ANNUAL REVIEW OF THE ARAB MACRO-ECONOMIC AND ENERGY INVESTMENT OUTLOOKS

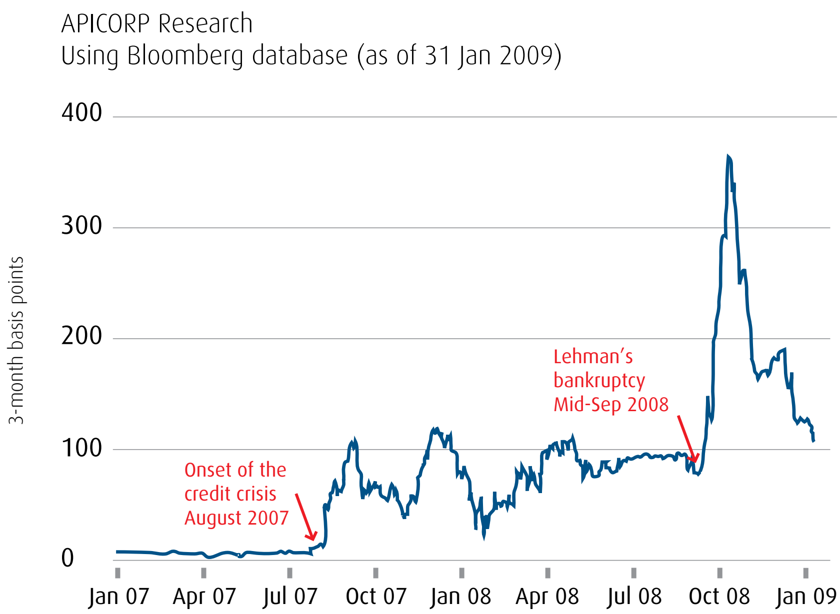
HEIGHTENED RISK IN THE MIDST OF A DUAL CRISIS

The subprime-mortgage-induced credit crisis that began in the United States has moved into a protracted and more severe phase. In spilling over to other sectors and spreading worldwide the crisis has thrown the global economy into what is feared to be a deep and severe recession. The Arab/MENA economies would have been more resilient if not for the subsequent collapse of oil prices. The credit market crisis and that of the oil market have now combined to heighten the downside risks to both the region's macro-economic and energy investment outlooks.

A great deal of analyses and interpretations of the credit market crisis have accumulated and continue to be added. They mostly trace the origins of the crisis to the bursting of the US house price bubble in the summer of 2007 and attribute its roots to mortgage lending securitization. Securitization is the financial process by which illiquid assets, typically loans, are transformed into tradable asset-backed securities. Investment banks purchase in bulk loans from local credit originators, pool and segment them into structured collateralized obligations, enhance their creditworthiness with the help of the credit rating agencies, move them off-balance sheet and trade them into open financial markets. This process worked fairly well until the subprime defaults started to disrupt actual cashflow to investors, ultimately dislocating the linkage between US borrowers and global capital markets.

As the subprime problems spread to other forms of credits, major banks and financial institutions reported huge losses, and some of them filed for bankruptcy protection. The collapse of Wall Street investment bank Lehman Brothers in mid-September 2008 eventually eroded what little confidence and trust was left in the financial system.

More than anything else, what the credit crisis has highlighted are much broader and larger structural issues. These



include pervasive under-pricing of risk, massive credit expansion, excessive use of leverage by investment banks and hedge funds, and uncontrolled and unregulated growth of derivatives and other complex financial products. The crisis has also underscored significant risk management weaknesses and vulnerabilities within the banking industry.

