Galp Energia First Quarter 2010 Results

Introduction

Good afternoon ladies and gentlemen, please welcome to Galp Energia’s First Quarter 2010 Results Conference Call. I’ll now pass the floor to Mr. Tiago Villas-Boas Head of Investor Relations Division.

Tiago Villas-Boas, Head of Investor Relations

Hello, good afternoon and welcome to Galp Energia 2010 first-quarter results conference call. Joining me today and as usual is our CEO, Manuel Ferreira De Oliveira; and our CFO, Claudio De Marco. We will start our presentation with the first-quarter results preview followed by an update of the execution of our strategy. Let me just end by reminding you that we will be making forward-looking statements. So I would like to draw your attention to the disclaimer at the end of the presentation.
And now, over to Manuel.

Manuel Ferreira De Oliveira, Chief Executive Officer

Slide # 3

Good afternoon or good morning, wherever you are to all of you. It's once again a pleasure to address all of you. Let me start with slide number three. Where I would like to emphasize the main drivers of the first quarter results. Crude oil increased both Q-on-Q and year-on-year, basically driven by the Tômbua-Lândana project and the Tupi development, which are progressing according to expectations, I would say even better than expectations. The Iberian poor economic environment, mainly in Spain, constrained our oil marketing results. The natural gas business, offered us better margins. We can clearly see that the business is now gaining an upside momentum. With a better contribution of E&P and Gas & Power, our net profit on a replacement cost basis increased 32% year-on-year, reaching €65 million, as you can see in the slide.

Slide # 5

Now I'm jumping up to slide number five where I'm going to refer to the operating and economic data associated with E&P. The Tômbua-Lândana field production, as expected, is ramping up and it reached on average during the quarter a total production slightly above 33,000 barrels a day, which gave net to us 9% of that. Let me say at this moment that this field is now producing above 40,000 barrels a day, according to its increasing volume expectations. The EWT, the extended well test in Tupi, produced so far this year approximately 1.6 million barrels, of which 10% is our entitlement production, which represents an additional increase to oil production. Apart from the increasing production from these two new projects, we benefited from the increasing prices leading the business unit to present an EBITDA on the replacement cost basis of €48 million.

Slide # 6

In slide number six, I summarize the basic results of the refining and marketing division. Although Galp Energia's refining margin was stable year-on-year, I want you to remember all of you that we have in the first Q2009 an incident in our utilities facilities in the Sines refinery. The refinery environment, apart from that, continues to be challenging on a yearly basis, not withstanding a good recovery during the 1Q this year where we achieved a total
Refinery margin of $2.7 per barrel. Due to the increase in our prices, the time lag was negative by €16 million. The time lag is the difference that we gain or lose in the transfer prices between refining and the other operators, including our own distribution business. The sales to direct customers posted a decrease, basically coming from the Spanish market where the economic context continues to be challenging. Due to the worse performance of the marketing division, the EBITDA decreased 23% on this division year-on-year to €66 million.

Slide # 7

In slide number seven, I go to the gas and power division. In this division, we should highlight the recovery of the supply margins. Not only on a year-on-year, but also and with greater importance, in Q-on-Q. In addition, the supply volumes reduced by 10% year-on-year, with an increased weight of the liberalized market. I emphasize that the liberalized market already represents 73.6% of the gas consumed, which obviously in the present environment context, benefits total margins. The infrastructure natural gas business maintained its stable contribution to results. The Sines cogeneration plant, which initiated operations in October of last year, had a positive impact on industrial volumes as well as in electrical power generation during the period. This had already an impact in the results of the 4Q09 and the 1Q of this year benefited from it. We are extremely satisfied with the performance of that investment because it is simultaneously contributing to the energy efficiency of the refinery, offering us margin in the supply of gas, and also benefiting from the contracts of power to the grid. The EBITDA of the gas and power division reached €61 million, with a contribution from the contracts regulated business. Now we will move to our financial performance and I ask Claudio De Marco to summarize to you the results we achieved. Thank you.

