Ewart S Williams: Stimulating domestic capital in the energy sector

Address by Mr Ewart S Williams, Governor of the Central Bank of Trinidad and Tobago, at the Trinidad and Tobago energy conference, Port-of-Spain, 8 February 2011.

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It’s a bit of a paradox but the facts are that the energy sector makes a major contribution to GDP, to the public finances and to exports, (but scarcely any direct contribution to employment) and depends very little on domestic financing.

Table I illustrates the contribution of the energy sector to the various economic aggregates.

You should note too, that since the beginning of the last decade, the energy sector was the main engine of growth and has grown at an average rate of 10.3 per cent per annum, outpacing the average growth of 3.8 per cent for the non-energy sector.

In terms of financing, ***Table II*** shows that the energy sector accounts for a mere 3 per cent of total banking system loans and virtually the entire bank exposure is to the “service” companies.

The picture is even worse if we look at the ***capital market***. With the exception of one small company listed on the second-tier market, ***none of the 32 listed companies on the first-tier of the stock exchange are in the energy sector***. In addition, of the $17 billion of (private) securities floated on the domestic capital market ***in the last decade***, none were for local energy sector companies.

And here I am defining the energy sector in the broad sense, comprising:

(i) upstream – largely multi-national firms specializing in exploration and the production (mining) of oil and gas;

(ii) the downstream petro-chemical sector (also largely foreign owned); and

(iii) the energy services sector (the smaller firms that provide support services) – these are largely locally-owned, though there are three multi-nationals that also operate in this sector.

The foreign-owned enterprises are financed almost exclusively from abroad through direct equity injections and intra-company loans. The **Table III** presents estimates of total foreign direct investment in the energy sector in the period (2001–2009). The significant inflows during the first half of the decade were on account of the considerable capital investments associated with the development of the LNG industry.

Of course, Petrotrin and NGC, the large local companies in the energy sector are state corporations who also finance their investment projects largely from international sources (of course, in addition to retained earnings). According to their published annual reports, external indebtedness by Petrotrin and NGC has grown tremendously. NGC’s external debt more than tripled between 2004 and 2006. Of the approximately $9 billion increase in Petrotrin’s debt over the period 2006–2009, almost all was financed on the external market.

The often repeated rationale for the limited involvement of the domestic financial sector includes:

(i) the large capital outlays and long lead times to production;

(ii) high risk and uncertainty associated with exploration investment;

(iii) potential for inherently variable resource revenue; and

(iv) the high interest rates and inefficiency of domestic capital markets.

It is true that the domestic capital market is limited in terms of the financing requirements of the larger companies. For example, Petrotrin went to the overseas market to raise US$750 million in 2007 and US$850 million in 2009 to finance the Gasoline Optimization Project and the ultra-low sulphur diesel plant. The domestic financial system certainly could not supply those resources. (But one is tempted to ask why a small portion could not have been raised here).

In terms of the ***capital market***, the largest local currency, private sector issue in the domestic capital market was TT$1 billion in 2005 for TSTT. In terms of foreign currency issues, the largest issue was US$130 million for the Trans Jamaica Highway in 2004, followed by US$120 million for the Government of Barbados in 2009.

The Petrotrin transaction in 2009 clearly shows that the required capital could have been raised on the local market at a lower interest cost (Table IV). However, the issue size was considerably larger than the customary values raised on the domestic market.

Apart from issue size, the multinational energy companies ***will not borrow on the domestic market because they can access financing at cheaper rates***. According to the BP's consolidated financial statements for 2009, the company's interest cost for ***fixed rate*** debt for US dollar, Euro and "other currencies" issues were ***4 per cent, 4 per cent and 6 per cent***, respectively. The rates were considerably lower for ***floating rate*** debt ***(1 per cent, 2 per cent and 3 per cent)***. In this year, the prime rate in Trinidad and Tobago was 11.9 per cent. Capital issues were at rates ranging from 5.25 to 8.95 per cent.

The pre-conditions for increasing domestic financing in the energy sector are better now than they have ever been.

First, excess reserves have averaged $2.3 billion throughout 2010, and the foreign exchange situation is strong enough to afford such loans.

Second, interest rate differentials between domestic and foreign interest rates have virtually disappeared and investors are looking for investment opportunities. In principle, there is the potential for both bank and capital market financing.

