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MENA Energy Investment Outlook: What We Should Really Worry About

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1. In the June issue of our Economic Commentary, we reviewed the IEA’s 2014 special report: ‘World Energy Investment Outlook’. Our attention was specifically on the question regarding whether we can still count on the Middle East and North Africa (MENA) to increase investment and extend supply over the medium to long run. In this issue we develop more fully our downcast arguments along the lines of the presentation we made to a preparatory consultative workshop that was meant to shape the IEA’s key findings and messages.

2. As producers, MENA largest holders of oil and natural gas resources have been struggling to adapt to unforeseen shifts in global supply and trade. As investors, they realize that they will continue to be subject to the uncertainties over trends in technology, policy and economics (Figure 1). However, because these uncertainties are long-term, intangible and inherently unpredictable, they can hardly feed into investment decision-making. Instead, investors tend to focus on more tangible, medium-term risks. Hence, our main arguments involve three risk concerns: flagging investment climate, rising project costs, and a constrained funding outlook.

Figure 1: Long-term Intangible Uncertainties

Flagging investment climate

3. Persistent political turmoil in parts of MENA has adversely affected the region’s business environment. The degree to which this has been the case is often measured using a proxy for country risk, mostly in the form of a sovereign rating. As shown in Figure 2, this method easily captures the marked bifurcation trend between GCC and non-GCC countries, omitting from the latter unrated countries. However, using such a proxy means that we are relying on a definition of country risk that focuses on the likelihood that the sovereign borrower will meet, or fail to meet, its debt obligations. More relevantly, country risk should be related to the likelihood of events impacting business and investment.

4. An alternative, less conventional measure of the degree to which the turmoil has affected MENA energy investment climate is provided using a ‘perceptual mapping’ - a multidimensional scaling analysis combining potential investment, country risk, and enabling business environment. Notwithstanding considerable uncertainty, the mapping offers a more nuanced reading of the complex situation investors are faced with (Figure 3).

Cost inflation

5. Accordingly, Saudi Arabia has maintained its position in the prime quadrant, nearest to an ‘ideal point’ benchmark. Next, taking the lead of its cluster in the second quadrant, the UAE has put some distance between itself and both Qatar and Kuwait. The two remaining GCC countries, Oman and Bahrain, have managed to secure their positions in the third quadrant. Beyond the GCC, most countries have reshuffled into new clusters. Tunisia has joined a group of lesser investment appeal formed of Morocco, Jordan and Lebanon. Iraq has now regressed after having relatively improved its position by crossing into the third quadrant and bonding with Egypt and Algeria. Libya’s position has deteriorated most, ending up in the least attractive quadrant in a cluster comprising Yemen, Sudan, Mauritania and Syria. Finally, even though having moved into the prime quadrant, resilient Iran is still far from its peer-energy producer, Saudi Arabia. Looking ahead, it is difficult to foresee any improvement to this mapping.

Cost inflation remains one of the most important factors driving the increase in energy investment. All research-oriented

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1 “IEA’s World Energy Investment Outlook: Can We Still Count on the Middle East?”, APICORP’s Economic Commentary, June 2014.

institutions have established that the costs of energy projects have been soaring (Figure 4).

**Figure 4: Cost Inflation of Large-scale Energy Projects**

7. The IEA for instance has found that investment cost has doubled during the past decade or so, due largely to rising prices of input factors, skilled personnel, and oilfield services. In the upstream sector, costs have additionally been found to closely correlate with the complexity of projects. CERA has established the same for power generation projects, with the nuclear generation component rising even higher. But as exhibited in Figure 4, APICORP has shown that, in the context of MENA, escalating project costs have stemmed from the concurrent inflation of the main price components of engineering, procurement and construction (EPC). Therefore, to the IEA’s factors, one should add contractors’ margins, project risk premiums and the ‘cost of excessive largeness’ which implies a diseconomy of scale due to significant delays and cost overruns of large-scale energy projects. Whatever reason, the likelihood is that costs will continue rising beyond normal inflation.

**Financing uncertainties**

8. Financing is crucial for investment decisions. It is basically determined by the structure of capital requirement, which we have established to be 33% debt and 67% equity for MENA medium-term energy investment (Figure 5).

**Figure 5: MENA Energy Capital Structure and Financing**

9. On the one hand, equity, which is a dominant feature of the upstream and midstream industry, is sourced internally either through retained earnings or state budget allocations. Therefore, its funding depends on the extent oil market price is sustainably above the fiscal break-even price, which we have established to be $105/bbl for OPEC as a group. As shown in the fiscal cost curve in Figure 6, this output-weighted average masks heterogeneity among key MENA members. The higher their fiscal cost, the less funds will be available for equity financing. Therefore, while we should not be particularly worried about Qatar, Kuwait, and to some extent the UAE, we should definitely be concerned about Saudi Arabia; and even more concerned, in ascending order along the fiscal cost curve, about Libya, Iraq, Algeria and Iran.

**Figure 6: OPEC Fiscal Break-even Oil Prices**

10. On the other hand, debt, which is a dominant part of the downstream industry, is sourced externally. Despite recent success in the issuance of bonds and sukuk, predominantly in the GCC, external financing of energy investment continues to rely heavily on a still distressed loans market (Figure 7). Even with greater involvement of export credit agencies (ECAs) and local commercial banks, this market will hardly fully recover without international banks renewing their commitment to the region. Meanwhile, meeting the potential debt requirement suggested in Figure 5 will remain a daunting challenge.

**Figure 7: Trends in MENA Energy Sector External Financing**

11. We conclude by summing up our three main arguments. First, the lingering turmoil in parts of MENA threatens to have a long-lasting, negative effect on investment climate outside core GCC. In this context, we continue to take a pessimistic view on Iraq and Iran - the major potential sources of capacity growth. Second, there is a strong likelihood that the costs of large-scale energy projects will continue escalating above and beyond general inflation. Third, securing financing will remain a daunting challenge. In this final respect, whatever the options for mobilizing financial resources, long-term funding requires affordable alternatives to non-sustainable, oil-price-dependent sources, as well as a commitment to broader and deeper regional capital markets.