

The external suppliers problems and risks related to the Third EU Energy Package and the ways to overcome them

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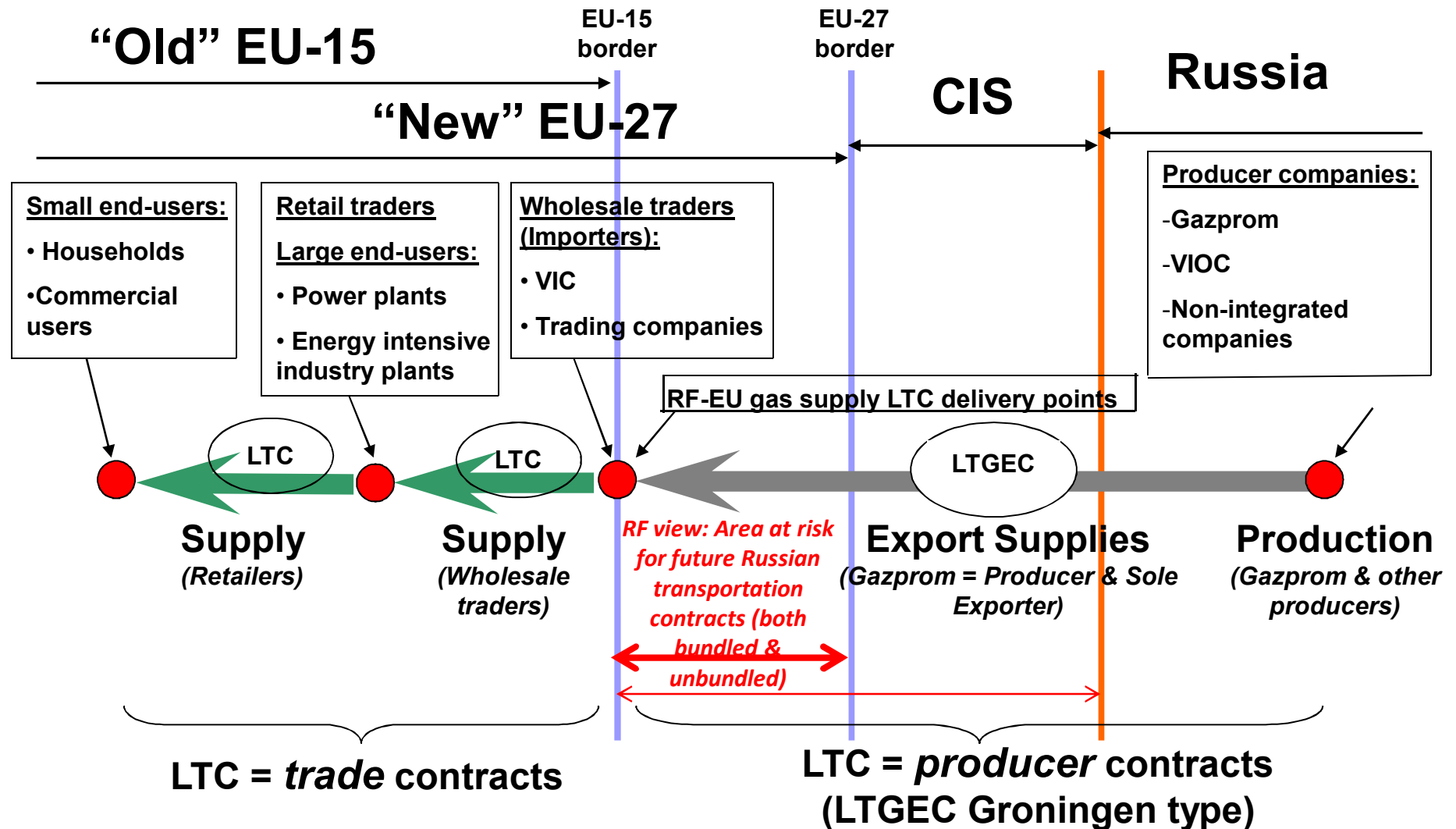
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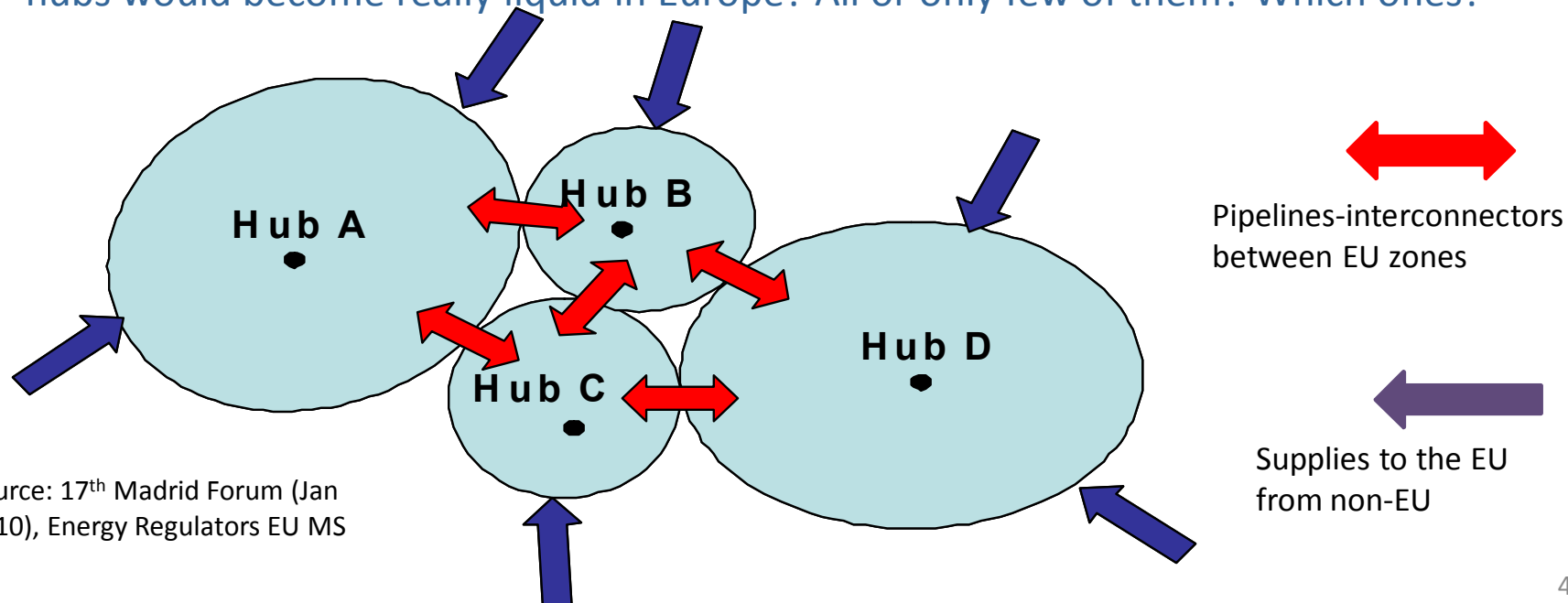
RUSSIA-EU GAS VALUE CHAIN: DIFFERENT TYPES OF LTC



