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DeFacto **ARTICLE**

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# FUEL PRICE: SWORD AND SHIELD

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WEEKLY

# The DeFacto Gazette

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## FUEL PRICE: SWORD AND SHIELD





№ 479

**JARGALSAIKHAN Dambadarjaa**

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# FUEL PRICE: SWORD AND SHIELD

**T**wo days ago we saw fuel prices increase in Ulaanbaatar yet again. The AI-92 fuel, which takes up 80 per cent of Mongolia's total fuel consumption, is currently being sold for 1,855-1,880 MNT per liter, which is 70-90 MNT dearer from the rates a week ago. Also, the price of diesel fuel has also gone up by 30-40 MNT per liter.

When fuel prices increase, we also see an increase in consumer goods, especially food products. However, the correlation doesn't work the other way – a reduction in

fuel prices doesn't mean cheaper consumer goods. So, when the sword of fuel prices strikes, it cuts down the real income of people.

*The fluctuations in fuel prices depend on three key factors:*

- Fuel supply being fully dependent on imports;
- Fluctuations in MNT rate; and
- Government attempts to set fuel prices.

## PLATTS PRICE AND MONGOLIA'S SOLE SUPPLIER OF FUEL

It can be said that Mongolia's sole supplier of oil products is Rosneft. Their oil refinery at Angarsk is the closest refinery to our northern border, which means it has the lowest cost of transportation. Therefore, Rosneft beats the competition from any other location.

Starting from five years ago, Mongolian companies reached a long term agreement with Rosneft to pre-determine the volume of fuel that will be supplied every month. It has improved the reliability and continuity of our fuel supply.

The agreement tied the price of fuel to the internationally accepted rates produced by Platts, a Singapore-based organization that determines the price of oil products. The price was set to be the average Platts rate of a given month. It has also enabled a better projection of how

the price is likely to be set the next month. Previously, the Russian manufacturer set its prices to their liking every month and made a different deal with Mongolian companies that import fuel. At the same time, these prices had also been dependent on changes to Russian exports and other taxes, price fluctuations in the domestic market, and changes to the railway tariffs.

In April 2019, the price of AI-90 and AI-92 fuel increased by 71 USD per tonne, compared to the month before. In May 2019, these prices went up by 47 USD compared to the average prices in April. Hence, the importers have decided to increase the fuel prices offered to customers. If the outlook of Platts prices is not to change, the price of fuel is projected to go up by 22 USD in June, while the price of diesel fuel increases by 17 USD.

