

## **Special Report: Petronas chafes at its role as Malaysia's piggy bank**

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**By Niluksi Koswanage and Emily Kaiser**

(Reuters) - State-owned oil company Petronas is tired of being Malaysia's cash trough. Its growing pique at the government flared into public view here in early June at the World Gas Conference.

Chief executive Shamsul Azhar Abbas took to the stage and declared that the government's policy of subsidizing fuel was plain wrong. A murmur ran through the crowd - his boss, Prime Minister Najib Razak, was sitting in the front row.

Moments later, Najib went to the podium himself to remind everybody that the subsidies - for which Petronas foots the bill - have "social-economic objectives."

The subtext of that rejoinder: Malaysians pay among the lowest electricity rates and petrol-pump prices in Asia. While the government has vowed to "rationalize" that, it's highly unlikely to happen before elections expected in a few months.

The polite but pointed disagreement was the latest sign of assertiveness from an oil company that prime ministers have treated as a piggy bank for pet projects since it was established in 1974.

Interviews with current and former officials and an examination of Petronas and government documents show that strains have been building behind the scenes over how much money the company hands over to the government in the form of fuel subsidies, dividends and taxes.

Financial data reviewed by Reuters show the government has increasingly relied on Petronas's payments - a "dividend" to its sole shareholder - to plug fiscal deficits that have begun to alarm ratings agencies and analysts.

The data also show these payments grew over the past several years as oil prices soared, along with government spending. But Malaysia's official accounts do not show how the money is being spent - and the government has steadfastly refused to disclose any details about that.

"WE NEED CASH"

Petronas is Malaysia's largest single taxpayer and biggest source of revenue, covering as much as 45 percent of the government's budget. Unlike other oil-rich nations such as Saudi Arabia, Norway or Brazil, Malaysia runs chronic, large budget deficits that have expanded even as oil revenues increased. Last year's fiscal gap, at 5 percent of gross domestic product, trailed only India's for the dubious distinction of biggest in emerging Asia, and it may widen this year.

Subsidies account for a big chunk of the deficit. They have other downsides as well, Shamsul noted in his speech to the gas conference. "Subsidies distort transparency, reduce competition and deter new investments," he said, adding that Petronas paid between 18 billion and 20 billion ringgit (\$5.75-6.35 billion) a year to subsidize gas consumption.

Malaysia isn't facing a fiscal crisis. Foreign investors eagerly buy Malaysian government bonds, confident the country's reserves of oil, gas and foreign currency are deep enough to ensure the debt will be repaid.

That faith will be tested over the next few months.

Falling oil and gas prices will likely constrain Petronas's 2012 profits, and a worsening euro-zone crisis may hurt the country's exports. Smaller Petronas payouts and slowing economic growth would pinch government finances.

Shamsul argues now is an opportune time to pursue foreign acquisitions on the cheap as Malaysia's domestic energy supplies deplete. On Thursday, the company announced it was acquiring its Canadian joint-venture partner, Progress Energy Resources Corp, for \$4.7 billion. More may be in the offing.

"Mind you, for that to happen, we need cash," Shamsul said in his speech.

The trouble is, the government needs the cash, too.

## TOWERS OVER MALAYSIA

Petronas, Malaysia's only global Fortune 500 company, towers over the Southeast Asian country - literally and figuratively. Its 88-storey twin towers, once the world's tallest buildings, dominate the skyline of Kuala Lumpur.

Petronas's oil and gas reserves rank 28th in the world, according to data from PetroStrategies in Plano, Texas, ahead of some better known players such as Norway's Statoil and CNOOC, China National Offshore Oil Corp.

Unusual for a state-owned enterprise, Petronas's debt is rated stronger than the sovereign state's. The company had about \$15.6 billion in total borrowing as of March 31 and counts U.S. insurer Aflac Inc among the debt holders.

Petronas' CEO and board, however, serve at the pleasure of the prime minister. Over the years, prime ministers have tapped into Petronas funds to build their dream projects and bail out their mistakes. Political leaders were used to dealing with yes-men in the company, which on Malaysia's organization chart is part of the prime minister's office.

Now Petronas is trying to say no.

Like all state-owned oil companies, Petronas is expected to pass along a share of profit to the government, just as a private sector oil company pays dividends to shareholders.

Those dividends gobbled up almost 55 percent of its net profits in the fiscal year ended March 31, 2011, well above the average of 38 percent paid by national oil companies around the world, Petronas figures show.