Claudio De Marco, Chief Financial Officer

Slide # 9

Thank you, Manuel. The E&P and Gas & Power business segments were the major drivers for the operating profit increase, which reached €95 million more, 27% on year-on-year basis. Below the EBIT line, we had lower financial results due to the higher average debt level, partially offset by a lower debt cost. In the first quarter of 2010, the cost of debt was 3.19%, less 28 basis points than in the same period of the last year. In terms of tax, the effective tax rate of 25% has benefited by the lower weigh in result of the tax oil paid in Angola. In conclusion, the first quarter 2010 net profit was €65 million, corresponding to an increase of 32% on a year-on-year basis.

Slide # 10

Moving on to CapEx in slide 10. This spending reached €192 million, the bulk is allocated on ongoing projects in E&P and R&M divisions. In the E&P, the CapEx was mainly focused in the developing works in Tupi field in Brazil. In R&M, the main spending was allocated to the refining upgrade project, which is on time and on budget and ready to start in operation in the second half 2011. In the Gas & Power, CapEx was in part related to the cogeneration in Porto refinery, an important project that we will allow to increase the energy efficiency in the refining system and as well provide a good contribution to the Gas & Power earnings. The cogeneration at Porto’s refinery is expected to start in operation in the first half of 2011.

Slide # 11

Now let’s look at the balance sheet. We can see an increase in net invested capital due to a stronger activity in investment projects as well as the increasing working capital due to the growth of accounts receivable mainly in the market of oil business. I highlight that €1.1bln of the asset is still allocated to work-in-progress, not yet generating cash flow. The total net debt was €2.2 billion, around €300 million higher than the end of 2009.
Slide # 12

Now in slide 12, I would like to give you an update of our debt structure. As we have already said, net debt totaled €2.2 billion, the average of medium-long term maturity is 4.1 years, with the major debt reimbursement to take place from 2011 onwards. At the end of March, our liquidity was €1.5 billion, of which 65% have committed lines. Now I will hand over to Manuel for the strategy execution update.

Slide # 14

Manuel Ferreira De Oliveira

Thank you Claudio. I’m going to slide 14 to summarize a short-term outlook, according to our current vision, and that will improve once our short-term results. On the E&P business, let me say to you that the production of Tômbua-Lândana for the 2Q will continue to increase. We expect in the 2Q a production not much different than today’s production. On the refinery and marketing division, we believe the environment has not yet stabilized, mainly on the refinery margins. The recent natural gas supply business will benefit the 2Q results from the acquisition we recently made in Spain. We also highlight that the regulated tariff will end for consumers consuming above 10,000 cubic meters per year, which represents 55% of the eligible consumers still under the regulated tariff. That will increase our exposure to the non-regulated business, hopefully benefiting our results. This will then be subject to the market tariffs where we consider that we have competitive advantages. In terms of financials, our liquidity position at present is about €1.5 billion, as Claudio just referred to you, will support our medium in CapEx execution.

Slide # 16

I move now to slide number sixteen, referring to another to one of the two critical projects that we have to put in place throughout the year. It is the Tupi development. The development of Tupi is progressing well. The recent wells’ results and the data we gathered from them show us that the reservoir is high quality and reassured us that the 5 to 8 billion barrels estimate of reserves is becoming robust. Tests will continue and an intensive drilling plan is being executed, which will help us to find more efficient ways to develop the field and then a dated view about the recovery factors will be achieved. Let me inform you that 216 kilometers gas pipeline to the Mexilhão platform, which will transport the natural gas from the field to onshore has started construction and has more than 100 kilometers already laid down. The plans is for the pipeline to be completed by July and there are no reasons to expect otherwise. The FPSO Cidade de Angra dos Reis, that is now under construction, has a storage capacity of 1.6 million barrels. And has oil processing capacity of 100,000 barrels a day, as we previously referred, and a gas treatment capacity of 5 million cubic meters a day. It is being at this moment fully equipped and we hope that the FPSO be on site by September and the first pilot commercial production of the field will have the opportunity of celebrating that hopefully by the end of October, but at least during the 4Q.

Slide # 17

And another project that we have ongoing is the conversion project and regarding this project, the project is going well, as it was previously said by Claudio, on budget and on time. It will be completed during the second part of 2011. The critical phase of the project has already been achieved with the hydrocracker reactor already installed. In addition, most of the other equipment has been already awarded with 80% of the equipment to be delivered until June 2010 and all the critical equipment totally guaranteed.

