REDUCING RISKS AND UNCERTAINTY OF EU THIRD ENERGY PACKAGE

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International gas markets, including the European market, have seen much higher risks and uncertainty since 2009 than in the previous years. There are four groups of increased uncertainties and ensuing risks on the EU market: the uncertainty of demand, supply, in the institutional sphere and in politics.

Gas markets: increased uncertainty

The uncertainty of demand arose, first of all, as a result of the global economic crisis of 2009-2010, the second wave of which is being predicted with a growing degree of probability. The drop in demand brought about by the crisis has transpired in the dynamics of forecasts.

Compared to pre-crisis predictions, the general trend in forecasts of gas demand made during the crisis showed a slower growth, while the bottom line of the "radical" range moved in the negative zone and was characterized by negative dynamics in the most "radical" forecasts, which are forecasts made by institutes and organizations sponsored by the European Commission.

Under these extreme scenarios (notably, those made under the PRIMES model), demand for imported gas in the EU till 2030 will be below the level of its own production and already contracted gas amounts.

At the same time, in addition to the well-known European energy program, 20-20-20, which seeks to improve energy efficiency and de-carbonize the European energy sector, a more radical scenario of this de-carbonization has emerged, the EU Energy Road Map '2050, which envisages reducing CO_2 emissions by 85%-90%. This Road Map makes natural gas, the most environment-friendly mineral fuel, the main victim in Europe's aspiration towards clean energy.

All this leaves open the question: is the current (caused by the crisis) decline in gas demand temporary or will it become a permanent feature in the development of the European energy sector and a policy of actual moving away from gas? As a result, the competitive niche of demand for Russian gas in Europe will become more uncertain at best, or will be significantly diminished at worst.

The uncertainties of supply are related to the growing list of gas suppliers to the European market and their increasing competition. The construction of new pipelines and LNG receiving terminals, founded before the crisis and bound for Europe, was complemented during the crisis with re-direction of LNG exports from the Middle East (first of all, Qatar), Africa and Latin America from the United States to the EU, since the American gas market was actually closed for imported LNG.

The latter was the outcome of the "quiet slate revolution" in the US. It did not only make the US economy selfsufficient with its own (including Canadian) gas, but also resulted in prices on the key American gas trading site, Henry Hub, dropping below the gas prices on the NBP (the National Balance Point), the UK gas trading site.

This created additional incentives for arbitration deals as part of spot LNG deliveries in the Atlantic region, which at a time of declining demand further increased the excess of supply in Europe, especially in West Europe. Further growth of slate gas production in the United States put on the agenda the issue of converting some of its imported LNG regasification capacities into slate gas liquefying terminals and of the US becoming an exporter of LNG produced from its slate gas instead of a net importer.

The bulk of American LNG exports, in case these projects are implemented, is likely to go to Europe. The prospects of producing non-traditional gas in the EU are still unclear. All this increases the uncertainty of potential amounts of gas supply to Europe, but definitely boosts competition among gas suppliers to the market.

It was during the crisis-induced excess of supply – on September 3, 2009 – that the Third Energy Package came into force. It drastically changes the architecture of the wholesale gas market in Europe and therefore creates additional – institutional – uncertainties for gas suppliers to the market (more about this below).

Finally, political uncertainty is, I believe, the result of numerous disagreements in the gas sphere between the former Soviet republics, which, in turn, reflect the long and sometimes very difficult transition towards market-oriented price setting and contracted supply.

These disagreements climaxed in Russian-Ukrainian gas conflicts that led to interruptions of transit gas supply to Europe in January 2006 and January 2009. As a result, the seemingly virtual possibility of interruption in Soviet/Russian gas supply to the EU (something America has been warning its European friends about since the 1970s) became a real and, unfortunately, recurring episode.

For buyers of Russian gas in the EU, the question who was to blame for the interruptions – the supplier (Russia) or the transit country (Ukraine) – is secondary and the answer to it is predetermined, since the long-term supply contracts make the supplier responsible for delivering contracted gas amounts to the turnover point within a specified timeframe.

As a result, the 22 days of interrupted supply canceled out 40 years of preceding uninterrupted supply and brought about a new element in the EU energy policy: a set of measures seeking to reduce dependence on Russian gas (further diversification of supply, construction of interconnector pipelines, underground gas storage facilities, etc).

Third Energy Package: risks of liberalization

At present, the EU Third Energy Package is the final document of the long-term reform, which began in the European gas sphere with the First (1998) and Second (2003) Energy Packages (Gas Directives and corresponding Regulations).

The Third Energy Package is an objective reality that will force Gazprom, whether it wants to or not, to organize its business in Europe in a new way, notably, to work on this market only as a supplier (consigner). But it also gives it a possibility (so far, a potential one) to supply gas directly to end consumers in EU countries, bypassing wholesale buyers/resellers.

Shaping of Europe's internal legislation is the sovereign right of the EU member states. Gazprom and other players on the European gas market were aware about the direction of the coming change for almost 15 years. At the same time, such transition should be evolutionary, giving economic agents an opportunity to gradually adjust the contract structure of their supply to the new legislative requirements as existing contracts are executed.

