Energy price reform in the GCC: long road ahead

Fiscal pressures due to the decline in oil revenues are forcing GCC governments to rationalise their spending and implement long overdue fiscal and economic reforms, including to energy prices. Saudi Arabia and the UAE are leading the GCC in raising energy prices and cutting subsidies. While the provision of low energy prices in the past few decades has helped the GCC to achieve key developmental and social objectives, this policy has come at a huge cost and has resulted in a wide range of distortions. Nevertheless, the increase in energy prices will have direct and indirect effects on the welfare of households and the profitability and competitiveness of GCC industry. The ability of the GCC governments to put in place effective measures to mitigate the impact of higher energy prices and develop a coherent communication strategy are key to the success of their reform plans. While the GCC countries have taken a step in the right direction, the path for energy-pricing reform will be long and fraught with risks.

In a clear signal of its willingness to implement long overdue fiscal and economic reforms, the Saudi government announced plans in December 2015 to reform prices of water, electricity, natural gas and petroleum products over the next five years, raising the price of various fuels with immediate effect. This followed the UAE’s June 2015 announcement to liberalise domestic gasoline and diesel prices. Since the Saudi announcement, other countries in the GCC such as Kuwait, Bahrain and Oman have followed suit, outlining plans to increase energy prices in the near future.

While the new prices are still low by international and regional standards, the reforms represent a fundamental shift in the Kingdom’s economic and social policies. For decades, the provision of cheap energy has been a main pillar of GCC development strategy aimed at achieving key economic, social and political objectives. These include distributing the rent to the wider population; protecting the income of households, especially those with lower income; enhancing the economy’s competitiveness and attractiveness to domestic and foreign investment; promoting industrialisation and diversification; and controlling inflation.

Unintended consequences

Low energy prices have enabled the GCC to achieve some of these objectives, but the policy has come at a huge cost. The inefficient allocation of resources prevents the GCC from maximising the value of its natural resources. The negative consequences of low energy prices are well known. They result in rapid growth in energy consumption beyond what can be explained by factors such as the rising income levels and population growth. They increase a country’s energy intensity of GDP because low prices distort investment decisions towards energy-intensive projects, hindering economic diversification. They also result in low efficiency as consumers and industries have little incentive to conserve energy. They distort a country’s energy mix by encouraging reliance on oil and gas, limiting the penetration of alternative fuels such as renewables and nuclear power, which struggle to compete with hydrocarbons.

Differences in energy prices also increase cross-border smuggling. Nor are low energy prices neutral in terms of their distributional effects. Low transport fuel and electricity prices reward higher-income households, which tend to consume more. Similarly, the provision of cheap gas to industry increases profits for the owners of industrial establishments and shareholders in these companies who mostly fall within the high-income groups.

Negative shocks and mitigation

Despite all these known distortions, a move to increase energy prices can induce negative shocks affecting households, industries, and the wider economy. Higher energy prices can spur inflation, especially if they result in a shift in expectations and wage-price spirals. Energy-pricing reform reduces the welfare of households both directly by raising the price of electricity, water and petroleum products, and indirectly, by increasing the price of other goods and services that use energy as intermediate inputs.

Higher energy prices also increase input costs for industries, reducing profits. This is especially true for energy-intensive industries that are not able to pass on the cost increase to end-buyers, either due to the competitive structure of the industry (such as petrochemicals) or the imposition of price...
controls cement. SABIC for instance said that as a result of the fuel and electricity price hikes its annual cost would increase by more than 5%; Saudi Arabia Fertilizers Company’s (SAFCO) production costs would increase by 8%; Yanbu National Petrochemical Company’s (YANASAR) costs would increase by 6.5%; while Saudi Cement Company announced that its production costs would rise by SAR68m ($18.1m). These companies added that they would increase the efficiency of their plants and cut other costs to offset the input price shock.

