Issue #1 June 2010

CMMB Emerging Markets Weekly

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The Gulf of Mexico's big headache

On 20 April 2010, under circumstances that have not yet been fully resolved, there was an explosion onboard the Deepwater Horizon drilling rig located in the Gulf of Mexico. The rig is owned and operated by Transocean Ltd, but was leased to BP plc. It was drilling at the Macondo prospect; a well site located in the Gulf of Mexico which is jointly owned by BP plc (65%), Anadarko Petroleum Corp. (25%) and MOEX Offshore 2007 (10%). The immediate implication of the spill was the loss of 11 crew members on the rig at the time of the explosion. However the aftermath of the accident will prove to be a major headache, not just for the Gulf of Mexico and the companies involved but for the entire U.S.

Economic damage

The Gulf of Mexico's US$234 billion economy is in jeopardy and the oil spill has placed the region's four biggest industries (oil, tourism, fishing and shipping) directly at risk. Following the disaster, President Obama declared a six-month moratorium on deep-water offshore exploratory drilling. Oil and gas interests accounted for US$124 billion of the Gulf of Mexico's economy in 2007, however the ban will effectively shut down 33 deepwater rigs, each employing an average of 1400 persons. Lost wages could add up to US$10 million a month per rig. The second biggest industry, tourism, contributes US$100 billion for the entire Gulf as fishing tourists, eco-tourists and those coming to experience the region's diverse culture cancel their plans. The spill's damage to the area's tourist-friendly image will probably persist for years to come. Finally, the fishing and shipping industry accounts for US$10 billion, and while the inconvenience to shipping lanes will be temporary, the fishing industry will suffer from the closure of 20% of federal waters, the reduction of fish populations and the contamination of existing fish stocks from oil and dispersant related pollutants. Of the lower 48 US states, 40% of the fish harvested and 67% of oysters come from the Gulf of Mexico. Additionally shrimp beds and fish nurseries have been affected by the oil slick.

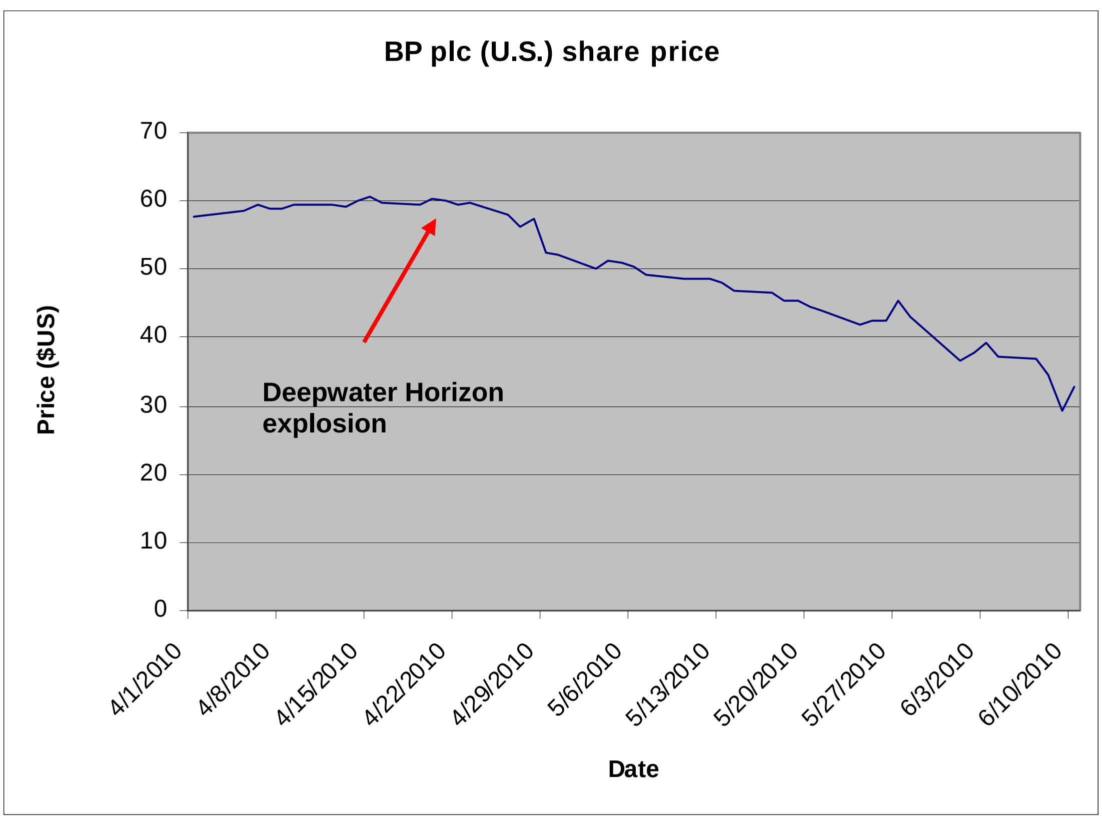
Deepwater drilling accounts for 80% of oil and 46% of natural gas production in the Gulf of Mexico so the ban raises concerns about the country's foreign energy dependence. In the short-term, a surplus supply of oil on the market and underutilized refinery capacity along with low demand resulting from weakened U.S. and European economies, should keep fuel prices from escalating. However any extension of the ban which will effectively restrict supply would cause fuel prices to increase. Additionally, future oil production and royalties are at risk as rather than sitting idly by for the expiration of the deepwater ban, companies will move their rigs to other well locations outside of the United States. The ban will defer oil production in 2011 by an estimated 80,000 bpd which would have generated US$7.6 billion in revenue for the government.

