Commentary

Equity Oil and India's Energy Security

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> *While the efforts of ONGC-Videsh and Indian Oil Corporation are laudable, there is still some distance our firms have to travel to catch up with global competition. I urge our oil and gas PSUs to think big, think creatively and think boldly in this context…They have to be more fleet-footed in making use of global opportunities, both on the supply and demand side, I find China ahead of us in planning for the future in the field of energy security. We can no longer be complacent and must learn to think strategically, to think ahead and to act swiftly and decisively.*
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> Prime Minister Manmohan Singh's speech
> at Petrotech India 2005 on January 16, 2005

It's not that the PM's speech galvanised the Indian oil companies into hunting for overseas energy assets. The policy for acquisition of overseas assets was launched in the 1990s, in a bid to minimise India's burgeoning oil imports even as domestic crude production continued to stagnate at around 32-33 million tonnes per annum, against a demand of 108 million tones, thereby meeting only 30 per cent of demand. The report of the Group on India Hydrocarbon Vision 2025, a ministerial group set up by the Prime Minister to focus on long-term energy security, had suggested, amongst others, that India's energy policy should have a focused approach to get equity oil and gas, besides building relationships with international oil companies.

According to Indian oil officials, by 2025, with the demand for oil projected to touch 370 million tonnes, India should produce at least 110 million tonnes per year. "Hence to maintain this level, we need to add 60 million tonnes of oil every year. We thought the only way to get this was to get it from outside India as equity oil. Our mission, therefore, is to get this 60 million tonnes every year by 2025," said Atul Chandra, who was the

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managing director of ONGC Videsh Limited (OVL), the overseas exploration arm of ONGC, in 2003.[1]

Where's the Competitive Edge?

Although Indian oil companies have notched up some successes over the last few years in buying equity stakes in foreign oil and gas blocks, the most notable being the Sakhalin-1 (offshore) project in Russia and the Greater Nile project in Sudan where the Chinese also have a major interest, it has failed in many more or managed to acquire marginal stakes in others. For instance, it lost a bid to acquire Royal Dutch/Shell's 50 per cent interest in Block 18 offshore Angola, which includes the Greater Plutonia development, with reserves of one billion barrels, after the Chinese government offered the Angolan government a 17-year, $2 billion loan at a low (1.5 per cent) interest rate along with the offer to build hospitals, and electronics manufacturing factories. The Indian government was also prepared to support ONGC by offering $200 million to help build a railway, but this was dwarfed by the Chinese package.

India's overseas energy policy came into the limelight recently when it entered – and lost – to Chinese national oil companies in their bid to acquire a foreign oil company to China National Petroleum Company (CNPC). PetroKazakhstan is a $3.3 billion Canada-based firm with all its assets in Central Asia. This was followed by another acquisition by CNPC to purchase oil and pipeline interests in Ecuador from EnCana, a Canadian natural gas giant. The $1.42 billion deal marked the second time in a month that the Chinese outbid ONGC in the competition for overseas asset acquisitions.

The recent losses would warrant a rethinking on India's overseas acquisition policies and the strategy pursued by its national oil companies. According to Mr Chandra, although acquiring overseas assets helps lock the ceiling prices for future supplies, this depends on the long-term assumption of oil prices being built into the acquisition cost. For instance, the Sakhalin crude would have a ceiling price of about $25-30 a barrel for the next 10-years while in the case of Sudan, it will be significantly lower. However, he adds that it is important that the assumed oil price for acquisition is reasonable and is lower than the market price on the long-term basis and warns that in the current environment, when the international price of oil is high, there is no incentive for the countries that own the oil to sell the asset unless a very high premium is paid. The danger is that the high premium would take away the entire value from the asset leaving almost nothing for the buyer barring some risks.

