OMV Petrom Q4 2018 Conference Call – Q&A Transcript

OMV Petrom published its results for January – December and Q4 2018 on February 6, 2019. The investor and analyst conference call was broadcast as a live audio-webcast at 2:30 pm local time. Below is the transcript of the question and answer session, by topic, edited for readability.

Group

1. Emergency Government Ordinance no. 114 and Neptun Deep

Question from Irina Railean (Banca Transilvania): Do you have some figures on the impact of the recent fiscal measures: both price capping and the 2% financial contribution?

Answer from Stefan Waldner (CFO): Let me start by saying that several provisions of this ordinance are actually not entirely clear yet and we are waiting for secondary legislation and interpretation of the Ordinance to really assess the impact. Secondly, that legislation is currently being drafted and in the consultation process, so I really cannot give you a final or definitive answer on the exact impact at this stage.

What I would say is that we have assessed the preliminary impact with regard to the 2% financial contribution and the gas price cap, in the amount of mid double-digit million euro number. So apologies for not being able to be more precise, but again, we are waiting for secondary legislation.

I would also want to highlight that this is now the short-term, immediate impact; what the Ordinance does or this higher level of regulatory uncertainty does is, of course, as Christina has also mentioned, impacting the stability and the predictability of our environment in a negative way, which has an impact on our investment projects. But that is exactly why we continue to be in a dialogue with the authorities and with the government to better understand this environment.

Question from Tamas Pletser (Erste Bank). First of all, on your **Neptun project**. How can we imagine this dialogue you mentioned between the government and you? Do you have any certain meetings or do you talk with the ministry or with the government from time to time? And are there any major milestones in these talks? Or can we expect any announcement? Anything you can say here, I would welcome.

Answer from Christina Verchere (CEO): With regards to Neptun Deep, I think that it is very fair to say that the development of the Black Sea and the Neptun Deep opportunity is of huge importance to OMV Petrom, and is also of huge importance to the Romanian State. And therefore, we anticipate constructive dialogue going forward to try and find a way forward in this. In regard to specific meetings, I am probably not ready yet to share that but be assured, I think they are equally keen to find the right way forward to develop this resource.

2. Capital allocation: capex plans resizing and dividends

Question from Tamas Pletser: Are these recent government measures affecting your CAPEX policy or can we expect any change in the production profile of Petrom just because of these measures?

Answer from Peter Zeilinger (EB Upstream): On the CAPEX profile and the impact on production, yes, we will see an impact on the projects going forward with respect to gas. Profitability is one of our main targets, so therefore we will rank our portfolio based on profitability. And with a loss in revenue over the next three years, expected at least for gas, I expect that some of our gas projects will be ranked lower. And this is reflected in the reduced CAPEX profile.

Question from Irina Railean: I would like to know your strategy, your view regarding the declining figures of proved reserves, compared to the previous strategy when Neptun Deep was taken into account in order to improve the reserves replacement rate. Now, given the current fiscal regulatory circumstances and given that you have announced a lower investment, Neptun Deep becomes much more uncertain.

Answer from Christina Verchere: Our CAPEX plan from 2017 to 2021 was set at EUR 5 billion, of which we have spent EUR 1.6 billion. We have been ramping up our investments. I think the really important thing is that the opportunity set remains unchanged. The resource potential is there. It is the pace at which we choose to do the investments, given the regulatory and fiscal environment right now, which is causing us to be cautious. We will be in lots of dialogue with the authorities because we are keen to reinstate these investment growth plans, because the opportunity set is there.

Question from Yuriy Kukhtanych (Deutsche Bank): My question is on your general capital allocation strategy, given what is happening in Romania and given quite adverse moves from the government.

I would start from your dividend announcement. We saw significant negative news flows on the fiscal side from the government last year and then the company announces a 35% increase in dividend. Should we see it as a signal that your investment plans in the mid-term will be lower than the company was guiding for? And is this policy going to be reverted in the situation that you will see some positive news from the government, so that the Neptun development, Black Sea development or any other area in the Upstream in Romania will see better returns? So should we expect that this dividend is sustainable? Or can this dividend be reduced in the future if there is a higher investment need again?