Slide # 18

Now a reference to the natural gas project in slide number 18. We have announced recently the acquisition for an amount of €60 million, of the commercial activities in 38 municipalities in the Madrid region. That acquisition will benefit our results from 2Q onwards. We expect to deliver an EBITDA not much different than €12 million for the remainder of the year and. And it represents the entrance in a relevant manner of our gas business into Spain, which is a market eight times bigger than the Portuguese market. We are already supplying 412,000 customers in that
region including about 8,000 customers where we offer gas and power. As you can see, our strategy in the gas business is to focus now in the supply segment so to leverage our know-how and competitive advantages and in this case in a market of higher potential than the Portuguese market. Thank you for your attention, and I now pass the word to Tiago.

**Tiago Villas Boas**

Hi, just one statement before Q&A. As opposed to what have been announced, the date for the second quarter 2010 release date will be anticipated to 30 of July. So we will pass from 5 of August to 30 of July this year. We will send an announcement after this call, but of course let me already tell to you guys that are on the call at this moment. And now we can start with questions, please.

**Questions & Answers Session**

**Jason Kenney, ING**

Hi, there. It's Jason from ING. I had a question regarding the euro, which has dropped significantly and is now below 1.27. And I wondered what impact you would envisage if the euro would stay at this level? What impact there could be for strategy, for funding, for debt and for cash flow for the near and medium term. And secondly, your tax rate guidance for the remainder of the year. Obviously, Angola slightly diluted the tax in the first quarter. Is that going to remain the case for the rest of the year? And finally just a small question. Could you tell me the contribution of power in the gas and power EBIT, if possible?

**Manuel Ferreira De Oliveira**

Jason thank you for the question. I will start up and probably pass the word to Claudio. You see, we are a dollar-based company. So as the dollar gets stronger, our euro results are improved. But we all know the relationship between the value of the dollar and the price of crude. So there is a complex relationship that is there. So we could see implications on the price of crude and probably on the refinery margins. My view, as a citizen of Europe, with a weaker euro, we might have a faster recovery of the economy and then some increase in demand. So from the market point of view, we would like to see increase in demand, which is putting pressure on refinery margins, and a weaker euro is better for us. As far as implications of that in debt and the tax expectations, I will pass it to Claudio. As far as the component of power in the gas and power business, €4 million. It's still a very small business as you can see. And when we look at the cogeneration with enthusiasm, as you probably have noticed in the tone of my voice, it's because it has a triple contribution to the company results: it's energy efficiency in the refinery, is the power business and it is in the gas supply business. Thank you.

**Claudio De Marco**

We expect a tax rate in line with the first quarter, about 25%.
Good afternoon, Manuel. Good afternoon, Claudio. Thanks for taking the question. A couple of areas just to focus on. Firstly, just on gas. I know you mentioned the recovery in the supply margin there. I was wondering if you could talk about how you see that margin moving through sort of Q2 and the rest of the year? Do you think that sustainable or not? The second question was just on Brazil. Thanks for the update on Tupi. I was just wondering what do you see as now the key risk, the delivery on the Tupi pilots for the Q4? And then just to follow up on Brazil, on the exploration side, could you please sort of confirm the timetable for the rest of the year in terms of exploration. Do you expect the BM-S-8 to start in Q2? Thank you.

