

**South Stream as one of Ukrainian
by-passes: How to find new
equilibrium in new circumstances
(some thoughts for further
consideration – invitation to the
audience for joint promenade
through the minefield)**

**Prof. Andrey A.Konoplyanik,
Advisor to the Director General, Gazprom export LLC,
Professor, Chair “International Oil & Gas Business”,
Russian State Gubkin Oil & Gas University**

Presentation at **The Sixth Annual Colloquium: “Geo-Eco Politics,
Eurasian Energy and (elusive) Transparency”, Session V. South
Stream Pipeline: Business or Politics? Road to Peace and
Cooperation?** – Columbia University in the City of New York, The
Harriman Institute, New York, NY, USA, 16 April 2013

Russia-EU-Ukraine's new circumstances: 22 days vs. 40+ years

- “Matrix effect”: 22 days of interruptions of Russian gas supplies to the EU via Ukraine (3 days in Jan’2006 + 19 days in Jan’2009):
 - Has overbalanced previous 40+ years (since 1968) of stable & non-interruptible supplies,
 - Has changed perceptions within all three parties on stability & non-interruptible character of future gas supply through this chain => each party has its own vision & answers
 - New perceptions => political statements & decisions => legal documents => investment decisions for new equilibrium to be reached =>
 - “No return” points for each party => What are they? Whether they are reached already?

EU-Ukraine-Russia: in search for new equilibrium with different aims & different responds

- EU:
 - *to diminish dominant role of Russia as major supplier*
- Ukraine:
 - *to escape monopoly of Russia as one single supplier*
- Russia:
 - *to escape monopoly of Ukraine as one dominant transit route*
- => to find new equilibrium within multidirectional individually enforced changes => a long & winding road to new compromise... but
- Narrowing corridor for new equilibrium

New risks, new challenges, new responds, “no return” points: the EU (1)

- Perception: as if non-reliable future supplies from Russia via Ukraine to EU =>
- Responds: organization of new internal EU gas market architecture with *multiple supplies* & (high) *flexibility*
- Multiple supplies by:
 - Alternatives to Russian gas (supply side): SOS Directive (3 gas supply sources/MS, etc.), LNG, shale gas, UGS => ***to diminish dominant role of Russia as major supplier***
 - Alternatives to (RUS) gas (demand side): climate change => decarbonization => RES, energy efficiency => shrinking gas share in fuel mix => the loser would be a less competitive gas supplier (perception: most distant & costly Russian gas?)

New risks, new challenges, new responds, “no return” points: the EU (2)

- (High) flexibility by:
 - Diminishing barriers for gas flows: interconnectors, reverse flows, spot trade, demand for softening LTGEC provisions (TOP), ..., new market organization => TEP
- Third Energy Package (03.09.2009):
 - Set of legal instruments providing multiple supplies & flexibility within EU & Energy Community Treaty area based on new principles of internal market organization
 - from a chain of 3 consecutive LTCs (1968-2009) – to Entry-Exit zones with Virtual Trading Points (hubs)
 - New architecture of EU gas market under development => Gas Target Model, 12 Framework Guidelines, 12(+1?) Network Codes
- => **“No return” point has been passed by EU**

New risks, new challenges, new responds, “no return” points: Ukraine (1)

- UA: Euro-integration vs. CIS-integration => this “no return” point was passed in 2004 => Euro-integration choice =>
- Since Spring’2004 => UA demand to unbundle supply & transit contracts & to move to “European formulas” in RUS-UA gas trade:
 - UA expectations: to receive higher transit rates
 - UA reality: has received higher import prices
- Since 2006/2009: UA disagreement on import pricing formula & price level resulted from move to “European formulas”=> transit crises Jan’2006 & Jan’2009 resulted, inter alia, from disagreements on supply contracts
- Perception of further RUS supply risks => search for multiple supplies => ***to escape monopoly of Russia as one single supplier*** =>

New risks, new challenges, new responds, “no return” points: Ukraine (2)

- UA economic & legal motivation to diminish dependence on RUS gas supplies:
 - Economic: High import price & RUS/Gazprom unwillingness to soften pricing policy (no price review results achieved yet) stipulates UA search for:
 - alternatives to RUS gas (domestic production – onshore & offshore, shale gas, LNG import, reverse flows & UGS) &
 - to deviate from gas (switch gas to coal, nuclear, energy saving & improving efficiency)
 - Legal: Euro-integration policy, membership in Energy Community Treaty => implementation of EU energy acquis (Third EU Energy Package) in UA => *legal obligations* for alternative supplies, interconnectors, reverse flows, unbundling Naftogas Ukraine, MTPA =>

New risks, new challenges, new responds, “no return” points: Ukraine (3)

- UA aim: to reach “no return” point before expiration of 2009-2019 RUS-UA gas contract =>
 - to negotiate new gas import contract with Russia within new economic & legal – competitive – environment (even before first new molecules of alternative gas reach UA) =>
 - After FID are taken on projects aimed to provide alternative gas supplies,
 - Alternative supplies (even if just expected in near future but proven by FID) will enable to change pricing formula => to deviate from PP-indexation to spot/hybrid pricing & lower prices
 - to create new perceptions as new negotiating position
- **“No return” point is almost reached? If not yet (?)** – is it just a matter of time (trend towards “away from Russian gas” is not to be changed?)?

