Managing Oil Wealth

- How large are the GCC oil reserves?
- How much oil does the GCC supply to the world?
- Is the GCC region still dependent on oil earnings?
- How large are the GCC sovereign wealth funds?
- How effectively has the GCC region managed its oil wealth?
- What are the common traits and differences between the oil surplus countries in the GCC and the West?
- What are the common traits and differences between the GCC and third-world oil surplus countries?
- Has the rise of shale gas threatened future oil earnings for the GCC?

INTRODUCTION

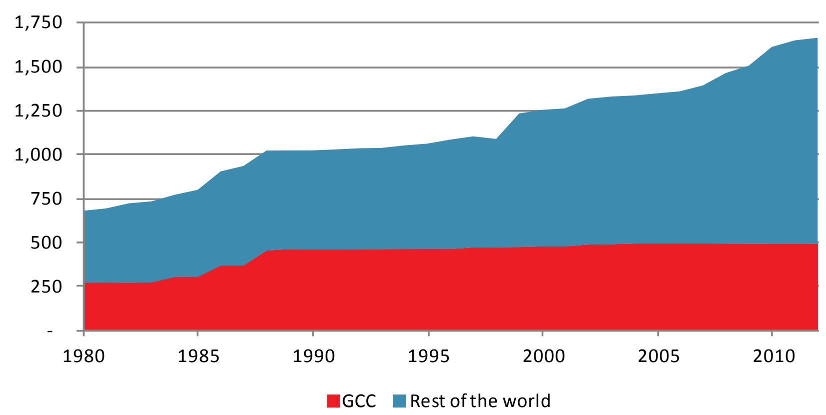
The GCC is an oil-rich region

Oil reserves and production in the GCC

GCC holds 30% of all the proven oil reserves in the world

The Gulf Cooperation Council (GCC) holds 30% of all the proven oil reserves in the world[1]. The region's share of proven oil reserves had reached a high of 45% in 1989. However, due to oil field discoveries in other parts of the world and high production of oil within the GCC, the share declined.

Exhibit 1: Proven oil reserves in the GCC vis-à-vis rest of the world (bbl billions)

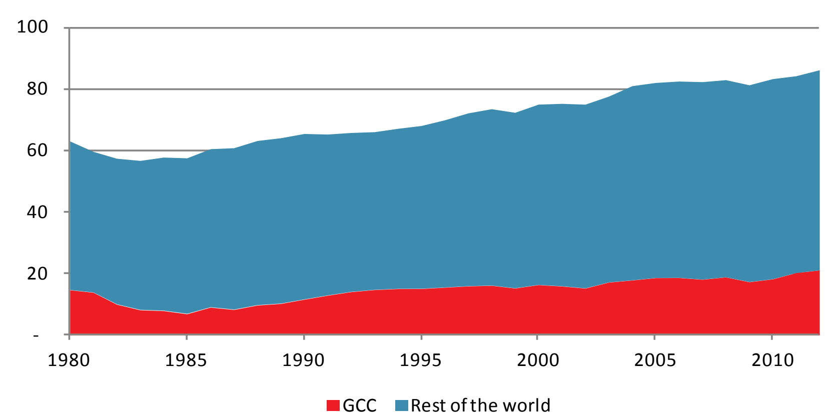


Source: BP Statistical Review, Al Masah Capital Research

The region accounts for one-fourth of the global oil production

Despite this decline, the world is getting increasingly dependent on the GCC for its oil needs. In 2012, the GCC produced 21 million barrels of oil per day, accounting for nearly one-fourth of the global oil production of 86 million barrels of oil per day.

Exhibit 2: Oil production in the GCC vis-à-vis rest of the world (bbl billions)



Source: BP Statistical Review, Al Masah Capital Research

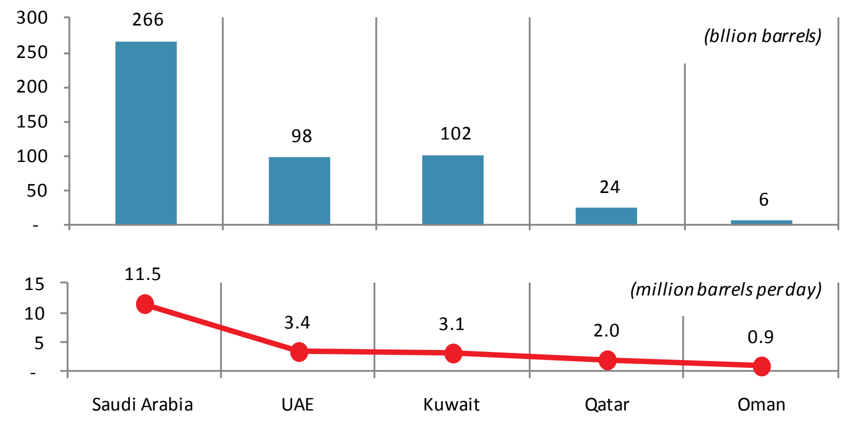
Saudi Arabia is the leading oil producer in the GCC. It holds 266 billion barrels of proven oil reserves, which, at the current production rate of 11.5 million barrels of oil per day,

[1] BP Statistical Review of World Energy, June 2013

Saudi Arabia is the leading oil producer in the GCC, followed by the UAE and Kuwait

could easily last another 60 years. The UAE and Kuwait are the other major oil producers in the GCC region.

Exhibit 3: GCC oil reserves and production in 2012



Source: BP Statistical Review, Al Masah Capital Research

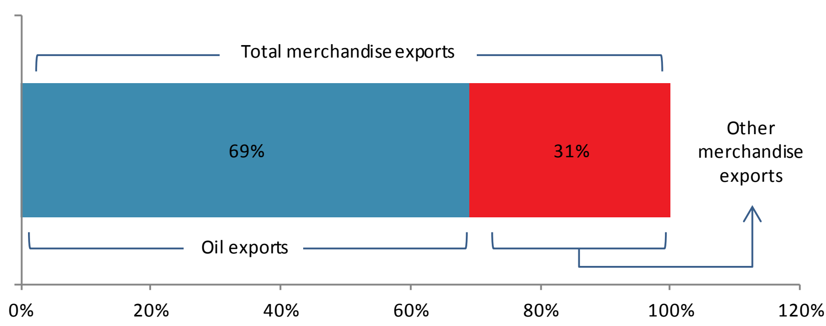
Oil dominates the GCC exports

Oil continues to dominate GCC region's exports, accounting for nearly 70% of all merchandise exports

According to the World Trade Organization (WTO), total merchandise exports from the GCC stood at USD1.06 trillion in 2012, up 11.8% from USD950 billion in 2011. In the same period, total oil exports from the region rose 8.1% to USD735 billion from USD680 billion[2]. The compound average growth rate (CAGR) of merchandise exports during 2008–12 stood at 6.8% versus 5.2% for oil exports.

Despite this growth, oil continues to dominate the GCC region's exports, accounting for nearly 70% of all merchandise exports.

Exhibit 4: Oil exports share in total merchandise exports for GCC (2012)



Source: WTO, IMF, Al Masah Capital Research

Oil exports formed 90% of total merchandise exports for Saudi Arabia, followed by Kuwait (89%), Qatar (82%), Oman (70%), and the UAE (33%).

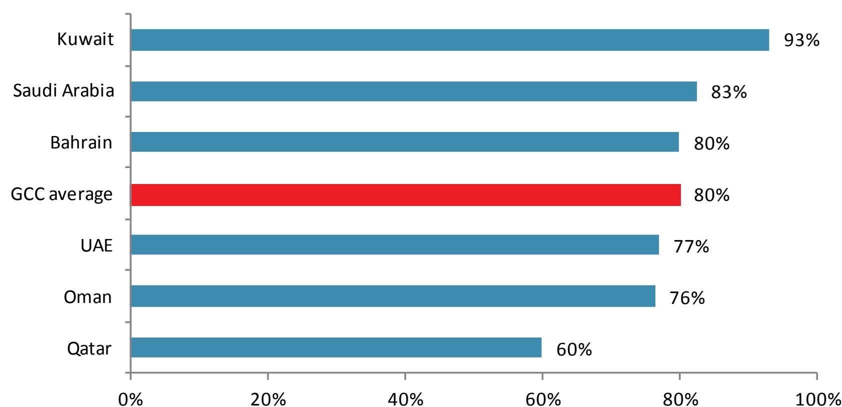
[2] International Monetary Fund WEO database, April 2013

Oil is an important source of income for GCC

Oil and gas form c.80% of government revenue for most GCC economies

Oil and gas are the mainstays of the GCC economies. In most GCC states, they form c.80% of government revenue[3]. Within the region, Kuwait's oil and gas resources account for the largest share (93%) of government revenues, followed by Saudi Arabia (80%), Bahrain (80%), the UAE (77%), Oman (76%), and Qatar (60%).

