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European Commission vs. Gazprom: How to Find a Balance (Between Demands for Immediate Competition From the First & Justified Long-Term Economic Considerations from the Latter) by A.A. Konoplyanik

European Commission vs. Gazprom:

How to Find a Balance (Between Demands for Immediate Competition From the First & Justified Long-Term Economic Considerations from the Latter)

Prof. Dr. A. Konoplyanik

The European Commission announced on September 4th, 2012, the beginning of antimonopoly investigation against Gazprom, suspecting the company of three types of anticompetitive practices in various countries of Central and Eastern Europe. Are these claims reasonable and well justified? Whether it is possible to find economic justification of the existing situation where it might not be Gazprom who is responsible for it? And if so, maybe the reasoning of the DG COMP (Directorate General on Competition) claims against Gazprom should be reassessed? Professor Dr. Andrey Konoplyanik[1] describes his observations on these issues.

1 Commission's press-release & Russia's respond on it

1.1 04.09.2012 Commission's press-release

On September 4th, 2012, the European Commission (CEC) issued a press release entitled "Antitrust: Commission opens proceedings against Gazprom"[2]. The document stated that Gazprom "might be hindering competition in Central and Eastern European

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[2] http://europa.eu/rapid/pressReleasesAction.do?reference=IP/12/937&format=HTML&aged=0&language=EN&guiLanguage=en

gas markets, in breach of EU antitrust rules. … The Commission has concerns that Gazprom may be abusing its dominant market position in upstream gas supply markets in Central and Eastern European Member States, in breach of Article 102 of the Treaty on the Functioning of the European Union".

The official document of the European authorities declares that "the Commission is investigating three suspected anti-competitive practices in Central and Eastern Europe. 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. Such behaviour, if established, may constitute a restriction of competition and lead to higher prices and deterioration of security of supply. Ultimately, such behaviour would harm EU consumers", - declares the Directorate on Competition of the European Commission.

According to RBK-daily's interview[3] with Antoine Colombani, the spokesman of Joaquín Almunia, who is the Commission Vice-President and CEC Commissioner on competition issues, the CEC approved to initiate a formal investigation towards Gazprom after analysis of results of tests performed in the 2011 (well-known seizure of documentation in foreign offices of Gazprom's subsidiaries and some of its counterparts on the territory of the EU, taken place on September 27, 2011). Mr. Colombani noted that the investigation concerns the activity of Gazprom in eight EU countries: Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland and Slovakia. According to him, Gazprom can receive a maximum penalty in the form of a fine of up to 10% of its annual sales on the European market if it is found to be guilty. This decision can be appealed in European courts. There are no terms for investigation of such issues. Their duration depends on each case itself and on the volume of interaction of a company with authorities.

[3] http://www.rbcdaily.ru/2012/09/05/tek/562949984652052/print/

The CEC declared that the matter will be considered a priority. The maximum value of a fine can reach the level of 6 billion US dollars since the value of exports to Europe has reached the estimated level of 60 billion US dollars.

According to the "EUOBSERVER"[4], when Antoine Colombani was asked in Brussels on September 5th, 2012 (day after the raid), about the reaction of Russian authorities on the actions of the European authorities, he stated "I want to clarify that such investigation concerns Gazprom, which is the company, operating in the Single European Market and selling gas to the members of the EU. That's why we are trying to monitor the behaviour of the company. This investigation is not connected with the Russian Federation in any way".

He has also tried to put aside all blames from Lithuania. But a number of experts and observers disagree that there is no role of Lithuania in this claim. For instance, Prof. Alan Riley has indicated that "the Commission received at least one formal complaint from the Lithuanian government with respect to exploitative pricing in their gas market".[5] A number of publications (Bloomberg, etc.) have mentioned that the country was the first in appealing for EU actions towards Gazprom in 2011-2012, when the Lithuanian government demanded that the EU authorities should investigate Gazprom's refusal to lower their latest export prices after the announcement of separation of gas supply and transportation on the territory the country (pursuant to the requirements of the Third Energy Package of the EU).[6] The Lithuanian government demanded that, further to the ownership unbundling provision of the Third EU Energy Package, Gazprom should withdraw from the ownership of "Lietuvos dujos", a gas transportation company, transferring supplies of the Russian gas to Lithuania[7].

[4] http://euobserver.com/economic/117441

[5] *Alan Riley.* "Commission v. Gazprom: The antitrust clash of the decade?" CEPS Policy Brief, No. 285, 31 October 2012, pp.6, 8. Available at <<*www.ceps.eu/ceps/dld/7433/pdf*>>; Ibid. "Commission v. Gazprom", Presentation at the European Gas Conference, Vienna, 31st January 2013, slide 2.

[6] http://washpost.bloomberg.com/Story?docId=1376-M9U0JN07SXKY01-6HKOJBL55I8H02MCV3LGGFS85U;

[7] For more detailed comment of this author on this issue, see: «*Андрей Конопляник*: Третий энергопакет ЕС в Литве: новая попытка проверить на прочность отношения с Россией». – *Информационное агентство REGNUM*, 14.02.2012 ("*Andrey Konoplyanik*: Third Energy Package in Lithuania: a new attempt to check reliability of relations with Russia", *REGNUM* Information Agency, 14.02.2012) (http://www.regnum.ru/news/1498697.html)

Lithuanian Energy Minister Arvydas Sekmokas said the EU probe is justified, the Baltic News Service reported on September 5th 2012.[8]

Colombani stated that the European Commission had decided to act not only because of Lithuania's claims (without actually denying the role of the country in the process of initiation of claims towards "Gazprom" - A.K.), but also as a result of its own "monitoring" policy and on the basis of information, received by the European Commission from "market participants".

1.2 Russia's political reaction: domino effect

The claims declared by the CEC towards Gazprom launched a political "domino effect." The Commission stated (through Mr. Colombani) that the investigation process towards its suspicions about anticompetitive practices of Gazprom, aimed at "price fixing" and other possible breaches of the EU competition law, have nothing to do with the relations between the Russian Federation and European countries. But Gazprom stated the clear connection. Russian authorities reacted to the actions immediately.

On September 5th 2012, the day after the European Commission issued their press release, as if in exchange of niceties, Gazprom published its own press release in which the company's representatives stated that "the OJSC "Gazprom" pays great attention to compliance with all norms of international law and laws of the countries in which the Gazprom Group operates", and that "the principles of operation of the Gazprom Group within the borders of the EU, including the applicable system of gas pricing, correspond to the standards, used by other producers and exporters of gas". And the most significant detail: Gazprom stated that the company expects that "investigation will adequately meet our rights and interests, arising from both EU and international law, and it will be taken into consideration that OJSC "Gazprom", being established outside of the scope of jurisdiction of the EU, is the company, having

[8] http://washpost.bloomberg.com/Story?docId=1376-M9U0JN07SXKY01-6HKOJBL55I8H02MCV3LGGFS85U

publicly significant functions and status of a strategic state-controlled entity, vested in accordance with the laws of the Russian Federation".

In other words, Gazprom has clearly defined that it is the company with a state behind its back and that it performs nationwide scale functions. It was an indirect though quite straightforward indication of the fact that from this moment the European Commission will have to deal with the authorities of the Russian Federation. It is like in children's conflicts, when children bully a boy and this boy begins to claim that he has an elder brother who is an expert boxer who will come to his aid if they don't stop.

And "the big brother" appeared immediately. The Russian government responded immediately with support for its core budget donor, who's basic income comes primarily from the European market.

On September 5th 2012, Dmitry Peskov, the press secretary of the Russian President, questioned the validity of the claims by the CEC, saying, according to Bloomberg[9], that "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? Because Gazprom was, is and will be a reliable supplier of natural gas to its customers?"

On September 9th 2012, the President of the Russian Federation Vladimir Putin responded to the actions of the European Commission personally in the course of the APEC summit in Vladivostok. He was saddened by the measures of the European Commission, taken towards Gazprom, but he said that he didn't consider such relationships as some kind of a "trade war."

"I don't agree with such assessment of relations with the EU. We have a very good and constructive relationship, not a kind of combat, not a trade war," - said the President, responding to the question, received from a journalist, calling the relations of the Russian Federation with the EU "the state of Trade Cold War". "The measures against Gazprom are not new in any way. The raids in some foreign facilities of

[9] http://washpost.bloomberg.com/Story?docId=1376-M9U0JN07SXKY01-6HKOJBL55I8H02MCV3LGGFS85U

Gazprom were made in the last year. It is the second step in the same direction and we are sorry for what is going on" – emphasized Mr.Putin. "United Europe wants to retain its political influence and it wants us to make a little payment for this. It is not a constructive approach," - he said, according to RIA Novosti[10].

Mr. Putin recalled that during the USSR times, gas was supplied to Eastern European countries (at that time the members of the COMECON – A.K.) at non-market prices. "And later, during our time, we have transferred to the market relations with the same states and to the market-based pricing. I think that we should stay on the basis of today's realities. And contemporary Russia has not undertaken and would not undertake any incremental obligations related to non-market regulation of the economy of these states", underlined Mr. Putin. According to him, gas pricing principles have been developed long ago, are fixed in the long-term contracts and have never been contested by anyone. "It is clear, that in a crisis environment there is a will to displace part of the financial burden onto others, such temptation appears. But I would like to underline once again that we consider such approach as a non-constructive one", - said Mr. Putin.[11]

So from the Russian President's view, the Commission's claim against Gazprom reflects just its non-constructive intention to displace part of the financial burden experienced by the EU Member-States who are facing economic difficulties due to the economic crisis on a Russian state company.

Then the President reacted to this "non-constructive" approach of the CEC, using a , in his view, more "constructive" method.

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[10] http://news.ru.msn.com/%d0%bf%d1%83%d1%82%d0%b8%d0%bd-%d1%81%d0%be%d0%b6%d0%b0%d0%bb%d0%b5%d0%b5%d1%82-%d0%be-%d0%b4%d0%b5%d0%b9%d1%81%d1%82%d0%b2%d0%b8%d1%8f%d1%85-%d0%b5%d0%b2%d1%80%d0%be%d1%81%d0%be%d1%8e%d0%b7%d0%b0-%d0%bf%d0%be-%d0%be%d1%82%d0%bd%d0%be%d1%88%d0%b5%d0%bd%d0%b8%d1%8e-%d0%ba-%d0%b3%d0%b0%d0%b7%d0%bf%d1%80%d0%be%d0%bc%d1%83

[11] Ibid.

1.3 Decree 1825

On September 11th 2012 Mr. Putin approved the Decree No. 1285 "On measures for protection of interests of the Russian Federation in the course of foreign economic activity, conducted by Russian legal entities".[12] This Decree is clearly the direct political response from a position of strength to the latest CEC raid against Gazprom. Its main point is clear: now the Russian Government will directly protect the interests of Russian strategic companies in their foreign operations. A list of such companies is given in the Decree of the President of the Russian Federation No. 1009, dated August 04, 2004. The OJSC "Gazprom" is one of the entities on this list.

The Decree No. 1825 contains three main components: provision of information, change of provisions of contracts, and sales of assets. The Decree states that Russian strategic enterprises and their subsidiaries "in case they came upon demands from foreign countries and international organizations, ... shall have the right to perform the following actions only with the prior consent of federal executive bodies, authorized by the Government of the Russian Federation:

a) provide ... information on activities;

b) make amendments in agreements, ... and other documents, connected with their business (price) policy on the territory of foreign countries;

c) dispose the owned ... (by them - A.K.) shares in foreign organizations, rights to carry out business activities in foreign countries and immobile property, situated out of the territory of the Russian Federation".

The Decree No. 1285 states that any federal executive body, authorized by the Government of the Russian Federation, shall refuse to give its consent for implementation of any actions, if they can hurt the economic interests of the Russian

[12] http://www.kremlin.ru/acts/16463; http://eng.news.kremlin.ru/acts/4401/print

Federation. But the definitions of "economic interests of the Russian Federation" and "damage" of such interests are not given in the decree. The government of the Russian Federation was given a one month term to determine the federal executive authorities - meaning there can be more than one authority - authorized to give their consent for strategic enterprises on performance of actions, provided by the Decree.

Gazprom's spokesman Sergei Kupriyanov declared in the course of the briefing, taken place on the day of issuing the Presidential Decree No. 1285, that "now the companies shall apply to the authorized bodies on issues connected with the process of provision of information, making changes in contracts and sale of assets. In cases where such issues do not correspond to the economic interests of the Russian Federation (though clarification of this term was not given which creates broad area for its interpretation – A.K.) the authorized body can deny the request"[13]. Actually, the Government provided some kind of protection for Gazprom in all directions of its involuntary activities in Europe, i.e. made under necessity to adapt both to changes of economic conditions on the European gas market as well as to application of provisions of the Third EU Energy Package, the latter forming a new architecture of a single internal gas market in the EU. This architecture is fundamentally different from the system which has been in place in Europe – Russia's main export market - for the last 50 years and which entered the era of radical transformation after 2009.[14]

On October 5th 2012, the Government of the Russian Federation by its Ordinance #1017 has approved the list of state agencies which will adjust mutual relationship with foreign authorities and commercial activities of the state companies abroad.[15] It is of no surprise that the Ministry of Energy was approved as a controlling (adjusting) Federal

[13] http://www.gazprom.ru/press/news/2012/september/article143671/

[14] See, for instance: *A.Konoplyanik.* "Russian gas in Europe: Why adaptation is inevitable". - *"Energy Strategy Reviews"*, March 2012, Volume 1, Issue 1, p. 42-56 (http://www.sciencedirect.com/science/article/pii/S2211467X12000119).

[15] Госкомпаниям расписали контролеров. Одиннадцать госструктур будут следить за 53 стратегическими предприятиями. - Коммерсант-daily, 13.11.2012, pp. 1, 11. (State companies have been allocated among auditors. Eleven state structures will control 53 strategic enterprises).

state agency for Gazprom within the framework as outlined in Presidential Decree No. 1285.

1.4 Asymmetrical measures

The actions of the CEC and response of Gazprom and the Russian President have actually pushed the debate further into political, partly legal, and obviously into "power struggle" field, thus transferring the conflict from a "force of arguments" into a "arguments of force" debate.

It is clear that Gazprom and the Government of the Russian Federation are bound to debate within the framework of the EU legislation, applicable within the borders of the EU, regardless of whether Gazprom and/or the Russian authorities like the situation. It is also clear that the most effective protective measures in such cases would have been the provisions of international law, should the parties agree that corresponding actions of the Commission violate any provisions included in various instruments of international law.

But it seems that both parties might not choose this avenue, though for different reasons. The withdrawal in October 2009 from the provisional application of the Energy Charter Treaty and the statement that Russia had no intention to ratify the ECT[16] (from this author's view – with no single well-justified and/or demonstratively proved reason[17]), it had shown that it does not welcome this most advanced and effective

[16] Распоряжение Правительства Российской Федерации от 30 июля 2009 г. №1055-р (Russian Government Ordinance as of 30 July 2009 N1055-r); The Energy Charter Secretariat. Message № 826/09: A Communication from the Depository of the ECT and PEEREA. Brussels, 25 August 2009.

[17] See author's publications such as, for instance: Россия и Энергетическая хартия: долгий и извилистый путь навстречу друг другу. – «*ЭКО: Всероссийский экономический журнал»,* декабрь 2010, № 12 (438), с. 114-132 (часть 1); Энергетическая хартия: отменить нельзя модернизировать. - «*ЭКО: Всероссийский экономический журнал»,* февраль 2011, № 2 (440), с. 118-136 (часть 2); Why Is Russia Opting Out of the Energy Charter? – *«International Affairs»*, 2010, vol. 56, № 2, p. 84 -96; Выход России из временного применения ДЭХ и «дело ЮКОСа»: комментарий по итогам процедурного решения арбитражного суда в Гааге. – *«Нефть, газ и право»*, 2010, № 1, с. 42-49; Выход России из временного применения ДЭХ: мифические угрозы оказались сильнее реальных выгод? – *«Нефть и газ»,* ноябрь 2009, № 9, с. 32-35 *(Украина)*; Russia remains a signatory of the Energy Charter Treaty. – *"Financial Times" (Comments/Letters to the Editor),* 26 August 2008, p. 6; Gas

energy-specific multilateral instrument of international law and thus has created a perceived vision in the international community that it does not prefer to resort to legal action for solving economic disputes, namely, by using dispute settlement procedures within the framework of international law (if applicable to the case).

On the contrary, the European Commission continues to believe (and it acts in accordance with such belief) that the legal system of the EU (*acquis communautaire*) and has the same priority within the international law system (i.e. is placed on the same level in the hierarchy of legal acts) as other international treaties concluded by the EU. The Commission is not ready to agree with the thesis that the EU's *acquis communautaire* is to be considered as the domestic law for the EU as a whole, and therefore it should be considered as subordinate compared to other international obligations of the EU.[18] Which means that in such cases as the discussed one the highest dispute settlement authority for the EU will be the European Court of Justice, and that it will be rather difficult for Russia/Gazprom to claim protection of international treaties (if any) beyond the EU rules.

