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Royal Succession And Oil Stay Steady In Saudi Arabia

Law360, New York (August 21, 2015, 11:07 AM EDT) -- Saudi Arabia's oil and gas industry has been, more than usual, in the headlines recently for two reasons. First, as world crude oil prices have dropped dramatically over the past year, the kingdom's petroleum policy has come under particular scrutiny. Second, as an accompaniment to a new king taking the throne and a number of significant changes having occurred at the highest levels of Saudi Arabia's government, there have also been adjustments in the leadership of the Ministry of Petroleum and Mineral Resources and the national oil company, [Saudi Arabian Oil Co.](#), or Saudi Aramco.

This article reviews the changes that have taken place, provides an outline of the current framework for investment in Saudi Arabia's oil and gas industry and seeks to identify some themes that might affect business in the sector in coming years.

New King, New Leadership

On Jan. 23, King Salman bin Abdulaziz Al Saud ascended to the throne upon the death of King Abdullah bin Abdulaziz Al Saud. Six days later, on Jan. 29, King Salman issued a number of royal orders, among which were edicts abolishing the Supreme Council for Petroleum and Minerals, the Supreme Economic Council and the Supreme Council of the King Abdullah City for Atomic and Renewable Energy. A further royal order created a new Council of Economic and Development Affairs ("CEDA") under the presidency of the King's son, H.R.H. Prince Mohammed bin Salman bin Abdulaziz (who had already been appointed minister of defense, chairman of the Royal Court and special adviser to the king).

The kingdom's long-serving minister of petroleum and mineral resources, H.E. Eng. Ali Al Naimi, was retained in his post and appointed a member of CEDA. A further royal order promoted another of the king's sons, H.R.H. Prince Abdulaziz bin Salman bin Abdulaziz, from his position as an assistant minister to the role of deputy minister of petroleum and mineral resources in the rank of minister. Prince Abdulaziz bin Salman is also chairman of the executive committee of the Saudi Centre for Energy Efficiency.



Edward Rose

On April 29, King Salman issued a second wave of royal orders. H.R.H. Prince Mohammed bin Salman was named the kingdom's deputy crown prince and second deputy prime minister. A new Supreme Council for Saudi Aramco was established with Prince Mohammed bin Salman as its chairman and with 10 members in total. Another royal order of the same day appointed H.E. Eng. Khalid Al Faleh, the then-president and chief executive officer of Saudi Aramco, as the country's new minister of health.

Saudi Aramco's board of directors was restructured shortly afterward, with H.E. Eng. Khalid Al Faleh named as its chairman. The ministers of petroleum, finance and communications will sit on the new board, as will the secretary of the Supreme Council of Saudi Aramco, the rector of King Fahd University of Petroleum and Minerals, three overseas representatives and Aramco's new president and CEO. On May 1, the appointment of Amin Nasser was announced as Saudi Aramco's acting president and CEO, with the job of leading the company's senior management team.

The royal orders of late January and late April have brought very rapid change to the governance of the kingdom's upstream oil and gas sector. The Ministry of Petroleum no longer oversees Saudi Aramco, although the ministry is expected to retain general regulatory authority over the kingdom's hydrocarbon and minerals sectors. The ministry is, for example, still representing the country's oil production and pricing policies internationally, including in Saudi Arabia's capacity as a member of the Organization of the Petroleum Exporting Countries. Domestically, the ministry is continuing to allocate gas feedstock among the kingdom's industrial users. The ministry is anticipated to begin taking a greater role in promoting energy efficiency within Saudi Arabia, not least as part of a drive to reduce the quantity of crude oil which the country consumes each day in power generation.

For its part, Saudi Aramco on the one hand has become independent of the Ministry of Petroleum, but on the other hand is now more directly overseen by the highest levels of government. H.R.H. Prince Mohammed bin Salman is both the president of CEDA and the chairman of the Supreme Council for Saudi Aramco, and five members of the Supreme Council sit on Aramco's 10-man board of directors. It appears to be the intention that the Supreme Council will set Aramco's broadest policies and objectives, while the board will oversee the company's business affairs, management and strategic direction.