Exhibit 5: Oil revenue as a % of government revenues in the GCC (2008)



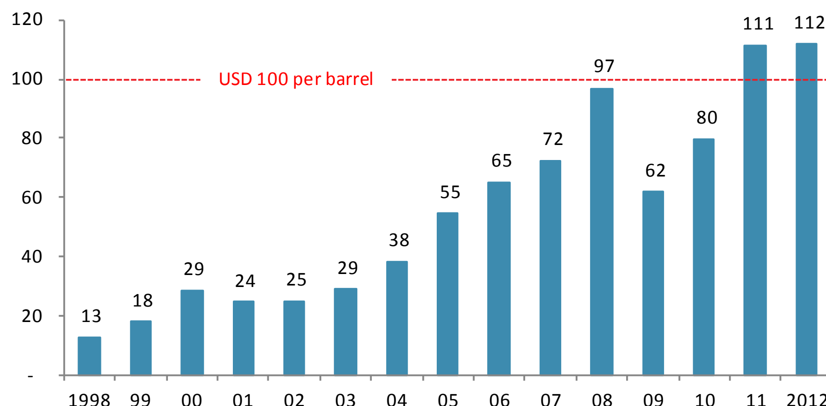
Source: MPRA Paper 21059 (Syed Abul Basher), Al Masah Capital Research

Secular uptrend in oil prices has resulted in massive oil wealth

GCC is enjoying the three-digit price of an oil barrel for the third year now

Price of Brent crude, the regional benchmark, averaged USD111.6 per barrel in 2012, about 0.3% higher compared with USD111.3 per barrel in 2011. Although the y-o-y increase could be considered to be miniscule, it was positive news for oil producing countries, especially in the GCC region, indicating that consumers have largely accepted the three-digit price of an oil barrel.

Exhibit 6: Brent oil price (per barrel) during 1998–2012



Source: EIA, Al Masah Capital Research

During 1998–2008, oil prices rose from a low of USD12.8 per barrel to USD96.9 per barrel (a CAGR of 22%), generating huge revenues for the governments of the oil-rich

[3]The GCC in 2020: Broadening the economy (EIU)

GCC countries. WTI went to USD146 per barrel in July of 2008. The price rise also compensated, to some extent, for the slow growth in oil production registered by GCC over the period.

The GCC oil production reported a CAGR of 0.7% during 1998–2008, rising from 16 million barrels of oil per day in 1998 to 18.7 million barrels of oil per day in 2008.

Role of OPEC

The OPEC has been regulating, monitoring, and advising on production, supply, and price stability for oil

The Organization of the Petroleum Exporting Countries (OPEC) is an organization of 12 oil producing and exporting countries, formed in 1960 for the purpose of regulating, monitoring, and advising member countries on production, supply, and price stability for oil. The OPEC member countries accounted for 43% of all crude oil production in 2012. In addition, they hold more than 70% of all proven oil reserves in the world.

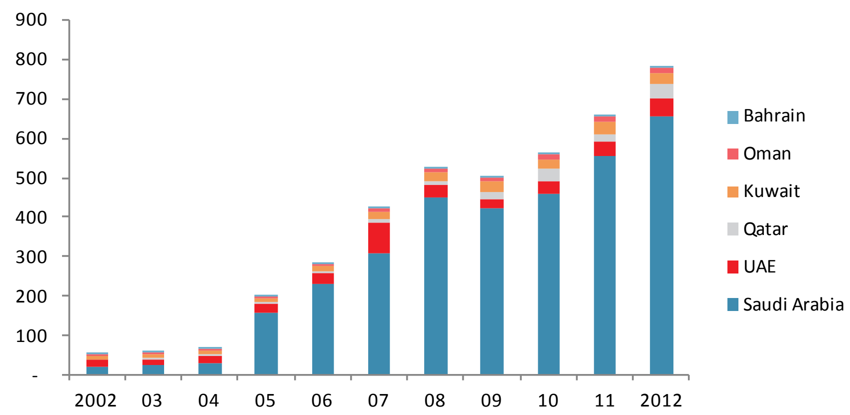
The 12 OPEC members are Algeria, Angola, Ecuador, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, the UAE, and Venezuela.

GCC foreign exchange reserves have expanded

Most GCC countries have significant foreign exchange reserves, attributed to increased oil production and higher crude oil prices. World Bank data indicates that total foreign exchange reserves for the GCC region expanded nearly 15x to USD785 billion in 2012 from USD54 billion in 2002. Saudi Arabia's foreign exchange reserves rose at an extremely fast pace, and it now holds the third-largest foreign exchange reserves in the world after China and Japan.

Total foreign exchange reserves for the GCC region have expanded at a quick pace

Exhibit 7: The GCC foreign exchange reserves over 2002-12 (USD billion)



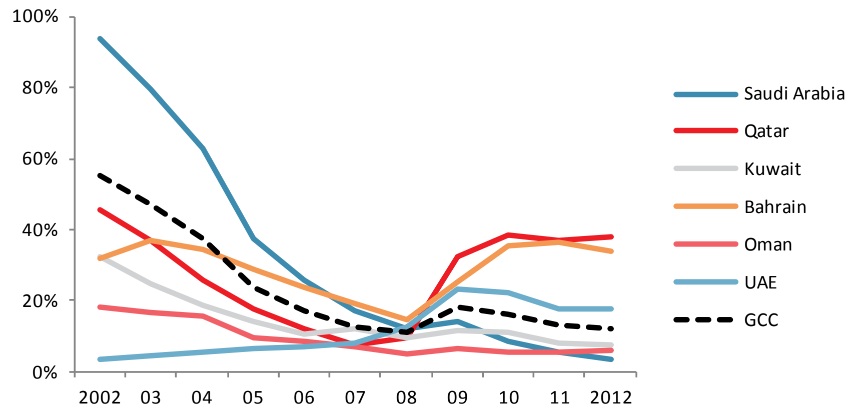
Source: The World Bank, Al Masah Capital Research

Oil income has led to a reduction in debt

Estimates from the IMF placed the total GCC gross debt at USD183 billion in 2012 (just 12% of GDP), down from a high of USD216 billion (55% of GDP) in 2002. Country-wise, absolute debt figures are the highest for Qatar, followed by the UAE and Saudi Arabia. However, when seen in terms of percentage of GDP, these countries are comfortably placed compared to many of the developed countries. Due to rising oil income, Saudi Arabia brought down its debt to 4% of GDP in 2012 from a high of 94% in 2002. Similarly, Kuwait's gross debt-to-GDP ratio reduced to 7% in 2012 from a high of 32% in 2002.

Oil income has led to a reduction in debt for the GCC countries

Exhibit 8: Gross debt as % of GDP over 2002–12



Source: IMF, Al Masah Capital Research

Creation of SWFs in the GCC

The oil boom led to the creation of Sovereign Wealth Funds in the GCC

The oil boom led to the creation of Sovereign Wealth Funds (SWFs) in the GCC.

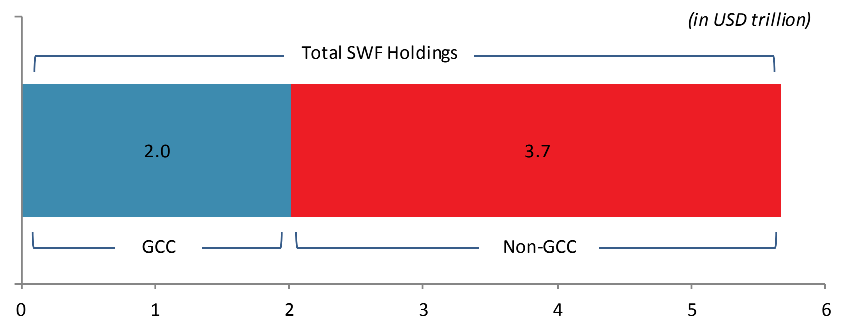
What are Sovereign Wealth Funds?