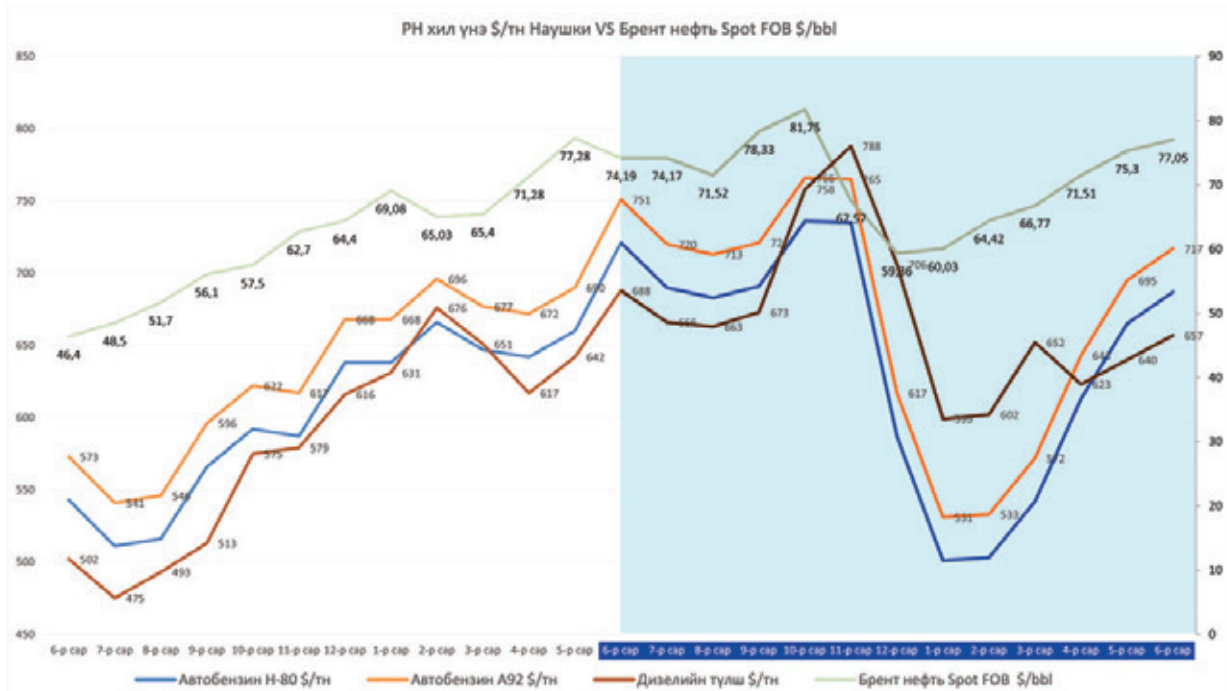


## ▶ OIL PRICES AND USD RATES

The price of oil is dependent on its key commodity – crude oil (Graph 1). Both prices are expressed in USD. There are two most commonly used prices on the international market. One is the European / Brent prices, and the other is the U.S. / WTI (West Texas Intermediate) prices. These two prices are subject to constant changes

triggered by many different factors. In the bigger picture, these factors often relate to the relations between the United States and OPEC (The Organization of the Petroleum Exporting Countries) as well as Saudi Arabia, Russia, and China.

| Graph 1



Globally, the United States and China are the largest consumers of crude oil. Thanks to their shale fracking technology, the United States have recently become the largest producer of oil. The escalation of the trade war between the United States and China impacts the global economy negatively and brings down market demands, which – in turn – reduces oil prices. However, the most recent expectation is that the price of oil will go up, because the commitment these two countries have made to resolve trade issues would affect the global economy positively and increase market demand. With the shale fracking technology, the United States has increased its extraction of oil. The price of oil goes down when the oil reserves increase. If the oil reserves decrease and so does the production, it drives the market demand up and increases prices. This year, it is projected that the United States will see a weaker growth of shale production, which is expected to increase the oil prices rather than bringing the prices down. Also, the positive outlook of the

U.S. economy would contribute to increasing oil prices. When the USD gets stronger, it looks as though the price of oil goes down.

OPEC and Russia are freezing their oil production in unison. Analysts expect that it will restrict the supply of oil and remove surpluses, which may even create a shortage and will increase prices.

The United States has put sanctions in place against Iran and Venezuela to stop their oil exports, which continues to drive oil prices higher. Generally, prices usually go up when there is instability in the oil exporting countries, including Iraq, Iran, Libya, Sudan, and Venezuela. Also, warmer seasons contribute to an increasing consumption of oil products, which also increases prices.

The overall expectation today is that the price of oil will increase in the short term. In Mongolia, when USD gets stronger, MNT sees weaker rates. As a result, consumer goods importers are driven to increase their prices. ▶▶

