

On Consumers Prices for Natural Gas

Recently there have been active public discussions about the possibility of reducing energy tariffs. An interview by journalist Telara Gelantia with the former Energy Minister Alexander Khetaguri, published in the the magazine-Business Time Georgia (08.11.2012), is also dedicated to this theme¹. Due to the great interest in the subject, this article has caught a great attention of the public. We were also contacted by several interested readers with the questions on this issue. Thus, we tried to have a closer look at the data provided in the article and to use this case in order to share our ideas with a competent reader; Particularly, since there is a risk that the state, due to the public expectations, may take the wrong route of additional subsidization of energy costs, which will deviate us from market principles and development of sound economic relationships, as well as will increase the risk of social inequality.

The main conclusion of the mentioned interview is that in today's conditions, it is impossible to reduce the gas consumption rate. The statement is illustrated by the data about the volumes and prices of gas imported, as well as domestic transportation costs and profit margins of gas distribution companies. Interested readers will easily discover several inaccuracies and discrepancies in the article above, which can lead to additional questions of persons more or less knowledgeable in the subject. In particular:

- If we believe in the gas volumes and prices received from different sources quoted in the article, the average price of the so-called “non-commercial” gas is not 143 USD per thousand cubic meters, as stated in the article, but significantly less (about 112 USD).
- It is not clear why the profit of gas distribution companies should amount to the level of 15% of all total revenues.
- What is the justification of gas being supplied to thermal power plants at a price, even lower than the so-called "social price" - and doesn't this lead to unjustified profits?
- Unexpected is the Russian - Armenian transit gas fee to be 110 – USD per one thousand cubic meter. Until now, it was known that the given transit fee remains free in Georgia. It is desirable to know, since when and why we pay such a price for what was supplied to us free of charge before.

Therefore, a suspicious reader may rush to conclude, that in reality, there are substantial reserves allowing for gas tariff reductions, which should indisputably be used to improve the economic condition of the population.

¹ http://www.btime.ge/page.html?id_node=358&id_file=3833 / <http://pirweli.com.ge/?menuid=16&id=19691>

We would like to emphasize that such a conclusion would be wrong and the corresponding act by the government inappropriate, which we will try to briefly explain below.

- **Energy tariffs are inappropriate instrument for social assistance**

First of all, it is necessary to separate the social assistance function from the tariff discussion. Price manipulation and artificial lowering of the tariff for social problem solving, leads to exactly opposite outcomes. Indeed, low-income citizens can benefit from price reductions, however middle-income and wealthy customers, including organizations, who consume significantly more gas will get a much larger benefit. Therefore, **tariff reduction means assistance to wealthier and larger consumers, rather than the poor population; on the contrary to expectations it leads to increasing social inequality.**

This conclusion is further supported by the fact that subsidies require the expenditure of state resources, which correspondingly are substituted from other programs including social welfare, health care, etc., which reduces the potential for targeted assistance for the socially vulnerable population. In fact, such activity becomes worthless waste of state-owned resources.

This issue is discussed in more detail in one of our earlier articles (Cf. www.weg.ge)². The impropriety of linking tariffs and social problems is demonstrated by the mere fact that by setting energy tariffs at any level, there will still remain poor families, for whom it will be difficult to pay, as well as the rest of users who will be happy to save the money. Then, following the same logic we should keep lowering the tariffs again and again, down to zero.

Thus, social welfare issues shall be better addressed through targeted financial assistance to lower income (but not the whole) population and without any connection to energy. The cash assistance can be spent at their discretion to support their greater priority needs. As for the countries where energy tariffs are largely used for social purposes, (e.g. Georgia of 90-s, or even present-day Kyrgyzstan and Turkmenistan), they are not appropriate models worth imitating.

Of course, the above does not deny the need for optimization of gas consumption rates, but this must be done in accordance with sound regulatory policies and based on market prices and economic calculations.

² [http://weg.ge/index.php?option=com_content&task=view&id=67&Itemid=55]. For soft version readers

• **The tariff should be based on economic calculations and market prices**

Gas tariffs are made up of regulated (transportation and distribution costs) and non-regulated (gas supply price) parts. The first is set by GNERC and provides for the income of distribution and transportation companies, the second however, must be determined by the supply market.

In our case, the government becomes one of the gas suppliers and provides the customers with gas at much cheaper price than dictated by the regional market, thereby subsidizing it from government resources. Indeed, according to the South Caucasus gas pipeline contract, the state was obliged to monetize the proceeds from gas transit over SCP – i.e. to sell it at the regional market price. Instead, the transit gas is supplied to consumers at a much cheaper price (143 USD/thd.m³), than it can be sold (Turkey - at about 350 USD/thd.m³) or additional volumes of gas can be bought (presumably at 240 USD from Russia, and 350 USD from Azerbaijan). Thus, the price of natural gas has already been subsidized by the state. This means that the consumers receive gas at a cheaper than market price and the wealthier and larger consumers receive larger benefits from this. Thus the main conclusion of the interview can be interpreted in a way that the state has no more resource to subsidize the gas price.

Regardless of whether this provision is correct or not, a further arbitrary reduction in gas prices is not warranted, since it will result in pointless waste of resources to help the wealthy, instead of carrying out targeted social assistance programs. In addition, **further subsidization will bring several negative results:**

- Consumption of imported gas will increase, therefore the country's dependence on external imports will increase, impacting negatively its energy security;
- The additional outflow of money the country for the purchase of additional gas at a higher price will, further aggravate country's foreign trade balance will. Additional financial resources will be directed to the economies of other countries rather than Georgia.
- Energy saving and local renewable resources like solar radiation, biomass, geothermal heat as well as the use of related modern materials and technologies will lose their economic attractiveness, discouraging activities in this direction and development of green economy.
- Another precedent of the populist government measure will take place, as we have already seen in the previous periods; this really hinders the formation of the country's proper governance and its correspondence with European standards.

In addition, it is unclear how far the tariffs should be lowered and why. The economic justification for such a decision is difficult to find, it will be more of a political decision, and as stated above – a counterproductive one.

The stated does not exclude the need for revising the regulated part of the tariff. However, the ways of tariff optimization should be sought in its regulated part, by reduction expense of undeserved profits of energy companies, rather than at the cost of subsidies. Deviations from market principles, usually raise additional problems.

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