

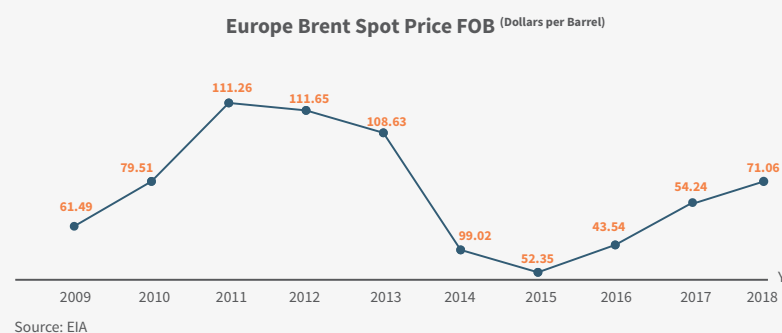
# REFORMING ENERGY SUBSIDIES: RENOVATING EGYPT'S FUEL PRICING MECHANISM

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For decades, Egyptians have relished subsidies targeting specific social and economic objectives. Subsidizing energy plays an important role in making fuel and electricity prices affordable, however, this governmental policy could be considered unsustainable.

Fuel subsidies are a burden on the public budget, as a major contributor to fiscal deficit. In addition, it has negatively impacted the Balance of Payments (BOP), with huge local energy demand resulting in a need for more imports, hence, energy subsidies reform was a priority for the government.

Although, phasing out subsidies significantly affects the main indicators of the Egyptian economy, such as the parameters of welfare and income distribution. Nevertheless, delaying that reform would further complicate the issues that will in return hinder economic development plans. Since the turn of the century, petroleum products and electricity prices witnessed many reforms. On the other hand, an increase in global oil prices meant that fuel subsidies increased as well.

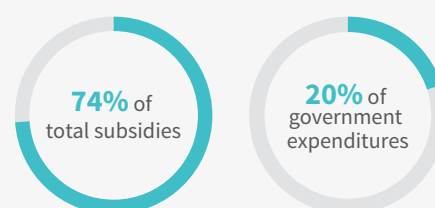


## ENERGY SUBSIDIES REFORM

Countries follow various approaches in implementing subsidy reform programs, as it differs in terms of the time frame and the outcomes. For instance, countries like Iran followed a radical approach, in which the reform was fully-implemented at one point. On the other hand, Morocco and Tunisia follow the gradual approach as many steps have already been taken with more reforms in plan. For example, Tunisia depends on simpler reforms accompanied with gradual hikes in prices and tariffs every quarter. A third approach was followed by Egypt and Yemen, as the two countries stepped up the process in 2014 after a period of gradual reforms.

Egypt started implementing minor reforms before engaging in the current energy subsidies reform program. In 2012, the government rose the price of gasoline. In 2013, household electricity and gasoline prices were increased. This increase was linked to consumption across multiple sectors, as was announced by the Ministry of Electricity and Renewable Energy. Before reform was first introduced, energy subsidies totaled EGP 139.5 billion, accounting for 74% of the total subsidies, and 20% of public expenditure in fiscal year (FY) 2013/14, according to the Ministry of Finance (MoF).

In FY 2013/14, Energy subsidies accounted for **EGP 139.5 billion**



Source: MoF

## PETROLEUM PRODUCTS SUBSIDIES REFORM AND ITS DEVALUATION IN EGYPT

In July 2014, the Egyptian government launched a reform program to gradually phase-out energy subsidies that particularly targets fuel pricing. Therefore, in FY 2014/15, fuel subsidies significantly declined to EGP 74 billion, representing 76% of energy subsidies, 49% of the total government subsidies, and only 10% of public expenditure, according to MoF.

It is obvious that between FY 2013/14 and FY 2017/18 fuel subsidies witnessed a significant reduction. Dropping from EGP 126 billion in FY 2013/14 to reach EGP 110 billion in FY 2017/18. It is worth mentioning that fuel subsidies reached its lowest level in 2015/16, recording only EGP 51 billion, due to lower global oil prices that averaged \$43.26 per barrel, according to United States Energy Information Administration (EIA).

