



USAID | Iraq Economic Governance II Project

Public Policy on Subsidies
Iraq Ministry of Electricity
Executive Summary

A number of subsidies in the present tariff structure of the Iraq Ministry of Electricity (MoE) already exist.

Existing subsidies

Table with 3 columns: Subsidy, Received by, Paid by. Rows include Capital Expenditure Subsidy, Fuel Price Subsidy, Inter-Class Subsidy, Intra-Class Subsidy, Domestic user subsidy, and Operating Cost Subsidy.

Issues:

- A. The Regulatory Construction and Fuel subsidies are the primary reasons the tariffs in Iraq are so low. However, changing these subsidies require economic and political decisions that have far reaching implications that should be addressed at the Government level.
B. Inter- and intra- class subsidies support certain customer classes and customers within some classes. However, the subsidies have been misdirected and should be corrected. To bring the tariffs back in line with cost and social equity, the Agricultural Class in particular, should be receiving a subsidy, not giving one.
C. Providing some form of relief to vulnerable social groups is a major concern. The key issues are whether the subsidy currently in place is sufficient and what the ability of the poor to pay really is.
D. Although inter- and intra- class subsidies already exist and incentives for conservation are in place through inverted block pricing, the impact is hardly being felt because of the low rate presently in place for all customers.
E. Overall tariff levels are not keeping up with the rapid rise of costs and the subsidy from the Ministry of Finance will continue without a strategic increase in tariffs.
F. The Proposed Tariff in front of the Prime Minister became politicized and changed during the approval process and is no longer cost based.

Recommendations:

- A. The Ministry (and the Government) must clearly set out its objectives for subsidy policy as a priority.
B. The current plethora of different subsidies is inefficient, uneconomic and should be streamlined and targeted in order to meet these objectives.
C. Address the Regulatory Construction and Fuel subsidies at the national level.
D. Studies are presently being conducted to address the ability of the poor to pay and will enlighten the situation shortly.
E. The Ministry of Electricity should not be in the welfare business. A subsidy for the poor should be paid by the central government though the social security program designed and administered by the government. Either a voucher scheme or direct payments are potentially attractive options.

The potential benefits of this approach include:

- Potential to increase the benefit to the target groups without any increase in cost.
- Subsidy only reaches the poorest, not those who can well afford to pay.
- Does not penalize the electricity sector – easier to set tariffs to cover operating costs.
- Reduced cost of providing the subsidy.
- Removes distortions from the electricity market.
- Increases transparency.
- Transfers the onus of providing the subsidy to the parts of Government best qualified to deliver it.

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Almost all countries have some form of subsidy for the most vulnerable social groups. The question is not IF there should be a subsidy in utility rates but rather HOW the subsidy should be targeted, designed and managed. The objective is to design a mechanism that only reaches the target groups, without distorting decision making for other stakeholders. In fact Iraq already has a number of different subsidies in place in the electricity sector.

Existing subsidies in the present tariff structure of the Iraq Ministry of Electricity (MoE)

A. Capital Expenditure Subsidy

Present regulations in Iraq require electricity tariffs to be set at a level sufficient to recover all operating costs of producing electricity. All costs of construction and expansion of the system have been provided by the Ministry of Finance and those costs have not been borne directly by customers. In most western countries in which utility systems are owned by private investors, or which are municipally owned, the capital costs of building the system are recovered directly from customers; the costs are included in the tariff structure.

B. Fuel Subsidy

The present pricing policy on setting the transfer price of fuel from the Ministry of Oil to the Ministry of Electricity is based on the premise that the dominant fuel burned in the power plants, residual oil, is considered a waste product for which a market in this region does not exist. Therefore the price is set extremely low compared to the typical market price obtainable elsewhere. Although the price is set “at cost”, it is far below the “opportunity cost” to be found in other markets and results in a subsidy to all customers, at the expense of the Ministry of Oil.

C. Inter-Class Subsidy (between customer classes)

There are five rate classes in Iraq and the cost burden has not been shared equally among the classes. The average rate paid in the Commercial Class is 5X that paid in the Domestic Class. Under the present rates in effect, the Commercial, Industrial, and Agricultural customers are subsidizing the Domestic and Government customers. In most emerging markets the agriculture sector receives subsidies, not pays them.

