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Last Updated:10 Mar 16

# Shift in strategy

By James Gavin

The Saudi decision in late 2015 to raise domestic gas prices has ramifications throughout the economy, but will it have long-term benefits?
The frenzied pace of policy announcements from the kingdom in recent weeks has been such that even seismic scale measures have been somewhat obscured. In early January, with oil markets agog to reports of plans to float some shares in Saudi Aramco, relatively little attention was paid to an equally significant move introduced in late December. The government announced on 28 December a slew of fuel-related subsidy reforms, including hikes in gasoline, diesel and electricity prices and - perhaps most crucial - an increase in the domestic sales price of natural gas.

The latter has been increased to $1.25/MMBtu (million British thermal units) from $0.75/MMBtu, and ethane, the main petrochemical feedstock, to $1.75/MMBtu, up more than 100 per cent from the decades-old fixed price of $0.75/MMBtu.

These changes, which took effect at the start of 2016. But the corollary is that the kingdom should reap substantive benefits as a consequence of the changes. Petroleum subsidies made up around 80 per cent of the kingdom's annual subsidy bill last year, and according to the IMF, cost 3.7 per cent of Saudi GDP. The local Jadwa Investment sees overall energy subsidies costing as much as $61 billion last year, with diesel accounting for a massive $23 billion of this.

At the very least, the changes should save the Saudi exchequer a significant amount annually. Take forecourt prices. Under cover of low oil prices, which have insulated car users from the full impact of price increases, the government introduced changes that saw a 50 per cent increase in higher quality 95-octane petrol prices, a 66 per cent increase in lower quality 91-grade petrol prices, and a 74 per cent increase in diesel fuel prices. Electricity tariffs were more acutely targeted at the wealthiest Saudis who are the largest power consumers, and the vast majority of Saudis should not experience any bill increases.

Government officials have framed the reforms as a five-year plan to create a more efficient, productive economy. As such, these impacts are not necessarily immediate. According to Moody's the GCC's savings from increased fuel prices will likely be small - an average of half a percentage point of GDP across GCC countries in 2016. Even if governments opt to link fuel price hikes to global oil prices, the gains would be much lower than the expected GCC fiscal deficit of 12.4 per cent.

"Recent moves to reform subsidies signal political willingness to address the damaging effect of low oil prices on budgets. However, they fall short of the scale of economic and fiscal reform required to achieve budget balance," says Mathias Angonin, an analyst at Moody's.

Moody's nonetheless says that these fuel price reforms will lower current expenditures and bolster government finances dented by the global oil price downturn, while reducing macroeconomic distortions.

And it is the broader reconfiguration of energy prices - viewing energy reforms as part of a much wider transformation of the Saudi economy - rather than the actual scale of price increases that is most significant, says Justin Dargin, an Oxford-based international energy expert.

"They have signaled that the era of subsidisation is being reconfigured, challenging the view that Gulf countries would never undertake such changes for fear of upsetting the social contract with their citizens. In Saudi terms, it is a monumental change and we see nearly all MENA energy producers are reforming their subsidy regimes," he says.

There are clear winners and losers out of the natural gas price changes, though these are not necessarily immediately evident. In the grand scheme of things, a $1 increase in gas prices is not huge, and is unlikely to materially alter the economics such that international oil companies would be encouraged to go back and explore for more gas trapped in the inhospitable Rub al Khali desert, as some did to little noticeable reward in the mid-2000s.

Raising the domestic sales price will not immediately transform Saudi Arabia into a US shale boom play. "In Saudi Arabia, the cost of production for shale gas is going to be more or less the same as in the US," says Dargin. "But countries are adopting different strategies. In Saudi Arabia they are looking for joint ventures with US companies that manufacture shale technology."

There will, though, be some major losers. Already, downstream producers have been factoring in the sizeable financial hits they will have to face as a result of higher gas prices. Saudi corporate earnings estimates unveiled in early January show that petrochemical firms are the biggest victims. State-owned Sabic foresees increases of five per cent at its subsidiary Saudi Arabian Fertilizers Company, indicating an eight per cent annual cost increase. National Industrialisation Company (Tasnee) predicts that the budget changes would shave some $51 million off its earnings, which chief executive Mutlaq al Morished described as "quite a hit".

Losses will have to be borne in the pursuit of more broad-based long-term economic objectives. Says Dargin: "Saudi Arabia has indicated that it is instituting broad-based economic reforms, of which energy subsidies are only part. That will make the overall economy more vibrant and dynamic, but it is a long-term vision, not a quick-win."

In this process of growth, says Dargin, Saudi policy makers are trying to create top-tier Saudi petrochemical players, who have grown used to highly attractive feedstock prices, more globally competitive. "It's going to hurt initially because many of these large industrial consumers are going to have to work that much harder. But ultimately, they should become more powerful players by absorbing the higher fuel prices in that they will have to become more efficient."

Unlike Egypt, which introduced big increases in domestic energy prices in a "big bang" programme, the kingdom has gone for a more conservative, go-slow approach more in tune with local mentality. But make no mistake, the end result is to ensure a much more competitive value-added industry in which Saudi companies will be expected to be competitive players well beyond the kingdom's borders.