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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 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.

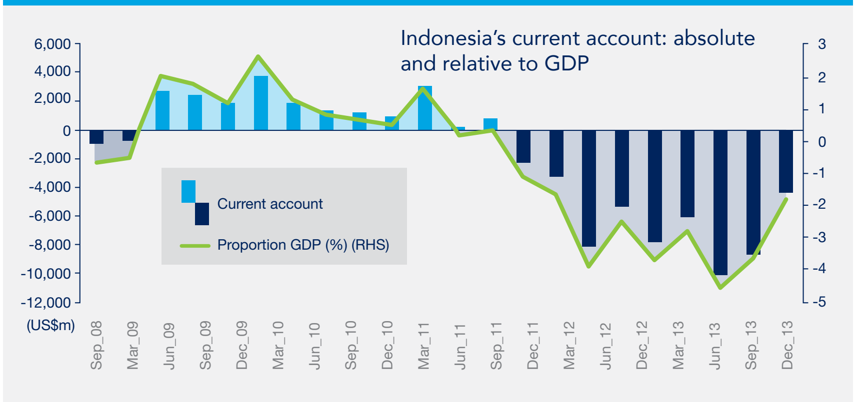
The inevitable consequence of narrowing the current account deficit is slower imports and consumption and therefore slower economic growth. Higher interest rates have dampened imports (the Central Bank has lifted the policy rate by 1.75% to 7.5% and there is talk of more tightening) and a failure by 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.

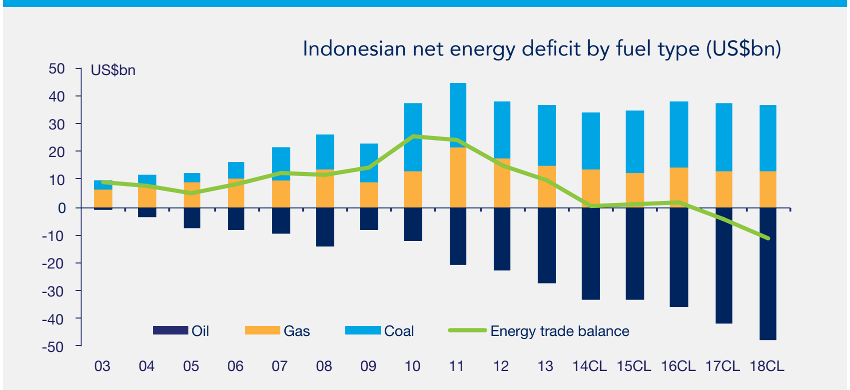
Indonesia now receives 16% of total government revenue from oil and gas royalties and taxation, down from 42% in 2000, and the state spends more on subsidies than it receives from the sector. Slow growth due to fiscal and monetary constraint is exactly what both presidential candidates do not want to 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.

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

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