Looking ahead, it seems likely that there will be a further round of high-level changes that will affect oversight of the kingdom's oil and gas industry. Current Minister of Petroleum H.E. Ali Al Naimi is rumored to want to retire; candidates to replace him might include H.R.H. Prince Abdulaziz bin Salman or H.E. Eng. Khalid Al Faleh. The role of president and CEO of Aramco is still to be confirmed on a full-time basis. It is also conceivable that Aramco itself might be restructured, perhaps splitting itself into an upstream company and a midstream/downstream company, or at least spinning off some of the noncore infrastructure activities that the company has been given responsibility for managing and delivering.

The recent changes which have occurred, together with any other structural adjustments that might take place, will lead to a period of policy review and revision. Accordingly, there is likely to be a certain level of opacity about the kingdom's oil and gas policies and the role of the various entities shaping the sector's governance and operations for several months yet, until the practical details of these reforms become known.

Same Legal Framework

Despite the above changes, Saudi Arabia has not yet seen any amendment of its hydrocarbon sector legislation. Oil exploration, drilling and production are still on the government's "negative list" and thus closed to direct foreign investment; Saudi Aramco can expect to continue to enjoy its monopoly on the kingdom's upstream concession interests. That said, foreign investment (in many areas with up to 100 percent overseas ownership) remains permitted in Saudi Arabia in oil and gas field services, geological/geophysical, surveying and testing services, as well as across the wider natural gas, refining, petrochemical, mining and metals industries.

Saudi Arabia's existing legal framework for hydrocarbon investment is therefore stable. The first step on the road to any overseas (i.e. non-Gulf Cooperation Council) investment is still, by and large, to obtain a foreign

investment license from the [Saudi Arabian General Investment Authority](#). Most investment in the energy sector tends to proceed through the formation of a limited liability company, which is often a joint venture between foreign and local shareholders.

The legal and regulatory building blocks for any successful investment in the kingdom, which are essential to understand at as early a stage as possible, remain the companies' law (affecting how local companies are set up and managed), the shareholders' agreements between the partners, the corporate tax regime, the labor law regime and any procurement rules maintained by the likely customers of the new company. Investors in the energy sector should also expect that they will continue to be encouraged (with some exceptions) to abide by the government's broad policies of promoting the use of local content and ensuring a commitment to the training and employment of young Saudis.

In legal terms, it is therefore business as usual. More broadly however, because Saudi Arabia is a hydrocarbon economy, it is possible to discern a handful of themes that are now emerging — driven by Saudi Arabia's economic and fiscal requirements — that are likely to lead to changes in the nation's oil and gas laws in the mid-term.

Economic Challenges

In simple terms, the kingdom seeks to maximize its revenue from crude oil sales in order to fund its development plans and recurring expenditure. It is estimated that Saudi Arabia needs an average oil price between \$65 and \$75 per barrel to balance its 2015 budget. However, world crude prices have fallen to the lower end of this range over the first half of the year, even dropping below \$50 per barrel in early August.

Saudi Arabia nevertheless appears intent on delivering the bulk of its spending plans. As H.E. Ibrahim Al-Assaf, the Minister of Finance, stated on April 18, 2015, at the 91st Meeting of the Development Committee of the [International Monetary Fund](#) in Washington, D.C.:

We are pursuing a robust growth strategy, a key component of which is to direct large amounts of public expenditures for the development of infrastructure and human capital. As part of our countercyclical fiscal policy, we are continuing to maintain these expenditures despite the challenge caused by the steep decline in the price of oil.

By way of example, in the power sector, the deputy minister for water and electricity has recently announced that Saudi Arabia is aiming to invest approximately \$187 billion in the domestic electricity sector over the next 10 years, and the Saudi Electricity Co. plans to add almost 48,000 megawatts of generation capacity by 2024 (MEED, Aug. 4, 2015). In the oil and gas arena, Saudi Aramco confirmed that it had received engineering, procurement and construction proposals from contractors on July 27 for a new gas processing plant at the Fadhili oil field in the eastern province; the project's overall EPC contract value is estimated at \$6.5 billion (MEED, July 28, 2015).

