The EU versus Gazprom

The EU's competition directorate has opened proceedings against Russian state gas company Gazprom on three suspected anti-competitive practices in Central and Eastern Europe. The investigation risks being interpreted as a politically motivated attack. **Andrey Konoplyanik** assesses DG competition's claims, the motivations that lie behind them, and the Russian reaction to events.

The European Commission published September 4 a press-release entitled: *Antitrust: Commission opens proceedings against Gazprom*. The release said that the EU's competition directorate would investigate Russia's state-controlled gas supplier Gazprom with regard to three suspected anti-competitive practices in Central and Eastern Europe. It said: "First, Gazprom may have divided gas markets by hindering the free flow of gas across member states. Second, Gazprom may have prevented the diversification of supply of gas. Finally, Gazprom may have imposed unfair prices on its customers by linking the price of gas to oil prices."

Under EU competition law, if Gazprom is found guilty, it could be fined up to 10% of its turnover in the European market. The annual value of Gazprom's gas exported to the EU is about $60 billion, which means the fine could potentially amount to as much as $6 billion. There is no time limit set for such investigations, which can often take years. Their duration depends on the specific case and level of cooperation between the company and EU competition authorities.

When the Commission's spokesman Antoine Colombani was asked in Brussels September 5 how the Russian authorities had reacted to the move, he said: "To clarify, this is an investigation which concerns Gazprom, which is a company active in the EU single market, which sells gas to the EU, and so we are looking at the behavior of this company. This does not concern Russia." He also tried to take the spotlight off Lithuania, which first called for EU action against Gazprom last year. Colombani said the Commission decided to act not just because of Lithuania, but also owing to its own "monitoring" and due to information from "market players."

Political response

The Commission may claim the investigation has nothing to do with EU-Russia relations, but Gazprom and the Russian government say it does. Gazprom published September 5 a press-release that stated: "OAO Gazprom scrupulously abides by all the provisions of international law and national legislation in all of the countries where Gazprom Group conducts business." In addition, "Gazprom Group's activities on the EU market are in full conformity with legal standards applied by other natural gas producers and exporters, this includes price formation mechanisms."

The company also made a point of particular significance; the press release said that Gazprom expects that in the course of the investigation "it will be taken into account that OAO Gazprom, registered outside the jurisdiction of the EU, is a business entity empowered, according to the legislation of the Russian Federation, with special social functions and a status of a strategic organization, administered by the government." This is a clear indication to the European Commission that in dealing with Gazprom, it is dealing with the Russian state.

Moscow reacted immediately in support of its major budgetary donor. Dmitry Peskov, a spokesman for Russian President Vladimir Putin, questioned the Commission's move, saying "it's not clear why this suddenly has become a subject for investigation. Why is there this assertion of a violation of the security of supplies?" Putin himself at the Asia-Pacific Economic Cooperation Summit in Vladivostok September 9, said that he regretted the Commission's actions. He said, "United Europe would like to preserve its political influence, and that we should pay for this. This is not a constructive approach."

More importantly, Putin signed September 11 Presidential Decree 1285 "On measures protecting Russian interests in Russian legal entities' foreign economic activities". This decree is a direct response to the Commission's investigation. It stated that the Russian State should protect the interests of Russian strategic enterprises in their operations abroad. Gazprom is listed as a strategic enterprise in Presidential Decree 1009, signed in August 2004.

Decree 1285 deals with three main aspects of business: disclosure of information, the alteration of contracts, and the sale of assets. It states that strategic enterprises and their subsidiaries "should supply information on their activities upon request from the authorities and agencies of foreign countries, international organizations, ... only subject to prior consent of a respective federal executive body authorized by the Russian Government."

The same procedure shall apply if such enterprises make amendments to contracts and other documents concluded with foreign counterparts concerning their commercial (pricing) policy in foreign states, and/or sale of assets and/or entrepreneurial rights. The decree states that the authorized body must refuse to grant its consent to these actions if they could harm Russia's economic interests. No definition of the country's economic interests is provided. The government has been given one month to appoint the relevant federal executive bodies.

