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## **GCC energy pricing**: mixed speed reforms

Energy-price reform is the low-hanging fruit for GCC governments facing fiscal deficits. But the pace of progress across the bloc varies. The collapse in oil prices that started in 2014 placed pressure on fiscal spending that, in turn, coaxed GCC governments to take a fresh look at energy-pricing reforms — part of a broader attempt to rationalise public spending. This was never going to be easy. Low energy prices have long been part of the social contract between the Gulf's governments and their citizens, so changing them was never going to be popular. But the fall in international energy prices has not just made such reforms necessary, it has also opened a window of opportunity. Now these governments must not wait, but grasp the chance.

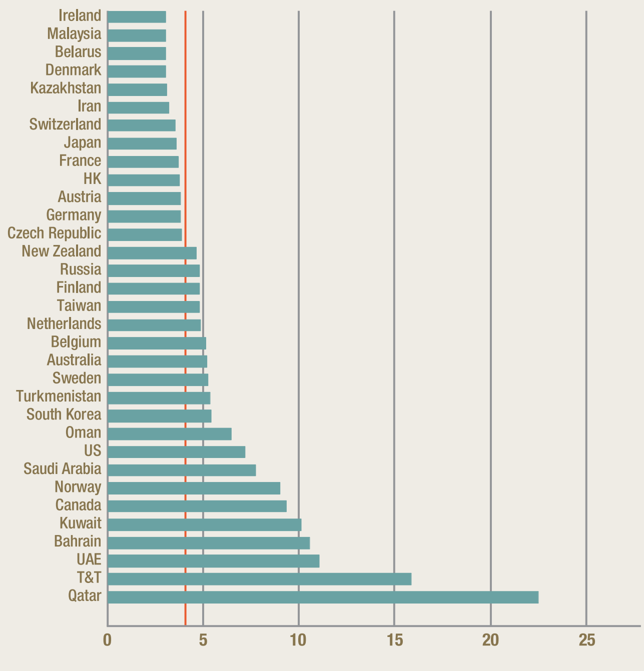
### Energy subsidies drive economic distortions

Reasonable social and economic rationale has long underpinned policy in the Gulf aimed at maintaining cheap energy prices. Chief among them was that, by keeping prices low and in most cases below the cost of production, rentier states could distribute to citizens the benefits, in kind, of their natural-resource endowment, supporting poorer households while also keeping a cap on inflation. Cheap domestic energy has also spurred strong economic growth by steering domestic and foreign capital investment into energy-rich industrial projects.

But the policy has also created distortions that have become less tolerable for energy exporters, especially in a period when they are competing to maximise market share and when hydrocarbon-export revenues are under pressure. The most obvious is that low domestic pricing encourages inefficiency in consumption and high demand growth — the latter at levels that are not sustainable in terms of the capital needed to invest in the energy provision. Inefficient domestic consumption also cuts into the volume of energy resources available for export. Thus the policy has also prevented resource-rich countries from maximising the value of their natural endowment, while also limiting efforts to diversify the economy by funneling capital towards energy-intensive industry.

Efficiency is, above all, a casualty. Low energy prices in the GCC, together with weak regulation of building standards, low efficiency regulations for air conditioning and car and truck transportation, have contributed to double-digit demand growth for years. This growth has exceeded that which can be accounted for by rising incomes and population.

