GCC-Implications of UAE’s Fuel Deregulation

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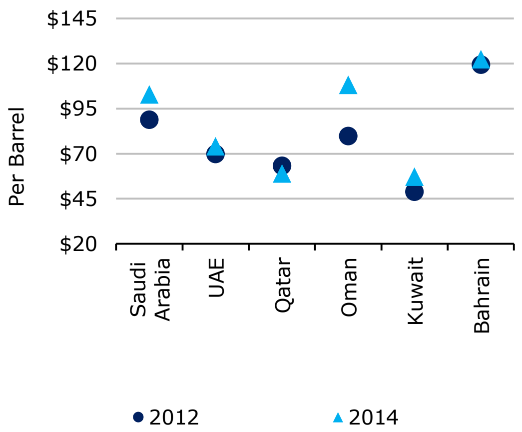
"UAE has announced deregulation of transport fuel prices"

In a pragmatic move aimed at boosting fiscal health and reducing domestic oil consumption in the UAE, the nation's Ministry of Energy announced that transport fuel prices would be deregulated as of 1 August 2015. With GCC economies steadily embracing market oriented reforms, the surprise move by the UAE has made it the first nation in the GCC to completely abolish fuel subsidies and join the league of other key emerging economies such as India, Indonesia, Mexico and Egypt that have deregulated fuel prices in the recent past. Through our report titled "GCC Budget Analysis" we had highlighted the need for GCC economies to initiate measures to lower energy subsidies, and this move by the UAE marks as a significant step in that direction. In this short note, we highlight the need for such reforms in other GCC economies.

"GCC economies face severe fiscal pressure"

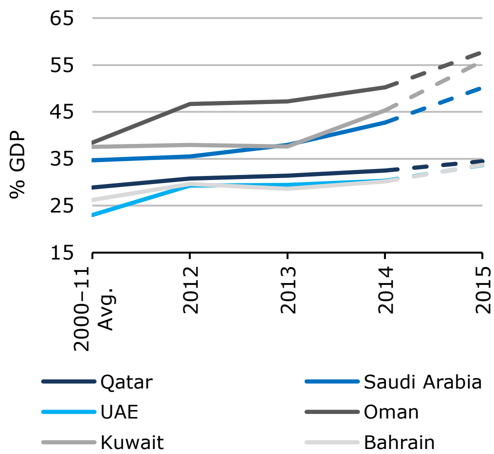
Oil has been a major contributor to government revenues, accounting for almost 90% of the total fiscal revenues in some of the GCC economies. With the global supply glut severely hurting oil prices lately, economies in the Middle East face a pressing need to reduce subsidies more than ever. Breakeven oil price, the price of oil at which an economy is expected to balance its budget, has been steadily nudging higher for GCC oil producers. This trend has accentuated lately, largely influenced by receding oil revenues coupled with record levels of budget spending in most of the Gulf economies. Despite the pressures from the oil market during the course of 2014, most GCC economies maintained fiscal expenditure at record levels. Although elevated levels of foreign exchange reserves can help most of these economies fend off immediate shocks, the persistent fatigue in the oil market could pressurize local authorities to embrace reforms aimed at ushering fiscal discipline. In the midst of the steep fall in oil prices, the UAE authorities have embarked on a rational move to offset fiscal stress. We believe that this move by the UAE could set a precedent, and could possibly prompt other governments to follow suit. However, local national factors could influence the extent of reforms.

Fiscal Breakeven Oil Price



Source: IMF

General Government Total Expenditure and Net Lending



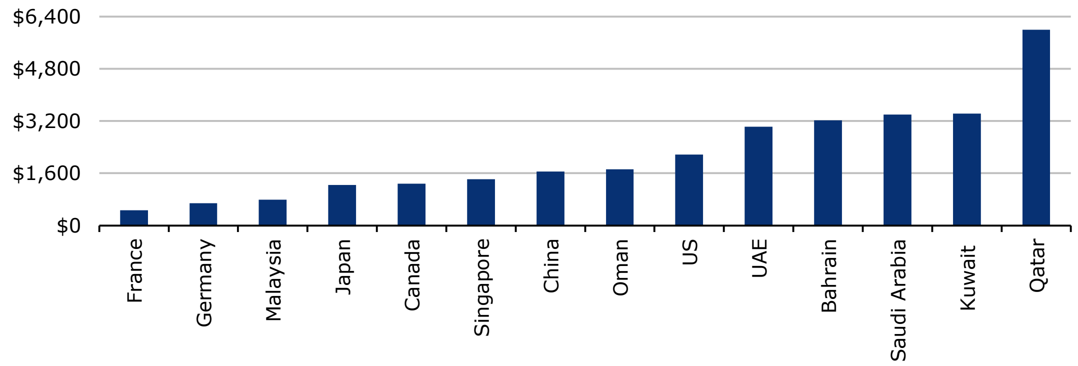
Sources: IMF

Although low priced fuel has been a major contributor to economic development in the GCC region, the increasing burden of subsides has started to weigh on the fiscal in these nations.