Future organization of internal EU gas market acc. to 3rd Energy Package: radical change of wholesale market architecture

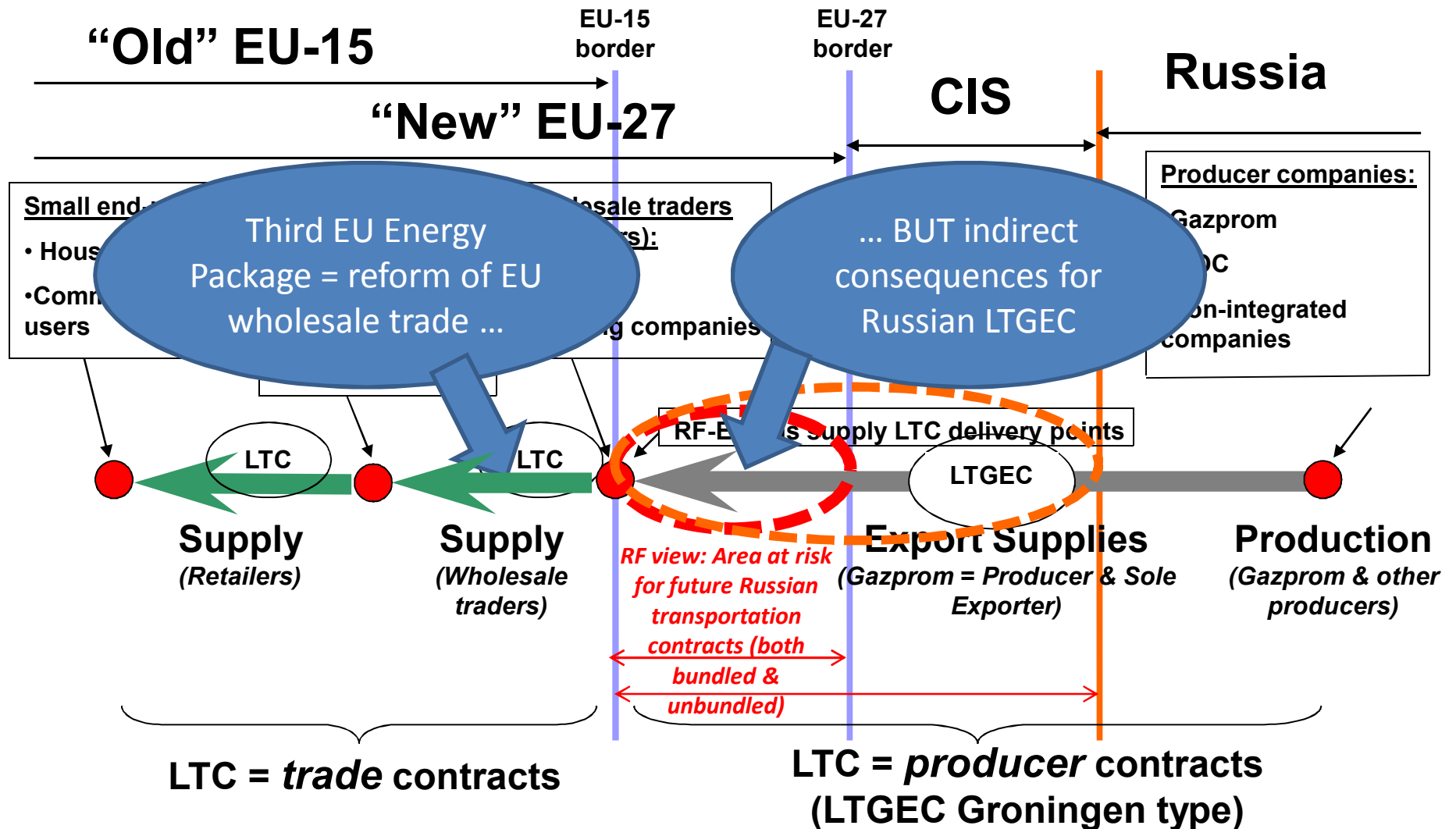
- No single (homogenous) internal EU gas market in the near future even as economic model
- All market areas to be organized as **entry–exit zones** with **virtual hubs** => Towards uniform capacity allocation mechanisms (“**bundled products**”) & gas pricing mechanisms (“**liquid hubs**”), but:

- (1) **Capacity allocation:** **short**-term vs. **long**-term? At zone borders? At hubs? Bundled products – volumes vs. duration? How to overcome inconveniences of the 3rd Package? (long-term: transportation = 1 year+, supply = 10 years+ => “contractual mismatch” ?)
- (2) **Gas pricing at hubs:** on **all** gas volumes or just on **portion** of gas supplies? When gas hubs would become really liquid in Europe? All or only few of them? Which ones?