Over the years, there have been two proposals pertaining to the multi-national upstream sector. The first is for these corporations ***to ring-fence their domestic operations and open these up to wider public participation*** – listed on the domestic stock exchange. The practical implications of this have not really been explored. There is, however, a view among some multi-nationals that adhering to differing capital market regulations in developing countries will be an unnecessary hassle.

It should be noted, however, that listings of multi-national operations have been successfully undertaken in countries such as Nigeria where ChevronTexaco and Mobil are listed on the Nigeria Stock Exchange. In the local context, it is not clear, for example, whether tax incentives could be used under these circumstances. ***Could some level of local equity participation be made a condition for new entrants?*** I raised this with an industry insider and the retort was... "could the process start with bringing Petrotrin and NGC (or part thereof) to market?" An interesting question indeed.

Second, the issue of depository receipts has also been raised.

Domestic capital in the energy sector could be enhanced with the introduction of depository receipts by the multinational corporations that operate locally. A depository receipt (DR) is a security issued by a depository bank to domestic buyers as a substitute for direct ownership of stock in foreign companies. A DR is a convenient way for companies whose stock is listed on a foreign exchange to cross-list their stock on the Trinidad and Tobago Stock Exchange (TTSE) and make stocks available for purchase by local investors without the concern of currency differences.

DRs have increasingly become a facet of the capital markets of countries where there is a strong multinational presence. DRs are issued in countries such as ***India, Taiwan, Hong***

Kong and South Korea. There is already a depository bank with local operations (Citibank) that can facilitate the process.

However, the challenge would lie in the negotiations with the multinationals – convincing them of the advantages of issuing DRs. ***Perhaps the government can consider enshrining provisions in future bid rounds or other long-term contracts with foreign companies which promote the issuance of TTDRs.***

Even if we put aside the larger multi-nationals, the active involvement of private domestic capital will greatly help the development of the energy services sector. These small local companies (drillers and other service operators) take on active role in reviving old wells as they assume control of small acreages on which they do their own exploration and production.

Output from these sources has declined in recent years. The Government has proposed changes for small land and marine operators to stimulate activity. The incentives are designed to increase the tax deductible costs to reduce the liability for the SPT.

I am suggesting that a ***Junior Stock Exchange*** could be an effective mechanism for raising capital for this sector, while broadening public participation.

A junior stock market is a mechanism whereby enterprises that find difficulty raising capital through commercial loans can source the required funding. Successful junior markets have been established in the United Kingdom (London Stock Exchange Junior Market) and Canada (Toronto Stock Exchange Junior Market). ***In 2009, a junior market was launched in Jamaica.*** From all reports, it has been very successful.

The main feature of a junior market is that it allows investors to place capital into listed SMEs. ***Market development is supported by appropriate tax incentives by the government as such exemption from taxes on dividends and share transfers.*** Some of the criteria for the establishment of a junior market are as follows (the process puts some obligations on the SMEs):

– Companies desirous of listing must do so ***via an IPO***.

– The preferred method of issue is via a Prospectus Issue where an offer is made to the public by or on behalf of a company, ***at a fixed offer price***.

– For the purpose of transparency, annual statutory audits, quarterly and annual reports are required in keeping with the submission requirements of the main exchange.

– A company which is wholly or partly a subsidiary of a registered entity on a recognized stock exchange shall not be eligible to be listed. (This disqualifies local operations of international oil companies)

I am told that there are some obstacles to be cleared before a junior market for energy service firms could be established. One is the assignment of acreages by Petrotrin and the second is the need to address trade union opposition.

It is said that our stock market has not flourished because shareholders are reluctant to dilute ownership and firms are reluctant to open themselves up to public scrutiny. However, the economic environment has changed and if we are to meet our investment requirements, a greater shareholding democracy is necessary. This is another area where private and public sector collaboration could yield dividends.

