UNITED NATIONS DEVELOPMENT PROGRAMME

ENERGY PRICING FOR DEVELOPING COUNTRIES

HIGH-LEVEL POLICY RECOMMENDATIONS

CONTENTS

INTRODUCTION

The world energy markets have gone through a tumultuous period since late 2021. Globally, energy prices have soared – owing to recovery from the COVID pandemic, significant supply side bottlenecks coupled with the conflict in Ukraine. Increasing energy prices have become a considerable challenge to many developing countries globally: on one hand to manage the fiscal and balance of payments repercussions and on the other hand manage the implications on the poor and vulnerable. Responding mainly to the latter, many countries have resorted to energy subsidies and in most instances blanket subsidies. This has aggravated fiscal and balance of payment imbalances accentuating fragility of countries. It has also served to distance climate goals and energy transition plans. Continuation of such policies could undermine and reverse human development achievements in many countries.

Rising energy prices have had a cascading effect on the entire supply chains leading to high inflationary environment globally. This has been met by policy responses to deflate economies, which has seen increases in global interest rates. This in turn has compounded economic woes in many developing countries already reeling under high energy prices. Indeed, many countries in Asia Pacific, South America and in Africa are currently undergoing economic crisis while several others remain on the fringe. The following policy recommendations aim to provide some guidance to policy makers on how to effectively position energy prices to avoid economic catastrophes whilst keeping nations on-track to meet their climate ambitions and energy transition goals.

High energy pricing can hinder the delivery of key services, such as healthcare.
Photo: a health center in Zambia without access to electricity. UNDP/Karin Schermbruckert

POLICY CONSIDERATIONS: THE OVERARCHING

1.

Policy makers need to be cognizant and be able to effectively communicate the fact that fair energy prices are an important element of the underlying social contract

A sound social contract is underpinned by twin principles of fundamental securities and fair price. As its part of the contract, the government undertakes to provide six fundamental securities to its people: (i) national security; (ii) food security; (iii) energy security; (iv) social security (encompassing health, education, and social protection for the poor and vulnerable); (v) economic and financial security and (vi) environmental security. In return, people undertake to: (i) uphold the law of the country and (ii) pay a fair price**, which is embodied in fair taxes as well as fair rates for the public services they consume based on the costs to deliver those. When energy products are priced fairly, the government does not need to compensate utilities and other energy companies for their losses. Its fiscal position is therefore unconstrained that allows it to provide for all fundamental securities in a consistent and sustainable manner. In addition, fair prices for energy products will curtail wasteful and excessive consumption of energy, in particular fossil fuels, that would promote economic, financial, and environmental security.

2.

Countries without fair energy prices but instead resorting to heavy subsidization of fuel and electricity in wake of price increases are significantly undermining their fiscal and external stability, compromising on the social contract and distancing their energy transition and net zero ambitions

This could undermine years of human development progress in countries. Over 60+ countries globally, are currently facing dire economic prospects. The economic woes are partly attributed to policy of heavy and untargeted subsidisation that causes significant fiscal and external strain, constraining government ability to protect the most vulnerable and fight climate change. Even among stronger economies, increased subsidies are becoming a major fiscal and external burden – with significant opportunity cost: money that could be better used for strengthening social protection, provide impactful economic stimulus and countering climate change.

** The concept of fair price embodies fairness on part of both parties to the contract – the government and people.

3. In this context it is important that countries reform their subsidized energy prices and countries that already have fair energy prices do not backslide to subsidizing them

As fair energy prices are needed for any country to ensure long term socio-economic stability (in fulfilling the underlying social contract), countries should move away from subsidizing their prices or avoid moving back to doing that. Even though times of low international energy prices are better to reform such subsidies because in these times the subsidized amount is smaller, fair energy prices are a policy with many positive long-term implications and therefore required independent of energy price cycles. Countries should therefore not use the current high prices as an excuse to delay reforming their subsidized energy prices or for re-implementing them but actively work on strategies to reform them. However, given the highly complex and volatile situation, the basic premises for fossil fuel subsidy reforms should be that measures be thought of and implemented in a progressive (and not regressive) manner. This means looking at measures that least hurt the poor but would alleviate the fiscal burden to an extent enabling fiscal space to further support the poor and vulnerable through effectively targeted social protection measures.*

*Recent electricity pricing reforms undertaken in Indonesia provides an example.