Sovereign Wealth Funds are government-owned investment vehicles that use national savings to acquire international assets for the purpose of stabilizing the economy in leaner years. SWFs are not a recent innovation and have been in existence for more than fifty years. The Kuwait Investment Authority, for instance, was created in 1953 from oil revenues.

Typically, SWFs have a diversified investment strategy. SWFs' portfolios include a wider range of financial assets, including fixed-income securities, equities, real estate, and alternative investments.

GCC SWFs hold as much as USD2 trillion in assets

Exhibit 9: GCC Sovereign Wealth Funds hold USD 2 trillion in assets



Source: Sovereign Wealth Fund Institute, Al Masah Capital Research

SWFs have grown rapidly over the past 10–15 years. In 1990, SWFs probably held a maximum of USD500 billion. According to the Sovereign Wealth Fund Institute, there exist about 70 Sovereign Wealth Funds (SWFs) in various parts of the world, owning almost USD5.8 trillion worth of assets.

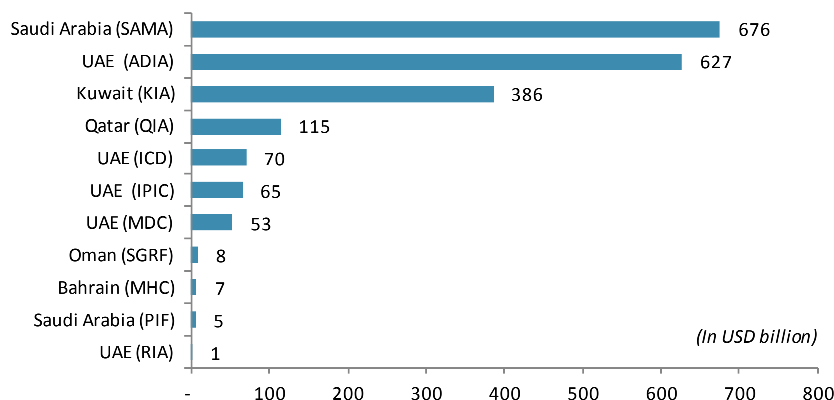
On account of the surplus petrodollars amassed, the SWFs in the GCC area account for 36% or USD2 trillion in assets under management (AUM) of total SWF assets globally.

SAMA Foreign Holdings is ranked as the second-largest sovereign wealth fund in the world

With an AUM of USD675.9 billion, SAMA Foreign Holdings (the SWF of Saudi Arabia) is ranked as the second-largest sovereign wealth fund in the world[4]. The Abu Dhabi Investment Authority (ADIA) is the third-largest SWF in the world. Established in 1976 by Sheikh Zayed bin Sultan Al Nahyan, the founder of the UAE, ADIA is headquartered in Abu Dhabi, and has AUM worth USD627 billion. Kuwait Investment Authority (KIA), established in 1953, is the sixth-largest SWF in the world, with total AUM of USD386 billion.

Other large SWFs in the region include Qatar Investment Authority (QIA), with an AUM of USD115 billion, followed by UAE's Investment Corporation of Dubai (USD70 billion), UAE's International Petroleum Investment Company (USD65 billion), Mubadala Development Company (USD53.1 billion), and Oman's State General Reserve Fund (USD8.2 billion).

Exhibit 10: List of GCC Sovereign Wealth Funds



Source: Sovereign Wealth Fund Institute, Al Masah Capital Research

Note: No details available on Emirates Investment Authority, Oman Investment Fund, and Abu Dhabi Investment Council

[4] Norway's oil fund is the largest SWF with an AUM of USD737.2 billion

HOW EFFECTIVELY HAS THE GCC REGION MANAGED ITS OIL WEALTH?

Where are they spending?

Economic diversification initiatives

GCC region has been targeting economic diversification

The GCC region has been targeting economic diversification for some time now. The money earned through oil helps the GCC governments in their pursuit of economic diversification. Economic diversification is required for several reasons. First, oil is a finite resource, it would not last forever. Therefore, the need arises to find other sources of revenue to run their economy once the oil resources are exhausted. Second, although oil has been the mainstay of many GCC countries, it causes erratic economic growth due to volatility in oil prices, which in turn hampers the development plans of the governments. Through diversification, the GCC seeks future stability and sustainability.

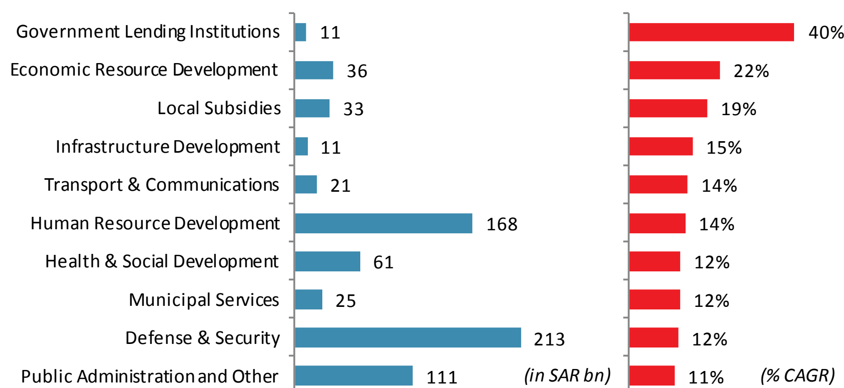
We take the case of Saudi Arabia, the largest economy in the GCC.

In 2012, Saudi Arabia earned USD350 billion from oil exports, the highest in the GCC. However, it also spent nearly USD230 billon to cover its annual budget expenditure for the same year.

The GCC is spending heavily on investment programs that enhance long-term sustainable economic growth and employment opportunities for its citizens

Studying Saudi Arabia's budgets during 2002–12, we understand that the country has been spending heavily on investment programs that enhance long-term sustainable economic growth and employment opportunities for its citizens. It has focused particularly on economic resource development, infrastructure development, transport & communications, human resource development, and health & social development.

Exhibit 11: Saudi budget allocations in 2012 compared to allocation CAGR during 2002–12



Source: KSA Ministry of Finance, Al Masah Capital Research

Creating a strong industrial and services base

As part of the economic diversification initiatives, the GCC governments undertook aggressive policy reforms and structural changes. Some concentrated on establishing a strong industrial base, while others emphasized on services.

Some GCC governments tried to create strong industrial base, while others emphasized on services

To benefit from comparative advantage, the GCC strategically targeted to develop energy-intensive industries such as petrochemicals, cement, and metals (including aluminum, steel, and copper), mostly through manufacturing free zones or specialized industrial zones. This was particularly witnessed in Saudi Arabia and the UAE. Establishment of SABIC, Dubai Aluminum, and Aluminum Bahrain are some of the live examples of the implementation of this strategy.

Exhibit 12: Some of the economic diversification strategies deployed in the GCC

1970s	1975	1980s
Energy-intensive heavy industry	Offshore banking hub	Free trade zones
GCC	Bahrain	Dubai

Source: Al Masah Capital Research

In addition to industrial sector development, the GCC also targeted to shore up its services sector. It planned to create the right infrastructure for becoming a service/financial hub, trade and transit center, and a tourist destination. In terms of services, Bahrain emerged as the banking and financial hub for the region, while Dubai developed its free trade zones and built/expanded its container port facilities to gain a foothold in trade and transport services.

Developing the GCC's social sector – a key to addressing the 'Arab Spring' and achieving economic diversification goals by leveraging oil wealth

The GCC governments are allocating larger funds to social developments

The GCC governments have realized that sustained economic growth and social harmony are contingent upon addressing youth unemployment and developing social infrastructure, primarily education, and healthcare. Although there are sustained efforts to develop the industrial and service sector base, results would be seen only when the local population is equipped with the requisite skills and knowledge to be able to benefit from the growth.