Including taxes, export duties and the dividend, Petronas estimates its total payments to the Malaysian government added up to 65.7 billion Malaysian ringgit (\$21.10 billion) in that fiscal year.

## SWELLING DEFICIT

Petronas has been pushing for a new dividend policy that would set the annual payout to the government at 30 percent of profits instead of the flat 28 billion Malaysian ringgit (\$8.75 billion) it will pay this year.

A lower payout would preserve money to reinvest in global oil and gas exploration in order to compensate for declining domestic supplies.

A Reuters analysis of Petronas and government financial data shows Petronas would have paid close to 17 billion ringgit in the March 2011 fiscal year if the 30 percent dividend formula was in place.

A smaller dividend payment would have deepened Malaysia's fiscal deficit, swelling it to about 6.5 percent of gross domestic product. That's nearly triple the average among the world's emerging-market economies, according to International Monetary Fund data.

With less Petronas money under the new formula, Prime Minister Najib would have three unpopular options: cutting spending, increasing taxes or ramping up the deficit. Worsening public finances could unsettle foreign investors, who hold about 39 percent of the government's local currency debt, the highest share in emerging Asia.

The Petronas CEO put a brave face on it when Reuters asked him if the new formula might be put in place this year, with elections now expected as soon as September.

"The government is fairly aware of Petronas's need to have our own funding for growth," Shamsul said after the company released financial results on May 31. "They respect that and they will agree to our request."

Najib's office declined to comment.

#### ELECTION STIMULUS?

Najib, who took over mid-term from his predecessor and has yet to receive an electoral mandate as prime minister, can ill-afford to accommodate Petronas right now on the dividend. He has raised civil-servant wages and approved cash payouts to low-income households - vote-winning measures paid for in part by Petronas.

Ratings agency Fitch warned in February that Malaysia's budget was too reliant on petroleum receipts, and elections could drive up spending and deepen the budget deficit.

"If aggressive stimulus measures were implemented and this led to a sustained increase in public debt ratios, it would be negative for the ratings," Fitch wrote.

That may already be happening. The government in June asked parliament to approve another 13.8 billion ringgit in supplementary spending - more than half of it for food and fuel subsidies - which would swell the fiscal deficit to 6 percent of GDP.

Petronas only began detailing its contributions to the government two years ago - around the time it began lobbying for a change in the dividend policy. Indeed, the word "dividend" does not even appear in its annual reports for 2001 through 2009.

Reuters has filled in some of the gaps from previous years, obtaining figures from former Prime Minister Mahathir Mohamad, now adviser to the oil company, dating back to 1976. Petronas declined to confirm their accuracy.

#### NO PUBLIC DISCLOSURE

Mahathir's data show Petronas payments to the state more than doubled between 2005 and 2011 as oil prices soared. Malaysia's spending swelled too, widening the budget deficit even though revenues rose. But Malaysia won't disclose what the Petronas money is being spent on.

Reuters placed an official request for that data from Malaysia's accountant general's office, but the audit agency said it could provide budgetary figures for everything except Petronas's contributions.

Without access to official figures, it is difficult to determine how the government spends Petronas money. Mahathir told Reuters he released additional Petronas data on his blog as an "appeal" for more clarity on where the money went after he stepped down from office in 2003.

The bulk of it appears to be going into operating expenses, including higher wages for the more than 1.4 million civil servants who are mostly ethnic Malays, Mahathir says.

Since Najib took office in 2009, operating expenses have risen by almost 16 percent. Development spending, which includes education, security and healthcare, has stayed flat.

Increased wages are a recurring cost, Mahathir pointed out in an interview from his office on the 83rd floor of the Petronas Towers. Once pay goes up, he said, it is difficult to cut in lean years.

"So the result is, you take more from development expenditure because development expenditure is not a statutory requirement," he said. "You can cut."

#### EXPANDING ABROAD

As domestic oil supplies shrink, Petronas has been expanding abroad, investing in Sudanese oil, South African petrol stations and European liquefied natural gas. Its corporate operations map shows a presence on five continents.

But 29 percent of the company's international production is concentrated in Sudan and South Sudan, and clashes along their border have virtually shut down most of the pipelines. Shamsul warned that a halt in Sudan production would cost the company 3 billion ringgit.