Also September 11, Sergey Kupriyanov, a spokesman for Gazprom, clarified at a press briefing that "now requests related to information disclosure, contract alterations and asset sales should be addressed to an authorized body, and if this is not in line with Russia's economic interests, a request will be refused by the authorized body". These statements and actions reflect both Moscow's willingness to defend Gazprom, as well as the rising temperature of EU-Russian relations following the announcement of the EU investigation.

Gazprom in Central and Eastern Europe

The European Commission's press-release stated that "Gazprom may be abusing its dominant market position in upstream gas supply markets in Central and Eastern European member states". Such a statement, the use of raids on Gazprom offices and the competition investigation create a perception of immediate guilt about which Gazprom can do little. The company does have a dominant position in CEE and, like any other business, seeks to maximize its profits.

However, this is a position that Gazprom has inherited. EU gas markets are dominated by 'incumbents', former monopolies that inherited their dominant positions when EU markets were liberalized. Gazprom finds itself in a similar position in CEE and is no less willing than its incumbent counterparts in the EU to give up the benefits of the monopoly position in which it finds itself.

Owing to the capital-intensive and long-lived nature of investments in natural gas supply and transmission, all companies live today with the results of decisions taken decades ago. Gazprom's dominant position in CEE markets is the result of investment decisions taken within the completely different political and economic environment of the Cold War, when CEE was part of the Council for Mutual Economic Assistance (COMECON). Gazprom cannot be held responsible for this. No alternative supplies were developed for CEE under the planned Soviet economy, which is why all pipelines destined for the CEE are east-west oriented.

For almost 40 years until the end of the 1990s, the pricing of such monopoly supplies favored the COMECON states, even after the organization's collapse at the end of the 1980s. Soviet (and later Russian) gas supplies to CEE were based on "cost plus" pricing, which resulted in lower gas price levels compared with "Net-Back Replacement Value" gas pricing with oil product indexation for Western Europe. Economic ties between the USSR and COMECON member states were based to a large extent on discounted oil and gas prices. These acted as the backbone of political ties within COMECON – discounted energy in exchange for political loyalty.

Only in 1998, ten years after the "velvet revolutions" in CEE states, and their move towards EU membership, was CEE import gas pricing transformed from cost plus to NBRV, in other words to "European formulas". At the time, the oil price was low, so the shift created no major negative results in CEE.

However, only when the situation in EU gas markets changed radically after 2009 did Gazprom become the target of EU attentions. Gazprom has stayed the same, while the external economic environment has changed. Economic crisis in the EU and the US shale gas revolution led to a surplus of gas in Europe and low spot prices in EU markets. Oil prices – and thus oil-indexed gas prices – remained high. This created a substantial gap between the prices provided by spot and long-term oil-linked contracts. Gazprom remains unchanged, but the market in which it is historically the dominant player has altered. It is the new market conditions that matter most today.

The charges

The EU's competition directorate claims that "Gazprom may have divided gas markets by hindering the free flow of gas across member states." As mentioned, Gazprom has not divided CEE markets, they were divided by former Soviet central planning.

Today's lack of 'free flow' between CEE markets is the result of a lack of internal EU infrastructure development (interconnectors, reverse flows, etc.). This, in turn, is the result of low investment stimuli for project financiers to invest in regulated infrastructure development within unbundled EU gas markets. Since 2003, the EU has imposed mandatory third-party access on infrastructure and nowadays de facto enforced spot/exchange pricing, which, inter alia, means that the rate of return on infrastructure developments is in the low-single digits with pay back periods in excess of 20 years.

However, DG competition most likely has existing infrastructure in its sights. In contrast to building new pipelines, which requires high levels of capital expenditure and long lead times, DG competition appears to want access to existing infrastructure. The utilization rate of EU gas infrastructure is estimated at about 70%. So the aim appears to be immediate access with no capital expenditure to infrastructure developed earlier on a project financing basis by other economic entities, regardless of both ownership rights and the contractual status of the infrastructure's capacity. If this is the case, the EU is simply after a capex-free ride.