Source: 17th Madrid Forum (Jan 2010), Energy Regulators EU MS

RUSSIA-EU GAS VALUE CHAIN & Third EU Energy Package



Trade LTC are of specific concern of CEC (DG COMP) and are directly influenced by 3rd EU Energy Package (by reform of internal EU wholesale gas trade), but lack of clarity has been interpreted as fight against Russian LTGEC & has established a “grey zone” for them from implementation of EU legislation (problem of “contractual mismatch”, etc.)

Russia's reaction on 3rd EU Energy Package

- RF withdrew from ECT provisional application (coincidence?)
- Gazprom's intention to continue participate in gas business inside the EU as both an owner/operator of gas transportation system **and** a shipper (supplier), **BUT**: Oettinger (03.03.2011): "The Russian partners have to accept our rules",
- Gazprom's intention to receive exemptions from MTPA for its new infrastructure projects (South Stream, OPAL, NEL, etc.) to provide their bankability, etc. => Art. 35-36 Directive 73/EC/09,
- Russia's intention to participate, together with EU Institutions, in forming comfortable - for ALL participants of the cross-border gas business - rules of the game at the emerging EU gas market with unbundled supply & transportation => **business model with Gazprom only as supplier/shipper inside the EU => the task of informal bilateral expert RF-EU consultations**

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Key provisions of the EU Gas Directives (1998/2003/2009) and the problems they created

Key CEC/DG COMP assumption/philosophy: *"The more competition (number of players / intermediaries) – the better it is for end-users"* (???) => the policies:

Key provisions 2 nd , 3 rd EU Gas Directives	Problems they creates (incremental risks for trade & investment)
Segmentation of VIOC (unbundling)	"Contractual mismatch" (long-term supply vs transportation contract: correlation in duration & volumes)
Mandatory third party access (MTPA) to gas transportation infrastructure,	Bankability of investment projects (MTPA discriminates project financing)
Switch from LTGEC with indexation to spot trade with futures	Increased price volatility & diminished price predictability (price losing its guidance for long-term & capital-intensive investment decisions)

3rd EU Energy Package = risks of disbalances:

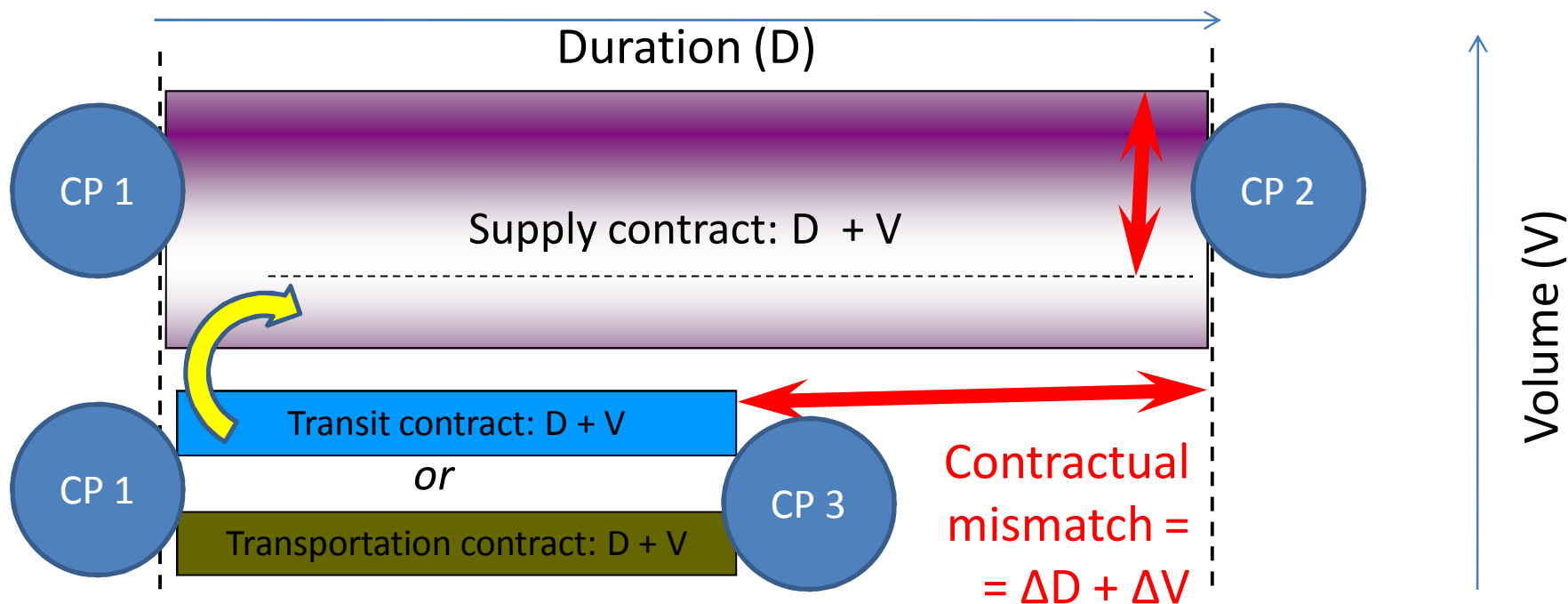
(1) long-term vs. short-term & (2) commodity vs. capacity

Unbundling & MTPA rules changes architecture of gas system: *from* bundled supply & transportation contracts within single VICs *to* unbundled system with separated supply & transportation contracts within different entities => to balance (long-term & short-term) + (capacity & commodity) contracts within now separated markets

	Commodity	Capacity
Long-term	No ?	No ?
Short-term	Yes, but with risky instruments	Yes, but with risky (wrong?) instruments

All architecture of gas target model (MECOS) is based on and resulted from definition of “wholesale market” as short/mid-term spot commodity market inevitably leading to development of paper gas market with all its deficiencies - despite the statement (MECOS, 04.04.2011, # 1.1) that “all economic pipeline investments (are to be) done”

