Prudence or Profligacy when Expectations are high but Markets Volatile….

2015 has been heralded as the year when PNG will enjoy the highest GDP growth rate worldwide on the back of the first full year of LNG production; in November Parliament approved a record 16.2 billion kina Budget, albeit dependent on substantial continued deficit financing and a somewhat implausible payment of 2.5 billion kina by landowners for their resource project equity. The major recent drop in energy prices has highlighted why the chickens cannot be counted before they've hatched, plus the risks of over-dependency upon a few volatile commodities, of heavy-borrowing against associated future revenue, and the need to focus on public expenditure priorities.

The 1990s are sometimes referred to as the lost decade; a period when, despite major new resource projects commencing, such as Kutubu oil, the country leapt from economic crisis to crisis, with Ministers dashing around desperately seeking overseas loans, but in the end funding little more than the payroll. After some overdue structural reforms in the early 2000s, the subsequent years were characterised by relative fiscal restraint and monetary independence, stable macro-economic conditions and enhanced investor confidence, and falling debt to GDP, particularly on the back of rising commodity prices. PNG was relatively immunised from the Global Financial Crisis, with prices of some of its key export commodities, notably gold, remaining strong throughout and the banking sector largely detached from overseas subprime markets. The so-called 'windfall' revenue, associated with the high commodity prices of the mid-late 2000s, was squirreled away into trust accounts, but largely ill-managed and accounted for, fuelling inflation, and providing a huge missed opportunity for sound investment and economic stabilisation, (the intent of the subsequently-planned but still non-operational sovereign wealth fund). Thereafter, the shelved Queensland pipeline project reinvented itself into PNG LNG, boosting investment confidence and providing a direct economic stimulus, particularly during its construction phase, but also stimulating unrealistic expectations, including amongst many politicians.

The accumulated impact of the economic crises of the 1990s and politicisation of public service appointments, followed by several years of fiscal restraint and failure to refocus public sector expenditure towards priority activities (and 'right sizing' the public service), left public sector capacity weak, with an ageing workforce by 2010, with limited new recruitment and training, and service delivery trailing well behind growing demand for schools, health facilities, policing and other priority services. Maintenance of public infrastructure had been inadequately funded for decades, and the stock of public goods badly deteriorated. The new government committed itself in 2012 to a comprehensive programme of tackling this backlog of decaying public infrastructure, upgrading education and health services to meet current demand, including free primary education and basic health access, reviving public goods at the district level, tackling corruption and restoring run down law and order services. These are widely accepted as key, or amongst the critical priorities for fostering both economic and social development.

Major increases in Budget allocation have been directed to address most of these priorities, ostensibly to make up for lost ground. However, weak policy conception, planning and implementation capacity and even poorer accountability have handicapped achievement of these stated objectives. It was widely recognised that revenue would be dip significantly during 2013-15 period, following the winding down and conclusion of the PNGLNG construction phase and prior to significant revenue emanating from the LNG project. Export earnings and revenue was also reduced by falling prices for most of PNG's export commodities from 2013, and lower production from several major projects, notably the Ok Tedi copper/gold mine. It was planned, therefore, to use deficit financing to sustain economic activity, including employment, during this interim downturn, progressing public infrastructure and service restoration and upgrade. However, the scale, utility, sustainability and cost of some of the major capital investment projects (including roads and sports stadiums) and their concentration particularly in the National Capital, raised concerns, even prior to the additional commercial borrowing for major speculative State share acquisition in private firms, on top of the State's existing equity entitlement in resource projects. By 2014 PNG's debt to GDP had increased from some 24% in 2012, to in excess of 35%, but, when liabilities devolved to State-owned enterprises and contingent liabilities were included, debt levels were entering increasingly risky territory and exceeding ceilings permitted under PNG law, with domestic and overseas servicing costs a rising burden, and the State having to pay higher rates to secure funds domestically, and the Central Bank increasingly financing the State's borrowing in 2014. Some restraint on expenditure and debt was achieved in the 4th quarter of 2014, albeit at the apparent cost of some essential services and obligations (e.g. teachers leave fares).

