EGYPT

Cairo reviews free zone tax

The levy on energy companies in Egypt's free zones, combined with the global banking crisis, is stalling progress on the state's ambitious refinery projects

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Egypt's oil and gas sector has come under increasing pressure to boost production over the past few years, as power demand increases in line with its growing population and industrial base.

Egypt's population of 81 million is growing at a rate of 2 per cent a year and, in sales terms, its petrochemicals industry alone has grown 10-fold over the past decade to $3bn from $300m. In 2007, power demand in the country was predicted to grow by 35 per cent within five years, from 2,000MW to 2,700MW.

The increasing demand for fuel has led the government to pursue ambitious plans for its downstream oil and gas sectors, in particular to expand refining capacity.

Despite having the largest refining capacity in North Africa, Egypt's oil production has been static since 2000, at 725,000 barrels a day (b/d).

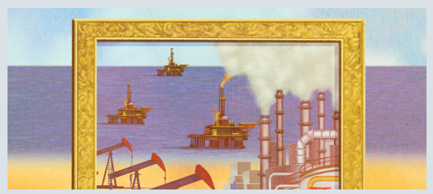
State-owned Egyptian General Petroleum Corporation (EGPC), which operates eight of the country's nine refineries, with a total output of about 30 million tonnes a year of mixed products, announced in 2006 plans to build five refineries over the next decade. To date, two have been commissioned, the Mostorod refinery near Cairo and the Middle East Oil Refinery project in Alexandria, which will supply the growing domestic market rather than provide oil for export.

Reducing commitments

These developments will maintain Egypt's focus on meeting domestic demand, a strategy that has meant the country lost out on oil export revenues as prices rocketed in 2007 and 2008. Oman, which has an approximately equivalent output of 760,000 b/d, earned $10bn in oil revenues in 2008.

With the global financial crisis taking hold in the final three months of 2008, however, Egypt's energy sector is now entering a period of retrenchment. Many of the international banks that had previously agreed to provide finance for the five new refineries have reduced their funding commitments because of the low levels of liquidity in the global banking system.

KEY FACT



2.3 million t/y

The projected output of high-grade diesel from the planned Mostorod refinery

t/y=tonnes a year. Source: MEED

"[The free zone tax] changed the investment environment. Companies are re-evaluating their investments"

Dubai-based industry source

"The finance markets have dried up, so refineries are looking to other sources," says Justin Dargin, research fellow at the Dubai Initiative of the US' Harvard University. "Some of the regional development banks are discussing refinery projects in Egypt."

"What is really impacting it is the crisis in the debt markets," says Marwan Elaraby, a partner at Egyptian private equity firm Citadel Capital, whose subsidiary Egyptian Refining Company is to operate the new facilities at Mostorod. "A good portion of the financing for our project is debt, and obviously commercial banks are not in the same position they were in a year ago. Their ability to generate the bulk of the debt is questionable."

Elaraby says development banks and export credit agencies are now considering investing in Egypt's refinery programme. The European Investment Bank has been involved from an early stage, the African Development Bank and Islamic Development Bank are considering joining the venture, and South Korean export credit agency Kexim plans to provide funding.

"Because it is a greenfield project, it creates jobs and has obvious social and environmental impacts – the refinery will produce low-sulphur diesel," says Elaraby. "It is a project that will lend itself well to export credit agencies."

In January, the construction of new facilities at the 140,000-b/d Mostorod refinery 10 kilometres outside Cairo was delayed because of the difficulties in securing financing. The refinery was planned to be the biggest project financing in Egypt, at a cost of $2.7bn. Initially, managers expected $2bn of the total cost would be debt.

In 2007, engineering, procurement and construction contracts for the Mostorod refinery were awarded to South Korea's GS Engineering and Japan's Mitsui. The refinery's expansion was intended to process 4.2 million tonnes a year (t/y) of fuel oil residue from existing refineries to produce 2.3 million t/y of high-grade diesel and 700,000 t/y of petrol. But the intended start-up date is now in doubt as new sources of finance have yet to be found to plug the funding gap.

However, Citadel is still confident that its planned refinery at Mostorod will come on line by 2014. "We still think we can put together a financing package [for Mostorod] and achieve financial closure by the end of 2009," says Elaraby. "Moving forward from that, we would start construction in early 2010. With four years' construction, we could commission in late 2013 or early 2014."

In the current economic climate, export credit agencies will play an increasingly important role in project finance. "Export credit agencies do not necessarily share the same logic as banks, so they are not subject to the same constraints on credit," says Dargin. "It is likely that they will step up to the plate."

But the participation of export credit agencies comes with conditions. "They are asking that additional sources of funding be found as well, meaning the international banks would have to reaffirm that they were willing to continue to fund the expansions," says Dargin. "This is not going to be easy at the moment."

One positive factor to emerge from the difficult global financial situation is the fall in engineering, procurement and construction costs.