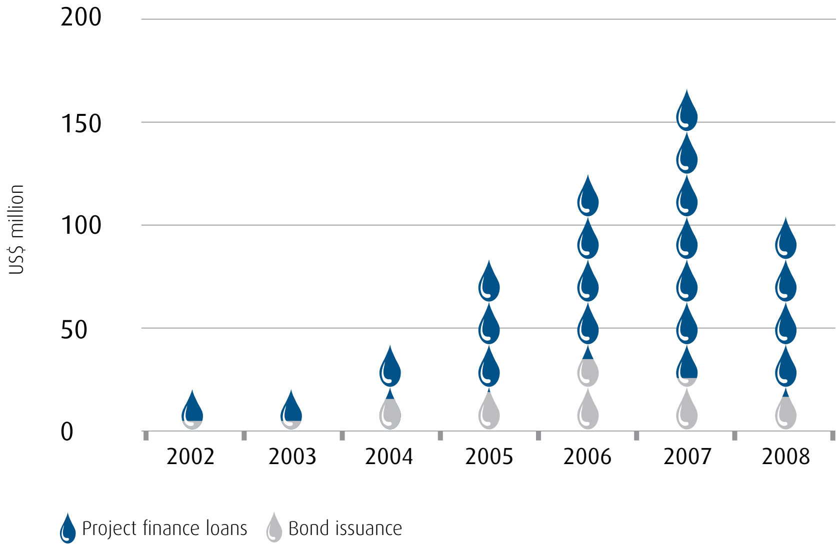
To be sure, drastic actions have been taken to prevent further bank failures and restore confidence into the financial system. Central banks have extended liquidity provisions beyond conventions and have aggressively eased monetary policies. Treasury departments have embarked on plans to bail out shaky financial institutions and have committed to purchasing troubled assets from banks and guaranteeing interbank lending. Ultimately, sovereign wealth funds from the periphery have been called upon to assist in the rescue effort, notwithstanding serious impairment of their own assets.

These wide-ranging policy actions or intended measures have so far had little impact. The best illustration of a still frozen credit market is that of the evolution of spreads between term London Inter-bank offer rates (US Dollar Libor) and the anticipated US Federal Reserve overnight index swap (OIS) (Figure below). This is a key measure of risk and liquidity in the money market. In normal times such a spread is below 10 basis points (bps). Although current spreads have fallen back to their pre-Lehman levels of around 85 bps, they are still too high to infer any momentous improvement in the market.

In the Arab/MENA world the most immediatly measurable impact of the crisis is a significant contraction of capital inflows. As shown in the Figure below, the combined bonds issuance and project finance loans to the region, which have peaked in 2007, have fallen well below their 2006 level. As a matter of fact, the total shown for 2008 is that realized during the first nine months of the year, since there were virtually no capital inflows in post-Lehman credit freeze. Should this trend continue into 2009, it would have lasting effects on the region’s economy.

MENA debt issuance

APICORP Research
Using IMF database (for bonds)
& Dealogic loanware (for loans)