It is clear that the measures regarding violations of the EU competition law that could be taken by Gazprom/Russian Federation towards legal claims of the CEC , can be only asymmetrical within the volume of powers in such political and legal confrontation of the parties. However, disputes between producers/exporters and consumers/importers are usually based on different economic fundaments (comparative powers) within the undersupplied (and/or with non-competitive supplies) and

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Transit in Eurasia: transit issues between Russia and the European Union and the role of the Energy Charter. – *"Journal of Energy and Natural Resources Law"*, vol. 27, #3, August 2009, p. 445-486; Energy Charter Plus - Russia to Take the Lead Role in Modernizing ECT? - *"Oil, Gas and Energy Law" (OGEL),* vol.7, 5 August 2009 (reprinted in: OGEL, vol.7 N4, December 2009); Russia: don't oppose the Energy Charter, help to adapt it. Russia should improve the Energy Charter process, not abandon it, says Andrey A Konoplyanik. – *"Petroleum Economist"*, July 2009, p. 2-3, etc.

[18] The author has been trying to prove this thesis through the period of his work in the Energy Charter Secretariat in his capacity of the Deputy Secretary General of the organisation since the beginning of informal expert consultations between Russian Federation and the EU on the open issues of the draft Energy Charter Protocol on Transit, which took place in 2004-2007 after the adoption of the Second EU Energy Package in 2003, and afterwards, since January 2010, in the process of informal consultations between the experts of Russia/Gazprom Group and EU energy Regulators, TSOs with participation of the Commission on the issues of implementation of the Third EU Energy Package that creates justified concerns of Russia/Gazprom Group.

oversupplied (with competitive supplies) markets. From this author's view, till 2009 Europe was living within a undersupplied market, and since 2009 within an oversupplied market[19]. The current market conditions of the EU gas market are characterized by the excessive supplies. And it seems that this excessive supply could be quite long-standing within the framework of the current economic crisis, spreading around the Eurozone, the EU decarbonization policy, etc., which will decrease (growth of) gas demand in the EU on the one hand, and with the redirection of the LNG supplies, initially destined for the USA, but now redirected to the EU as a result of the US shale gas boom, etc. which increases gas supply to the EU, on the other hand. In such circumstances it becomes difficult for Gazprom and its major stockholder to stand against the EC with hard-line policy in conditions of: (i) increased competition at the EU gas market, shrinking competitive niche for Russian gas in particular and for gas in general, (ii) legal claims of Gazprom's "old friends/long-term business partners" (EU wholesale intermediaries/purchasers of Russian gas) against pricing policy of Gazprom dated back to the 1960-ies, and (iii) inevitable need of the company for adapting/restructuring of its operations in Europe to changing market conditions[20] and as result of entering into force of the Third EU Energy Package[21] in September 2009, etc.

In fact, the relationships between Gazprom and the CEC are "diagonal" in nature and are based on the scheme "agent (company) – sovereign (state)". Under these circumstances it was required by the "agent" to call the "big brother" (its major stockholder) into the play to move the debate to the level of two "sovereigns". Or the "big brother" decided to enter the game by itself to defend its "younger brother" (and, by coincidence, one of the major budget donors).

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[19] *A.Konoplyanik.* The economic implications for Europe of the shale gas revolution. – *"Europe's World",* 13 January 2011; *A.Konoplyanik.* "Russian gas in Europe: Why adaptation is inevitable". - *"Energy Strategy Reviews"*, March 2012, Volume 1, Issue 1, p. 42-56.

[20] Ibid.; *Alan Riley.* "Commission v. Gazprom: The antitrust clash of the decade?" CEPS Policy Brief, No. 285, 31 October 2012, pp.6, 8. Available at <<*www.ceps.eu/ceps/dld/7433/pdf*>>, etc.

[21] *A.Konoplyanik.* Third EU Energy Package: Regulatory Changes for Internal EU Energy Markets in Gas and Possible Consequences for Suppliers (Incl. Non-EU Suppliers) and Consumers. - *"Oil, Gas and Energy Law" (OGEL),* Provisional Issue, June 2011, 37 p.

The actions undertaken by DG COMP in the provocative, attention-getting manner, has pushed the first token in the "domino effect" towards political dimension of the debate and has led to increased political tension between the Russian Federation and the EU. However, there is no doubt that if there is a different point of view between the two parties, it requires a common understanding and mutually acceptable – in substance - decision. It seems that a well-balanced consideration of the economic side of the issue, in particular, consideration of the validity of the claims of the Commission towards Gazprom, will help to return the discussion back to the issues raised in the Commission's press release, to a more constructive course of action (from political arm-wrestling to economic consideration of tolerable level of risks and uncertainties in adaptation to the new state of the market), by reducing the tension between the parties and find the opportunities for mutually acceptable solutions.

2 Gazprom's dominant position in CEE

2.1 Gazprom in CEE: "And that was also done by me?..."

The Commission's press release states that Gazprom "might be hindering competition in Central and Eastern European gas markets", it "may be abusing its dominant market position in upstream gas supply markets in Central and Eastern European Member States" "[22]. I tend to believe that the CEC provides the right facts, but interprets them incorrectly because of the wrong cause-and-effect relations, leading to the present situation, taking place in the CEE. The use of this approach immediately causes (despite its presumable character) "the bias effect" around Gazprom together with the assumption that the company is really responsible for the situation in CEE which initiated the actions against Gazprom and that it is this company which is fully responsible for this perceived "guilt" it is claimed for.

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22 http://europa.eu/rapid/pressReleasesAction.do?reference=IP/12/937&format=HTML&aged=0&language=EN&guiLanguage=en

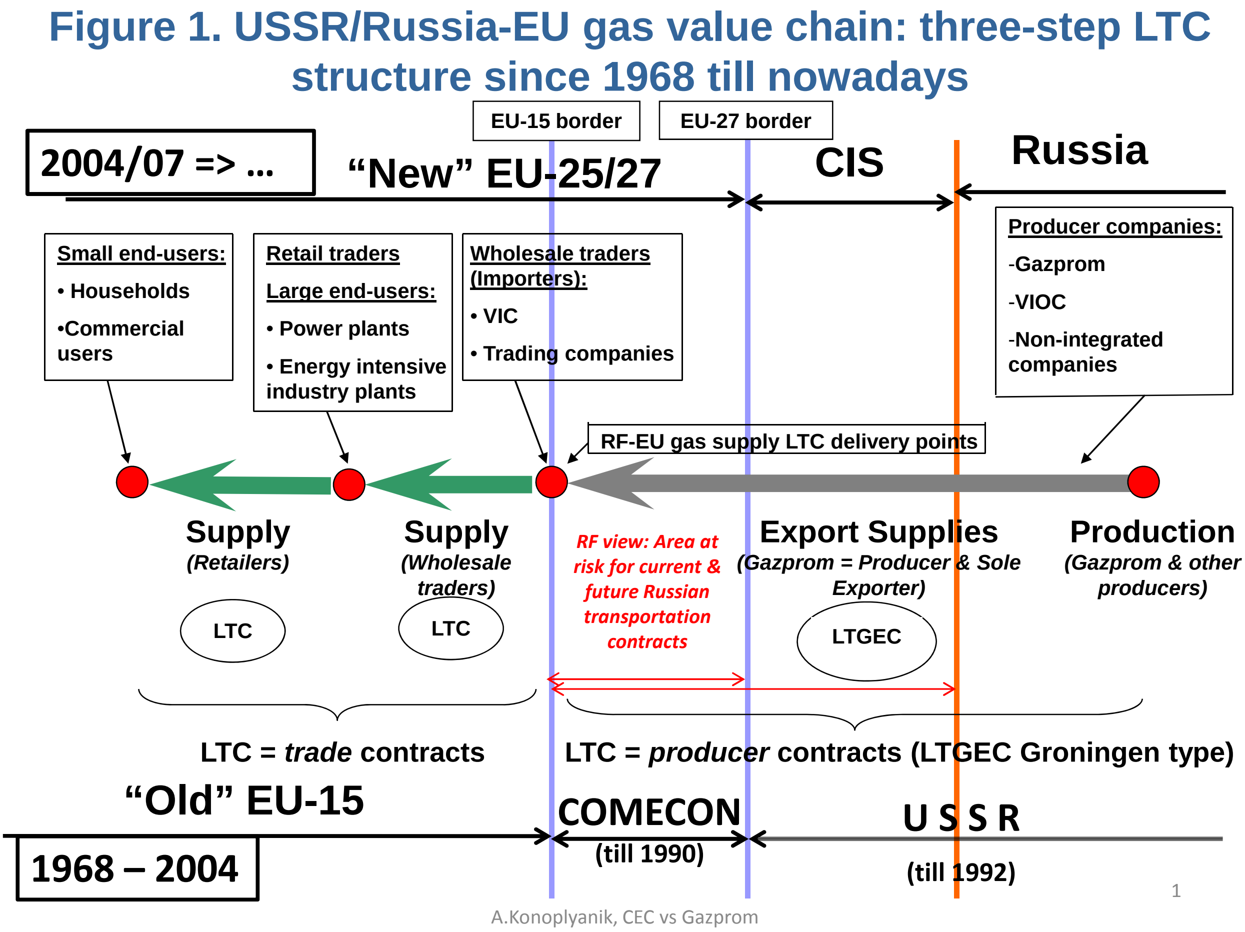
From my point of view, there are many kinds of sins for which Gazprom can be criticized: sins both in its core and non-core activities, sins both actual and virtual (as well known, "nobody is perfect"), but there is no need to criticize the company for sins it didn't commit.

Gazprom, being the commercial organization, obviously wants to maximize all its economic benefits (economic rent, including price rent) in situations, not created by him, but only inherited from the historical past. And it would be unnatural if the company acted in a different way. Gazprom seeks to maximize the resource rent (both Ricardian and Hotelling rents[23]) from exploitation of non-renewable energy resources which it develops and exports. But Gazprom is just an "agent" company for Russia as the host state. Russia is the owner of non-renewable energy resources within its territory and "sovereign" for Gazprom and other upstream companies – other "agents" - developing Russia's natural resources. It is also the dominant stockholder in Gazprom. So Gazprom depends on the Russian state twice –, first as the major stockholder and second as its host state – and has been considered as a major budget donor.

Gazprom, being the commercial organization, behaves exactly as any company would behave in this position: any company wants to obtain and maintain (hold) its monopoly position in the market for recovery of monopoly rent besides performing of other measures. It is exactly the point in which the European Commission has always blamed its "national champions" (the companies like EON-Ruhrgas, RWE, GDF, ENI, etc.), which buy Russian gas at the outer edge of the "old" EU (EU-15) and transfer it further to the European wholesale markets, using pipelines, initially belonged to them (which were built by these companies, using their own and/or borrowed money) (Figure 1). The peak of radical liberalization measures of the Second (2003) and Third (2009) EU Energy Packages (mandatory third-party access (MTPA) to the gas transportation/transmission infrastructure, unbundling of vertically integrated companies (VIC), etc.) were directed against these EU companies, which are the

[23] For more details see chapter 2 "Explaining Oil and Gas Pricing Mechanisms: Theoretical and Historical Aspects" (pp. 41-62) in: *Putting a Price on ENERGY: International Pricing Mechanisms for Oil and Gas.* Energy Charter Secretariat, Brussels, 2007, 236 pp. (www.encharter.org/publications/2007)

wholesale purchasers and resellers of Russian gas and which abuse their monopoly position in the EU markets.



(Figure 1. Russia-EU gas value chain: three-step LTC structure since 1968 till nowadays)

As I have already written before[24], Gazprom became firstly an "indirect victim" of the second wave of internal EU liberalization reforms (Second EU Energy Package of 2003)

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[24] Here are just some author's publications on this topic in English: "Russian gas in Europe: Why adaptation is inevitable". - *"Energy Strategy Reviews"*, March 2012, Volume 1, Issue 1, p. 42-56; "Russia and the Third EU Energy Package: Regulatory Changes for Internal EU Energy Markets in Gas and Possible Consequences for Suppliers (Including Non-EU Suppliers) and Consumers". - *"International Energy Law Review"*, 2011, Issue 8, p. 24-40; The 3rd Energy Package and the concerns of non-EU gas producers: An interview with Dr. Andrey Konoplyanik. – *"Eurasia Energy Observer",* February 12, 2011; Evolution of gas pricing in continental Europe: a view from Russia (Modernization of indexation formulas versus gas-to-gas competition). - *"Oil, Gas and Energy Law" (OGEL),* June 2010, #021, 32 p. (reprinted in: OGEL, vol.9, Issue 1, January 2011); Gas Transit in Eurasia: transit issues between Russia and the European Union and the role of the Energy Charter. – *"Journal of Energy and Natural Resources Law"*, vol. 27, #3, August 2009, p. 445-486; Evolution of contractual structure of Russian gas supplies to Europe. –

because of the enlargement of the EU from EU-15 to EU-25/27, when the great part of the infrastructure in the former COMECON states of CEE, created by Gazprom and/or its predecessors on the basis of the same principles, which were used by many European companies within the EU, turned out to be situated since 2004/2007 within the borders of the new enlarged EU (Figure 1) and has thus come under the EU regulation. And then, after the unfortunate Russian-Ukrainian events of January 2006 and January 2009, Gazprom became the part of the "target audience" for further liberalization measures at the single EU gas market (aimed, inter alia, to diminish dependence on Gazprom and Russian gas), being formed at that point in time (Third EU Energy Package).

I think that it is exactly the growing competition at the EU gas market, which will effectively force Gazprom to adapt its contractual and pricing policies to the new realities of the European gas market, causing it to be more competitive in the process for the race of expanding its presence within the narrowing competitive niche of the Russian gas in Europe. I think that administrative intimidations, like the most recent (04.09.2012) or the previous (27.09.2011) raids, cannot really influence the situation.

The measures taken by the CEC are probably more based on the desire of the DG COMP to choose a manner of action similar to corresponding American events, which took place a century ago. In 1890 the U.S. Congress adopted the antitrust "Sherman Act", aimed at the de-monopolization of the US oil market. As a result in 1911, Rockefeller's "Standard Oil of New Jersey" was forced to be split to 34 smaller independent companies, though not horizontally, in a way that unbundling ("segmentation" of VICs) is happening now at the European market, but vertically. It was much easier afterwards for the US government to deal with each of them rather than previously with one strong super-giant since "economy of scale" effect ("effect of concentration") applies not only to the economy, but to the politics as well ("divide and rule" principle).

"Perspectives in Energy", 2006, volume 10, N 1, p. 1-24; Russian Gas to Europe: From Long-Term Contracts, On-Border Trade, Destination Clauses and Major Role of Transit to …? – *"Journal of Energy and Natural Resources Law",* 2005, vol.23, N 3, p. 282-307, etc.

2.2 Result of decisions of historic past

When I just became a first-year student at the Energy Faculty of the Moscow Institute for Engineering and Economics in September 1970, almost at the first lecture of the “Introductory Course to Energy Economics” one of the greatest Soviet energy economists, prominent specialist in system studies in the energy field, academician Lev A. Melentyev, reading the named lectures to us, accented the words, which I remember, and repeat, in turn, nowadays to my own students: "In the field of energy we live in the era of investment decisions, adopted 15 years ago". However, the high level of capital intensity of investment projects in energy and their long lifecycles (especially in upstream in development of giant fields) has increased significantly. So now we live in the era of investment decisions, taken not 15 years, but even some decades ago. This note can be fully applied to Gazprom and to its operations in Europe, since in todays’ gas market we face a situation in CEE as the result of investment decisions taken a few decades ago. Europe has inherited the current configuration of its gas infrastructure and the mode of its operations in gas since the historical past of the 1960s.

The current monopoly position of Gazprom on the current CEE market, where the countries of Central and Eastern Europe are already members of the EU, is the result of investment decisions for infrastructure development carried out during another political era and in different economic conditions. It was the then divided Europe during the time of the Cold War, when the CEE countries were members of the CMEA and formed a part of the world centrally planned system, when this infrastructure was created based on realities of that political era. That political era has now gone, but its material results (configuration of the capital intensive immobile infrastructure) are still in place predetermining the configuration of gas flows and their underlying economics.

I think that, first of all, it is not Gazprom who is responsible for the lack of development of the gas transportation infrastructure in the CEE, though it is Gazprom who is nowadays blamed for this. The infrastructure was created primarily in "pre-

Gazprom" times by the Soviet state-planned economy. No alternative supplies (both supply sources and/or transportation routes) were planned and developed during this USSR/CMEA era within CEE territory according to the core principles of central planning. It was the centrally planned monopoly of supplies from the USSR to CMEA countries that had been developed very actively. That is why all existing pipelines within the former USSR/CMEA region (now within the chain of sovereign states such as Russia, Ukraine, Belarus, CEE states of the EU) have the orientation from East to West.

Such a monopoly of supplies within a politically determined pricing system (political pricing) had been used in favour of CMEA/CEE countries for 40 years (from early 1960's to late 1990's). The Soviet gas supplies to CMEA socialist countries (and later Russian supplies to CEE) had been conducted at prices set on the basis of the "costs plus" pricing system. At the same time gas supplies to the capitalist countries of the Western Europe had been performed at prices on the basis of the "net-back replacement value” principle with gas pricing formulas indexed to oil products prices.