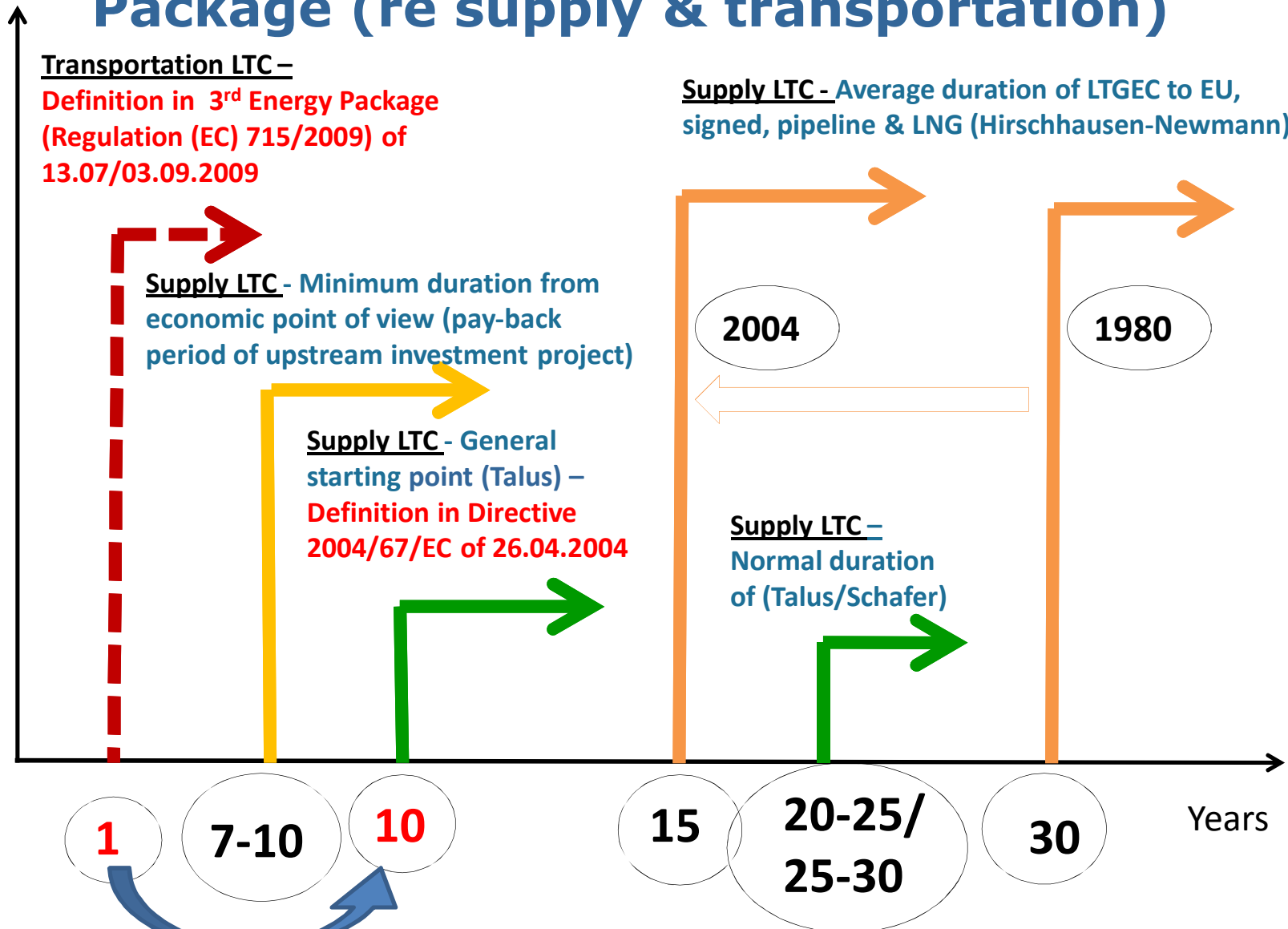
Contractual Mismatch Problem



Contractual mismatch: between duration/volumes (D/V) of long term supply/delivery contract (LTGEC; CP1-CP2) and transit/ transportation contract (CP1-CP3); the latter is integral part to fulfill the delivery contract => risk non-renewal transit/ transportation contract => risk non-fulfillment supply/delivery contract.

Core issue: guarantee of access to/creation of adequate transportation capacity for volume/duration of long term contracts

“Long-term”: different durations in historical gas business practice & its definition in 3rd EU Energy Package (re supply & transportation)



Alternative proposals to the EU gas market model currently under development (for joint discussion & consideration)

➤ **Long-term supplies (firm contracts, main/basic demand load):**

More flexible LTGEC (off-taking of contractual volumes & pricing formulas & price review rules)

+ long-term access to transportation capacity for full duration & volume of LTGEC (open seasons)

+ modified pricing formulas linking gas to its replacement fuels (indexation not only to petroleum products)

➤ **Short-term supplies (interruptible contracts, additional/semi-peak & peak demand load):**