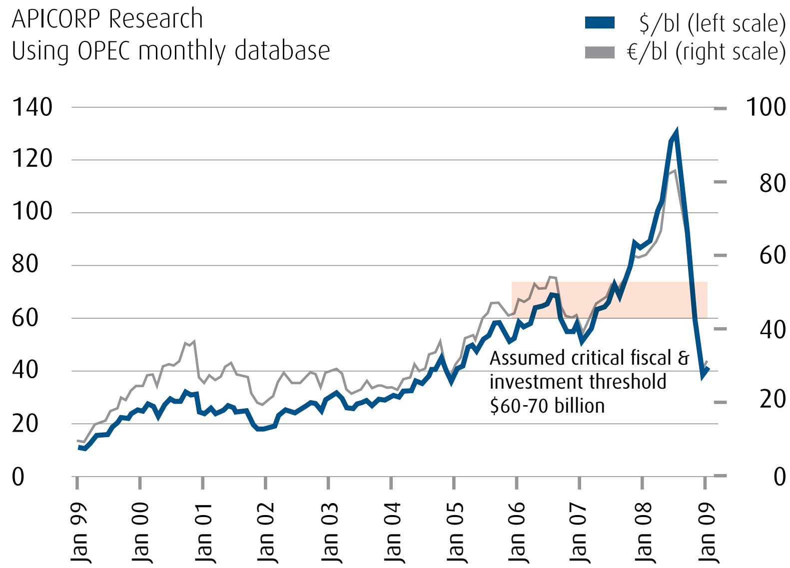


THE OIL MARKET CRISIS

The credit market crisis has concealed another crisis, that of the oil market. Until the summer of 2008, when oil prices reached an all time high of $147/bl on the New York Mercantile Exchange (Nymex), it was believed that large scale involvement of investment banks, on behalf of commodity futures investors, had led to a serious market dislocation. In a context of reduced scope for arbitrage between physical and futures markets, both the Organization of the Petroleum Exporting Countries (OPEC) and the U.S. Commodity Futures Trading Commission (CFTC) refrained from drawing boundaries of tolerable market behavior. Instead, they indulged in a sterile debate over whether speculation or fundamentals were driving up oil prices.

Central to this controversy was the concern that neither institution wanted to be held responsible for the surge in oil prices. As international pressure mounted, however, Saudi Arabia moved in to cushion the physical market with extra crude. Simultaneously, but on a different plane, CFTC focused its scrutiny on swap dealers and commodity index traders in a move to shed light on the activity of investment banks and improve transparency and control of the futures market. With some success : the 2008 summer oil price bubble burst. But prices have since fallen steeper than oil market analysts anticipated and much lower than oil producers expected .

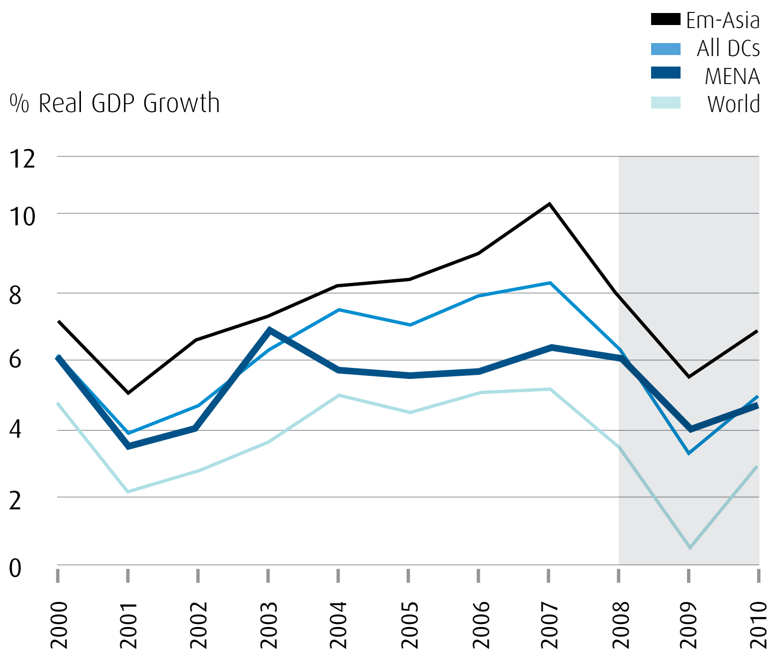
In an effort to shore up prices, OPEC has implemented two production cuts agreed in September and December 2008. But this has only prevented its reference basket price from falling under an average monthly of $40/bl (Figure below). A level far below the producers' critical fiscal and investment threshold that APICORP Research estimates in the range of $60 to 70/bl.[1]



IMPACT ON THE ARAB/MENA MACRO-ECONOMIC OUTLOOK

Top-down institutional macroeconomic forecasters have increasingly been criticized for being "behind the curve" (a phrase used to refer to one's inability to anticipate changes and act swiftly). Not only did it take some time for the IMF to recognize the spillover of the credit crisis to the real economy, but it went through two revisions of its October 2008 forecasts before acknowledging what many bottom-up forecasters had already anticipated. "We now expect the global economy to come to a virtual halt" states the IMF Survey of 28 January 2009.

The IMF's revised growth forecast points to a much below trend rate of 3.9% in 2009 and 4.7% in 2010 for the Arab/MENA region. This contrasts with our own forecast of 4% for the period 2009-2013, which assumes lower growth for 2009 and 2010, but moderate fiscal and current account deficits. Furthermore, whatever the macroeconomic scenarios are, recent trends of rising inflation and decreasing unemployment are reversing. This will put unemployment back at the core of policy concerns.