▶ **GOVERNMENT POLICY IN SHAMBLES**

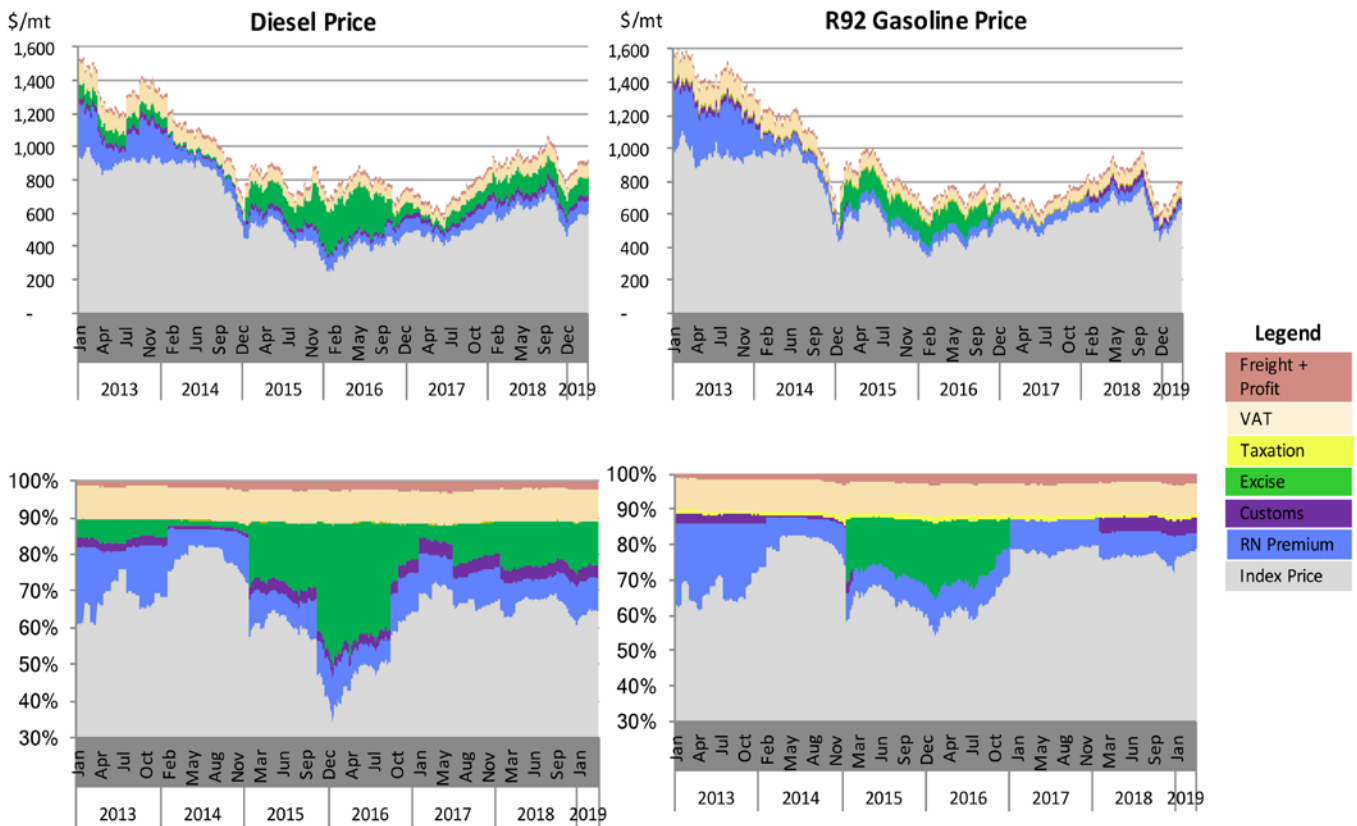
The Mongolian government pretends that they're caring for the people when they set the prices of consumer goods. However, this action eventually results in causing more harm than benefit. Fuel prices are still controlled by the government via specially imposed taxes. This special tax, which comprises 25-50 per cent

of the fuel prices, has been reduced when USD grew stronger and increased when USD weakened (Graph 2). However, instead of setting this tax as per a certain percentage in the prices at the border, this tax is directly imposed as MNT per tonne. Therefore, the prices don't go down when and if MNT sees stronger rates.