That is one reason behind the planned purchase of Canada's Progress Energy. Shamsul said Thursday that the deal would boost the company's gas resources in "a geopolitically stable region."

Deals like this take money, and Petronas argues it cannot fulfill its mission when it is handing over more than half its profits to the government.

Petronas board member Mohammed Azhar Osman Khairuddin told unidentified U.S. diplomats that the oil company "feels tremendous pressure to grow its business in order to maintain Malaysia's political status." Azhar said Petronas wanted the money invested in oil and gas assets "to promote future profitability rather than be spent now on domestic programs for political gain", according to a diplomatic cable released by Wikileaks in June of last year.

Neither Azhar nor Petronas responded to requests for comment.

The tug-of-war between government payments and corporate investments is a sore point with other oil companies as well.

Petronas faces a milder version of the dilemma facing Mexico's national oil company, Pemex. The Mexican government is extracting so much cash from the business that Pemex is having trouble investing in production - and output has waned. Fitch assigned a "BBB" rating to the oil company's latest debt issuance, citing a substantial tax burden and "exposure to political interference risk."

With global energy demand expected to rise by around 30 percent by 2050 as the population rises to 9 billion, oil executives are asking whether governments are a major obstacle to ensuring future supplies at affordable levels. Exxon Mobil Chief Executive Rex Tillerson told the World Gas Conference that regulation, taxes and subsidies are placing at risk the projects needed to fuel global growth. If the situation persists, governments will find their economies "walking backwards," he said.

Petronas has four oil projects in Iraq, which are expected to achieve commercial production this year. Shamsul estimates that Petronas's share of Iraqi output will peak at 800,000 barrels of oil per day by 2015 - about 45 percent more than Malaysia's annual crude oil production.

The company has not disclosed how much it is investing in Iraq, but as much as \$8 billion is going into one field alone, Gharf Oilfield, which Petronas is developing along with Japan Petroleum Exploration Co.

"The reason (Petronas) does not want to give money to the government is because it needs the money to reinvest," Mahathir said. "This is a very costly business as you know. Everything runs into the billions of dollars."

## GOOD GOVERNANCE

As state oil companies go, Petronas has a good reputation for governance. A 2011 World Bank working paper on governance and performance of national oil companies ranked Petronas slightly above the global average.

But it has been called upon to bankroll some questionable projects, both under Najib and his predecessors. Twice - in 1984 and 1989 - Mahathir asked Petronas to bail out scandal-ridden Bank Bumiputra Bhd from collapse. In those two rescues, Petronas injected a total of 3.3 billion ringgit into the bank.

Mahathir drew criticism for tapping Petronas to bail out a debt-burdened shipping concern controlled by his eldest son, Mirzan, and again to support Malaysian auto company Proton, which makes the Lotus Formula One car.

Mahathir denied he had bailed out his son. Petronas "drove a very hard bargain" and ended up turning a profit on the deal, he insisted. Petronas has repeatedly declined to discuss the bailouts.

The strains between Petronas and the government spilled out into the public after Najib took office in 2009.

Hassan Marican, Petronas's CEO at the time, disagreed with Najib over issues ranging from who should be named to the Petronas board to which Formula One car to sponsor.

Reuters has learned that Najib gave Hassan just six days' notice that his contract would not be renewed in 2010, ending a 21-year career. Three people with direct knowledge of the situation said Hassan was let go because he did not get along with Najib.

"Six days to pack up a career spanning more than two decades," said a person close to Hassan.

Hassan, now a board member at U.S. oil major ConocoPhillips and chairman of utilities company Singapore Power, did not respond to repeated interview requests.

Appointed by Mahathir, the 59-year-old accountant by training had considerable freedom before the clashes with Najib. Mahathir said Hassan often said "no" to his suggestions, though he did agree to bail out the national car company that was the prime minister's pride and joy and the company owned by Mahathir's son.

Hassan refused to use inexperienced Malaysian companies to develop Malaysia's oil and gas industry, or to pursue costly ventures to develop the country's marginal oil fields, the source close to Hassan said.

Those two projects are now part of Najib's ambitious \$444 billion economic transformation program launched in September 2010 - just seven months after Hassan's removal. (\$1 = 3.1985 Malaysian ringgit)

(Additional reporting by Mica Rosenberg in Mexico City and Yantoultra Ngui in Kuala Lumpur.; Editing by Bill Tarrant and Michael Williams)

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