Lots of talk, but little action on GCC subsidy reform

Even the wealthiest Gulf states are weighed down by the burden of the subsidy regimes their citizens have come to rely on. The remedies are well known, but administering them remains fraught with political danger

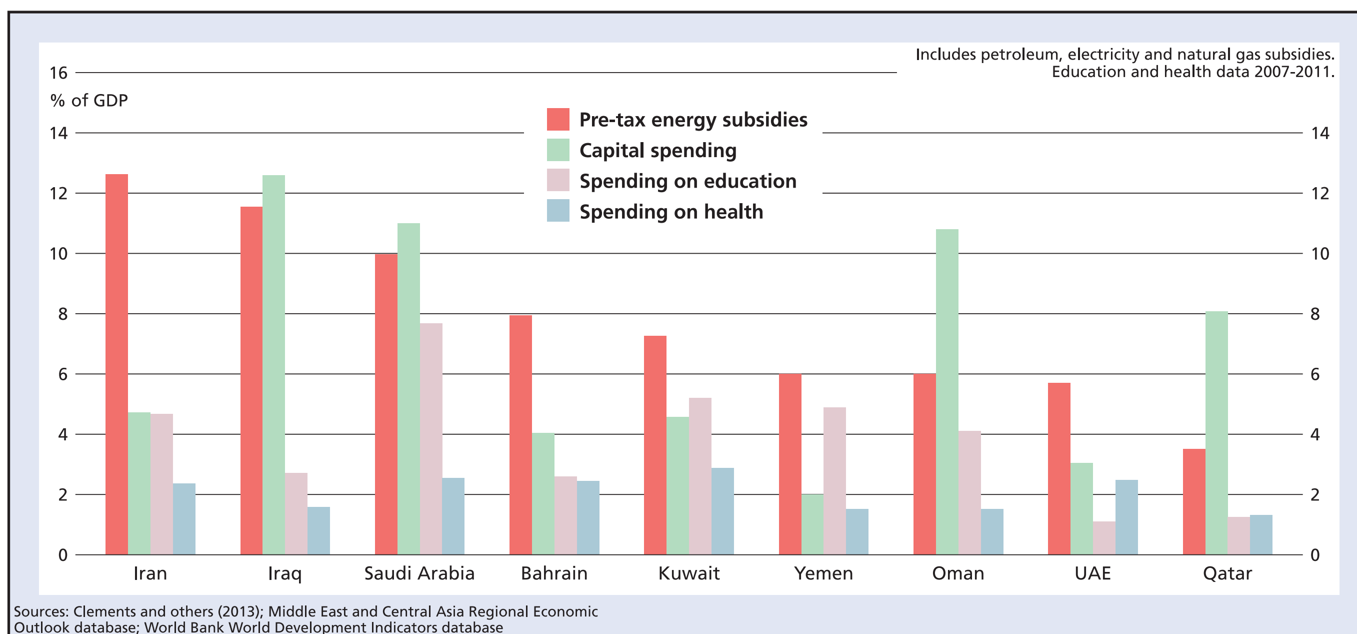
Saudi Arabia's Electricity and Cogeneration Regulatory Authority (ECRA) released its annual fiscal review on 1 July. Hidden inside the lengthy report was a startling figure: in 2012-13, Saudi government support to the Saudi Electricity Company alone was worth around $40bn, compared to an overall subsidy bill (electricity and gasoline) of roughly $13.3bn in 2010. ECRA said the subsidy reduced the cost to the company of producing, transporting and distributing a kWh of electricity to 15.2 halalas from a potential 80 halalas.

Across the Gulf, the subsidy bill is growing, and its effect on the economic stability of Gulf Co-operation Council (GCC) governments is a much-discussed topic among economic analysts. According to the International Monetary Fund (IMF), energy subsidies are so widespread in the Middle East/North Africa (Mena) region that they account for about half of all global energy subsidies. They weigh heavily on government budgets – effectively bankrupting poorer administrations such as Morocco's, which is paying out around $5bn/yr – and burn money that could be spent elsewhere. The IMF estimates that the energy subsidy burden on GCC governments ranged from 9% to 28% of revenue in 2011, compared to just 3.5% spent on education across the region. Rising energy prices in recent years have increased the burden.

GCC governments are well aware of the problem. The UAE has been particularly frank; energy minister Suhail Al-Mazrouei told reporters in Abu Dhabi on 22 June that the government was not happy with the amount of electricity being consumed, which he said was two to three times the global average. "You will never have a strong economy if you are subsidising," he was quoted by *Bloomberg* as saying. Even the more reticent Saudis have spoken up. "These subsidies are increasingly distorting our economy," economy and planning minister Mohammed Al-Jasser told a conference in Riyadh in May 2013, promising that the issue was "something we are trying to address". Kuwait is also seeking a review of its $16bn/yr subsidy bill, and similar initiatives have been touted in Oman, Bahrain and Qatar.

But putting policy into practice has proved far trickier. Few governments have followed the path of (resource-poor) Dubai, which implemented an electricity tariff increase in 2011 (*see box, page 9*). "There has been a lot of talk about this issue, and there appears to be consensus-building regarding this problem, but I have seen no evidence of concrete action to roll back subsides or raise prices on energy," energy fellow at Rice University's Baker Institute Jim Krane told *GSN*.

