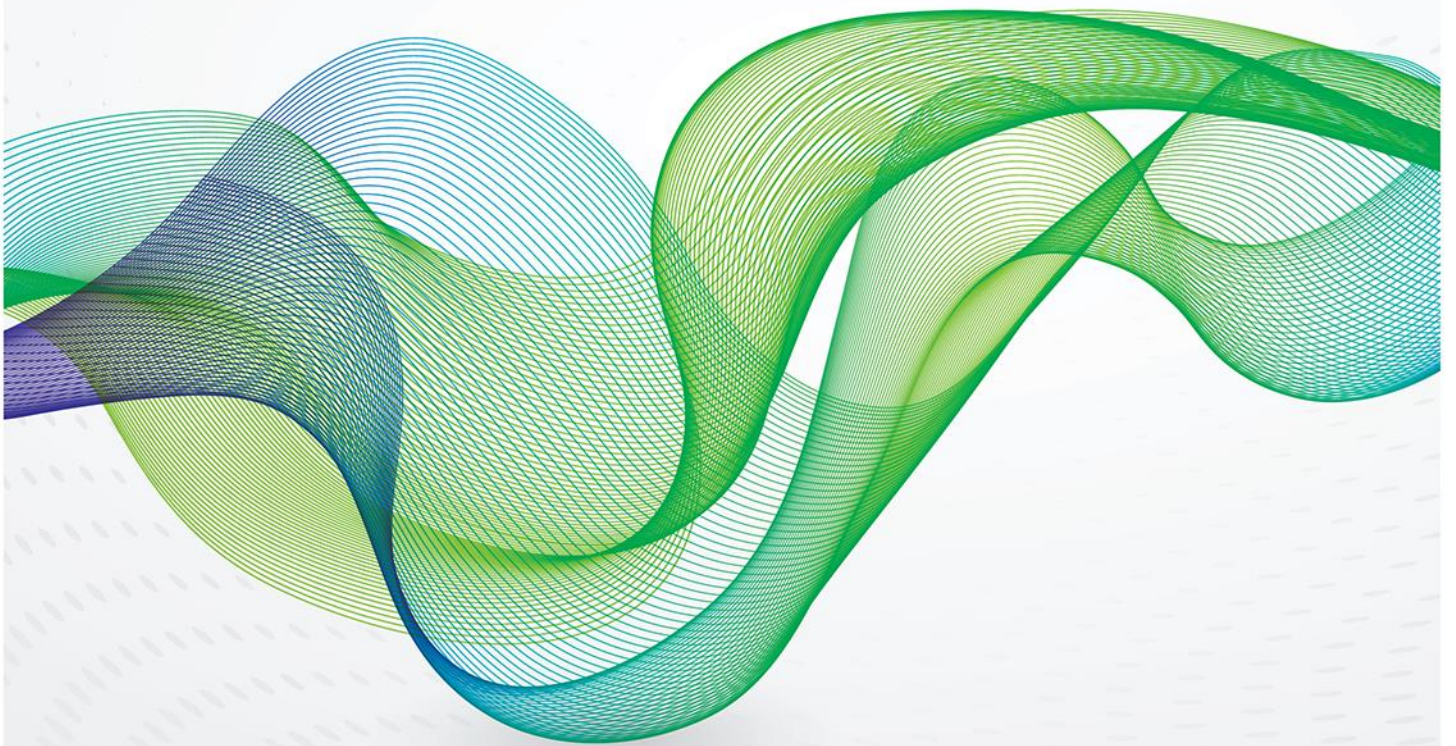




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Striking the Right Balance? GCC Energy Pricing Reforms in a Low Price Environment



OXFORD ENERGY COMMENT

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1. Introduction¹

In 2015, the Gulf Cooperation Council (GCC) countries began implementing and accelerating pricing reforms targeting the removal of energy subsidies. While the price increases were from a low base and domestic energy prices are still well below international levels and among the cheapest in the Middle East and North Africa (MENA) region, the recent increases represent a fundamental shift in the GCC's economic and social policies. Low energy prices have been a central element of the implicit social contract between the rulers and the citizens, and are seen by many as one of the methods of rent distribution. They have also been a central part of these countries' attempts to industrialize through investment in energy intensive industries. Low energy prices have also provided a safety net for low-income households. Further, by keeping energy (and food) prices low, GCC governments have been able to keep inflation under control, supporting macroeconomic stability.

Conversely, low energy prices have resulted in wide distortions and inefficiencies in the GCC economies that have prevented governments from optimizing the use of their natural resources (for a detailed discussion see Fattouh and El-Katiri, 2013). For instance, they have caused rapid growth in domestic energy consumption and a rise in the energy intensity of GDP, as low energy prices encouraged wasteful consumption and industrial policies biased towards investment in energy intensive projects, such as petrochemicals and aluminium. They are also inequitable, with households in high-income brackets (enjoying relatively higher levels of consumption), capturing most of the benefits from low energy prices. The large differences in the prices of diesel and gasoline in the region have also encouraged smuggling within the GCC and MENA region.

Typically, for producers attempting to reform energy prices, incentives are mixed and the timing of reform matters (Ladislaw and Cuyler, 2015). Energy pricing reforms in oil exporting countries are best carried out in 'good' economic times when revenues and fiscal buffers are plentiful; however, this is politically difficult as these are also times when the difference between subsidized prices, and prices which reflect full costs, are highest. As shown in Table 1.1, during times of high oil prices, the fiscal urgency of reform is low as revenues are plentiful; the economic cost of reform is high as the adjustment to opportunity cost prices is steeper; and the political cost of reform is also high as prices have further to go to reach full-cost levels and governments are under pressure to increase spending when oil revenues are 'pouring in'.

When oil prices are low, the fiscal urgency for reform is conversely high as export revenues are lower; the economic cost of reform is low as the adjustments to full or opportunity cost are potentially smaller; and the political cost of reform is low *relative to full/opportunity-cost prices*. Nevertheless, if price increases are carried out without introducing mitigating measures to help offset the negative impacts on households' welfare, the political cost of reform could potentially be high as citizens of resource-rich governments may view price increases as clashing with the implicit social contract.

Table 1.1: Fiscal–Economic–Political matrix of incentives to reform energy prices

	High Oil Price	Low Oil Price
Fiscal urgency of reform	Low	High
Economic cost of reform	High	Low
Political cost of reform	High	Low or High

Source: Authors

In the case of the GCC economies, although current low international prices imply that domestic prices have relatively less far to go in order to align with international prices, a high reliance on oil revenues for distribution, public spending, economic development, and diversification during a period

¹ The authors would like to thank Giacomo Luciani, Jason Bordoff and Ali Aissaoui and for their valuable comments on previous drafts and also the Kuwait Foundation for the Advancement of Sciences for funding support.

of geopolitical challenges implies that the political cost of raising prices to market levels is not insignificant. The successful implementation of energy pricing reform in resource-rich economies, therefore, involves striking a balance between their fiscal, economic, and political elements. GCC countries can ill afford to make policy mistakes when it comes to pricing reforms, given the political sensitivity of these reforms and the legacy of entitlement among their citizens.

Although the distortions caused by low energy prices have been well recognized by GCC governments (IMF, 2015f), we argue that it is the short-term fiscal pressures resulting from falling oil revenues that have been the primary driver behind the recent price increases. The recent reforms could also be construed as an opportunistic move, in a time when there is a higher acceptability for broader reforms brought about by the sharp decline in oil revenues. In the background, there have been growing concerns over economic inefficiencies, and the long-term fiscal sustainability and viability of the current welfare model.²

We argue that, contrary to conventional wisdom, the implicit social contract in the GCC has proved to be elastic and sufficiently malleable to accommodate recent energy price increases. However, it may not prove sufficiently resilient to accommodate further price increases in all GCC countries; further reforms may therefore not be viable in the absence of effective communication strategies and mitigation measures that could offset the adverse impact of higher energy prices on households and firms. The pace and urgency with which the recent price increases have been carried out over the last few months could affect the ability of the GCC governments to sustain these reforms in the longer term. There is sufficient international experience of energy subsidy reform to suggest that reforms can fail when:

- fuel prices are increased too rapidly;
- long-term commitment to reform is unclear or lacking;
- pricing policy decisions are not depoliticized;
- there is a failure to introduce appropriate social safety nets as part of the reforms; and,
- reform objectives and planned mitigating measures are not communicated clearly to citizens (IMF, 2015f).