Thus, in any energy-pricing reform strategy, it is essential that governments put in place measures to mitigate these negative impacts. For instance, the government should design schemes to compensate households, especially those with low incomes. It should establish specialised funds that provide technical assistance and soft loans to help industries most affected adjust to the higher cost by increasing efficiency through the introduction of new technologies and equipment upgrading. It is the ability of the GCC governments to put in place such schemes and communicate their policies effectively and transparently that will determine the success of their energy-pricing reform programmes in the longer term.

**Saudi Arabia: a broad reform**

The Saudi government has opted for a gradual (five-year) but broad-based reform that covers a wide range of fuels including natural gas, gasoline, diesel and electricity, as well as water. The price of natural gas has seen some of the highest increases; for methane it was raised from $0.75/mmbtu to $1.25/mmbtu, while the ethane price was raised from $0.75/mmbtu to $1.75/mmbtu. The impact of these price increases will be mainly felt by the power sector and industry, which account for the bulk of ethane and gas consumption. The government also increased the price of higher-grade unleaded petrol to SAR0.90/litre ($0.24) from SAR0.60/litre and for lower-grade petrol to SAR0.75/litre from SAR0.45/litre. Households will feel the main impact of the increase in gasoline prices given their reliance on personal transport and the limited public alternatives. Diesel, mainly consumed by the power sector and industry, was raised to $14/b while diesel for commercial transport was raised to $19/b. Households with low levels of consumption (less than 4000kwh) were shielded from the increases in electricity prices, but for consumption levels between 4000kwh and 6000kwh, prices were raised from SAR0.12/kwh to SAR0.20/kwh and for consumption levels above 6000kwh, prices were unified and set at SAR0.30/kwh.

**UAE: low-hanging fruit**

Despite its strong fiscal position, the UAE was one of the first countries in the GCC to liberalise its gasoline and diesel prices. The government still sets the domestic fuel prices on a monthly basis, but these are directly linked to international prices. While liberalising prices in the UAE has received wide media attention, the increase in gasoline prices has been rather limited, as prices were already close to international levels; while diesel prices have been cut in recent months. The UAE has introduced electricity reforms, but the impact on the country’s nationals has been limited (especially in Abu Dhabi) with non-UAE nationals bearing the brunt of the reform. Subsidies for natural gas, which account for the bulk of the UAE’s subsidies, remain in place. Compared to Saudi Arabia, therefore, the breadth of the UAE’s reforms has been limited, while sharp increases are needed to bring local Saudi prices closer to international rates.

**Kuwait: resistance to reforms**

Compared to some of its neighboring GCC countries, Kuwait is in a better financial position to deal with the current weakness in oil prices due to its large fiscal buffers. Nevertheless, the Kuwaiti government has been keen to rationalise spending and balance the budget. In its 2015-16 budget, the government plans to slash expenditure by 20.7% from 2014-15 levels, with subsidy reductions accounting for most of the decline. In 2014-15, total subsidies cost KD5.799bn ($18bn) and the objective is to reduce subsidies to around KD3.776bn in the 2015-16 budget, a decrease of nearly 35%. Achieving this reduction, however, is ambitious. In January 2015, the government raised the price of diesel at wholesalers and filling stations to KD0.170/litre from