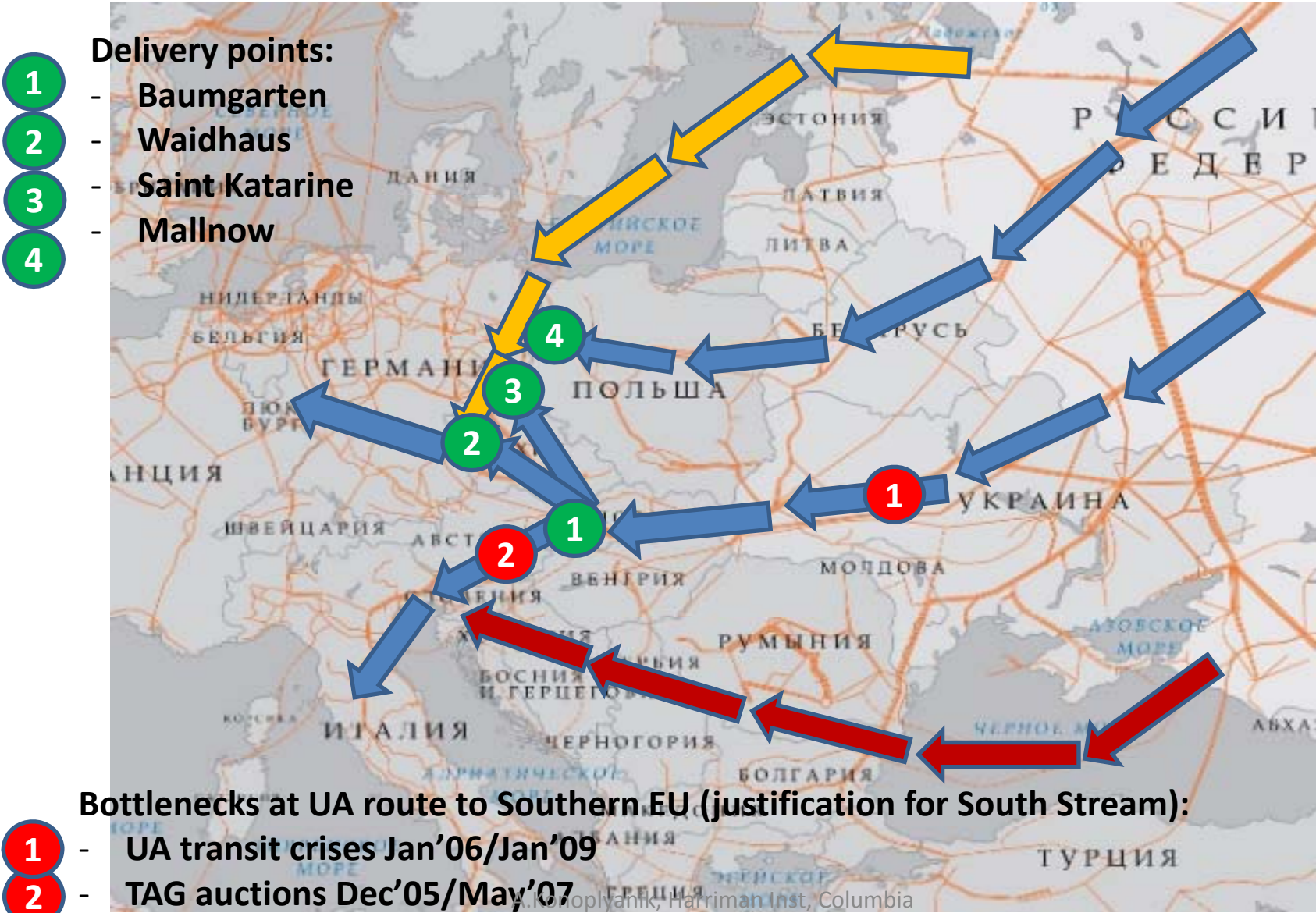
New risks, new challenges, new responds, “no return” points: Russia (1)

- Transit risks:
 - Post-2006/2009 – both materialized & perceived risks,
 - *Materialized*: not sanctioned off-take of gas in transit (at least 2 episodes – Jan’2006 & Jan’2009) => but: it is RUS supplier who is responsible for gas delivery to EU delivery point => risk of legal claims of EU customer against RUS supplier in case of non-delivery / violation of contract => EU customers has not raised such claims in Jan’2006 / Jan’2009 cases, but what about the future if repeated?
 - *Perceived* (to materialize in near future – result of UA accession to Energy Community Treaty):
 - MTPA vs transit flows (risk of contractual mismatch)
 - Forthcoming unbundling of Naftogas UA => risk of factual unilateral change (disappearance) of one Contracting Party