Any combination of these factors can lead to a slowdown in the pace of reforms or even to their reversal, as indeed has been the case in many countries around the world.³ An additional complexity is that policy decisions often cannot be entirely depoliticized, as they form part of the implicit social contract that GCC governments have with their citizens in the redistribution of oil wealth.

The objectives of this paper are to analyse the fiscal pressures which led to the acceleration of pricing reforms, which we argue were building even during the period of record high oil prices preceding it; to review recent energy pricing reforms in GCC countries; and to analyse the implications of recent energy pricing reforms for the social contract between GCC governments and their citizens. We conclude with some observations on the sustainability of the current pricing reforms.

2. The fiscal pressures motivating pricing reforms

The heavy reliance of the GCC on oil revenues implies that their economies are highly exposed to developments in the global oil market. The sharp decline in the oil price has altered the economic outlook for the GCC (see Table 2.1). After a period of sustained real GDP growth, which averaged above 5 per cent during 2000–12, GCC growth rates have started to slow down in recent years, while the IMF projects that growth will slow further in 2016 (see Table 2.1). Also, after having achieved large fiscal surpluses in the period of high oil prices, the GCC countries ran large deficits in 2015 and

² For instance, the IMF (2016a) argues in its latest Regional Economic Outlook that the 'current growth model based on the redistribution of resources by the government is no longer sustainable, given the fiscal retrenchment and a rapidly growing labor force'.

³ For instance, in Yemen, Indonesia, and Nigeria.

are projected to run further deficits in 2016 and 2017. The change in the macroeconomic outlook is already having an impact on key sectors. The region's stock markets have fallen from the high levels reached in the first half of 2014, local banks are reining back on their lending activities, and the confidence of the private sector has taken a hit.

Table 2.1: Selected macroeconomic indicators for the GCC countries

	Average 2000–2012	2013	2014	2015	2016 (proj)	2017 (proj)
Real GDP (% annual growth)	5.1	3.2	3.5	3.3	1.8	2.3
Current Account Balance (% GDP)	17.1	21.3	14.5	-1.0	-7.0	-4.1
Overall Fiscal Balance⁴ (% GDP)	10.8	10.2	3.3	-9.9	-12.3	-10.8

Source: IMF (2016a)

2.1 Fiscal pressures not uniform across the GCC countries

Although a necessary element of longer-term broader economic reforms, recent price increases have been motivated primarily by short-term fiscal pressures created by falling oil revenues. This applies not only to countries with limited 'fiscal space', such as Oman and Bahrain, but also to those with more robust public finances, such as Saudi Arabia, Kuwait, the UAE, and Qatar.

Of the GCC countries, Oman is particularly vulnerable to sharp drops in oil revenues. Its finances have deteriorated sharply following the recent oil price fall, with the provisional deficit for 2015 reaching OMR4.5 billion (USD11.7 billion),⁵ well above the OMR2.5 billion (USD6.5 billion) originally projected in the budget. The 2016 budget projects a budget deficit of OMR3.3 billion (USD8.6 billion), despite the government's efforts to boost revenues and cut spending (including cuts to energy subsidies)⁶. To finance the 2015 deficit, Oman drew down on its foreign reserves and resorted to local borrowing. The Omani government plans to tap international debt markets to help finance the 2016 deficit, but this will come at a higher cost, given its recent downgrade by credit rating agencies.⁷ The IMF has estimated that without further fiscal adjustment, financing the projected cumulative fiscal deficit between 2015 and 2020 would either exhaust Oman's fiscal buffers and raise debt to about 25 per cent of GDP, or increase government debt to over 70 per cent of GDP by 2020 if buffers were to be preserved.⁸

Like Oman, Bahrain's projected budget deficit for 2015/16 has soared, to BHD3.04 billion (USD8.05 billion)⁹; this had to be financed by transfers from the Future Generations Reserve Funds, GCC aid, and local and foreign borrowing. Even before the fall in the oil price, Bahrain had registered fiscal deficits for each year since 2009, underlining the country's budgetary challenges.

Even countries like Qatar, which has enjoyed years of budget surpluses, now face budgetary shortfalls¹⁰. The Qatari government recently announced a record budget deficit for 2016 of QAR46.5 billion (USD12.8 billion) despite plans to cut spending. The 2016/17 Kuwait budget revealed a projected deficit of KWD12.2 billion (USD40.42 billion) compared to a deficit of KWD8.18 billion (USD27 billion) for the 2015/16 budget¹¹. Meanwhile, for the first time since 2002, Saudi Arabia has budgeted a cut in total spending in 2016. It still, however, projects a fiscal deficit of SAR326 billion

⁴ Net lending/borrowing. Sources were IMF (2016a; 2015d). All other data was from IMF (2016a).

⁵ See Appendix for exchange rates used.

⁶ MEES (2016b)

⁷ MEES (2016), 'Oman Raises \$1bn Loan', 22 January, 59(03).

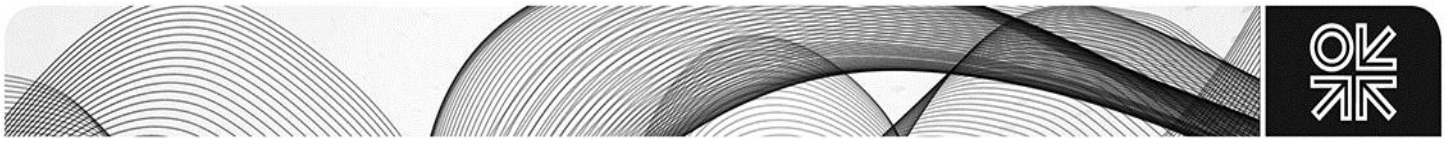
⁸ IMF Executive Board Concludes 2015 Article IV Consultation with Oman, May 5 2015.

<https://www.imf.org/external/np/sec/pr/2015/pr15189.htm>

⁹ MEES (2015), 'Bahrain 2015-2016 Budget Deficit Soars', 5 May, 58(20).

¹⁰ MEES (2015), 'Qatar 2016 Budget: \$13bn Deficit, the First in 15 Years', 23 Dec, 58(52).

¹¹ MEES (2016a)



(USD87 billion) compared to its forecast of a SAR145 billion (USD39 billion) deficit for 2015 – the actual deficit last year was higher, at SAR366 billion (USD98 billion).

2.2 Fiscal pressures were building during a period of record high oil prices

It would be inaccurate to say that the fiscal pressures which motivated the GCC economies to embark upon energy pricing reform following the 2014 oil price decline came about without any warning. Despite the seemingly robust fiscal position, these pressures were arguably building during the period of rising oil and gas prices. A slow global economic recovery following the 2008/9 global recession, as well as uprisings in many parts in the Arab world, led most GCC governments to announce large increases in wages, employment benefits, social spending, and infrastructure development programmes, as part of an attempt to pre-empt social unrest in their countries.

For instance, in 2011, the Saudi government unveiled a series of support measures to promote job creation, expedite the supply of housing, and improve funding for education, charity associations, cultural and sporting clubs, and professional associations. The measures also included a 15 per cent pay raise for state employees and (for the first time) a pledge to provide unemployed Saudis with financial support. In February 2015, even at a time when oil revenues had already started falling, the government announced handouts that included a bonus of two additional months of salary to a wide range of state and military employees, retired government and private sector workers, and social security beneficiaries. The total spending package amounted to USD32 billion, of which 80 per cent was current spending, to be spread out over a period of a few years (MEES, 2015).