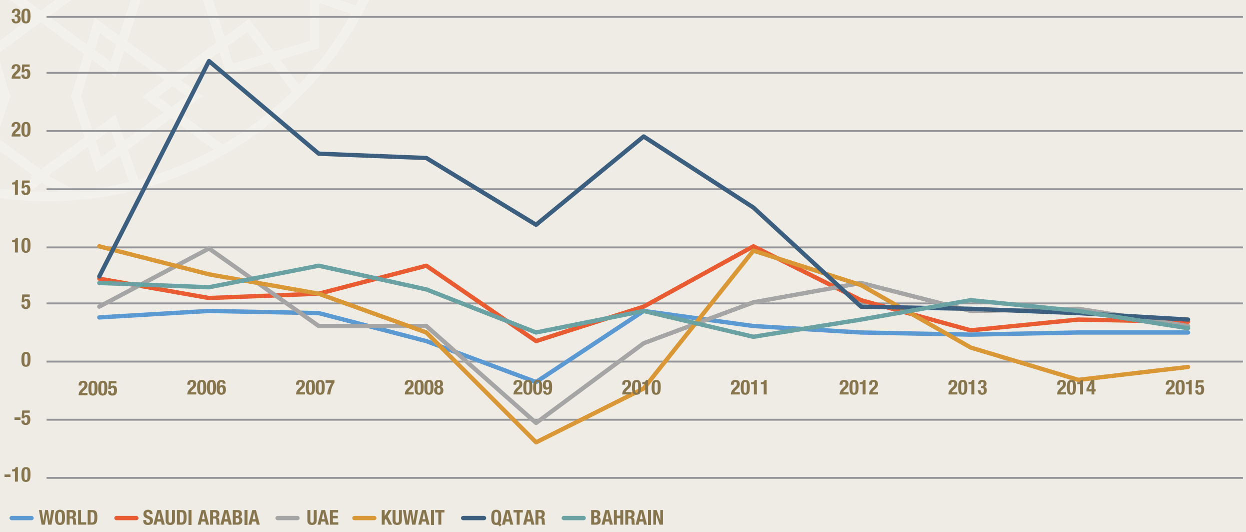
FIGURE 01: **PRIMARY ENERGY CONSUMPTION PER CAPITA FOR SELECT COUNTRIES, 2014**




Source: BP Statistical Review, IMF

High energy use per capita, driven by low prices (see figure 01), has also made it difficult, in some cases, for greener technologies to compete, limiting the progress of renewable and other non-hydrocarbon sources of energy, such as nuclear.

FIGURE 02: **GDP GROWTH 2005-15 (%)**




Source: World Bank

Finally, the deep energy subsidies have been expensive in opportunity cost terms (the depletion of resources that otherwise would have captured higher value) and yet often failed to deliver the social balancing intended. While offering benefits to poorer segments of the population, low energy prices offer even greater benefits to the well-off, who are always able to consume more. A well-meaning policy designed to help the poor has become an expensive subsidy for the rich.

But since oil prices started to decline in 2014, the biggest motivation for reform has been ballooning fiscal deficits, driven by falling growth (see figure 02). The logic of reform is plain. Eliminating energy subsidies would help to reduce deficits.

## Need for mitigation strategies

If the rationale for price reform is straightforward, this does not mean such a policy shift is without risks. Such a move is politically sensitive — higher prices are never popular in the short term, even if they benefit the economy as a whole in the long term — and also brings some negative economic impacts. Energy-price reforms will, all things being equal, drive higher inflation, hurting the spending power of lower-income citizens, and feed secondary inflation effects, such as wage growth (see figure 03). Higher energy input costs also limit the profitability of businesses where these costs cannot easily be passed through to consumers.

So energy-pricing reforms, while progressive for GCC economies, require parallel mitigation strategies to offset the impact on lower-income groups. This will include direct welfare payments and tariffs that maintain cheaper fuel prices for low-volume energy users. For industry, specialised help in terms of funding should be made available to allow businesses to make efficiency gains over time, thereby compensating for the near-term shock of higher input costs.

Public buy-in to such reforms is also crucial. Effective government communications with citizens to explain policy changes can ease public resentment at higher costs. This is as easy to get wrong as to get right: such policy changes by fiat without adequate public discussion will raise hostility; but a dedicated and pro-active public-relations campaign can lessen or neutralise discontent. Meanwhile, the policy shift must also come hand-in-glove with concrete — and, to the public — visible improvements elsewhere. The best of these is the provision of well-designed, affordable public transport in urban areas, demonstrating that the government is serious not just about its policy redirection but also about bettering the lives of its citizens, mitigating the negative impacts of energy price hikes especially on the poor.

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## The GCC's multi-speed approach

Within the GCC, the commitment to energy-pricing reform has taken various policy pathways and been enacted at different speeds. Those that started the process earliest have, in most cases, achieved the greatest level of economic impact and social acceptance. Road-transport fuels, particularly gasoline, have been priorities for reform (see figure 04).

In the region's largest economy, Saudi Arabia's policy-makers launched a first phase of energy-price reforms in January this year. The kingdom's stated ambition is to bring domestic prices in line with international ones by the end of the decade. Starting from a low base, price increases for liquid fuels, electricity, gas and water were significant in percentage terms but still leave them cheap by regional and especially international standards. The highest rises were reserved for gas: the price of ethane was lifted by 133% to $1.75/mBTU and that for methane by 67% to $1.25. Gasoline and diesel prices were both increased by 50-79% and electricity hiked using a slab tariff, with higher prices for those consuming more than 4,000 kWh annually, thereby keeping prices for smaller consumers unchanged.

