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Oil and gas policy steps

The government seems to be quite active in the energy sector; the hard work of the last one year of the Energy Task force has started yielding results.

Earlier, an 'Alternative Energy Policy' draft was circulated which attracted the stakeholders' interest. Now, the ingredients, if not policy, of the oil and gas sector have been revealed. Simplifying and activating the petroleum concession, incentives for local gas production, carrot and stick approach with old refineries, opening up the LNG sector and privatizing LNG terminal business relieving government from onerous financial risk and responsibilities are some major policy thoughts. We will examine the Oil and Gas sector issues here in some detail.

We will take the issues one by one but let us start with the most important and probably contentious issue of LNG terminals. Currently, the government or its nominee public-sector companies have to enter into a 'take or pay' contract with the LNG terminal developers and owners under a competitive bidding process. Although take or pay contracts are not uncommon in the energy sector, there is political controversy about it and public opinion is turning against such liabilities. Almost riskless, the LNG terminal business in the form of take or pay contracts and sovereign guarantees should and has evinced a lot of interest. However, it would be of interest to see if that interest would sustain in the new policy.

The CNG sector had earlier been granted an open policy which the sector has not yet been able to avail. However, now the CNG sector may be able to form some coalition with international companies in this respect. Associations have problems in decision-making and there are always usurpers ready to exploit. There is no free lunch. The government is shifting the risk and risk cost money. However, an additional advantage is the flexibility and supposedly higher efficiency of the private sector. There are problems and issues, however.

Would regulators have any oversight role? The LNG terminals capacity may be more than demand and pricing may be based on 60-70 percent capacity utilization. It would not be a pure competition situation of many buyers and many sellers. There are allegations or fears of collusion even in cement and sugar where possibly much more competitive ingredients exist. Moreover, it would have to be assured that there are no restrictive practices and that there is third-party access to LNG terminals and the associated transmission facilities. And, finally, should the other two LNG terminals be eventually brought under the market mechanism? Maybe eventually under a negotiated settlement?

Eventually, we will have to decide whether over-supply is better or some-under supply can be afforded. If the current capacity trap in the power sector is a guide, one would be more inclined to suffer, say, an hour of short supply in a day than having to pay for two or more hours of surplus. Competition requires surplus which has costs. The cyclical crisis of capitalism is well known.

Secondly, the side-by-side management of the regulated sector and existing term contracts has to be handled somehow. For example, the LNG-Qatar contract of \$10-12 vs the seasonally variable lower spot prices of \$4-14. Some back to back contracts would have to be there to absorb the supply under these contracts. Or the government would have to resell the gas to the market at acceptable market price, earning and losing money seasonally. However, this issue is more related to opening up the whole LNG and gas sector than liberalizing LNG terminals business.

The local gas production scenario does not appear to be very hopeful. It appears that LNG will form an increasingly higher share in our gas supply. It is already 40 percent and known reserves can hardly survive beyond 10 years. There is potential if exploration activities are incentivized and enhanced and bottleneck in the sector removed. The new policy approach intends to do this. They want to reduce or eliminate red tape and simplify the concession approval process. It appears that they also want to cut the feathers of the petroleum concession bureaucracy and bring in the regulator to solve the grievances of E&P companies.

It is hoped that the new arrangement will be better than the existing one. How about an energy tribunal which handles a wide variety of issues of the whole energy business, developers, contractors etc? The scope of the existing electricity tribunal (B-to-B), although not yet implemented, may be broadened.

There is a possibility of incentivizing and expanding output from the known oil and gas resources. There are marginal fields or those that have been closed down or may be about to be closed, which could have produced more under an incentive programme of slightly higher prices; after all, we import LNG at higher prices. There are existing policies in this respect which have not been able to attract enough interest and increase local gas supply. The new policy approaches appear to be acting in this direction, streamlining and further incentivizing. Surely, some short-term improvement would come by.

There has to be some market manager; currently, the petroleum division is doing that directly. In the power sector, there is the NTDC and CPPAG which are managing these functions. Demand and supply management and balancing the cost and the price, and managing subsidies etc, could be better done in a corporate setup. While the gas system operator may take time to implement along with other sector restructuring issues, there should be no problem in bringing about this central agency.

The role of Pakistan LNG may have to be broadened or it be merged into a new company. The first or second step in gas market liberalization would be and should be the parting away of spot purchases function from the public sector to the private sector. The ultimate solution, though, may be retail competition ala petrol, wherein marketing companies procure and sell directly to the consumer, even small consumers. In that case, transmission and distribution companies would be pipes only.

Fortunately, there is no more import of furnace oil. However, there is a lot of infrastructure of local production in the form of refineries, and of consumption in the form of furnace oil power plants. The nexus and match of this demand and supply does create some rationale and market pressure for not undoing furnace oil totally. The problem is the high cost of furnace oil and low efficiency of old furnace oil power plants.

In the intervening period, local refineries must manage to export furnace oil at some loss. The government seems to have made up its mind to show the exit door to the old, inefficient and market incompatible refineries, and has offered them a tax holiday incentive for new investments. This appears to be a step in the right direction. Renewable energy would be able to fill the gap, if any, at lower prices. There is thinking that some rules be developed to maintain the availability of the efficient ones FOPPs in one form or the other to take care of possible LNG emergencies.

In conclusion, the path from the public sector to competition, private sector and market liberalization is a difficult one. Some further homework may be required with respect to LNG terminals. The LNG /gas storage issue has to be resolved as well as many others. Positive news is coming from other areas as well. It appears that we are moving in the right direction.

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