New risks, new challenges, new responds, “no return” points: Russia (2)

- Change of the whole transit economics for supplier (if precedent-based “risk” element included) => responds:
 - ***to escape monopoly of Ukraine as one dominant transit route*** => to create *alternative & non-transit* routes => their economics compared to existing *transit* routes improved by increasing value of transit risks =>
- Dilemma:
 - Two routes to each major markets (“least radical” scenario):
 - (a) UA GTS + Nord Stream – to North-West Europe,
 - (b) UA GTS + South Stream – to Southern Europe,
 - Supply volumes to be distributed within each pair of routes, or
 - One direct new route (no transit) to each major market (“most radical” scenario):
 - (a) Nord Stream – to North-West Europe,
 - (b) South Stream – to Southern Europe
 - All transit volumes switched to new routes => UA GTS dried up?
- Different “no return” points under different scenarios: some are passed, other – not yet => no clear final picture yet...

Ukrainian by-passes: alternative gas pipelines to major RUS markets in EU (2 routes for each market)



Russia: what are “no return” points for South Stream

- Onshore part within Russia:
 - No one “no return” points any more?
- Offshore part:
 - Dec.7, 2012 = “no return” point for construction of first line (15.75 BCMA)
 - “No return” point for throughput capacity => whether it has been passed already?
 - Before 07.12.2012: 0 - 63 BCMA
 - After 07.12.2012: 63 BCMA or 15.75 - 63 BCMA ?
- Onshore part within EU:
 - No one “no return” point has been passed yet?
 - Debate with CEC on bilateral agreements
 - No clear procedures yet?:
 - To be based on Art.36 (derogations if Gazprom is shipper & TSO), or
 - To be based on Art.13.2 (no derogations needed if Gazprom as shipper only => TSO shall invest in case of market demand for capacity) => whether such procedures exist? Case study proposed within informal RUS-EU Consultations on Third Energy Package

3rd EU Energy Package: two “standard” procedures to build new capacity in EU

3rd EU
Gas
Directive

Art. 13.2

Standard “no-exemptions” procedure = “*bottom-up*” approach based on market demand for capacity = SHOULD BE a mainstream procedure => should be (?) based on EU-wide coordinated (& legally binding) “open season”

Art. 36

Workable but (might be) not best effective procedure:
(1) too lengthy (Nabucco: 28 months to receive exemptions, while Turkmen-Uzbek-Kazakh-China pipeline was built from the scratch in shorter time),
(2) each exemption based on individual perceptions, etc.

Standard “exemptions” procedure = “*top-bottom*” approach (SOS-based, etc.) or when derogation from the rules of *acquis* = FACTUAL mainstream procedure = exemptions from the EU rules as a general rule (22 major EU gas infrastructure projects since 2003)

Russia-Ukraine: negative domino effect?

- No economic space for both Nord Stream, South Stream & UA GTS to work together at each one's maximum capacity within current state of EU gas market development
- Broken balance: UA revenues from gas transit of RUS gas to EU – to pay the bill for import of RUS gas supplies to UA => domino effect:
 - RUS alternative pipelines to go = UA transit throughput to diminish =>
 - UA transit revenues to decrease =>
 - Less UA capability to pay the bill for imported RUS gas at high PP-indexed prices =>
 - more stimuli for UA to fight against current (19.01.2009) RUS-UA contract structure (contract volumes, TOP, penalties for off-taking below TOP, PP-indexed pricing formula) =>
 - price review clause does not work yet (Gazprom not persuaded yet to change contract provisions) =>
 - UA does not have alternative choice yet =>
 - UA to deviate from RUS contract & to substitute RUS gas supplies by receiving &/or creating alternative choices
- South Stream as accelerator for UA to deviate from RUS gas supplies (on top of other items)

South Stream within new equilibrium (testing the minefield)

- Maximum choice:
 - Nord Stream max (lines 1-4) = 110 BCMA, South Stream max (lines 1-4) = 63 BCMA =>
 - zero transit throughput through Ukraine =>
 - most negative RUS-UA domino effect development
- Minimum choice (after 07.12.2012):
 - Nord Stream (lines 1-2) = 55 BCMA, South Stream (line 1) = 15.75 (?) BCMA =>
 - non-zero transit throughput through Ukraine
- What is optimal choice:
 - balance between South Stream capacity within 15.75-63 BCMA range (economics ?) & lower transit volumes through UA GTS?
 - what vision of UA Gas Transportation Consortium? (my view: trilateral, 25%+1 = UA, 25%+1 = RUS, 50%-2 = EU-controlled financial institutions)

**Thank you for your
attention!**

**www.konoplyanik.ru
andrey@konoplyanik.ru
a.konoplyanik@gazpromexport.com**

Disclaimer

- Views expressed in this presentation do not necessarily reflect (may/should reflect) and/or coincide (may/should be consistent) with official position of Gazprom Group (incl. Gazprom JSC and/or Gazprom export LLC), its stockholders and/or its/their affiliated persons, and are within full personal responsibility of the author of this presentation.