Source: IMF Revised World Growth, 28 January 2009

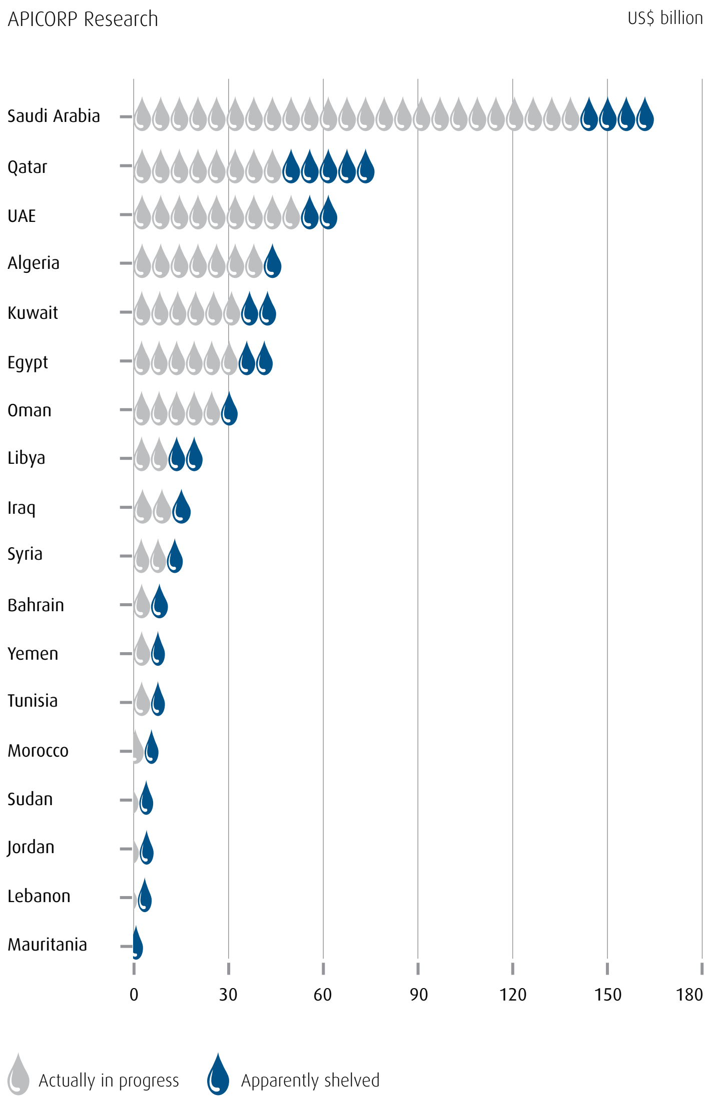
[1] Under an alternative investment framework, such a price signal can be worked out as the unit present value of future fiscal petroleum revenue streams. For further details see APICORP's Economic Commentary Vol 3 No 11-12 Nov-Dec 2008 – "Shaping Long Term Oil Price Expectations For Investment: Is It Workable? Is It Achievable?", a reprint from an earlier commentary published in the Middle East Economic Survey (MEES 50:51 dated 17 December 2007).

ANNUAL REVIEW OF THE ARAB MACRO-ECONOMIC AND ENERGY INVESTMENT OUTLOOKS

IMPACT ON ARAB/MENA ENERGY INVESTMENT OUTLOOK

Against a backdrop of collapsing global growth, scarce and high-cost credits and depressed oil prices, our 2009-2013 review of energy investments in the Arab world points to a significant capping of their potential. This stems from the shelving or postponement, beyond the 5-year review period, of a substantial number of initially planned projects, mostly downstream in the oil and gas supply chains. As a result, actual capital requirements are projected at US450 billion, falling short by 19% of potential.