"Subsidies in the region are high"

GCC economies account for the highest per capita subsidy among major economies. For example, Qatar ranks the highest in terms of per capita energy subsidy in the world, with total energy subsidies (post-tax) expected to touch an estimated $6,000 in 2015, of which petroleum subsidy is expected to account for close to 50%. Petroleum subsidies in Saudi Arabia and Kuwait account for greater than 70% of the total post-tax subsidies. Meanwhile, in other GCC economies, such as the UAE and Oman, electricity and natural gas account for a major portion of the overall subsidy outflow. The IMF expects MENA economies to cumulatively spend close to $360 billion on post-tax subsidies, and these subsidies are likely to account for 6.75% of GDP during the current year.

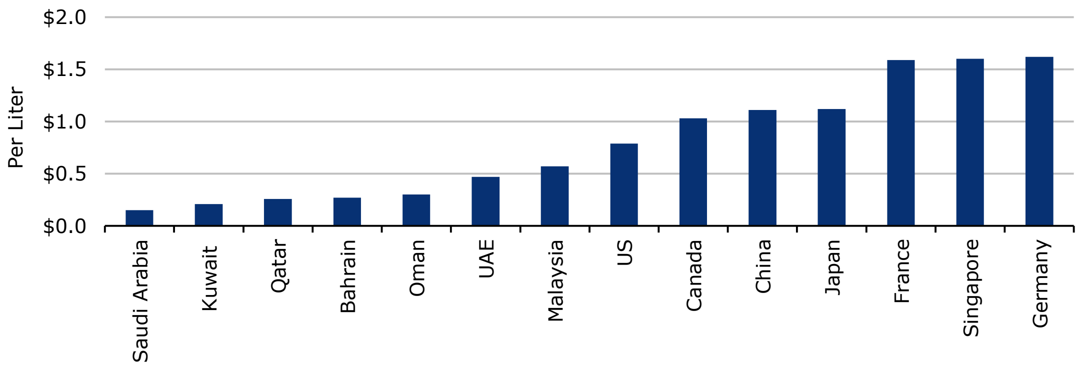
Comparison of Per Capita Subsidies in the GCC and other Leading Economies



Sources: IMF, Counting the Cost of Energy Subsidies Report July 2015

These subsidies have resulted in retail fuel prices which are substantially lower than global benchmarks. For example, the price of premium unleaded gasoline in the UAE is currently about 40% cheaper than prevailing prices in retail outlets in the US, while in Saudi Arabia petrol prices are as low as $0.15 per liter.

Global Gasoline Prices

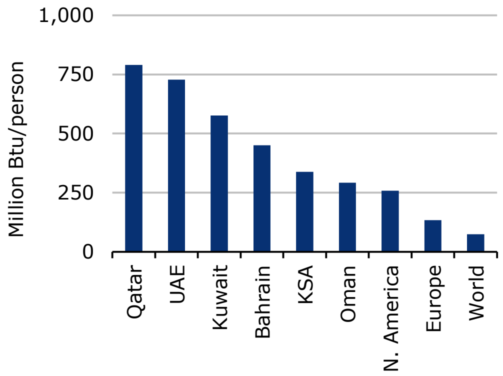


Sources: Global Petrol Prices, As of July 2015

"Fuel subsidies lead to over consumption, inefficiencies and adverse environmental impact"

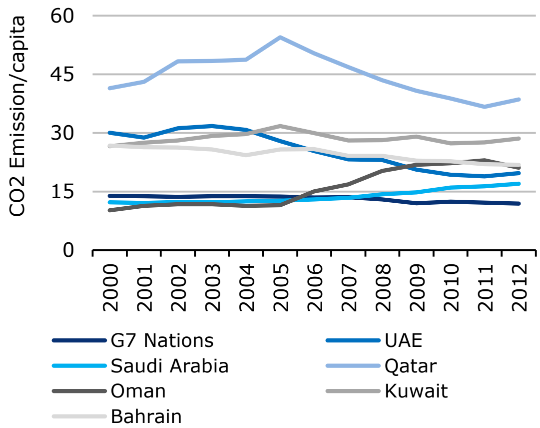
Subsidies lead to market distortions in consumption patterns. The economic boom in the GCC over the last decade, coupled with cheaper fuel, has led to a dramatic rise in oil consumption across the region. Domestic oil consumption in Saudi Arabia, UAE, Qatar and Kuwait has cumulatively grown by 5.4% annually from 2004 to 2014, outpacing the consumption growth in faster growing economies such as China and India. Data from the EIA shows that average per capita primary energy consumption of the six GCC countries stood at 529.5 mbtu per person in 2011, which was markedly higher than the OECD average of 191 mbtu per person in the same year.

