Sustainable Energy Hub UNDP

Fossil Fuel Subsidy Reforms

Development context

The Sustainable Energy Hub

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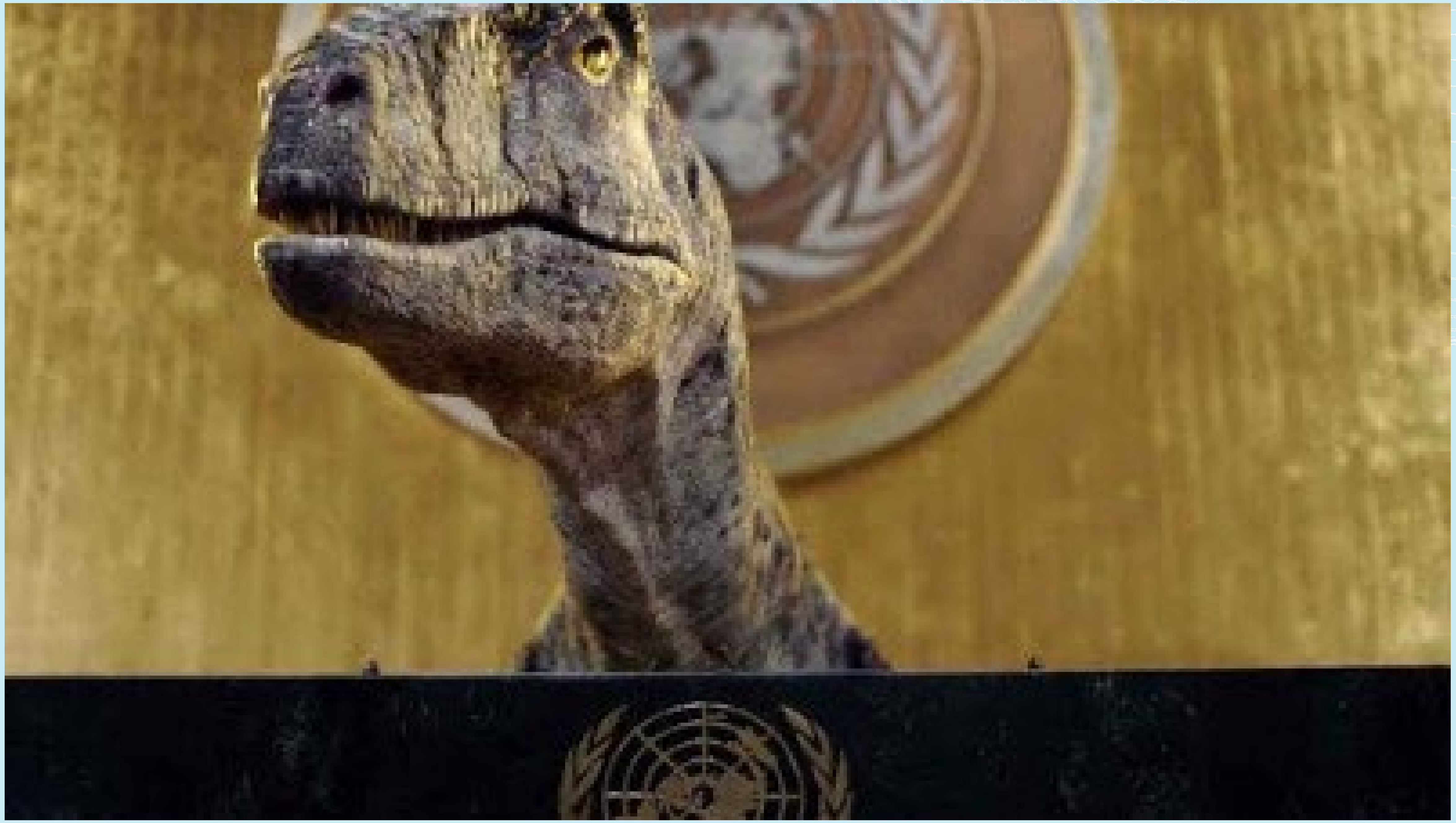
High -level advocacy on Fossil Fuel Subsidy Reforms