Similarly, Kuwait launched its long-term economic development trajectory, 'Vision 2035'¹² in 2009, targeting the transport, water, power, and refining sectors of its economy in an attempt to diversify away from crude oil export dependence. It continued with its expansionary fiscal policy through 2011–14 (the final year of its Ninth Development Plan). But the bulk of fiscal pressures did not come from spending on social infrastructure, but from increases in public sector wages, as the country struggled to catalyse an increase in private sector employment of Kuwaiti nationals.¹³

Oman followed in the footsteps of its GCC neighbours and continued to pursue an expansionary fiscal policy (albeit with relatively greater constraints) during the period of high oil prices. It increased public spending during 2010–14 in response to social demands. Oman faces similar fiscal pressures to Kuwait from higher wage bills. It also has the highest rates of unemployment amongst GCC countries and a disproportionately higher number of nationals in the public sector as opposed to the private sector.¹⁴

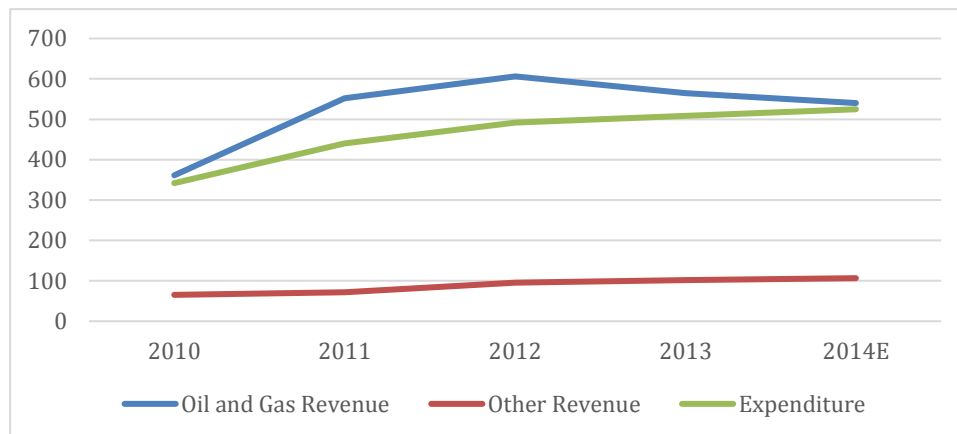
As a result of these changes, GCC economies became ever increasingly reliant on oil revenues to fund these commitments. Figure 2.1 shows that from 2010, government revenues from oil and gas increased relatively faster than revenues from other (non-hydrocarbon) sources, alongside a concomitant increase in government expenditure. This increase in government expenditure, together with a higher reliance on oil revenues to fund this increased spending, consequently exposed GCC economies further to volatility in oil price movements. Indeed by 2013, within the GCC, Bahrain was seen as operating at an 'unsustainable fiscal spending level' given its high breakeven oil price and lack of fiscal buffers; Saudi Arabia, the UAE, and Oman were seen as 'facing a threat of fiscal deterioration' in case oil prices dropped; while Kuwait and Qatar were, at the time, seen as being the least fiscally vulnerable to oil price fluctuations, as both nations 'managed to sustain fiscal expenditures at more prudent levels' (GIH, 2014).

¹² All GCC economies have at some time announced long-term economic development programmes of a similar nature. For instance, Oman adopted 'Vision 2020', while Saudi Arabia announced a 'National Transformation Plan 2020', and Qatar 'National Vision 2030'.

¹³ Kamco (2015) points to the rising incidence of public sector strikes.

¹⁴ In 2012, public sector employment stood at 194,000 people whereas the private sector employed roughly 1.4 million. However, 86% of public sector jobs were taken by nationals compared with only 12% of private sector jobs (GIH, 2014).

Figure 2.1: GCC government revenues and expenditure, 2011–14 (USD bn)



Source: GIH (2014)

2.3 Fiscal adjustment in a low price environment

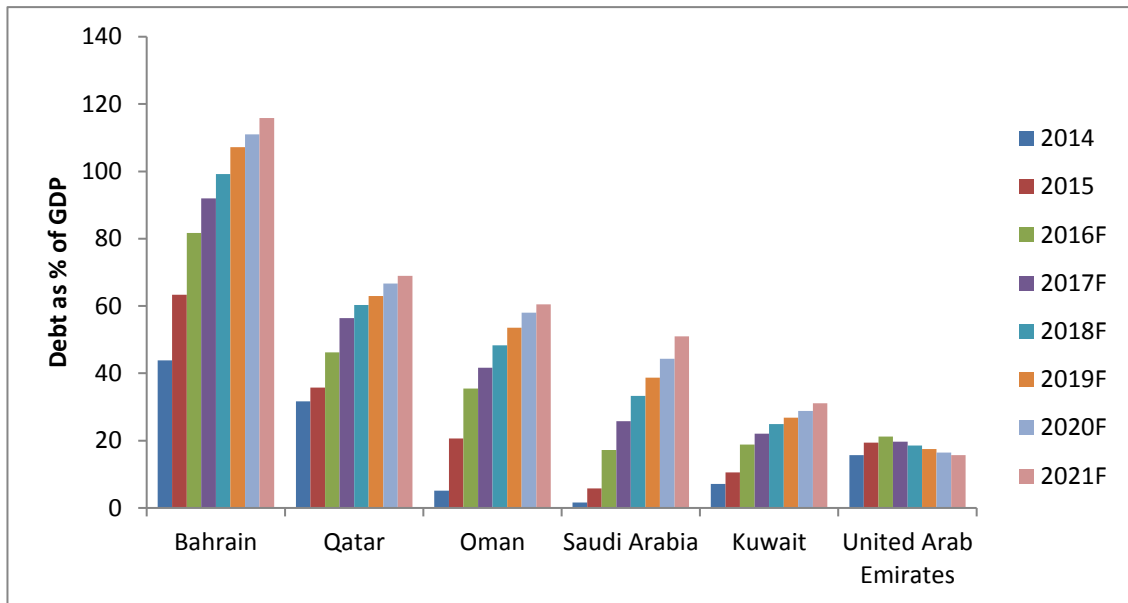
In response to the decline in oil revenues and deteriorating fiscal positions, GCC countries face a menu of policy choices, each being different in its relative ease of implementation. These include: borrowing from local and international markets; drawing down foreign reserves and/or liquidating Sovereign Wealth Fund (SWF) assets; letting their currencies devalue; increasing revenues by introducing various forms of taxes such as VAT and increasing corporation taxes; and rationalizing government expenditure by reducing current expenditure, cutting subsidies, and scaling back capital projects.

In the face of shocks, GCC countries can rely temporarily on their fiscal buffers.¹⁵ Fiscal buffers can be broadly assessed by the size of net foreign assets, extent of government debt, and access to SWFs. It is difficult to estimate the precise size of these buffers accurately for each individual GCC country, due to the manner in which financial reserves and foreign assets are managed in different GCC countries. For instance, Saudi Arabia does not have a dedicated SWF or a fiscal stabilization fund, but it entrusts the management of its financial reserves to the Saudi Arabia Monetary Agency (SAMA), while Kuwait, Qatar, and the UAE have large sovereign wealth/investment funds.

GCC countries are split between countries with relatively large fiscal buffers (Kuwait, Qatar, Saudi Arabia, and the UAE) and those with relatively smaller buffers (Bahrain and Oman) (IMF, 2015d). Oman and Bahrain are particularly vulnerable due to a combination of high debt-to-GDP ratios (see Figure 2.2) and low net foreign asset holdings (Figure 2.3). However, there are constraints to the use of fiscal space, even for better-off countries; for instance, although low levels of public debt have permitted some GCC countries to issue bonds and borrow from local banks, the underdevelopment of domestic capital markets risks squeezing liquidity and crowding out the private sector. Also, in the face of structural shocks, these buffers can easily be eroded, impacting upon country credit ratings and Credit Default Swaps (CDS) (IMF, 2016a) and pushing up the cost of borrowing both from local and international markets.