**Manuel Ferreira De Oliveira**

Thank you for the questions, Theepan. Let’s see the supply margins in the gas business. What is happening now is that you probably are aware of the force majeure in Nigeria, for certain contracts. So we’re not taking all the volumes contracted from Nigeria. In the present economic environment, the contract is slightly more expensive than the spot gas and that offers opportunities to optimize our supply activity. It is I would say a transitory situation. On average, I would say that under normal circumstances we see the supply margins constant. Apart from the comment that I made, nothing new to add to that. On the price to the customers, we see that the removal of the tariff system in Portugal opens us the opportunity to improve the results. Now going to the key risks for the Tupi pilot. We are all aware, it is a major milestone for the pre-salt. Commerciality will be declared by the consortium to the national agency of petroleum by the end of the year. I personally have even this morning reviewed the planning of activities and I see that the statement that we will be producing commercially crude oil from the Angra dos Reis in the 4Q is a very robust statement. I will say that my opinion is that they will be ready in the first part of the quarter, rather than in the second part of the quarter. In terms of exploration, we have as you probably are aware an intensive exploration program this year, exploration including evaluation and sub development in the Santos Basin. We will be drilling in the BM-S-11, approximately seven wells this year, according to the present plan. Most of them are evaluation wells and development wells in BM-S-11. One will be Iara, which will take place in the third quarter of this year. We will have one in the 4Q in BM-S-24, Jupiter. And the well planned for BM-S-21 has been postponed to 2011, with an agreement with the national agency. And in BM-S-8 we will be drilling a well end of 2Q, beginning of the 3Q. In summary, BM-S-8 2Q/3Q a well; BM-S-11 still seven wells being drilled, one of which in Iara. The BM-S-21 postponed to 2011; BM-S-24, one well in the fourth quarter. That’s the summary of the pre-salt drilling.

**Bruno Silva, BPI**

Good afternoon, everyone. I have three questions. The first one, going back to gas and power, it really looks important. Could you please quantify what will be the impact from the entry of the new cogeneration in Porto? And also what was the impact from the Sines cogeneration? And also, what is the impact from the renegotiation of supply contracts that you have been provisioning during all of 2009? Or if that is already included in the supply margins we are seeing today, and therefore we could assume that there won’t be more significant or material changes on a quarter-on-quarter basis? The second question, I think it is also a follow-up from the previous question on the sovereign crisis. Do you really see this as a potential accelerator to your alternative scenarios in terms of financing? Like what you have mentioned in the past, the potential refinancing of the regulated networks? Or as Repsol suggested in the recently in Investor’s day, a potential spin-off or IPO of Brazilian assets. And the last
question, if I may, there is a highlight in Bloomberg, Petrobras apparently mentioned a cut in the cost estimate for Tupi. I don’t know if that is new or it is just an update that is actually outdated or not? Thank you very much.

Manuel Ferreira De Oliveira

In the gas and power division, the effect of a cogeneration plant, as you can see, a cogeneration consumes continuously natural gas and sells power to the grid at a contracted price. In the gas in power division, when we report the cogeneration project, we refer to the results associated with the sale of power and steam. Each generated €4 million in the 1Q. So it’s a continuous operation giving us €16 million of EBITDA from that operation. Additionally, it increases the demand for gas, adding the standard margin of gas to the industrial sector to improve the energy efficiency of the plant.

Claudio De Marco

We expect the same contribution of the Porto cogeneration plant of €16 million of EBITDA.

Manuel Ferreira De Oliveira

So the cogeneration of Porto is under construction is similar under all conditions to Sines. You refer to the refinancing of our distribution business. We are proceeding with all the legal basis to do that. We already have the approvals from the ministry of the energy to do that. And we are proceeding as we communicated to the market. So you can take in due time a decision to probably sell a stake of our infrastructure business to an infrastructure fund. The final decision has not been taken yet and it is on our list of things to do. As far as the statement from Bloomberg in the cuts of costs by Petrobras, I am not aware of the background of that statement. What we see is that we are continuously reducing costs of drilling and optimizing investment. That is our continuous job and because I don’t know the background of the comment, I cannot answer to your question. Thank you.

Bruno Silva, BPI

And on Brazil, has your view of the situation changed with sovereign risks in terms of financing of the project? Would you consider selling part of the assets or a stake in your portfolio there?

Manuel Ferreira De Oliveira

We have not considered that scenario. We think we can finance our commitments and the strategy that in due time we shared with the market. We have no news on that issue. We are working on the execution of what we have committed to the board, to the market and what was approved by our board.

Jean Luc, CMCCA Securities

Hi, good afternoon. If I am correct you started drilling on the block BM-ES-31, the Ambrosia prospect. Could you give us an update on that and also tell us if you have pre-salt prospects in this area?
Manuel Ferreira De Oliveira

In BM-ES-31 where we have 20% and Petrobras has 80%. The attractiveness of this block is the prospects that were identified during the seismic work. We drilled a well this year, is a committed well imposed by the contract with the national agency, it was a post-salt prospect. It was a prospect that we never had high expectations on it. And we declared that well dry. The BM-ES-31 in the post salt prospect drilled was dry. What we have to drill as soon as we have a rig available is a deeper well in the pre-salt and we are expecting to do it by 2011. That's what I can tell you about the BM-ES-31. It is clearly an attractive block for pre-salt exploration. Thank you.