Don’t Choose Extinction

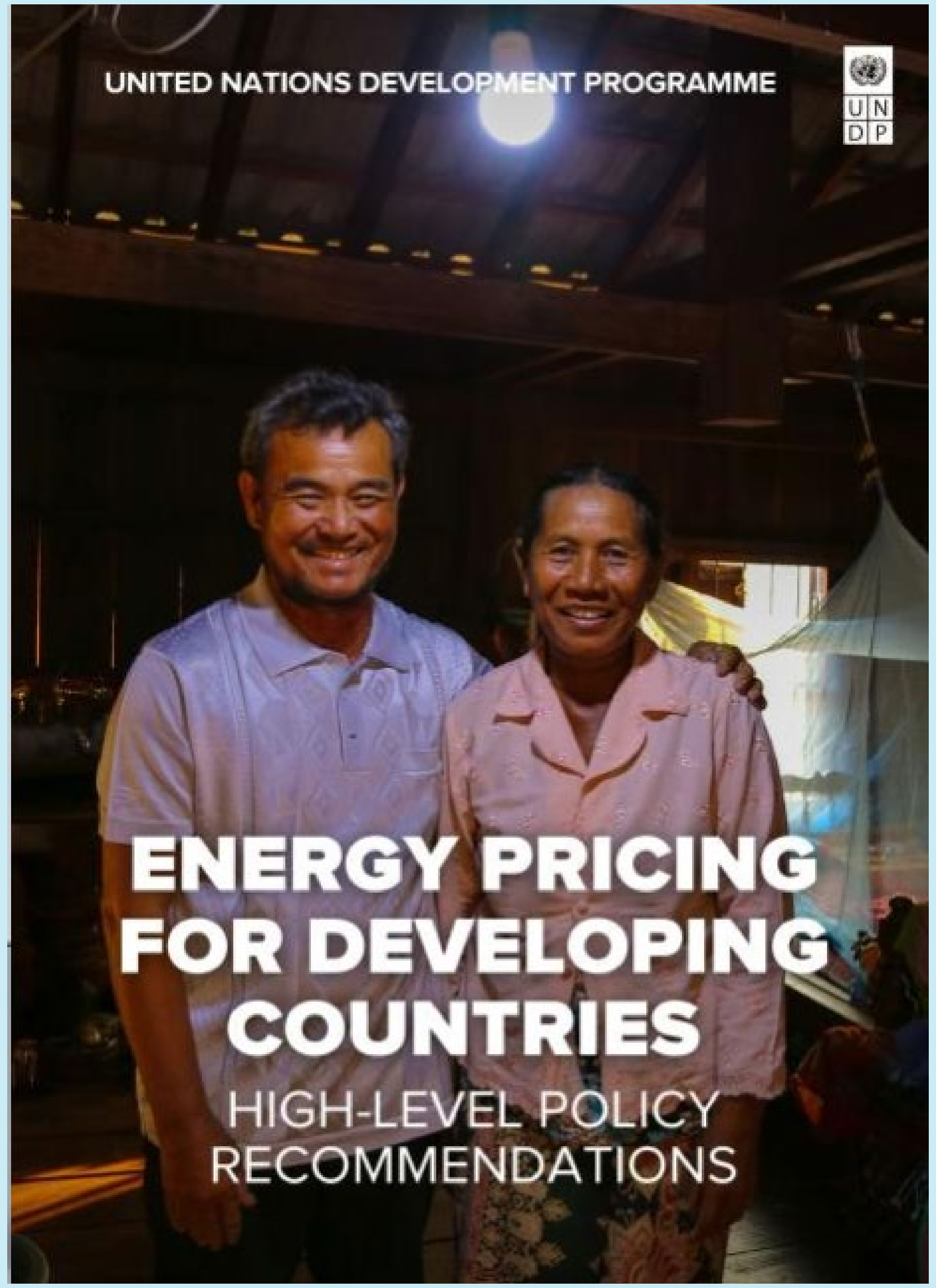
UNDP Flagship Campaign since 2021



High -level advocacy on Fossil Fuel Subsidy Reforms

High-Level Policy Recommendations for Energy Pricing in Developing Countries

[Policy brief released at COP27]



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.