The competition directorate's second claim is that Gazprom "may have prevented the diversification of supply of gas". In 1911, Winston Churchill, then UK Navy Minister, famously proclaimed that energy security meant diversity of supplies. In today's world this means for the consumer the diversification of supplies, in terms of conventional and unconventional gas, and in suppliers, both domestic and external. However, these are decisions for gas buyers and other gas suppliers, not Gazprom. Gazprom can't prevent the development of alternatives to its own supplies, such as LNG, shale gas and alternative pipelines.

Moreover, as Gazprom deputy ceo Alexander Medvedev argues, Gazprom has been the initiator of competitive supplies to the EU market by breaking the monopoly power of Ruhrgas as sole importer of Russian gas to Germany and by establishing Wingas (a 50/50 joint venture with BASF) to provide alternative supplies. Even now, Gazprom has been actively improving the diversification of gas supplies to the EU by developing the North-South gas supply corridor, which is critically important for the CEE.

The combination of the Nord Stream, OPAL and Gazelle pipelines creates alternative routes for EU gas supplies. Supply from planned LNG terminals at Krk Island in Croatia and Swinoujscie in Poland to this North-South gas pipeline system are inevitable. This will add a new dimension to the corridor, which includes the diversification of supply sources beyond Russia.

In addition, Gazprom's pricing policy unintentionally stimulates EU gas supply diversification, especially in CEE, where member states have the least competitive supply choices, compared with the older EU members. If alternative gas supplies emerge within the EU, for example shale gas, Gazprom's oil-indexed gas would be the first victim.

Gazprom would already have lost more export volumes had it not been for "take-and/or-pay" (TOP) provisions and price review clauses in existing long-term contracts which prevent an immediate switch from contractual gas to spot gas. When the current LTGEC terms expire, Gazprom, as marginal-cost supplier to the EU, will definitely suffer most. But Gazprom's refusal to ban TOP provisions cannot be considered a prevention of diversification, since no unilateral decisions in bilateral contracts are allowed. This is why wholesale buyers of Gazprom's gas started arbitration procedures.

What really prevents diversification is a lack of investment stimuli i.e. unattractive rates of return and long pay-back periods. Diversification needs adequate infrastructure to create choices both for consumers and producers. The Third EU Energy Package provides possibilities, but they need to be implemented (converted) into regulatory procedures incorporated into corresponding Network Codes. Russian and EU experts have been jointly developing such procedures both within informal EU-Russia expert consultations on Third Energy Package issues, and within the framework of the newly established Russia-EU Gas Advisory Council. Gazprom representatives have actively participated in both processes.

The third charge is that "Gazprom may have imposed unfair prices on its customers by linking the price of gas to oil prices". Consumers and producers have different views of what constitutes a 'fair' price. Indeed, the meaning of a 'fair' price changes as markets evolve. However, no price should be considered "unfair", if two commercial entities agreed on its value or on the mechanism of its calculation in a contract.

In the initial stage of gas market evolution, cost plus prices were used. These reflected costs plus an acceptable rate of return e.g. a minimum acceptable price for the producer. Consumers had no alternative supply choices. Cost plus is an "investment pricing" mechanism in non-competitive markets. It resulted in 'fair price' levels adequate for conditions of initial market development, and for political pricing as well.

In the next stage (intensive market development) indexation evolved on the NBRV principle, linking gas prices to the prices of alternative fuels at the point of end-use. This appeared in competitive markets where inter-fuel substitution and competition existed. NBRV pricing provides a maximum marketable price for the producer/supplier and an affordable, competitive, preferential price for consumers, which is lower than that of alternative fuels. Regular adaptation of NBRV prices (price reviews) helps to support its competitive level. Oil indexation is an "investment pricing" mechanism in competitive markets. It results in "fair price" levels adequate for conditions of intensive market development.

Contrary to both investment pricing mechanisms, spot pricing is a "trade pricing" mechanism. It is short-term pricing adequate for trade transactions, but not for project financing. Project financiers will never prefer spot pricing for developing new projects and will accept it only as a result of external pressure.

Oil indexation has been used in the EU since 1962. It emerged in the Netherlands and has been an integral part of the Groningen-type LTGEC. It took almost 50 years for it to spread across Europe and beyond. In the 1960s, replacement fuels for gas were residual fuel oil (RFO) and light fuel oil (LFO). Nowadays, a broader spectrum of replacement fuels is available in the EU end-use energy mix.