Despite such substantive announcements, it is clear that the kingdom's economy is already being affected by the low oil price. Recent indicators include the following:

- Oil revenues have slid from \$323 billion in 2013 to \$285 billion in 2014, and they are forecast to drop to \$171.8 billion in 2015 (Jadwa Investment; SAMA).
- The government's 2015 budget, published in late December 2014, provided for the spending of almost \$230 billion (Ministry of Finance).

- Foreign currency reserves have declined by \$67.5 billion in the first six months of 2015, from \$732 billion on Dec. 31, 2014 (Jadwa Investment; SAMA).
- Foreign direct investment fell by \$900 million in 2014 compared to the level seen in 2013.

On June 1, the IMF, after completing its 2015 Article IV Mission to Saudi Arabia, made the following preliminary remarks:

The decline in oil prices is resulting in substantially lower export and fiscal revenues. ... Government spending in 2015 is expected to remain strong ..., while oil revenues have declined. As a result, IMF staff projects that the government will run a fiscal deficit of around 20 percent of gross domestic product.

The IMF has predicted that the 2015 deficit will amount to approximately \$150 billion.

The authorities therefore have a significant spending gap to close. Part of this spending gap will no doubt be addressed by the country's striving to maintain its market share of world crude oil sales (in May-July, Saudi Arabia pumped a record level of approximately 10.3 million barrels of oil per day). The government has also announced its intention to issue its first sovereign debt since 2007. H.E. Fahd Al-Mubarak, the governor of the Saudi Arabian Monetary Agency ("SAMA," Saudi Arabia's central bank) was reported in the local press in late June as confirming that the government had already placed \$4 billion of bonds with local banks this year. We understand that plans are in place for the issue of up to \$25 billion of further bonds by the end of 2015 (Arab News, Aug. 5, 2015).

In addition to these measures, it is likely that the government will introduce a number of structural reforms to the energy sector as a means of improving economic performance over the longer term. Various emergent trends point to areas of the new administration's thinking.

Trends and Opportunities

Energy Efficiency and Alternatives

The kingdom burns a high proportion of its daily crude oil output in its own power stations in order to meet the country's electricity generation and water desalination needs, in particular during the summer months. Some estimates point to approximately 2.5 million to 3 million barrels of oil per day being consumed in this fashion — approximately one-quarter to one-third of Saudi Arabia's daily production. This usage has a significant, direct impact on Saudi Arabia's hydrocarbon revenue.

The government has indicated that it will seek to pursue more strongly over the mid-term a twin-track approach toward addressing this situation: first, by accelerating its currently tentative drive to identify alternative sources of fuel for electricity generation (from offshore gas exploration to the development of nuclear and renewable power) and, second, by introducing policies aimed at efficient energy use. These initiatives — if and when launched — will offer a wide range of opportunities for local, regional and international investors.

In terms of renewables, there has been increasing talk from the Ministry of Petroleum and Mineral Resources about solar power in particular. The Minister of Petroleum, H.E. Ali Al Naimi, for instance, made the following remarks during the May 20 and May 21 Business and Climate Summit at [United Nations Educational, Scientific and Cultural Organization](#) in Paris: "[W]e have embarked on a program to develop solar energy. ... Hopefully, one of these days, instead of exporting fossil fuels, we will be exporting gigawatts of electric power." He reinforced this statement with similar comments on June 3 on the sidelines of the OPEC meeting held in Vienna.