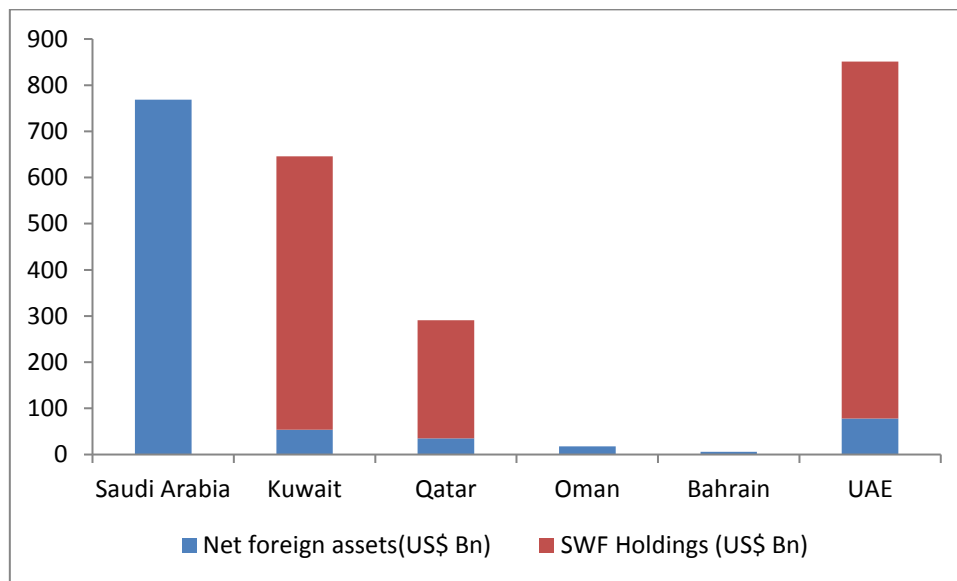
¹⁵ In 1998, a prolonged period of low oil prices left MENA oil exporters with limited buffers, so that many were forced to tighten fiscal policy; by 2008/9 these buffers had been replenished, allowing for more countercyclical policies (IMF, 2015d).

Figure 2.2: Evolution of debt-to-GDP ratios



Source: IMF (2016a)

Figure 2.3: Estimated net foreign assets of GCC countries (current USD bn)



Source: WDI (2016); SWFI (2016)

Another component of fiscal space in the GCC relates to longstanding currency pegs against the US dollar. Many major oil exporters (for instance, Russia and Venezuela) have devalued their currencies substantially, essentially transferring the burden of adjustment to citizens who earn incomes in their national currencies. Notably, none of the GCC states have followed this course and all have taken measures to protect their currencies.¹⁶ While de-pegging and devaluation could generate greater government revenues by lifting the dollar oil revenues in local currency terms, it could also impose

¹⁶ There have been pressures on these pegs in forward currency markets in recent months, but as the IMF notes these markets are relatively illiquid and the buffers in most GCC countries are large enough to fend off such pressures (IMF 2016a).

heavy costs such as rising inflation, a loss of policy credibility, and a risk of capital flight;¹⁷ these are costs which the GCC governments are keen to avoid.

Most GCC governments have announced plans to implement taxation reforms, as taxes have historically contributed a negligible proportion to GDP (see Table 2.2), with very low rates and very narrow bases raising little revenue (IMF, 2015g). For instance, in December 2015 Oman's parliament voted to increase tax rates for oil and gas companies from 12 to 35 per cent, and for LNG companies from 12 to 55 per cent, in an attempt to bridge its budget shortfall in 2015. It also planned to bring small- and medium-sized companies within the tax net by lifting a USD78,000 tax-free ceiling.¹⁸ Kuwait announced a 10 per cent tax on corporate profits in March 2016 while Bahrain increased taxes on tobacco and alcohol. All GCC governments also envisage the introduction of a Value Added Tax (VAT) by 2018.¹⁹

Table 2.2: GCC Countries – breakdown of tax revenue (% of GDP)

	Total	Income	Goods & Services	Corporate	Trade	Property	Other
Bahrain	0.6	0	0	0	0.6	0.3	-0.3
Kuwait	0.8	0	0	0	0.6	0.03	0.2
Oman	2.8	0	0	1.4	0.7	0	0.6
Qatar	1.7	0	0	1.3	0.4	0	0
Saudi Arabia	1.4	0	0	0	0.9	0	0.5
UAE	2.5	0	0	1	0.7	0	0.7

Source: IMF (2015g)²⁰

Within government expenditures, current spending on public sector wage bills constituted the largest component. On average, it is estimated that the GCC countries spend twice as much on their public wage bills as other emerging market and developing countries (IMF 2016a). For instance, wages and salaries accounted for 50 per cent of current spending in Saudi Arabia in 2015. Similarly, in Kuwait, public sector salaries have remained immune to spending cuts; salaries and related spending account for 55 per cent of total spending (with 80 per cent of Kuwaiti nationals employed by the state) and they are estimated to rise by around 10 per cent in real terms in the 2016/17 budget (MEES, 2016a).²¹ In Oman, an estimated 50 per cent of state spending goes towards salaries, exemptions, and subsidies (MEES, 2016b). While constituting the largest component of government spending, the wage bill is the most difficult item to cut.

In previous cycles, expenditure on capital projects has taken the largest hit (IMF, 2015d). This cycle may not prove much different, especially because there is considerable scope for cuts in capital spending in some countries (such Saudi Arabia and Qatar) where capital spending forms a large proportion of their budget following years of heavy investment in infrastructure projects. In Kuwait and Oman, however, expenditure on capital projects constitutes a lower proportion of total spending and is mainly directed towards the oil and gas sector; room for manoeuvre is therefore more limited (see Figure 2.4).

¹⁷ 'Fiscal reforms to stabilise GCC economies', *Gulf News Economy*, 6 March 2016.

<http://gulfnews.com/business/economy/fiscal-reforms-to-stabilise-gcc-economies-1.1685271>.

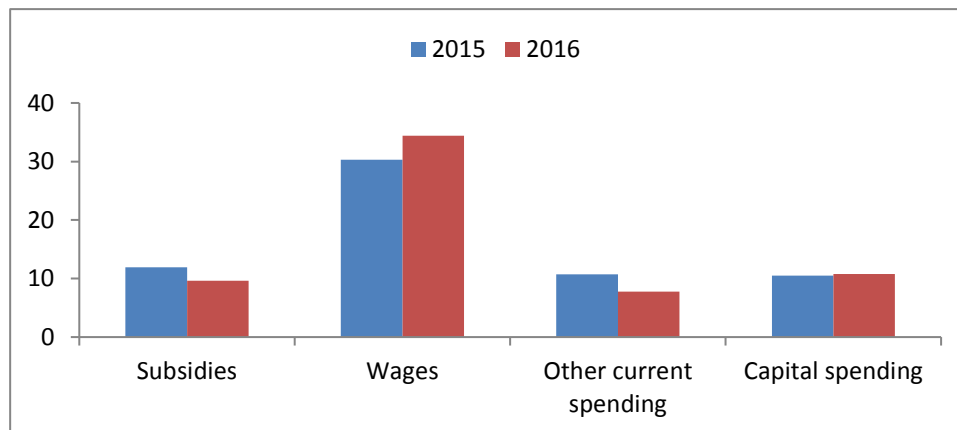
¹⁸ 'Oman's oil-gas companies face a "taxing" 2016', *The New Arab*, 23 December 2016.

¹⁹ IMF (2016a) estimates that introducing a 5 percent VAT could raise about 1.5 per cent of GDP in revenues.

²⁰ Latest data for 2014 where available; Qatar total revenue is for 2013; Kuwait trade tax data is for 2012; Bahrain and Kuwait property tax data are for 2004 and 2012, respectively; 'Other' taxes calculated as residual.

²¹ Some GCC economies are currently attempting to tackle this: Saudi Arabia in its 2016 budget announced plans to reduce spending on public sector wages, while Kuwait's government is considering reforms to standardize the wage structure in the public sector and to limit wage growth from 2016/17 (IMF, 2015e).

Figure 2.4 Composition of spending in Kuwait (USD bn)



Source: MEES (2016a)

3. Recent energy pricing reforms in the GCC

Along with the public sector wage bill, energy subsidies have been a huge drain on GCC public finances. In some countries such as Kuwait and Oman, subsidies are recorded explicitly in the budget. In countries such as Saudi Arabia, subsidies do not appear in the budget and hence are implicit – by selling energy at artificially low prices to domestic consumers the government and state-owned companies are subsidizing end-users, but without these subsidies appearing in the budget. Eliminating these implicit transfers has the effect of boosting government revenues and narrowing the deficit (Fattouh and El-Katiri, 2013).