Per Capita Primary Energy Consumption



Sources: US EIA, Data as of 2011

High CO2 Emissions



Sources: World Resource Institute and CAIT

The high energy consumption also has an adverse impact on environment. Data released by the World Resource Institute and CAIT shows that carbon emissions per capita in the UAE, Oman and Bahrain were almost double than that in the G7 nations in 2012, while it was significantly higher in Qatar and Kuwait. Most of the GCC countries rank among the leading per capita carbon emitters globally. Although energy sensitive industries in the UAE are not likely to be extensively influenced by the latest development, this move might encourage individuals to adopt fuel saving vehicles and increase usage of public transportation. Therefore, apart from the noticeable benefits likely to be derived from a decline in fuel subsidies, the move is also aimed at tackling growing environmental issues.

Various studies have revealed that energy subsidies fail to have a meaningful beneficial impact on the weaker sections of the society. Historical evidence shows that over dependence on generous subsidies often results in a culture of inefficiencies and wastages and an adverse environmental impact. With this backdrop, Emirates and other GCC economies need to explore methods to abolish all forms of fossil fuel subsidies, possibly in a phased manner.

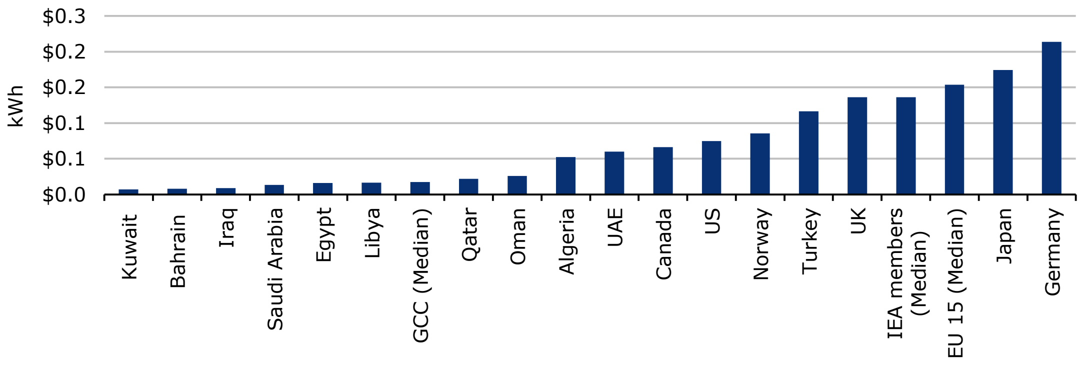
"Political backlash is keeping governments away from subsidy reforms"

Curtailing subsidies is the need of the hour for the GCC region. Oman's Minister for Financial Affairs, Darwish Al Balushi, recently stated that the Omani government plans to lower fuel subsidies this year. Separately, many of the local authorities seem inclined to implement such measures but have failed to pursue it aggressively amid fears of a political backlash and rising pressure to cater to domestic public opinion. Political pressure prompted authorities in Kuwait to partially reverse the hike in fuel prices that was administered in early 2015. Rising fiscal vulnerabilities in Bahrain prompted policymakers to roll back subsidies in goods and services such as meat and electricity. However, the budget was passed after a six month delay on account of failure to build consensus. As a way out, the Bahraini government decided to lower subsides for the expatriate population while the Bahraini citizens would continue to receive direct cash transfer in order to offset the cut in subsidies. Meanwhile, state-owned oil companies in Saudi Arabia continue to offer natural gas and other feedstock at cheap rates in order to support the nation's downstream activity. In order to avert an adverse one-time impact on consumers, governments in the GCC can introduce these measures in a phased manner, similar to reforms in India, in order to smoothen the impact on consumers.

"Proactive steps needed in energy sector reforms – else development activities will suffer"

Apart from measures to regulate petroleum prices, local authorities also need to initiate steps to deregulate electricity and natural gas prices in order to ensure efficient usage of fossil fuels and to boost fiscal revenues.

Average Retail Electricity Prices in Selected Countries, 2012



Sources: AUPTDE (2013), IEA

With local governments increasingly focusing on infrastructure activities, the unprecedented levels of energy subsidy could stifle the funds left for developmental activities. For instance, in 2013, post-tax subsidy outflow in Saudi Arabia stood at about $129 billion, which was more than 50% higher than the nation's capital expenditure during the same year. Moreover, rising current and defence expenditures have also resulted in governments failing to efficiently allocate funds for developmental activities. Taking cognisance of these contentious issues, local governments need to fast-track the process of fiscal consolidation despite the growing resentment against such measures. The earlier they start, the better!

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