In such cases, geographical contiguity plays a major role. Therefore, despite the high price paid for the PetroKazakh deal ($4.18 billion), it is a valuable asset for the Chinese. Not only do they have their own pipeline from Kazakhstan which would allow them to reduce the transportation cost by $2-3 a barrel, by sourcing Chinese goods and services to develop the field, their rate of return may well exceed 12 per cent. In addition, they would ensure supply security even in the event of a war. But for a company that does not have a strategic advantage, such a high cost of acquisition may not make sense.

Many in the oil industry agree that the most pragmatic acquisition strategy would be to look for good exploration blocks. But this is predicated on having a corporate team capable of evaluating possible exploration acreages in the world, which the big international oil companies have. Unfortunately, however, most of the Indian oil companies do not have a comprehensive set-up or database to follow this strategy, with the result that India ends up acquiring blocks that are in the "very high risk" category. Neither are the exploration blocks acquired in the bidding round examined in depth due to shortage of time available thanks to lack of adequate research of the area.[2]

China Looms Large

Both, the Chinese and Indian energy companies seem to be chasing the same assets. Consequently, the competitive bidding is pushing up the price of assets. This is likely to hurt the Indians more than their Chinese counterparts, which are bigger. Observers also say that the aggressive bids by the Indian and, particularly the Chinese, companies in exploration auctions reflect a readiness to accept a lower rate of return than western companies in order to secure a strategic asset. As a result, the Chinese seem to have succeeded in clinching some major successes over a relatively short period of time, despite their entry into the overseas acquisition game as late as 1997 and over the last few years, Chinese firms have acquired many exploration and production assets in several countries and regions.

Besides the PetroKazakhstan deal, CNCP has several other projects in Kazakhstan. It owns 85.42 per cent of Aktobemunaigas Corporation (now CNPC Aktobe), 100 per cent of the Bars exploration and development block formerly owned by Nimir Petroleum Bars Holding BV of Great Britain, and 50 per cent of the North Buzachi oil and gas field located in northwest Kazakhstan, also formerly of Nimir and Chevron Texaco.

Additionally, CNPC is a joint, 50 per cent investor in the Atasu-Alashankou pipeline with KazMunaiGaz, Kazakhstan's state oil company, which runs from a production facility in Atasu, in central Kazakhstan, to a railroad station in Alashankou in China. It will have an immediate 200,000 barrels-a-day capacity, and a peak capacity of 400,000 barrels a day. Completion is scheduled for December 2005 with commissioning in 2006. CNPC is augmenting the Atasu-Alashankou with a wholly domestic pipeline, a 246-km line that runs from Alashankou to a refinery in Dushanzi.

In West Asia too, where China is strengthening its relations with regional producers, Sinopec signed an exploration agreement for Iran's Zavareh-Kashan block in 2001. Moreover, China and Saudi Arabia have an agreement on petroleum cooperation since 1999 and CNPC's engineering division helped build several oil processing facilities in Kuwait. The scale of Chinese involvement in the region grew sharply in January. Sinopec and Saudi Aramco signed an agreement for gas exploration and development in South Ghawar region, while Sinopec agreed to a deal with Iran, in which it will buy 250 million tonnes of LNG over 30 years. Sinopec will also become the operator with a 50 per cent stake of Yadavaran oil fields, which are expected to produce 300,000 barrels per day.

In Africa, China is emerging as a serious rival for other oil companies. CNPC was awarded a major stake in the 320,000 barrels a day Greater Nile Oil project (GNOP) in Sudan. In 2003 and 2004, it signed exploration deals in several African countries including Chad, and during Premier Hu Jintao visit to Algeria, Egypt and Gabon in early 2004, an exploration deal was signed between Sinopec and Gabon and a cooperation agreement with Algeria.