In the 1970's the rapid rise of oil prices began. Soviet gas prices for the Western Europe, indexed to petroleum products prices, started to rise in parallel (though with a delay according to the formula) with oil prices, as opposed to stable and relatively low prices, determined in accordance with the "costs plus" basis for the Soviet gas, supplied to the CEE countries. Regarding Soviet oil supplies to the CEE at that time, they were provided at discounted prices measured as three-year average from the world oil price.

Thus, economic relations between the USSR and CMEA relied heavily on discounted Soviet oil and gas export prices for CEE countries. Such relations had been correspondingly forming the economic basis of political unity of the CMEA system (discounted export prices of Soviet energy for CEE countries in return for their political loyalty to the exporter). This situation was mentioned by the Russian President in Vladivostok in September 2013 (see above).

However, Russian export prices for the CEE countries were transferred from the "costs plus" formula to the "net-back replacement value" pricing formula indexed to petroleum products. This is what used to be called the "European formula". The transfer took place in late 1990s (e.g. in 1998 for Slovakia and the Czech Republic), ten years after the "velvet revolutions" in the CEE countries which led to the collapse of the CMEA. The aforementioned CEE countries declared from the very beginning their desire to join the EU and were on their way to it in 1998. At that time oil prices were at their historically low levels in result of the Asian financial crisis. So the transfer from “cost plus” to “net-back replacement value-based” price levels took place without any significant adverse economic impact on the CEE and without any political upheaval.[25] No blaming of Gazprom took place then.

Gazprom’s involvement was only raised when the situation on the European gas market started to change in 2009. Gazprom policies hadn’t changed. Its European policy (regarding contracts and pricing) didn’t changed either. It is the EU and its market conditions that were changed, which formed the changing external environment from within Gazprom operates: economic recession in the Eurozone and a "domino effect" in the EU-oriented supply chains as a result of the "quiet shale revolution" in the USA (redirection of Qatari LNG flows from US to the EU), led to the oversupply of the European gas market and to lower gas prices in Europe. At the same time, high global oil prices kept contract prices for Russian gas imported to the EC at the high level through the mechanism of petroleum product indexation. The gap between spot and contract prices increased and reached its double amount at the peak of the crisis.

Thus it is not Gazprom itself, but the market conditions that have changed. The conditions of the market, in which it historically takes the key/dominant position, are in fact the source and cause of the EC concerns.

[25] see: *Putting a Price on ENERGY: International Pricing Mechanisms for Oil and Gas.* Energy Charter Secretariat, Brussels, 2007, p.168 (Figure 42).

3 Claim 1. But could Gazprom separate the markets?

The EC declares, that "first, Gazprom may have divided gas markets by hindering the free flow of gas across Member States".[26] But Gazprom hadn't actually done this as it was shown earlier.

Let's have a closer look at the second part of the Commission's claim that Gazprom "may have … hindering the free flow of gas across Member States".

First of all, all markets of the EU (in Western and Eastern Europe) are actually divided, separated. This is true. It is declared by the CEC itself. It develops the Third Energy Package and sets the task of formation of the single EU gas market beginning from sub-tasks of forming market areas which will unite at least some neighbouring Member States, and/or creating preconditions for free flows of gas within the borders of a number of EU countries by 2014. What's the role of Gazprom in this situation?

Secondly, the markets in the CEE countries were not divided by Gazprom, but by the centralized planning system of "pre-Gazprom" period as shown earlier. But this system, in turn, was the inevitable result of the configuration of the political map of a then divided Europe that predetermined and defined for the future decades the configuration of gas supplies and transportation grid for CEE that we are facing today.

Finally, there are some general objective trends in the development of energy markets to be identified. Energy markets are initially developed as individual markets within national boundaries. At this stage, existence of trade relations between neighbouring countries doesn't mean the existence of the single market space between them. At some further stage the further development and further diversification of infrastructure (incl. both transportation and storage, opportunities for reverse flows, etc.) leads to a convergence of the markets and the occurrence of a single market area with free trade and investment flows within this group of states based on the existence of common, adequate to market needs, and freely accessible infrastructure. It is

26 http://europa.eu/rapid/pressReleasesAction.do?reference=IP/12/937&format=HTML&aged=0&language=EN&guiLanguage=en

something that is not only described by the word "market", but what is actually is the market.

It is not possible, in my view, to speak about a single market area with a limited existing infrastructure. While speaking about limitations to free flows, there is a cause and the result. The result is limited access of all potentially interested market players to the physically limited infrastructure. But the real cause of this is the lack of available transportation capacities (alternative pipelines and transportation routes).

And it are investments in new infrastructure that create preconditions for transferring separate multidirectional trade flows into a single market area with a free flows of goods and services. A key limitation for free gas flows within specific area is not the behaviour of an entity within the limited infrastructure (which throughput capacity is in deficit compared to market demand for it) but a lack of investment stimuli for project investors (whether TSOs in the unbundled markets or TSOs and VICs in the bundled markets) to finance and develop such an infrastructure and thus developing an adequate level of its diversity which will provide both producers and consumers the option to freely select their trade partners within the available transportation capacities (adequate to the market needs) of the market area.

So, from my view, it is not Gazprom who hinders "the free flow of gas between member States". They are hindered by the lack of a single market space within the borders of the EU, which is just being transferred to the corresponding stage of development. And this is recognised *de facto* by the Commission itself who strived for this by drafting the Third Energy Package and other instruments to develop multiple supplies to the EU by creating corresponding opportunities for this within the capacities market: developing interconnectors, reverse flows, storage capacities, etc. How can Gazprom prevent to develop these capacities which will enable gas to move freely within the EU?

3.1 Destination clauses

Another logical question arises in such a situation: what does the wording "may have divided gas markets" mean (the first part of the first claim)? I do not think I will be mistaken by suggesting that the CEC refers to the use of the system of long-term gas export contracts (LTGEC) with destination clauses (territorial resale restrictions). At least I am not alone in this view as this is also expressed by Prof. A. Riley.[27]

Destination clauses were an integral part of the so-called Groningen model of LTGEC developed by the Dutch Government and first implemented by Gasunie in 1962.[28] This model with so-called "European (pricing) formulas" has expanded since in an eastward direction until it covered the whole of "broader energy Europe" in 2009/2010.[29] But, within the EU, destination clauses were abolished in Russian contracts in 2003/2004[30].

This organization of contractual relations (LTGEC with, inter alia, destination clauses) has been reflecting the economic realities from 1960s and up to the present day. Historically, supplies of the Soviet / Russian gas were carried out towards a limited number of delivery points on the outer (eastern) border of the "old" EU-15. At each point, gas deliveries were destined for different markets of individual EU Member States, located at different distances from that delivery point. For this reason at each delivery point a number of supply contracts existed with different contract prices depending on the final destination. Based on the "European formulas" linking gas price to its replacement value at the consumer/end-use market and netting them back to the

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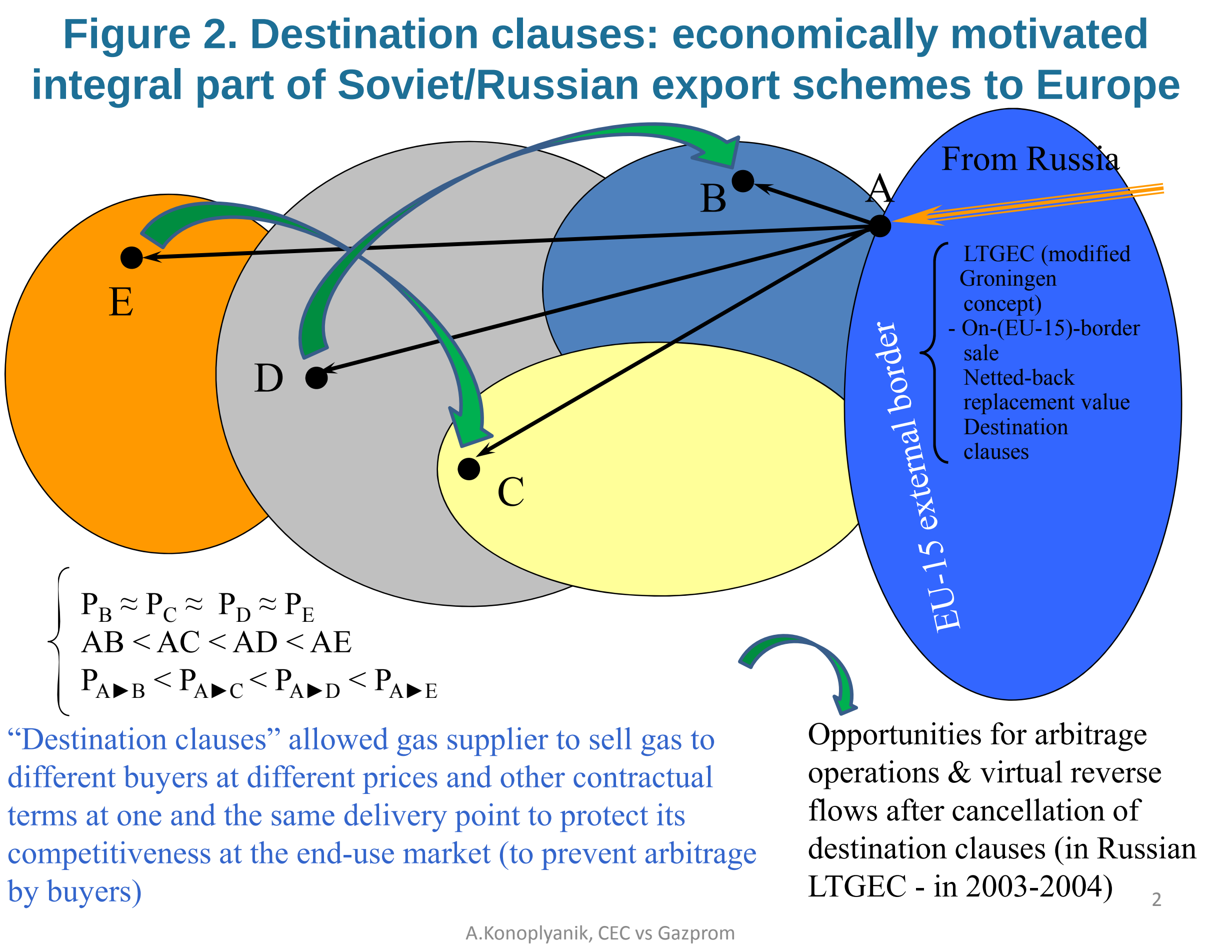
[27] *Alan Riley.* "Commission v. Gazprom: The antitrust clash of the decade?" CEPS Policy Brief, No. 285, 31 October 2012, p.8; Ibid. "Commission v. Gazprom", Presentation at the European Gas Conference, Vienna, 31st January 2013, slide 11.

[28] *Correlje A., van der Linde C., Westerwoudt T.* Natural gas in the Netherlands: From Cooperation to Competition? Oranje-Nassau Groep, 2003; *Putting a Price on ENERGY: International Pricing Mechanisms for Oil and Gas.* – Energy Charter Secretariat, Brussels, 2007.

[29] *А.Конопляник.* Российский газ в континентальной Европе и СНГ: эволюция контрактных структур и механизмов ценообразования. - ИНП РАН, Открытый семинар «Экономические проблемы энергетического комплекса», 99-е заседание 25 марта 2009 г. – Москва, Изд-во ИНП РАН, 2010 г., 102 с.

[30] See, for instance, Commission press-release on banning territorial restrictions – destination clauses in the contract between Gazprom and ENI, IP/03/1345, 06.10.2003// Commission Staff Working Paper "Energy Dialogue with Russia. Update on progress", 28.01.2004, SEC (2004)114, Annex 6.

corresponding delivery point (in order to provide competitive gas prices at the consumer end), the contract prices at the delivery points were the highest for the nearest market to this delivery point and the lowest – for the most distant market from the delivery point (Figure 2).



(Figure 2. Destination Clauses: Economically Motivated Integral Part of Soviet / Russian Export Schemes to Europe)

The ban of arbitrage operations aimed at utilising contractual price differentials destined for different markets in the same delivery point for the EU wholesale purchasers of Russian gas - i.e. prohibition of resale between different end-user markets further down from delivery points - had been introduced through the mechanism of destination clauses. It had been protecting the well justified economic interests of the producers/exporters and states-owners of non-renewable natural resources up to 2003 in the case of Gazprom/Russia. This mechanism prevented the reselling of gas destined for the most distant market (for which contract price at the delivery point is the lowest) on the closest market to the delivery point (for which contract price at the delivery point was the highest in result of "European formulas" based on net-back replacement value at end-user end of the gas value chain).

This protection of the resource owner's justified interests in receiving the maximum possible (which means marketable) resource rent (including both Ricardian and Hotelling rents) is based on the internationally accepted principle of sovereign rights of the national state over its natural resources which was first accepted by the international community in the UN General Assembly Resolution N1803 "Permanent Sovereignty over Natural Resources" in December 1962[31], and then was reconfirmed in Art.18 of the Energy Charter Treaty "Sovereignty over energy resources"[32] (the ECT was signed in December 1994 and has entered into force in April 1998). So this principle is nowadays an integral part of international law.

Destination clauses aimed to prevent unfair redistribution of the resource rent in favour of intermediate reseller of producer's (Russian) gas further through the value chain to a downstream market. If at that time the producers (including USSR/Russia) would have had access to the end-users (instead of selling its gas at the political border between the East and West), there would have been no need in using wholesale intermediaries and to incorporate destination clauses into contracts. Another argument in favour of them at the time was to prevent reselling Soviet gas by CMEA countries (which was exported to them at discounted prices determined at cost-plus pricing) to the West (where the prices were higher since were determined at replacement value based formulas with petroleum products indexation).

It is common knowledge that destination clauses in Russian/Gazprom's contracts were abolished as a result of the trilateral package agreements in 2003-2004 between Gazprom, EC and relevant EU companies-importers of the Russian gas (ENI, EON-

[31] UN 1194 Plenary, General Assembly resolution 1803 (XVII) of 14 December 1962, "Permanent Sovereignty over Natural Resources", http://www.unhchr.ch/html/menu3/b/c_natres.htm

[32] http://www.encharter.org/fileadmin/user_upload/document/EN.pdf

Ruhrgas, OMV, etc.).[33] It should be noted however, that it was agreed as a part of these deals, that direct Gazprom's losses from cancellation of destination clauses in acting contracts would be compensated by some future measures. For example, in case with ENI, it was agreed that Gazprom would be compensated by providing Russian company with expanded direct access to the Italian gas market. For this purpose it was planned to expand the throughput capacities of the transit TAG pipeline, going through Austria to Italy, by which Russian gas is supplied to the country.[34] The auction on access to the first tranche of additional TAG capacity took place in December 2005. It was organised in such a way that all 149 nominees were announced the winners. Most of them were affiliated with each other and didn't possess any gas. Gazprom was among the bidders, one of the few that possess gas, and was ready to book all additional capacity (3 BCM) on a legally binding basis guaranteeing supplies. After the auction was over, many of its "winners" turned to Gazprom with the offer either to sell them some gas, or to buy from them (at least some of) their capacity of the TAG pipe which they won[35]. At least a number of these affiliated bidders, participating in the TAG auction, knew that Gazprom has gas, was interested to increase its sales to Italy, and they just tried to resell their lots (of future incremental TAG capacity) that they won to Gazprom. So they were participating in the auction not with the aim to transport gas, but with the aim to resell the capacity afterwards, even immediately. As a result, the word "TAG auction" became the common synonym of how procedures on testing demand for the capacity and/or its allocation should *not* be organised.

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[33] *A.Konoplyanik.* Russian Gas to Europe: From Long-Term Contracts, On-Border Trade, Destination Clauses and Major Role of Transit to …? – *"Journal of Energy and Natural Resources Law",* 2005, vol.23, N 3, p. 282-307.

[34] См.: Пресс-релиз Комиссии о территориальных ограничениях – оговорках о пунктах конечного назначения в договоре между Газпромом и ENI, IP/03/1345, 06.10.2003 // Commission Staff Working Paper «Energy Dialogue with Russia. Update on progress». 28.01.2004. SEC (2004)114. Annex 6.

[35] *Фейгин В.И., Медведева Е.А.* «Дьявол в деталях» европейской либерализации: вокруг аукциона по TAG. Институт энергетики и финансов // Экономическое обозрение. 2006. № 5. С. 37–39; *Конопляник А.* Взаимоотношения России и Европейского союза в газовой сфере и роль Энергетической хартии (с. 166–196) – в кн.: *Нефтегаз, Энергетика и Законодательство (выпуск 7/2008).* Информационно-правовое издание топливно-энергетического комплекса России и стран СНГ (ежегодник). Москва: «Нестор Академик Паблишерз», 2008. 196 с.; *А.Конопляник.* Правовые аспекты процедуры недискриминационного конкурентного доступа к свободным мощностям транспортировки (ДЭХ, TAG и ЕСГ), с.142-156, – в сб.: *Нефтегаз, энергетика и законодательство (выпуск 8 / 2009).* Информационно-правовое издание топливно-энергетического комплекса России и стран СНГ (ежегодник). – Москва, «Нестор Экономик Паблишерз», 2009, 160 с.;

From my view, most of the blame towards the lack of "free flows" of gas can be put on the CEC itself after it forced Gazprom and its key trade partners to refrain from destination clauses in 2003 and in subsequent years. Lack of "free flows" is first of all the result of a lack of the available infrastructure (pipelines-interconnectors, reverse capacities at the borders, underground gas storages, etc.). The mentioned factors are the result of the weak investment stimulus for project financiers to invest mostly debt capital (through the mechanisms of project financing) into development of gas infrastructure within the framework of an unbundled EU energy market. Since 2003 (after Second EU Energy Package came in force) development and regulation of the trade flows (commodities markets), on the one hand, and of infrastructure (capacities markets), on the other hand, within the EU are carried out separately as opposed to before, when both of these segments (commodities and capacities) were developed and managed as a single economic complex within individual VICs.