| *Graph 2*

**MONGOLIAN PRICE STABILIZATION**

**5 YEAR PRICE HISTORY**



If the price is set by the market, consumers will benefit the most in the long term. It will also make it easier to predict the market and reduce inflation. It is only the prices set by the market that can give consumers the most accurate information, which will help them understand the cost structure and make decisions for the short and

long term. If fuel prices are set by the market instead of the government, there will be a healthy competition between fuel importers. When the fuel importers start cutting down their costs to become more competitive, consumers will enjoy cheaper prices. ▶▶

► **SHIELD THAT PROTECTS FROM PRICE INCREASES**

Even if Mongolian companies realise that the prices will go up next month and want to stock up the fuel bearing their own risks, they cannot order more fuel due to their limited storage capacity. Different types of fuel products require different storage specifications; therefore, it is largely impossible to stock up for a duration of more than one month. For example, they need to exhaust the diesel fuel for winter first, before they can purchase the fuel for summer. Given the lack of free competition, significantly reduced profitability of fuel business, and high loan interest rates, the fuel importers rarely have the financial capability to stock up fuel. Also, if the prices do the unexpected and go down instead of up, they will

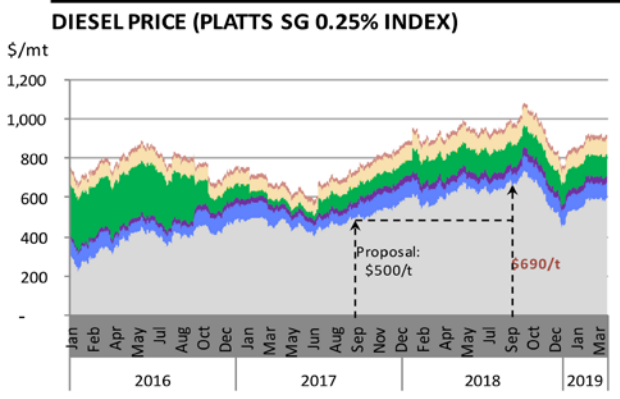
have to sell at lower prices and run a loss.

Insurance is a way to protect oneself from risks. In commerce, the insurance that protects you from adverse effects if price fluctuations are called 'hedging'. How does hedging work as a shield? Simply put, hedging works on the basis of doing an agreement on a specific price. When the agreed time comes, the agreed price comes into effect, regardless of how the price on the market has changed (Graph 3). To enable this arrangement, you have to pay a premium in advance. The insured party benefits when the price increases and loses if the price goes down. Vice versa for the party that provides the insurance.

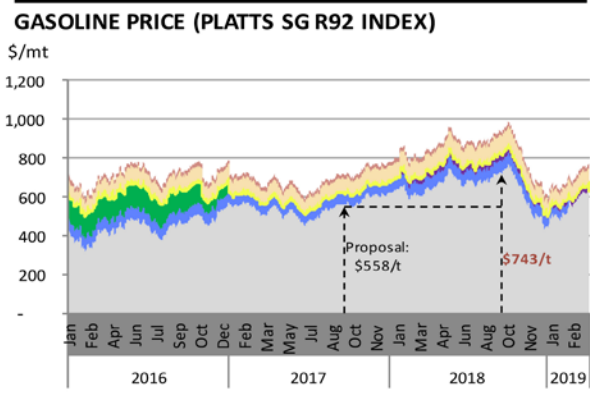
| Graph 3

**MONGOLIAN PRICE STABILIZATION**

**RECENT PRICE INCREASE**



- Diesel price increased to \$690/t (↑ \$190/t) since our original 1 year option proposal in Sep-2017.



- Gasoline price increased to \$743/t (↑ \$185/t) since our original 1 year option proposal in Sep-2017.

Дизель	Strike		Option Cost	
	\$/bbl	\$/mt	\$/bbl	\$/mt
<b>6 Month</b>	80.26	598	5.27	39
<b>12 Month</b>	80.66	601	6.82	51

Gasoline	Strike		Option Cost	
	\$/bbl	\$/mt	\$/bbl	\$/mt
<b>6 Month</b>	76.74	639	4.95	41
<b>12 Month</b>	77.41	645	6.30	52

The international commodity traders who have large trade turnovers often use this shield. There is even another type of hedging that gives you an option to choose the new price. If prices decrease and you choose to buy with the decreased price, there is an additional payment. The reason this option is selected is that, if you don't buy at the reduced price and be able to sell at the same lower price as your competitors, there is a risk of losing your market.