The most visible policy measures have been on fuel price reforms, as several countries have resorted to large price hikes. In August 2015, the UAE fully liberalized its gasoline and diesel prices, introducing a pricing mechanism where domestic prices are set on a monthly basis and are directly linked to international prices. Given the sharp fall in the oil price over the last two years, gasoline prices actually increased by only a small amount (as international prices fell towards the former subsidized prices), while diesel prices have actually fallen since the announcement of full liberalization. The UAE has also increased the price of electricity, but Emirati nationals have been largely shielded from such increases. For instance, in January 2016 Abu Dhabi announced an increase in the electricity tariff to 31.8 fils (USD0.09)/kWh for expatriates living in villas and using more than 200 kWh/day (a flat rate is applied to consumption of up to 200 kWh/day).²² However, the fact that cost-reflective prices²³ only begin at a very high consumption of over 200 kWh/day implies that there remains considerable scope for measures promoting the efficiency of electricity usage. Subsidies for natural gas, which are key to the competitiveness of industry and a big component of the current subsidy bill, remain in place (Boersma and Griffiths, 2016). What is, however, noteworthy is that price increases in the UAE were initiated before the current fall in oil prices (Boersma and Griffiths, 2016).²⁴

In Saudi Arabia, pricing reform has affected almost every fuel, including those that have a direct impact on the profitability of key industries such as petrochemicals and cement. The price of ethane, the main feedstock used in the petrochemical industry, was raised from USD0.75/MMBtu to

²² See 'New water and electricity tariffs structure', Regulation and Supervision Bureau, Abu Dhabi.

<http://rsb.gov.ae/en/sector/new-water-and-electricity-tariffs-structure>. Also see 'Abu Dhabi raises water, electricity tariffs', *Gulf News Energy*, 2 January 2016. <http://gulfnews.com/business/sectors/energy/abu-dhabi-raises-water-electricity-tariffs-1.1647201>.

²³ In 2013/14 the Abu Dhabi Regulation and Supervision Bureau published a statement on electricity and water costs indicating that the cost reflective electricity tariff for residential consumers in Abu Dhabi was \$0.089/kWh and \$0.066/kWh for commercial and industrial customers (Boersma and Griffiths, 2016).

²⁴ For instance, in about 2009, Dubai launched a public relations campaign explaining the necessity of price reforms, and encouraging efficient consumption; this preceded increases in electricity tariffs (Boersma and Griffiths, 2016).

USD1.75/MMBtu, an increase of 133 per cent. Diesel for industry was raised from USD9.11/barrel to USD14/barrel. These price increases have drawn reactions from industry, relating to concerns over a shift in their cost structures, thereby reducing their profit margins²⁵. This is especially true for energy intensive industries that are not able to pass through the increase in their costs to end-buyers, either due to the competitive structure of the industry (such as petrochemicals) or the imposition of price controls (cement). Following the increase in energy prices in Saudi Arabia, a number of companies announced adverse projected impacts on their cost structures for 2016. However, the majority of these firms remain highly profitable even with the new price,²⁶ which remains one of the lowest in the world.

Among the Kingdom's transport fuels, premium gasoline prices were raised by 50 per cent to USD0.24/litre and lower-grade prices increased by 67 per cent, while diesel for commercial transport was raised to USD19/barrel. Given the high level of consumption of these fuels in Saudi Arabia, these price increases alone are estimated to have generated savings of around SAR16 billion (USD4.3 billion).²⁷

The prices of fuels used in the power sector – diesel, crude oil, heavy fuel oil (HFO), and methane – were also raised. The increases ranged from 67 per cent for methane to 225 per cent for diesel (see Table 3.1), but the Saudi Electricity Company (SEC) was making losses even before these feedstock price hikes. The SEC could see its revenues boosted by the recent increases to electricity tariffs. Households with low levels of electricity consumption less than 4,000 kWh per month were shielded from the increases in electricity prices, but for households with consumption levels of between 4,000 kWh and 6,000 kWh per month, prices were raised by 67 per cent to SAR0.20 (USD0.05)/kWh, while for consumption levels above 6,000 kWh per month, prices were unified and set at a higher level of SAR0.30 (USD0.08)/kWh. However, these tariff hikes are not large enough for SEC to recover its losses, given the increases in fuel prices.

Table 3.1: Saudi Arabia – fuel prices in electricity generation (USD/MMBtu)

Fuel	Old	New	% increase
HFO	0.43	0.86	100
Gas (methane)	0.75	1.25	67
Diesel	0.67	2.18	225
Crude Oil	0.73	1.02	40

Source: MEES (2016c)

In January 2016, the Omani government increased the price of premium gasoline from USD0.31/litre to USD0.42/litre and of regular gasoline by 20 per cent to USD0.36/litre. For diesel, prices were raised from USD0.38/litre to USD0.42/litre. The prices of these fuels will be set on the basis of a pricing formula that would take into account international levels as well as levels in neighboring UAE.²⁸ Oman increased its gas tariffs for industrial producers and the power sector in 2015, to USD3/MMBtu, with plans to increase gas prices by 3 per cent annually in subsequent years. The Omani government has been increasing gas prices gradually, and the 2015 price is already twice the 2012 price of USD1.5/MMBtu. Oman's government in January 2016 announced that it would review electricity tariffs for industrial and commercial (and possibly domestic) consumers, in a move widely seen as being a broader shift towards cost-reflective pricing. This prompted an outcry from industries, some of which stated that the increases could hit profits by as much as 25 per cent.²⁹ Through these measures, the government hopes to reduce the size of subsidies by more than half, from OMR900 million

²⁵ MEES (2016), 'Riyadh Cuts Fuel Subsidies, Petchem Producers Count the Cost', 8 January, 59(01).

²⁶ Ibid.

²⁷ Al-Iqtisadiyah, 'Taa'deel As'aar El-Benzin Wal Diezel Yowaffer 16 Million Riyals a'la Khizanat Al'Dawla' December 29, 2015

²⁸ Reuters, 'Oman plans spending cuts, tax rises, fuel price changes', December 30, 2015.

²⁹ See 'Industries brace for power tariff hike in Oman', *Oman Daily Observer*, 3 January 2016.

<http://omanobserver.om/industries-brace-for-power-tariff-hike-in-oman/>.

(USD2.3billion) to OMR400 million (USD1.04 billion). But even with this ambitious plan, subsidies will continue to account for around 3.4 per cent of total spending.

The Bahraini government raised the price of super gasoline from USD0.27/litre to USD0.43/litre and that of regular gasoline from USD0.24/litre to USD0.33/litre in January 2016. The government also confirmed the implementation of its four-year plan to increase the cost of diesel by 5 cents/litre each January to USD0.42/litre in 2016 and USD0.47/litre in 2017. Until 2004, natural gas was priced at USD0.25/MMBtu for the power sector and USD0.75/MMBtu for other major users. The government adopted a new pricing policy in 2005 by setting a unified price of USD1.0/MMBtu for all users and a gradual escalation formula. By April 2015, the price of natural gas to industries had reached USD2.50/MMBtu. The multi-phased adjustment programme will see the price of natural gas increase by USD0.25/MMBtu each year to USD4/MMBtu by the beginning of 2022. In March 2016, Bahrain's government announced increases in water and electricity tariffs (Table 3.2) for expatriates (which form the majority of the population) and Bahrainis with multiple electricity and water accounts. Further, it stated that prices would rise every year in March until 2019, to meet the cost of electricity production, which has been estimated at 29 fils/kWh (USD0S\$0.77).³⁰

Table 3.2: Bahrain – average electricity prices for consumers (USD/kWh)

	Old Tariff	New Tariff	%Increase
Electricity: Domestic Residential			
1–3000 units	0.08	0.16	100
3001–5000 units	0.24	0.34	44
5001 units & over	0.42	0.50	19
Electricity Non Domestic			
1–5000	0.42	0.42	-
5001–250,000	0.42	0.50	16
250,001–500,000	0.42	0.56	24
500,001 & over	0.42	0.77	45

Source: HB (2016)