On November 3, 2016, the Central Bank of Egypt (CBE) radically freed the exchange rate of the Egyptian pound, as part of a commitment to the International Monetary Fund (IMF) to obtain a \$12 billion loan, which the government viewed as a necessity to recover the crippling foreign exchange reserves and control the rise of the currency black market. This led to controlling the rising currency manipulation and speculations, but it also left a toll on the local currency. Consequently, the value of the pound noticeably depreciated. Only one day after the flotation, the Egyptian



pound went down against the US dollar by about 67%, as shown by the CBE's data. This led to another increase in fuel subsidies in FY 2016/17.

FY 2016/17 witnessed two cuts in fuel subsidies. The first was in November 2016, followed by another one in June 2017. Fuel subsidies were decreased from EGP 115 billion, which represented 81% of the energy subsidies, 57% of the total subsidies



### Fuel Subsidy Reform

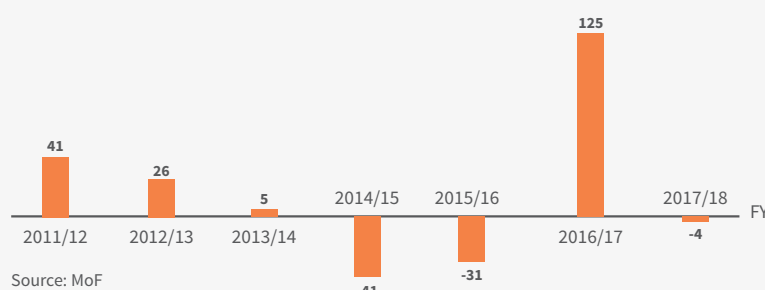
- Launched** → FY 2014/15
- First Round of Subsidy Cuts** → November 2016
- Second Round of Subsidy Cuts** → June 2017
- Third Round of Subsidy Cuts** → June 2018

Source: MoF & MoP

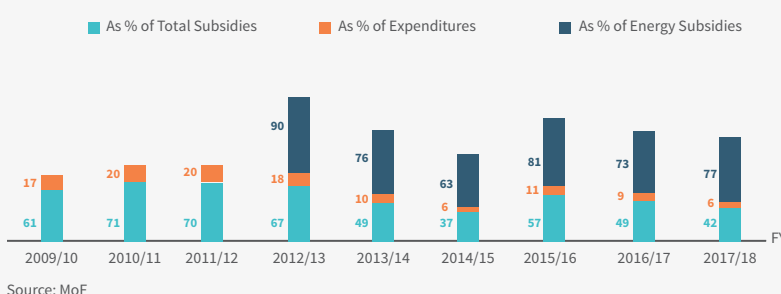
and 11% of public expenditure in FY 2016/17, to EGP 110 billion in FY 2017/18, accounting for 73% of the energy subsidies, 49% of the total subsidies, and 9% of the total government expenditure. Furthermore, a third cut to fuel subsidies took place in June 2018, explained by MoF.

## FUEL SUBSIDIES REFORM IMPACT ON THE EGYPTIAN ECONOMY

Annual Change in Fuel Subsidies (%)



Share of Fuel Subsidies



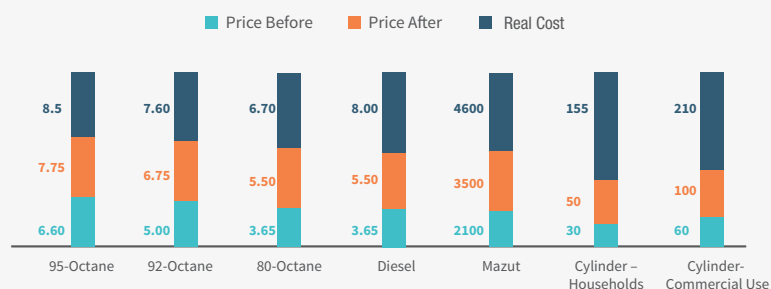
## 1. FUEL PRICES AND INFLATION

Fuel subsidy cuts usually result in significant inflationary pressures. In 2014, fuel prices noticeably increased with the new government starting to introduce measures. Thus, households and businesses saw an increase in energy costs. For instance, subsidy cuts vividly affected the prices of mazut, as well as commercial and household butane cylinders, rising by nearly the same percentage at 66.67%. In addition, the prices of diesel, 80 octane gasoline and 92 octane gasoline increased by 64%, 78%, and 40%, respectively, according to the data of the Ministry of Petroleum and Mineral Resources.