D. Intra-Class Subsidy (within a customer class)

Only the Agricultural Class has a flat rate structure, where all customers pay the same rate for each kwh. The Industrial Class has a flat rate structure that varies by voltage delivery. Both of these classes have no direct subsidies within the class. The other 3

have multi-block rate structures with inverted price blocks to encourage conservation (each higher block of usage has a higher price). There are huge subsidies between the low users and the high users. Within the Domestic Class, 94% of the kwh used falls within the first rate block and pays 1 Dinar / kwh. Those in the remaining blocks pay 4 - 30 times as much per kwh. The same situation exists in the Commercial Class with the spread between first and remaining blocks being 2 – 12.5X. In the Government Class, the spread is 1.25 – 2.5X.

E. Domestic User Subsidy

Consideration is usually given to the poor in society and those on fixed incomes where even the lowest usages can be a financial burden. The present tariffs have an inter-class subsidy for the Domestic Class being paid for by the other classes. The average price for all Domestic customers is 1.4 Dinar / kwh compared to other average prices of 2.7, 3.1, 5, and 7. An intra-class subsidy exists in the Domestic Class where the lowest price in the first block is 1 Dinar / kwh. However, the first block is 1500 kwh long, effectively giving the subsidy aimed at the poor to almost all users. Although aimed at the poor in fact all domestic customers benefit, even those who could easily afford to pay. The proposed tariff awaiting approval has broken the first block into three blocks of 600, 300, and 600 kwh. This will help to target the subsidy properly.

F. Operating Subsidy from the Ministry of Finance

This is a temporary measure whereby the Ministry of Finance has agreed to cover the MoE's shortfall of revenues until the tariff can be increased to cover all operating costs again. In the past, the MoE has been a net revenue generator for the government. Even at 2004 cost levels the Ministry is only able to cover about 10% of its operating costs. If the proposed tariff increase before the Prime Minister were to be accepted, the collection rate would increase to about 75% of the 2004 budget figures. The 2005 Budgeted costs are substantially higher; the collection rate for 2005 will continue to decline until tariffs are increased.

Who should pay for the subsidy?

The Capital Expenditure and Fuel subsidies have been created by public policy decisions and are presently being paid by the central government. The inter- and intra- class subsidies are presently being paid by other customers. The subsidy from the Ministry of Finance will eventually disappear once tariffs are increased to cover all expenses. The outstanding question is who should pay for subsidies for the poor.

The options typically are as follows:

1. Other customers through either a) inter and intra-class subsidies to cover a lower price in the first block OR b) a Lifeline Rate.

- a) When tariffs are increased to the Domestic class, shorten the first block to a reasonable level aimed at the poor, maintain the price in the first block at a reasonable level, and increase all other blocks to pay for the subsidy.

- b) Develop a Lifeline Rate aimed at the poor that is only accessible to those truly poor (they would need some sort of proof). Develop a qualifying test that verifies eligibility and limit access to the Lifeline rate to those that qualify. Any shortfall of revenue from the discount given for the Lifeline amount of kwh used can be subsidized by higher prices from the remaining customers.

2. Government. Taking care of the poor in society is the domain of the government through social security policy. The MoE should not be in the welfare business. As a social security program is developed to care for the needs of the poor, an electricity component can be added to give a cash benefit to the recipient to reimburse them for the cost of the Lifeline usage. An alternative would be to give a voucher for an equivalent amount to hand in with the MoE payment. The vouchers can then be turned over by the MoE to the government for reimbursement. This method eliminates the burden from the MoE of developing an eligibility test for the poor and the administration of its application, both functions which belong to the central government.