3.2 Risks for project financing

Additional risks and uncertainties for project financing of the infrastructure (aimed at preventing deficit of capacities to appear and thus to provide free flows of gas) within the current framework of the unbundled EU gas markets are created by the following factors:

(i) mandatory third-party access to the gas transportation/transmission infrastructure (MTPA),

(ii) accelerated introduction by regulatory measures of spot and exchange-based pricing,

(iii) implicit discrimination of LTGEC with oil-indexation mechanism, which are favoured by project financiers as investment tools, and

(iv) regulated transportation tariffs with restricted ceilings of rate of return on investment in infrastructure development at the extremely low level (5-6% and/or lower, like in Germany). This extends the payback period of such projects up to 20 years and makes all investments in the infrastructure development of no interest for private business.

And what does the notion "free flows" means in the scope of such investigation? Does the CEC imply the following by its use:

(1) "old" (existing) and "new" (incremental) multiple supplies/gas flows through "old" (existing) *and* "new" (incremental) multiple capacities/transportation routes, or

(2) "old" and "new" multiple supplies/gas flows, but only with the use of existing transportation capacities?

Option (1) requires an enormous investment and long project lead-times and thus lacks immediate results in terms of additionally available capacities. Option (2), which seems to be the preferred scenario for the DG COMP/CEC, means zero investment and zero lead-times , in other words - the immediate access, though to the existing and already contracted infrastructure. The possible argumentation in favour of this second option by the Commission can be backed by calculations, made by the Institute of Energy Economics at the University of Cologne for the CEER (Council of European Energy Regulators). They show that the average annual utilization rate of existing pipeline infrastructure in the EU is equal to 70%.[36] This figure is widely accepted by European energy regulators and is interpreted in a way that there is no major need in incremental/new infrastructure. And that the absence of free flow of gas does not result from inadequate, compared to market needs, infrastructure capacities, but due to its improper utilization by incumbents (by those who have developed and have been historically using their transportation capacities). In other words, there is enough transportation capacities within the EU, it is fully contracted by incumbents, but not fully used in the most effective manner. This figure and all corresponding conclusions are widely used today in Europe by the proponents of the Third Energy Package despite the well justified concerns and action plans for developing interconnectors, etc.

[36] *Stefan Lochner, Caroline Dieckhöner, PD Dr Dietmar Lindenberger* (Institute of Energy Economics at the University of Cologne). Model-based Analysis of Infrastructure Projects and Market Integration in Europe with Special Focus on Security of Supply Scenarios. *Final Report,* May 2010

This way, the main goal for the EC's investigation can be formed by the desire of getting a "free" (free of charge, without making any investments in incremental capacities/alternative choices) access to already contracted but temporarily unused (for seasonal, operation mode, maintenance, and/or other reasons) infrastructure, which:

(i) was financed and built earlier by other economic entities on the principles of "project financing",

(ii) belongs to them on the right of ownership, and

(iii) is contractually not available for other market players for the duration of the given supply contract in order to exclude "contractual mismatch".

Such an approach brings to mind the philosophy of a "free rider" or, in the worst case, "confiscatory access", though both lines of actions are criticized by the philosophy of "a fair market"...

4 Claim 2. But could Gazprom hinder the process of diversification?

The CEC states that "second, Gazprom may have prevented the diversification of supply of gas."

It is widely known that in 1911 Winston Churchill, being the Minister of the Royal Navy, was the first to proclaim that energy security means diversity of supplies. In the modern world it means for any consumer, multiple supplies (their diversity) in result of investments aimed to increase the range of supplies and suppliers (both domestic and foreign), delivery routes, energy resources (including today's "traditional" and today's "non-traditional" energies which will become "traditional" ones tomorrow), etc. For producers this competitive mix is supplemented by another element – by diversification of markets (both in terms of new areas as well as new industries/sectors of economy).

If we try to concentrate on this understanding of the term "diversification of supply", then we'll see that Gazprom can't hinder the process of diversification by definition, namely: it can't hinder development of alternative supplies (including LNG, shale gas), creation of new delivery routes and appearance of new suppliers (new market participants). They are just out of the Gazprom's reach.

Moreover, I tend to agree with the thesis, regularly repeated for a number of years by Alexander Medvedev, Deputy CEO of Gazprom and General Director of "Gazprom export LLC" (who has, by coincidence, became my direct boss since January 2013), that Gazprom was (at least one of) the pioneer(s) and ancestor(s) of competitive supplies on the European gas market. Gazprom was the first to break the monopoly of Ruhrgas, which had been historically the sole wholesale purchaser and reseller/supplier of the Russian gas to Germany, by establishing the Wingas company (then 50/50 joint venture with BASF) as an alternative delivery channel to this country.

In my view, the diversification of supply routes is one of three equally important elements of the multi-facet process of diversification in regard to a single energy resource (another two are diversification of supply sources and of the markets). During my tenure there as Deputy Secretary General of the Energy Charter Secretariat we developed this view in the course of international debate on international energy security in the course of preparation for and as our input to the 2006 G-8 Summit in Saint-Petersburg, where "international energy security" was one of the key items at the agenda. But not everyone in the energy and/or political world shares this point of view. For instance, in the series of my occasional face-to-face and extra-mural debates on this subject with Joschka Fischer, the former Minister of Foreign Affairs of Germany and current political advisor of RWE, he strongly rejected the thesis that the development of alternative delivery routes from the same producer turned out to be the said diversification[37].

However, I tend to consider that nowadays Gazprom doesn't prevent, but actively contributes to the process of diversification of gas supplies to Europe, adding to

[37] See, for instance: http://mega-streaming.info/video/UYW9H4AA9SMK/Le-grand-Monopoly-du-gaz

development of, for example, the "North-South" gas corridor, which is very valuable for the CEE countries, according to the authorities of these countries and of the EU. The combination (chain) of pipelines, consisting of offshore Nord Stream and onshore OPAL and Gazelle pipelines, creates a new route for the delivery of gas to the countries of Central and Eastern Europe, additional to the existing east-west routes. The further connection to the North-South route of supplies of re-gasified LNG from its import terminals on Krk Island in Croatia (in the South) and Swinoujscie in Poland (in the North) will be complementing to and lock-up this "vertical" supply chain consisting of both alternative supply routes and supply sources.

4.1 Gazprom implicitly stipulate diversification

Besides, Gazprom by its pricing policy and high contract oil-indexed gas prices unintentionally encourages the EU Member States to diversify, especially the CEE countries and foremost those of them which have the least opportunities for competitive supplies compared to the "old" EU member states. In cases where alternative supplies (of EU domestic and/or foreign origin) and incremental infrastructure appears in CEE and oversupply continues within the EU, Gazprom supplies may be the "first victim of diversification" for being the most expensive (due to oil indexation). Gazprom supplies could have been such a "victim" of oversupply today already if not the "take-and/or-pay" and "price review" clauses in Russian LTGEC. These clauses prevents an immediate switch of wholesale intermediaries - buyers and resellers of Russian gas – from the more expensive contractual Russian/Gazprom's gas to the cheaper spot gas available at least in the North-Western part of the EU.

Gazprom in the EU is a company with marginal costs (due to its high production and transportation costs both in absolute and comparative terms) and marginal prices (due to oil indexation) and the largest supplier (in terms of export volumes). So Gazprom can suffer more than other gas suppliers to the EU after its existing LTGEC would expire if it would not adapt its contractual structures and pricing mechanisms accordingly. But that should not be done by administrative pressure and restrictive measures of the EU institutions – this will be done by market forces should Gazprom wish but fail to protect its competitiveness within a competitive environment.

So the driving force for the EU policies on this issue should be, in my view, slightly different to what seems to be the dominant EU policies (action plan) towards Gazprom today: a development of competitive environment around Gazprom in CEE and not administrative pressure on it to become competitive within an uncompetitive environment. The first option I usually described as a "cucumber effect": if a fresh cucumber is placed into salty water, after some time, whether the cucumber would like it or not, it would become a salty one.

Bearing that in mind, Gazprom's unwillingness to reject the use of "take-and/or-pay" (TOP) clauses, in my opinion, cannot be considered as the "barrier for diversification". It is correct to state that Gazprom counterparties can't stop implementation of TOP clauses in LTGECs unilaterally, because any unilateral measures within the framework of bilateral agreements like LTGECs are invalid. That's why the wholesale purchasers of Russian gas opened their legal proceedings against Gazprom, seeking, inter alia, the cancellation of TOP clauses in the courts. I tend to believe that here lays the reason behind the intention of DG COMP to declare that TOP clauses and (oil) price indexation within LTGECs are unjust and non-market practice as it has declared 10 years earlier in regard to destination clauses.

And maybe DG COMP seeks to repeat nowadays its "successful story" that it managed to implement earlier (in 2003-2004) with destination clauses, but this time in relation to TOP off-take provisions of LTGEC and oil indexation as their pricing mechanism?

The causes which really are hindering/preventing the process of diversification are the lack of investment stimulus for infrastructure development - long payback periods and low level of returns on investments. For example, the above-mentioned Gazelle pipeline, which is *de facto* an extension of the Nord Stream – OPAL transportation system, transferring gas from the North further South through the Czech Republic to Waidhaus, has a payback period of 23-24 years because of the EU regulatory rules on infrastructure. But these are purely internal EU measures, the measures of the EU investment climate for infrastructure development. What has Gazprom to do with this situation?

Diversification means the creation of infrastructure, sufficient to provide multiple choices for suppliers and customers, in other words - to ensure the market demand for transportation capacities (to deliver gas to the customers). The Third EU Energy Package potentially creates such opportunities, but they need to be converted into the regulatory procedures, which should be described in relevant Network Codes, which are currently being developed. Russian/Gazprom Group experts and European energy Regulators, TSOs and representatives of the Commission are working *together* on development of such procedures, European participants as the drafters and Russian experts as their sparring partners. This is being done within two (now merged) processes: (a) by informal consultations on implementation of provisions of the Third Energy Package which raise justified concerns of the Russian/Gazprom Group side (beginning from January 2010), and (b) within the framework of the Work stream 2 (on internal markets) of the EU-Russia Gas Advisory Council (from November 2011)[38].

Representatives of the Gazprom Group (both from Gazprom, Gazprom export, Gazprom Marketing and Trading) are actively participating in both processes.

5 Claim 3. But could Gazprom implement the unequal prices?

The EC declares that "finally, Gazprom may have imposed unfair prices on its customers by linking the price of gas to oil prices."

First of all, I would like to highlight the fact that the concept of a "fair price" (content and price level) is different for suppliers and purchasers, which are two parties of the same contract. But the price can't be called unfair, if both parties agree on its level and/or the mechanism of its definition within the contract. Moreover, the importance and mechanism for determination of the "fair" price differ, depending on

[38] For more details on these processes see corresponding publications and presentations of this author at www.konoplyanik.ru.

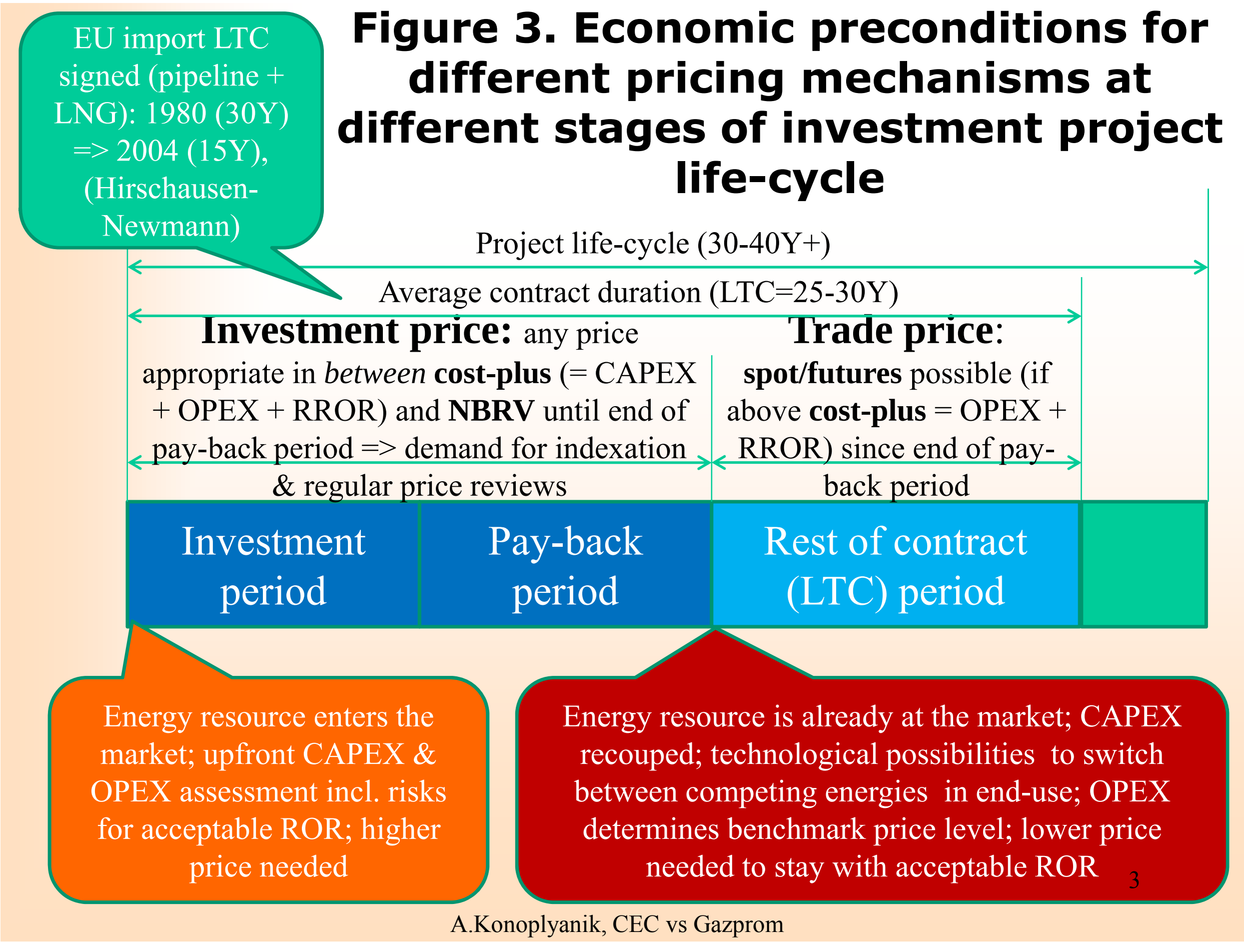
the stage of development of the market and used contractual structures and pricing mechanisms.

5.1 Contractual structures, pricing mechanisms and market stages

At the initial stage of gas markets development, the price can be established only within a pair "producer - purchaser" and only as a term/contract price for the period not shorter than the payback period of the given investment upstream project. This is a firm requirement of project financing: to provide guarantees of financial flows (monetary receipts from selling gas produced) to pay-back project CAPEX covering costs of gas production and its transportation to the delivery point which in case of Russian export gas supplies are located thousand kilometres away to the West from the well-head. The contract price at this stage may be fixed in monetary terms and be determined on the "costs plus" basis.

Such a price reflects the minimum acceptable price for the producer – this is their minimum investment price, a project financing price. This price should cover all costs and provide the reasonable rate of return (ROR) on investment. And it is not the producer, but financial institutions who consider and evaluate risks and uncertainties of the given project in the given country. And it is a result of their evaluation of risks that the value of reasonable/acceptable ROR for the project is calculated. Financial institutions are currently providing debt capital for about 70% of project CAPEX in capital intensive upstream energy projects. So they are looking for the shortest durations of pay-back periods in order to minimize the risk of possible non-return of the debt capital they have provided. So they are aimed at as high a contract price as is practical. And as nowadays oil indexation provides the highest possible price levels, project financiers are in favour of oil indexation.

