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COMMENTARY

Strategic Moves for the Saudi Petrochemicals Sector

Petrochemical producers have faced a very testing last 12 months. Those based in Saudi Arabia are no exception.

Producers across the globe have been forced to cope with significantly reduced income levels. The prices at which they sell their products tend to track the price of crude oil, which has declined steeply between late-2014 and mid-2016 and is struggling to recover.

Saudi Arabia's petrochemical companies have suffered a second shock. On Monday, 28 December 2015, the government unexpectedly announced that basic feedstock prices would be increased in support of its fiscal goals of reducing the country's budget deficit and cutting energy subsidies. The gas (methane) price was lifted to US$1.25/MMBtu (from $0.75/MMBtu), and the cost of ethane, the main raw material for petrochemicals production, was hiked to US$1.75/MMBtu (up from $0.75/MMBtu).

In the first half of 2016, several publicly listed producers issued statements through the Tadawul (the Saudi stock market) forecasting that these trading conditions would have an impact on their financial performance.

It is also possible, given the broad principles set out in the Saudi government's recently published Vision 2030 and National Transformation Program 2020, that remaining domestic feedstock subsidies will be eliminated entirely by the end of the decade. Gas and ethane prices would then be subject to negotiation. The scarcity of both feedstocks within the Kingdom means that prices could well rise further.

What can a Saudi-based primary petrochemical company, which relies on natural gas or raw ethane for feedstock, do to try to improve its position in these challenging circumstances? As lawyers, we have seen three trends beginning to emerge.

Capital Costs

Plant owners who are considering new plant expansions, whether by debottlenecking or by developing new facilities, are tightening up the contract terms and conditions which they are offering to contractors. We have been asked to give standard forms of contract a fresh review, to make certain that the client's rights and the contractor's rights and obligations are clearly and unambiguously set out.

For example, we have assisted a client to ensure it has a broad right to "de-scope" contract works, in case the economics of the project change during the construction period and the client wishes to reduce or delete certain facilities. We have also advised on methods of improving the contractual controls on an EPC contractor's ability to claim for additional work and extensions of time.

With regard to projects that are in the midst of construction, clients have been requesting legal support in evaluating claims from contractors, as well as in developing strategies for resolving claims as effectively as possible. We have, for instance, helped a client reach a resolution with a technology licensor over alleged performance failures and remedial work. We have also undertaken a series of complex "strengths and weaknesses" analyses for another client, who desired a better understanding of its legal and contractual position prior to entering settlement negotiations with two of its EPC contractors. On delayed projects, we have assisted clients in developing precise strategies to better ensure the earliest possible completion date.

In each of the above cases, our mandate has been to help the client save money on completing its capital projects, efficiently and speedily, so as to reduce exposure to unbudgeted costs and ensure commercial production can commence without undue delay.

The government's imposition of higher feedstock tariffs has also caused project owners to re-read the terms of their gas supply agreements. Depending upon the exact provisions within the contract, the supplier may not have the unilateral right to lift prices at all, particularly if a fixed tariff or a formula for price escalation was specifically agreed between the parties at the time of signature. Owners should consider requesting staged increases and/or the easing of other contract terms (e.g., "take or pay" related penalties), in consideration for agreeing to price rises.

If a project has been successfully project-financed on the basis of the Kingdom's original feedstock prices, and is still in its construction phase or early years of operation, the sudden requirement for greater expenditure on gas supplies will affect the project's financial model. Owners will need to discuss the impact of this move with their lenders and seek ways in which to preserve levels of profitability.

Specialty Products

In the face of lower prices for commodity products, petrochemical producers are also now examining the feasibility of adding greater quantities of specialty products to their output. Market prices for specialty products have been much more robust in recent years.

Plant owners have therefore been engaging in discussions with technology licensors about obtaining access to innovative technology, and asking us to provide legal support in reviewing the terms of proposed new licence agreements. Driven by the commercial value of such technology, we have worked to help clients secure wide rights regarding the use of technology in the manufacture and sale of the specialty product in question, often on an exclusive basis within the MENA region.

Producers are seeing value, for example, in negotiating proprietary rights in any "improvements" which are made to the underlying technology while it is being used in their plants in Saudi Arabia. These improvements can then be exploited commercially to other licensees, either solely or through joint ownership with the original licensor. Clients are additionally seeking to obtain flexible trademark rights, designed to allow them to use the trade names and logos which are already associated with these specialty products; such rights can help position products in a new market more easily.

M&A Activity

Saudi-based producers still enjoy certain competitive advantages. Feedstock prices remain well below international averages, and many local companies remain relatively cash rich. While other companies are struggling, this may be an opportunity for those with the financial strength to make strategic acquisitions.

We have seen two recent examples of this kind of M&A activity, one in which a client is considering a move further downstream through the purchase of manufacturing assets, and another whereby a client has acted to acquire a complementary producer of specialty products.

A particular theme of each transaction has been a focus on securing a strong and appropriate set of representations and warranties from the respective sellers. We have, for instance, spent time negotiating guarantees, indemnities and warranties regarding IP rights, as well as important representations and warranties relating to product quality and liability, permits and consents, and environmental issues.

A solid set of reps and warranties not only gives a high degree of comfort to the acquirer at the time of purchase, but also provides the acquirer with a head start when it comes to integrating the acquisition and growing the newly combined operations.

Conclusion

The Kingdom's petrochemical companies represent an ever-growing proportion of world production. They have collectively enjoyed many years of strong growth. However, the recent combination of lower commodity product prices and higher feedstock costs has inevitably triggered a collective pause and a period of strategic thinking.

A review of project contracts (whether EPC contracts, technology licences or feedstock supply agreements), a move into specialty chemical production, or a carefully planned acquisition are all steps that can help Saudi Arabian producers ensure that they are well prepared and positioned for the decade to come.

Lawyer Contacts

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