Accordingly, the GCC governments are allocating larger funds to social developments and are formulating policies more conducive for the social sector's growth. The Saudi government, for instance, increased allocation for education in its 2013 budget to USD54.4 billion, up 21% Y-o-Y. The program included construction of 539 new schools, 15 new colleges, facilities and campuses, among others. Furthermore, it raised the healthcare/social affairs spend by 16% Y-o-Y to USD26.7 billion toward construction of 19 new hospitals/healthcare centers and for continuation of work at 102 hospitals and five medical cities.

The UAE recently approved a USD12.5 billion federal budget for 2014, allocating a large share of 50.6% to healthcare and education. Mubadala, Abu Dhabi's SWF, has also made key domestic investments in the healthcare sector. Its notable investments include: Abu Dhabi Knee & Sports Medicine Centre, Capital Health Screening Centre, Cleveland Clinic Abu Dhabi, Healthpoint, Imperial College London Diabetes Centre, and Tawam Molecular Imaging Centre, among others. Mubadala is taking key steps to develop the education

sector, including organization of forums on career counseling and conducting educational tours. It is also a financial contributor to the Emirates Foundation, a charitable organization, and the Khalifa Fund for Enterprise Development to help fund a new generation of Emirati entrepreneurs.

Saudi Arabia, UAE and Qatar are allocating larger funds to social developments

Qatar is boosting its social development investments as well. The government is expected to invest a total of QAR38 billion in the healthcare sector for the next five years, an average of QAR7.6 billion per annum, under its 'National Health Strategy' (NHS), compared to a current annual expenditure of QAR1.34 billion. The number of projects under its NHS program has increased 30% since its launch in 2011. The Qatari government is one of the largest spenders on education in terms of budgetary allocations in relation to its GDP size. It is budgeted to spend about QAR22 billion in the education sector for the current fiscal year 2013–14. It is undertaking a USD7.5 billion expansion of the Education City, due to be completed in late 2014. The country is also expanding Hamad Medical City and Sidra Medical and Research Centre.

Pursuing strategic interests in foreign markets

Overview of the GCC SWFs

There are about 14 SWFs in the GCC, holding close to USD2 trillion

As mentioned earlier, there are about 14 SWFs in the GCC, holding close to USD2 trillion in AUM. However, many of them (including SAMA Foreign Holdings) continue to be highly secretive about their investment portfolios, making it difficult to analyze their investment strategy. Yet, owing to the transparency shown by SWFs such as Abu Dhabi Investment Authority (ADIA) and Qatar Investment Authority (QIA), it can be assessed that many GCC-based SWFs are making investments in foreign markets.

ADIA clearly states on its website that it does not invest in the UAE, nor does it invest in the Gulf region, except when the company is part of an index. In terms of portfolio holdings, ADIA has stakes in Citigroup, Gatwick Airport, Thames Water, and Ooredoo, among others.

Exhibit 13: Select investments by two GCC-based SWFs

Abu Dhabi Investment Authority		Qatar Investment Authority	
Investment	**Country**	**Investment**	**Country**
Citigroup	US	Xstrata	Switzerland
Gatwick Airport	UK	Barclays	UK
Thames Water	UK	Royal Dutch Shell Group	Netherlands
Ooredoo	Qatar	Tiffany & Co	US
Arab International Bank	Egypt	Alpha Bank	Greece

Source: Zawya

Prior to the Arab Spring, the GCC countries were focused on branding themselves. During distressed times, SWFs in the GCC region used the low market prices to acquire, what an Ernst and Young report refers to as, 'Trophy Assets'. QIA's investments in Credit Suisse, Barclays, Sainsbury, Volkswagen, Porsche, Tiffany, and their USD2.3 billion purchase of the luxury store Harrods, are prime examples of 'Trophy Assets'.

Role of SWFs has evolved – Strategic investments and political angles come to fore

SWFs are now investing in businesses that enable access to certain capabilities and knowledge

Apart from being pure financial investments and 'Trophy Assets', SWFs are have become a tool for making strategic investments. Such strategic investments could help the sovereign funds not only make investment for financial gain, but also help them get access to certain capabilities and knowledge. For instance, Abu Dhabi's SWF investment in the US-based General Electric involved technology transfer of the latter's renewable energy technology. Another example is the joint production and training agreement for electric automobile between Daimler and Abu Dhabi, following the Abu Dhabi SWF's USD2.7 billion investment in the former in 2009.

It is inevitable that large international investments, especially in critical sectors/areas would have political connotations. Such investments can be made for longer term to bolster inter-governmental ties. However, since SWF investments also have political involvement from the investing fund, they can be linked to political motives and may face opposition from investee countries. A famous example of the rejection of Dubai Port World's bid for the port operator P&O. P&O, a British company, was involved in the operation of sea ports in Eastern US, and Dubai's investment was considered by many in the US Congress as a national security risk, despite Presidential approvals. The deal got approved only after DP World agreed to transfer operation of those ports to US entities.

The GCC SWFs involvement in financial sector investments during the 2008/09 financial crisis helped change perceptions

The GCC SWFs involvement in financial sector investments during the 2008/09 financial crisis helped change perceptions

The GCC SWF investments in the financial sectors of the US and Europe during financial crisis have been viewed as an important source of capital at the time of liquidity crunch. Moreover, many of these deals turned out to be profitable investments for the SWFs. Abu Dhabi's International Petroleum Investment Co (IPIC) reportedly made a profit of GBP1.46 billion on a convertible note investment in Barclays in 2008. KIA made USD1 billion in profit in 2009 on a preferred capital investment in Citigroup. Qatar, on the other hand, has been active in investing in the European banking space, where it has made investments in Credit Suisse, Santander (Spain), and the EFG Eurobank/Alpha Bank merger support (Greece).

The SWFs' evolving foreign investment roles have thus gained many dimensions, encompassing financial, strategic, technical, and political aspects.

Has the management of oil wealth been effective?

Impact has been very limited – discussion on positive developments

The GCC has achieved a lot, but still faces some political, economic, and social challenges

Since the oil boom of the 1970s, the GCC countries have witnessed impressive social and economic progress. The sale of oil to high-demand but energy-deficient countries has resulted in a massive windfall for the GCC countries. The GCC governments have channelized this oil income into infrastructure development and for building a solid industrial base. However, the GCC still faces some political, economic, and social challenges.

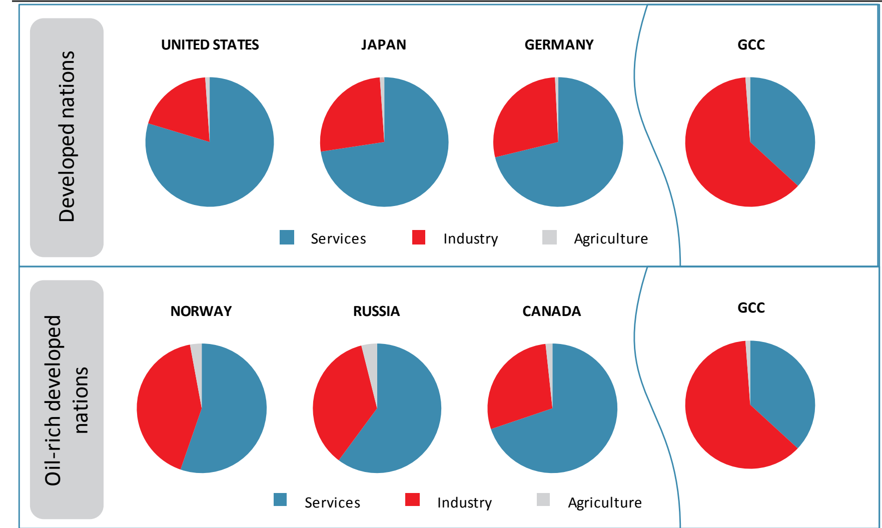
Economic structure has still not changed meaningfully, majority of government revenue still dependent upon oil

Growth in the GCC continues to be driven by the energy sector. The GDP composition of the GCC is tilted toward this sector (62% of the GDP). This is unlike the case in developed markets of the US, Japan, and Germany, where GDP is mainly composed of the services sector. Even in oil-rich developed nations such as Norway, Russia, and Canada, a substantial portion of the GDP is contributed by the services sector.