The costs of drilling in the future may also increase. Increases in taxes on companies to help offset future spill cleanup costs have been proposed. Already a reality, according to a report by Moody's Investor services, is the increase in insurance for deepwater drilling rigs which have already increased by 25% since the accident and this may increase further. The laws regulating drilling are being overhauled, which can further increase operating costs. Companies, for example, will be required to have an independent third party confirm that "the devices to stop spills work and are compatible with well locations". Already, all companies involved in offshore drilling (regardless of depth) are being asked to resubmit their applications to meet the new standards. And the changes may not be limited to oil industry as U.S. regulators and insurers are likely to look across the board at other industries where similar accidents could happen.

Ecological damage

Since the initial accident, an estimated 12,000 to 19,000 barrels of oil per day have been discharged into the Gulf of Mexico. Fish and bird kills have been reported in small numbers, along with sea-turtle and dolphin deaths; however many dead or dying animals are expected to simply sink without coming to shore and will never be counted. Therefore the extent of the ecological damage may not be fully determined. Oil making landfall will affect delicate (and hard to clean) marshes and mangroves and the economic loss from the services that these areas provide (fish hatcheries, water filtration, storm-damage prevention) was initially billed at US$1.2 billion when the accident occurred. Additional fish kills are expected when the populations of oil-eating bacteria reach supernormal levels, drastically reducing oxygen levels in the water. These bacteria will finish off what is left of the spill but there is the likelihood that the water chemistry of the Gulf itself may be changed (the possible effects of which have not been determined). Eventually the Gulf will recover thanks to both natural processes and human intervention, but this may take decades.

Company losses



BP’s share price has fallen 47% on the U.S. equity market, from US$60.48 on 20 May to US$32.16 as at 9 June. Similarly the share prices of Anadarko Petroleum Corp. and Transocean Ltd. have fallen by 29% and 25% respectively. In BP’s case, this drop represents a loss of US$88 billion in total share value. Needless to say shareholders, 39% of who reside in the U.S., are angry and at least one lawsuit has been filed which seeks to “sue the board of BP Plc for failing to monitor safety and exposing the company to potentially enormous liability related to the Deepwater spill disaster in the Gulf of Mexico”. In addition to the loss in share value, BP’s planned dividend payout is being criticized by President Obama, who would rather see the funds being used to aid the relief effort.

BP is required to pay for all clean up costs as well as for any economic damage suffered by the Gulf community resulting from the spill. This is capped at US$75 million, and efforts are being made to raise this cap even higher, but regardless of what the final figure is, BP has pledged to pay any and all costs incurred. Currently the spill is costing BP US$27 million per day and a recent release from Credit Suisse suggests the total cost of the clean-up may reach US$37 billion. Of course, with the hurricane season approaching, these costs can escalate very quickly if a storm enters the Gulf. Moody’s Investor Services and Fitch Ratings have both lowered BP’s credit ratings on senior unsecured debt by one level with the possibility of further adjustments. BP can also expect to incur penalties from the Environmental Protection Agency if it is found in violation of the country’s safety laws.

