



Devising an energy pricing strategy for GCC countries

Robert Bacon

All the GCC states provide their domestic economies with energy at a fraction of the international price, using both direct and indirect subsidies. Although such subsidies reflect important economic and social goals, they also impose large costs on their economies. The increasing scale of such subsidies is becoming harder to justify and a strategy for their reform will become ever more pressing.

What is meant by a subsidy?

Subsidies are a feature of those markets where prices are controlled by the government, rather than being set by a free market. A consumer subsidy is defined as the difference between the actual price paid by a consumer for an item, and the price at which that item would be sold in a free market. For a country that is a net importer of the energy source in question, the free market price would be the import cost c.i.f. plus domestic distribution costs, while for a net exporter the free market price would be the export price f.o.b. minus distribution costs required to export the product. The export price may be above the domestic cost of production and it represents the maximum value that could be achieved by its sale. Selling domestically at cost would forgo the extra revenue obtainable from export markets; this could be used to benefit the domestic economy according to the government's strategy.

With the exception of Bahrain, all the GCC states, are net exporters of oil and gas, so any subsidies on petroleum products or gas will arise from setting domestic prices below export prices. For GCC producers the costs of oil and gas production are usually low, so that the price charged

to consumers still leaves a substantial margin for the national oil company, as well as for the government through its taxation structure. The argument that the resulting price structures do not qualify as subsidies fails to take into account the fact that were the domestic price to be set at the export price level, there would then be an increase in government revenue larger than the loss of consumer surplus from charging higher domestic prices. After all, the revenue from the export – rather than domestic consumption – of domestically produced energy could be used by the government in ways that produced an overall net increase in welfare for the economy, although some individual consumers might be worse off.

.....

'ALL THE GCC STATES PROVIDE THEIR DOMESTIC ECONOMIES WITH ENERGY AT A FRACTION OF THE INTERNATIONAL PRICE, USING BOTH DIRECT AND INDIRECT SUBSIDIES.'

.....

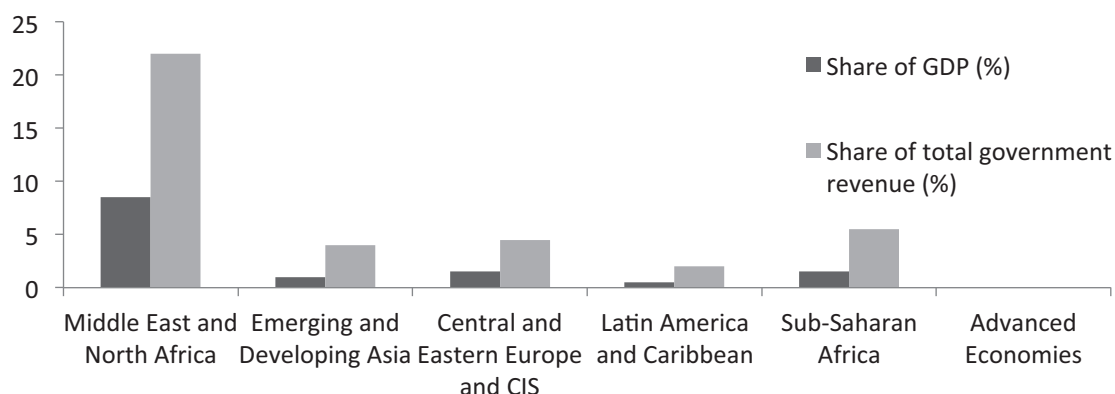
Electricity is markedly differently from domestically sold oil and gas; it is little traded so that selling below the cost of production requires an explicit subsidy, unless oil or gas are as used as inputs and provided below market prices. In the latter case there is an implicit subsidy since the power utilities do not experience financial losses that need to be reimbursed.

The benefits of energy subsidies, and unwanted side effects

A number of reasons have been advanced by governments for the use of subsidized energy prices, these include: the expansion of access to energy, particularly in countries where a large fraction of the population

cannot afford electricity connections or petroleum products for household use; and supporting low-income households, particularly against energy price inflation. Two other objectives are also of particular relevance for oil and gas producers: sharing national wealth and encouraging industrial development. Countries that produce oil or gas receive a rent from the revenues accruing to the government. As a way of sharing this wealth among all citizens, it has been common practice to provide the associated energy products at subsidized prices. Because higher income households purchase more energy, they end up receiving larger benefits from this form of rent distribution. Supplying energy to certain industries at a price below the international equivalent will provide a competitive advantage and could possibly encourage the growth of such a sector as it substitutes imports and even starts to export. As the sector grows, employment may be expected to increase and this is attractive for countries where employment opportunities are limited.

In practice, the use of subsidized energy prices has a number of side effects that can partially or totally negate their original purposes, and these effects have been emphasized by studies describing the need for subsidy reform. The direct costs to the budget of explicit subsidies, or the opportunity costs of implicit subsidies, take resources away from other goals of public spending that may be more desirable than the goals of the energy subsidies. Lowering the price charged for energy, particularly when this applies to all users, encourages the demand for energy to increase, which increases the total subsidy costs and



Total pre-tax energy consumer subsidies as shares of GDP and of total government revenues by region in 2011 (%)

Source: IMF, 2013

distorts the pattern of the economy. Furthermore, many studies have shown that higher income households receive a much larger share of the total subsidy benefit than do poorer households, so attempts to use subsidies to protect lower income households have unnecessarily high fiscal costs as a result of leakage to better-off households. Finally, where utilities are forced to accept losses, through the provision of subsidized prices in the absence of compensation from the government, they will tend to under-invest. This can result in shortages of energy supply, as evidenced by power rationing and blackouts.

How large are energy subsidies in the GCC?

