Economic cost of cheap Russian gas

Analysis and Policy Recommendations

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Motivation

- 7 April 2011, press release: “Gazprom said it would treat Ukraine as a domestic consumer, cutting its gas bill by USD 8 bn per year, if it joined Russia, Belarus and Kazakhstan in a customs union” (EurActiv, 8 April 2011)
- At first sight: USD 8 bn per year (i.e. 5% of expected GDP in 2011) look rather appealing
- Questions in this presentation:
  - What would be the economic consequences for Ukraine of accepting this proposal?
  - Should Ukraine accept this proposal?

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Structure

1. The features of the proposal
   a. Short-term character
   b. Barter deal
2. Conflicts with Ukrainian energy policy goals
   a. Goal of energy security
   b. Goal of decreasing the energy import bill
3. Conflicts with other Ukrainian policy goals
   a. Impact on investment
   b. Good governance
   c. Development of gas market
   d. Ecological effect
4. Final remarks: Pros and cons of proposal

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1. The features of the proposal

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a. Short-term character

- In theory: Price discount should last for some years
- In practice: Very hard to predict how long the price discount will hold
- Reason 1: Russia has in recent years repeatedly violated trade agreements with Belarus, Ukraine, Moldova and Georgia.

  Thus: High risk that Russia will not stick to gas agreement
- Reason 2: If Russian domestic prices go up quickly (as planned), then no or less price discount for Ukraine
- **Conclusion 1**: Deal could be ended unilaterally by Russia at any time and has thus a short-term character

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b. Barter deal

- Usual market transaction: Goods/services are exchanged for money
- Proposed deal: No exchange for money
- Instead: Participation at customs union and further services (yet to be specified)
- Thus: The Russian side seems to propose a barter deal
- Important feature, since barter deals are quite unusual in modern foreign trade

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2. Conflicts with Ukrainian energy policy goals

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a. Goal of energy security

- If gas is subsidised in the framework of a barter deal:
  - Discussions about the right price and the right conditions to be expected
  - Experience shows that such discussions tend to take place in the height of winter (heating season)
- Instead: If market prices apply
  - No reason for Gazprom to interrupt the supply of gas to Ukraine, since there is a business case to deliver gas

  → Security of energy
- **Conclusion 2**: Cheap gas would reduce the energy security of Ukraine

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Less diversification

- Besides: Preferential gas supply contract would cement the high regional concentration of energy imports of Ukraine
- But: Higher concentration means higher supply risks
- Thus: Proposed deal would decrease energy security in Ukraine
- **Conclusion 3**: Cheap gas would prevent diversification and thus further reduce energy security

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b. Goal of decreasing the energy import bill

- Energy import bill: cost = price x quantity
- Lower price helps reducing the energy import bill
- But, lower price leads to higher demand than under market conditions => Increasing quantity might even out the cost reductions
- In the short-term: Price effect probably stronger than quantity effect => Reduction in energy import bill
- In the medium term: Lack of investment in energy efficiency and less rational use of energy resources
- Thus: Quantity effect becomes stronger year after year

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Quantification/Estimation:

- Short term: Typically, a 1% price decrease leads to 0.3% higher demand in the short run
- Thus: The total effect (price and quantity effect) in the short-term is much less than the pure price effect
- Long term: Typically, a 1% price decrease leads to 0.8% higher demand
- Thus: Almost no saving in the energy bill
- **Conclusion 4**: Cheap gas does not imply a significant lower energy import bill in the long term perspective!

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3. Conflicts with other Ukrainian policy goals

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a. Impact on investment

Lower import gas prices:

- Negative effect on investment in domestic gas production
  - Conventional gas
  - But also non-conventional gas
- Negative impact on investments to increase energy efficiency in different sectors of the economy (buildings, manufacturing, transport)
- At the same time: No positive effect on investment in energy-intensive industry, since investors have a long-term perspective and the proposed deal a short-term character
- **Conclusion 5**: The overall impact of the proposed gas deal on investment is clearly negative

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b. Good governance

- Generally speaking: Market transactions involving cash are more convenient and easier to conduct than barter deals (main reason for existence of money!)
- Thus: Proposal for barter deal should be taken with some care
- As a rule: Barter deals disguise important issues (i.e. are intransparent) and are not compatible with good governance
- **Conclusion 6**: The proposed barter deal would decrease transparency and could contribute to deterioration of good governance in Ukraine

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c. Development of gas market and gas transit

- Barter deal involving subsidised prices implies a dominant role of state monopolies in the gas sector
- Thus: Negative effect on further development of domestic gas market
- Besides: Probably negative effect on transit fees for Russian gas to the EU (as “implicit” part of barter agreement)
- **Conclusion 7**: Cheap gas through barter inhibits the development of the domestic gas market and might imply lower gas transit fees

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d. Ecological effect

- Causal chain: Cheap gas => High demand for gas
  => High consumption, waste of energy resources
- Implications:
  - High energy consumption (relative to GDP)
  - High CO2 emissions
  - Bad for environment and climate change
  - Less room for international cooperation and for participation in the international carbon market, including possibility of revenues from this market
- **Conclusion 8**: Negative ecological impact of proposed deal

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4. Final remarks: Pros and cons of proposal

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„Pros“ of proposed deal

- In order to make a decision on an economic proposal: Need to analyse the pros and cons of proposal
- As shown above: “Pros” of cheaper gas are rather doubtful
  - Only short-term advantage (lower import bill)
  - But lots of short- and long-term problems, which are intrinsically linked to this short-term advantage
- Most severe negative effects:
  - Lower energy security in Ukraine
  - Medium-term: Higher demand for gas (because “cheap”) and less supply of gas (because less investment)
  - However: What Ukraine needs is to reduce demand and to increase supply of gas!
  - Thus: Double negative effect (on demand and supply side)

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Cons of proposed deal

- At the same time: Huge negative effect ("cons") of joining customs union and not signing a FTA with EU
  - Renegotiations with WTO countries → Extremely complicated process and most likely very costly for Ukraine
  - Trade diversion effect of customs union: Imports of capital goods from EU will be partly substituted by imports from Russia → Negative impact on international competitiveness
  - Maintaining outdated Soviet-standards → No gain in access to third export markets → Less exports than under FTA scenario
  - No anchor for structural reforms
- **Conclusion 9 (final conclusion)**:
  - Weak "pros", strong cons of Russian gas proposal
  - Proposal not in the economic interest of Ukraine

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