Moderator

Angus Graham

Risco Energy

Act or react

In a matter of days, 186 million Indonesians will have voted in the world's biggest direct presidential election. They face an unusually binary choice for Indonesia's 7th president, with only two qualifying candidates: Jakarta Governor Joko Widodo ("Jokowi") and former Suharto son-in-law and general, Prabowo Subianto. To help inform debate about the election and its impact on the energy industry, we asked two independent experts, in Indonesian politics and investment respectively, for their views on the candidates' policies and ability to affect the country's oil and gas future.

A critical element to both campaigns is Indonesia's ongoing economic prosperity and increased growth rate targets. Indonesia's energy sector is a significant economic constituent, representing 15.6% of GDP in 2012 with oil and gas alone providing 16% of state revenues. However, production in ASEAN's historically dominant oil and gas producer is stagnating in the face of soaring demand, prompting an ever-expanding deficit gap currently being filled by imports. Imports have fuelled pressure on the country's current and trade accounts, which will only increase without increased oil and gas production. This pressure is exacerbated by fuel subsidies dating back to Indonesia's OPEC membership (it exited in 2009), which currently cost the government more than oil and gas revenues.

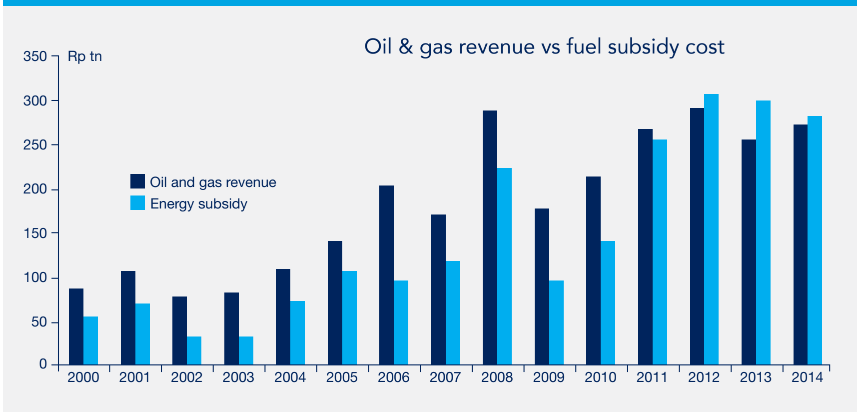
In his analysis for Risco, Indonesian political expert and commentator Kevin Evans explores Jokowi and Prabowo's energy platforms, highlighting commonality in their economic and resource nationalism, albeit to varying degrees. Kevin ultimately concludes that we are unlikely to see a policy environment that genuinely encourages foreign investment in the sector without a major economic shock and expects no material change to the current trajectory of oil and gas in Indonesia.

Jayden Vantarakis ,Deputy Head of Indonesian Research at CLSA, Asia's leading independent equity brokerage, is more optimistic for change. He sees GDP growth of 7-9% pa as a priority for both candidates and the current structural energy trade deficit and fuel subsidies as a significant barrier to achieving this. This will compel the new president and his government to implement positive structural reform to encourage oil and gas investment to in turn stimulate higher production.

There is greater overlap in Kevin and Jayden's conclusions than might appear at first glance. Both see Indonesia's overall economic performance as a key motivator for action. History would support this view, expressed by the current administration's articulate Minister of Finance as "good times lead to bad policy and bad times lead to good policy". The difference in their view lies in the implicit timing, with Jayden believing the next government will be proactive in protecting targeted growth, while Kevin believes change will only be stimulated by an economic shock. Time will tell.

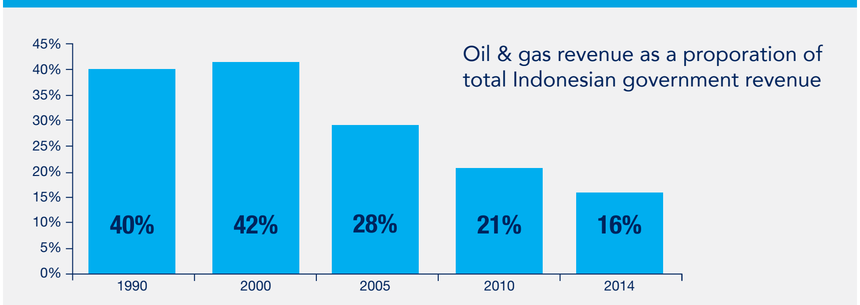
One area of oil and gas investment that seems set to receive greater support whoever becomes president is domestic participants. This is potentially a welcome source of investment, although it is not a singular solution and is unlikely to make material impact on such a significant (and expanding) energy shortfall. Domestic oil and gas participants naturally face balance sheet, funding and skill constraints in an industry that is highly capital and skills intensive and, for Indonesia, set to become even more so as the industry seeks resources in the more challenging eastern and deepwater areas of the country.