At the early market stages - with the absence of alternative supplies/suppliers - a consumer usually has no alternatives to select supplier/supplies and should/must accept the given cost-plus price. In such cases the "cost plus" mechanism is the "investment" pricing mechanism for non-competitive markets and the price, determined in such a way, is the bottom (minimum) "investment" price. It reflects the "fair" price level of the producer at early stages of market development (Figure 3). But it also reflects the price of the producer as a result of political pricing (like in above mentioned historical situation with CMEA countries). At non-competitive markets cost-plus pricing, from my view, should also be considered as a fair pricing mechanism for the consumer, since at this stage of market development the latter has no alternative supplies of this particular good and the choice for him is either to receive this good at the given cost-plus price (and to generate further value added at his consumer end), or not to receive this source of energy at all. The relatively high price in this situation (through, say, higher ROR) can represent scarcity and/or monopoly rent, and the higher it is – the stronger and more effectively it will trigger demand for developing competitive supplies.



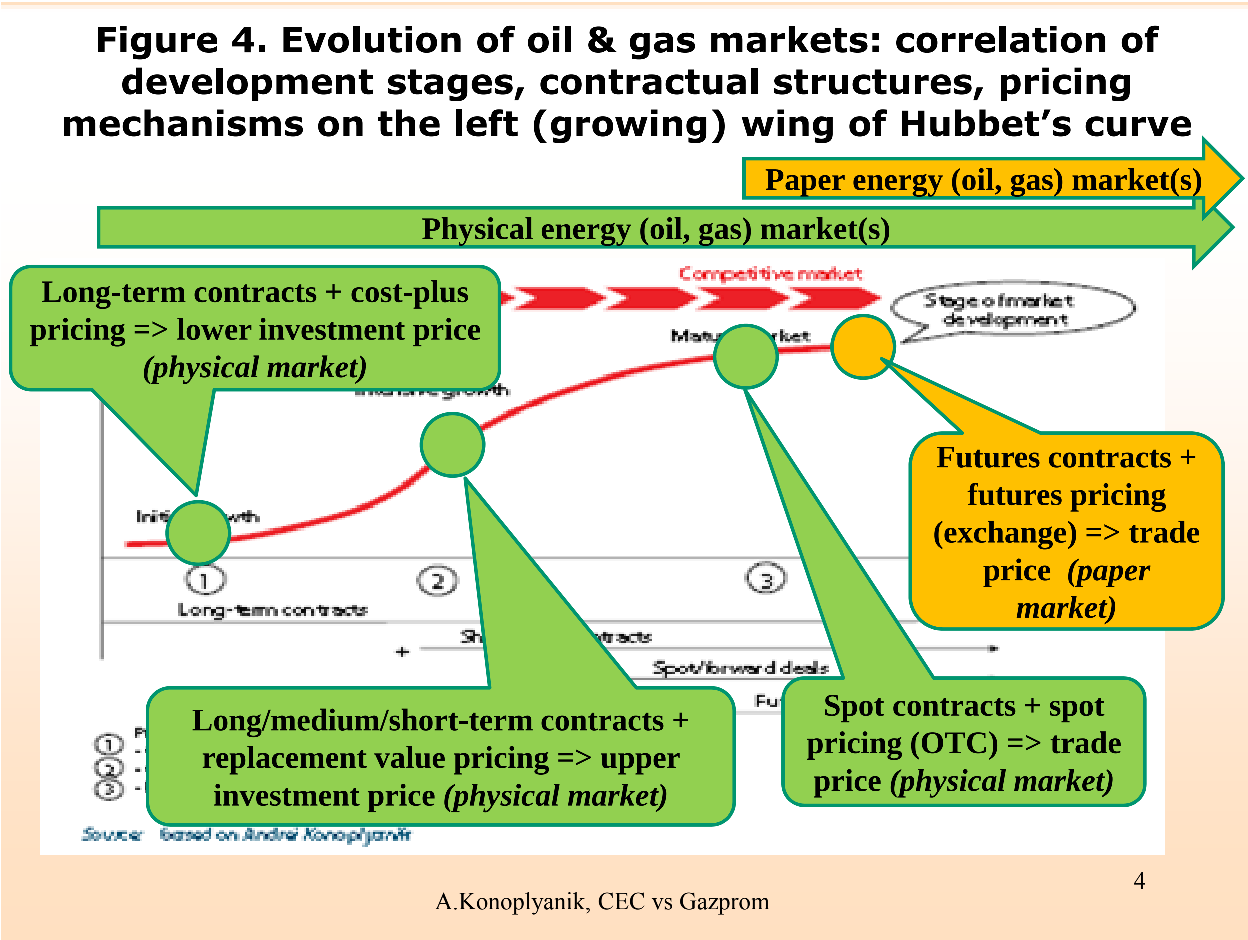
(Figure 3. Economic preconditions for different pricing mechanisms at different stages of investment project life-cycle)

At the next stage - of intensive market development – indexation appears as pricing mechanism linking the gas price to the price of energies competing with gas in the end-use. This mechanism is called "net-back replacement value-based" (NBRV) pricing and it appears on competitive markets with an inter-fuel competition. NBRV pricing provides a maximum marketable price for gas producers/exporters (higher than the cost-plus) and an appropriate, affordable price (lower than the prices of available alternative fuels) for the customer. Regular adaptation of the NBRV-based price within mutually agreed contractual mechanisms (price reviews) supports its competitive level. Thus, indexation within NBRV pricing is an investment pricing mechanism within competitive markets. It results in a "fair' price level for the stage of intensive market development.

Contrary to both "investment" pricing mechanisms, spot pricing is a "trade" pricing mechanism. It is not a long-term, but a short-term mechanism, appropriate for trade operations, but it is not welcome for project financing. Project financiers would never accept short term pricing (spot) if long term pricing (NBRV with indexation) is available. Only under external pressure they will give up financing tools based on long-term contract with NBRV and price indexation and will accept, say, hub-based pricing with spot transactions[39].

The evolution of contractual structures and pricing mechanisms is presented at Figure 4. Each new combination (pair) of contractual structure and pricing mechanism attributed to it appears only when the preconditions for them are available on the market with, first and most, an adequate development of infrastructure. The growing level of diversification brings gas markets from one stage of development to another and creates preconditions to move to a higher level of competition on the market. Though there is one general principle: new market structures appears in addition to existing ones and not instead of them, just the contractual mix becomes more competitive from stage to stage (Figure 4).

[39] That was the case with Ormen Lange project (Norwegian shelf, North sea), when such "external pressure" was provided by the CEC, according to senior management of Statoil, and the fact that all supplies were aimed at the UK market with NBP (National Balancing Point) as its single pricing platform. By the way, according to my knowledge, this project is the only upstream oil & gas project financed and developed without LTC and based on spot prices.

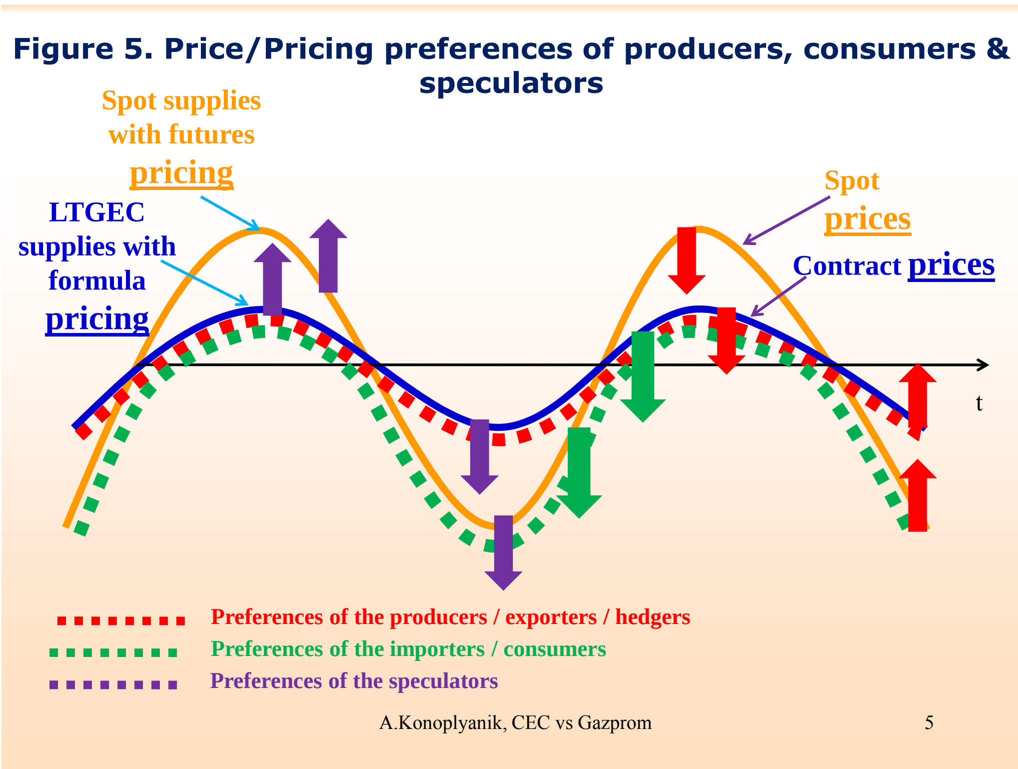


(Figure 4. Evolution of oil & gas markets: correlation of development stages, contractual structures, pricing mechanisms on the left (growing) wing of Hubbet's curve)

5.2 Different market players – different price/pricing preferences

In a gas market with both term and spot trade there is a conflict of interests between three group of players: (i) producers/exporters, (ii) consumers/importers, who can be considered as hedgers (physical market participants), and (iii) speculators (paper market participants). Industrialists have to be considered as hedgers and have no interest to speculate since at the end of the day they will transfer the variability of input price to the consumers.

When the markets are tight and contractual prices are going slowly upward (since in the contractual formulas gas price for the given period equals to weighted average for reference fuel within 6-9 previous months), spot prices rise quickly with advanced speed. During that period consumers and importers would prefer not spot, but contract prices. On the other hand, when there is oversupply in the market, spot prices diminish faster than contractual prices and drop much below the latter. During that period consumers will prefer spot. Consumers and importers are not much interested in pricing mechanisms, they are interested in lowest possible level of price, non-dependent which pricing mechanism at the moment will enable such lowest price level. That explains the current (since 2009 and until nowadays) preference of the consumers and importers for spot pricing in the period of oversupply. But price volatility (both corridors and frequency of price fluctuations) of the spot curve is much higher than of the contractual one[40] (Figure 5).



(Figure 5. Price/Pricing preferences of producers, consumers & speculators)

[40] It was once again demonstrated during, for instance, extra-cold days in early February 2012: price difference between Russian contractual gas price and NBP price was equal to about plus 150 USD/mcm in mid-January, has overturned to minus 200 USD/mcm in early February, and then converted back to plus 100 USD/mcm in mid-February.

Producers/exporters/hedgers (Industrialists) are interested to go along with the LTGEC pricing curve since this curve provides the lowest level of price fluctuations, the highest predictability and transparency of future price behavior due to indexation formulas. And they will be interested to diminish, to narrow the gap of price fluctuations, to decrease price volatility which is detriment to their (mostly long-term) investment and trade decisions non-dependent what is the absolute level of gas prices. Industrialists used hedging with the main purpose to avoid a too high price volatility. And they are looking for a maximum investment price for project financing purposes thus preferring oil indexation among other types of possible indexation instruments.

On the contrary, Commoditization (Anglo-Saxon model) is the main driver of risks and volatility increases, with no benefits for Industrialists. The only beneficiaries are the Banks and other financial institutions who propose derivatives to mitigate these growing risks. But Commoditization develops a vicious circle of risks (as was clearly shown by the oil market development prior to and immediately after the oil price peak of 2008)[41]: the broader the spectrum of risks at the paper market (due to globalization trends), the broader is the spectrum of financial tools to mitigate these risks presented to the market by Banks, etc. This results in higher earnings of financial institutions from their operations at paper commodities market with spot and futures pricing. The losers are the Industrialists (investors in upstream and downstream gas projects) since Anglo-Saxon model is detrimental to project investments and project financing.

5.3 Oil indexation: arguments in favour & against

Petroleum products indexation (PP indexation) has been used in Europe since 1962. It firstly appeared in the Netherlands and has been since then an integral part of the LTGEC of the Groningen type. It took almost 50 years for the contracts of this type (with PP indexation) to spread over throughout the whole territory of the "broader

[41] A. Konoplyanik. Who sets international oil price? A view from Russia (Analysis of 2003-2008 oil price increase and its collapse examined within historical evolution of international oil market contractual structures and oil pricing mechanisms). - *"Oil, Gas and Energy Law" (OGEL),* June 2010, #022, 26 p. (reprinted in: OGEL, vol.9, Issue 1, January 2011).

energy Europe".[42] As it is known, Central Asian gas supplies to Russia – reflecting cross-border supplies within the most Eastern part of the "broader energy Europe's" immobile gas transportation infrastructure - were transferred to the "European formulas" only in 2009-2010.

In the 1960s replacement fuels for natural gas, which has just began to enter the energy balances of the EU states, were residual fuel oil (RFO) in industry and electricity generation and gasoil/diesel (light fuel oil – LFO) in the households. Today a broader spectrum of gas replacement fuels is available in the end-use of the EU states. For example, in EU electricity sector (in electricity production) gas competes today not with RFO (which was almost fully switched away from fuel balance in power generation by oil crises of the 1970s), but with coal and primary electricity, both of non-renewable character (like nuclear) and renewables, while the latter includes both 'traditional', like hydro, and 'new' ones (mostly wind and solar).

But oil indexation still dominates in European LTGEC. According to the International Gas Union, its share has diminished from 80% in 2005 to 2/3 in 2009[43]. According to a DG COMP 2007 Energy Sector Inquiry, in LTGEC of major gas suppliers to the EU (Netherlands, Norway, Russia) PP-indexation equals to around 90%, Algeria has pure oil indexation[44]. The 20-30-years-long duration of LTGEC has expanded implementation of these indexation formulas, relevant for the pre-oil-crises 1960s, to the post-oil-crises years. This means that the gap has been increasing between the economic substance of the "replacement value formulae" and its contractual embodiment, especially in the 1970s and beyond, when after the oil shocks both LFO and RFO began to lose their competitive niches in their respective areas, especially RFO which is no more a dominant fuel both in industry and in electricity generation.

[42] in which I include not only the EU, but all states linked with the territory of the EU with immobile fixed (stationary) energy transportation infrastructure. In other words, nowadays this is the rest of geographical Europe, North Africa, portion of Asia with at least Western Siberia (from where Russian gas supplies to Europe begin), Trans-Caucasus and Central Asia.

[43] Walter Boltz. Presentation on "Gas Pricing" at the 11th round of informal Russia-EU expert consultations on the Third EU Energy package issues/4th meeting Work Stream on Internal Markets, Russia-EU Gas Advisory Council, Moscow, Gazprom / Gazprom export, 26-27.06.2012

[44] DG COMPETITION REPORT ON ENERGY SECTOR INQUIRY, 10 January 2007. Brussels, 10 January 2007 SEC(2006) 1724, p. 103

Moreover, evaluating the entire European gas supply (not only its LTGEC component) in comparative pricing terms between spot indexation and oil indexation, Société Générale analysts estimated that the European gas supply was 44% spot-indexed in 2011, over 50% spot-indexed in 2012 and is likely to exceed 55% spot indexation in 2013.[45]

This shows there is an evident and growing gap between the contract practice and economic realities of using PP-indexation as pricing mechanism in LTGEC. This explains why this issue remains the focus of active debates. Some key arguments of proponents and opponents of NBRV indexation in general and oil indexation in particular are summarised in Table 1. The variety of arguments in favour and against oil indexation clearly indicates that drawing a conclusion that pegging gas prices to oil quotations leads to "unfair prices" is too premature.

Table 1. Oil indexation: arguments "in favour" and "against"

"In favour"	"Against"
1. Contract parties can not manipulate	1. Liquid fuel ceased to be a replacement fuel for gas in industry, electricity generation, but just a reserve (back-up) fuel
2. Worked out in practice for 50 years => convenient for users (got used to it)	2. Conservation without changes does not correspond to evolution of "replacement value-based" mechanism within LTGEC (based on inter-fuel competition) => increasing gap between contractual practice & real life
3. Narrows corridor of price fluctuations, increases price predictability, minimizes investment risks	3. Withhold gas price below oil parity (price of oil in energy equivalent)
4. Convenient (well developed) tool for financial institutions => hedging => softens debt financing	4. Links gas price to highly liquid, but manipulated and unpredictable futures oil/derivatives market => multiple risks for RF budget earnings
5. High oil prices good for project financiers => shorter pay-back periods	5. RF Gov't aim to diminish oil dependency => oil-indexation increases/holds oil-dependency
6. Professional, homogenous, stable and narrow circle of wholesale market participants => transparent and understandable pricing mechanism (for professionals)	6. Confidentiality, thus closed and non-transparent for the public
7. Proposed alternative (spot/futures) is not better today: low liquidity (EU), high possibility for manipulations	7. Post-2009: higher contractual prices compared to spot transactions

Area of continued debate => How to find a compromise (volume flexibility X price flexibility)? Whether it can be found? What can it possibly be alike? No marginal view to win!!! 6

A.Konoplyanik, CEC vs Gazprom

(Table 1: Oil indexation: arguments "in favour" and "against")

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[45] As was citied in presentation of A. Barnes and E. Gribov (Gazprom Marketing & Trading) "Gas producers at liberalized markets" at the pricing Workshop organized within the framework of EU-Russia Gas Advisory Council in Brussels on March 15, 2013.