Majority of government revenue in the GCC is still dependent upon oil

The GCC countries where Industry forms nearly two-thirds of GDP are: Qatar (74%), Oman (66%) and Saudi Arabia (65%).

Exhibit 14: GDP composition of GCC vis-à-vis developed nations



Source: CIA, IMF, Al Masah Capital Research

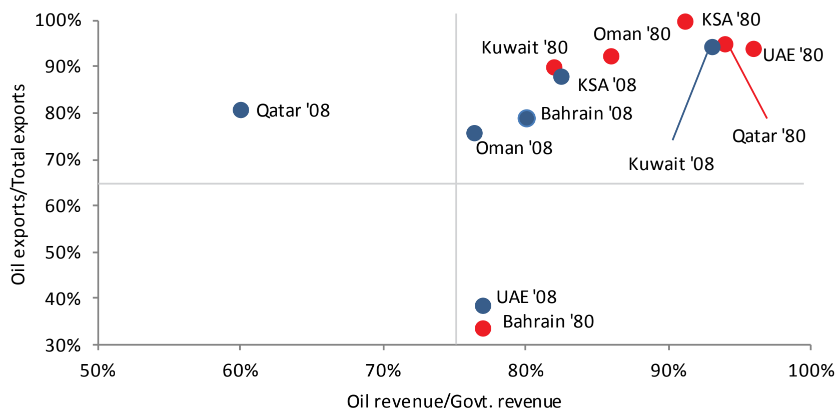
Oil and gas form the base of the GCC economies. In most GCC countries, they make up around 80% of export earnings and government revenue[5].

Kuwait's oil and gas resources account for 53% of GDP, 93% of government revenues, and 94% of export earnings. The situation in Saudi Arabia and Qatar is similar. Saudi Arabia's oil and gas resources account for 50% of GDP, 83% of government revenues, and 90% of export earnings, while those of Qatar account for 56% of GDP, 60% of government revenues, and 80% of export earnings.

[5] The GCC in 2020: Broadening the economy (EIU)

Oil and gas form the base of the GCC economies

Exhibit 15: GCC Countries: Oil Dependency from 1980 to 2008



Source: MPRA Paper 21059 (Syed Abul Basher), Al Masah Capital Research

Labor dynamics mostly unchanged; unemployment remains high

In the past, the GCC region relied on cheap foreign labor to meet its manpower requirements as the nationals either did not have the right skills or were keener to take up public sector jobs with higher pay and better entitlements. The number of working women was also low. This posed a challenge when the GCC realized that the population in the countries was rising fast and the educated youth would soon need jobs. The "Arab Spring" was a result of this shift which the governments did not foresee.

The GCC still relies on expatriate workforce

As a result, the labor dynamics remain mostly the same even now. According to the World Bank, there are an estimated 12 million expatriate workers in the GCC, with a majority being employed in financial, personal, and community service sectors, including construction activities.

Exhibit 16: GCC workforce (2010)

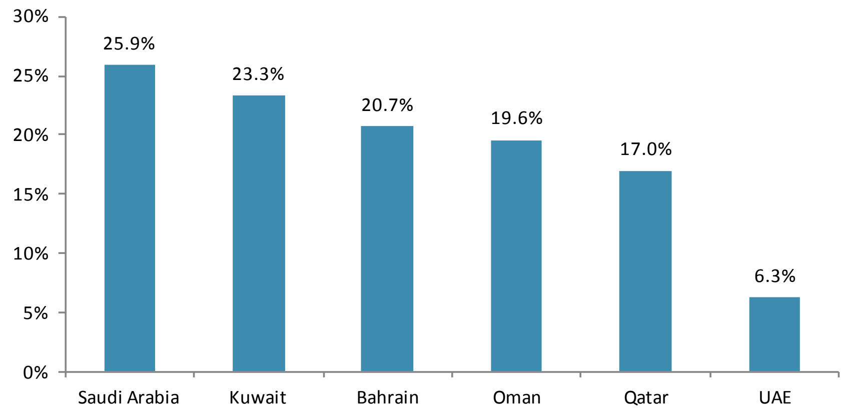
Country	Public Sector		Private Sector	
	Nationals	Expatriates	Nationals	Expatriates
Bahrain	88%	12%	18%	82%
Oman	86%	14%	16%	84%
Saudi Arabia	92%	8%	10%	90%
Kuwait	74%	26%	2%	98%
Qatar	44%	56%	1%	99%

Source: Assessment of International Migration In the Arab Region, June 2013

Despite efforts such as Nitaqat, Emiratization, among others, being undertaken, a lot of time would be required to change the labor dynamics in the region.

The GCC also suffers from high levels of unemployment, especially among the youth (age group of 15–24 years). In our report "MENA Land of Job Creation", we had mentioned that unemployment rate among youth in the GCC is the highest in Saudi Arabia (26%), followed by Kuwait (23%), Bahrain (21%), Oman (20%), Qatar (17%), and the UAE (6%).

Exhibit 17: Youth unemployment rate in GCC (2010)



Source: ILO, UNDP, Others, Al Masah Capital Research

A McKinsey report "The Power of Many" states that economic loss on account of youth unemployment exceeds USD40–50 billion annually across the Arab world.

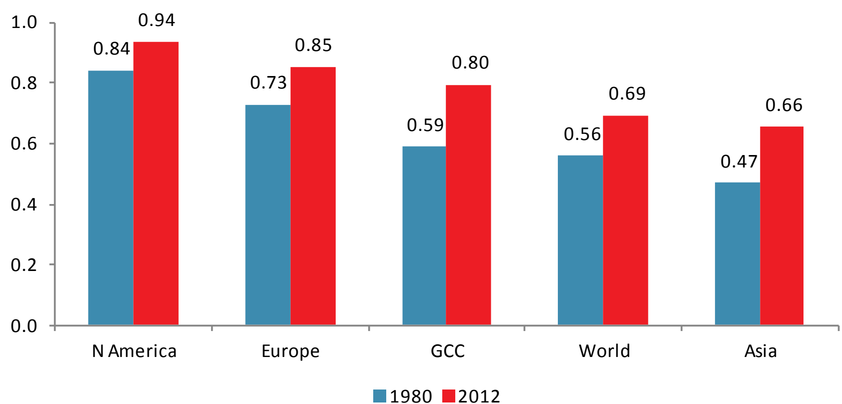
The GCC continues to trail Europe and North America on the Human Development Index

The GCC has registered remarkable improvement in its HDI scores; it still lags behind North America and Europe

We also referred the Human Development Index (HDI) to answer the question whether the management of oil wealth has been effective. Although the GCC has registered remarkable improvement in its HDI scores (0.80 in 2012 from 0.59 in 1980), it still lags behind North America and Europe.

The HDI measures the average achievements in a country on three basic parameters of human development: a long and healthy life, access to knowledge and a decent standard of living.

Exhibit 18: GCC remains below North America and Europe on HDI scale



Source: UNDP, Al Masah Capital Research

Qatar and the UAE are the two countries scoring high on HDI parameters in the GCC region. However, it seems that Saudi Arabia, the main oil producing nation, has been unable to effectively put its oil wealth to use. In terms of "Income" and "Health", Saudi

Arabia is ranks fifth within the GCC. "Education" is the only parameter where Saudi Arabia stands second in the region, after Bahrain.

Oil-rich developed nation Norway (with a score of 0.96) is ranked the top among the 186 countries tracked by the agency.

