The recent price discount for imported gas: What does it mean for end user tariffs?

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1. Need for a reassessment

- In our policy paper PP/02/2012 we showed that gas tariffs, especially for households and heating companies, are significantly below the cost recovery level
- The economic cost of this subsidy was estimated to amount to 6% of GDP in 2012
- As of the 1st of January 2014 the price of natural gas imported to Ukraine via Russia's Gazprom has been reduced to 268.5 USD per 1000 cubic metre (tcm)
- As this marks a significant reduction compared to the 416 USD/tcm paid in 2012, it makes sense review our assessment from 2012

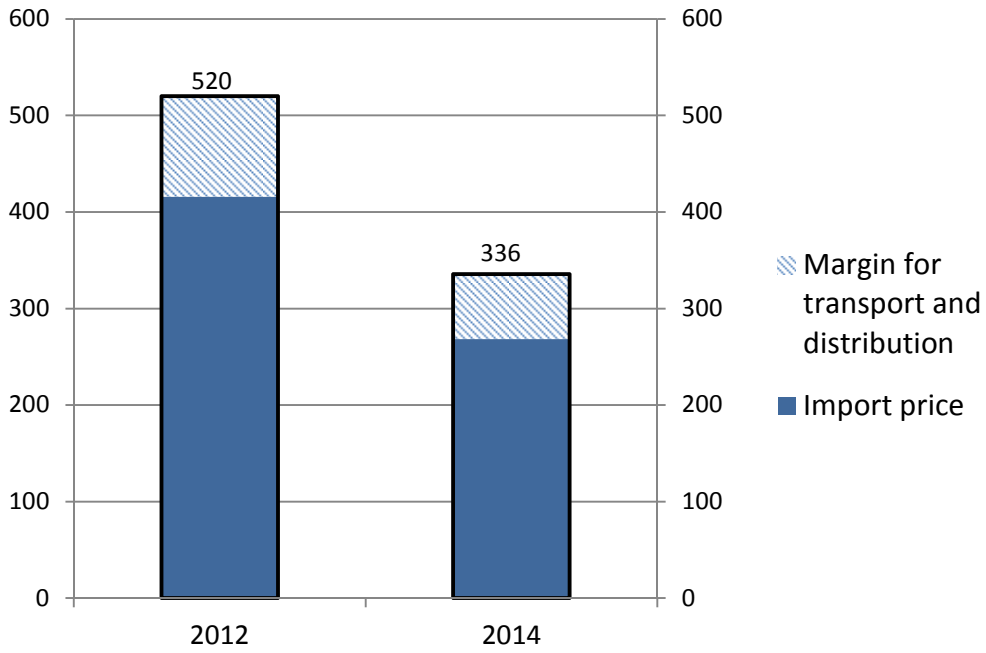
Question: What does the recent import gas price reduction mean for the need to adjust domestic gas tariffs?

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2. What is the cost recovery level after the import price reduction

Cost recovery level, USD



Source: Own analysis

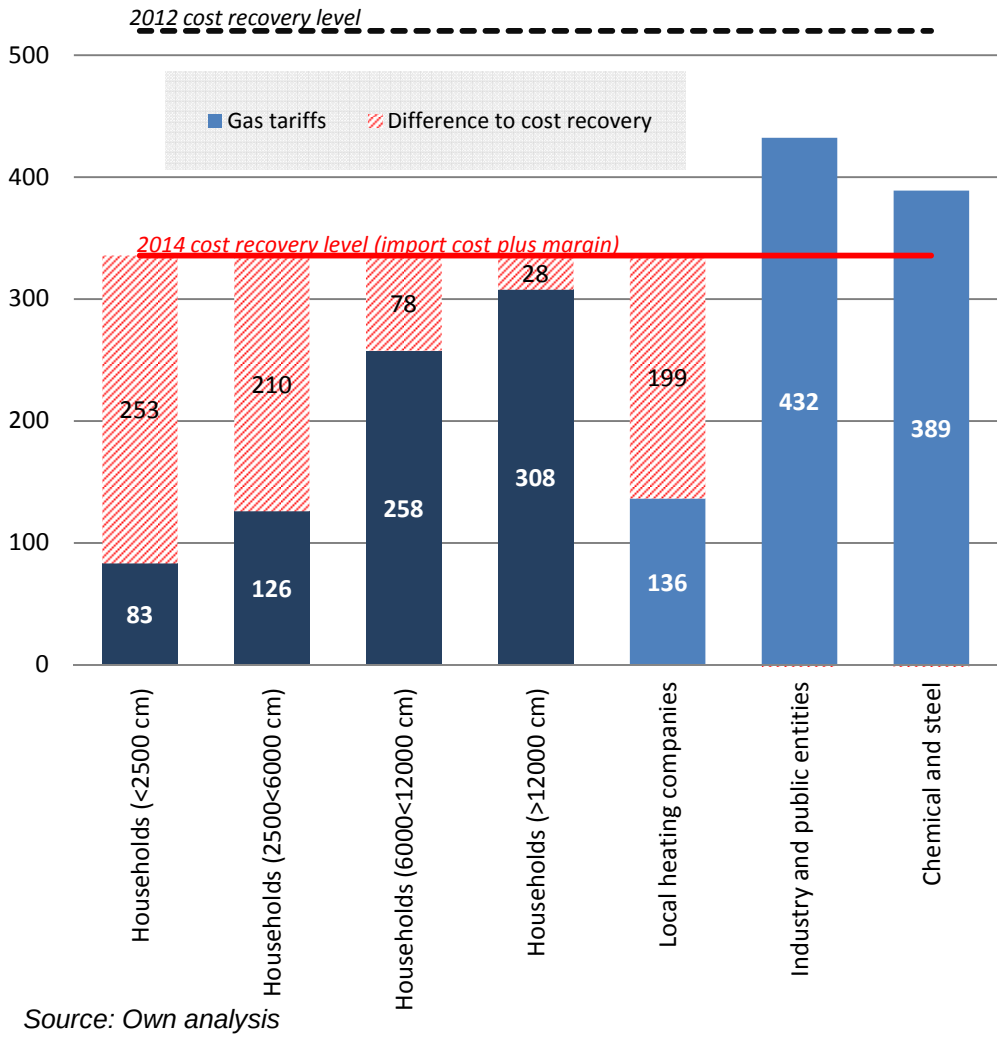
- In order to be cost effective, the domestic tariff for gas needs to cover the import cost plus a margin for the cost of transporting the gas and its distribution
- For better comparison we assume a margin of 25% on the import price as was done in our original analysis in 2012
- With the new import price of 268.5 USD/tcm the resulting cost recovery level for domestic gas tariffs is 336 USD/tcm
- Thus, the lower import price has led to a 35% lower cost recovery level
- Question: How does this compare to the current tariff levels for the different user groups?

