POWER GENERATION

When governments attempt to go quiet

Wholesale shifts in market fundamentals have encouraged a new public sector approach to controlling demand / DAMON EVANS, Asia correspondent

FUEL subsidies, par for the course in Asian economies during high oil prices, are going out of fashion. China and India, the region's economic powerhouses, have repeatedly tried to reform their energy-market pricing in recent years. It has been a similar story across Southeast Asia, where fast, subsidised demand growth has been bad for the budget, giving governments reason to stop incentivising consumption.

But energy exporters need not fret. Subsidy reforms should not dent demand growth in the region's biggest energy consumers. While in Malaysia and Indonesia, Southeast Asia's biggest consumers, politics looks set to stymie pricing liberalisation, if global oil soars again.

Indonesia, which spent $28bn on fuel subsidies in 2014, before it completely abolished them on gasoline and capped them on diesel in January 2015, is still set to be the world's largest gasoline importer as early as 2018. Ominously, the government did not increase pump prices to match global benchmarks in April and May 2015 for fear of social unrest. There are no plans to make subsidy removal more equitable yet and powerful interest groups that control the lucrative fuel-import business will try to frustrate any plans that could derail oil demand.

Return to fundamentals Malaysia removed gasoline and diesel subsidies in December 2014. But the country's prime minister, Najib Razak, remains embroiled in a growing embezzlement scandal that threatens his ability to see through unpopular policies. If global oil rebounds steeply, it's hard to imagine him allowing domestic prices to follow, bringing simmering civil tensions to the boil.

In China, the world's biggest energy consumer, subsidies are now much more limited. But market pricing, which is regulated, brings its headaches too.

In mid-January China made a significant adjustment to its fuel-price mechanism to curtail demand growth and curb pollution. It set a $40-a-barrel oil-price floor, below which no adjustment will be made to refined-oil product prices.

This isn't the sop to refiners it might seem. Beijing has set up a fund to accrue the savings from lower prices to help it develop a more sustainable energy sector.

The effect of the measure will be to lessen the demand response to oil prices below $40/b. It's also an indirect signal to Opec and other suppliers: their largest customer believes oil prices are too cheap. Even at today's weak oil prices – which in the past might have spurred more consumption – oil exporters are now helping China to develop an economy that will use oil more efficiently.

Meanwhile, the upper end of the adjustment is set at $130/b, effectively acting as a cap on oil prices for Chinese consumers. Markets look unlikely to test this threshold any time soon – but if they did, Chinese refiners would have to suck up the losses. The changes are significant – but despite an ideological shift to market-based pricing since 2013, the new price band shows the government remains willing to take a price-setting role in China's energy market.

Beijing's strategy hasn't always worked. For most of 2015, the government maintained its policy of keeping gas prices among the highest in the world – and significantly higher than oil-product substitutes. Growth subsequently collapsed, more a result of mispricing than weak fundamentals.

Real terms apply This had implications beyond China too. The country's imports of liquefied natural gas fell 1.1% in 2015, marking the first year-on-year decline since the country began buying seaborne gas supplies in 2006. But last November the government also lifted some controls that had kept gas prices high, a move that should start to perk up demand.

India, the world's fourth-largest energy consumer (*see p38-39*), is also moving to market-based pricing in its energy sector. Gasoline and diesel prices were deregulated in 2010 and 2014. Gasoline demand growth has remained robust, while demand for diesel, which makes up 70% of transport fuel use, is flattening.

The government has been broadly committed to making electricity and natural gas prices better reflect the real market too.

Nonetheless, end-use electricity tariffs for most consumers remain below the cost of supply.

Fertiliser plants and grid-connected power plants are entitled to lower prices. But gas subsidies have resulted in a rationing system – an outcome Sarah Fairhurst, director of the Hong Kong-based Lantau Group, a specialist economic energy consultancy, describes as "truly bizarre". India divides up its limited gas supplies – the fertiliser sector gets first dibs – and what is left over is shared among the other consumers.

Subsidised gas prices are so low – around $4 per million British thermal units – that everyone wants a share. Despite much upstream promise, producers have – unsurprisingly – hardly been rushing to bring new supplies to a market that will barely reward them for the effort.

There is no structure in place to determine market value of gas and the long-debated solution was to pick a basket of international prices to generate a reference point, which is out of step with local dynamics.

India's price-sensitive consumers have high latent demand for gas, making it a potential major market for LNG.

Subsidies are a useful device for governments to have a hand in controlling market economies, but their withdrawal certainly doesn't signal a long-term preference for classical economics. The greater onus is on suppliers to work toward fundamentals, temporarily. When prices start to rise again so also will the government's need to intervene. PE