Pre-tax energy subsidies, capital & social spending in Gulf states, 2011



Sources: Clements and others (2013); Middle East and Central Asia Regional Economic Outlook database; World Bank World Development Indicators database

GCC subsidies prove difficult to roll back

Kuwait: Extravagant subsidies

When it comes to Gulf Co-operation Council (GCC) subsidy regimes in need of reform, Kuwait appears to be in most need. All residents, including foreigners, benefit from subsidised petrol, cheap electricity and water, while Kuwaiti nationals get extra support for housing and food. Electricity prices have not changed since 1966, at KD0.002 (2 fils – $0.007)/kWh. The Ministry of Electricity and Water is selling power for just 5% of the cost of production – part of the reason why Kuwait's total subsidies bill is reportedly $16bn/yr (*see main article*). Kuwait's turbulent politics don't help: a series of elections and reshuffles in recent years have made things even more difficult for political leaders who fear any reform could create further instability. Nonetheless, Kuwaiti MPs were reported in April to be mulling over a proposal to at least lift subsidies for expatriates and raise electricity prices.

Dubai: The best performer?

The only glimmer of hope in subsidy reform throughout the Gulf has been provided by Dubai. "After the economic crisis in 2008, in the wake of austerity, the Dubai government set about raising prices on citizens and expats," energy fellow at Rice University's Baker Institute Jim Krane said. Ruler Sheikh Mohammed Bin Rashid Al-Maktoum (MBR) gave permission for a 30% increase in electricity prices – 15% as an increase in electricity consumption tariffs and 15% as an LNG surcharge.

Following the global credit crunch, which had a very negative impact on Dubai's highly leveraged economy, MBR installed a known spending hawk, Mohammed Al-Shaibani, to head his ruler's diwan, and charged him with implementing austerity measures. The Dubai Supreme Council of Energy (DSCE) was created in June 2009 to make policy and regulate the electricity and water sector. DSCE director Nejib Zaafrani, a well-connected former Shell executive, declared that Dubai, as a net importer of energy, should cut its projected electricity demand in the period to 2030 by 30%. A measure towards this, Dubai's tariff increase went into effect on 1 January 2011 – at the same time as the beginnings of the Arab Spring protests throughout the Middle East and North Africa (Mena) region.

The price rise brought angry Emiratis into the Dubai Electricity and Water Authority (Dewa) headquarters, demanding to see the person in charge of billing, which by tradition they could demand. Others sought redress with tribal leaders, who went directly to express their disquiet. "Emiratis complained vehemently and, when afforded the opportunity, many expats grumbled to the media," Krane said. In a bid to save costs, the emirate's government, through Dewa, took a step forward on subsidy reform, but the price increases on citizens were ultimately diluted when the government agreed to pay an LNG surcharge that would have been added to citizens' bills. In the end, only expatriates and commercial customers were required to pay the surcharge. "Political stability concerns trump economic worries, especially when the region is aflame. Emirati citizens had the political clout to reduce their share of the increase, but expatriates and businesses were stuck footing the full bill."

The Persian model

In the wake of domestic turmoil following the controversial re-election of Mahmoud Ahmadinejad in 2010, Iran laid out plans for an ambitious subsidy reform strategy. The government ended its extensive subsidy regime (estimated at $70bn) in December 2010 and replaced it with a cash subsidy programme; Iranians started receiving direct payments of around $45/month into their bank accounts. At first a success, the second phase involving a new round of price increases was postponed after international sanctions ravaged the economy. As a result of sanctions, economic growth decelerated, inflation rose and the Iranian rial depreciated sharply. Planned government revenues expected from increasing energy market prices never materialised, causing a shortfall of committed cash transfers to Iranians; the second phase never went through.

According to the International Monetary Fund, "the initial success of the reform in driving down the consumption of the subsidised products and improving income distribution waned because of the sharp increase in inflation in the absence of supportive macroeconomic policies". Since the rapprochement with the West, things have been moving positively with President [Hassan] Rouhani raising petrol price by 75% from IR4,000 to IR7,000 ($0.16 to $0.28) per litre.

Not as easy as raising prices

Keeping domestic energy prices low, regardless of income levels, and paying subsidies out of the revenues generated from hydrocarbons exports, is not a very sustainable model. "Energy price reform is not as simple as raising prices," said University of Oxford energy expert Justin Dargin. "For reform to be achieved, a detailed action plan needs to be developed at the highest levels of government involving all of the stakeholders. There must be a strong will and desire for the leaders to take what would undoubtedly be unpopular [measures]."

This notion of political stability has held governments back from reform. As Dargin observed, across Mena, "the advent of the Arab Spring at first made governments even more hesitant to modify the energy status quo". The critical question is when the buying political stability argument will be overweighed by economics.