Table 1. Economic Contribution of the Energy Sector

/Per Cent/

	2006[r]	2007[r]	2008[r]	2009[r]	2010[P]
Share of GDP					
Energy Sector	47.0	45.0	49.1	35.8	35.7[f]
Of Which:					
Exploration and Production	27.8	24.1	27.9	20.3	20.3[f]
Refining (including LNG)	7.0	7.5	7.6	6.5	5.7[f]
Petrochemicals	7.2	7.0	6.8	4.5	5.8[f]
Share of Government Revenues (fiscal years)	61.9	55.5	57.1	49.5	52.3
Share of Merchandise Exports Receipts					
Energy Sector	91.1	87.0	88.2	85.4	83.5
Of Which:					
Extracted	15.5	11.3	14.0	12.9	17.9
Refined	60.7	54.9	56.0	62.9	49.9
Share of Total Employment	3.5	3.7	3.4	3.3	3.3

Source: Central Bank of Trinidad and Tobago.

Table 1(a). Economic Growth in Trinidad and Tobago

/Per Cent/

	2001-2003	2004-2006	2007-2009
Real GDP	**8.5**	**8.7**	**1.2**
Energy	16.8	12.7	1.4
Non-Energy	4.2	5.8	1.5

Source: Central Statistical Office.

Table II. Credit to the Energy Sector by the Financial System

/TT$ Millions/

		2005	2006	2007	2008	2009	Sep-10
Commercial Banks	Private Sector	499.0	749.6	751.7	995.1	417.4	446.6
	Public Sector	309.9	525.3	374.3	500.8	1,013.4	1,127.0
	Total	**808.9**	**1,274.9**	**1,126.1**	**1,495.9**	**1,430.8**	**1,573.7**
Non-Banks	Private Sector	477.8	535.7	158.1	155.1	10.8	6.0
	Public Sector	0.0	0.0	0.0	0.0	0.2	0.2
	Total	**477.8**	**535.7**	**158.1**	**155.1**	**10.9**	**6.2**
All Institutions	Private Sector	976.8	1,285.3	909.8	1,150.2	428.2	452.7
	Public Sector	309.9	525.3	374.3	500.8	1,013.5	1,127.2
	Total	**1,286.7**	**1,810.6**	**1,284.2**	**1,651.0**	**1,441.7**	**1,579.9**
Memo Item:							
Petroleum Sector Loans/Total Loans (per cent)		**3.7**	**4.5**	**2.8**	**3.2**	**2.8**	**3.1**

Source: Central Bank of Trinidad and Tobago.

Table III. Foreign Direct Investment in the Energy Sector

/US$ Millions/

Item	2001	2002	2003	2004	2005	2006	2007	2008*	2009
Petroleum Industries	816.3	738.2	738.5	913.4	857.2	794.9	763.4	588.8	646.9
Of Which:									
Mining, Exploration and Production, Refineries & Petrochemicals	*787.2*	*694.8*	*710.3*	*867.2*	*813.0*	*735.5*	*710.6*	*532.5*	*610.2*
Service Contractors, Marketing and Distribution	*29.1*	*43.4*	*28.2*	*46.2*	*44.2*	*59.4*	*52.8*	*56.3*	*36.7*
TOTAL FDI	**834.9**	**790.7**	**808.3**	**998.1**	**939.7**	**882.7**	**830.0**	**2,800.8**	**709.1**
Petroleum FDI/Total FDI	**97.8**	**93.4**	**91.4**	**91.5**	**91.2**	**90.1**	**92.0**	**21.0**	**91.2**

Note: In 2008, the RBC purchase of RBTT injected US$2,194 million.

Source: BOP Report 2009, Central Bank of Trinidad and Tobago.

Table IV: Interest Rates of Issues Raised on the Domestic and External Capital Markets

/Per Cent/

Year	Local Rate	Foreign Rate*
2007	5.9-11.0	6.06
2009	5.25-8.95	9.75

*Interest rates for Petrotrin's Senior Unsecured Notes.

Source: Petrotrin Consolidated Financial Statements ,2009.

Proposals for Stimulating Domestic Financing

- **Bank financing is a credible option.**
  - ➢ The banking system is strong enough to participate in syndicated loans.
  - ➢ In 2010, excess reserves averaged $2.3 billion.
  - ➢ The foreign exchange position is comfortable.

Proposals for Stimulating Domestic Financing

- **Financing of Multinational Operators**
  - ➢ Listing on the Trinidad and Tobago Stock Exchange via IPO of local operations or issuance of Depository Receipts.
- **Financing Small, Domestic Producers**
  - ➢ Access the banking system for amounts up to US$160 million.
  - ➢ Establishment of a Junior Stock Market.