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.

UNDP Fossil Fuel Subsidy Reforms Offer:
Integrated agenda for a just and inclusive transition

TWO KEY PILLARS

1 **Partnerships**
Global/Regional
Local

2 **Packaging**
Energy Security
Green recovery/growth
Decarbonization/NZT

OFFER ELEMENTS

→ **Support to external clients**
Governments

→ **Support to internal clients**
UNDP Country Offices,
Other UN agencies

→ **Supplementary services**
Knowledge Products
Facilitation of Knowledge-sharing
Global, regional, country-level dialogues

Key tools for external client support

FOSSIL FUEL SUBSIDY REFORMS
POLICY FRAMEWORK

Fossil fuel subsidy reforms strategy

Governance and institutional mechanisms

Economic, Environment, Social and Poverty Assessment (ESPA)

Governance, Institutional and Capacity Assessment (GICA)

Strategy pillars:
- prioritization, sequencing, phasing of reforms
- Use of fiscal savings

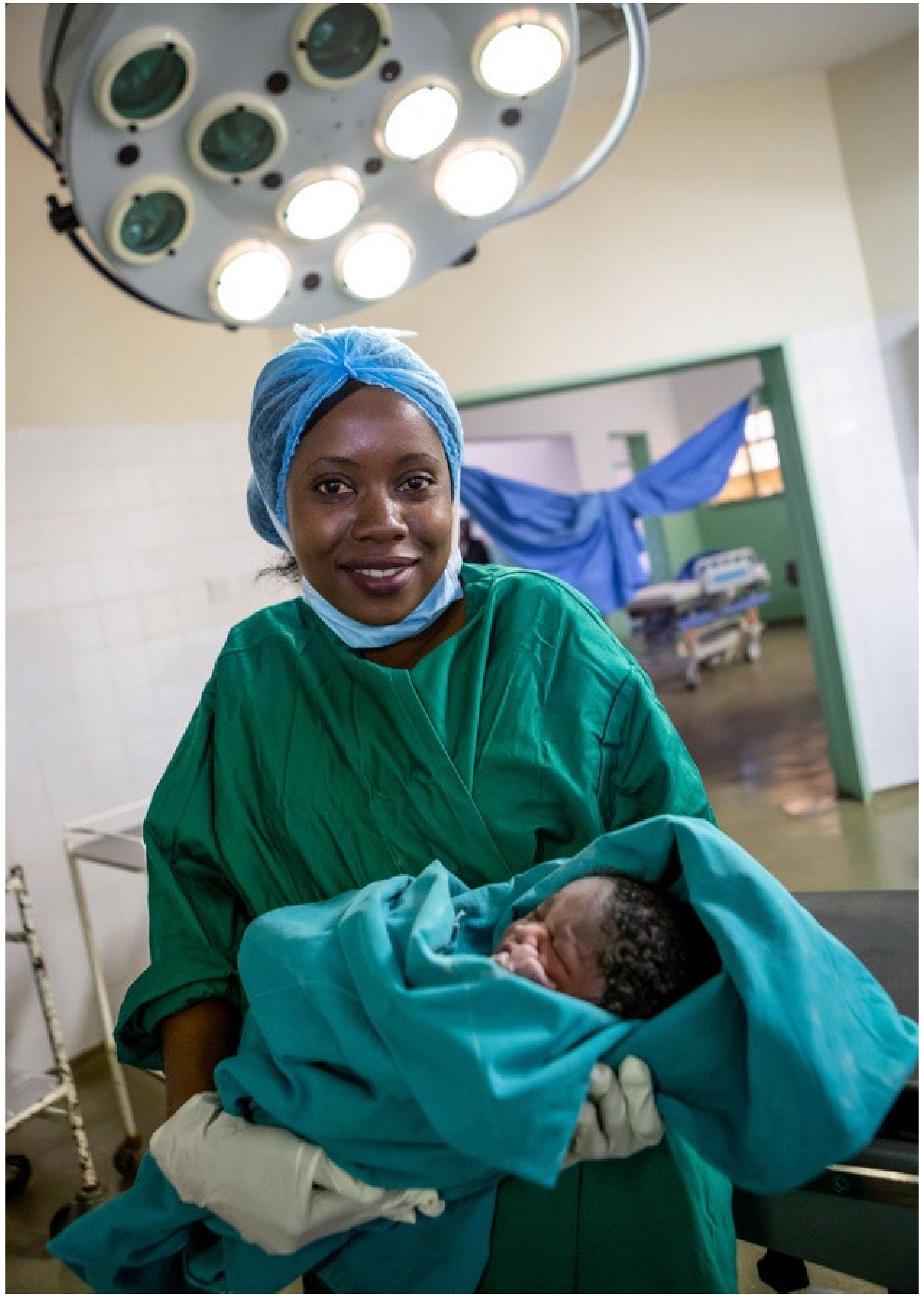
Establishment of governance and institutional mechanisms
- Capacity development
- Depolitization of reforms
- Automatic Pricing Mechanisms (APM)
- Smoothing mechanisms