CNOOC has also secured equity in Indonesia's Tangguh and Australia's North West Shelf projects, and is negotiating for a 12.5 per cent stake in Gorgon (Australia). CNOOC is the largest oil producer offshore Indonesia after its bought oil and gas assets from Repsol YPF in 2002. Moreover, both Sinopec and CNPC are driving major investments in Canada's oil sands and several Chinese and Latin American energy accords were signed in early 2005 including with Venezuela, Argentina, Brazil and Peru in 2003.[3]

India's Limited Success

In contrast, India's successes have been more modest. Selecting target countries on the basis of a nine-block matrix with the emphasis on the "prospectivity" of the country or region and OVL's ability to compete there, the projects that came under OVL's consideration included those in Vietnam, Russia, Iraq, Iran, Libya, Sudan, Indonesia, and the US.

In order to leverage India's buying power OVL had teamed with other domestic oil companies like IOC, OIL and GAIL as well as multinational companies such as British Petroleum, Exxon-Mobil, British Gas, and Sodeco of Japan in overseas projects. A consortium comprising OVL, IOC and OIL signed a contract in 2002 with Iran's National Petroleum Company (NIOC) for the exploration of the Farsi block in the Persian Gulf while in the Myanmar block, it had entered into a partnership with GAIL.

However, so far, it can count only a few. Among its projects, the most notable one is Sakhalin-1 (offshore) in Russia, where OVL has acquired a 20 per cent participating interest in the project. It is involved in the project through a consortium arrangement with Exxon-Mobil, Sodeco and the Russian companies RN Astra and SMNG. Exxon-Mobil is the operator. At $1.7 billion, this is the largest single investment ever made by an Indian corporate. Production will commence in 2005. India's share in the first six or seven years is about 5 million tonnes a year, which includes Russia's share as part of the repayment for a loan to the Russian government. After the loan is repaid, India's share tapers off to 2.5 million tonnes a year. Gas production is scheduled to commence in 2008.

OVL also has three major stakes in Sudan – including in the GNOP project in partnership with CNPC and Malaysia's Petronas. Besides the company also has a stake in an offshore gas project in Vietnam along with British Petroleum and PetroVietnam and another in the Myanmar offshore, where OVL is participating in the exploration along with Daewoo International Corporation, GAIL and Korea Gas Corporation (KOGAS) of South Korea.

In Libya, OVL signed an agreement in August 22, 2002 with the Turkish Petroleum Overseas Company to acquire 49 per cent stake in two onland oil and gas exploration blocks. In the US, OVL has started exploring in the shallow waters of the Gulf of Mexico; Sakhalin India Limited has signed an agreement with McAlester Fuel Company of the US to take a 10 per cent stake in an offshore gas exploration block on the Louisiana coast.

The Downsides

The overseas acquisitions game has its fallouts. Many countries are aware that they can derive benefits by forcing Chinese and Indian companies to compete. For example, Russia is playing ONGC and CNPC off against each other for a 15-20 per cent interest in the re-nationalised Yuganskneftegaz, a subsidiary of Yukos. CNPC is said to be offering a $6 billion advance payment on future oil sales, while ONGC proposed a $2 billion investment and a $4 billion loan.

Realising the problems Indian oil companies are facing and in a bid to end this damaging competition, Indian Petroleum Minister Mani Shankar Aiyar said that “China and India need to adopt a collaborative approach in bidding, whenever possible”, and added that energy companies from the two countries will “cooperate” and “compete”, depending on the situation. Not surprisingly, Mr Aiyar intends to visit China by the end of the year and at this time there are expectations that oil giants from the two countries will draft an agreement in order to foster relations between them.

ONGC chief Subir Raha has also argued for more collaboration with China because “the current situation is unfeasible - we can’t keep fighting”. He favours an Indo-Chinese agreement on where to bid, with the winner swapping or sharing recoverable reserves. “There are many permutations but agreement will cap spiralling prices, which only benefit sellers.” He says he has won over Indian officials, whose suspicion about China had once ruled out any accommodation and said that the Chinese are open to such cooperation. Some observers are, however, sceptical and say that while it is in the Indian companies’ interests to seek cooperation, the cash-rich Chinese can afford not to.

In the meantime, Indian companies are also trying to get its act together to increase their leverage. For instance, several Indian firms are pooling their assets to increase their kitty in the bidding game, with some success.

