Turning up the heat

Energy companies in the Middle East were hit hard by the economic downturn, but the current revival is putting pressure on treasury departments to improve their operational efficiency and enhance working capital, as Lance T Kawaguchi explains.

Last year, oil and gas companies in the Middle East had to cope with a significant fall in demand for their products. It led to considerable price uncertainty, as a result of the global economic downturn. Investment in new projects was reduced, or completely shelved, pending an upturn. Government-owned national oil companies and international oil companies all felt the impact of reduced demand, and all sectors of the industry were affected – upstream, midstream and downstream.

Crude oil spot prices averaged $72 a barrel in August 2010, reflecting the recent market gains. The US Energy Information Administration predicts that crude prices will remain relatively flat until the economy rebounds, which is uncertain to many analysts at this time.

As for capital spending, World Energy Outlook 2009, published by the International Energy Association (IEA) in November 2009, noted that “energy investment worldwide has plunged over the past year in the face of a tougher financing environment, weakening final demand for energy and lower cashflow”. It said that energy companies were drilling fewer oil and gas wells, while cutting back spending on refineries, pipelines and power stations.

This made conditions increasingly tough for treasury departments in Middle East energy companies. They came under more pressure from line managers, executive managers and boards to improve operational efficiency across the entire treasury function and enhance the performance of much needed working capital. With revenues falling, margins contracting and credit becoming harder and more expensive to access, treasury departments were under unprecedented pressure to unlock trapped capital.

Good Times Are Go
But this year, the world economy has recovered, demand for energy has increased, and so have prices, albeit slowly. World Energy Outlook 2009 warned that the speed at which energy demand would rebound in the short term was uncertain and depends on the pace of global economic growth.

In the long term, however, the outlook is good. According to the IEA’s Reference Scenario (a baseline picture of how global energy markets would evolve if governments make no changes to their existing policies), world primary energy demand is projected to increase by 1.5% a year between 2007 and 2030, from just over 12,000 million tonnes of oil equivalent (Mtoe) to 16,800 Mtoe, an increase of 40% (see Figures 1 and 2).

Fossil fuels will continue to dominate the energy mix, accounting for more than three-quarters of incremental demand between now and 2030, estimates the IEA. Non-OECD countries will account for over 90% of this increase, and China and India alone for over half.

In the Reference Scenario, oil demand will recover in 2010, reaching 88m barrels a day (mb/d) in 2015 and then 105 mb/d in 2030, a 23.5% increase on 2008 (see Figure 3). Natural gas demand will rise from 3.0 trillion cubic metres (tcm) in 2007 to 4.3 tcm in 2030, a 41% rise.

Increased demand will necessitate renewed investment. "The capital required to meet projected energy demand through to 2030 in the Reference Scenario is huge, amounting in cumulative terms to $26 trillion (in 2008 dollars), equal to $11 trillion or 1.4% of global gross domestic product per year on average," predicts the IEA.

Treasurer Challenge
Energy companies in the Middle East, and everywhere else for that matter, are having to step up to meet resurgent demand. For treasury departments this
is creating challenges in four distinct areas: capital expenditure, joint venture arrangements, mergers and acquisitions, and competition to purchase hydrocarbon assets. These challenges need to be met by improving treasury management efficiency and optimising working capital.

Greater capital expenditure will be necessary to ensure the oil and gas keep flowing. Many of the oldest and biggest fields in the Middle East are past their most productive phases and require more expensive methods of extraction. New fields need to be developed, and undiscovered fields discovered. Downstream facilities for refining and marketing the oil and gas will have to be built.

When an energy corporation increases its capital spending, working capital can become scarce. Extra investment and activity creates greater cashflows which, if not managed carefully by the treasury department, can lead to working capital shortages. The result of this is that treasurers may find it necessary to arrange complex financing to align project completion dates with debt maturities, and if schedules are not met, cash outflows may exceed cash inflows. The result of this is that treasurers may find it necessary to arrange complex financing to align project completion dates with debt maturities, and if schedules are not met, cash outflows may exceed cash inflows. A second challenge is posed by joint venture projects, which are increasingly common. For example, in the second-round bidding for Iraqi oil and gas production contracts in December 2009, many bids came from joint ventures: Royal Dutch Shell (60%) and Petronas (40%) teamed up to win the bid for the Majnoon field; Lukoil (85%) and StatoilHydro (15%) took West Qurna 2; Petronas (60%) and Japex (40%) won the bid for Charraf; and Gazprom (40%), KOGAS (30%), Petronas (20%) and TPAO (10%) got Badra.