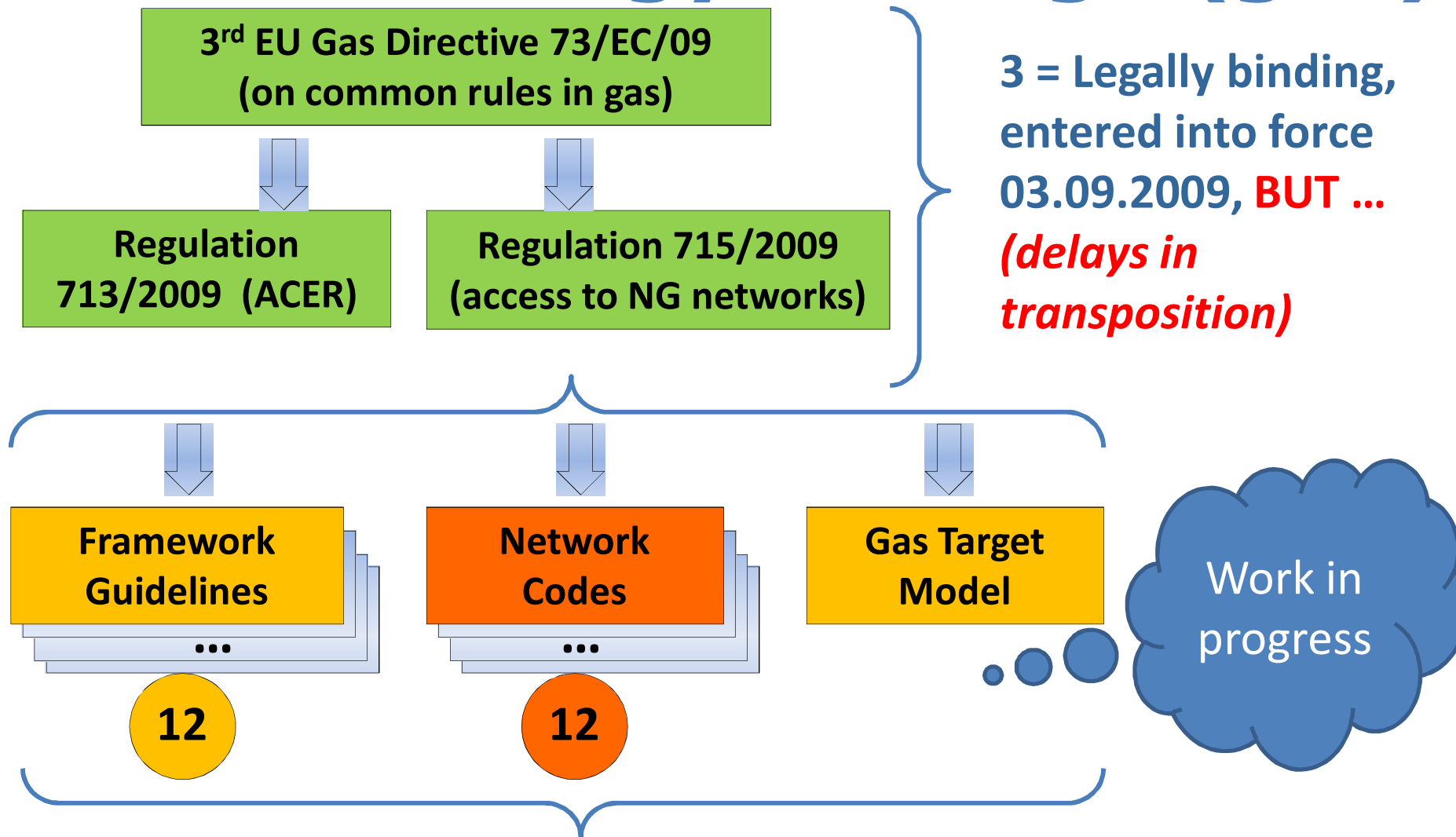
Spot contracts

+ exchange pricing (futures, gas indexes, forward curves)

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Third EU Energy Package (gas)



25 = Still need to be drafted and approved, then - legally binding (NC) or non-binding (FG + GTM), **BUT ... (delays in drafting)**

Delays: for bad or for good? (1/2)

3rd EU Energy Package (gas): Directive + 2 Regulations

- Legally binding, entered into force 03.09.2009;
- EU MS were to comply by March 03, 2011 (Art.11 Directive - by 03.03.2013) => None has done in time
- CEC (28.02.2011): “7 MS are expected to notify the Commission of the arrangements required “in the coming weeks”, 9 others - are expected to follow suit in the summer” => None have notified yet
- G.Oettinger gave MS “until the autumn to transpose Community law into national law”.

