

Economic And Political Implications Of Rise Of Russian Gas Price For Armenia.

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Armenia has declined most of the proposals set forward by Russia in exchange of its decision to keep gas price constant, whereas the gas price for most of other former Soviet countries was raised. Russia's suggestions were: either Armenia agrees to pass more of its energy-producing assets to Russia or takes an interstate loan from Russia on commercial terms. If the price is raised, Armenia's economy will suffer relatively low, but the concept of the Armenian-Russian "strategic partnership" may be revised.

BACKGROUND: Russia has been the only exporter of gas to Armenia over the last decade. Armenia, lacking hydrocarbon reserves, imports around 1.7 billion cubic meters of gas a year. Roughly half of that amount is used by the thermal power plants, the rest by other consumers, including the transport (an estimated 40% of cars and trucks use natural gas instead of gasoline).

The share of thermal plants (TPPs) in the power production of Armenia is ca. 26-30%, which makes power production relatively independent of gas (the remainder is produced by the nuclear power plant and hydropower). Besides, due to a debt-for-equity deal signed in 2002, Russia has become the owner of the largest thermal plant of the country, the Hrazdan TPP (80% of the TPP capacities of the country).

Russia is also the owner of several hydropower stations and the only energy distribution company of Armenia. The formal owner of all these companies is the Russian power monopoly, RAO UES or its subsidiaries.

Besides, Gazprom itself has a 45% stake in the Armenian gas supply monopoly, Armrosgazprom.

During the last two years, Armenia has undertaken steps to end its unilateral dependence on fuel supply from Russia. In December 2004, construction of an Iran-Armenia gas pipeline started, which can - if necessary - fully replace supplies from Russia. Deliveries of Iranian gas are expected to start late this year. However, pressure of the Russian side has resulted in two preconditions. First, imports of Iranian gas will be restricted only by the amount necessary to produce electricity for exporting back to Iran. Thus, Iranian gas will not compete with Russian gas in the rapidly growing Armenian market (the number of household gas consumers has been growing and double by 2008). The second restriction is that the diameter of the Iran-Armenian gas pipeline is 700 mm, so its capacity is insufficient for transit of Iranian gas further north (e.g., to Georgia and Ukraine). Anyway, the availability of Iranian gas in the South Caucasus is an obvious reason why Russia has set the "market price" for this region at \$110 per 1000 cubic meters, whereas for Ukraine, which is much closer to the Russian gas fields, the price was set at \$230.

Armenia is planning to construct two new TPPs in the next 2 to 3 years, including the completion of the unfinished fifth block of the Hrazdan TPP. Contrary to the four working blocks, the fifth block did not pass to Russian control in 2002. Moreover, Russia's bid to acquire its shares (together with the right to finish its construction) failed in August 2005. The Iranian state company Sanir won the tender instead, and the block will remain Armenian property.

Another new thermal power unit is to be built in Yerevan with funds of a concession loan provided by Japan. Recent media reports suggest that, despite the generally pro-Russian mood, most of the local population is against handing additional assets to Russia.

IMPLICATIONS: It was evident that Russia had no clear strategy last year when initiating the transfer to "market prices" for gas sold to former Soviet countries. Whereas Ukraine and Georgia were informed about the future rise in the price in August, Armenia was sure that it would get the gas at the same price as before (54 dollars per 1000 cubic meters). Only in late November did Gazprom declare that the price for Armenia was to be raised as well, thus causing shock for Russia's strategic partner (the budget of Armenia for the year 2006 was already adopted then). Due to subsequent urgent top level negotiations, the previous gas price was left unchanged until April 2006, and talks are underway as for what the exact price for Armenia may be (110 dollars, as for Georgia and Azerbaijan, or somewhat lower). According to latest reports, a final agreement may be reached by mid-February.

As Armenia recovered after the deep energy crisis of the early 1990s, its economy has become much less energy-consuming than before. In 2005, it regained the level of GDP of the last years of the Soviet rule, while consuming less than half the amount of electricity and around a third of the gas it consumed in the 1980s (moreover, Armenia also exports electricity to Georgia). Given the relatively low share of TPPs in the power balance of the country, Armenia can easily withstand the shock caused by the gas price rise. In the worst scenario, if the Russian gas price is set at 110 dollars per 1000 cubic meters, the gas price for the final consumers may increase by around 20-25 percent, and electricity tariffs may rise 10-15 percent.

In this case, a spike of inflation of 5-7 percent at most (in recent years, inflation was below 3% a year) could occur. Moreover, the government can easily compensate this rise at the initial stages to make the shock lower.

As Russia is not only a gas supplier, but also has large gas consuming assets in Armenia, the possible loss in the profit margin of these plants should also be taken into account. This is first of all important for the Hrazdan TPP. The four blocks owned by Russia are obsolete and may become fully uncompetitive when new TPP capacities are ready in 2007-2008.

For these reasons, Armenia has declined Russian proposals to pass additional assets to Russia in exchange for keeping gas price unchanged. According to media reports, these proposals concerned the Hrazdan fifth block, the cascade of HHPs on the Vorotan river in the South of the country, the state's share in Armrosgazprom, and the Iran-Armenian gas pipeline. Armenia also has declined Russia's proposal of a commercial loan (similar to the one proposed for Ukraine).

The discussion about gas prices has yielded another consequence, of political nature. Numerous Armenian politicians expressed disappointment with the Russia's policy towards Armenia, saying that Armenia, which is Russia's only military and political ally in the South Caucasus, should be given some privileges in the politically motivated policy of raising gas prices. Many of them, including those known as having pro-Russian sympathies, argued that Armenia needs to change its orientation to the West. The top leadership of the country does not share this opinion, however, saying that the strategic partnership is not determined by the gas price. At the same time, they also say that the terms of the Armenian-Russian strategic

partnership may be revised, "to make its boundaries more precise".

CONCLUSIONS: Russia is obviously trying to acquire additional energy assets in Armenia using gas price as a leverage. Armenia, on the other hand, tries to avoid putting new strategic assets under the Russian control. On the other hand, the shock caused in Armenia by a possible rise in the gas price is most frequently overestimated in media, and Armenia can handle it with relatively limited loss. Instead, a rise in the gas price will surely make the Armenian population and political elite less pro-Russian, and the Hrazdan TPP, owned by Russia, less competitive in the near future. Armenia's policy will prevent Russia from gaining full control on the Armenia energy sector, first of all, due to Iran's penetration of the market.

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