The most heralded achievement of 2014 was the completion and first shipment from PNG's largest-ever project occurring ahead of schedule, with 55 cargoes shipped by late-January 2015, notably to its 4 long-term customers in East Asia. The lenders' operational completion test, an important milestone, was also passed in mid-January. This should enable 'financial completion' also to be brought forward (to the first half of 2014), when the loan guarantees will be released, repayments commence and the co-venturers able to share profits. Early and increased sales boosted project earnings in 2014, will enable timely loan repayments. However, the plummeting price of oil and other hydrocarbons in late 2014 (from USD 110+ per barrel from 2011-mid-2014 to below USD 50/barrel in early 2015) will impact heavily earnings to oil companies and oil/gas producing States worldwide. Whilst PNG's modest oil production has diminished steadily over the past 20 years (to around 20 million barrels in 2014 – boosted somewhat by associated gas production), the lower LNG prices will have a much greater impact for the country if sustained. Although a few forecasters predict some early price recovery, many foresee an era of lower hydrocarbon prices, thanks to the changed supply and demand scenario. The high oil prices and supply uncertainty prevailing, albeit inconsistently, since 2007, stimulated massive investment in new exploration, new technology, unconventional sources and alterative power generation, changing the overall market balance for time being. Lower prices will not affect production in the shorter run, although clearly restraining investment in certain exploration and new technologies.

The Saudi's refusal to slash oil production to sustain price, stimulated the market reaction, but clearly it was intended to have the opposite effect in the longer term, by squeezing out higher cost energy producers, and particularly new exploration and development, and encouraging the return, in due course, to a price sustained perhaps nearer USD 70/barrel. Whether this can be achieved will depend on multiple factors, including the falling costs of energy production, with new technology in oil/gas production and from alternatives, but also steadily growing global energy demand, plus supply disruptions, notably in the Middle East, and (particularly for gas) weather conditions and climate trends. There has been an attempt to delink LNG pricing from oil, but, although LNG is used almost exclusively for power generation, it remains essentially a substitute (albeit cleaner) for oil. With LNG increasingly commoditised and tradable, a much greater portion is sold on the spot market, than in the earlier years, when 20-40 years supply contracts and fixed prices prevailed in the 1960s.

PNG's initial LNG sales were sold substantially on the spot market, until production reliability was more assured and longer term contracts sought, particularly when prices started slipping by mid-2014. The majority of PNG's LNG is now traded in these longer term sales and purchase agreements (SPAs) with 4 customers, to provide relative supply and sales reliability for both parties. There are multiple variations of SPAs, but essentially they are linked to the oil spot price, notably adjusting to average prices on a monthly basis, and invariably including extensive renegotiation and termination clauses. PNG is certainly not immunised from the market trends, although in future the stabilisation component of the planned sovereign wealth fund should reduce the shorter-term budgetary impact of volatile prices, so long as the fund is run transparently, according to the (higher) Santiago principles (as opposed to the furtive accountability of many of PNG's SOEs).

As an operating project, production from PNGLNG is unlikely to be affected by the lower market prices, although income to the investors, including the State, and subsequently to the State from tax revenue, clearly will be substantially reduced if prices remain subdued, and with the period and cost of loan repayment also extended. The development of some major new fields in PNG (notably Elk/Antelope and P'nyang) are also likely to still proceed, if resource estimates are verified, particularly where they enhance the utilisation of existing facilities (as opposed to requiring investment in new standalone facilities).

Although the commencement of LNG production was forecast to stimulate a high GDP growth rate for 2014 and particularly 2015 (the first full year of production – currently forecast by Treasury at 15.5%), revenue from LNG was expected to remain relatively limited for 2014/15, and not build up substantially until 2017 as dividends are increasingly supplemented by tax receipts and with debt servicing the major initial requirement. With GDP relatively intangible (and relatively irrelevant with respect to LNG, which provides very limited direct local economic, including employment, impact once the construction phase is over), the main benefit emanates from the revenue to the State and associated local investors (certain provincial governments, landowner companies, but also through companies with a local footprint e.g. including foundations), and how effectively they utilise the proceeds (and manage the wider economic conditions).