Today, two of the major arguments in favour of oil/PP-indexation are linked with (a) project financing of upstream projects, and (b) macroeconomic (budgetary) considerations of the countries involved. This means that they are located outside of a purely trade transaction between the seller and the buyer, which, in turn, is a part of the broader investment cycle (project financing considerations), which, in turn, is a part of the broader budgetary consideration of the host state – the owner of the non-renewable resource and the major stakeholder of the company (e.g. Gazprom) who is a producer and seller of the gas (budgetary considerations).

Proponents of oil indexation argue that it is mostly used now as a hedging instrument since all financial institutions got used to deal with oil-futures-linked financial derivatives. In these supporters view, this helps to escape gas price manipulations by the gas actors at the yet non-liquid gas hubs since oil-indexed gas price is linked to price of oil which is developed at the most liquid and global market and it is outside of the reach of the gas market players. However, this argument seems to be flawed to me.

Firstly, deviation of the oil pricing from oil fundamentals link the gas price to the price of a commodity which is established mostly by the non-oil speculators as a virtual price with high volatility based on perceptions of global financial players[46]. Secondly, it seems that the oil price established at the commodities exchanges can be manipulated as well, for example by the major investment banks who are the key actors at oil derivatives markets (this was proven by the US Congress/Senate's investigations regarding the 2008 oil price developments) and/or by oil traders (which was recently illustrated by The Wall Street Journal)[47]. So though as if escaping possible

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[46] А.Конопляник. Кто определяет цену нефти? Ответ на этот вопрос позволяет прогнозировать будущее рынка «черного золота». – *«Нефть России»,* 2009, № 3, с. 7-12; № 4, с. 7-11; A.Konoplyanik. Who Set International Oil Price? A View From Russia. – Centre for Energy, Petroleum & Mineral Law & Policy, University of Dundee. International Energy Law and Policy Research Paper Series, Working Research Paper Series No: 2010/02, 18 February 2010, 20 p. (http://www.dundee.ac.uk/cepmlp/gateway/index.php?news=30776); Бушуев В.В., Конопляник А.А., Миркин Я.М. и др. Цены на нефть: анализ, тенденции, прогноз. – М:, ИД «Энергия», 2013, 344 стр.

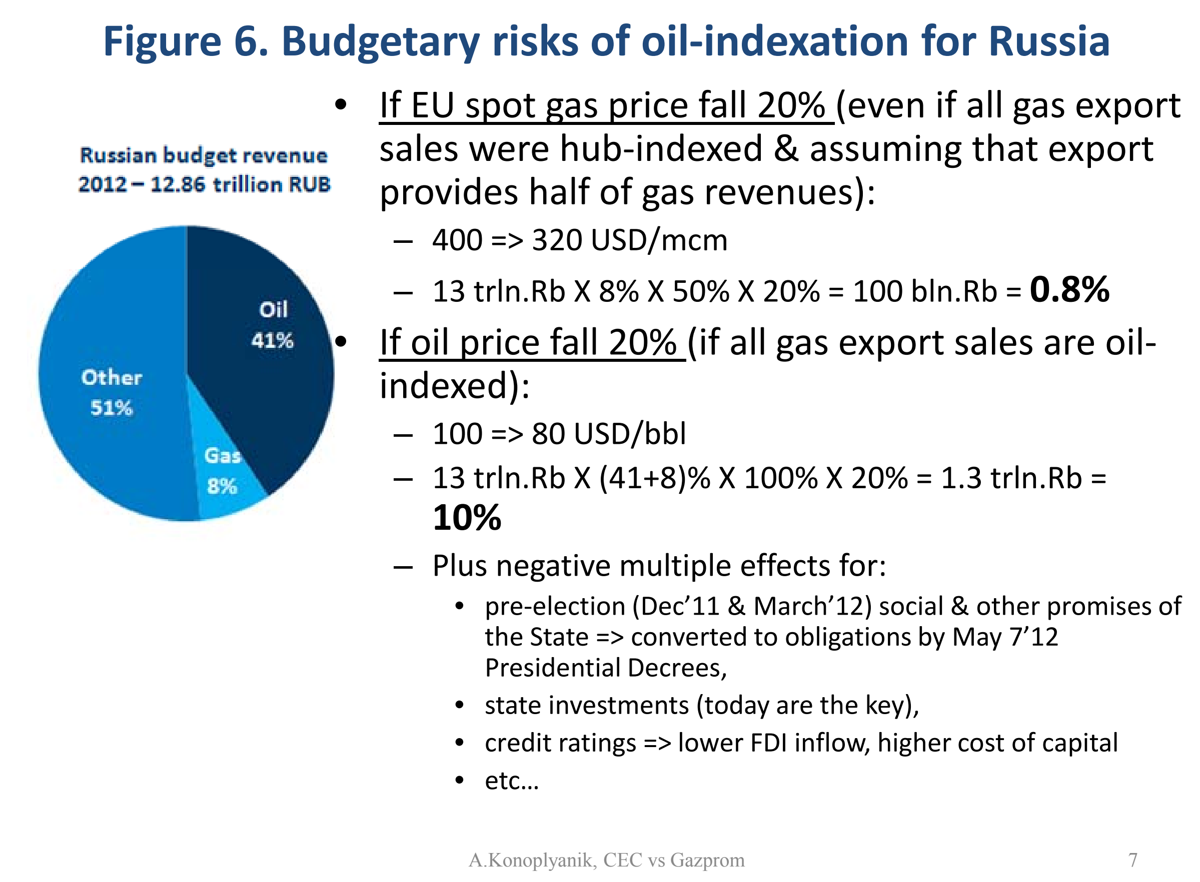
[47] Джастин Шек, Дженни Гросс. Как нефтяные трейдеры манипулируют ценами. – «Ведомости», 20.06.2013, 107 (3369) (http://www.vedomosti.ru/newspaper/article/472991/kak_neftyanye_trejdery_manipuliruyut_cenami#ixzz2WkIT

manipulations of the gas price by gas actors by linking it to oil price, established at the commodities exchanges through the trade in oil-related financial instruments (derivatives), we thus just jump into real manipulations of the oil price by non-oil financial speculators and/or oil traders.

And the risks of price fluctuations at the oil market would be much more dangerous and destructive for the oil and gas dependent Russian state budget than the risks of possible gas price manipulations by the hub players, if one would suppose that all gas pricing in the EU is switched from mostly oil-indexation to total hub-indexation, as (has been) proposed by, say, J. Stern[48] and/or is aimed for by the EU Regulators in further implementation of the provisions of the Third EU Energy Package in gas (Figure 6). Illustrative calculations show, that if gas prices fall by 20% (from 400 to 320 USD/mcm) in case of a, say, non-oil-indexation of gas price (i.e. hub-based price), Russia's budgetary losses will equal to 0.8% of budget revenues. But in case of 20% fall in oil prices with continued oil-indexation in gas, this losses will be more than ten times higher – 10% of budget revenues.

Uhd5); М.Овчаренко. Как Platts защищается от манипуляторов. – «Ведомости», 03.07.2013, 116 (3378) (http://www.vedomosti.ru/newspaper/article/482241/kak-platts-zaschischaetsya-ot-manipulyatorov#ixzz2XzC9W1fW).

[48] See Jonathan Stern's publications and presentation at www.oxfordenergy.org, and, for instance: Jonathan Stern and Howard Rogers. The Transition to Hub-Based Gas Pricing in Continental Europe. The Oxford Institute for Energy Studies, March 2011, NG 49, P.31-32, http://www.oxfordenergy.org/wpcms/wp-content/uploads/2011/03/NG49.pdf



(Figure 6. Budgetary risks of oil-indexation for Russia)

It is quite clear that the major challenge which the Russian Government - the major stockholder in Gazprom – is facing today is how to find a balance between short-term budgetary requirements and long-term macroeconomic state considerations.

Short-term budgetary constraints are the result of pre-election social & other promises of the State in December 2011 (State Duma elections) and March 2012 (Presidential elections) which were converted into State obligations by May 2012 Presidential Decrees. They demand the support of a high selling price within the given contractual structures by any means, including in arbitration courts, when/if price review negotiations will happen to end up there. Court procedures (if the claims from commercial counterparties are not settled in pre-arbitration order) will definitely last for some time and their decisions will not necessarily end in favour of Gazprom's customers. But if so – it is not necessary that court decisions will be enforced to the initial date of the claim or the date when the price gap has appeared. So the Russian state might expect by this short-term approach to at least prolong some period of incremental budgetary earnings though losing step-by-step long-term market share of its gas in Europe.

Longer-term macroeconomic considerations should be aimed at protecting Russia's/Gazprom Group's market share in the EU which requests reaching a mutually appropriate price level both for producers and consumers, exporters and importers. In today's circumstances this means, from my view, to find a compromise "between Komlev and Stern".

5.4 "Between Komlev and Stern"

During the 5th Gas Congress of the CEE countries, which took place on September 11-12, 2012, in Prague, Jan Klepac, the Executive Director of Slovak Gas & Oil Association, mentioned that "in debates on gas pricing mechanisms we live in Europe between Komlev and Stern". These words meant that both of the aforementioned gentlemen presents diametric views in the spectrum of possible opinions, regarding the future prospects of indexation as a gas pricing mechanism.

Sergei Komlev, the Head of Contract Structuring and Price Formation Directorate, Gazprom export LLC, is actually the official public representative (spokesman) of Gazprom in support of keeping PP-indexation in Russian LTGEC to Europe[49] within the term contract's segment of two-segment EU gas market model.

Jonathan Stern, Chairman and Senior Research Fellow, Natural Gas Research Programmes, The Oxford Institute for Energy Studies, has an opposite view stating that the best pricing mechanism for gas for emerging internal European gas market is a hub-based pricing both within spot and term market segments[50]. He proposes two-step move to hub-indexation in term contract's EU gas market segment:

[49] See S.Komlev's presentations at www.gazpromexport.ru

[50] See J. Stern's presentations and publications at www.oxfordenergy.org.

- at the first – transition - stage he proposes step-by-step switching from PP-indexation to hub-indexation (providing as example a six-month transition period), taking today's correlation between contractual and spot prices as a starting point and bringing it to 1:1 in the end of sixth month. That will enable, from his view, very easily to move then – when same price levels achieved – from one pricing mechanism (PP-indexation) to another (hub-indexation),

- at the second stage – to continue with hub-indexation, "adjustment completed, market price adopted thereafter",[51] everywhere – both in spot and term-contracts market segments.

In my opinion, both positions present rather marginal views. This author tries to find a mutually acceptable compromise between Komlev's Scylla and Stern's Charybdis. I think it is impossible to maintain the all-round PP-indexation within all LTGECs within term segment of gas market in Europe (Komlev's view), nor possible to transfer all gas pricing in Europe to the spot quotations, both in spot transactions per se, as well as to switch to them in LTGECs (Stern's view).

In the latter case the idea of switching from oil-indexation to spot-indexation in the existing Russian supply contracts to the EU, e.g. in the contracts with major wholesale EU intermediaries (with the delivery points at the former "old" EU border), who will then just re-sell Russian gas at the EU hubs and/or to the final customers thus minimising their own pricing risks to zero by using the same pricing mechanism (spot-indexation) in their buying (LTGEC purchases with hub indexation) and selling (hub-trading with hub indexation) schemes is a "no go" scenario" for Gazprom/Russia since it will put all the incremental risks on the producer.[52]

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[51] Jonathan Stern and Howard Rogers. The Transition to Hub-Based Gas Pricing in Continental Europe. The Oxford Institute for Energy Studies, March 2011, NG 49, P.31-32, http://www.oxfordenergy.org/wpcms/wp-content/uploads/2011/03/NG49.pdf

[52] For more details see, for instance: A.Barnes, A.Konoplyanik, D.Leonov. "Long term contracts and oil indexation". - EU-Russia Gas Advisory Council's Pricing Workshop, Albert Borschette Conference Centre – Room 4C, Rue Froissart, 36 – 1040 Brussels, May 15, 2013; A.Konoplyanik. "Russian gas to Europe: from simple to multiple contractual structure". – Выступление на VIII Международной конференции «Энергетический диалог: Россия-ЕС. Газовый аспект», Круглый стол 2 «Давайте поговорим о бизнесе: Как российские и европейские компании хотели бы работать друг с другом?», 30 мая 2013 г., Брюссель, Бельгия.

So it is very important to bear in mind that the contractual structure of Russian gas supplies to the EU should not and will not stay the same. It shall be adapted. The opportunities provided by the Third EU Energy Package to non-EU suppliers to go directly to the hubs and/or to the final customers and thus by-pass existing major wholesale buyers-resellers of Russian gas "at the border", will change the pricing mixture not within existing contractual structures but within the new contractual structure of Russian gas supplies to the EU which will be much more flexible and will provide the opportunities for Russian gas flows to move to/from term segment of the EU gas market to/from its spot segment. The Third EU Energy Package provides for Russian gas to be directly present at the hubs without EU intermediaries. So it would be no more possible for wholesale EU buyers of Russian gas to resell at the hubs excessive volumes of Russian gas (bought under TOP obligations and within LTGEC nominations flexibility in favour of the buyer) and thus to drive down further the EU hub gas prices to the detriment of the producers facing capital-intensive obligations in the upstream.

From my view, it is for market players to decide which particular mix of contractual structures and pricing mechanisms they would prefer in each individual case within the legal framework of the Third EU Energy package. It should be a "soft landing" to a new equilibrium consisting of different contractual mixes based on a portfolio management approach within different EU areas with different availability of alternative supplies and diversity of infrastructure.

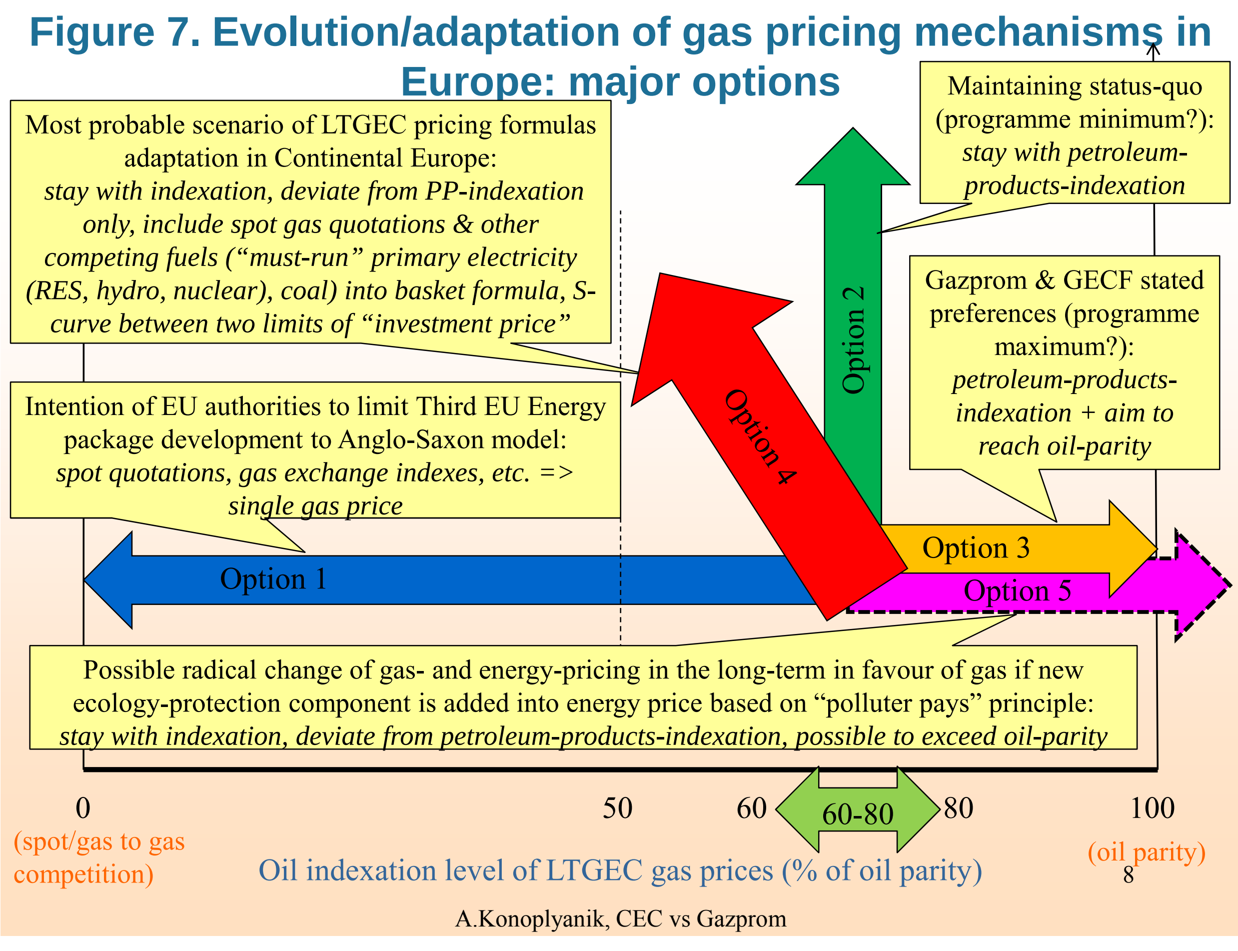
I think that the most likely scenario among those five that I identify today in the public domain, including Komlev's and Stern's[53], is that indexation mechanism in European LTGEC (piped gas) will be kept since it links gas price to prices of competing energies and, within gas-to gas competition, to alternative gaseous energies (pipeline gas vs. LNG, shale gas…) and gas supplies/suppliers. PP-indexation will not stay, from my view, as the sole type of indexation within term-contract's market segment.