Progress in the wealthier states of Qatar and Kuwait has been more erratic. Qatar's approach to increasing energy prices has been ad hoc. In 2011, the Qatari government increased the price of gasoline and diesel by as much as 25 per cent. But it then did not adjust these prices until 2015, when in a surprise move it increased the price of gasoline (super 97 Octane) from QAR1 to QAR1.30 (USD0.35/litre), while the price of Premium (90 octane) increased by 35 per cent, from QAR0.85/litre to QAR1.15. The government also increased water and electricity charges in October 2015. In April 2016, it announced that petrol and diesel prices would be liberalised from May onwards, with frequent adjustments each month thereafter, based on 'global and regional factors, and costs linked to fuel production and distribution.'³¹

Kuwait remains the only country within the GCC that has not increased its energy prices, despite the recognition by many government officials of the need to rationalize energy prices to control domestic consumption growth. In January 2015, the government increased diesel, kerosene, and aviation fuel prices, but in the face of political opposition and public protests, the government reinstated the old prices a few weeks after the announcement, for some users³². In the 2015/16 budget, subsidies amounted to KWD3.60 billion (USD11.9 billion) or around 22 per cent of current spending. The government has recently introduced a plan in its 2016/17 budget to cut the amount of subsidies by 22 per cent to KWD2.90 billion (USD9.6 billion), which is quite ambitious given the strong public and parliamentary resistance. Some deputies are proposing the imposition of quotas on consumption of fuels such as gasoline to reduce consumption, a scheme which would be very difficult to implement.

³⁰ See HB (2016) for details of planned tariff increases in 2017, 2018, and 2019.

³¹ 'Qatar says to liberalise fuel prices', *Daily Mail*, 26 April. <http://www.dailymail.co.uk/wires/afp/article-3559773/Qatar-says-liberalise-fuel-prices.html>

³² MEES (2016), 'Kuwait Delays Implementation on Planned 22% Subsidy Cut', 5 Feb, 59(5).

Kuwait also plans to introduce tariff slabs based on differential consumption between different consumer groups – for instance, ‘heavy’ consumers (including residential) could see their tariffs rise by 7.5 times.³³ The legislation required to implement these changes is yet to pass.

What is immediately evident from recent energy pricing reforms in the GCC countries is that the magnitude of price increases has been large (though starting from a low base) and in some countries like Saudi Arabia the reform has been broad, affecting a wide range of fuels. Table 3.3 depicts the magnitude in percentage terms of the price hikes for gasoline and diesel. For low octane gasoline, these range from 20 per cent in Oman to 67 per cent in Saudi Arabia, while for high octane gasoline these range from 30 per cent in Qatar to 50 per cent in Saudi Arabia. The increase in diesel prices has been more modest, except in the case of Saudi Arabia where prices increased by more than 70 per cent. However, the biggest increases have been seen in the prices of natural gas – mainly used by industry and the power sector, (Table 3.4), although in countries like Bahrain and Oman these increases have been achieved in a gradual manner.

Table 3.3 Gasoline and diesel prices (USD/litre)

	gasoline low octane		% increase	gasoline high octane		% increase	Diesel		% increase
Saudi Arabia	0.12	0.2	67	0.16	0.24	50	0.07	0.12	71
Kuwait	0.2	0.2	0	0.21	0.21	0	0.36	0.36	0
Qatar	0.23	0.31	35	0.27	0.35	30	0.27	0.27	0
Bahrain	0.24	0.33	38	0.27	0.43	59	0.37	0.42	14
Oman	0.3	0.36	20	0.31	0.42	35	0.38	0.42	11

Source: MEES (2016d)

Table 3.4: Natural gas prices (\$/MMBtu)

	Old	New	% increase
Saudi Arabia (methane)	0.75	1.25	67
Saudi Arabia (ethane)	0.75	1.75	133
Oman*	1.5	3	100
Bahrain**	1	2.5	150

* In comparison to 2012; ** In comparison to 2005.

Source: Authors' calculations

4. The political economy of pricing reforms

The effective implementation of many of the GCC pricing reforms appears to be nuanced, with the presumption that significant price increases in the GCC would not be possible, since low energy prices are a cornerstone of the implicit social contract between the rulers and the citizens. The implicit social contract in GCC countries takes up a central role in most of the literature, as it characterizes the relational dynamic between government and its citizens.³⁴ In exchange for loyalty and a

³³ Tariffs could rise from a flat rate of 2 fils to prices in a range of 5–15 fils/kWh. See ‘Kuwait plans steep rise in electricity charges for heavy users’, *Arabian Business*, 31 March 2016. Available at www.arabianbusiness.com/kuwait-plans-steep-rise-in-electricity-charges-for-heavy-users-626848.html

³⁴ For recent discussions, see Chatham House (2016), ‘The Social Contract in the GCC’, Middle East and North Africa Programme Workshop Summary, January 11-12.

redistribution of resource rents, the government is endowed with the privilege and responsibility to extract, manage, and trade the country's hydrocarbon resources. As energy resources are at the heart of the social contract, it seemed implausible that GCC states could reform energy prices without being perceived as breaking that social contract. This supposition only gained prominence in the wake of the Arab Spring, when popular uprisings brought down authoritarian powerhouses in Tunisia, Egypt, and Libya. The fear of contagion was genuine in many GCC states – and on average they increased public spending by 20 per cent during 2011 (Ulrichsen, 2013).

But this 'rentier reflex' is increasingly unsustainable as governments' financial buffers decrease (Moerenhout, 2015; IMF 2016a). Fiscal distress in a time of low oil prices and erosion of export capability due to the exacerbating effects of domestic consumption has challenged the traditional rentier state model and is pressing for energy price adjustments across the GCC. That said, the timing of the recent GCC energy pricing reforms does not merely reflect the fiscal crisis, but should also be understood as an opportunistic move at a time when there is a higher public acceptability for broader reforms. Understanding the opportunity gives a much better insight of why the social contract argument appeared less rigid than it was so often perceived to be.

4.1 Energy pricing reform seen as necessary for fiscal sustainability

A perception of greater acceptance for pricing reforms comes from different sources, starting with the political environment in the MENA region. Most countries have now acknowledged the necessity of fossil fuel subsidy reform, even more so since the Arab Spring. As El-Katiri and Fattouh (2015) argue:

'While it is clear that energy subsidy reform will not be the only variable at play, its potential socio-economic dividends are important factors enabling some common regional objectives – sustainable fiscal policy, fiscal space to invest in key areas (education, health and social welfare) and a more efficient and equitable distribution of scarce resources – to be achieved, helping to promote a more stable political status quo in the long term'.

Morocco first raised prices in 2012 and has continued an impressive reform process since then, targeting all fuels except for LPG. Algeria announced increases in VAT on diesel, electricity, and natural gas at the end of 2015. Tunisia started reforming prices in 2010 and has increased prices every year except during the high point of the Arab Spring. Jordan, closer to the Arabian Peninsula, reformed fuel prices in 2012 and kept them fluctuating with FOB Arab Gulf prices (Kojima, 2016). Iran initiated bold reforms in 2010, and while experiencing difficulties in subsequent years, the government was able to sustain its reform and continued with a further price adjustment in 2014 (El-Katiri and Fattouh, 2015). Even countries experiencing political instability, like Iraq and Yemen, are envisioning reform to reduce the destabilizing gloom of excessive fuel subsidization. However, reform efforts in these two countries have not been successful so far, as their governments still lack the credibility to push reforms through.

Within the region, the position of Egypt may be most significant to GCC countries. This country, having had one of the most significant Arab Spring experiences, has demonstrated that pricing reform is fiscally and economically necessary, regardless of its unpopular nature. President El-Sisi used his electoral legitimacy, the strong support from his base for the onslaught on the Muslim Brotherhood, and a wave of nationalist fervour to firmly initiate a reform process by adjusting prices within his first month in office (James, 2015; El-Katiri and Fattouh, 2015). These reforms were substantial, and at the same time a more long-term agenda to reform the country's economy was initiated.

As the threat of Arab Spring contagion quietens down, and as protests against energy price increases become muted, energy pricing reform has gained more acceptability across the rest of the region. This gave space to GCC countries to step away from the rentier reflex and to behave in a fiscally more rational manner, especially as fiscal pressures mounted.