Conclusions

1. The Ministry (and the Government) must clearly set out its objectives for subsidy policy as a priority.
2. The current plethora of different subsidies is inefficient, uneconomic and should be streamlined and targeted in order to meet these objectives.
3. Maintaining a Capital Expenditure Subsidy is an economic and political decision that eventually will need to be addressed if foreign investment is sought for capital expansion.
4. Maintaining a Fuel Subsidy is also an economic and political decision that has far reaching implications that should be addressed at the national level.
5. Inter- and intra- class subsidies already exist and offer support to certain customer classes and to customers within some classes. However, the subsidies have been misdirected and distort customer incentives. To bring the tariffs back in line with cost and social equities, the Agricultural Class, in particular, should not be subsidising other customers.
6. The huge subsidy given to all Domestic customers should be reduced by shortening the first block and eliminating the subsidy to higher blocks.
7. Although inter- and intra- class subsidies already exist and incentives for conservation are in place through inverted block pricing, the impact is hardly being felt because of the low rate presently in place on all customers. Overall tariff levels are not keeping up with the rapid rise of costs and the subsidy from the Ministry of Finance will continue without a strategic increase in tariffs.
8. The Ministry of Electricity should not be in the welfare business. A subsidy for the poor should be paid by the central government through a voucher that is part of a social security program designed and administered by the government.

**Attachment A
Growing MoE Budgets**

**Shift Movements in Revenue Requirements
Ministry of Electricity**

(1,000 ID)	TOTAL
1Rev from Present Rates - 2004 KWH	71,436,273
22002 COS - Financials	74,380,867
32004 COS Budget (April 2004)	191,044,223
4BK Proposed COS Rate (June 2004)	267,823,140
5Budget 2004 - (March 2005)	299,667,737
6Budget 2005 - (March 2005)	468,280,540
7Draft 2005 COS Budget w/Adjustments Case 1- LF based on Cus Profile	499,753,845
8MoE Proposed Rate 4-2005 359 B-ID Target Tariff Revenue	624,505,000
9Budget 2006 –	Not Available yet

Note: All above Budgeted figures need to be compared to actuals.
Awaiting 2004 Financial Statements for vetting of budget process.

**Attachment B
Cost of Service Shifts**

Shift Movements in Cost of Service

(ID/kwh)	TOTAL	Domestic	Sm Comm	Industrial	Governmental	Agricultural
1Present Average Rate	2.5	1.4	7	3.1	2.7	5
22004 COS Budget 267 B-ID Budget	9.495	9.83	9.867	9.058	11.02	3.232
3BK Proposed Rate 6-2004	9.5	8.3	13.9	9.9	12.3	5
4MoE Proposed Rate 4-2005 359 B-ID Budget	9.95	3.6	15.9	20	10	15
5Draft 2005 COS Budget Case 1- LF based on Cus Profile	13.831	15.49	12.953	10.63	14.85	10.796
6Draft 2005 COS Budget Case 2 - LF based on 2004 Typical study	13.831	18.361	13.125	9.618	6.3	14.647

Cases 5 and 6 show the shift among rate classes that can occur depending on customer load factor estimating methods and allocation methodologies.

Attachment C
Ministry of Electricity of Iraq
Proposed Electric tariffs

Proposed Increase 4/26/05

Domestic

Present	(ID/ kwh)		Proposed	(ID/kwh)
First 1500 kwh	1		First 600 kwh	2
			Next 300 kwh	4
			Next 600 kwh	6
Next 600 kwh	4		Next 600 kwh	8
Next 900 kwh	7		Next 900 kwh	10
Next 2100 kwh	15		Next 2000 kwh	16
Rest	30		Rest	30

Small Commercial

Present	(ID/ kwh)		Proposed	(ID/kwh)
First 300 kwh	2		First 300 kwh	12
Next 300 kwh	4		Next 300 kwh	14
Next 300 kwh	8		Next 300 kwh	15
Next 600 kwh	12		Next 600 kwh	20
Next 900 kwh	20		Next 1500 kwh	25
Rest	25		Rest	30

Industrial

Present	(ID/ kwh)		Proposed	(ID/kwh)
0.4 KV	8.5		0.4 KV	20
11 KV	3		11 KV	20
33 KV	2.5		33 KV	20
132 KV	2		132 KV	20

Governmental

Present	(ID/ kwh)		Proposed	(ID/kwh)
First 10,000	2		First 10,000	10
Next 10,000	2.5		Next 10,000	10
Next 20,000	3		Next 20,000	10
Next 60,000	4		Next 60,000	10
Rest	5		Rest	10

Agricultural

Present	(ID/ kwh)		Proposed	(ID/kwh)
All kwh	5		All kwh	15

NOTE: This is the Rate Proposal that is presently before the Prime Minister. It became politicized and changed during the approval process and is no longer recommended by BearingPoint.