In 2016, the government took further steps towards reforming energy prices. Accordingly, diesel prices increased by 31%, 80 octane gasoline rose by 47%, while 92 octane gasoline price was increased by 35%. However, it is worth noting that the prices increased in a decreasing rate. The year 2017 witnessed another hike in fuel prices, as diesel, 80 octane gasoline and 92 octane gasoline went up by 55%, 55%, and 43%, respectively. Accordingly, the prices differed before and after implementing the reform as per the Ministry of Petroleum and Mineral Resources.

Accordingly, there were slight changes in consumer prices (inflation rate) over the period from FY 2013/14 to FY 2015/16, ranging from 10.13% to 10.27%. After the huge cuts to fuel subsidies in FY 2015/16, the following year witnessed a remarkable surge

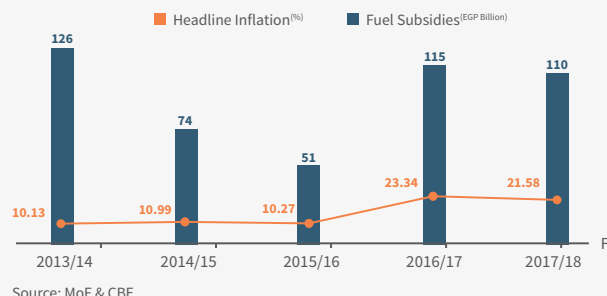
Fuel Subsidy Cuts (EGP)



with inflation rate reaching 23.34%. Fuel subsidies then ranged between EGP 115 billion and EGP 110 billion in FY 2016/17 and FY 2017/18, respectively. Consequently, inflationary pressures cooled, with headline inflation rate gradually decreasing from nearly 33% in July 2017, to 13.5% in July 2018, according to CBE.

## 2. FUEL SUBSIDY CUTS AND BUDGET DEFICIT

Fuel Subsidy Cuts and Inflation



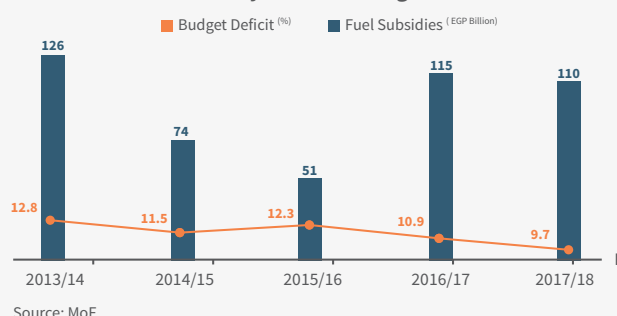
Egypt's budget deficit witnessed several fluctuations over the period from FY 2013/14 to FY 2015/16, followed by a downwards trend until FY 2017/18.

According to MoF, the general budget deficit reached 12.8% of Gross Domestic Product (GDP) in FY 2013/14, decreasing to 11.5% in FY 2014/15, as fuel subsidies were decreased to EGP 74 billion. Despite the huge cuts in the fuel subsidies in FY 2015/16, the deficit increased to 12.3%, which is attributed to the existence of exogenous factors.

Budget deficit was at its peak in FY 2015/16, at the early beginning of the subsidy reform program, it then started to decrease gradually along the mentioned period. It is obvious that any action taken concerning subsidy cuts do not affect the budget deficit immediately during its implementation. Budget deficit takes time to respond back towards any changes in fiscal or monetary policies.

From FY 2015/16 to FY 2017/18, budget deficit decreased along with fuel subsidies. It is worth noting that as fuel subsidy cuts decrease, so does the budget deficit, relatively. The FY 2018/19 budget estimates an average oil price of \$67 per barrel. Moreover, deficit between July 2018 and January 2019 recorded 4.2%, according to the MoF.

Fuel Subsidy Cuts and Budget Deficit



## THE NEW FUEL PRICING INDEXATION MECHANISM

In June 2018, Egypt's Prime Minister approved a new pricing mechanism to efficiently regulate fuel market. This step was encouraged by the IMF in their third review, in July 2018, under the \$12 billion finance agreement. The IMF mentioned that once the automatic fuel price indexation mechanism is implemented it would help relieve the public budget from the unexpected fluctuations in exchange rates and global oil prices. Moreover, the automatic mechanism will ensure that resources are directed to support the most vulnerable categories.



The automatic fuel **pricing indexation mechanism** was approved in June 2018.

