. access to proprietary technology
4. political strength
5. G to G relationship

o Value-adding integration

Because of its long term view and desire to contribute to the economic development of the host country, Petronas will, whenever feasible, integrate business activities.

In Sudan for example we bought over Mobil's downstream assets to complement our upstream assets. Recently we have formed a joint venture with the government to construct a refinery in Port Sudan to process local crudes.

Slide IV

o Risks mitigation

The global oil industry is extremely volatile and is subject to various risks and uncertainties. It is capital intensive and has a long development period. And because it is considered a strategic industry, it is also subjected to regulations and directives by the governments.

Therefore to be successful it is imperative that we understand, measure and mitigate the various risks that we are exposed to. We must comprehend the legal, regulatory and the political environment and evaluate its economic consequences. Due diligence must be done to understand its implication. The many risks that I can mention are :

1. Credit strength of counter parties
2. Price, interest rates and forex fluctuations
3. Technology applied
4. Political and regulatory changes
5. Operating
6. HSE

In Petronas we mitigate the above risks by doing the following :

o. Credible partners

Partnership with reputable players to spread financial risk exposure as well as to attract financial institutions to help fund the project. Such alliance enhances comfort on the part of lenders to participate in the financing of the project.

- o Equitable sharing of risks

Host governments can be engaged to participate in the project to mitigate adverse governmental actions. Maintaining long term presence through reinvestment of funds guaranteed from the projects undertaken in the country and participating in nation building of the host country will provide comfort to the host government and ensure good and continued cooperation. Better still, engage the host government to participate in the supply chain.

Another way of limiting the company's exposure is to share the risk with the lenders through non-recourse or limited recourse project finance. Such scheme is possible through the involvement or support of multilateral agencies such as World Bank & EIB, and Export Credit Agencies such as JBIC, as well as commercial banks/financial institutions. The involvement of multilateral agencies also helps to mitigate political risk of the host country.

For example, the Chad/Cameroon project involves the World Bank to part finance the project.

The shareholders' exposure may be limited to the extent of providing guarantee during construction up to project completion, in addition to certain minimum level of equity.

Having skilled staff and invest in training of local staff to ensure assets are operated safely and effectively. Inculcate right values such as integrity and loyalty to encourage ownership of assets.

Integrate the operations. The integration may not reduce the political and regulatory risks but it helps to cushion the price and demand fluctuations.

- o G to G relationship

The strong backing and support from Malaysian government provides comfort when dealing with the government of host countries in which Petronas operates, as well as with overseas financial institutions.

- o Portfolio management

It has to be recognised that not all of the above risks can be mitigated. In this instance we just make a call and bite the bullet in the hope to generate appropriate returns commensurate with the risks that have to be taken. However, it has to fit into the portfolio of assets which allows the company to withstand failure without sinking the company.

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