Woodside's Sunrise in the East

By Matthew Stevens, The Australian Financial Review   29 Oct 2014

Woodside Petroleum has put the strife-delayed $US14 billion ($15.8 billion) Greater Sunrise LNG project back into its short-term project mix after agreeing to consider locating the project in Timor Leste.

Timor's determination to host the Greater Sunrise processing facilities has been fiercely contested since 2009, with Woodside insisting it was too risky and expensive. But in recent discussions Woodside is understood to have agreed to reconsider its once fervent opposition to landing the Greater Sunrise gas at Baucau on Timor's south coast.

Greater Sunrise has the capacity to support a one-train facility that would produce 4 million tonnes or so of LNG. As modest as that might sound, it would be a game-changer for Timor.

Pretty obviously, Woodside's circuit-smasher arrives with myriad complications, not least the need to ensure the Australian government and Woodside's partners in Sunrise are up for this new ride.

Woodside owns 33.4 per cent of Greater Sunrise and its partners in anxiety are ConocoPhillips (30 per cent), Shell (26.6 per cent) and Osaka Gas (10 per cent). It is far from clear what they think about Woodside's effort to cut the Gordian knot.

But once offered, it is hard to see how Woodside can walk away from a proposition whose underlying economics are said to have been changed by developments in underwater pipeline technologies over the past four years.

The Sunrise and Troubador gas fields were discovered in the Timor Sea in 1974. Within a year, Indonesia had invaded East Timor and pretty much ever since, the gas and condensates of Greater Sunrise have been a matter of tectonic tension with our nearest neighbour and a source of deep-water frustration for Woodside.Royalty flows

The controversial geopolitics of Greater Sunrise are shaped by a treaty called CMATS (or the Treaty on Certain Maritime Arrangements in the Timor Sea). It sets the rules for the development of Greater Sunrise and enshrines a 50-50 split between Australian and East Timor on royalty flows.

Given most of the gas to be developed sits on what Australia calls its side of the Timor Sea, the view from Canberra is that this is a pretty generous outcome.

But Timor wants more of the royalty and revenue pie, and has taken its case to The Hague for arbitration by the International Court of Justice.

The dispute between Timor and Woodside has been rather more prosaic but, until recently, equally intractable. Woodside rejected the Baucau option because it would add technical risk and $US5 billion to the cost of the project.

The technical problem was that the gas would need to be piped across the legendary Timor Trench and back in 2010-11 that was a task deemed to sit on the edge of known technologies.

Apparently this case for the negative no longer holds and Woodside has advised the duelling governments of the potential that gas could now be safely and economically landed in Timor.

Well-placed sources suggest that this reassessment is the product of the determination of Woodside boss Peter Coleman to add options to his medium-term future by getting Sunrise back on track.

Quite obviously, Coleman is taking a very different tack to his predecessor Don Voelte. In summing up his approach to Sunrise back in 2011 Voelte said: "If we run into a little bit of a brick wall here and we can't get around it or go through it, well, we'll go over it.''

Coleman might well have managed to do just that by performing a back-flip with pike. And, as a result, discussions about Greater Sunrise can now focus on more productive nitty-gritty like future fiscal frameworks and investment and construction protocols.

The first step will be defining just who would own the LNG project over the longer term.

The live options there run the gamut from a traditional project structure that sees the owners of the gas finance and own the processing facility to an arrangement that would see the project transferred to government ownership after a period of accelerated cost recovery over the early years of production.

The mining and petroleum world is right on track to the past.

The whole industry is “mean reverting” as a former BHP Billiton chief executive might say.

Costs will drive prosperity rather than prices. The lowest-cost operator with the best balance sheet is going to win. It is that simple. And that complex.

This, of course, is how it was right up until the long bull run that started around 2004. And until you get your head around this recovery of long-established fundamentals, then you are going to struggle to get to grips with what on earth the likes of BHP boss Andrew Mackenzie are thinking about.

From day one, in February 2013, Mackenzie has talked about productivity being the most profitable way to grow in a post-boom environment. Over 20 months, the thesis has been refined then proved through cold, hard numbers.

The narrative in numbers Mackenzie rolled out in London on Monday should further reinforce confidence in the Scot’s mission to transform resources extraction into a sophisticated manufacturing business.

Mackenzie’s role call of the “key numbers” is informative. “Twenty three per cent, the projected two-year growth rate of our core portfolio; $3.5 billion, our minimum target for productivity; $2.3 billion, our minimum cost out target; and 20 per cent, the return that we can exceed by investing in our best projects,” he said, adding, “These are hard targets.”

And they offer compelling evidence of promise becoming reality. BHP is driving costs down while growing efficiency that ends up adding what is effectively free additional production.

Since 2012 BHP has squeezed out $US6.6 billion of sustainable annual productivity gains. It plans to add another $US3.5 billion to those gains by the end of financial year 2017. Just more than $US2 billion of that will come from cost savings while the rest will come from productivity tonnes.

Meanwhile, capital spending was hauled down last year to $US15 billion from a peak of $US21 billion. So, while commodity prices have fallen, BHP has added $US8 billion to its cash flow. And that trend will continue. Capital expenditure will come in just under the $US14 billion financial year 2015 target and Mackenzie revealed considerable downward flex in the numbers beyond that. BHP’s financial year 2016 commitments stand at about $US10 billion, leaving $US4 billion to play with.

By living ever more within its means and adding to that public commitment to favour shareholders over new investment, BHP has buttressed confidence in its ability to maintain its progressive dividend policy in the face of a changed pricing outlook.

The dividend increased 4 per cent to US121¢ in financial year 2014. That represents a payout ratio of 48 per cent and that ratio sits at better than 50 per cent once you discount for SpinCo, which will be made a reality next year. Mackenzie’s pledge is that the dividend is in effect the first capital priority, which suggests that, among his many ambitions, BHP can be a resources-based annuity stock.

Meanwhile, BHP’s ability to optimise and self-finance growth only affirms its A credit rating and that looms as an ever-more important competitive advantage, as so much that is old in the bulk commodities game becomes new again.