STAKEHOLDER ENGAGEMENT AND COMMUNICATIONS

IMPLEMENTATION OF FOSSIL FUEL SUBSIDY REFORMS

POST-IMPLEMENTATION RESULT MONITORING

Development context of Fossil Fuel Subsidy Reform



- Underlying social contract, underpinned by two principles:
  - ✓ **Government ensures six fundamental securities**
    - national security
    - food security
    - energy security
    - social security (health, education, and social welfare)
    - economic and financial security
    - environmental security
  - ✓ **People pay a fair price**

- Fossil Fuel Subsidy Reform:
  - ✓ Government part of the contract: freeing fiscal space to ensure fundamental securities
  - ✓ People side of the deal: fair price for fuel/ electricity, fair taxes

→ This makes the **whole system sustainable.**

Development context of Fossil Fuel Subsidy Reform

Fossil Fuel Subsidy Reform has considerable utility for:

CRISIS RESPONSE

First order subsidy reforms and institutionalization in Sri Lanka and Pakistan helped stabilization and curtailing fiscal and external hemorrhage.

MEETING DEVELOPMENT NEEDS

- Support Energy Transition: e.g. MOVES project in Uruguay
- Ramping up social protection, social welfare and poverty alleviation measures: e.g. India, Mauritania, Indonesia and others
- Invigorate economic growth (investments in climate resilient and green infrastructure) and facilitate economic diversification: e.g. Initiatives underway in the GCC.

Development context of Fossil Fuel Subsidy Reform

And there are many others…

INNOVATION

Supporting innovation, technology and entrepreneurship in developing countries, providing a permanent fillip to economic growth.

DECARBONI - ZATION

Supporting broader decarbonization efforts that spans a broad spectrum (energy, agriculture, transportation, industry, land use and waste management) towards systems change and a different way of approaching economic development policy.

In many developing countries, energy transition will not happen in the face of continued subsidization of fossil fuels.

FINANCE FOR DEVELOPMENT

Fiscal savings could be used to securitize thematic debt issuances (Green Bonds, Sustainability Linked Bonds etc) or create collateral funds for de-risking both debt and equity resources for development..

Thank you.

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UNDP Sustainable Energy Hub

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