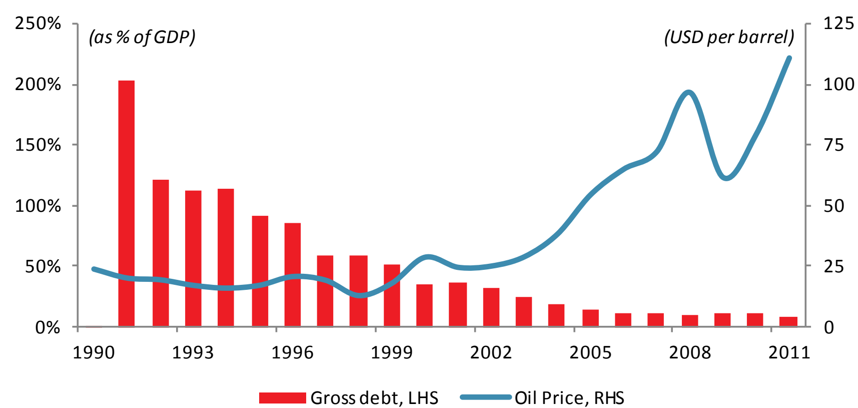
Key reasons as to why management of oil wealth has not been effective in the GCC?

Oil price volatility

GCC government budgets are highly vulnerable to changes in oil prices

The GCC has been pursuing its economic diversification strategy supported by massive oil earnings. However, considering the volatile nature of oil prices and the unpredictability of revenues it carries, their budgets are highly vulnerable to trade shocks such as the ones that appeared during the 1980s and 1990s, when oil prices plunged sharply. As a result, GDP dropped, and most GCC economies were burdened with debt. Debt as a percentage of GDP even breached 100% in several GCC countries such as Kuwait and Saudi Arabia.

Exhibit 19: Debt as a % of GDP for Kuwait versus oil price



Source: IMF, EIA, Al Masah Capital Research

Note: Debt figures for Saudi Arabia before 1999 are not available

Politically influenced

GCC spending seems politically influenced rather than need-based

The GCC governments' efforts to diversify economies away from oil have long been undermined by the trend of aggressively raising public spending, where money were spent on funding the salaries and subsidies rather than on productive economic activities. The stimulus measures announced during the Arab Spring showcase the same.

In 2011, Saudi Arabia, the largest economy in the GCC, announced a generous bonus to state employees, an increase in minimum wage, and loan forgiveness schemes, to stave off unrest rocking the Arab world. Other GCC countries were quick to follow suit. The UAE raised pensions for military personnel by 70%, apart from providing state subsidies for rice and bread. Kuwait gave cash handouts of USD3,500 to every citizen; it also made basic food items free for 14–18 months. Qatar announced USD8 billion for salaries and pensions of public sector employees. Oman raised minimum wages by 43% and

introduced unemployment benefits of USD390 per month, while Bahrain announced cash transfer of USD2,660 to each family.

Although measures like these might work well in quick-fixing problems, they place a strain on annual budgets, and force cuts in activities that are required for strengthening the economy.

Does the GCC suffer from the "Dutch disease"?

"Dutch disease" refers to the sudden discovery of a natural resource, such as oil and gas, which leads to an increase in the value of exports in a country causing the real exchange rate of the currency to rise. This in turn causes the exports of the pre-existing dominant sector (primarily manufacturing or agriculture) to become more expensive, resulting in its decline.

None of the GCC member countries seem to suffer from the Dutch disease

Dependence on oil carries some serious risks, including the so called "Dutch disease". However, none of the GCC member countries seem to suffer from the Dutch disease completely. This is because despite having oil as the prime export for over three decades, the GCC governments have efficiently managed their economies through diversification measures and stable exchange rate (a result of the currency peg). In addition to this, the GCC's dependence on foreign labor also works in its favor as labor migration offsets the negative impact caused by the resource movement effect.

Lessons from the Western oil-surplus countries

The GCC's common traits and differences with the Western oil-surplus countries

Our understandings are drawn from the attributes of Western oil-surplus countries

Think long-term, invest in socioeconomic development, inculcate a habit to save, and be transparent are some of the lessons drawn

First lesson is to think long-term as long-term investment decisions are a precursor for the success of any strategy. Second, invest in socioeconomic development that fuels economic growth. Third, inculcate a habit to save, since savings act as stabilization tools in years of distress. Fourth, be transparent, as transparency leads to trust and belief.

Let us consider Norway, an oil-rich country that is known for its effective use of oil wealth. Management of oil wealth by Norway is a highly discussed topic in the global financial sphere.

For the purpose of this discussion, "Norway" would represent the Western oil-surplus countries.

Norway became an oil producer in 1971, two years after the discovery of the Ekofisk field in the Norwegian continental shelf by Phillips Petroleum. Foreign companies dominated exploration off Norway in the initial phase, and were responsible for developing the country's first oil & gas fields. In 1972, Norway created the state-owned oil company Statoil. It also established the principle of 50% state participation in each production license. Norway established a proper system of balance and checks by separating ownership and management of its SWF. As a result, Norway runs the world's largest USD737.2 billion sovereign wealth fund, financed by the Nordic nation's oil wealth.

Like the GCC region, Norway is an oil-surplus country that generates billions of dollars in revenues annually from oil and gas. But important differences exist with regards to how

the GCC and Norway collect, save, and spend their wealth, and issue exploration/production leases.

Some of the common traits and differences between the GCC and the Western oil-surplus countries

Most of the GCC SWFs invest both inside and outside the country, whereas the Norway SWF only seeks investments outside the country to ensure risk diversification and to shield the non-oil economy from transitory and volatile revenues stemming from the petroleum sector. Moreover, each year, money is withdrawn from the Norway SWF only to cover any non-oil budget deficit, whereas the GCC countries rely more heavily on oil revenues to finance current spending.

Exhibit 20: Common traits and differences

	Factors	Western countries	GCC countries
Common	Government owns the resources	Statoil	Saudi Aramco
	SWF guidelines for investment	Well in place	Well in place
	Performance benchmarks	Yes	Yes
Differences	Taxes	Heavy taxes on oil companies' profits	Taxes are lower than the western countries
	Foreign investments	SWFs can only invest outside the country	SWFs can invest both inside and outside the country
	Fiscal spending rule	Maximum 4%	No such limit
	Transparency: investments and asset allocation	Transparent	Opaque
	Separate ownership from management of SWF	Yes	No
	Active management	Yes	Active to a certain extent, only

Source: Al Masah Capital Research

Saudi Arabia became an oil producer in 1938, after California Arabian Standard Oil Company (now Saudi Aramco) struck oil in Dammam. Saudi Aramco was granted a concession to extract oil for over 60 years. In 1950, the Saudi government and the company agreed to a 50:50 profit-sharing agreement. However, gradually, the Saudi government decided to take hold of this critical business and officially bought out the company and renamed it Saudi Aramco in 1980.

THE NORWEGIAN MODEL

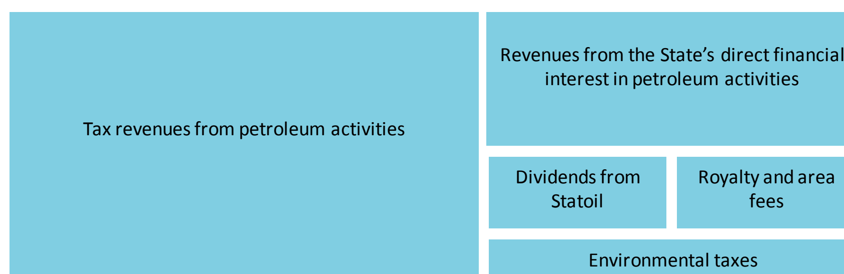
Norway established the Government Pension Fund Global (GPFG) in 1990 with a twofold purpose of establishing a long-term savings vehicle to secure the income from a non-renewable resource by investing in a diverse portfolio of international securities and for protecting the Norwegian economy by insulating it against the "Dutch Disease". The assets owned by the GPFG are not earmarked for any specific person, purpose, or organization. No one, individual or organization, has a direct claim to the GPFG's assets. All capital transfers are made directly into the state budget. From there, the Government of Norway utilizes the funds to benefit its people through public expenditure-related activities. To add fiscal pressure on government spending, the size of the transfer from the fund into the budget cannot exceed a long-term average of 4%. This corresponds to the Fund's expected long-term annualized return. Thus, during booms, when there is sufficient income from tax revenue, the government withdraws

less than 4% from the fund, and during busts, when there isn't enough revenue from the tax income, the government withdraws more than 4%, ensuring that it meets the long-term average of 4%.