"We are talking to most of the banks. But time is not our enemy now, as it was two years ago," says Elaraby. " Construction prices are dropping, whether it is for steel or cement, so we can benefit from any delay. The name of the game from our point of view is to rephase procurement for the banks to come in when liquidity conditions approve, and taking into account the costs."

Rescheduling construction

The uncertainty over oil prices, caused by the financial downturn and a resulting slump in world trade, was a major factor behind the decision of Middle East Oil Refinery (Midor) to shelve its expansion plans for its refinery near Alexandria, opting instead to expand its coking unit. The plant can process both heavy and light crude, but heavy crude is cheaper to process, and expansion of the coking unit will enable it to process more of the heavier grade.

France's Technip won the $55m engineering, procurement and construction contract to expand the coking unit. The unit will have a production capacity of 30,000 b/d and will be delivered by the third quarter of 2010.

However, there is no consensus that the effect of weak crude prices is the main reason for Egypt's refinery programme hitting delays and changing direction. Refineries are obviously affected by the oil price, but the relationship is complex. "It depends on what kind of refinery it is, what kind of deal they have for their feedstock," says the Egypt-based industry source. "Clearly, product prices have also fallen significantly, whether it is for diesel, gasoline or naphtha."

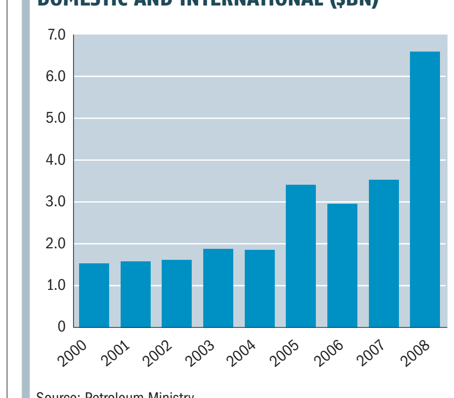
The majority of Egypt's refineries are government run and serve the domestic market. "They process crude from EGPC, send it back to the government and get a fee," says the source.

But there is a consensus over the impact of a government decision in May 2008 to abolish free zone privileges for energy-intensive companies to cover the cost of increased public spending. The decision came in the wake of social unrest over rising food prices that started in 2007 and led to a series of food riots in the spring of 2008, when inflation hit 20 per cent. In March, President Hosni Mubarak announced food subsidies and a 30 per cent increase in civil servants' pay in a bid to dampen unrest. In May, the Egyptian parliament voted to raise fuel prices, vehicle licence fees and cigarette duties, and abolish free zone privileges to pay for these increases in public spending.

OIL AND PETROCHEMICAL PRODUCTS

Source: Petroleum Ministry

INVESTMENT IN EGYPT'S ENERGY SECTOR



Source: Petroleum Ministry

As a result, energy-intensive industries operating in Egypt's free zones are now subject to import duties. The move has not helped Egypt's hopes of encouraging the kind of international investment it needs to boost its refining capacity. "This totally changed the investment environment," says one Dubai-based industry source. "Companies from Saudi Arabia, Kuwait and India are all seriously re-evaluating their investments."

This was confirmed in December 2008 by Shamil Hamdy, first secretary at the Petroleum Ministry, who noted that companies considering new refinery projects said it was not worth investing if they had to pay taxes and customs on exports. "There have been some noises from Egyptian politicians that the free zone status should be reinstated," says the industry source.

According to Ahmed Amin, managing director of Cairo-based Integrated Consulting Bureau, a memorandum calling for an amendment to the free zone law was presented to parliament on 25 February. The amendment calls for the specific exemption of the refining industry from taxes and duties within the free zone. While this would be welcome news for investors, it may be too late for some that have already made up their minds not to invest in Egypt.

"The projects that were suspended were not suspended because of the international crisis," says Amin. "It happened before because of the new tax law, so investors decided to hold on. The international crisis is just another hurdle for the industry. It is unfortunate that this problem was protracted for so long and coincided with the global financial crisis, as most of the projects were quite well advanced."

However, there is hope for Egypt's refinery expansion plans. Cairo and Tripoli recently signed a memorandum of understanding for the construction of a 250,000-b/d refinery on Egypt's Mediterranean coast, and the upgrading of the 47,000-b/d Asyut refineries in the south of the country, which requires an investment of $5-6bn.

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In a telling sign of how important the refining industry is to Egypt's industrialisation plans, Mubarak led the delegation of senior officials to Tripoli in December 2008. The memorandum of understanding was signed by EGPC and Libya Oil Holdings.

"The chances that this will succeed are quite high," says the Dubai-based industry source. "Libya Oil Holdings is a subsidiary of the Libyan Investment Authority, a sovereign wealth fund. This should be a much more stable situation."

The reasons for Egypt pushing ahead with its refining plans are many, not least the population and industry growth.

Meeting this power demand will allow Egypt's industrial base to grow, contributing in turn to higher export revenues. But the government's decision to tax these energy-intensive industries is a short-term step that has dented the long-term outlook for the refining sector and the downstream industries that are dependent on it. A reversal of this policy would help ensure the plans for Egypt's refining industry are realised.