It is impossible to demand that economic agents renegotiate existing contracts due to changes in the legislation, as this contradicts the principles of the contract law. Contracts, especially investment contracts, are usually protected by the so-called "grandfather provisions" that do not allow retroaction of legislative acts.

At the same time, such reforms shaping the EU common internal gas market should not create unjustified obstacles for gas supply to consumers, limit their choice of suppliers and/or tools of ensuring gas supply (contract structures and price setting mechanisms) or artificially diminish the efficiency of supply within the gas market architecture chosen by sovereign states for their territory.

We can single out a few key theses of the EU Gas Directives (of 1998, 2003 and 2009) and the problems they create, which generate additional risks for investment and trade.

One of the key problems on the EU gas market is the risk of the so-called contract discrepancy. Its emergence is a logical result of the EU conscious policy towards dividing the business of gas supply and the business of its transportation and, consequently, towards separate and independent development and regulation of the gas market and the gas transportation capacities market. In the end, the risk of contract discrepancy makes supply more costly, while its emergence can result in a supplier not honoring its commitments under the contract for reasons he has no influence over (more about it below).

Third Energy Package: advantages and disadvantages for suppliers

Many believe that the “EU common internal gas market” will be a homogeneous unit, a unified zone, a single market space on the territory of 27 countries. This is not so. Under the Third Energy Package, the EU common internal market will represent a number of regional zones with entry-exit tariffs and a virtual liquid hub (a trading site – a spot gas trading center) in each zone.

It is, however, necessary to note two important things related to virtual hubs.

(1) Regional hubs within the model of the EU common (efficiently functioning) gas market are declared liquid. However, none of the hubs in continental Europe can be classified as liquid. The liquidity indicator in the hubs of continental Europe does not exceed 3-5, while the commonly accepted level for classifying a trading site as liquid is 15.

Only NBP has a liquidity level of around 15. At the same time, the growth of liquidity of European hubs in recent years (during the crisis) was connected mainly to reselling on these trading sites of gas excesses from contract purchases (including of Russian gas) above the minimum take-or-pay amounts. So I consider it doubtful that these sites will see their liquidity grow fast in future.

(2) When organizing trading via a system of virtual hubs, gas that enters the entry-exit tariff zone (after the entry tariff is paid) is considered to be in the hub. Then the burden of delivering gas within the zone to a specific consumer falls on the operator/owner of the transmission network.

So if a contracted consumer is inside the zone (the Third Energy Package allows for signing direct contracts with end consumers, bypassing wholesale and/or retail intermediaries/resellers), and a turnover point for Russian gas is traditionally situated on a country (zone) border, this creates risks and uncertainties related to gas delivery from the zone border to the consumer inside the zone (a “contract discrepancy” inside the zone).

Because of that, even though the Third Energy Package is a reform of the wholesale gas trading sector within the EU, it nevertheless has a direct influence on existing Russian contracts for gas supply to the EU, since turnover points of Russian gas are deep inside the EU.

The initial target of the European Commission when changing the rules of the game on the gas market was not Gazprom’s contracts, but long-term contracts of the national champions Eni, Ruhrgas, Gas de France and others, as the Commission believed they monopolized the internal national markets of the EU member states. The reform of the wholesale trading sector seeks to reduce their monopolistic stand on national markets and on the EU market in general.

Under these circumstances, Gazprom has become an indirect victim of the reform (got it in the neck, as they say) in relation to its contracts within the EU. Still, the Third Energy Package also has articles that target Gazprom directly, e.g. Article 11 of the Third Gas Directive on a special certification procedure for companies from third countries. Naturally, Russia views the Package first of all in terms of it jeopardizing its gas supply to Europe.

To be fair, while creating all these real risks and uncertainties for existing Russian contracts, the Third Energy Package simultaneously declares potential opportunities and creates pre-conditions for new advantages inside the EU for outside gas suppliers.

The Package allows bypassing supply to intermediaries and working directly with end consumers, enjoying all the advantages of direct supply. However, these advantages are so far purely potential and their feasibility will depend on how the possibilities of their implementation are spelled out in additional legislative acts for the Package…

Today, the European Commission plans to complete drafting the necessary documents to launch the common EU gas market only in 2014. A positive moment here is that this expands the timeframe for cooperating with developers of legislative acts for the Third Energy Package to ensure that they more readily take into account the interests of all participants of trans-border gas production and sale chains oriented towards the EU, in order to minimize risks and uncertainties for all players on the gas market.

This is necessary, since it is commonly accepted that, being an innovative document that suggests a drastically new model of the EU gas market architecture and, besides, a product of political compromise, the Third Energy Package, to put it mildly, is not without shortcomings and is unbalanced in many respects, its provisions allowing for different interpretations.

So this creates possibilities for a dialog, in order to persuade our European colleagues to suggest such interpretations of the Directive’s provisions that would not generate additional risks for gas businesses in Europe.

To sum it up, the political goal of preparing a more liberal model of the EU gas market, which is a sovereign internal matter of the EU member states, can nevertheless be achieved through more mutually acceptable (in terms of economic interests and sometimes even common sense) operational procedures than it was initially envisaged by the Third Energy Package.