Inflows into the fund

Norway generates money for the fund from various sources. Taxes[6] contribute the most to government petroleum revenues, accounting for almost 60% of the total net cash flow. Revenue from the State's direct financial interest (SDFI) in petroleum activities is the second- largest source of revenue, contributing around 30% of the total net cash flow. Other sources of cash flow include royalty and area fees, taxes on CO_2 and NOx emissions due to petroleum activities, and dividends from 67% ownership in state-owned oil company Statoil.

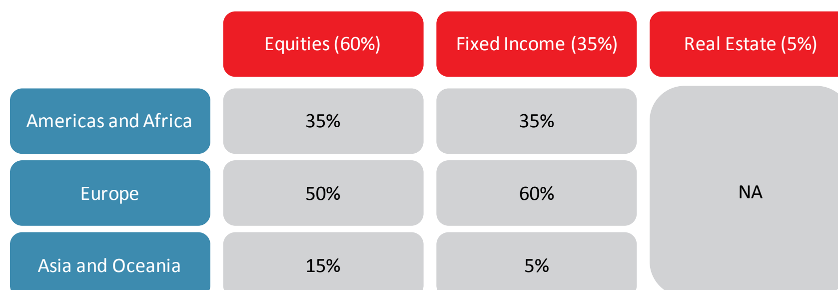
Exhibit 21: Inflows into Government Pension Fund – Global



Source: Norges Bank Investment Management, Al Masah Capital Research

Norway has adopted a sensible approach to oil wealth management. First, its SWF strictly invests outside the country to avoid overheating. Second, the SWF invests in global stocks, bonds, and real estate. Norway's SWF is allowed to invest up to 60% of its portfolio in the international stock market, 35% in fixed income (bonds), and 5% in real estate. Within equities, the allocation is 50% in Europe, 35% in the Americas, Middle East and Africa (AMEA), and 15% in Asia and Oceania. According to NBIM, the fund had 63.4% of its money in equities and 35.7% in fixed-income investments, and the remainder in real estate[7].

Exhibit 22: Asset allocation by NBIM



	Equities (60%)	Fixed Income (35%)	Real Estate (5%)
Americas and Africa	35%	35%	NA
Europe	50%	60%	
Asia and Oceania	15%	5%	

Source: The Case of the Norwegian Sovereign Wealth Fund, Jan Isaksen)

[6] Norway charges 28% corporate tax to oil companies drilling in their territory
[7] Market value (Key figures), 2Q 2013

The ownership and management of Norway's SWF are handled by two separate agencies. While the Ministry of Finance is the owner, Norges Bank Investment Management is the operational manager. Accordingly, the Ministry of Finance decides the investment strategy (encompassing strategic benchmarking, rebalancing scheme, scope of active management, and investment universe). It also develops ethical guidelines and monitors the performance of the operational manager. NBIM invests the monthly inflows in accordance with the investment strategy laid out by the Ministry. NBIM actively manages the portfolio within risk limits to achieve excess return.

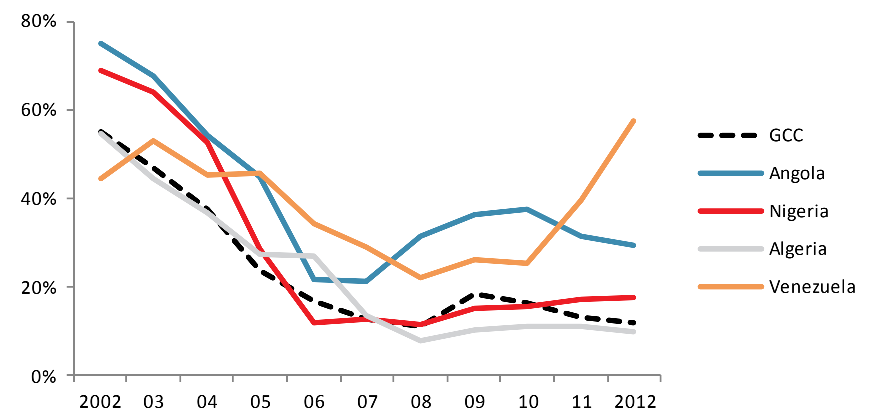
Is the GCC better off than third-world oil surplus countries[8]?

Third-world oil surplus countries hold more debt than the GCC

Third-world oil surplus countries have cut their debt levels, but do not fare as well as the GCC countries

In consideration of debt to GDP, it can be seen that while most third-world oil producing countries have been able to cut their debt from where they stood at the beginning of last decade, they still do not fare as well as the GCC countries.

Exhibit 23: Gross debt as % of GDP over 2002–12



Source: IMF, Al Masah Capital Research

In 2012, total GCC gross debt was just 12% of GDP compared to countries such as Venezuela (57%), Angola (29%), and Nigeria (18%). Only Algeria seems comparatively better with a debt-to-GDP of 10%.

Third-world oil surplus countries are ranked low on the "Ease of Doing Business index"

Saudi Arabia is ranked 22 on the "Ease of Doing Business index"

The third-world oil-producing countries are also below the GCC countries in the Ease of Doing Business index compiled by the World Bank. Saudi Arabia leads the GCC countries with the rank of 22. It does well on parameters such as paying taxes and property laws. The UAE comes next, at rank 26, scoring high on paying taxes, property laws, and conditions for starting a business. Most GCC countries are ranked high on the paying taxes parameter.

The third-world oil producing countries seem to suffer from heavy red-tape on starting a new business and on tax laws. The highest ranked third-world oil producing country is Nigeria, with a rank of 131. It manages just about an average score on getting credit and

[8] Third-world oil surplus countries include Nigeria, Venezuela, Angola, Libya, and Algeria

protecting investors. The other countries are Algeria rank (152), Angola (172), and Venezuela (180).

The GCC's common traits and differences with the third-world oil surplus countries

Just like the GCC, many of the third-world oil surplus countries indulge in inefficient use of windfall revenues

There are many common traits and differences between the management of oil wealth in the third-world oil surplus countries and the GCC nations.

- Increasing wasteful expenditure such as subsidies: just like the GCC, many of the third-world oil surplus countries indulge in inefficient use of windfall revenues such as granting subsidies (especially fuel price subsidies and electricity subsidies) to the people for political purposes, which would be difficult to sustain once oil revenues dry up.
- No reciprocity between citizen and government: governments in the GCC and the third-world oil surplus countries have not been able to establish an efficient tax system because of direct access to oil income. As a result, the link between implicit tax collection and the social services provided by the state has been severed.
- Investment in over-ambitious projects: several public investment projects in the GCC and the third-world oil surplus countries are either on hold or have been found to yield minimal rates of return.

Additionally, unlike the GCC, many of the third-world oil surplus countries suffer from corruption and regular conflicts.

HAS THE RISE OF SHALE GAS THREATENED FUTURE OIL EARNINGS FOR THE GCC?

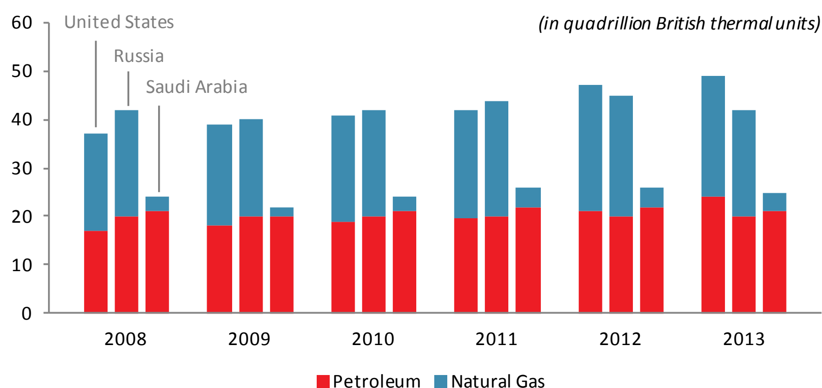
The shale oil revolution in the US (and the larger part of North America) could pose a serious threat to the GCC oil nations. The US is emerging as a major energy producer, partly due to development of its shale gas reserves.

