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Saudi energy price reform getting serious

Two years after the Kingdom introduced the first phase of energy price reforms, the government has announced the second round of its ambitious programme. While the first phase was generally well-received by the public, it was more challenging for the second phase to achieve popular approval. Unlike the first round, the government launched an effective public campaign before it raised prices – and introduced the cash transfer programme (Citizen's Account) which is central to its efforts to protect low and middle-income households. While these are all steps in the right direction, there are still several challenges that need to be addressed.

In late 2015, the Saudi government began its ambitious plan to reform energy prices, with the prices of natural gas, gasoline, diesel, electricity, and water all being raised. Although prices for these products increased from a very low base and were still significantly below international levels, this represented a major policy change and highlighted the difficult choices the government is willing to make to address its fiscal deficit and achieve its economic transformation plan. There have been multiple objectives for the provision of cheap domestic energy prices. They included protecting household incomes especially those in low income brackets, increasing the competitiveness of energy-intensive industries such as petrochemicals, attracting foreign and domestic investment, and controlling inflation. But this came at a heavy cost. In 2015, the government spent around SAR300bn on subsidies. The dire need to reduce budget deficits during the low oil price environment and divert resources to sectors to diversify the economy left the state with no choice but to begin the challenging process of reforming energy prices.

The outcome of the first phase was positive

The first phase of the reform was arguably the easiest. With prices representing some of the lowest in the world, the government was able to increase them by up to 80% and still offer very low prices by regional and global standards. The prices of gasoline 95 (high grade) and gasoline 91 (low grade) were raised from SAR0.60/litre to SAR0.90/litre and SAR0.45/litre to SAR0.75/litre respectively.

Households that consume high grade gasoline have largely offset the increase by switching to low grade gasoline. For diesel, retail prices were raised from $0.067/litre to $0.12/litre, a near 80% increase. In industry, diesel prices increased from about $9/b to approximately $14/b. The Kingdom also raised electricity prices. Households with consumption levels below 4,000kWh were unaffected while the price for consumption between 4,000kWh and 6000kWh increased from SAR0.12/kWh to SAR0.20/kWh and for consumption levels above 6,000kWh, price was set at SAR0.30kWh.

The hikes were generally accepted by the public, and overall the first phase of energy price increases has been successful without the government needing to publicise the reforms or introduce compensatory schemes. The energy price increases had their desired impact on energy demand. Energy demand growth decreased from 3.5% in 2015 to 1.7% in 2016. However, it is difficult to solely attribute this to the price hikes given that GDP growth - one of the main demand drivers - fell to 1.4% in 2016 compared with 4.1% in 2015. In terms of savings, the government reduced its subsidy bill by SAR27-29bn.

Second round of reforms accompanied by a cash transfer programme

After a successful first phase, the government is showing its determination to continue its energy pricing reform plans. In January 2018, the government introduced another significant increase in gasoline and electricity prices.

Saudi energy prices

Product	Unit	2015	2016	Increase	2018	Increase
Natural Gas	($/mmbtu)	0.75	1.25	67%	Unchanged	0
Ethane	($/mmbtu)	0.75	1.75	133%	Unchanged	0%
Gasoline - High Grade	($/litre)	0.16	0.24	50%	0.544	127%
Gasoline - Low Grade	($/litre)	0.12	0.2	67%	0.365	83%
Diesel Transport	($/litre)	0.07	0.12	79%	Unchanged	0%
Diesel Industry	($/barrel)	9.11	14.1	55%	16.15	15%
Arab Light Crude	($/barrel)	4.24	6.35	50%	Unchanged	0%
Arab Heavy Crude	($/barrel)	2.67	4.4	65%	Unchanged	0%
Kerosene	($/barrel)	23.00	25.7	12%	Unchanged	0%

Source: Apicorp research

The prices of high and low-grade gasoline rose from SAR0.90/litre to SAR2.04/litre and SAR0.75/litre to SAR1.37/litre. The widening gap between the two grades of gasoline will invariably push more consumers to the low grade. On the other hand, diesel prices for transportation remained unchanged, resulting in a huge discrepancy between gasoline and diesel prices.

As for electricity, prices for the for low consumption brackets rose sharply from SAR0.05/kWh to SAR0.18/kWh for residential consumption levels 1-6,000kWh/month. Residential consumption levels above 6,000kWh/month remained at SAR0.30/kWh. The increases did not affect government and commercial sectors.