Reflecting the distribution pattern of petroleum reserves in the region, 69% of these investments are located in the Gulf Cooperation Council (GCC) area, and a little more than half continue to be shouldered by Saudi Arabia, Qatar and the United Arab Emirates. In addition to the deteriorating economic and credit environment highlighted above, the GCC area faces specific challenges since nearly all Gulf countries have experienced to one degree or another gas supply shortfalls. As a result, the availability of high-quality and low-cost feedstock adds further uncertainty to the investment outlook.



On the sector level, the oil supply chain (including the oil-based integrated refinery-petrochemical link) accounts for the biggest share of 48% of the expected US$450 billion actual capital investment requirements. The gas supply chain (including the gas-based petrochemical and fertilizer links) accounts for 35%. The remaining 17% of requirements are those of the oil-or-gas-fuelled power generation sector.

The associated capital structure is more complex to determine, particularly in a context of an unprecedented credit crisis. The industry would normally prefer retaining enough earnings to fund upstream and midstream activities. By contrast, it tends to rely more on debt for downstream activities. Most recent trends have continued to point to an average equity-debt ratio of 30:70 in the oil-based refining/petrochemical sectors. In the gas-based downstream sector, the ratio is set at 40:60 to factor in higher feedstock risks. Finally, in the power sector, the ratio is put back at 30:70 to reflect expected reduced leverage in the IPP-IWPP sector. Under these conservative assumptions, the resulting capital structure for the period 2009-13 is likely to be 57% equity and 43% long-term debt (Table below).

APICORP Research

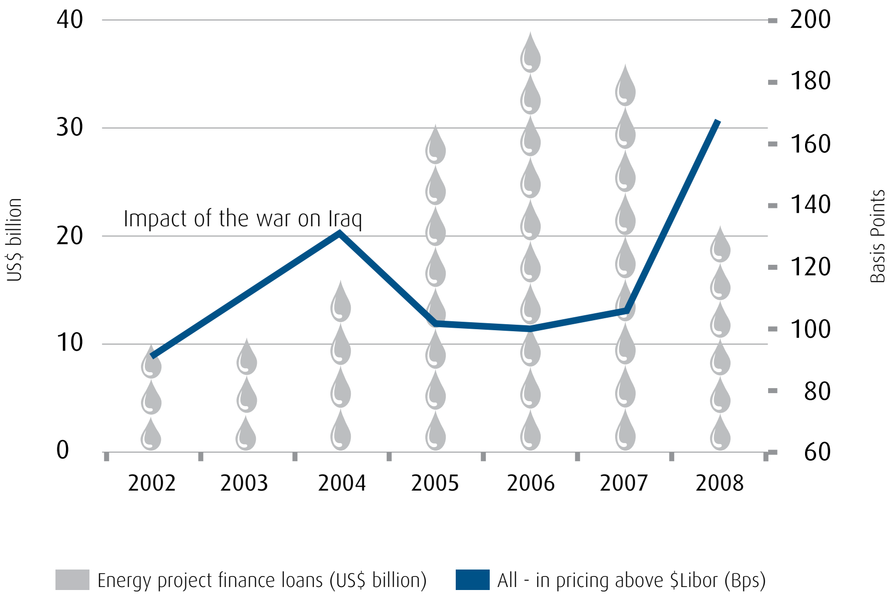
Arab world	Actual Capital US$ billion	Capital Structure	Equity	Debt
Oil supply chain				
Upstream	83	18%	100%	0%
Midstream	12	3%	100%	0%
Downstream	115	26%	35%	65%
Gas supply				
Upstream	54	12%	90%	10%
Midstream	13	3%	100%	0%
Downstream	96	21%	40%	60%
Power link				
Generation	77	17%	30%	70%
Total	**450**	**100%**	**57%**	**43%**