IOC and OIL joined forces without ONGC to win an exploration block in Libya. They plan to do the same in the second round of bidding due soon. Earlier, there was also a proposal to build a company with genuine overseas clout as part of a merger of the five national oil companies, which, however is still under consideration.

This strategy of intensified acquisition of equity oil has also met with considerable scepticism from international oil market analysts. They argue that overseas investments are unlikely to shelter countries from oil market volatility. They argue that equity investments by China (or India) in distant producing fields in Africa, Latin America, or West Asia are not likely to improve the physical security of its energy supply. Whether purchased on the open market, or produced by its national oil companies, they will have to effectively pay the world market price either directly or in foregone revenues if China were to ship every barrel of equity oil back home. In fact, according to industry press reports, most of the oil currently produced by Chinese oil companies abroad is not shipped back to China, but instead is sold on markets closer to production.

Crude oil is fungible and the market for this commodity is globally integrated. Due to the laws of supply and demand, any oil that is pumped from the earth and added to the world market will increase supply relative to demand and tend to have a downward effect on price. Any increase in demand relative to supply would tend to push prices upward. Even if national oil companies continue their acquisition strategy, it is very unlikely that they would be successful in satisfying demand or insulate its economy through their acquisitions and will continue to be affected by the world market like other countries.

They also argue that in their rush to stake claims around the world, Chinese and Indian companies accept terms that would often not be considered commercially viable for the oil majors, who base their investment criteria assuming a long-term average price of oil at between $20-30 per barrel. If oil continues selling for $50-60 per barrel, the assets may be an advantage, but if prices drop considerably, the results could be quite painful.

Renewed Thinking

It is noticable from the above observation that India doesn't necessarily have to play the punishing game of last man standing with China on the overseas equity oil. The ability to forge long-term supply contracts is critically important as much as is the capability to enhance energy security through discoveries within the country. It is also true that a surging Indian economy would require abundant energy, at the cheapest price. However, it is detrimental to reason that because the cheapest and most efficient way to produce energy is through oil, therefore it does not make economic sense to pursue other alternative sources. After all global oil production is reaching its peak; this is to say that production will only fall. Therefore, in midst of spiralling oil prices and global demand that is projected to grow faster than production capacity, a larger question remains: how to find a path that lessens our dependence on oil. The 'powerdown' approach based on cooperation, conservation and sharing as well as aggressively pursuing alternative energy keeps haunting us whenever there is an oil crisis and this needs to be revitalised.

The recent India-US agreement on civil nuclear cooperation, which also commits the Bush Administration to press its allies to let India into future-oriented nuclear ventures, is part of a larger energy dialogue that provide oversight of not only oil and gas but also coal and renewable sources. This is indeed significant. India is probably the only country that has a full-fledged ministry dedicated to renewable energy (Ministry of Non-conventional Energy Sources) and this needs to be effectively strengthened with incentive driven commercialisation. Almost immediately after Dr Manmohan Singh's visit to Washington in July, India along with US, China, Australia, South Korea agreed to the Asia-Pacific Partnership on Clean Development and Climate. The pact "seeks to use scientific innovation and technology transfers to reduce carbon dioxide emissions, in contrast to the binding emissions targets of the Kyoto Protocol."[4] If followed in the right direction, this pact should act as a catalyst for converting - through proven clean development mechanism - indigenous coal supplies into methanol, which is not only a high performance motor fuel but can also be stored in tanks and transported by pipeline and tankers. Clearly such initiatives will help energy-driven India to minimise the impact of global oil price fluctuations and relatively free itself from being a captive to oil.

References/End Notes

1 "The Global Player", *Frontline*, 20, January 18-31, 2003.

[2] *Financial Express,* August 30, 2005.

[3] *Petroleum Economist,* March 2005.

[4] http://www.eia.doe.gov/emeu/cabs/MEC_Current/July.html.

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