The cost of fuel subsidies wipes out revenue from oil and gas



Source: CLSA

Oil & gas is material to Indonesia - albeit proportionately less than before



Source: CLSA

Contributor

Kevin Evans

Founder: www.pemilu.asia

Change won't be easy

Indonesia will go to the polls for the second time this year on 9 July, this time to elect either Joko Widodo or Prabowo Subianto as the country's next president. As voters decide who will take office in October, the oil and gas industry waits to see how the election's outcome will impact Indonesia's energy future.

Both candidates propose platforms that suggest the recent trajectory of more state and Indonesian private sector interests in oil and gas will continue. In addition to formal statements and official candidate platforms, it is also useful to consider the "networks" of supporters of each presidential candidate to identify policy directions.

Joko Widodo's – Jokowi – team released a quite detailed list of policies regarding oil and gas. They propose to support enhanced oil recovery including using special regulations and financial stimulus to encourage use of old oil wells, better calibrate risk with flexibility considering potential rewards to encourage state and private sector investment while recognising existing fiscal systems are out of date. Additional incentives to invest will go beyond production sharing to include aspects like net present value, internal rates of return, payback periods and profitability ratios in the context of the geology of sites.

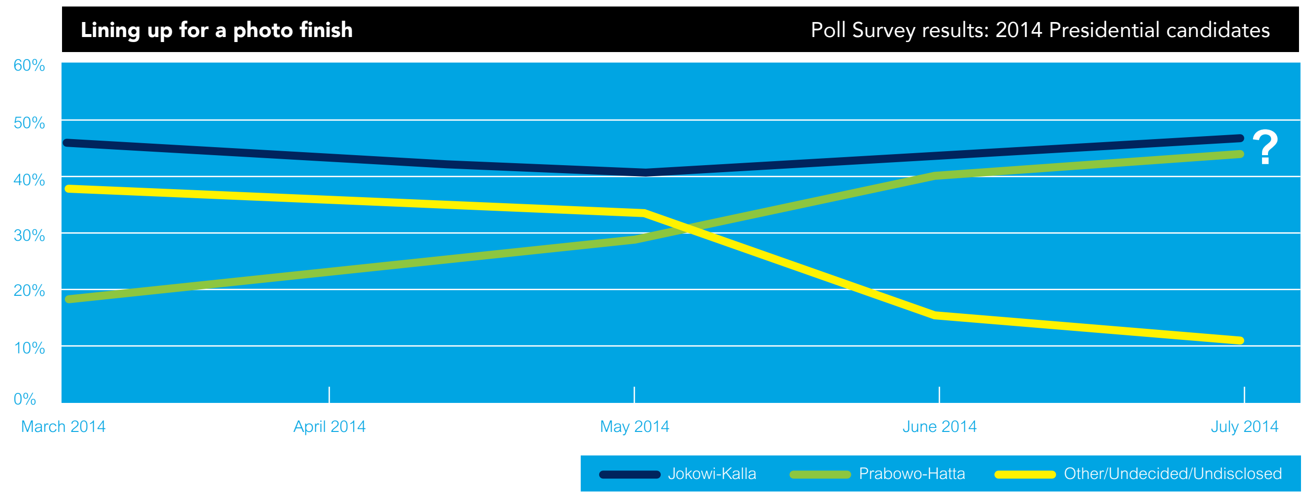
Jokowi's team also proposes to encourage more national energy autonomy and encourage long-term legal certainty by issuing an emergency regulation to become a revised Oil and Gas Law focused on building national capacity.

Prabowo's team has provided much less detail but does propose to revise the Oil and Gas Law so that it aligns with contemporary economic nationalist interpretations of the Constitution. They also propose to build various oil and ethanol refineries as well as terminal and distribution facilities through state and private sector investment.

Both teams propose to encourage more use of gas and bio-fuel for transportation, as well as buoying renewable energy sources - with Team Prabowo specifically proposing a target of 10,000 MW for geothermal.

There is also alignment in a stated desire for the gradual reduction of fuel subsidies, although the manner of execution and extent of removal differ. Jokowi articulates a program of gradual subsidy elimination over four years; Prabowo seeks to retain fuel subsidies for the poor and removal for everyone else. While both sides may see the practical benefit of subsidy reduction, there is likely insufficient pressure from both Parliament and the public to reallocate such funds away from fuel subsidies to other areas.

It may well be that some of the economic nationalist and populist rhetoric of the candidates around oil and gas represents the standard electoral hyperbole. Even so, there is no reason to suggest the inclination to resource nationalism evident in the last several years is likely to change in the near future. Moves to create a policy environment that genuinely encourages foreign investment would require a major economic shock such as economic growth falling to, say, 3% over a two year period. With the current trajectory set to continue, there is little reason to expect dramatic and material change in government policy with regards to an oil and gas sector that is already struggling to attract sufficient investment.