The diagram illustrates IMF calculations for energy subsidies that rely on a price-gap measure of energy prices, and shows the importance of energy subsidies in the Middle East region. The shares of subsidies in GDP, and as a share of total government revenue, were higher for oil exporters than for oil importers in the Middle East, but both were much higher than in any other region. The losses of government revenue through the use of energy subsidies were

equal to almost 10 per cent of GDP and to a quarter of the governments' total revenue.

Data for consumer subsidies on individual energy sources for the GCC countries are shown in the table. These indicate that not only are subsidies on petroleum products and natural gas very large, but that subsidies on electricity are also substantial.

These figures indicate the magnitude of the resources in GCC countries which are devoted to providing consumers with energy below the market price equivalent. The demand for power and for petroleum products is likely to increase at least proportionately as GDP rises in these economies, so that without some

pricing reform the burden of subsidies will not decline. Indeed, judging by past experience, the burden may well increase. GCC countries, facing the large budgetary implications of their energy subsidies policies, have to consider whether the rationale for such policies is still valid and, if not, how to reform energy pricing without damaging the economy.

Incomes have risen throughout the GCC to a level where it is unnecessary to provide energy subsidies in order to induce the poorest to switch to modern forms of energy – there are no large groups without electricity, or who use biomass as a household fuel instead of electricity or petroleum products. Nor can it be argued that

Country	Petroleum products	Electricity	Natural gas	Total
Bahrain	5.4	2.6	n.a.	8.0
Kuwait	3.1	2.9	1.3	7.3
Oman	3.0	0.8	2.2	6.0
Qatar	1.2	1.2	1.1	3.5
Saudi Arabia	7.5	2.5	n.a.	10.0
United Arab Emirates	0.5	1.9	3.4	5.8

Source: IMF, 2013



energy subsidies help equality by providing greater assistance to low-income households. The reverse is probably true – the share of subsidies going to the better-off households is much greater than the share going to the poorest households. This observation can, in fact, help to explain the persistence of the magnitude of energy subsidies in certain countries. The removal of energy subsidies would have a substantial negative impact on large middle-income groups of the population who are not among the leading beneficiaries of the nation’s wealth. Protests from such groups can appear threatening to the government and hence, even though it is recognized that energy subsidies may have an overall negative impact on the economy, governments are unwilling to risk energy price reform. This is particularly true where the government has limited resources to ‘buy-out’ possible opposition to increasing energy prices. Where political agitation is present, as has been the case in Bahrain, governments may discuss energy price reform but be unable to find a path to implement it.

.....
‘LOWERING THE PRICE CHARGED FOR ENERGY, PARTICULARLY WHEN THIS APPLIES TO ALL USERS, ENCOURAGES THE DEMAND FOR ENERGY TO INCREASE ...’

Governments of countries that are major oil and gas producers have been able to subsidize energy, even while devoting substantial spending to other social goals (such as health and education). In addition, support to domestic industry, as a means of job creation, remains important. Were the subsidies to be suddenly withdrawn, some industries would no longer be competitive and jobs would be lost. Because the provision of employment can be a crucial policy goal, in order to avoid social unrest and disenchantment,

governments are likely to continue to look for means to support such industries, and the use of subsidized energy inputs, rather than direct subsidies to the industries in question, may be politically expedient. The challenge is thus to find ways to support these industries using more focused assistance than is possible with a broad energy subsidy and that can also be phased out as the industry grows and becomes able to compete without continued government financial support.

Strategies for energy price reform

The reform of energy prices, where a government has decided that the present system of subsidies is not optimal, is achieved through adopting new rules for setting the official administered prices. However, governments nearly always also need to adopt complementary policies that can offset some of the effects of the subsidy reform itself. There are two major considerations involved in such a step: the impacts of the new prices and other policy changes on all affected parties in the economy; and the extent and effectiveness of opposition to the new policy.

Experience from several countries where there have been attempts to reduce energy subsidies has shown that failure to fully consider such impacts has led to policy abandonment or reversal. There are several steps that need to be taken before the actual implementation of an energy pricing reform occurs. These include: *stakeholder identification* – all parties affected by the change of consumer subsidies and the proposed complementary policies should be considered; an *impact assessment* to quantify the impacts of alternative policies on affected parties should be carried out (the importance of such changes can be correlated with a power analysis of the various groups

– large losses for a group that has considerable power to obstruct the change may require an adjustment of the policy, or the introduction of some compensation mechanism); and finally, a *policy marketing strategy* – experience from many countries relating to the introduction of large policy changes suggests that a well-articulated information campaign may be able to reduce opposition (based on misinformation and misunderstanding) to a proposed policy change.

.....
‘THE REMOVAL OF ENERGY SUBSIDIES WOULD HAVE A SUBSTANTIAL NEGATIVE IMPACT ON LARGE MIDDLE-INCOME GROUPS OF THE POPULATION ...’

For the GCC states in particular, these general considerations suggest that for successful reform of energy prices in a GCC member state, a detailed action plan would be required; this would identify beneficiaries of the present price structure and quantify costs of subsidies to these groups, while considering alternative pricing regimes in which the subsidy cost might be reduced. This could include: changes in the amount of a universal subsidy (as for petroleum products); the removal or reduction of exemptions to the pricing regime (such as government departments that receive free electricity); the introduction of smart cards to allow price discrimination by quantity purchased, or by category of user, for certain petroleum products; changing the tariff structure for the power sector by, for example, replacing a rising block tariff by a volume-differentiated tariff; replacing energy subsidies by targeted cash transfers limited to lower income or needy households; or developing targeted industrial policies that are limited to support for key aspects of industries that need help to compete but that have the potential to evolve to a position where support is no longer needed.