Hedging and having options are highly costly, therefore there is no other choice to use international trading companies as an intermediary. If the government chooses to continue its price controlling policy, they need to build a fund using the revenue from special taxes, so that they can do hedging.



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## HEDGING FUEL PRICES TO COMBAT INCREASES IN THE PRICE OF FUEL

Fuel price in every country depends on the price of petroleum products. Countries that don't produce petroleum are also dependent on raw materials. In the Mongolian market for example, fuel prices are dependent on the price of petroleum products in the Singapore market where an S&P Global Platts, an institute that publishes fuel prices on a weekly basis. I wrote an article on fuel prices that will be published in this week's gazette. It details the factors that influence fuel prices, one of which is definitely the price of raw materials measured by WTI and Brent.

The price of those raw materials is cyclical in nature and depends on relations between big powers such as the US which has become the biggest producer of oil thanks to the oil shell and China is the largest consumer. It is dependent also on efforts of Russia and OPEC to limit the production of oil. Controlling the production of a limited resources artificially increases its price. Many things also depend on the situation in oil producing countries such as Iraq, Iran and Venezuela.

Mongolia is on the other hand dependent on one refinery in Angarsk, near Baikal lake as other suppliers are unable to compete with the prices they offer. I wrote another article on how Russia utilizes its vast resources within the framework of a carrot and stick approach. This gives us grounds to be careful but Rosneft, the owner of the refinery proposed Mongolia buys a stake in the refinery which we declined. A 10 million USD was also presented by them to the President of Mongolia for the 70th anniversary of the battle of Khalkhiin Gol during the war with Japan.

Two requests that were made by Rosneft were that they operate their own gas stations on the Mongolian side of the border and on the supply of kerosene to the two major airports in Mongolia. The first request was unfeasible given that there are regulations in Mongolia prohibiting the entrance into retail of suppliers who supply more than 30%



of a given product. It seems however that we are moving forward with the second request.

The fuel price in Mongolia is dependent on the price of oil and oil products on the international market as well as the exchange rate given that we purchase in USD and sell in MNT. In order to combat the erratic fluctuations of the fuel prices, we can implement an insurance mechanism called hedging. It establishes a set price at which we will purchase a commodity for a given period of time. The risk is that if the market price of the commodity falls below the set price, we would lose the difference.

Even if we wanted to pursue this however, the size of our economy and the amount of petroleum we purchase are unlikely to make this a worthwhile investment for the major players in the petroleum trade. We also don't possess the storage space that would become necessary should we pursue a hedging agreement. Unfortunately, there is little that can be done to influence exchange rates. It depends on the capacity of the economy to make USD.

We borrow USD and invest in infrastructure

that does not offer any return on investment in the immediate aftermath. Moreover, the funds generated from bonds are often used in a careless manner. The best thing I believe would be free prices in the oil sector. This would stimulate competition between the largest petroleum importers which would in turn lead to a decrease in prices. People now understand that there is nothing that can be done to influence international oil prices and that it is bound to change. Suppliers minimizing the cost of their product will allow individuals to make rational and informed decisions on how to deal with the inevitable changes in the price of fuel that will come about.

There is a billion-dollar refinery that is being constructed with Indian financing in Altanshiree soum, Dornogobi aimag. The feasibility study is complete, and the infrastructure and power lines

are also nearing completion. However, the raw oil is to be transported 670km by pipelines which has not even begun construction due to lack of funds. There is some money remaining from the Indian financing that will be utilized to build the refinery itself. A second issue is that we have to purchase oil from China who we have a production sharing agreement regarding crude oil in Dornod. We would have to purchase oil from them at the international price but there are concerns of whether they would be able to meet Mongolian demand.