Answer from Stefan Waldner: As regards the dividend proposal, we clearly stick to the dividend policy that we have published last year where we are very much committed to progressively increasing dividends. And on that basis we have also decided to propose the dividend of RON 0.027 per share. We want our shareholders to participate in the very strong results and the strong cash generation that we had in 2018. We are not using the dividend policy as a response to the regulatory changes that we have recently seen here.

More generally to the capital allocation, we have very consciously built up a very strong balance sheet over the last couple of years. We have very much focused on cash generation over the last couple of years, to give us now the flexibility to do exactly that: to stick to our dividend policy that we have issued last year and we have no intention to change that in the current environment.

But also with regards to the CAPEX programme, I think the level of uncertainty has caused us to pause some of the growth projects that we are planning. But the resource is still there and we are still pursuing those projects, for example, Neptun Deep. That is why I think it is fair to say that the capital allocation strategy has not changed. What has changed a little bit may be the pace of our growth projects. And that is why it is so important to continue the dialogue with the authorities to understand the way forward, but that has not changed our capital allocation strategy.

Question from Yuriy Kukhtanych Are there any opportunities outside the Black Sea development? Can you still increase investments onshore? Because I appreciate there is a resource potential, but what would be the targeted returns for you to allocate cash, for example, and increase investments in onshore Romania?

Answer from Stefan Waldner: We still see substantial opportunities also onshore in Romania and our guided CAPEX of RON 3.7 billion is still a very sizeable investment budget. As regards the returns, we always target double-digit returns in any of our projects, so this really does not change.

Question from Yuriy Kukhtanych: Could you refresh our memory on your general allocation strategy, how are you going to recycle your cash given the fiscal uncertainty in the country and given all the risks that we are currently facing in Romania? What will you do if there is a significant build-up of cash? Are there any plans to invest money in transition strategies or in some international expansion?

Answer from Stefan Waldner: In terms of geographic focus, we also continue to pursue our strategy as we have outlined it before, so in addition to the Black Sea organic growth opportunities, we are looking at potential inorganic growth opportunities; be it exploration, be it producing assets in the Black Sea area, in the Caspian region or in the Mediterranean. So also on this side, no major changes to our strategy.

Upstream

1. Production decline

Question from Irina Railean: Does the 5% year-on-year decline in production refers more to gas or to oil?

Answer from Peter Zeilinger: First of all, last year, the production decline amounted to 5%. However, this, of course, included divestment activities that we had announced previously and happened in the Q3 2017. Clear of production optimisation, of divestment activities, we would have had a 4.4% decline year on year.

Now going forward, we also show a 5% decline vs. the 4.4% on a like-for-like basis in 2018. In 2018, if I do the split between oil and gas, then we would see that we have a much slower decline in oil compared to gas. In oil, the decline in 2018 was 2%; in gas it was 7%. The majority of the gas decline was due to our biggest gas field Totea Deep, which entered the decline phase, and therefore will also see a disproportionate decline compared to oil in 2019 and going forward.

Question from Tamas Pletser: Do you have any estimate of what percentage of the production can be affected or maybe how many barrels or thousands of barrels of production per day decline can we expect just on the lower CAPEX on gas projects?

Answer from Peter Zeilinger: The guidance we gave was 5% without any portfolio optimisation. As you know, we have ramped up our CAPEX investments into drilling of new wells quite significantly from 2016 to 2018. Now we will pause in order to reassess. The measure came rather unexpected and surprising at the end of the year. So, of course, our drilling plans need to be re-evaluated. We are still early in the year in order to see how we have to adjust. But the first indication is a ramp down or a reduced CAPEX profile and a stronger decline, similar to last levels in gas rather than oil.

2. Opex/boe

Question from Oleg Galbur (Raiffeisen Centrobank): On the OPEX/boe in the Upstream segment: taking into consideration the projected decline in production, what is the level of OPEX/boe that you would expect for the current year? For example, are levels reached in the second half of last year sustainable in the short to medium term?

Answer from Peter Zeilinger: I have to say that we are very pleased that we have been able, despite the 5% decline last year, to keep our production costs per boe or the unit production cost broadly stable, if we take out the exchange rate effects. Without the exchange rate effects, we have been more or less in line with the previous year. This is remarkable because as I said, it is 5% decline in production, largely in gas but also 2% in oil.