Iain Reid, Macquarie

Hi, it's Iain, here, from Macquarie. Hi, Manuel and Claudio. Can I ask a couple of questions on CapEx? And one on Tupi? Could you remind us of the total cost of the conversion project and how much of that CapEx you spent to date? And can you do the same for the Tupi project as well, please? And thirdly, in terms of production from Tupi, can you tell us based on your planning at the moment, what do you expect to produce from Tupi on a gross basis in the fourth quarter? And how long it will take to reach the 100,000 barrels a day plateau? Thanks.

Manuel Ferreira De Oliveira

On EBITDA and CapEx, Claudio, has got the numbers, but I will start with the production. The production in Tupi, which is now going on, is the EWT. And as you are aware, it is constrained by gas limitations and we are basically producing 14,000 barrels a day out of the well. And in short periods, up to 20,000 barrels a day, always limited by gas flaring authorization. The first commercial unit is designed to produce from five wells, an average of 100,000 barrels a day. It will be connected when it is commissioned only with two wells. One well is the present Tupi that is under production and then another well that is now being completed. The gross production in Brazil is equal to the entitlement production. We do not have in Brazil production sharing agreements. So we are entitled to 10% of the total production. We expect to get to 100,000 barrels a day volume by the end of 2011, approximately that. And ramping up from 40,000 barrels a day to 100,000 barrels a day as new wells are connected. The field will operate initially with four producing wells and one is injection well and then there would be another four production wells to be incorporated in time and two are injections wells. That's in short what the field will be. As far as the CapEx numbers, Claudio, I think he has the numbers with him, so he can share them with you. Thank you, Iain.

Claudio De Marco

About the capital expenditure related to the conversion project, the expected total cost will be €1.4 billion of which €400 million already spent. For Tupi, the total cost of the Tupi, 100% is about $3.7 billion and up to now the spending for Galp was about $100 million.

Iain Reid

Thanks. And can I just come back on to Tupi production. Can you give us an estimate on what you think the fourth quarter production will be from Tupi? Given the fact that you are starting the two wells and presumably ramping up from then?
Manuel Ferreira De Oliveira

As soon as the unit is in place in September, one well will be connected, which is at present a producing well. In that case, it will have no gas constraints. So we will be producing probably about 20,000 barrels a day. It's one well. And then the risers will be connected to a well that is being completed now and we will end up the year with two wells producing. So, I do not have the exact date, but it should be probably during November, December we will have 40,000 barrels a day. Then, we will have the remaining wells to be drilled and completed during 2011 and we'll have by the end of 2011, beginning of 2012, the 100,000 barrels a day. I want you to remember that work is already started for the second commercial module, which will be commissioned by the end of 2013. Which we will have, that one, a capacity of 120,000 barrels a day, not 100,000 as this one.

Iain Reid

Thanks, Manuel. One other thing, if I can. You also mentioned during the Tupi development description something about updating recovering factors. Can you just explain what you mean by that and when we are likely to hear that?

Manuel Ferreira De Oliveira

I am trying not to give you a technical answer. You see the present numbers have been calculated with the recovery factor of 28%, approximately that. You know the tremendous impact of the slight increase on that. The many wells that are being drilled are basically simultaneously evaluation wells and production wells. More about the porosity of the reservoir and the pressures there, we'll have a more optimistic view about the recovery. At this moment I would not want to make a formal statement on that. You see we have tests in that region with production achieving up to 50,000 barrels a day, that is a clear indication of high porosity and good flow of crude oil, which means higher recovery. Thank you.

Oswald Clint, Sanford Bernstein

Good afternoon. Just kind of related to an earlier question, last quarter you talked about expectations of cash flow being much better in 2010 versus 2009. I just wondered if you could still confirm that statement? Or talk about how you expect operating cash flow or free cash flow to progress now that we are in May and almost halfway through the year? And then secondly, just on Brazil again, have you said or can you say exactly the reserves which do you expect to be extracted with this first FPSO? And also what is the actual crude price that you are getting today for the Tupi volumes? Thank you.