Financial woes aside, BP’s reputation and brand image have suffered immensely from the manner in which the spill was handled. The company’s initial response, one of solidarity with, and commitment to the Gulf, was well received by stakeholders. However BP’s lack of clarity over the amount of oil being discharged (figures exploded from 5,000 bpd to 19,000 bpd), their planned dividend payout and the series of insensitive comments made by BP’s CEO, Tony Hayward, (his latest being “There's no one who wants this over more than I do. I’d like my life back”) has served to turn public support against the oil giant. US president Barack Obama, has openly condemned Tony Hayward who is expected to testify before Congress later this month. President Obama has stated that “he would have fired the BP chief if he were working for him”. It is widely believed that BP’s CEO, as well as BP’s chairman, Carl-Henric Svanberg, will be asked to step down from their positions in the company.

Political damage

The BP heads aren’t the only ones taking a pounding from this spill. President Barrack Obama has taken a lot of flak for this disaster and his administration’s subsequent handling of the oil spill response. His opponents have blasted his administration as being too slow to respond and likened their response to the last administration’s response to Hurricane Katrina. Additionally the drilling moratorium has triggered criticism from the oil industry for being too harsh. According to a recent USA Today/Gallup Poll, 53% of Americans believed that President Obama had done a “poor” or “very poor” job on his handling of the disaster. In response, promises have been made to take BP to task over the spill and to end the “cozy” relationship between industry regulators and big oil companies.

Tightening regulations (including the measures mentioned before) may ultimately be the only way to prevent the reoccurrence of similar accidents in the future. The 2008/2009 financial crisis occurred when big businesses were left to govern themselves. The expectation was that businesses, in their relentless pursuit of profit, would employ strategies that maximized returns while minimizing risks and that maintaining a properly functioning financial system was for the benefit of all involved. The post-mortem on the financial crisis showed us that such trust was misplaced. In October 2009, OSHA fined BP US$87.4 million for failing to correct deficiencies at a Texas refinery after an explosion in 2005 killed 15 workers. Now in 2010, unconfirmed reports suggest that the blowout at Deepwater Horizon might have resulted from management cutting-corners to save time and money. If proven to be true, history would have repeated itself once again. So what can we expect to happen now? Well, we can expect the industry to resist what they might view to be overly stringent regulations. We can also expect that as drilling and exploration costs increase, or as oil production drops, consumers will have to face the effects of increasing oil prices. But in the future, if businesses are not properly regulated, we can expect disasters like the Deepwater Horizon spill to re-occur.

FINANCIAL & ECONOMIC INDICATORS

As at 10 June, 2010

Exchange Rate/US$	Closing Value	Previous Week
Yen	91.34	92.71
Euro	1.21	1.22
Jamaica	87.18	88.08
Guyana	204.90	203.90

Commodity Prices	Closing Value	Previous Week
Crude oil (US$/bbl)	75.48	74.61
Natural Gas (US$/mmbtu)	4.68	4.46
Gold (US$/Troy Ounce)	1216.55	1206.65

Eurobond Indices (As at 10-May-10)	
JP Morgan EMBI+ (Basis points)	321
JP Morgan Central America and Caribbean Index (CACI) (YTD return %)	7.60

Policy Interest Rates (%)	Closing Value	Previous Week
United States	0.25	0.25
Euro Zone	1.00	1.00
Japan	0.11	0.10
Brazil	9.40	9.40
Trinidad	5.00	5.00
Jamaica	10.50	10.50
Barbados	2.50	2.50

Market Interest Rates (%)	Closing Value	Previous Week
US 90-day T-Bill	0.08	0.14
US 10-Yr Treasury	3.32	3.37
3-month UK Libor	0.73	0.72
Japan 90-day T-Bill	0.28	0.28
Brazil 90-day T-Bill	10.96	10.35
TT 90-day T-Bill	1.16	1.16
Jamaica 90-day T-Bill	9.77	9.77
Barbados 90-day T-Bill	3.25	3.25

Sources: Bloomberg, CMMB, Central Bank of Trinidad and Tobago, Bank of Jamaica, Central Bank of Barbados, www.lehman.com