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COMMENTARY

Saudi Arabia's Oil and Gas Sector—An Update: Part 2

Part 1 of this *Commentary* looked at recent changes to the governance of the hydrocarbon sector in Saudi Arabia. Part 1 additionally suggested that various themes are now beginning to emerge which are likely to affect the Kingdom's future economic policies and energy law framework.

This second part of the *Commentary* begins by highlighting a number of indicators relevant to Saudi Arabia's oil economy. It goes on to evaluate the trends which are likely to come to the fore in the country's energy sector over coming years, and what opportunities might therefore present themselves to local and international investors.

Economic Challenges

In simple terms, the Kingdom seeks to maximise its revenue from crude oil sales in order to fund its development plans and recurring expenditure. It is estimated that Saudi Arabia needs an average oil price of between US$65–75 per barrel to balance its 2015 budget. However, world crude prices have fallen to the lower end of this range over the first half of this year, even dropping below US$50 per barrel in early August.

Saudi nevertheless appears intent on delivering the bulk of its spending plans. As H.E. Ibrahim Al-Assaf, the Minister of Finance, stated on 18 April 2015 at the 91st Meeting of the Development Committee of the International Monetary Fund ("IMF") in Washington, D.C:

> We are pursuing a robust growth strategy, a key component of which is to direct large amounts of public expenditures for the development of infrastructure and human capital. As part of our countercyclical fiscal policy, we are continuing to maintain these expenditures despite the challenge caused by the steep decline in the price of oil.

By way of example, in the power sector, the Deputy Minister for Water and Electricity has recently announced that Saudi Arabia is aiming to invest approximately US$187 billion in the domestic electricity sector over the next 10 years, and Saudi Electricity Company plans to add almost 48,000MW of generation capacity by 2024 (*MEED*, 4 August 2015). In the oil/gas arena, Saudi Aramco confirmed that it had received engineering, procurement and construction proposals from contractors on 27 July for a new gas processing plant at the Fadhili oil field in the Eastern

Province; the project's overall EPC contract value is estimated at US$6.5 billion (*MEED*, 28 July 2015).

Despite such substantive announcements, it is clear that the Kingdom's economy is already being affected by the low oil price. Recent indicators include the following:

- Oil revenues have slid from US$323 billion in 2013 to US$285 billion in 2014, and are forecast to drop to US$171.8 billion in 2015 (*Jadwa Investment*; *SAMA*).
- The Government's 2015 budget, published in late December 2014, provided for spending of almost US$230 billion (*Ministry of Finance*).
- Foreign currency reserves have declined by US$67.5 billion in the first six months of 2015, from US$732 billion on 31 December 2014 (*Jadwa Investment*; *SAMA*).
- Foreign direct investment fell by US$900 million in 2014 compared to the level seen in 2013.

On 1 June, the IMF, after completing its 2015 Article IV Mission to Saudi Arabia, made the following preliminary remarks:

> The decline in oil prices is resulting in substantially lower export and fiscal revenues.... Government spending in 2015 is expected to remain strong..., while oil revenues have declined. As a result, IMF staff projects that the Government will run a fiscal deficit of around 20 percent of GDP.

The IMF has predicted that the 2015 deficit will amount to approximately US$150 billion.

The authorities therefore have a significant spending gap to close. Part of this spending gap will no doubt be addressed by the country's striving to maintain its market share of world crude oil sales (in May–July, Saudi pumped a record level of approximately 10.3 million barrels of oil per day). The Government has also announced its intention to issue its first sovereign debt since 2007. H.E. Fahd Al-Mubarak, the Governor of the Saudi Arabian Monetary Agency ("SAMA", Saudi Arabia's central bank) was reported in the local press in late June as confirming that the Government had already placed US$4 billion of bonds with local banks this year. We understand that plans are in place for the issue of up to US$25 billion of further bonds by the end of 2015 (*Arab News*, 5 August 2015).

In addition to these measures, it is likely that the Government will introduce a number of structural reforms to the energy sector as a means of improving economic performance over the longer term. Various emergent trends point to areas of the new administration's thinking.

Trends and Opportunities

Energy Efficiency and Alternatives. The Kingdom burns a high proportion of its daily crude oil output in its own power stations in order to meet the country's electricity generation and water desalination needs, in particular during the summer months. Some estimates point to approximately 2.5 million to 3 million barrels of oil per day being consumed in this fashion—approximately a quarter to a third of Saudi's daily production. This usage has a significant, direct impact on Saudi's hydrocarbon revenue.

