KFM Economics Note | 29 March 2022

Russia/Ukraine: Update

Since our initial Note on March 1, much-publicised discussions by countries and multi-national corporates alike against Russia have taken effect, including: imposing sanctions on Russian Banks; freezing the financial assets of billionaire oligarchs linked to President Putin; and companies including Apple, Amazon, DHL, and British American Tobacco among many others either suspending or taking steps to divest their business interests. In the energy resources sector – oil majors including Exxon, BP and Shell have also announced exit plans from their Russian operations. This note briefly touches on the consideration that global price increases for **Crude Oil will have on the PNG economy.**

Imported Inflation vs Increased Government Revenue

The global economy was already experiencing inflationary pressures prior to the Invasion. Pent-up demand on the back of the 2021 global economic recovery has contributed to supply-chain bottlenecks at shipping ports, in turn delaying the delivery of production inputs. Many of the world's Central Banks also acknowledged at the beginning of this year that the global inflationary pressures were more 'broad-based' than initially thought. Following Russia's decision to invade Ukraine, perhaps the most telling impact for global financial markets has been the ***higher commodity prices, particularly for Oil and LNG.*** For PNG, the higher commodity prices has predominantly 2 major effects: **higher commodity export revenues** and the **increased cost of imported goods, leading to inflation.** Of particular interest has been the price of Crude Oil.

Crude Oil Price Volatility

Immediately following the invasion, Crude Oil prices soared past US$100/ barrel. For context, the average crude oil price during the previous 2 years leading into 2022 was US$55/barrel. During the first 2 weeks of the crisis, Crude Oil has bounced around between **US$95/barrel - US$130/barrel.** We anticipate that this **high pricing volatility** will gradually ease as markets adjust to the supply-shock.

Who imports fuel?

PNG's fuel supply industry is heavily dependent on importation. The major companies that procure fuel are Mobil (refined fuel) and Puma Energy Refining Ltd (refined and crude). Puma Energy Refining imports crude oil which it processes at its Napa Napa refinery.

Distribution

Refined fuel products are distributed by the following companies in PNG: Total, Bige Petroleum, Mobil, Islands Petroleum, Niugini Oil Company and Puma Energy PNG Limited (separate from Puma's refinery business) .

Regulation

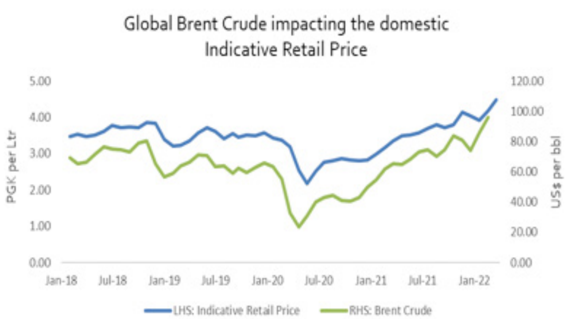
The **pricing of fuel** that is sold at retail outlets is calculated and regulated by the **Independent Consumer & Competition Commission (ICCC).** This price is referred to by the ICCC as the **Indicative Retail Price (IRP).** The ICCC publishes the IRP schedule on a monthly basis and monitors the pricing activity. This schedule of IRP prices covers the indicative price for **petrol, diesel, kerosene and JET-A1 fuel** for aircraft operations.

What factors impact the IRP?

The ICCC takes into various factors when setting the IRP, including coastal shipping rates, road transport costs and Import Parity Price (IPP). The **IPP formula** was established in the initial Project Agreement between the Government and InterOil (later purchased by Puma Energy), when the NapaNapa refinery was constructed.

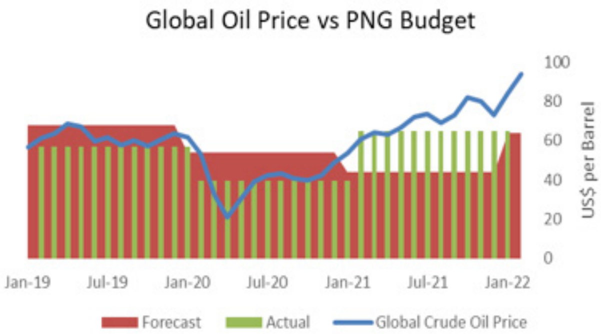
Before the Russian invasion took place, there was already a constraint on refined fuel imports due to the much publicised **shortage of Foreign Currency available to importers.** Now that global oil prices (denominated in US dollars) have increased, this problem has been exacerbated, with importers having to pay more PNG Kina for the same quantity. The IRP for petrol has increased by 14%, while the diesel IRP has increased by 18% since January. As indicated in the below graph, the IRP trends with the movement of global oil prices - *therefore what happens to global oil supply, and ultimately the oil price – impacts the IRP and therefore PNG households as well.*

Indicative Retail Price impacted by global supply



2022 Budget Financing

The below graph shows the average price of Crude Oil (US$ per barrel) since 2019. The brown area shows the PNG Government's Oil price assumption to forecast tax revenues from exporters, while the green columns represent the actual tax receipts. As noted in the graph, ***actual receipts*** have fallen short of the forecasts since 2019. In the 2022 Budget, the Government forecasted that the Oil price would be at US$64/barrel. However, as shown by the blue line, the global Crude Oil price has been on a steep upward trend since April 2020; and now the rise has been exacerbated by the supply shock caused by Russia's invasion of Ukraine.



Source: PNG Budget Database; World Bank Commodity Price Data (Pink Sheet)

What would higher tax revenues mean? Higher tax revenues will mean the Government **will not** need to borrow as much as it had initially planned to finance the 2022 budget. However, the tax revenues are always slow to come into Government accounts, and with the added pressures of the looming Elections, we remain conservative on the impact that forecasted higher revenues will have on the budget deficit – meaning that the Treasury may still execute its initial domestic financing plan.

Outlook Inflation

- Initial forecasts of 5.6% in the 2022 Budget were based off assumptions that global Brent Crude would be US$64/barrel.
- Current Oil prices have been 55% higher since the start of the invasion – which would naturally point to ***higher inflationary pressures (exceeding 5.6%).***
- The IRP has increased on average by *13.5% since the beginning of the year* for petrol, diesel and kerosene.
- *The fuel shortage and price increase will impact* electricity generation, airline airfares, motor vehicles and motor boats.
- The price volatility also needs to be considered in the longer-term. How long this crisis continues will also be a factor in forecasting the oil price for this year – it appears to be still *too early to ascertain a range for the oil price.*
- It remains to be seen whether the *inflationary pressures* could prompt *Government intervention* for fuel supplies to stem the rise in fuel-based consumption prices.

[1] ICCC Petroleum Industry Pricing Review 2019 Final Report
[2] The Project Agreement contains the formula that sets the IPP. The IPP is calculated to reflect the international price of refined fuel products delivered into PNG from Singapore (ICCC Petroleum Industry Pricing Review 2019 Final Report).

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