FIGURE 03: **WEIGHTS OF ENERGY PRODUCTS IN CPI (%)**

| CPI Item | Bahrain | Kuwait | Saudi Arabia |
|---|---|---|---|
| HOUSING | | | |
| Electricity, gas and other fuels | 2.02 | 0.53 | 1.83 |
| Electricity | 1.73 | 0.35 | 1.59 |
| Gas | 0.27 | 0.12 | 0.18 |
| Other fuels | 0.02 | 0.05 | 0.07 |
| TRANSPORT | | | |
| Fuels and lubricants | 3.42 | 2.11 | 1.46 |
| Gasoline/Diesel | 3.26 | 1.79 | -- |
| Lubricants | 0.16 | 0.31 | -- |
| ENERGY PRODUCTS | 5.44 | 2.63 | 3.29 |

Source: IMF

The kingdom's intentions, as laid down in the National Transformation Program 2020 (NTP), are to reduce water and electricity subsidies by SR200bn ($53bn) by 2020, a level that would sharply reduce the public deficit, which was budgeted at $87bn this year. At the launch of Vision 2030, Deputy Crown Prince Muhammad bin Salman indicated a desire to target subsidies more effectively at those in need, also pointing to the structural problem with blanket subsidies. "We plan to raise the efficiency of the government's support system and make the best use of its benefits by redirecting it and targeting eligible citizens and economic sectors," he said. "We understand that providing subsidies with no clear eligibility criteria is a substantial obstacle to the energy sector's competitiveness.". The NTP also projects a sharp rise in renewable-energy investment, particularly solar power, against more modest, but achievable targets, as can be seen in recent photovoltaic-expansion plans launched by Saudi Electricity Company.

## Qatar, Oman track UAE model

Qatar and Oman announced reforms in January following Saudi Arabia's move, opting for initial price increases for transportation fuels with the option to make monthly adjustments thereafter to track movements in international energy prices.

Following an ad hoc 30-35% rise in gasoline prices in January, Qatar shifted to a new system of monthly adjustments from May, bringing gasoline and diesel pump prices more closely into line with regional spot prices. Qatar said the moves were aimed at encouraging consumers to rationalise their energy usage.

Power utility Kahramaa increased water and power charges in September 2015, its first price rise since 2002. As with Saudi Arabia's electricity billing, the smallest-volume consumers are protected under a slab system, whereby those consuming less than 20 cubic metres of water a year pay no more than before — QR4.40/cm ($1.19) — and those consuming less than 2,000 kWh of electricity annually pay the lowest rate (QR0.08/kWh). As is the case of Saudi Arabia, Qatar continues to sell water at well below the cost of production, relying heavily on desalination plants. The next phase of Qatar's energy reform is expected to target natural gas pricing. With 4bn cf/d being consumed domestically, of which 25% is for power, Qatar will have to address some of the distortions in the gas-purchase agreements for its oldest and least efficient generation units. The present system encourages Kahramaa to run these ahead of more efficient plants with higher gas-purchase prices.

Oman increased gasoline and diesel prices in January too, establishing a government committee to monitor international prices and make monthly adjustments. The committe hiked prices over the summer. With limited oil and LNG exports, Oman's budget is one of the GGC's most vulnerable to low oil prices and reforms to energy subsidies became urgent as the sultanate grappled with its projected budget deficit of OR3.3bn ($8.6bn) in 2016. Energy subsidies were estimated to have accounted for OM580m in 2015.

## UAE reforms target power sector

The UAE was the first in the GCC to reform its energy pricing and has the bloc's highest outright prices for gasoline and diesel — since 2015, these have been linked to international prices and adjusted monthly. Electricity pricing in the UAE was adjusted in January this year and continues to put most of the burden on expat consumers, who pay up to five times more than UAE nationals for water; and a similar multiple for electricity. Natural gas pricing accounts for the bulk of the UAE's energy-subsidy bill and has yet to be tackled, although policy-makers indicated earlier this year that electricity and natural gas sold to power generators would be the next focus of reform. UAE policy-makers have argued that energy subsidies need to be removed to boost public funds available for health and education investment.

## Bahrain and Kuwait move cautiously

Bahrain has been lifting natural gas prices progressively for some time but, until 2016, had shied away from doing the same to gasoline. Natural gas prices for industry were raised in 2015 from $2.25 to $2.50/mBTU, after a 50% price hike in 2012. Manama has set out a plan to lift natural gas prices by $0.25/mBTU every year on 1 April until they reach $4/mBTU in 2022, bringing them roughly in line with some international prices (but 50% above Henry Hub). A similar approach has been implemented for diesel despite parliamentary opposition: prices are to be lifted by 20 fils/litre ($0.05) each January until they reach 180 fils/l in 2017.

In January, Bahrain decided to follow the Saudi lead and tackle the sensitive issue of gasoline prices, lifting them by 55-60%, with 95 RON raised to 160 fils/l and 91 RON to 125 fils/l. Over the summer, Bahrain indicated it would establish a committee to provide periodic reviews of gasoline pricing to bring it into line with international prices — although it is not clear whether these adjustments will be made regularly, as they are in the UAE.