4.2 Divergence in GCC experiences and the ‘state project’

To truly understand the difference in political economy dynamics amongst GCC countries, it is useful to stress that the urgency for pricing reform is not uniform across the GCC. Like Egypt, Oman and Bahrain have little choice but to reform quickly; but while Qatar, the UAE, and Kuwait benefit from a more healthy fiscal and economic position, their governments, aware of the eventual need for price rationalization, also desire reform, to further strengthen their economies and fiscal positions.

With relatively low GDP per capita when compared to the rest of the GCC, a low resource base, and fiscal deficits that are already high, Bahrain and Oman are in most need of reform. At the same time, they have particularly difficult political economies. Bahrain’s majority Shiite population stood in stark opposition to the country’s Sunni leadership during the Arab Spring. In Oman, in 2011, multiple demonstrations that attracted a variety of societal groups set forward demands for economic and educational reforms. While at the time not representing a substantial risk for the survival of the leadership, the protest’s coverage shook Oman and made structural long-term reform a necessity to maintain the country’s stability (Worrall, 2012).

Governments in Kuwait and Qatar face very different political economies. In Kuwait, the social contract appears much more stringent. Its parliament is able to exert much more power over energy policy than anywhere else in the GCC. This reality – in which the energy sector remains heavily politicized – makes it difficult to see through structural reforms, even if these are initiated and supported by the executive leadership. Together with a relative abundance of resources and a safe fiscal situation, this explains the difficult planning and implementation of energy pricing reforms. The role of the Shura Council (advisory council) is much more limited in Qatar; this somewhat reduces the politicization of pricing policy and helps explain the ease with which Qatar raised gasoline and diesel prices and electricity and water charges; by more than 25 per cent in 2011 (the first time), and again in 2014 and 2016.

When Saudi Arabia decided not to adjust its output in the wake of falling oil prices it – purposely or not – paved the way for structural reforms and rationalization in spending, including the reform of fuel prices. The vulnerability of the Saudi economy to the sharp fall in oil revenues, despite the existence of strong fiscal buffers, signalled the inevitability of economic reform. Saudi Arabia also pursued a more assertive foreign policy against Iran’s ‘nefarious activities’³⁵ including waging a war in Yemen. The upsurge in political turmoil across the region led to further increases in social and military spending (including boosting financial support for some of its ailing regional strategic partners such as Egypt and Bahrain), but it reasserted Saudi Arabia’s leadership as regional power and ‘Sunni’ leader. Saudi Arabia’s power display, both domestically and abroad, also increased the leadership’s legitimacy for tougher reforms by adding in an element of national identity beyond the limits of the social contract. These two factors largely explain the elasticity of the social contract, but the question is: to what extent can the social contract be accommodated before cracks appear?

While this element of national identity gave the Saudi leadership increased legitimacy to implement reforms, it should not be forgotten that, in essence, the Arab Spring was a battle for socio-economic justice and citizens’ rights. The masses that built up momentum were primarily concerned with a credible ‘state project’ that could foresee a level of welfare for its citizens. Governments have positioned their energy pricing reform efforts as an integral component of the strategy to build this state project. One case in point is Egypt, where the Muslim Brotherhood won the elections and immediately pushed forth a ‘nation’ project. The Brotherhood’s election, in part due to its rigorous organization, did not preclude rapid popular discontent when its reign showed little progress on delivering the ‘nation’ project. The fact that organized opposition to pricing reforms could more easily push forward a narrative on citizens’ rights and socio-economic justice should alert other GCC governments and confirm the necessity of also transforming the ‘state project’.

For instance, Saudi Arabia announced its ‘Vision for the Kingdom of Saudi Arabia’ in April 2016. One part of this Vision will be the development and implementation of its long-awaited National

³⁵ ‘Saudi Arabia warns against “nefarious activities” by Iran’, Reuters, 21 January 2016.

Transformation Project. While mostly focusing on economic objectives, the plan also foresees social and education reforms, thereby recognizing a comprehensive approach to socio-economic woes. The plan will also include measures to hold regulatory bodies more accountable (Hamade and Shahine, 2016).

4.3 What was missing (1): compensation measures for citizens

By increasing domestic energy prices, GCC countries have adversely affected the welfare of their households, both directly by increasing the cost of transport fuels and electricity, and indirectly through the impact of the higher cost of these fuels and electricity on the provision of other goods and services. At the time of subsidy cuts, none of the GCC states implemented compensation measures to mitigate these direct and indirect impacts and to gather popular support for their recent reforms.

While the recent price increases started from a low base and it is generally accepted that some reforms were needed, further price increases and more substantial reform of the energy sector will likely necessitate the introduction of compensation measures to offset the loss of citizen welfare across the other GCC countries. This is especially the case for households in low-income brackets. In the absence of compensatory schemes, GCC governments run the risk of tilting the trade-off made by citizens in such a way that these citizens decide to exert effective political action by organizing mass protest; if this happens, governments may be forced to reverse their policies. As demonstrated during the Arab Spring, the advent of social media has put the control of communication between citizens well beyond governments' capability. There are already some concerns that the implementation of pricing reforms has not gone as smoothly as envisaged. For example in Saudi Arabia, citizens have been protesting against the huge water bills, prompting the Saudi authorities to acknowledge that the reform was not being implemented in a satisfactory way (Nereim, 2016).

Many MENA countries that reformed energy prices have also paved the way towards implementing mitigation measures to increase the chances of successful and sustainable implementation (Sdrzlevich et al, 2014). In Morocco, the government both expanded existing, and introduced new, social protection programmes. At the same time it guaranteed to the public that LPG (a widely used household fuel) would remain subsidized. Tunisia and Jordan implemented broad cash transfer schemes; these could subsequently strengthen social data collection methods and improve the targeting of transfers (Kojima, 2016). Egypt used a smart card system to deliver more targeted subsidies, and allocated a significant part of subsidy savings to health, education, and social protection programmes. It is also preparing to launch two cash transfer programmes for the elderly poor, the disabled, and families with young children (Kojima, 2016). At the same time, the food subsidy system was expanded prior to the energy price increase (Clarke, 2014). Finally, Iran advertised its notoriously sizeable and unconditional cash transfer scheme before they revealed the level of price increases (IMF, 2013).

While many of these mitigation measures still fall significantly short of offering a dynamic and well-targeted social safety net, they did manage to gather support for governments by emphasizing their intention to restructure welfare distribution to a model that was more socio-economically just. Like many other MENA countries, GCC member states do not yet have adequate institutional capacity to set up well-targeted compensatory schemes such as cash transfers. While specifics of the envisioned Saudi cash transfer scheme have not been disclosed at the time of writing, one challenge seems to be the lack of social data collection. As Saudi Arabia, like other GCC countries, does not impose income taxes, it is difficult to know the different levels of income amongst Saudi households (Nereim, 2016).

The transition from wealth distribution by means of across-the-board underpricing of various commodities and services, to a system of more targeted social programmes, requires institutional innovation. Technocratic competency needs to be developed, to estimate impacts and deliver targeted social assistance. In addition, intra-governmental coordination must become more effective, as targeted social safety nets are complex creatures that can only be managed with a functional partnership of multiple ministries. While there are notable initiatives across GCC countries, little is known about the actual specifics. Kuwait, for example, started a review of ministries and existing social safety net policies in 2013, but little is known about the outcomes of this review. Recently,

Saudi Arabia's Deputy Crown Prince Mohammed bin Salman announced the Kingdom's plan to soften the burden associated with subsidy cuts by implementing a cash transfer programme for low- and middle-income Saudi households (Nereim, 2016). As with the situation in Kuwait, however, little is known about the specific content of envisioned reforms.

4.4 What was missing (2): mitigation measures for the private sector

A key component of the GCC's industrialization strategy has been investment in energy intensive projects that take advantage of abundant and cheap energy supplies. But structural energy pricing reforms affect production costs and reduce these industries' competitive advantage. For instance, in Saudi Arabia, a number of listed companies announced the potential impact of these increases on their cost structure; these companies included the petrochemical giant SABIC, which reported a 5 per cent annual increase in its cost structure.³⁶ The majority of these firms, however, remain highly profitable even with the new price, which remains one of the lowest in the world. If governments are planning on further pricing reforms and moving beyond industrialization in energy intensive industries, they will inevitably have to take into account the ways in which energy pricing reform affects the competitiveness of domestic industries (Moerenhout 2015). Therefore, the reform of energy prices cannot be isolated from wider structural reforms and requires an overhaul of current industrial and diversification policies.

