COALITION PROVISIONAL AUTHORITY

BAGHDAD

ϕ PSD

PRice Reform

ACTION MEMO

December 6, 2003

8

FOR: Ambassador Jones

FROM: [redacted], Director, Private Sector Development

SUBJECT: Recommendations for liberalizing energy prices

This memo presents the set of recommendations arrived at after considerable study, debate, and review by the Energy Subsidy Reforms task team. Energy subsidy principals, including [redacted] concur with these recommendations, and we believe Ambassador Bremer would like to use this as a basis for discussion with the Governing Council.

Current Policy. Iraq has a policy of controlling prices on crude oil and refined oil products sold domestically. The government-owned oil companies receive 50 Iraqi dinar (ID) or $0.025 at current exchange rates for each barrel of oil produced in Iraq, compared with an export price of about $25 per barrel. Wholesale and retail petroleum product prices in Iraq reflect some of the costs of refining and distributing these fuels, but are not taxed. Thus, the price of premium grade gasoline is 50 ID per liter (or 2.5 cents per liter) in Iraq compared with over $1 in Turkey, $0.42 in Jordan and $0.50 in Syria. Some resellers of fuel, including unauthorized resellers, charge prices at rates higher than the Government set rates and hence are the beneficiaries of part of the subsidy. Illegal exporters also benefit greatly from this discrepancy in prices.

Each day around 400,000 barrels of Iraq's oil production are used for domestic refining and consumption. An additional 75,000 barrels of product are imported. The cost of these imports ran between six to eight million dollars per day in September and has risen sharply now that kerosene is being imported for the winter.

Why Change Current Policy? The removal of government control of prices (price liberalization) is an important step in Iraq's move toward a free market economy. Controlled fuel prices are a very expensive form of subsidization, despite their popularity in oil exporting countries. The detrimental economic and political consequences of fuel price controls are most readily seen in the cases of Nigeria, Iran, and Venezuela, where the diversion of resources into keeping refined oil product prices below market levels has led to periodic fuel shortages and a lack of funds for government services, including education and health care. In the case of Iraq, fuel price controls are having the following effects:

1. Energy subsidies impose an unsustainable burden on the budget in terms of foregone revenue. The total opportunity cost of the provision of oil products at government established prices is estimated at $4.892 billion per annum for Iraq, equivalent to more than a third of the 2004 budget. Once donor assistance ends, the Iraqi government will no longer be able to afford this subsidy.
2. Because fuel prices are so low, demand is unconstrained by price. Despite massive imports of kerosene and other refined oil product, paid for by $900 million from the Supplemental, Iraqi "demand" for refined oil products can still not be satisfied.
3. Because domestic fuels are sold so cheaply, Iraqis smuggle fuels abroad, bribing customs and government officials in the process.
4. The ~~combination of unfettered demand~~ and smuggling makes it virtually impossible to supply the domestic market, which results in shortages, blackouts and lines. Queues have triggered demonstrations and riots; blackouts contribute to looting.
5. Subsidized energy prices distort the market which hinders economic growth and delays the creation of badly needed new private sector jobs.
6. Energy subsidies create powerful, misleading price signals that systematically distort consumption and investment behavior. Iraqi households are purchasing diesel generators and air conditioners that cannot be economically operated once fuels rise to reflect true costs. The perception of unmet demand is resulting in waste and overinvestment in refinery upgrades and new generating capacity.
7. Fuel price controls discriminate against the poor and in favor of the rich. Upper income individuals tend to own more cars, drive more, have larger homes, and consume more electricity than lower income households. Consequently, they derive more benefit from fuel subsidies than lower income households.

Original Proposal. The energy subsidy reform task team has proposed the following reforms:

1. All refined oil product prices, except kerosene and LPG, should be liberalized in one step, on a date between January 1, 2004 and the date of implementation of a cash compensatory payment for kerosene and LPG.
2. Kerosene and LPG prices should be liberalized, but not before a compensatory cash payment can be made. The compensatory payment, in an amount still to be determined, should offset the approximate increase in the direct cost of energy (LPG, kerosene, gasoline and electricity) for a moderate income family.
3. As a basis for determining the amount of the compensatory payment, the Central Statistical Office should be commissioned to conduct a survey of physical consumption of LPG, kerosene, gasoline and electricity by Iraqi households.
4. Fuel price liberalization will be implemented by levying a tax on crude oil at delivery to the refinery in an amount equal to the difference between the full production cost to the Ministry of Oil and the price of crude oil at export terminals (Ceyhan and Umm Qasr) plus transportation cost.
5. Public transportation costs should be held constant for at least six months following liberalization of gasoline and diesel prices.
6. Refiners, wholesalers, and retail providers will be permitted to sell refined oil products at whatever they can charge, following the implementation of the tax. Competition will be provided by permitting unrestricted imports of refined oil products.
7. Non-residential electricity rates should be raised to regional parity rates of approximately 110 dinars (5.5 cents) per kilowatt hour, effective January 1, 2004.