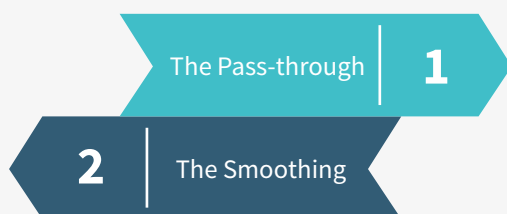
The mechanism targets adjusting fuel prices including diesel, gasoline, kerosene, and fuel oil. This process is based on the movements of global prices, exchange rates, and domestic consumption.

Emerging countries tend to adopt this price adjustment mechanism when they are on their way to eliminate fuel price subsidies. Moreover, the mechanism helps countries to protect their fuel tax revenues.

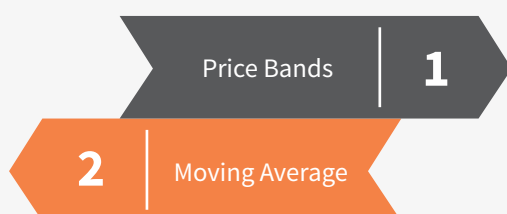
In 2012, the IMF published a technical note titled "Automatic Fuel Pricing Mechanisms with Price Smoothing: Design, Implementation, and Fiscal Implications" in which the fund explained that the mechanism is applicable through two methods. First, the pass-through method, based on which the effect of changes in global oil prices is passed to the local market, either fully or partially. Secondly, the smoothing mechanism, where local fuel prices are not highly vulnerable to global fluctuations.

The smoothing mechanism is applied through two main alternatives. The first depends on setting price bands, while the second depends on calculating moving average prices for imported fuel.

### The automatic fuel pricing indexation mechanism has **two** methods



### The Smoothing Mechanism has **two** Alternatives



The process of shifting to an automatic price mechanism starts with determining the automatic pricing equation. After that, comes the part of defining the targeted tax revenue from each fuel product, followed by setting the guiding prices, the applied smoothing mechanism, and the timing of applying the mechanism.

It is argued that despite the positive impact of this mechanism on budget deficit, it can hurt lower-income households. Accordingly, the IMF technical note recommended that the application of such a mechanism needs to be followed



by an increase in the government expenditure. The note mentioned that the government needs to follow with expansionary policies to relieve the social impact of the mechanism on the most vulnerable groups.

Several countries applied the gradual fuel subsidy cuts process combined with social safety measures. For example, in 2005, Jordan started a gradual cut in fuel subsidies. In return, the minimum wage was increased and a bonus was given to low-income public employees and pensioners.

As a start point to execute the new mechanism, the Egyptian government preferred to choose the 10% price band for the 95-octane gasoline. In January 2019, the Egyptian cabinet approved introducing the automatic pricing indexation mechanism by the beginning of April for 95-octane gasoline.

According to the new system, the price of 95-octane gasoline will fluctuate along with global prices. However, the price changes will be kept at  $\pm 10\%$  band. Currently, the price of 95-octane gasoline is EGP 7.75 per liter. With the implementation of the mechanism, it will be amended.

To apply the new system, a committee made up of representatives from the ministries of finance and petroleum, in addition to members from the Egyptian General Petroleum Corporation (EGPC), will re-price 95-octane gasoline on a quarterly basis. The price will be set according to the global price of Brent crude, the US dollar exchange rate, and other relevant costs including transportation costs.



### 95-octane Automatic Pricing

- ◆ The price will fluctuate with changes bands at  $\pm 10\%$ .
- ◆ 95-octane represents around **4%** of Egypt's total benzene consumption.

Subsidies are intended to fix the market deficiencies and help the poor pursue a better standard of living. However, these subsidies have dragged Egypt into a troubling situation, which will be hard to tolerate by any means. Energy subsidies reform is considered challenging, however, it could be a crucial step towards a more sustainable and stronger economy. Accordingly, the Egyptian government targets reducing fuel subsidies to EGP 89 billion in FY 2018/19. In Q1 2018/19, fuel subsidies stood at EGP 22.5 billion. In addition, the fuel bill is expected to reach EGP 43.5 billion during the first half of the same year. Hence, the new pricing mechanism, adopted by the government, needs to be implemented in the light of full transparency and disclosure of various steps and a thorough a comprehensive study of different fuels cost structuring.