For instance, in EU electricity generation, gas no longer competes with RFO, but with coal, nuclear and renewables. But oil indexation is still dominant in European LTGECs. According to the International Gas Union, its role had diminished from 80% in 2005 to two-thirds in 2009. According to DG competition's Energy Sector Inquiry (2007), 90% of the LTGECs of three key EU gas exporters – Russia, Norway, and the Netherlands – referred to RFO plus LFO. Algeria, like Japan, indexed its gas to crude oil.

The evident and increasing gap between contractual and physical practice is why there is such heated debate about oil indexation. But that does not mean that the practice is "unfair". The slow adaptation of oil indexation is inevitable, but not a full conversion to spot pricing throughout the EU. The preferable and most probable scenario for LTGEC pricing formulas in Continental Europe is to retain indexation, but to include greater elements of indexation to spot gas prices and other competing forms for electricity generation, such as nuclear, coal and renewables.

DG competition's Energy Sector Inquiry (2007) demonstrated that there is a historical evolution in the structure of indexation from less to more liberalized regions in the EU. While the initial Groningen pricing formula presented 100% oil indexation (40% RFO/60% LFO), current contracts in Eastern Europe are based 95% on oil and in most of Western Europe 80%. In the UK, the proportion is only 30%. This suggests that the more competitive the market, the less the dependence on oil indexation.

CEE countries are at the back not the fore-front of this movement. However, the driver of evolutionary change should be objective market development trends, and the build-out of infrastructure that creates choices, not administrative pressures.

The role of politics

The EU's competition directorate has provided the right facts, but got both the reasoning behind them and, arguably, the target wrong. This mistaken logic could set in chain actions that damage rather than improve cooperation between Russia and the EU in the energy sphere.

Moreover, from a Russian perspective, there are other possible explanations for the timing of the EU's move against Gazprom. The current economic crisis and its apparently approaching second wave is one reason. In these circumstances, the Commission wishes to support domestic energy companies, which are wholesale buyers of Russian gas and big EU taxpayers.

Gas oversupply has led to low retail prices, while contract wholesale purchasing prices stay high. TOP obligations forced EU gas companies to buy at high wholesale market rates, while regulatory measures oblige them to sell to end-users at low spot prices. This resulted in negative spark spreads and huge losses for these intermediaries, prompting the wave of arbitration procedures initiated by EU companies against Gazprom. Nothing personal, just business – on both sides.

However, the EU's competition probe could be interpreted as a means of casting Gazprom in a negative light, and thus an attempt to influence neutral and independent court decisions in favor of buyers. This interpretation is especially seductive, if one takes into consideration that the Commission has opened its investigation on the basis of information from "market players", as Colombani said.

Gazprom may well be the wrong target. The business of reselling Russian gas to EU end-users by wholesale EU intermediaries, which have grown to the level of 'national champions', has began to slip. The EU's Third Energy Package opens the way to bypass these national champions by developing new streamlined gas value chains between producers and end-users.

The role of such dominant intermediaries, historically justified by the political split of Europe, may no longer be appropriate in the new architecture of the internal EU gas market. The dominance of EU incumbents has for long been a source of irritation for EU competition policy, yet the charges against Gazprom appear to be an attempt to support them by artificially worsening the business conditions of their foreign-based competitors and/or collaborators.

Another purely political explanation for the Commission's behavior might be to switch the public's attention from internal crisis to an 'external enemy'. Unfortunately, the Russia-Ukraine gas crises between 2006-2009 have already prepared the ground for Gazprom to be demonized.

There is a clear sense that the EU is using its competition policy in a less than even-handed way. The aim is to declare oil indexation and TOP conditions unfair, not because they necessarily are, but because the economic environment has changed to make such a decision highly advantageous to EU gas companies. However, increasing competition in the EU gas market would be a better means of forcing Gazprom to adapt to a more open market rather than administrative attack, which will be interpreted as politically motivated rather than an objective matter of competition law.

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