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Some thoughts on fuel subsidy cutback

Government total withdrawal from its direct price setting role

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- **Deficit reduction pledge.** In the aftermath of 2008 financial crisis, the Government of Malaysia undertook aggressive counter-recessionary measures to avert the economy from stalling. Subsequently, it embarked on ambitious economic initiatives to propel the economy further forward. Consequently, the government finances is now approaching the 55% (of GDP) debt ceiling as allowed under the law. Thus it has targeted to gradually reduce fiscal deficits and eventually achieve a balanced budget by 2020. For 2014, the nation's fiscal deficit is estimated at RM37.1b.

- **Cutback in fuel subsidy is necessary…** According to Budget 2014, spending on subsidies, including fuel, would total RM39.3b. Therefore, subsidies may represent nearly 106% of total estimated fiscal deficit this year. Hence it is rather striking that a total cutback in subsidies alone would help the government to instantaneously achieve a surplus budget. It must also be highlighted that fuel component of the subsidies represents approximately 63% of the total with RM24.8b budgeted for this year. And so, significant reduction in the amount of fuel subsidy is a necessary mean to achieve the fiscal target.

- **…but how?** There are many ways to skin a cat, so the saying goes. We list down three methods, namely (i) Step-up, step-down, (ii) Multi-tier, and (iii) Float & crawl-up.

Step-up, step-down

- Under this method, retail pump price is fixed at a predetermined discount to average market price of gasoline. As and when the average market price substantially deviates from the earlier fixed retail pump price, the latter shall be adjusted accordingly. The government assumes a direct (at the pump) price setting role via a so-called Automatic Pricing Mechanism (APM).

- In theory, the APM is a straightforward way to control the amount of fuel subsidy in any given period. It also helps to shield retail gasoline price against the daily volatility of world's market price.

- But the main setback is that the subsidy outlay is blanket, i.e. not rightly targeted, and in fact benefits the rich more than the poor.

- More importantly, in practice, while it is easy to step-down (i.e. reduce price at the retail pump), it is politically difficult to step-up (i.e. increase price at the retail pump). It is especially so under a scenario of sustained rise in the market price of crude oil, and consequently gasoline, which necessitates frequent upward retail price adjustments.

- Without the necessary political will, we can expect (i) the government to over time be saddled with ballooning fuel subsidy bill, and (ii) the consumers will eventually be burdened with sudden big hikes in retail gasoline price.

- In reality, we are arguably in this very predicament right now.

Multi-tier

- Under this method, retail pump price is fixed at a level on par to average market price of gasoline. Therefore, the retail pump price shall be adjusted periodically to reflect any changes in the average gasoline market price. The government, at least in the eyes of the public, retains its direct price setting role via the APM.

- A multi-tiered fuel pricing structure, as the name implies, discriminates the consuming public based on their economic status. Entitled users shall be accorded pre-determined discounts to the retail pump price depending on their income levels.

- This process may involve the use of IT system and identity verification such as the MyKad in order to validate the identity of entitled users at the pump and prevent abuse. But despite its apparent sophistication, there is no guarantee that it will not be fraught with implementation issues. And due its apparent sophistication, there is no guarantee that it will not be beset with operational cost issues.

- Granting it the benefit of the doubt, we reckon this method would help to achieve the goals of subsidy reduction as well as right-targeting the subsidy outlay. However, it still fails to totally relieve the government of its direct price setting role which, in the past, had unfairly invited more brickbats than compliments from the public.

Float & crawl-up (plus BR1M)

- The Float & crawl-up method involves two sequential steps.

- *Firstly,* the retail pump price shall be floated from prevailing level which effectively pegged the amount of subsidy per litre going forward.

- To illustrate, the market price of RON95 gasoline is RM2.78 as of August 2014 while the pump price stands at RM2.10 with a subsidy of 68 sen per litre. Thus if the retail pump price were to be floated henceforth, the subsidy would remain at 68 sen per litre as the movements in retail pump price would then on mirror the nominal changes in gasoline market price.

- The initial step shall help expose the consumers to floating price environment. This vital first step is meant to transition the psyche of our consuming public with daily price upticks and, more importantly, downticks as well as build their acceptance towards a more market-oriented variable pricing regime.

- *Secondly,* the still unremoved subsidy shall then be withdrawn, gradually and stealthily.

- To illustrate using the above example, the subsidy of 68 sen per litre of RON95 gasoline may be gradually removed by 1 sen at each time. Hence 68 crawl-up adjustments are needed to complete the withdrawal. As the market price of gasoline, which is derived from (i) Mean of Platts Singapore (MOPS), and (ii) USD/MYR exchange rate, normally moves up or down on daily basis, the necessary adjustments can be masked within the market price movements.

- To remain stealthy, each adjustment should only be made on occasions when the daily market price corrected by at least 3 sen. For example, a 3 sen decline in gasoline daily market price will produce only a 2 sen reduction in retail pump price. Hence the process may take up to 1 or 2 years to complete despite the mere 68 crawl-up adjustments required.

- Under this method, the adjustment process towards market pricing would be gradual, stealthy and least discernable to the consuming public. But most importantly, the government shall thenceforth be totally relieved of its direct price setting role.

- Having said that, it does not necessarily mean that the retail fuel pricing structure should be totally deregulated all at once. While the cost of product should be based on daily market price sourced from the MOPS, or equivalent benchmark, all (or some) other price components such as (i) alpha, (ii) operational/transport costs, (iii) oil company margin, and (iv) dealer's margin may continue to remain fixed until our fuel supply chain is ready for an outright price competition.

- Furthermore, it must be highlighted that the financial welfare of lower income motorists is not in any way overlooked despite the complete removal of subsidy element in retail fuel pricing. We are of the opinion that some of the subsidy cutback should be rechanneled directly to deserving recipients via an existing government cash assistance programme.

- For this purpose, in order to minimize the duplication of administrative infrastructure, we reckon it would be more efficient to integrate the fuel cash assistance, as well as all other types of government cash assistance (general, schooling, etc.), under the umbrella Bantuan Rakyat 1Malaysia (BR1M) programme.

• **We prefer Float & crawl-up…** The Step-up, step-down method was, in practice, manifestly problematic as the "automatic" APM was often times being manually overridden by political considerations. The Multi-tier method, on the other hand, is risked of being fraught with implementation well as operational cost issues. More so, it still fails to totally relieve the government of its direct price setting role. Hence among the above methods, we are most inclined towards Float & crawl-up due to its market-oriented philosophy with the adjustment process towards market pricing being gradual, stealthy and least evident to the consuming public.

• **…(plus BR1M) with government total withdrawal from its direct price setting role.** And most importantly, the Float & crawl-up method would in the end totally relieved the government of its direct price setting role which, as we stated earlier, had unfairly invited more brickbats than compliments from the public. Nonetheless, the government total withdrawal from its direct (at the pump) price setting role hence the resultant removal of subsidy element in retail fuel pricing would be supplanted with fuel cash assistance under the BR1M programme.

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