[redacted]

8. Residential electricity rates should be raised gradually over a six-month to one-year period following the raising of kerosene and LPG prices.

Advantages of the Proposed Reforms. This policy is the most effective way to improve Iraq's fiscal balance, eliminate politically explosive shortages, queues, and blackouts, and end smuggling and the associated corruption of government officials. As shown by the experiences of other transition economies, a rational pricing structure is the key initial step for creating the proper price signals needed for a well-functioning market economy.

Despite these advantages, concerns have been raised about the impact of proposed reforms.

1. *Single-step elimination of subsidies will be a significant shock to the system.* A phase-in program of energy subsidy reforms increases the likelihood of failed reforms. Experiences elsewhere in developing countries show that governments face less overall opposition if prices are raised to market clearing levels in one go rather than stretching out the pain through multiple increases. Each subsequent price increase provides another occasion to marshal opposition. Logistically, a multi-step system requires a longer and more complex communication plan. It also demands greater levels of coordination regarding fuel supply stockpiles and military/security support than a single step approach. A single step approach will ensure the fastest possible adoption of rational decision-making, limit the level of hording, and minimize the logistical challenges and security threats.

2. *Raising energy prices will trigger high inflation.* Prices will rise substantially compared to current official prices. Costs of transport and energy-intensive products will also rise. Some of the price rise will be absorbed by middlemen: currently households often pay prices for gasoline and LPG that are several times official rates. If the Central Bank of Iraq properly accommodates for the increase in prices, second-round inflation should be modest.

3. *Poor Iraqi households will not be able to afford higher prices.* The program is designed to more than compensate low-income households for the increased costs of heating, cooking, and electricity. This proposal also recommends that public transportation be held constant for at least six months following liberalization of gasoline and diesel prices to lessen the impact on lower-income households. Wealthier households, who own more cars and consume more energy, will bear the brunt of the increase in costs.

4. *The elimination of energy subsidies will result in riots and public unrest.* Analyses by the World Bank and other institutions find that by informing consumers that prices will rise, providing adequate supplies before and after price increases, and by timing price increases so that they do not take place in sensitive time periods (such as the beginning of the winter heating season) dozens of countries have successfully liberalized prices without domestic unrest.

   Discussions with the World Bank also indicate that if there is public unrest, it generally stems from truckers, taxi drivers, and students. This resistance can be limited and at least partially diffused with a strong informational campaign and by also timing the implementation of the reforms for low demand days such as non-work days. In general, smuggling and overuse due to the current low pricing schemes for fuel and electricity result in long lines at fuel pumps and electricity outages for significant portions of the day. The overall reduction in demand created by the reforms will decrease the burden on the infrastructure and will help to ensure that fuel and electricity are available on demand. This, in addition to the issuance of a cash compensatory payment, will help to counteract the potential unrest.

5. *Liberalizing energy prices entails political risk.* Elimination of energy subsidies is critical for removing distortions in the market, developing the private sector, and laying the foundation for a sound global economy in Iraq. While there is some political risk for the CPA if these reforms are made during its tenure, deferring this important decision until the departure of the CPA will also provide ammunition for political criticism. The transitional Iraqi government may not have the strength or the incentive to implement this program given the newness of the government and the political aspirations of that group with regard to the 2005 elections. The increased time associated with a decision made exclusively by Iraqis will delay economic recovery and may severely limit foreign direct investment and aid programs.

Timeline. The timing of the implementation of the energy subsidy reforms is laid out here and is dependent on the monetization of the food basket. The implementation of this program also depends on which approaches are selected for fuel and electricity subsidy reforms.

December 2003:

- Begin discussions with the appropriate Ministries and the Governing Council about the proposed program.
- Launch strategic communications campaign to discuss and debate the proposed program.

January 1, 2004

- Ministry of Electricity recommences billing residences at old rates for electricity usage.
- Raise electricity prices for commercial entities to regional parity rates of approximately 110 dinars (5.5 cents) per kilowatt hour; (billing of commercial entities recommenced during the last quarter of 2003).

January – March 2004:

- Commission the Central Statistical Office to conduct a survey of physical consumption of LPG, kerosene, gasoline and electricity by Iraqi households as a basis for determining the amount of the compensatory payment.

Timing of these steps is dependent on monetization of food basket:

- Raise prices for all refined oil products, except kerosene and LPG, in one step on a date between January 1, 2004 and the date of implementation of a cash compensatory payment for kerosene and LPG.