---

**Natural gas and liquid fuel prices in Saudi Arabia**

<table>
<thead>
<tr>
<th>Product</th>
<th>Saudi Arabia (old)</th>
<th>Saudi Arabia (new)</th>
<th>Percentage increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Natural Gas ($/mmbtu)</td>
<td>0.75</td>
<td>1.25</td>
<td>67</td>
</tr>
<tr>
<td>Ethane ($/mmbtu)</td>
<td>0.75</td>
<td>1.75</td>
<td>133</td>
</tr>
<tr>
<td>Gasoline ($/litre)</td>
<td>0.16</td>
<td>0.24</td>
<td>50</td>
</tr>
<tr>
<td>Gasoline ($/litre)</td>
<td>0.12</td>
<td>0.20</td>
<td>67</td>
</tr>
<tr>
<td>Diesel transport ($/litre)</td>
<td>0.067</td>
<td>0.12</td>
<td>79</td>
</tr>
<tr>
<td>Diesel industry ($/barrel)</td>
<td>9.11</td>
<td>14.10</td>
<td>55</td>
</tr>
<tr>
<td>Arab light crude ($/barrel)</td>
<td>4.24</td>
<td>6.35</td>
<td>50</td>
</tr>
<tr>
<td>Arab heavy crude ($/barrel)</td>
<td>2.67</td>
<td>4.40</td>
<td>65</td>
</tr>
<tr>
<td>Kerosene ($/barrel)</td>
<td>23.00</td>
<td>25.70</td>
<td>12</td>
</tr>
</tbody>
</table>

Source: APICORP calculations
KD0.055/litre. The government also increased kerosene prices, used mainly in aviation. These adjustments, it was hoped, would save the government around $1bn a year.

However, in face of parliamentary opposition, the government was forced to back down on its original plans, cutting the prices of diesel and kerosene at filling stations and providing diesel and kerosene to some customers at the old price. In light of recent price increases in neighbouring countries, the government’s attempt to increase prices may get a new boost. The minister of finance recently announced that his ministry has plans to submit recommendations to the cabinet’s economic committee for increases in fuel prices and other services, although it did not say what these recommendations were. Media reports claim that the next step is to increase the price of gasoline to KD0.100-0.115/litre from its current level of KD0.055/litre. Such an increase is likely to meet stiff opposition in parliament and it is yet to be seen whether the government will succeed in its efforts.

Oman and Bahrain: limited options

With low levels of foreign assets, Oman’s economy is one of the most vulnerable in the GCC to the oil-price slump. Oman posted a budget deficit of OR4.5bn in 2015 and the government projects the deficit to reach OR3.3bn in 2016 in its recently announced budget. This is despite the Sultanate’s ambitious plans to boost non-oil revenues and cut heavily on spending. The government has advanced plans to increase income taxes on businesses and to bring all companies under the taxation system. The parliament (the Shura council) has already voted in favour of a bill to hike taxes. Cuts in energy subsidies are key for the government to meet its ambitious target of reducing its expenditure by 11% from the 2015 level. The allocated subsidy for petroleum products, electricity and other goods in the approved 2016 budget is estimated at OR400m; a decline of 64% from the 2015 level. Achieving such a reduction requires sharp rises in energy prices across the board. In January 2015, Oman doubled gas tariffs for industrial producers and the power sector, to $3/mmmbtu, with the provision for annual increases of 3% in subsequent years. The Ministry of Oil and Gas has plans to lift the prices of petroleum products in line with international prices, starting from mid-January 2016, though no specific details have yet been released. The undersecretary at the Ministry of Oil and Gas told reporters that Oman “will not liberate prices completely, but they will be adjusted in a way where the end result is zero subsidy. Depending on international prices, the committee might choose to subsidize one product against the other”.

Like Oman, Bahrain also raised the price of natural gas to industries in April 2015, to $2.50/mmmbtu from $2.25/mmmbtu. The last increase, to that tariff, was a 50% hike in 2012. The Bahraini government also introduced a multi-phased adjustment programme for gas prices, which will see the price of natural gas increase by $0.25/mmmbtu each year on 1 April to top $4/mmmbtu in the beginning of 2022. Back in 2013, Bahrain also announced plans to gradually increase its domestic selling price for diesel fuel by BD0.02/litre each year from BD0.12/litre in 2014 to BD0.18/litre in January 2017. But this plan met heavy resistance in parliament, and the government was initially forced to back down. Following the recent price increases in a number of GCC countries, the Bahraini cabinet has approved a new pricing system for diesel and kerosene that is set to begin in January 2016. The full details are not yet available, but the government announced that there would be a “gradual increase” in the cost of both fuels to domestic customers in the coming years.