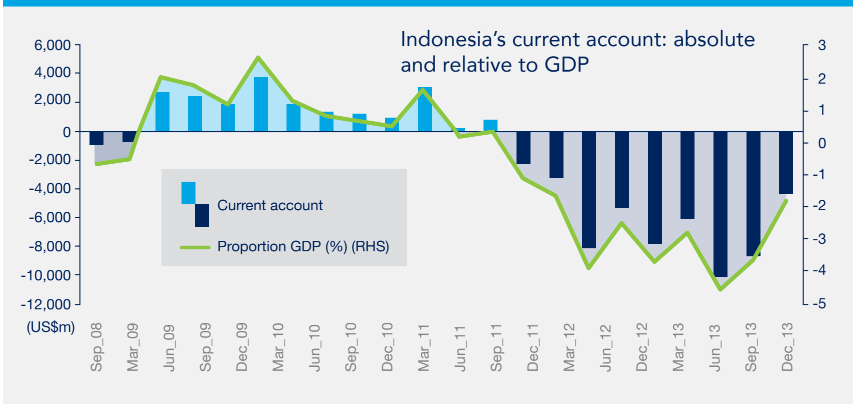
Source: Jakarta Globe; final data point from Indo Barometer survey 19-22 June 2014 (1,200 sample size in 33 provinces).

Contributor
Jayden Vantarakis
CLSA

Oil and gas reform is essential for growth

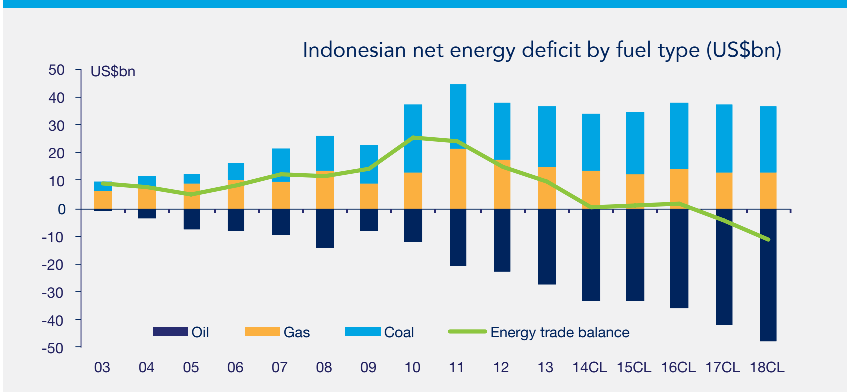
It is difficult to assess the likely impact of the upcoming presidential election on Indonesia's oil and gas industry without first considering the country's broader economy and its recent performance. We consider broader economic factors to be key in determining the potential for structural reform in Indonesia's oil and gas sector.

Indonesia's current account has moved into deficit



Source: Government of Indonesia, CLSA

Indonesia's existing oil & gas net deficit is set to become a total energy net deficit



Source: CLSA estimates

Indonesia was given a shock in the second half of 2013 that rekindled memories of the painful Asian financial crisis of the late 90s. The Indonesian Rupiah – seen rightly as a barometer of confidence in the country – swiftly declined 24% to levels above 12,000 against the US Dollar. The currency has since hovered between 11,000 and 12,000 during 2014. The key reason for the decline is Indonesia's growing current account deficit and international investors' aversion to funding deficit countries – and particularly emerging markets – as the global economic situation shows signs of recovering. Indonesia's current account deficit widened during 2013 to 4.5% of GDP. The Central Bank has now set sensibly about keeping it in check at maximum 2.5% of GDP, a level it argues is supported by baseline portfolio and foreign direct investment flows.

The inevitable consequence of narrowing the current account deficit is slower imports and consumption and therefore slower economic growth. Higher interest rates have dampened imports (the Central Bank has lifted the policy rate by 1.75% to 7.5% and there is talk of more tightening) and a failure by Indonesia to address infrastructure bottlenecks and labour laws during the past four years of cheap global money means exports are not taking up the slack. After enjoying years of above 6% real GDP growth, Indonesia has become complacent. In the first quarter of 2014 real GDP growth slowed to 5.2% and looks set to remain subdued.

Turning our attention to the performance of the country's energy market within this broader economic context, we estimate that Indonesia will become a net importer of energy, in monetary terms, sometime between 2014 and 2017. This is driven by continued subdued thermal coal prices, rising unchecked oil consumption fueled by wasteful subsidies, and stagnating oil and gas output. If Indonesia pursues a path of industrial development to pursue further growth, we estimate that its energy needs will continue to rise, increasing from an estimated US$100b in 2012 to US$190b in five years' time. On the production side, oil output continues to slide, now 20% short of Indonesia's elusive 1 million barrels per day target with less than ten years' reserves and flat gas production.

Without addressing the structural energy trade deficit Indonesia is now saddled with thanks to years of regressive policy in the oil and gas sector, the country faces the prospect of even slower economic growth in the years to come. It also restricts state finance and the ability of the next president to carry out other economic programs.

Indonesia now receives 16% of total government revenue from oil and gas royalties and taxation, down from 42% in 2000, and the state spends more on subsidies than it receives from the sector. Slow growth due to fiscal and monetary constraint is exactly what both presidential candidates do not want to see – with each candidate aiming at the time of writing for 7-9% GDP growth. For these reasons, we expect that, regardless which presidential candidate is elected on 9 July, the next government will bite the bullet and set a program of encouraging investment in oil and gas through positive structural reform.