Nevertheless, particularly with the tight prevailing revenue from the mineral sector overall, LNG was certainly expected to provide an increasing revenue contribution, to sustain expenditure and restrain the accumulating deficit since 2013, into 2015 and 2016. Early production and sales, at higher prices, will have boosted revenue due for 2014 (not committed for debt servicing), once funds are approved for release, but this will be countered by significantly reduced dividend and tax revenue since late 2014.

Different estimates have been provided of the impact with Government suggesting minimal impact and firm immunisation from short term market conditions, and independent analysts suggesting a K1.4 billlion reduction in revenue from lower oil and gas prices alone (10+% of total revenue), compounding a reduction of revenue also from other sources with a wider sluggish economy. The IMF's Article IV consultation report (Dec 2014), written largely before the recent slide in energy prices, particularly emphasises caution in avoiding potential burgeoning debt, notably through expenditure restraint. The drop in revenue probably lies lower than the independent observers have highlighted, partly as shorter term LNG revenue forecasts were relatively modest during 2014-2016 in the first place (even before further equity acquisition). Nevertheless, with the rest of the economy (apart from public expenditure) relatively restrained in 2014-15, lower LNG revenue against forecasts, later into 2015 will have a significant impact. While continued interim fiscal stimulus measures are justified, during this subdued economic period, it is important to:

1. recognise that LNG prices might remain subdued for the medium even longer term
2. avoid accumulating debt (through unsustainable deficits or major further borrowings, particularly for activities which are marginal to government's functions; such as equity acquisition, except under the auspices of the SWF)

3. review revenue and expenditure early in the year, and be ready to make early adjustments, to avoid lower priority activities, including some capital works, from squeezing out priorities (later in the year), related to education, health (including TB prevention and control), basic access and infrastructure maintenance/emergencies, law and order etc.

The positive aspect of lower fuel also needs to be recognised, notably on energy demanding industries, such as transport, including airlines (and rural air-services), processing, commercial agriculture, but also upon consumers of power and goods needing shipment to markets. Lower energy costs enhance the viability and potential for various industries, stimulating employment and restraining the high living costs in PNG's rural and urban areas.

LNG development in itself has gained great hype in the media and stirred up political and public expectations. Much of PNG's population has seen little change over the past two decades, except mobile phone access and tall buildings (and traffic jams) emerging in the National Capital, now viewable even in remote locations via that expanding mobile network. Although some provinces and districts have performed much better than others, much of the population has limited access to basic services or markets, with many roads and airstrips also closed down even during the past decade. Ironically some of the resource-rich provinces have amongst the worst services and social indicators, as exemplified by the very high rates of drug resistant TB now recorded in Western Province (and HIV/AIDS in Enga).

Action is being taken by government, churches, business foundations and development partners to address these challenges, from a new Rural Airstrips Agency to a major planned School of Government, but it remains sporadic and ill-coordinated, with the public sector capacity, performance and accountability the weakest link. A further LNG project construction in the near future would briefly and usefully generate extra jobs and economic activity, but PNG needs to find practical ways for LNG production and exports to stimulate broader-based economic opportunities, through prudent investment of public funds into priority expenditure and services. The current lower oil and gas prices provide a sobering, but potentially valuable reality-check on the need to avoid the pitfalls of the 1990s, with its unrealistic expectations and loose fiscal management, to avoid squandering funds on low priority activities and once-off events, to establish and operationalize the long-delayed sovereign wealth fund, to re-crank up the anti-corruption and accountability effort, focus policies on establishing favourable conditions for economically and environmentally sustainable activities, particularly agriculture, and focus expenditure upon the needs of all Papua New Guineans and not just selected components of the community, especially empowering young men and women to participate actively in the economy, not merely as observers, or displaced from their land.