Saudi Electricity Tariffs (SR/kWh)

Sector	End-2015	Start-2018	% Change
Residential : 1-6,000 kWh/month	0.05	0.18	260
Residential - above 6,000 kWh/month	0.3	0.30	0
Industry	0.18	0.18	0
Government	0.32	0.32	0

Source: MEES

Unlike the first round of reforms, these increases were accompanied by a cash transfer programme under the Citizen's Account scheme, which is expected to disburse SAR30bn in 2018. The compensation scheme is arguably the most important policy mechanism designed to protect the income of low-income groups from the adverse effects – both direct and indirect – of higher energy prices and increase public acceptance of reforms. The program proved popular with 3.7 million households – representing around 13m citizens – signing up. The government will only support low and middle-income Saudi households by providing cash transfers to mitigate the impact of higher energy prices. The first round of handouts in late December 2017 totalled SAR2bn, with beneficiaries reaching over 10m. Approximately 700,000 families received payments of over SAR1,000 while half of the country's households received on average SAR938. The minimum amount distributed for middle income groups was SAR300 per household.

The main variables that determine the amount families receive are its size, income and age of family members. The government is also looking at factors such as the additional cost that families will incur from the price hikes, as well as other costs associated with government efforts to increase non-oil revenues, such as VAT.

Step in the right direction, but many challenges remain

The first phase of the reforms did not pose serious challenges for the government. But as the reform programme enters its second phase, we envisage several challenges that need to be addressed.

First, higher energy prices will have a direct impact on households as fuel and electricity enter into their consumption basket. There are also the indirect effects, such as higher energy and electricity prices (alongside the introduction of VAT) feeding into the costs of other goods and services, which rely on fuel for production and transportation. Beyond this, higher energy prices can also have an impact on wage and inflation expectations as those Saudi households and non-nationals affected by the energy price increases will start demanding higher wages and renegotiating their contracts in anticipation of future price increases. The last round of hikes will put a strong upward pressure on inflation, which the government will be wary of, though these inflationary pressures could be a one off if the shift in inflationary expectations is well managed.

Second, unlike the first round of reform, the cash transfer programme was introduced to offset the impact of increases in energy prices on poor households. Implementation of the programme was challenging despite the government managing to obtain information and identify eligible recipients. It will need to continue to ensure that it is able to include and identify all eligible households. The reliability and strength of existing and new government databases will be important in ensuring that this does not become an issue. The government will also need to continue to ensure that the process is transparent, simple and efficient.

Third, the amount of money transferred was not enough to fully offset the direct and indirect impact which created social media backlash. As a result, the government announced handouts which were higher than the money devoted to the Citizen's Account in the first place. While the estimated cost of the programme for the first year is around SAR30bn, the royal handouts to public servants and military personal will cost SAR50bn this year. However, these handouts were given to public sector employees and are likely to benefit those in higher income groups. Given that the handouts will be provided for a year, it is unclear how easy it will be for the government not to extend them. A better approach would have seen the government increase the allowances through the Citizen's Account.

Fourth, unlike the first round of reforms that affected all fuels, the increase this time only affected the gasoline and electricity prices. Currently, the price differential between gasoline and diesel is too high and it is only a matter of time before the government has to adjust diesel prices as well. For next year, we expect to see a divergence of diesel and gasoline demand. Following some sharp declines in the last two years, diesel demand is expected to rise given the record budget announced and the support packages for the private sector and infrastructure which will stimulate growth. On the other hand, gasoline demand is likely to fall as consumers rationalise their consumption and change their driving behaviour.

Lastly, the price of industrial fuels such as natural gas and diesel for industry has not been increased. This suggests that the reform will be uneven: industry prices are increasing gradually and are not expected to increase to levels that jeopardise the competitiveness of the energy intensive industries, which were established and driven at the behest of cheap feedstock and energy prices. This highlights the strategic importance of the energy intensive industries in shaping the reform agenda. The country will still rely on industries such as petrochemicals and aluminium to support its diversification efforts, despite officials' announcement that Saudi Arabia's future economic growth will come from non-oil sectors.

While the government's plan to phase out subsidies are on the right track, there are challenges that still need to be addressed. The government is applying international best practices to ensure successful reform, but it will also need to make sure that these practices work in the Saudi context. The initial reforms in late 2015 were well received, mainly because prices still remained very low. The current phase is going to prove more challenging, but ultimately more rewarding in terms of real benefits to government finances and the long-term health of the economy. The government has shown a strong commitment to take tough economic measures; despite social media backlash, the government did not backtrack on the recent energy price hikes. But the offer of monthly handouts shows a government that is willing to respond and adjust its policies to ease public concerns. It also reveals that there is still room for improvement in designing and implementing policies and that reform is likely to follow an uneven path with two steps in the right direction and one step backward.

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