Besides the increasing cost of subsidies, energy demand is rising (*GSN 966/12*). Together, the six GCC economies consume more primary energy than the whole of Africa, according to London-based think tank Chatham House's 2013 report *Saving Oil and Gas in the Gulf*. Subsidies have been instrumental in driving increased demand and, with energy prices so low – or even free, as is the case for electricity (and water) for locals in Qatar – demand has rocketed in recent years. Only a change in policy will break the vicious circle, and at least reduce the vulnerability of economies linked so closely to energy prices on the world market.

A social contract

Ruling family-dominated governments in the GCC have for decades enjoyed a social contract with their citizens based on the view that 'if you don't get involved in politics, we will provide you with all the services you need, for free'. The response to the so-called Arab Spring across the region in early 2011 again demonstrated the monarchs' reliance on this recipe for calm. In Saudi Arabia, where a mild protest started to take shape, King Abdullah Bin Abdelaziz flew back from Morocco (where he had been receiving medical treatment) and announced a $10bn benefit package just hours after getting off the plane (*GSN 895/1*). No political reforms were included, and the protest movement was quickly put down. In Oman, Sultan Qaboos also relied on largesse to quell political unrest, though he did also remove a few unpopular politicians and grant some legislative powers to councils that had previously acted as advisory institutions.

The big question is: what would happen if the terms of the contract changed? If, for example, subsidies on services such as electricity were rolled back, how great would be the popular backlash? Ageing rulers – who ultimately make the important decisions in most jurisdictions – fear their polities could be politically destabilised as ruling families are no longer able to meet their side of the bargain. There are precedents of popular anger having political impact, such as in 2011 in Kuwait, when months of protests, corruption scandals and frustration about the lack of economic development and bad services forced the emir's nephew, Sheikh Nasser Mohammed Al-Ahmed Al-Sabah, to resign (*GSN 914/4*, *913/1*).

It is not just the rulers who need to adapt. As Dargin told *GSN:* "Reform can only arise when there is a conceptual shift in the minds of the populace and industry that they will have to pay more, but by paying more, they will guarantee consistent power and natural gas supply, in contrast to the current blackouts and shortages."

Such conceptual shifts are not yet apparent in populations or, indeed, in the minds of senior rulers – even if they are in ministries of finance, central banks and other more technocratic institutions. But if and when the shift arises, it may bring with it a wider-reaching change in mindset. Should citizens see an increase in electricity or petrol prices as tantamount to a form of taxation, they may soon find themselves agreeing with the demand, famously iterated by US founding father Thomas Jefferson, that there should be "no taxation without representation".

IRAQ

KRG threatens buyers of Iraqi crude

The Baghdad/Erbil brinkmanship continued on 14 July as the Kurdistan Regional Government (KRG) published a notice in London's *Financial Times* threatening to take legal action against anyone who buys oil from the federal government without paying the KRG a share. Baghdad has also threatened legal action against anyone buying oil directly from the KRG (*GSN 973/22*, *971/12*).

"The KRG notifies all persons that have purchased or may purchase oil or gas from any division of the Iraqi federal government, including the federal oil ministry or SOMO [State Oil Marketing Organisation], that the KRG will consider such buyers and those who have facilitated shipments on their behalf or on behalf of SOMO as colluding in, supporting, or facilitating violations of the KRG's rights… unless such buyers pay the KRG 17% of the purchase price," the notice said. "The KRG will take such legal action against buyers of oil from the federal oil ministry and SOMO (or any other division of the Iraqi federal government) as may be necessary to protect the KRG's constitutional and legal rights."

As the crisis in Iraq continues (*GSN 972/1*), the Kurds seem to be limbering up to argue the case for independence. On 11 July, Kurdish forces said they had taken full control of Kirkuk's oil fields; the same day, Kurdish politicians said they had suspended participation in the government, in protest at Prime Minister Nouri Al-Maliki's accusations that the KRG region was sheltering extremists. Kurdish MPs did still plan to attend parliament though, where the tussle to agree on the next prime minister looks set to go on, despite agreement on Salim Al-Jubouri as speaker.

NEWS IN BRIEF

SAUDI ARABIA: SRAK struggles

Royal Dutch Shell (Shell) has stopped its investment in the Kidan gas development project. In a 5 July interview with *The Sunday Telegraph*, Shell director of upstream international business Andrew Brown admitted the company's decade-long search for gas in the Rub Al-Khali had been fruitless. "We haven't had a very successful exploration campaign…We aren't conducting any operations there at the moment," Brown said. Two days later, Shell emailed a statement to media saying: "Shell has decided to end further investment in the Kidan development. This was a difficult decision but Shell remains committed to the kingdom and we are keen to grow our investments, both in upstream and downstream." The South Rub Al-Khali Company (SRAK) – a Shell/Saudi Aramco joint venture – did find small quantities of gas in the Kidan field, which it got permission to appraise in 2011. But the costs of developing sour gas and low gas prices in Saudi Arabia have been a major deterrent. In March 2013, *Reuters* quoted industry sources as saying that Shell wanted to pull out of SRAK due to disagreements with the government over terms. Eni and Repsol have also abandoned their search for gas in the Empty Quarter. Total was originally a third partner in SRAK, but sold its 30% share back to Shell and Aramco in August 2008.