FIGURE 04: **GCC TRANSPORTATION FUEL PRICES 2015-16 ($)**

| | Gasoline 91 RON | | | Gasoline 95 RON | | | Diesel | | |
|---|---|---|---|---|---|---|---|---|---|
| | Price Oct 2016 | Price Oct 2015 | % Change | Price Oct 2016 | Price Oct 2015 | % Change | Price Oct 2016 | Price Oct 2015 | % Change |
| Saudi Arabia | 0.20 | 0.12 | +67 | 0.24 | 0.16 | +50 | 0.12 | 0.07 | +81 |
| Kuwait | 0.20 | 0.20 | n/a | 0.21 | 0.21 | n/a | 0.36 | 0.36 | n/a |
| Qatar | 0.31 | 0.23 | +35 | 0.35 | 0.27 | +30 | 0.27 | 0.27 | n/a |
| Bahrain | 0.33 | 0.24 | +39 | 0.43 | 0.27 | +60 | 0.42 | 0.37 | +14 |
| Oman | 0.36 | 0.30 | +23 | 0.42 | 0.31 | +33 | 0.42 | 0.38 | +10 |
| UAE | 0.41 | 0.43 | -6 | 0.43 | 0.46 | -8 | 0.43 | 0.63 | -31 |

Source: MEES

Kuwait's strong currency reserves have made it one of the most resilient of the major Gulf oil exporters in fiscal terms. But this has also encouraged political resistance to energy-pricing reform in parliament, where government plans have been blocked. Energy subsidies account for around $20bn annually, not far short of the government's projected budget deficit of $23bn for the year 2016-17. So the government has a sound fiscal rationale to address costly fuel-subsidies as part of its broader efficiency efforts.

While parliamentary opposition to diesel and kerosene price hikes in early 2015 forced those changes largely to be rolled back, the government approved a plan over the summer to raise gasoline prices by 42-83% depending on octane level. In September, MPs again voiced their opposition, although the dissolution of parliament in October should allow the government to implement the gasoline price hikes unchallenged. While the latest reforms will apply to prices across the board, Kuwait has suggested in the past that price reforms would be targeted to avoid hurting lower-income groups, possibly by allowing poorer citizens to receive an allocation of cheaper fuel every month.

## Conclusion

This year's deep fiscal contraction in the Gulf has made public spending reduction a priority for GCC countries, adding urgency to energy-price reforms. Price liberalisation has been under discussion for decades in many countries of the region. But the courage for delivering reform has been absent, especially during a decade when high oil prices sapped the appetite for such structural changes and diversification. On the other hand, oil-price weakness since 2014 has in turn required fiscal consolidation on a level not seen for decades, forcing governments to risk public discontent by instituting higher prices.

Yet the first significant steps have been made. Those countries that have committed to raise prices regularly will likely see improved public acceptance more quickly than those that continue to set prices with no regard either to cost of production or opportunity cost. The UAE has led the way in this regard, with liberalised prices across transportation, power and water establishing a regional benchmark for reform. Kuwait and Saudi Arabia are heading in the right direction but will need to shift towards market-pricing mechanisms if they are to eliminate the cost of energy subsidies from public spending. Bahrain's annual price adjustments may prove less popular than more transparent and swiftly implemented adjustments. While some reform has been delivered in the natural gas and power sectors, distortions around older supply contracts persist. They need to be addressed before pricing reforms will wholly succeed.

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In the long term, mitigation policies will be crucial to win public acceptance and avoid negative economic impacts. First, governments will have to recognise and compensate for the inflationary impact of price reform on the end-consumer, especially on poorer citizens. Monetary authorities may need to adjust policy to counter higher trend inflation in the broader economy. Second, energy-intensive industries need to be prepared and in some case compensated for higher, market-based energy prices. Soft loans and government investment may need to be directed to sectors that have relied on cheap energy for their competitive edge, possibly at the expense of efficiencies elsewhere. Third, citizens need to be given opportunities to use alternative energy or means of transport. Governments must establish a fiscal platform that encourages the use of non-hydrocarbon energy in the domestic economy. Commuters need to be provided with efficient and affordable public transport.

Those countries well on the way to building diversified economies have little to fear from market reforms, which should in time funnel capital investment into more productive industrial sectors. If properly supported at the highest levels of government, energy-price reforms will also give a huge boost to the development of renewable and particularly solar energy, where GCC countries also have a huge built-in advantage. Price reform in the GCC is a daunting task: but it is necessary, will strengthen its economies and is well within the grasp of any forward-thinking government.