The refinery was delayed for two years which is unsurprising given that there is a history of large scale projects in Mongolia being delayed or cancelled such as power station 5 which has been in discussion for 20 years. Therefore, no one will take responsibility for the delay.

## WHO IS INFLUENCING THE PRESS

The President declared that the press should be the voice of the people which is a noble ideal but it depends on the President and other politicians as they also own media outlets. The same goes for the two largest banks in Mongolia. According to a Reporters without borders report, 75% of our media outlets are owned by current or former political figures and. I am perplexed as to how discussions of a free media can take place under these circumstances. Media outlets have become disseminators of fake news and libel against individuals upon the orders of others.

Firstly, all media leaders should be transparent. Many media outlets owned by political figures don't list their true stakeholders in the outlet. Secondly, journalists should refrain from disseminating fake news or propaganda against competitors at the behest of politicians. During a forum of independent journalists in Mongolia, the President of the Federation of Mongolian Journalists, Mr. Mandakhbayar stated that the Mongolian media is not independent. Questions raised by journalists are strictly controlled and Mongolian journalists don't have the right to keep their sources secret.

The 4,500 journalists in Mongolia have extremely small salaries. We need to make amendments to the legislation on and to build some form of a journalist palace that can be constructed through donations. It would serve as a hub for journalists to get together and to conduct work without exterior influence. A lot of work needs to be conducted to develop the human resources of journalists including retraining of existing journalists. In particular, we need to develop technicians for the equipment required for journalism.

The small salaries of journalist's force individuals to work at multiple media outlets or change outlets frequently. These small salaries owe itself to the fact that the proceeds from the advertisement industry estimated at 20 million USD has to be divided amongst 500 outlets. The majority of outlets operate at a loss through the financing of politicians and banks. This leads to a lack of competition in the media and in turn to a lack of specialization. Politicians should be prohibited from owning media outlets which is ridiculous.



## NEW LEADERSHIP INDEPENDENT AUTHORITY AGAINST CORRUPTION

Under the Convention of Anti-Corruption to which Mongolia is party to requires us to operate an agency to combat corruption in public offices. The first Head of the Agency was killed under questionable circumstances and the second one was imprisoned under questionable circumstances. The third and fourth heads resigned leading to the appointment of Mr. Dashdavaa as the new Head.

If I was given the decision, I would appoint a foreign citizen to the head of this organization. In Hong Kong, it is common practice to recruit police commissioners and judges from other countries. This is better because they lack connections with Mongolians that may incentivize them to overlook instances of corruptions.

If I was the commissioner, I would look into the heads of the two political parties launch an inquiry into how they acquired their financing and expenses. This is because the three most corrupt institutions in Mongolia are the Democratic Party, People's Party and the People's Revolutionary Party. Nobody other than the heads of those political parties are aware of how they are financed and what their expenditures.

A second priority would be to reacquire lost public moneys such as the 33 trillion MNT that was mismanaged. One of the largest obstacles the previous head of IAAC faced was the Presidential pardon of this 33 trillion MNT mismanagement. I would inquire each member of parliament that voted in favor of this as to their reasoning behind their votes. The new head is not expected to take

these measures, but he will most likely tackle the 23 cases recommended by parliament and bring results.

The main obstacle the IAAC faces is that only a small minority of cases it recommends for litigation see the inside of a courtroom. While the IAAC claims that there are 224 cases in which there are grounds for criminal charges, the prosecutor claims that no such ground exists in 2018. If this is the case, the prosecutor should appraise the public as to why there is no grounds for criminal cases. Should this be true, then why is the IAAC spending so much of our resources on issues that are not criminal. In any case, we want to see the criminals that steal our money and lands to go to prison after returning the moneys they embezzled.



*Mr. Dashdavaa*

*This review has been edited here for space and clarity. You can watch the full 30-minute review on the Defacto website [HERE](#).*

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