GCC countries have not provided any mitigation measures to the industrial sector following the recent price increases. It has been suggested that governments could create a fund, with the objective of supporting companies on a case-by-case basis (APICORP, 2016). There have also been suggestions that specialized funds should be established to help industries upgrade their equipment and improve efficiency. It may be in the interests of GCC countries to aid those companies that will have a key role in the economic diversification process, as well as those that are of primary importance to larger stakeholder groups. For example, in Morocco the government helped public transport companies to avoid large fare increases, while in Iran the agricultural sector was allowed to benefit from relatively lower price increases (Kojima, 2016).

4.5 What was missing (3): effective communication campaigns

GCC governments failed to set up communication campaigns to gain trust from their citizens and to engage them as stakeholders in the latest reform process. In most countries, price increases were not announced. For example in Qatar, the state oil company Woqod sent out a memo to commercial petrol stations on 14 January 2016 announcing the mandatory new prices to be used as of the following day (Scott, 2016). The news spread rapidly and led to queues at petrol stations. Also, in other countries, such as Oman and Bahrain, large queues developed once citizens discovered that price rises were imminent (Naar, 2016). Whereas the risk of alerting people to start hoarding is a good reason for governments to avoid announcing price hikes early on, it is a high-risk strategy, especially if no compensation measures are offered. Rising living costs reportedly frustrate both citizens in relatively lower per capita income countries such as Bahrain, as well those as in more wealthy countries like Qatar. This discontent has led to controversy on social media from Doha to Muscat. As social media has become widespread across the GCC, communication campaigns have become more essential. In their absence, an uncontrolled discourse on social media can lower a government's credibility and reduce the cost of political mobilization.

It can be argued that GCC citizens were aware that domestic energy prices were at very low levels – below both production costs and international benchmarks. The necessity for pricing reform became very apparent when oil prices began their plunge, increasing the acceptability of reforms. However, repeated price increases necessitate targeted communications campaigns. For example in Saudi Arabia, a 2016 survey disclosed that 86 per cent of young Saudi nationals still think electricity and fuel should be subsidized (Nereim, 2016).

Other countries in the region have invested strongly in communication campaigns, often with success. Morocco set up extensive communication campaigns via different media to educate its citizens on

³⁶ MEES (2016), 'Riyadh Cuts Fuel Subsidies, Petchem Producers Count the Cost', 8 January, 59(01).

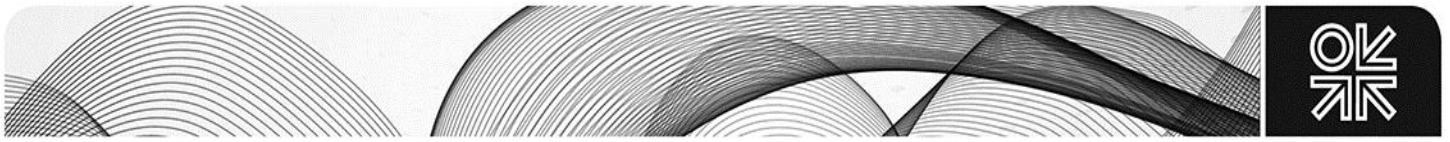
energy subsidies and change the perception around reform (Boersma and Griffiths, 2016; El-Katiri and Fattouh, 2015). Months before President El-Sisi was elected to office, Egypt was already preparing a similar communication campaign aimed at generating increased credibility in the government's ability to reinvest savings in a rational and socio-economically just way. Much like communication campaigns in Jordan, Egypt also stressed the urgency of implementing reforms. Iran, to counter the risk of hoarding, did not communicate the extent of the price increase beforehand, but it did announce large compensation measures widely, which made it an effective communication strategy (Hassanzadeh, 2012).

The setting up of communication campaigns is institutionally more complex than it may appear at first. Ideally, the content and delivery of messages are adjusted to particular stakeholder groups. Like the organization of compensatory measures, this first requires intra-governmental coordination to ensure consistent communication. Inconsistency in messaging generally reduces credibility in a government's capability to deliver on the positive aspects of reform. At the same time, the planning of communication campaigns also involves the expertise to conduct stakeholder interviews and to bring together focus groups to verify the strength of particular messages, and suitable media to reach them.

5. Conclusions

The decline in oil prices that began in mid-2014 acted as a catalyst for GCC countries to undertake the latest energy pricing reforms; but arguably, the fiscal pressures had in fact been building during the period of record high oil prices. Energy price increases have been the most visible fiscal response to low revenues, as they are immediately apparent to consumers (through direct and indirect effects), as opposed to other measures such as reductions in capital spending which arguably take time to filter through. The latest attempts at energy pricing reforms in the GCC countries have raised questions around whether the changes are transitory, permanent, or even reversible. Specific conclusions can be drawn from the discussion in this paper.

- **Recent energy price reforms appear to have been driven primarily by short-term revenue needs.** Although the GCC governments have for a long time recognized the distortions caused by low energy prices, it is the decline in revenues and the fiscal pressures that have provided the impetus for the recent increases in local energy prices. Given that these recent price increases have been in response to deteriorating fiscal balances, there is always the risk that if oil prices start recovering, the pressure that has driven recent subsidy reforms will start to ease and the pace of reform could slow down. Also, in a higher oil price environment, the increase required to align prices with those in international markets becomes larger and hence more challenging, both politically and economically, for GCC governments to implement.
- **The implicit social contract is not as rigid as originally perceived.** Contrary to conventional wisdom, the social contract has proved to be elastic and sufficiently malleable to accommodate the latest energy price increases, but it is nevertheless under increasing pressure, especially in countries where reforms are urgent. The elasticity of the social contract is brought about through a combination of fiscal pressures, geopolitical dynamics, and concerns about economic inefficiencies and long-term fiscal sustainability; these issues have increased the acceptability of broader structural reforms, which include energy pricing reforms.
- **But the social contract may not prove sufficiently elastic to accommodate further price increases and deeper reforms will therefore not be viable unless governments introduce mitigation measures and implement effective communication strategies which emphasize the importance of energy pricing reform for national transformation.** The magnitude and pace of pricing increases, as this paper has shown, have been unprecedented in the GCC, underlining the fact that communication strategies and mitigation



measures are critical to the sustainability of reforms. Any further increases in energy prices will have a negative impact on citizens' welfare and industrial competitiveness; recent increases have already begun to feed into inflation,³⁷ which could ultimately stretch the social contract beyond a breaking point, forcing the GCC governments to abandon the reform process. Unless GCC governments take credible measures and put in place effective governance and institutional mechanisms to mitigate the negative impact of higher energy prices (through designing appropriate compensation schemes, while using the savings to improve the provision of public services such as education, housing and health and to build more diversified and resilient economies), GCC governments run the risk of facing popular opposition, as acceptability for such reforms will falter. GCC countries in particular cannot afford to make policy mistakes or suffer from credibility loss in implementing reforms, given the legacy of entitlement to cheap energy among their citizens.

³⁷ Saudi Arabia's Consumer Price Index (CPI) accelerated to 4.3% in January 2016, its highest rate in five years, (from 2.3% in December 2015). The housing and utilities sector component within the CPI rose from 4% to 8.3% in the same period, while the transport component recorded an even sharper acceleration from 1.3% to 12.6% – the highest it has been in 21 years – driven directly by fuel price increases (or first round effects). Domestic inflationary pressures are expected to intensify in 2016, as second round effects (such as the higher costs of input for industries) feed through (Jadwa, 2016).



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Appendix: Exchange rates used

(where specified in parentheses)

	US Dollar (USD)
Saudi Riyal (SAR)	0.2666
Qatari Rial (QAR)	0.2747
Omani Rial (OMR)	2.5975
Bahraini Dinar (BHD)	2.6527
Kuwaiti Dinar (KWD)	3.3128
UAE Dirham (AED)	0.2723

Source: OANDA Historical Exchange Rates; Annual Midpoint (14 March 2015 – 13 March 2016); rates are illustrative only.