A company entering into a joint venture faces considerable counterparty risks. The role of the corporate treasurer here is to scrutinise the partners to understand what the financial dangers are, and then take appropriate steps to mitigate those risks and ensure the long-term security and viability of the project.

A third potential difficulty is mergers and acquisitions. The $30bn acquisition by ExxonMobil of XTO Energy, the Texas-based oil and gas producer, could signal more acquisitions in the sector, with a trend developing for major oil companies to buy up smaller, independent producers around the world.

Acquisitions, whether financed by stock or cash, or a combination of the two, will deplete balance sheets at a time when credit and capital markets are hard to access. In such a dynamic environment, corporate treasurers need full visibility across the enterprise to understand where internal cash is located and how to unlock it. Ensuring systems are fit for purpose to achieve this must now be at the top of any energy business’s agenda.

Finally, competition for hydrocarbon assets is getting fiercer. The tendency for national oil companies aggressively to acquire hydrocarbon assets outside their own countries, and pay significant premiums to do so, is making it harder and more expensive for independent oil companies to compete for these assets. The list of national oil companies owning oil and gas fields in other countries is a long one. It includes CNOOC (China National Offshore Oil Corporation), CNPC (China National Petroleum Corporation), ONGC (India’s Oil and Natural Gas Corporation), PDVSA (Petróleos de Venezuela SA), Petrobras (Brazil), Petronas (Malaysia) and Statoil (Norway).

With so much money being channeled into this scramble for assets, companies are depleting their balance sheets and stretching their credit lines. Treasurers in both types of business, but especially in international oil firms, are under pressure to operate as efficiently as possible, to ensure they are making use of all available cash, and to use supplier finance and export agency finance where appropriate.

THE SOLUTIONS Those are the pressures facing treasurers in energy companies. How should they deal with them? The solutions fall into five broad categories. In each case, the company’s bankers play a role. The first solution is to...
AS THE GLOBAL ECONOMY RECOVERS IN 2010, ENERGY COMPANIES IN THE MIDDLE EAST ARE GEARING UP FOR BETTER TIMES AND A REBOUND IN DEMAND.

Supplier finance can be used to pay suppliers in a timely fashion, perhaps even earlier than usual, yet at the same time allow energy companies to extend their DPO. Export agency finance diversifies funding sources and preserves bank lines, because the agency-guaranteed part of a loan (typically between 50% and 95%) does not count against bank credit; and project finance allows energy companies to match financing payments with the revenues generated by a project. Finally, next-generation banking platforms should be put to work to improve operational efficiency and produce tangible cost savings. The best global banks can provide electronic bank account management (eBAM), which allows corporate clients to manage hundreds of accounts around the world. Opening, maintaining and closing accounts is a significant administrative overhead and closely scrutinised by auditors. eBAM allows treasurers to standardise and simplify processes globally and improve controls. eBAM is also being developed to incorporate electronic documents and automated bank account action messaging, signed with digital certificates.

WORKING IN PARTNERSHIP As the global economy recovers in 2010, energy companies in the Middle East are gearing up for better times and a rebound in demand. This will create pressure in a number of areas, especially in relation to capital expenditure, joint ventures, mergers and acquisitions, and competition for hydrocarbon assets – pressure that corporate treasurers can help relieve by improving the efficiency of their operations and enhancing working capital. In setting out to achieve these goals, treasurers will not be working alone. They will be enlisting the services of their bankers to deploy solutions that work to best effect and drive operational excellence.

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Figure 3: Primarily oil demand by region in reference scenario (mb/d)

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<tbody>
<tr>
<td>OECD</td>
<td>41.3</td>
<td>44.7</td>
<td>43.2</td>
<td>41.2</td>
<td>40.1</td>
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<tr>
<td>NON-OECD</td>
<td>20.0</td>
<td>26.6</td>
<td>35.0</td>
<td>40.2</td>
<td>56.2</td>
<td>2.20%</td>
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<tr>
<td>INT BANKERS***</td>
<td>3.4</td>
<td>5.2</td>
<td>6.5</td>
<td>7.0</td>
<td>8.9</td>
<td>1.50%</td>
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<tr>
<td>WORLD</td>
<td>64.7</td>
<td>76.5</td>
<td>84.7</td>
<td>88.4</td>
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**Compound average annual growth rate. ***Includes international marine and aviation fuel. In previous WEOs, international aviation fuel was included at the regional level. Source: World Energy Outlook 2009, IEA.