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3. Comparison of domestic gas tariffs with cost recovery levels

Domestic gas tariffs and cost recovery level, USD



Source: Own analysis

- The chart shows domestic gas tariffs and compares them with the tariff level required to cover costs
- As expected reduced import cost have significantly lowered the cost recovery tariff level
- However, even after the recent reduction most user groups do still pay well below even this reduced cost recovery level
- For example, most household users pay only 83 USD/tcm which is only 25% of the cost recovery tariff
- Only domestic gas tariffs for industry are breaking even
- Question: What are the aggregate cost of tariffs below cost recovery levels?

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4. Estimated cost of subsidising gas

Consumer group	Cost recovery level USD/tcm	Domestic gas tariff USD/tcm	Win / loss per unit USD/tcm	Consumed quantity bn cm	Aggregated economic cost* bn USD
Households	**336**	**125****	**-211**	**18.4**	**-3.9**
Heating companies	**336**	**136**	**-199**	**8.8**	**-1.8**
Industry	**336**	**432**	**+97**	**15.8**	**+1.5***
Steel & Chemicals	**336**	**237**	**+54**	**8.0**	**+0.4**
				Total subsidies	**-5.3**
				Total surplus	**+1.5**
				Net economic cost of subsidising gas tariffs	**-3.8**

- The cost of subsidising gas tariffs for households and heating companies is likely to reach USD 5.3 bn in 2014
- However, with some industry users paying tariffs above the cost recovery level, there will also be a surplus of USD 1.5 bn in 2014
- Nevertheless, even after accounting for this surplus, the net economic cost of subsidising gas is estimated to amount to USD 3.8 bn per year – the equivalent of 2.0% of GDP in 2014

** Positive numbers denote a surplus, that is – the distributer currently earn some money*
*** Weighted average of household tariffs*
Source: Own analysis

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5. Summary of the assessment

- As expected the reduced price for gas imported from Russia does substantially reduce the economic cost of subsidising gas for households, heating companies and other user groups
- However, as tariffs remain below the cost recovery level for most user groups, the state effectively subsidises these groups
- We estimate that this is likely to result in economic cost of USD 3.8 bn (2.0% of GDP in 2014) for this year even after a potential surplus from industry users is accounted for
- Given the size of the cost already incurred at current tariff levels, there is no room for tariff reductions
- Instead, some of the savings from reduced cost of subsidising gas tariffs should be used to fund measure to increase energy efficiency

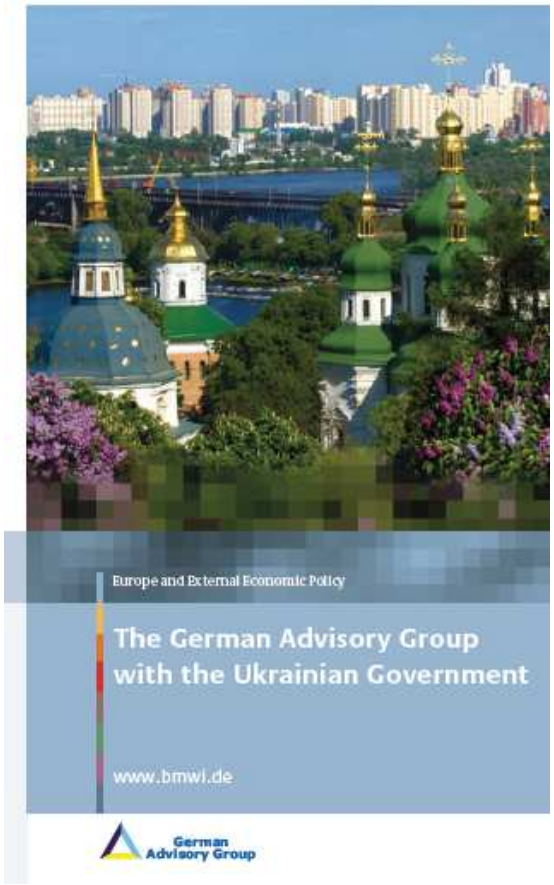
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