The US is likely to become the top producer of petroleum and natural gas hydrocarbons in 2013

US is expected to be the largest producer of petroleum & natural gas hydrocarbons this year

According to the US Energy Information Administration (EIA), the US is likely to become the top producer of petroleum and natural gas hydrocarbons in 2013, moving past Russia, the current leader. The EIA projects that between 2008 and 2013, petroleum production in the US would rise roughly 7 quadrillion British thermal units (Btu), while natural gas production would move up by about 3 quadrillion Btu. The agency mentions that growth in hydrocarbon production has come about mainly on account of the rapid increase in production of shale gas in the US.

Exhibit 24: Estimated petroleum and natural gas production in US, Russia and Saudi Arabia



Source: US EIA

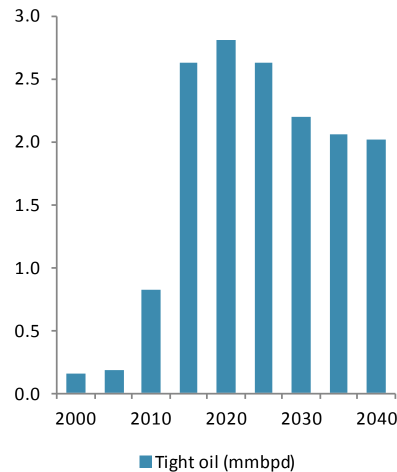
Shale gas production by the US is expected to cross 16.7 tcf per year by 2040

Discovery of shale oil & gas reserves is bringing about this change

Shale has played an important role in increasing the production of liquid fuels in the US. From a rate of 0.54 million barrels of oil per day (mmbpd) in 2008, the tight oil/shale oil production jumped nearly four times to about 2 mmbpd in 2012. Production from key shale plays Bakken and Permian Basin moved up at a CAGR of 49.5% and 31%, respectively, over 2008–12. Considering the massive potential of the shale play in the US, the EIA projects shale oil production to reach a peak of 2.81 mmbpd by 2020 before declining to 2.19 mmbpd in 2030 and 2.02 mmbpd in 2040. The shale gas play is expected to display a continuous increase in production until 2040. Shale gas production by the US is expected to cross 16.7 tcf per year by 2040 from 4.86 tcf per year in 2010. The process of oil and gas extraction from shale rock formations has developed rapidly in the US (whose recoverable shale oil resources amount to 58 billion barrels), according to

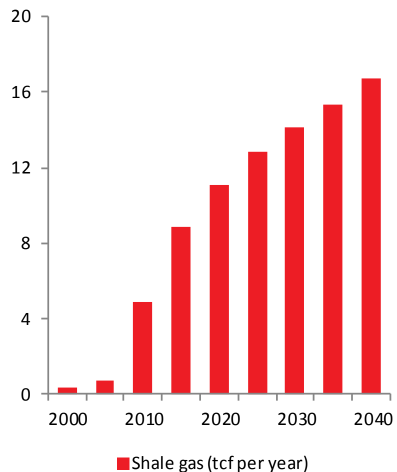
the US EIA. The US also boasts of 665 trillion cubic feet of technically recoverable shale gas.

Exhibit 25: US shale oil production (2000–40)



Source: US EIA

Exhibit 26: US shale gas production (2000–40)



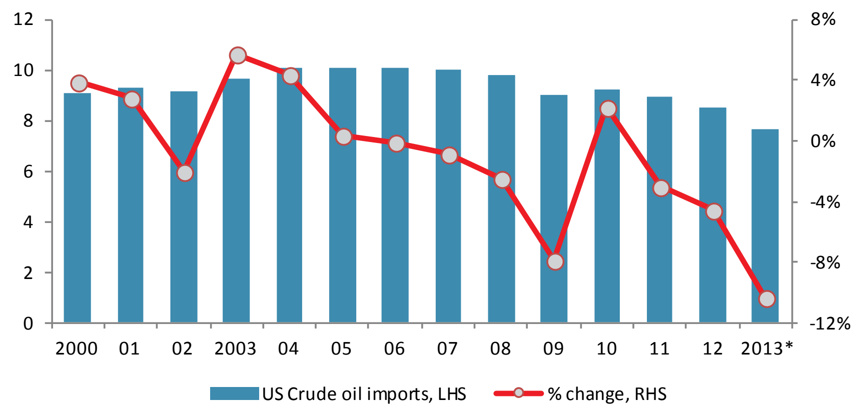
Source: US EIA

US crude oil imports have been on a decline

The US has been importing lesser quantities of crude oil

The US has been importing lesser quantities of crude oil. In 2012, the US crude oil imports fell to 8.53 million barrels per day (mmbpd) from 8.94 mmbpd in 2011. Oil imports averaged 9.21 mmbpd in 2010. The reasons for this are: the US economy (in line with the global economy) is going through a difficult period; the Arab Spring caused disturbances in the world oil supplies; US domestic energy production has risen; and the US energy demand has witnessed a decline. However, the most important factor posing a serious threat to the GCC oil exporting countries is the rise in US energy production.

Exhibit 27: US crude oil imports (million barrels per day)



Source: US EIA

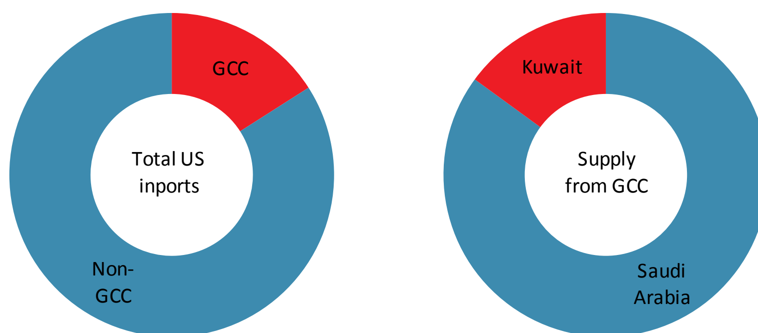
Note: 2013 figures are for the first half of the year

This could hurt the GCC oil exporters, especially Saudi Arabia

Saudi Arabia accounted for a massive 16% of US oil imports last year

The rising shale oil & gas production in the US could significantly alter Saudi Arabia's export mix, as the Kingdom accounted for a massive 16% of US oil imports last year. Saudi Arabia and Kuwait are the two major GCC-based crude oil exporters to the US. Alternately, the US consumes about 10–12% of all crude oil produced by Kuwait and Saudi Arabia.

Exhibit 28: Saudi Arabia is the largest GCC-based crude oil supplier to the US



Source: US EIA

However, shale production is a high-cost proposition

Shale oil extraction is relatively high-cost and much more complex compared to crude oil extraction

Shale oil extraction is relatively high-cost and much more complex compared to crude oil extraction. It is more difficult to extract shale oil because it is heavier and doesn't flow as easily. New technologies such as fracking are boosting shale oil production in the US, but they are a high-cost proposition. Extracting shale oil is believed to cost nearly 20 times and even more, as compared to extracting the most easily accessible crudes in the GCC[9]. This essentially means that if oil prices were to fall below the current levels, it would stave off the threat of shale oil to the GCC and other conventional oil producing countries.

[9] US shale: Better drilling techniques line road to profit (Financial Times, May 2013)

CONCLUSION

Petrodollars earned by the GCC are now being well spent

The GCC is learning to manage its oil wealth better. The petrodollars earned are now being well spent on building social infrastructure to empower the local populace with the requisite skills and knowledge to be able to create a knowledge economy, and on economic diversification initiatives.

There is no standard model that can be adopted; however, there definitely are best practices that could be picked-up, modified, and adapted

Although most would agree that there is no standard model that can be adopted by an oil-rich country on belief that it worked well in another oil-rich country; however, there definitely are best practices that could be picked-up, modified, and adapted so that the results are in line with targets. The GCC could also take note of mistakes/faults of other oil-rich countries and cut down on wasteful expenditure such as subsidies and investment in over-ambitious projects that yield minimal rates of return or never see the light of day.

On the positive side, the GCC has both oil and price in its favor, which gives it the time and resources to try methods to manage its oil wealth better. The region has vast reserves of oil, which could easily last for a few more decades. It is also benefiting from a secular uptrend in oil prices, which have been favorable for the past two years, with no eclipse in sight.

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