- Develop appropriate reserves to prepare for pre-emptive stockpiling by residences and prevent shortages.
- Distribute cash to appropriate banks or post offices (based on the process for monetization of the food basket) to cover cost of cash compensatory payments for LPG, kerosene, and residential electricity.
- Eliminate subsidies on LPG, kerosene, and residential electricity once the mechanism for a cash compensatory payment is in place.

<u>Recommendation</u>
There is a consensus among the energy subsidy reforms task team that the recommendation presented here is the optimal methodology for elimination of energy subsidies, taking into consideration the political, economic, and security situation. We request your approval to present this option to start a dialogue with the Governing Council and begin a broader discussion with the appropriate Ministries.

Approve:________ Disapprove:________ Approve with modification:______

ATTACHMENTS: None

COORDINATION: [redacted] Office of Policy Planning
[redacted] Private Sector Development

[redacted]

ϕ PSD - Price reform

MEMORANDUM

Date: October 14, 2003

To: [redacted]

From: [redacted]

Re: **Social and Political Consequences of Increasing Prices**

Concerns about violent responses to price liberalization in Iraq are germane in light of the current political situation. At the request o[redacted] I have written a quick overview on social and political consequences of increasing prices of refined oil products and electricity.

Experiences in Other Countries and Best Practice

Virtually every stabilization program involves increases in controlled prices, especially for electricity and refined oil product prices. The vast majority of these increases are usually not accompanied by violence.

This said, a number of countries have experienced violence or demonstrations following price increases. Major failed instances of price increases include the Sadat decision to raise bread prices circa the mid-1970s, multiple attempted fuel price increases in Nigeria, and more recent increases in Zambia and Zimbabwe. Price increases for food and fuel of 40 to 70 percent triggered riots in 1998 in Indonesia, but political opposition to the Suharto regime also played a role. The demonstrations were led by students. Violent opposition to price increases has had a long history. Bread riots were frequent in ancient Rome and Byzantium.

The most sensitive items include bread and other grain products, like mealy meal, and fuels for household consumption like kerosene and liquid petroleum gas (LPG). Demonstrations or violence stemming from gasoline or diesel price increases are usually triggered by jitney bus and taxi drivers and truckers. Although a number of things can trigger violent reactions, demonstrations or riots are more likely to occur if the following conditions are exist:

1) The population harbors a number of other grievances against the government, including incompetence, graft on the part of senior officials, brutality on the part of security forces, etc. Dictatorial regimes appear to be especially susceptible to demonstrations and riots accompanying price increases.
2) The price increase is planned in secret and implemented overnight, coming as a surprise to most of the population.
3) The increase takes place without any public discussion. The government does a poor job of explaining why the increase needs to take place or how the amount of the increase was determined. The government also fails to publicly reveal the cost structure of the refined oil product distribution system.
4) The price increase is not large enough to trigger substantial demand and supply responses. If consumers still have to queue for fuel even after the price increase, political discord is more likely.

[redacted]

5) Powerful political groups use the price increase as a rallying point for their own agendas. Opposition to price hikes in Nigeria have been lead by the labor unions; in Indonesia, by students pushing for a more democratic regime.
6) Police respond to demonstrations with violence or are unable to keep demonstrations peaceful, i.e., fail at crowd control.
7) Once a decision is made after public consultation, the decision has to be implemented. If the government does not respond to public debate, but does back down in the face of protests it teaches citizens that public discourse is ineffective, but violent protest works.
8) The price increases take place in an overall inflationary environment, in which prices of other household basics are increased at the same time.
9) Timing: increases in prices before the winter heating season, in the midst of election campaigns, or at the beginning of the work week make it easier for opponents to get people out on the streets in opposition to the increase.

Einar Hope and Balbir Singh, *Energy Price Increases in Developing Countries: Case Studies of Colombia, Ghana, Indonesia, Malaysia, Turkey, and Zimbabwe,* The World Bank, March 1995.

Bottom line: Price increases in all six countries had highly beneficial effects on the economy. Industry responded to price signals by becoming more efficient and substituting for less costly fuels. Industrial output rose with the exception of one or two energy-intensive branches. Fiscal balances improved, inflation did not accelerate, in part because of smaller fiscal deficits stemming from the decline in state fuel subsidies. Economic growth accelerated following the introduction of a more rational pricing structure.

The study undertakes a detailed analysis of welfare effects. Welfare effects on the household sector ran from 1.3 to 2.2 percent of disposable income in the case of increases in kerosene prices and 2.2 to 3.35 percent for electricity. Although households do feel welfare effects of this magnitude, the offsetting improvements in fiscal balance, inflation, and the overall economic environment more than compensated for these declines in net income. Most importantly, the welfare effects were concentrated in middle and higher income households. Consistent with other studies, it finds that fuel price subsidies disproportionately favor middle to upper income urban households.