POLICY CONSIDERATIONS: THE SPECIFICS

4.

Reforming subsidized energy prices should be a gradual process

Fair energy prices should be gradually phased in so as to not overburden consumers with large price increases at one time and allow for time to adapt alternative strategies. In addition, regular price adjustments will be required once the fair price level is reached to ensure pass through of international prices to domestic prices and avoid falling back into subsidizing energy prices. A particular policy measure that could be employed by developing countries to effectively remove and then also avoid subsidies whilst offering some protection against price shocks is an automatic fuel pricing mechanism (APM) with a smoothing factor. An APM will effectively align domestic energy prices with the international markets, essentially with a short time lag. A smoothing factor will ensure that periodic price adjustments avoid large changes at times of high price volatility (especially when prices are rising). Several developing countries have implemented APM's in the past (such as for example Jordan, Indonesia Gabon and Egypt) and in recent times many countries in crisis have adopted the measure as a means of limiting fiscal and external haemorrhage and part of recovery policies (such as for example Sri Lanka and Pakistan)*. Ideally, an APM should be implemented through a de-politicised institutional mechanism that limits ad-hoc government interference in the scheme allowing for its independent and effective functioning.

5.

Over the long term, fair energy prices should also embody progressive carbon taxes

Carbon taxes targets indirect subsidies or those that account for negative externalities of fossil fuel use, such as air pollution, traffic congestion and of course climate change. Carbon taxes could be imposed in any number of ways – such as for example license fees, green taxes, environment levies etc and it is estimated that around 30 countries currently have some form of carbon tax systems**. These carbon taxes (in whatever form they are imposed) should be based on twin considerations of who should pay (environmental/social impact of emissions) and who could pay (means to pay)***, and should also be phased in gradually over time.

* However only few countries (for example Egypt in 2019) implemented an APM with a smoothing factor.
** Current carbon tax regimes are mostly in developed countries. However, in several developing countries such as Senegal, Cote d'Ivoire and Botswana carbon taxes are under consideration.
*** As an alternative to carbon taxes, government may also encourage establishment of emissions trading system or ETS. However, this is a somewhat of a challenging consideration for many developing countries given the lack of capacity.

6. If pricing reforms are undertaken, simultaneous ramp up of social protection measures would need to be a top policy consideration

In many developing countries, social protection measures remain at an inadequate level -- not affording sufficient protection to the poor and vulnerable exposing them to considerable plight particularly in light of the current crisis. In fact, governments often consider subsidized energy as a means of social protection., But actually, poor and vulnerable groups tend to benefit the least from such blanket subsidies. Governments should therefore move away from subsidizing energy to supporting people directly, as this can provide more targeted support while simultaneously allowing energy demands to be met even through alternative sources to fossil fuels. Social safety nets and other measures – paid by subsidy savings and revenues from carbon taxes – needs to be ramped up through an effective targeted manner. Technology backed cash transfer mechanisms remains a highly potent means of providing social protection for those who deserves. Consideration could also be afforded to establishing social protection floors linked to energy prices. For effective implementation, these measures would need to be incorporated into government medium-term fiscal programming.

7. Temporary targeted support measures should also be afforded to enterprises and businesses

In many countries, businesses are required to pay the market prices for energy (in contrast to many households) and are therefore now experiencing a double whammy stemming from faltering consumer demand and high energy prices. However, rather than providing blanket support governments need to drill down exactly what is needed and provide support without using fuel prices as an intermediary. They should focus only on companies that are experiencing liquidity problems directly resulting from the current crisis. However, this targeted support should only be provided on a temporary basis during the transitional period of adapting to higher energy prices.

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Cover photo: Manuth Buth/UNDP Cambodia