Manuel Ferreira De Oliveira

We all look forward for hopefully a better availability in the oil and gas industry in 2010. We have higher crude oil prices than last year, so it will help our E&P business. The only thing that is going against our expectation is that the downstream market is not as we expected. In the refinery margins, they are not yet at the level that consider a minimum acceptable level. We see an improvement in our EBITDA this year, even in the present context, but not necessarily the one that we wish. So I would not make forward statement on that. But I clearly see from the gas business and the E&P business, an improvement in EBITDA. As far as the Brazil, each well will be producing the reserves that are and the influence of an FPSO. The basic economics that we made are for each FPSO to extract
something between 300 and 500 million barrels. That's the outlook, we do make the economic study and this is why we will have talking about a minimum of the 10 FPSOs for the development of Tupi. And they will reach production depending upon the location of each unit and its equipment between 100,000 and 150,000 barrels a day. This will get to 100,000 barrels a day. The fourth one coming to 120,000 barrels a day. And that's basically I think the answer to your question.

Oswald Clint

Yes, thank you very much and just finally what was the price that you are getting for the Tupi volumes today. The actual oil price, is there a discount to a market price?

Manuel Ferreira De Oliveira

In the 1Q, the numbers reported is about $66 a barrel. Let me tell you that this is a very small operation with high logistic costs. So the price of oil is the price of oil with a link to brent. What we will have then is reducing the logistics costs when we go to a lighter unit in the 1Q of this year.

Filipe Rosa, BES

Hello, good afternoon, everyone. Just regarding the working capital swings that you have in the first quarter and in the last quarter of last year. I would like to understand if this working capital swing will continue or can we expect the current working capital structure to remain stable towards the end of the year? Because this has had a very strong impact on your liquidity and so I think that it is important to clarify that issue. Also regarding the refining margin, could you provide us an update following the first quarter? You are now mentioning that refining margins are back to below minimum acceptable levels. Could you provide us an update on that front? And the last question is if you could update us, the guidance for production costs and depreciation costs, per barrel in Angola? Thank you.

Manuel Ferreira De Oliveira

Claudio will address the issue of working capital and look at refinery margins. In the present terrible times, it would be totally improper for us to give a guideline on the refinery margins. They one day are good on the refinery margins. On the other day, they are close to zero. So it's major volatility that goes on in the markets and there is not much that we can tell you. We, however, in our business plan, when we talk about benchmarking refinery margins and I assume you know it means, it's expressed in our publications. We see in order to, not only in the business in the year, but along the business plan, we see a very low number. In the range of I would say in the order of $1.2 to $1.7 a barrel of cracking refinery rotterdam, that's what we see. We are going through a period of major terribleness in these refinery margins. I see that we have touched the bottom. That's my only reliable opinion on this. I think as far as a working capital, Claudio, can address that to you.

Claudio De Marco

In terms of working capital, the first quarter was an increase in the working capital of about €200 million. It's due to only the clients' receivables, that increased about €200 million. It is because of a turnover increase in the first quarter compared to the last quarter 2009. In the first quarter the turnover was 3.3 and in the last quarter 2009 it was 2.9, as well as the increase of the clients' receivable base from 20 to 22 days. We continued our efforts to
manage the working capital in order to minimize the impact on our cash flow. We continued to improve our cost management as we continue also to negotiate better payment conditions with our suppliers.

Manuel Ferreira De Oliveira

Thank you, Claudio. Now a comment on your question on depreciation and costs of the net entitlement production in Angola. The answer is not simple. Let me try to, at least, help you to make your research. What we produce is working production, what drives is the working production. But the unit costs are total costs, divided by the net entitlement production. And the same is for depreciation. What is depreciated is assets. But the unit depreciation is the total depreciation divided by net entitlement production. The net entitlement production is a function of the crude oil prices and of the moment and of the level of undepreciated capital. That defines the net impact on the production. If you want some more details on that, you can talk with Tiago and he will help you to understand that. But it's a characteristic of any production sharing agreement contract. So the variable is the difference between net entitlement and working production, it determines variations on depreciation and OpEx per barrel.