Dated (1993) household consumption figures for Iraq showed average household expenditures on fuel and lighting at 2.1 percent of total household expenditures. This was a period when households paid for electricity and official fuel prices were higher in real terms. Very substantial increases in kerosene, LPG, and gasoline and diesel prices would reduce real household incomes, but probably not much outside the bounds of the six countries analyzed by the World Bank.

All of the six countries adopted "big bang" approaches: diesel, gasoline and kerosene prices were raised at one time and sharply, in some cases by over 260 percent. There was no mention of political backlashes. Four of the countries were democratic or somewhat democratic democracies (Colombia, Malaysia, Turkey and Zimbabwe) and two had authoritarian governments (Indonesia and Ghana). All the price increases took place during periods of economic change and stress as the governments were undergoing fiscal and balance of payments adjustments. The changes in Turkey were accompanied by strikes, triggered by a variety of wage and other issues. Elsewhere, the introduction of higher prices was greeted relatively quiescently.

Prices were generally not liberalized, although except in the case of Indonesia, a net oil exporter, they were raised above export parity levels, i.e., in-country retail prices were higher than f.o.b.

[redacted]

wholesale import prices. All the countries raised prices sharply, but because of high inflation, a depreciating currency, or other factors, most continued to raise prices in subsequent years. However, the World Bank categorized the approach as "Big Bang" as the real price adjustment took place in one jump. Subsequent increases often just kept the real price of diesel and kerosene constant, i.e., compensated for inflation.

Many of the countries had used de facto quantity controls to allocate diesel and kerosene when prices were low. As in Iraq, middle men skimmed a substantial part of the difference between regulated prices and the actual prices households paid. Consequently, the actual increase in prices to households was less than the overall official price increase because middlemen margins were squeezed or eliminated.

(here the "middlemen" are the profiteers + smugglers.

United Nations/World Bank Joint Iraq Needs Assessment, October 2003. This document advocates phasing out oil price subsidies in stages to avoid undue social unrest. UNDP, in particular, often provides faulty political/economic advice, but a one-off price adjustment would run contrary to the advice in the Needs Assessment.

Eleodoro Mayorga-Alba, "Deregulation and Reform of Petroleum Markets: From Monopolies to New Regulated Markets,"
http://www.worldbank.org/html/fpd/energy/energynotes/energy06.html

Bottom line: Because of supply side rigidities (monopolization of the wholesale and pipeline network, state-ownership of filling stations) the author emphasizes reducing barriers to entry in conjunction with price liberalization. In particular, the author argues that imports should not be subject to tariffs, that regulations be kept to a minimum, that registration procedures for new entrants be kept simple and transparent, and that where the state remains a monopolistic provider in one portion of the supply chain, that private and state-owned customers be treated equally.

Individuals to Contact with Experience in Increasing Fuel Prices

[redacted]
Senior Advisor Middle Eastern Department
IMF
[redacted]

[redacted] is responsible for Iraq. He is planning on a country visit the second week of November. During his last visit, he was wounded in the UN mission bombing. He has had experience with price liberalization and price increases as part of adjustment programs in a number of Latin American countries.

Vladimir Dlouhy
Former Deputy Prime Minister and Minister of Economy of the Czech Republic
International Advisor
Goldman Sachs Europe Limited
Wratislavsky palac I Trziste 13/366
118 00 Prague 1
420 257 532 531

[redacted]

420 257 530 635 (FAX)
vladimir.dlouhy@gs.com

Vladimir implemented increases in gasoline and diesel prices in Czechoslovakia, and continued after the break-up of the country, with increases in the Czech Republic. The increases were 110 percent (August 1990), 89 percent (September 1991), and 51 percent (mid-year 1991), and took place in 12 month intervals. Overall inflation was 51 percent in 1990 and 10 percent in 1992. Dlouhy's children were given security escorts to school because of threats from irate motorists. However, there were no strikes by truckers or taxi drivers.

Peter Akos Bod

I will dig out his contact information, if you would like to talk to him.

Peter was Minister of Economics in the first post-Communist government headed by Jozsef Antall when he raised gasoline and diesel prices. (He later became Governor of the Hungarian National Bank.) In Hungary, taxi drivers struck and tied up central city traffic. Motorists were so irate about the price increases that the government almost fell. The price increase was not broadcast ahead of time and the government did a poor job in explaining the need for the increase.

Yegor Gaider
Marek Belka has contact information.

Gaider was acting prime minister when Russia liberalized refined product prices in 1992. Because of the overall very high rate of inflation that year (1,433 percent), refined oil product price liberalization was just one other shock to the economy that year among many and did not elicit anymore political discontent than was generally the case in a very volatile year politically.

Policymakers from Estonia and most of the other former Soviet republics encountered similar experiences: refined oil product price liberalization was just one more element in the overall chaotic environment.

[redacted]