FINANCING OPTIONS AND CHALLENGES

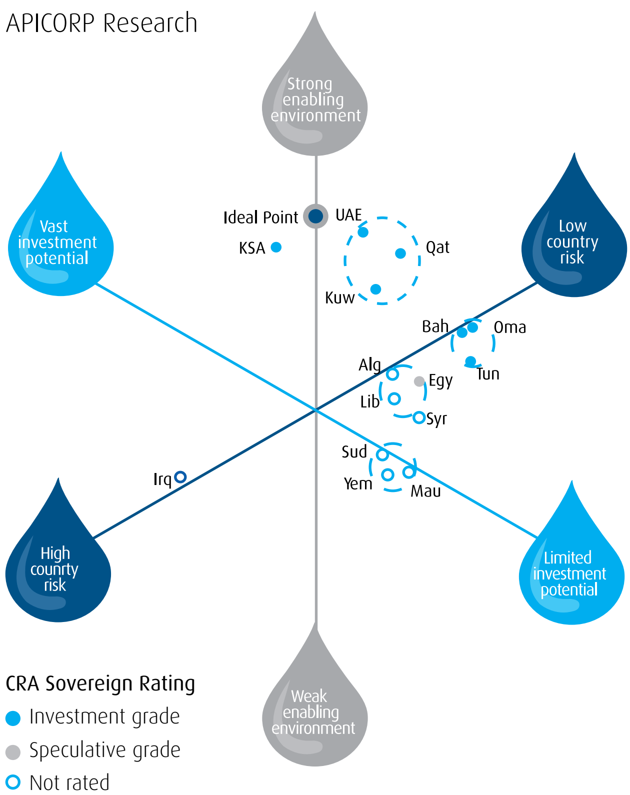
The trend towards more equity-weighted structure is likely to be more pronounced in the future. Whatever the structure, however, funding both equity and debt is expected to be extremely challenging. On the one hand, low oil prices will hamper project sponsors' capacity to fund the upstream and associated midstream through retained earnings. On the other hand, funding prospects for the still highly leveraged downstream will be uncertain. The annual volume of debt of US$39 billion, resulting from the above actual requirements and the corresponding capital structure, is comparable to the all-time record achieved in the loan market at its peak in 2006. These amounts would hardly be met should current credit-market conditions persist. Not only has the cost of borrowing soared as a result of an upward re-pricing of risks (Figure below), but credit standards have been severely tightened.

In this context, and more than at any time before, project sponsors' credit ratings, which measure their ability to service debt, will be closely monitored, as well as the sovereign ceilings that bind them. Regrettably, not all countries in the region have sought a rating. Among the fifteen Arab petroleum-producing countries only eight have been listed, seven of which with investment grades. The fewer countries in the GCC area that have managed to keep their upper ratings, will be able to raise debt at relatively low cost and less stringent terms, once the credit markets stabilize.

APICORP Research
Using Dealogic loanware database



To complement the above limited number of sovereign ratings, APICORP Research has developed a perceptual mapping of the energy investment climate that encompasses all Arab petroleum-producing countries. The mapping, which combines three attributes, namely investment potential, country risk, and the enabling environment, highlights the strength of key GCC countries (Figure below). Despite the challenges highlighted earlier, the GCC area appears better placed to expedite project gestation and implementation and ensure a rapid resumption of energy investments, once the dual crisis is over.



CONCLUSIONS AND POLICY RECOMMENDATIONS

The economic crisis has broadened and spread to gradually engulf the Arab/MENA world. Current trends in the credit and oil markets have combined to heighten risks, mostly relating to the availability and cost of funding. As a result, not only may the economic outlook deteriorate substantially, but the energy investment potential is likely to be capped further.

Accordingly, our main policy recommendations fall within four areas. First Arab governments should make up for shrinking foreign capital inflows by reallocating internally the net assets invested offshore by their sovereign wealth funds. Secondly, in providing liquidity and supporting the recapitalization of pan-Arab financing institutions, they should target those contributing to the development of the petroleum industry, which remains a powerful economic lever, as well as those focusing on job-creating sectors. Thirdly, in reviewing their investment strategies, public and private project sponsors should exclude from any “option to wait” economically viable infrastructure energy projects. Finally, The best policy response to risk aversion, and the resulting higher capital cost, is to reduce perceived risks. In this regard, our perceptual mapping, demonstrates that consistent efforts should be made to catch up with the GCC are in improving the overall investment climate.