[53] A.Konoplyanik. How to manage gas price risk? - *"Echanges"* (Bulletin of French Society of Chief Financial Officers), № 298, May 2012, p.42-46.

We will, most probably, face something like "hybrid indexation", e.g. increasing indexation to:

- hubs (hub-indexation), which will reflect growing gas-to-gas competition,
- and other – new – energies, which will reflect growing gas vs. non-gas competition. These "other" includes, first of all, "must-run" primary electricity from "new" renewables such as wind and solar, but also hydro, nuclear and coal (Figure 7).

This is Option 4 at Figure 7.



(Figure 7. Evolution/adaptation of gas pricing mechanisms in Europe: major options)

In my view, such a soft adaptation is inevitable since the gas business, as any other capital-intensive business, is not tolerant to upheaval and sharp movements. Through at least the last decade the gas business consistently stays with the opinion that oil-indexation will stay as a part of the LTGEC. Results of regular polls organised by the above-mentioned Prof. J. Stern at the annual FLAME gas conferences, shows that diminishing, but still visible part of the audience consider straightforwardly that oil-indexation within LTGEC will stay forever. Their portion began to quickly diminish as of 2009 when the EU gas market has started and continuously been facing since then the oversupply (Table 2). And in J. Stern's own interpretation, that he gave to me during one of our personal communications, the part of the audience (approximately half of respondents) that have been choosing the answer "After 2015" in the recent years to the poll's question: "When do you expect European long term contract gas prices will become decoupled from oil and determined by spot and futures prices?", was factually considering that oil-indexation will stay for long time but do not know for how long. This is why they have been choosing this neutral answer which can mean both 2020, 2030, etc. So in conclusion, from even his view, we can consider that at least 2/3 of the audience think that oil-indexation in LTGEC will around stay for a long time.

Table 2. Results of J.Stern's FLAME polls on expected time of gas price decoupling from oil prices, 2004-2012 гг.

<u>Table 1:</u> When do you expect European long term contract gas prices will become decoupled from oil and determined by spot and futures prices? (% of total)

Year of Conference poll	2004	2005	2008	2009	2010	2011	2012
Before end 2010	24	15	9	4	4	7	4
Before end 2015	36	15	22	20	20	24	28
After 2015	15	39	43	44	51	45	53
Never	24	31	29	32	25	24	14

Source: J.Stern. "Continental European Long-Term Gas Contracts: is a transition away from oil product-linked pricing inevitable and imminent?", OIES, NG34, September 2009, p.5; Ibid. "Gas Price Formation in Europe: rationale and next steps", GMT, 8 October 2010; and also the data kindly provided personally by J.Stern to the author

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A.Konoplyanik, CEC vs Gazprom

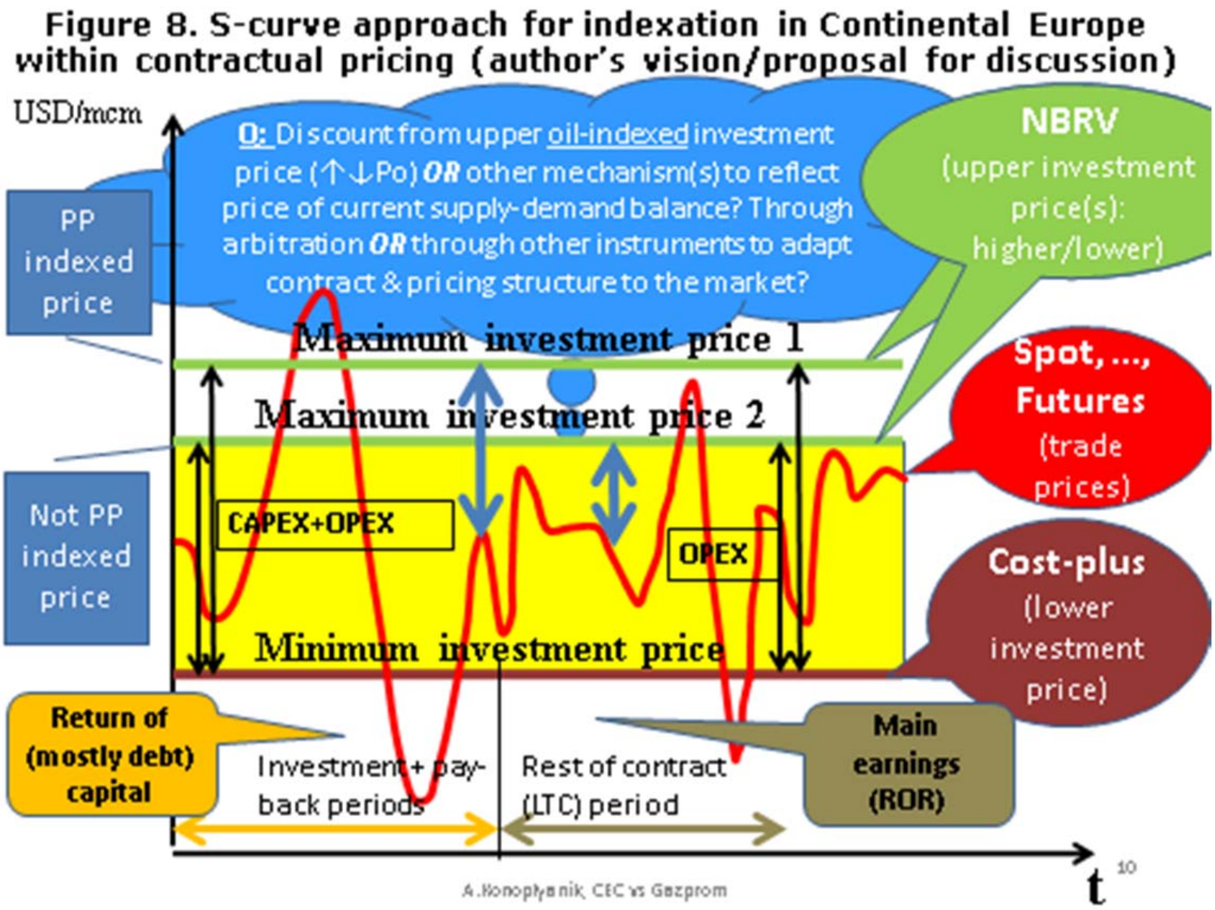
(Table 2. Results of J. Stern's FLAME polls on expected time of gas price decoupling from oil prices, 2004-2012 гг.)

5.5 S-curve within two investment prices

The other variant of hybrid indexation might also be possible to consider: the use of the so-called S-curve mechanism. I mean the introduction of the upper and lower limits for fluctuations of gas prices (corresponding to the maximum and minimum investment prices in terminology of this article and as reflected at Figure 3) within LTGEC pricing mechanism in conditions when the price itself might reflect spot quotations within any specific regional area, where the end-use customers of the given supplier are located.

The upper investment price level corresponds to NBRV and it shall be the maximum acceptable price for the consumer (and the minimum price among competitive supplies available to him). It should be not higher than the lowest NBRV level from available competitive supplies in this area, e.g. both from other energies competitive to gas, as well as from other competitive supplies of gaseous fuels.

The lower investment price is a cost-plus price which is minimum acceptable price for project financing. Such mechanism with upper (ceiling) and lower (floor) limits for price fluctuations can apply, in my view, at least for the investment plus pay-back period (Figure 8), as it provides opportunities for project financiers to calculate project's financial economics. So, the price lower than the bottom price level is discriminative for gas supplies (discriminates project financing), and the price higher than the upper price level is discriminative for gas supply of the given supplier (if exceed his competitive price which will stipulate deviation from his gas in particular), and when/if it will go higher, it might become discriminative for gas demand in general.



(Figure 8. S-curve approach for indexation in Continental Europe within contractual pricing (author's vision/proposal for discussion))

The key question is what to do when there are available supplies in the given market area with the prices below oil-indexed LTGEC price? There are at least two possible options (to be further discussed) of how the level of competitive price in this area can be achieved by the supplier in such case. Option 1 – to stay within oil-indexation but to discount from upper oil-indexed investment price by changing in a handy manner the level of "Po" in the oil-indexation formulas[54]. Option 2 – to deviate from oil-indexation and to find other ways and means which will lead to a price reflecting current supply-demand balance in this area.

In case of option 1 the next question arises: how LTGEC oil-indexed prices should be adapted: through arbitration mechanisms (obligatory decisions of the third party) or through other instruments to adapt contractual and pricing structure to the market (including, of course, bilateral negotiations between the supplier and his customer)?

In answering this question, the industry view is quite clear (as it was demonstrated, for instance, by one other poll, organized by Gas Strategies at one of the European Annual Gas Conferences)[55]:

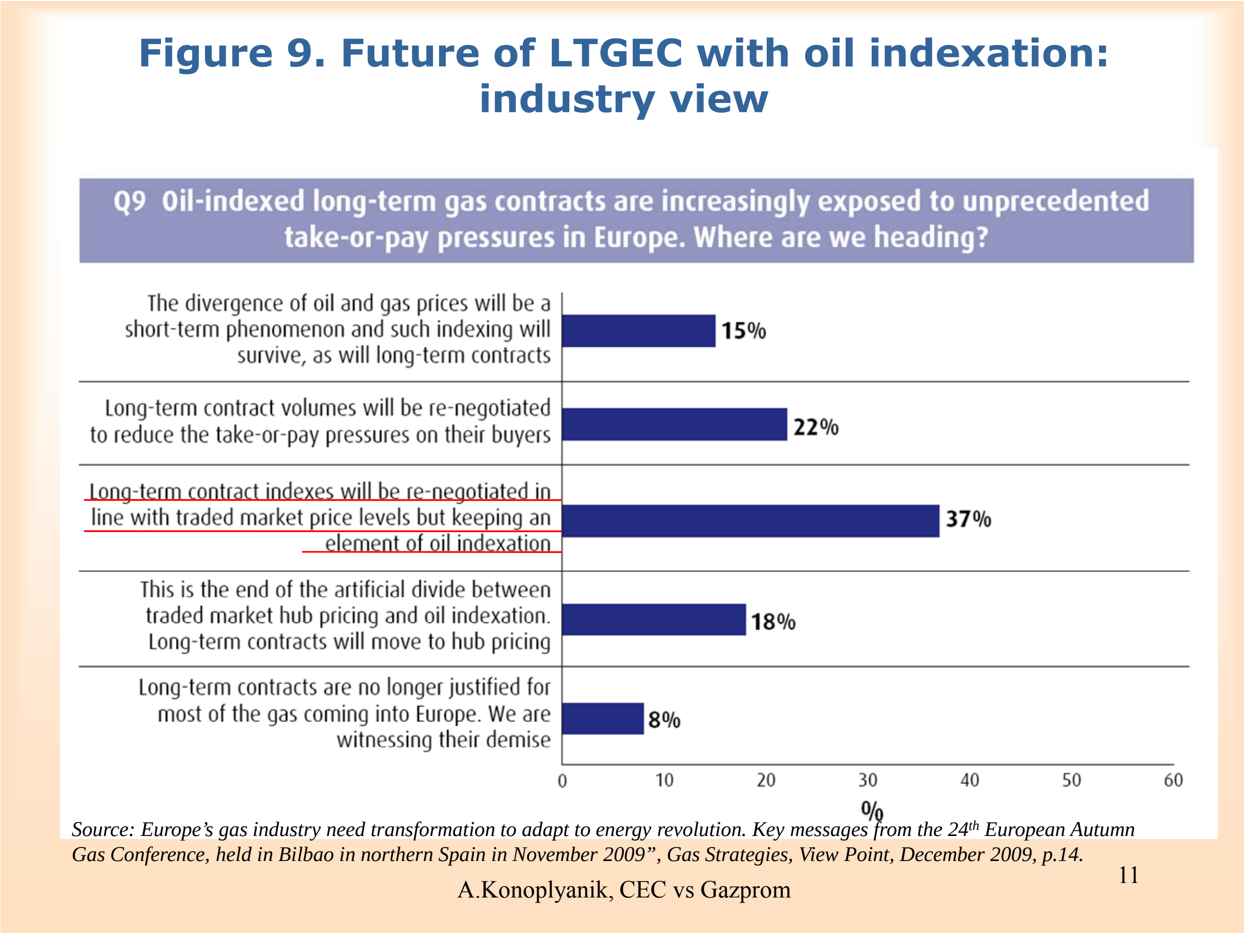
- in answering the question: "Oil-indexed long-term gas contracts are increasingly exposed to unprecedented take-or-pay pressures in Europe. Where are we heading?", relative majority of respondents (37%) has answered that "Long-term contract indexes will be *re-negotiated* (italics – A.K.) in line with traded market price levels but keeping an element of oil indexation" (Figure 9), and

- in answering the question: "With an increasing number of long-term contracts under review pressure, how do you think this is most likely to be resolved, given the large amount of value embedded in them?" absolute majority of respondent (2/3) has answered that "The issues are too profound and complex to leave to

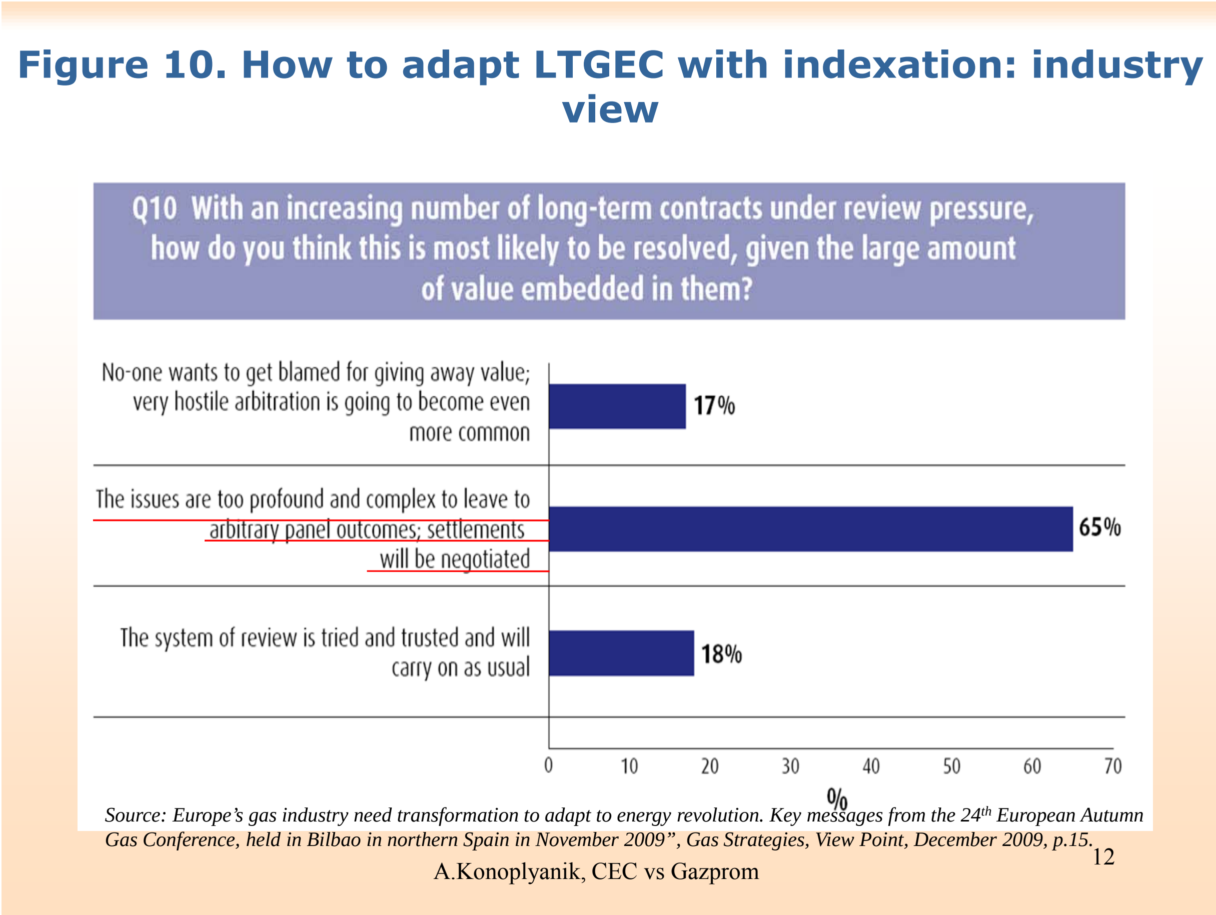
[54] For general structure of the oil-indexation formula see, for instance: *Putting a Price on ENERGY: International Pricing Mechanisms for Oil and Gas.* Energy Charter Secretariat, Brussels, 2007, p.154-155 (www.encharter.org/publications/2007); А.Конопляник. Российский газ в континентальной Европе и СНГ: эволюция контрактных структур и механизмов ценообразования. Москва: ИНП РАН, 2010 г., с.17.