The Government has indicated that it will seek to pursue more strongly over the mid-term a twin-track approach toward addressing this situation: first, by accelerating its currently tentative drive to identify alternative sources of fuel for electricity generation (from offshore gas exploration to the development of nuclear and renewable power) and, second, by introducing policies aimed at efficient energy use. These initiatives—if and when launched—will offer a wide range of opportunities for local, regional and international investors.

In terms of renewables, there has been increasing talk from the Ministry of Petroleum and Mineral Resources about solar power in particular. The Minister of Petroleum, H.E. Ali Al Naimi, for instance, made the following remarks during the 20–21 May Business & Climate Summit at UNESCO in Paris: "...we have embarked on a program to develop solar energy.... Hopefully, one of these days, instead of exporting fossil fuels, we will be exporting gigawatts of electric power". He reinforced this statement with similar comments on 3 June on the sidelines of the OPEC meeting held in Vienna.

To date, Saudi's solar power programme has moved slowly under the oversight of the King Abdullah City for Atomic and Renewable Energy ("KA-CARE"). However, with KA-CARE's Supreme Council having been removed on 29 January and its mandate now uncertain, it would appear that other Government bodies may seek to drive the country's solar initiative. On 30 July, for example, Saudi Electricity Company signed an MOU with two Government-related technology entities for the establishment of a 50MW solar photovoltaic power plant with a 25-year offtake term (*Arab News*, 5 August 2015).

As to promoting the efficient use of energy, some are anticipating an expansion of the Saudi Energy Efficiency Program, which is already working to raise standards in the construction, industrial and land transportation sectors. Indications are also emerging that the Government is considering reforming the system of fuel subsidies. The Kingdom's bill for fuel subsidies amounts to approximately US$60 billion a year, according to International Energy Agency figures. It is notable that H.E. Fahd Al-Mubarak, the Governor of SAMA, stated in a speech given at a seminar in Riyadh earlier this year (published on 8 February 2015):

> One of the existing challenges is enhancing the efficiency of local consumption of energy and water, which results in a distortion and a significant waste of those important resources in addition to increasing the financial burden on the Government. This requires a review of price subsidies, which should be changed in a gradual and elaborated manner…

In May, the IMF also suggested that "comprehensive energy efficiency and price reforms" should form a central element of the Kingdom's future fiscal strategy.

Conversion Industries. Having focused in recent years on expanding the country's petrochemical production base (through world-scale schemes such as Sadara and PetroRabigh) and on the creation of a large-scale aluminium industry (through the Ma'aden/Alcoa project), the Government is now encouraging the creation of a series of "conversion" industries, able to capitalise on the chemical and metal raw materials which are beginning to be produced domestically.

In Jubail, for example, Sadara is supporting the launch of a PlasChem Park located adjacent to its production complex, and Petrochemical Conversion Company has already developed its own specialist plastics conversion park. Ma'aden is similarly seeking to create an aluminium and metals cluster close to its facilities at Ras Al Khair. In each of Jubail, Yanbu and Ras Al Khair, the Royal Commission continues to offer investors industrial land and infrastructure at attractive rents. Opportunities for investment also lie along the logistics and supply chains which will be necessary to support these conversion industries, many of which will be entirely new to Saudi Arabia.

Added-Value Technology. A further trend is the stepping up of Saudi Arabia's efforts to attract high-value technology and intellectual property which can be commercialised locally to the benefit of the Kingdom's hydrocarbon sector. A number of entities, ranging from Saudi Aramco Energy Ventures and Dhahran Techno Valley Company to the SAARA/Technovia initiative (a commercial and academic research alliance), are aiming to identify emerging technologies, help fund their commercialisation and promote their adoption by the energy industry within the Kingdom.

The Government is clear on its pursuit of this policy. Addressing the Saudi Economic Association in Riyadh on 7 April, H.E. Ali Al Naimi stated:

> We aspire for the Kingdom not only to be an oil producing nation, but also a global centre for the production of the materials and services needed by the oil, energy, petrochemical and other industries. The oil and petrochemical industries focus on scientific research and studies and obtaining patents. We believe that, for any industry, scientific research and new inventions are the best way to progress and compete.

Conclusion

Despite the rapidity of the recent changes which have affected Saudi's energy sector, the basic legal framework remains unaffected at present. A number of important themes are becoming apparent within the sector, however. These will not only be critical for the Saudi economy in coming years but will also be of keen interest to prospective investors in the Kingdom's hydrocarbon industry. Under Saudi Arabia's current Government, it would appear that the country's petroleum policy will be directed both externally toward global oil markets and domestically at expanding the nation's economic base, promoting energy efficiency and continuing a drive for greater industrialisation.

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