To date, Saudi Arabia's solar power program has moved slowly under the oversight of the King Abdullah City

for Atomic and Renewable Energy ("KA-CARE"). However, with KA-CARE's Supreme Council having been removed on Jan. 29 and its mandate now uncertain, it would appear that other government bodies may seek to drive the country's solar initiative. On July 30, for example, Saudi Electricity Co. signed a memorandum of understanding with two government-related technology entities for the establishment of a 50 MW solar photovoltaic power plant with a 25-year off-take term (Arab News, Aug. 5, 2015).

As to promoting the efficient use of energy, some are anticipating an expansion of the Saudi Energy Efficiency program, which is already working to raise standards in the construction, industrial and land transportation sectors. Indications are also emerging that the government is considering reforming the system of fuel subsidies. The kingdom's bill for fuel subsidies amounts to approximately \$60 billion a year, according to International Energy Agency figures. It is notable that H.E. Fahd Al-Mubarak, the governor of SAMA, stated in a speech given at a seminar in Riyadh earlier this year (published on Feb. 8, 2015):

One of the existing challenges is enhancing the efficiency of local consumption of energy and water, which results in a distortion and a significant waste of those important resources in addition to increasing the financial burden on the government. This requires a review of price subsidies, which should be changed in a gradual and elaborated manner.

In May, the IMF also suggested that "comprehensive energy efficiency and price reforms" should form a central element of the kingdom's future fiscal strategy.

Conversion Industries

Having focused in recent years on expanding the country's petrochemical production base (through world-scale schemes, such as Sadara and PetroRabigh) and on the creation of a large-scale aluminium industry (through the Ma'aden/[Alcoa](#) project), the government is now encouraging the creation of a series of "conversion" industries, able to capitalize on the chemical and metal raw materials, which are beginning to be produced domestically.

In Jubail, for example, Sadara is supporting the launch of a PlasChem Park located adjacent to its production complex, and Petrochemical Conversion Co. has already developed its own specialist plastics conversion park. Ma'aden is similarly seeking to create an aluminium and metals cluster close to its facilities at Ras Al Khair. In each of Jubail, Yanbu and Ras Al Khair, the Royal Commission continues to offer investors industrial land and infrastructure at attractive rents. Opportunities for investment also lie along the logistics and supply chains, which will be necessary to support these conversion industries, many of which will be entirely new to Saudi Arabia.

Added-Value Technology

A further trend is the stepping up of Saudi Arabia's efforts to attract high-value technology and intellectual property which can be commercialized locally to the benefit of the kingdom's hydrocarbon sector. A number of entities, ranging from Saudi Aramco Energy Ventures and Dhahran Techno Valley Company to the SAARA/Technovia initiative (a commercial and academic research alliance), are aiming to identify emerging technologies, help fund their commercialization and promote their adoption by the energy industry within the kingdom.

The government is clear on its pursuit of this policy. Addressing the Saudi Economic Association in Riyadh on April 7, H.E. Ali Al Naimi stated:

We aspire for the kingdom not only to be an oil-producing nation, but also a global center for the production of the materials and services needed by the oil, energy, petrochemical and other industries. The oil and petrochemical industries focus on scientific research and studies and obtaining patents. We believe that, for any industry, scientific research and new inventions are the best way to progress and compete.

Conclusion

Despite the rapidity of the recent changes which have affected Saudi Arabia's energy sector, the basic legal framework remains unaffected at present. A number of important themes are becoming apparent within the sector, however. These will not only be critical for the Saudi economy in coming years, but will also be of keen interest to prospective investors in the kingdom's hydrocarbon industry. Under Saudi Arabia's current government, it would appear that the country's petroleum policy will be directed both externally toward global oil markets and domestically at expanding the nation's economic base, promoting energy efficiency and continuing a drive for greater industrialization.

—By Edward Rose, Yusuf Giansiracusa and Jeffrey Schlegel, [Jones Day](#)

[Edward Rose](#) and [Yusuf Giansiracusa](#) are Saudi Arabia-based partners at Jones Day.

[Jeffrey Schlegel](#) is a partner in Jones Day's Houston office, where is co-head of the firm's global energy practice. Schlegel is a former chairman of the international section of the Institute for Energy Law.

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