[55] Europe's gas industry needs transformation to adapt to energy revolution. Key messages from the 24th European Autumn Gas Conference, held at Bilbao in northern Spain in November 2009, Gas Strategies, View Point, December 2009 (link at: http://www.gasstrategies.com/node/45684)

arbitrary panel outcomes; settlements will be *negotiated*' (italics – A.K.) (Figure 10).



(Figure 9. Future of LTGEC with oil indexation: industry view)



(Figure 10. How to adapt LTGEC with indexation: industry view)

This means, that from the industry's view it is for market participants to decide which particular pricing mechanism and contractual structure suits them best in the given circumstances and to find the best effective well balanced long-term solutions – and not to be decided for them by the third parties.

The most frequently voiced proposal for option 2 (at least by the consumers) – is to index gas price in LTGEC to hub prices, i.e. to substitute within current contractual structures (LTGEC between producers and wholesale buyers - resellers of their gas) oil-indexation by hub-indexation. But from my view, this is a "no go" scenario for gas producers, who have been facing continuously increasing investment risks in producing incremental amount of gas needed both for providing additional supplies of gas to the market, but – most importantly – to compensate for the diminishing volumes of production at existing fields to fulfill contract obligations within acting LTGECs. They need to develop more costly fields located in more distant areas (from the markets) and more severe environment. This is why substitution of oil-indexation by gas-hubs-indexation (gas-to-gas competition) *without* changing/adapting existing in Europe (for 50 years already and for well-explained above political and economic reasons) contractual structure between producers and wholesale buyers is not a balanced (and thus is not a long-term) solution since it will put all the price risks on the producers. Why so? Just because, as was already mentioned above, within existing LTGEC with hub-indexation wholesale buyer/reseller will face zero price risk since he will buy and then resell the gas at hub-based prices. And it will be producer who will face all price risks in such case.

On top of this, consumers demand that TOP obligation should be either cancelled (by proposing to deviate from term contracts to spot transactions where there will be just no place for TOP provisions) or to significantly downgrade TOP level within existing LTGEC structures with proposed deviation from oil-indexation to hub-indexation. But TOP provisions in the LTGEC structure is a major mechanism of providing to producer (and to financial community which provide debt financing for producers) minimum guarantees of cash flow (export revenues) needed to repay his CAPEX in upstream project (production + transportation) and thus to receive upfront major commercial debt financing.

So both interlinked proposals from the consumer-side on how to adapt existing oil-indexed LTGECs (to deviate from oil-indexation to hub-indexation and to downgrade TOP levels within LTGECs) will definitely favour major wholesale intermediaries (and not necessarily end-users) but would be definitely to the detriment of the producers – wholesale suppliers. So this debate should be continued.

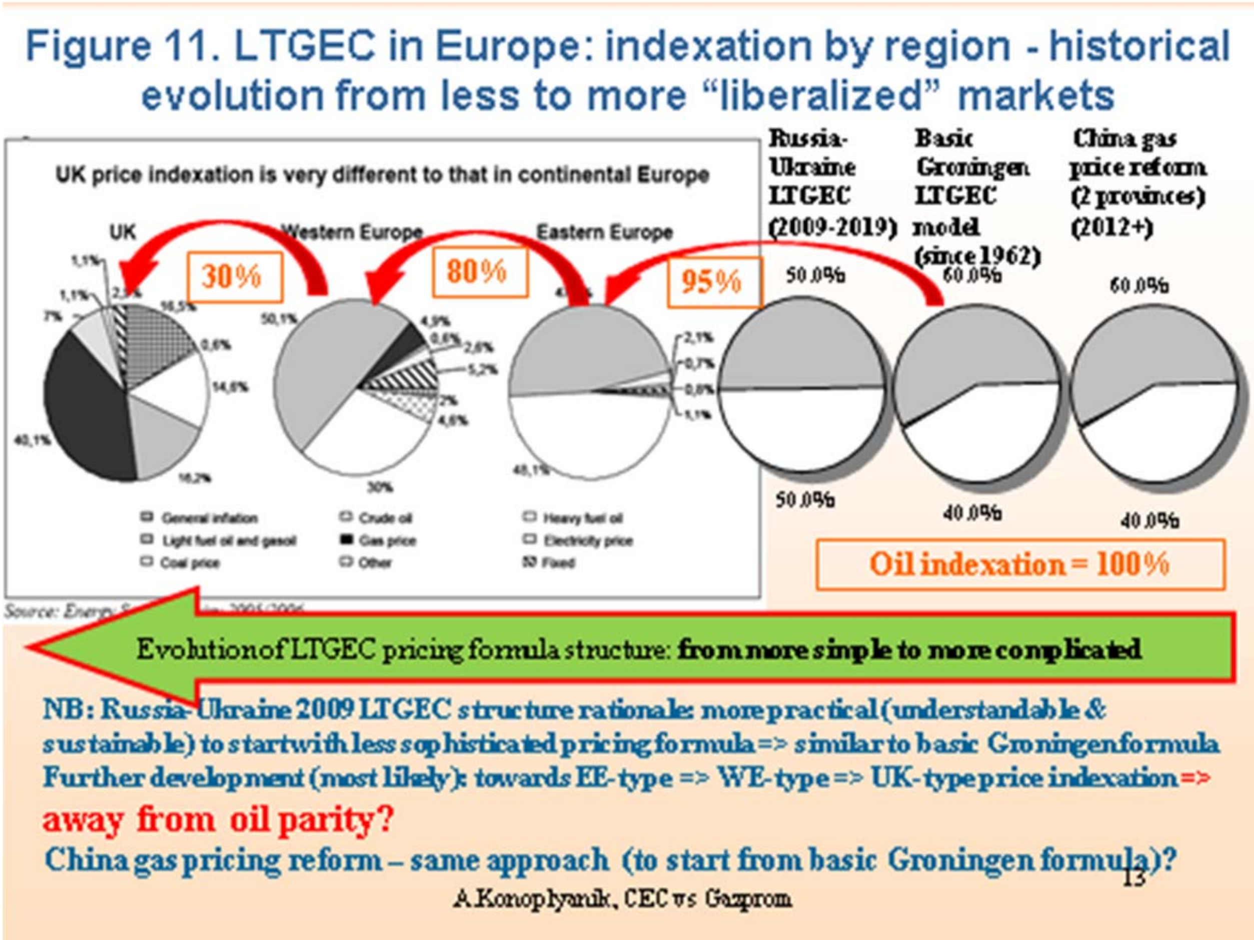
Both proposed options (illustrated at Figures 7 and 8) and related argumentation can be considered as this author's contribution to and subject for continuing debate on the best effective adaptation of gas pricing mechanisms in the Continental Europe’s market. And I have no reason to consider, as the DG COMP/CEC seems to do, that Gazprom works with "unfair prices" which it imposes on its buyers. If Gazprom’s customers (including corresponding EU Member States and/or EU in general) have not taken care of the formation of alternative supplies through more than 20 years of their factual independency (since the disintegration of CMEA) and through almost their 10 years of membership in the EU, what then are Gazprom's faults in the inactive behaviour of these countries in this regard?

5.6 More liberalization & competition – less oil-indexation?

In 2007 the DG COMP presented its "Energy Sector Inquiry"[56] which shows that there is a justified evolution of the structure of gas price indexation mechanism (gas pricing basket) within LTGEC in Europe as the markets move from less to more liberalized energy markets. In my opinion,[57] it can be considered as on objectively determined trend.

The basic Groningen LTGEC formula proposed the 100% oil/PP-indexation with 40% in price basket (pricing formula) for RFO and 60% for LFO (gas-oil and diesel). In modern Eastern Europe (which is the least liberalized or the least competitive part of the EU) the PP-indexation covers 95% of the LTGEC pricing formula. In more liberalized "core" part of Continental Western Europe this ration is at the level of 80% and in the most liberalized and most competitive part of the European gas market, the United Kingdom, it is only 30% (Figure 11). The conclusion is obvious, at least to me: the more competitive is the gas market, the less dependent it is from PP-indexation (the lower is the role of PP-indexation if the pricing basket), the more complex (diversified) becomes the structure of such price basket. It more and more tends to be formed within the given company/country on the basis of the "portfolio pricing" principle.

[56] DG COMPETITION REPORT ON ENERGY SECTOR INQUIRY, Brussels, 10 January 2007, SEC (2006) 1724, 110 p.
[57] Which is based on and supported by my long academic experience and is incorporated in my lecture's courses at the Masters Programmes at the Chair "International Oil and Gas Business" in the Russian State Gubkin Oil & Gas University.



(Figure 11. LTGEC in Europe: indexation by region - historical evolution from less to more "liberalized" markets)

The above-mentioned trend makes the following conclusion for me quite obvious, though this conclusion has no direct connection with Europe and conflict between the EC and Gazprom/Russia resulted from the Commission's raid against Gazprom on September 4th 2012. The gas pricing reform, started simultaneously on different markets, such as the Russian-Ukrainian gas trade relations, on the one hand, and reform of the domestic Chinese gas market, on the other hand, seems to have some general characteristics in its basis:

(1) it is more practical (comprehensible and safe) to begin the transfer to contractual frameworks with integrated pricing mechanisms starting with a less complex pricing formula, similar to the Groningen basic formula, worked out during 50 years of its practical implementation,

(2) the probable further development of the pricing formula structure in both cases seems to follow the movement in the direction of further "diversification" of the pricing formula (increasing number of its ingredients) through the trajectory "Eastern Europe - Western Europe - United Kingdom".

(3) the role of PP-indexation in the average pricing formula will be imminently diminishing, though it will stay within (protect) its competitive niche.

The CEE countries have started late and are moving most slowly with the aforesaid changes in Europe gas markets for obvious reasons. And it is not Gazprom's fault as is presumed by the CEC/DG COMP.

Once again: the key principle for any capital-intensive industry, including the upstream gas (production and transportation, especially long-distance, which means long-term, which in turn means big volumes of supplies to justify through "economy of scale" principle acceptable economics of these supplies) is: no revolutionary changes, only soft adaptation. The driver for soft evolutionary changes should be the objective tendencies of gas market development, which means increased competition, not the administrative pressure and, more than that, - not administrative confrontations. And for forming a competitive market, adequate development of infrastructure is needed in which the investment climate plays an important role in the country or, in other words, in the EU. Again, Gazprom has no role to play in this situation with regards to the EU's investment climate.

6 Are there any other reasons?

What are the possible other reasons for the current confrontation of the CEC against Gazprom?

The current economic crisis in the Eurozone and its approaching second wave are, of course, one reason. In such circumstances the Commission might want to support their national energy companies - the wholesale purchasers (intermediaries/resellers) of the Russian gas and large taxpayers in the EU. The oversupply of gas in the EU has led to reduction of its retail prices (sales prices for purchasers and wholesale resellers of the Russian gas), while the wholesale prices (purchase prices of the Russian gas for these intermediary companies) remained at a high level. "Take-and/or-pay" obligations are forcing them to continue to buy the Russian gas at high wholesale prices while the market is characterized by the excess supply of gas with lower spot prices. All regulatory measures, including restrictions on retail sales on the long-term basis, force them to sell the gas, purchased at high wholesale prices, to end-users in accordance with low prices of the spot market.

This situation leads to the negative profitability of electricity generation from oil-indexed gas (negative spark spreads) and to huge losses of these EU intermediary companies. And if there is no profit – there are also no income taxes because of the fact that the taxes in Europe are not revenue-based, but profit-based, contrary to, say, the Russian Federation. It is exactly this situation which, in my opinion, has quite naturally provoked the waves of lawsuits and arbitration proceedings, initiated by European companies-purchasers of Russian gas against Gazprom since these companies have not managed to persuade Gazprom (and/or its major stockholder) to lower its oil-indexed export prices. So, it is nothing personal, but just business, for both sides.

Taking into consideration that we nowadays live in an era of not so much actual facts and events, but one of their interpretations and/or expectations, assumptions and perceptions, I think that one of the real intentions of the loud-spoken statements about the investigation of the Commission against Gazprom might be the desire to create the negative public environment, an image of negative expectations, assumptions and perceptions around Gazprom (on top of the existing ones) in the processes of arbitrations, commenced against it by a number of the EU companies. This situation can influence neutral and independent European and/or international courts in the process of arbitrations against Gazprom and in the process of decision-making in favour of the purchasers of its gas. This matters especially when we consider that - according to the statement of Mr. Colombani (see the beginning of this article) - the Commission launched the investigation at the request of "market participants".

"Economy of trade" based on the resale of the Soviet/Russian gas to the end-users in the EU by large European companies - wholesalers-intermediaries, which for the last decades have grown on this business up to the level of "national champions", begins to experience problems. The role of these companies wanes. The Third EU Energy Package opens (though yet potential) opportunities for bypassing these intermediaries (their exclusion from gas supply chain) by establishing direct links between producers (both European and non-European ones) and European end-users of gas. In the long term, within the new framework of the European gas market, these wholesalers-intermediaries will probably not find any other such a market niche (at least, such a great one), which was predetermined for them in the conditions of politically divided Europe at the time of the Cold War, when the current gas infrastructure within the "broader energy Europe" was formed.

Therefore, on the one hand, these "national champions" with their long-term "trade" contracts (as opposed to long-term "investment" contracts of the producers, see Figure 1) were the genuine goal of reformative efforts of the Commission and its DG COMP. On the other hand, today the Commission seems to support national companies of the EU countries, by means of artificial worsening of competitive environment for their non-EU partners-competitors. One of the means for this charitably speaking, for example, is insufficiently economically motivated claims and trials.

One more purely political explanation of the Commission's behaviour (from the position of "populism policy") might be a enforced switching of the public opinion of the EU from their inner crisis problems of the Community to the mythic "foreign enemy", forming from this enemy an image of "real threat". Unfortunately, the Russian-Ukrainian crises of Jan'2006 and Jan'2009 played their negative role and provided willingness of the European public opinion to take the "bait" once again and be ready to accept the "enemy image", which is shaped from Gazprom by collective efforts (alas, but sometimes not without the help of Gazprom itself).

I say it time and again that the 19-days break in gas supplies (3 days - in January 2006 and 19 days - in January 2009) not only crossed out 40 previous years of uninterrupted gas supplies from the USSR/Russia to Europe in the eyes and minds of many Europeans, but, and this is more significant, launched the "domino effect" in the EU:

- first, there were politically-motivated decisions adopted aimed at diminishing of the dependence on the Russian gas and at increased diversification of gas supplies;
- then they were strengthened by adoption of corresponding legislative acts, requiring investment decisions for their implementation ;
- after that these investment decisions were launched which means coming through the "no return" point which since that moment made realization of the model on drift from the Russian gas a slow but irreversible process.

Thus, the shrinking of the competitive niche for Russian gas and the increasing competition within this niche becomes today, within an oversupplied EU gas market, a more difficult process for Gazprom to protect its competitive niche, at least, with the help of traditional tools, used in the past, in the period of relative undersupply of gas in the EU prior to 2009. There is an urgent need to adapt behaviour in accordance with the changing market pattern and Gazprom has already started such an involuntary adaptation after 2009. Gazprom will be more effectively forced to continue such adaptation due to the increasing competition and changing external environment (due to Third Energy Package rules) for their operations on the EU market, rather than annual raids of the Commission and its DG COMP.

Summarizing: In my opinion, the DG COMP represents the true factual angle in this case, but made incorrect assumptions and cause-and-effect relations towards the current dominant position of Gazprom in the CEE countries. Thus it provides the wrong course (logic) for further actions. They seemed to have triggered a political "domino effect" preventing the strengthening of cooperation between the EU and Russia in the energy field (and not only in such field). But both countries should focus instead on finding mutually acceptable/beneficial decisions for the EU and Russia (as two sovereigns) or the EU and Gazprom (as a sovereign and an agent managed by another sovereign), increasing the level of cooperation between the parties, minimizing risks and uncertainties to the tolerable level.

List of abbreviations:

CAPEX – capital expenditures

CEC – Commission of the European Communities

CEE – Central and Eastern Europe

CEER – Council of European Energy Regulators

CEO – Chief Executive Officer

COMECON, CMEA – Council for Mutual Assistance and Cooperation

DG COMP – Directorate General for Competition of the Commission

DG ENERGY – Directorate General for Energy of the Commission

ECT – Energy Charter Treaty

GAC – (EU-Russia) Gas Advisory Council

LFO – light fuel oil

LLC – Limited Liability Company

LNG – liquefied natural gas

LTGEC – long term gas export contract

MTPA – mandatory third party access

NBRV – net back replacement value

OJSC – open joint stock company

OPEX – operating expenditures

PP – petroleum products

RIA “Novosti” – Russian Information Agency “Novosti”

RFO – residual fuel oil

ROR – rate of return

TOP – “take-and/or-pay” (provision of LTGEC)

TSO – transmission system operator

VIC – vertically integrated company

USD – United States dollar