Going forward, we do not give guidance on that. We have strategically always stated that we try to run our business efficiently, which of course means a continuous reduction in our operating costs. These operating costs will then, of course, have to overcompensate or compensate part of the decline in production. And the guidance we gave is 5% decline in production without optimisation of our portfolio, which has to be seen as what can be closed and what will be achieved this year.

Downstream Gas

1. Regulated electricity price

Question from from Irina Railean: Will the Downstream Gas be subject to electricity price capping?

Answer from Franck Neel (EB Downstream Gas): The latest secondary piece of legislation was published by the regulator, ANRE, just yesterday, so it is quite new and we are still assessing it. But what I can tell you already is that there is indeed an obligation to sell a fixed quantity of electricity based on a regulated contract. But it is in the ascending order of prices. And first will be the producers with the lower cost of production, so nuclear and hydroelectric. Then the producers with cogeneration units which benefit from the bonus support scheme. And then are the thermal producers, which includes Brazi power plant.

Our understanding so far is that the price will be regulated at a level of approved cost plus 5% margin. Also, our understanding is that Brazi should not be fully impacted by this measure in 2019, but from 1st of January 2020, and we do not know yet which volume exactly will be impacted. It has not been communicated.

2. Gas price cap and export possibility

Question from Oleg Galbur: I will start with a question on your gas business. It seems that the export of gas from Romania would not be subject to price regulation. Assuming the Transgaz finalises the interconnections with the neighbouring countries, Bulgaria and Hungary next year, how much of the gas production could Petrom actually export? And apart from capacity availability, would you think of any other obstacles which would limit Petrom's gas export such as regulatory or of other nature?

Answer from Franck Neel: At the moment, in Romania there is limited capacity for export. We consider there will be still limited capacity this year. Potentially, when BRUA will be finalised at the end of 2019, beginning of 2020, we shall indeed have potential capacity for export.

Now considering what will be the gas export strategy, I will say it is still early to say, because the secondary legislation on gas is for consultation at the moment. ANRE is looking at some priority customers who need to be supplied with the natural gas production and we have an obligation to sell to these priority customers. So we need a clarification about the volume that will be allocated to these priority customers before we can decide about any other marketing strategy.

3. 2% financial contribution

Question from Oleg Galbur: My second question relates to the 2% fee on gas and power turnover. Is there more clarity on the application of this fee? Would you see it applying to the turnover generated both in the Upstream and Downstream Gas segments, which would in fact mean double taxation of the gas transferred from the Upstream segment to the Downstream Gas segment?

Answer from Franck Neel: We had some clarification this week, it is still very fresh, it has changed our interpretation that we previously had. But we consider that the 2% will apply first on the production side. And then from the supplier point of view, the 2% will apply only on the margin generated, so not on the total turnover. It is still a draft for consultation.

Downstream Oil

1. Polyfuel project and IMO 2020 regulations

Question from Oleg Galbur: Can you share with us some more information on the expected impact on earnings of the Polyfuel project which is expected to start soon?

Answer from Radu Caprau (EB Downstream Oil): On Polyfuels, as mentioned by Christina, mechanical completion was done at the end of 2018 and in Q1 it is going to come to life. It allows us to increase our output of high-demand or high-value products, and it is helping us also to increase the flexibility of the production. And as an indication, you could say that it helps us on shifting refining production of up to 50,000 tons of LPG and LCO, for example, into gasoline and middle distillates pool.

Question from Oleg Galbur: And in terms of the expected impact on earnings?

Answer from Radu Caprau: We cannot disclose this kind of information.

Question from Oleg Galbur: Just to follow up on Polyfuels, let me ask it differently. Would this project put Petrom's refinery in a better position under IMO 2020 regulation?

Answer from Radu Caprau: From IMO perspective, we are on a very good position considering the benefit we are having from our equity crudes. 80% of those equity crudes are with very low sulphur content and therefore we are in a good position from this perspective. Also the white products pool percentage helps us a lot in ensuring the refinery margin benefit that is expected to come with IMO. Of course, this contributes as well because, this is moving from the bottom of the barrel and LPG products to the white products pool.