Qatar: sitting on the fence

Qatar has followed an ad hoc approach to its energy-price increases and so it is difficult to talk about a coherent energy-pricing strategy. Back in 2011, the Qatari government increased the prices of petrol and diesel by more than 25%, with the litre price for super 97 octane set at QR1 ($0.27) and the premium petrol price at QR0.85/litre. The government also raised the price of diesel to QR1/litre and kerosene to QR0.80/litre.

There has been no further adjustment to these prices since 2011. But in October 2015 Qatar General Electricity and Water Corporation surprised many by hiking the water and electricity charges with effect from September 2015. In its 2016 budget, the government slashed its expenditure by 7.3% in nominal terms, but with no indication that there would be a cut in subsidies or in capital expenditure, with education bearing most of the spending cut. The Qatari government plans to cover its projected deficit by raising debt in international markets.

Step in the right direction, but the road is long

While it is still early on to evaluate the recent announcements of increases in energy prices and their impacts on the wider economy, it is possible to discern some trends, which will shape the reform agenda for years to come.

First, more price increases are very likely in the coming years. Countries such as Saudi Arabia have specified a clear time framework (in its case, five years) while others have shied away from committing to a specific time frame.

Second, it is important not to underestimate the spillover effect within the GCC. The UAE and Saudi announcements have encouraged other countries in the GCC to follow suit. But this can also work in the opposite direction. Any reversal or slowdown in policy in these two countries will have an impact on the reform agenda elsewhere in the GCC.

Third, the need to generate revenues in these difficult times has been the main driver of the recent increases in energy prices. This is not ideal. Experience suggests that reforms are better implemented in good times, when the economy is in a better shape. However, a period of weaker oil prices makes it easier for countries to adjust their domestic prices to international levels, hence presenting a unique opportunity to align the two. It remains to be seen whether governments will continue with their reform agenda when fiscal pressures ease.

Fourth, none of the GCC governments has yet put in place mitigating measures to protect the household incomes from the price increases, perhaps because the increases for now remain modest and are starting from a low base. But designing compensation schemes for households would be essential to avoid backlash from consumers if GCC governments decide to further increase gasoline water and electricity rates, as these have a direct impact on household welfare. Lessons from neighbouring countries can be useful in this context. For instance, increases in energy prices in Jordan were accompanied with direct cash handouts to households with low income whilst
Egypt and Morocco ensured that reforms to LPG prices were minimal to ensure the vulnerable still had access to energy for cooking. The effectiveness of GCC governments to design and execute such compensatory schemes will be closely monitored.

Fifth, the increase in energy prices will affect the cost base of some key industries and companies reducing their profitability. Governments could establish specialized funds to help industries adjust to higher costs by introducing new technologies and upgrading equipment, though any assistance should be on a case by case basis as some of the companies already benefit from different forms of government support and remain highly profitable even after the current increase in energy prices.

Finally, designing an effective communication strategy that transmits information in a timely and transparent manner and that reaches all segments of society impacted by the price increases is key to the success of any reform programme. Part of Morocco’s success was a result of a well-orchestrated communication strategy that included public TV and radio discussions, advertisements and debates explaining the reform steps, the reasoning behind the reform and the benefits to society. The recent experience in most GCC countries is not encouraging in this respect: most countries announced the price increases in an ad hoc manner and without an effective communication strategy to explain the reasons behind them, who the main beneficiaries would be, and whether compensation schemes would be put in place.

While some of the GCC countries have taken a step in the right direction, the road for reform is still long and fraught with risks. The GCC governments can breathe a sigh of relief that the initial announcements did not generate much public opposition. But it is too early to celebrate as experience shows that price reversals are possible. For reforms to succeed, a clear vision, political resolve, the involvement of different segments of the society, effective and transparent communication strategy, and well-designed compensatory schemes to mitigate the negative impacts on households and industry are all essential.

In the GCC countries, the jury is still out as to whether the preconditions for a successful pricing reform programme have been appropriately put in place.