3rd EU Energy Package & Russia's reaction in Polish & Lithuanian cases (Autumn 2010)

Poland & Lithuania: implementation of Directive 73/EC/09 provisions on unbundling (Art. 9, 15, 26), MTPA (Ch. 7) & “third party clause” (Art.11) began in Sept.2010, while:

- Art. 54 Directive: EU MS were to transpose provisions of Directive only by 03 March 2011 (*6 months later*) & provisions of Art.11 of Directive only by 03 March 2013 (*30 months later*)
- None of EU MS has complied with Directive by March 2011 (nor by today), at best about 15 MS might transpose by Autumn 2011 – Poland & Lithuania are *not* in this list (CEC)
- Both countries are “new” EU MS (former COMECON) & are much less than “old” EU MS (Germany, France, Italy, etc.) currently prepared for implementation of 3rd package (historically low level of diversity of energy infrastructure => central planning)
- In both countries “phantom pains” exists of their recent historical relations with Russia (stronger than in other EU MS)

Q: Why to start implementation of 3rd package provisions with EU MS less prepared for this & prior to deadlines established in Directive?

Delays: for bad or for good? (2/2)

3rd EU Energy Package (gas): 12FG + 12NC + GTM

- In the process of being drafted & discussed among MS
- EU Heads of State (28.02.2011): a clarion call for the “speedy & full implementation” of energy market liberalization – by 2014 => [...] of 25 are ready by 2014?
- If positive reading of new (later) date: it opens broader window of opportunities to make 3rd Package effectively workable, **BUT:** from “*learning by doing*” to “*learning by advanced thinking & discussing*” =>
- 3rd Package to be effective in practical use – regular, continuous & well structured cooperation/discussion needed with major suppliers & transit states =>
- This is the aim of our informal consultations supported by political leadership within RF-EU Energy Dialogue

Informal expert consultations Russia-EU on problematic issues of 3rd EU Energy Package

- 02.09.2009 (Alpbach, Austria) – expression of mutual interest in such dialogue (EU: to explain intentions, RF – to explain concerns)
- Jan. 2010 – regular informal consultations started + Russian/Gazprom Group experts began to participate in internal EU public consultations on draft FG/GTM
- Consultations participants: Russia/Gazprom Group experts + Energy Regulators of EU MS & representatives of the Commission
- 22 June 2011 – 7th round of consultations planned

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Gas Target Model: From different views on key issues... (1/2)

- 3rd package is aimed at forming effective EU wholesale market with multiple supply instruments, **BUT:** current GTM is aimed mostly at forced conversion of trade into short-term trade based on virtual hubs in emerging market zones
- Current concept of forming “entry-exit” zones does not consider physics of gas flows => leads to significant under-utilization of pipeline capacities => creation of virtual liquid hub in each zone leads to consolidation of zones where capacity underutilization problems will be more severe

Gas Target Model: From different views on key issues... (2/2)

- Fight against pipeline capacity hoarding (based on as if 70% is extremely low UR) threatens LTC (e.g. re-nominations) & contradicts provisions of 3rd package aimed at transportation capacity development according to market demand for them
- GTM lacks transition measures from existing to new EU gas market architecture which are prerequisite for its sustainable functioning
- etc.

... to common understanding of risks thus leading to mutually acceptable draft solutions ?

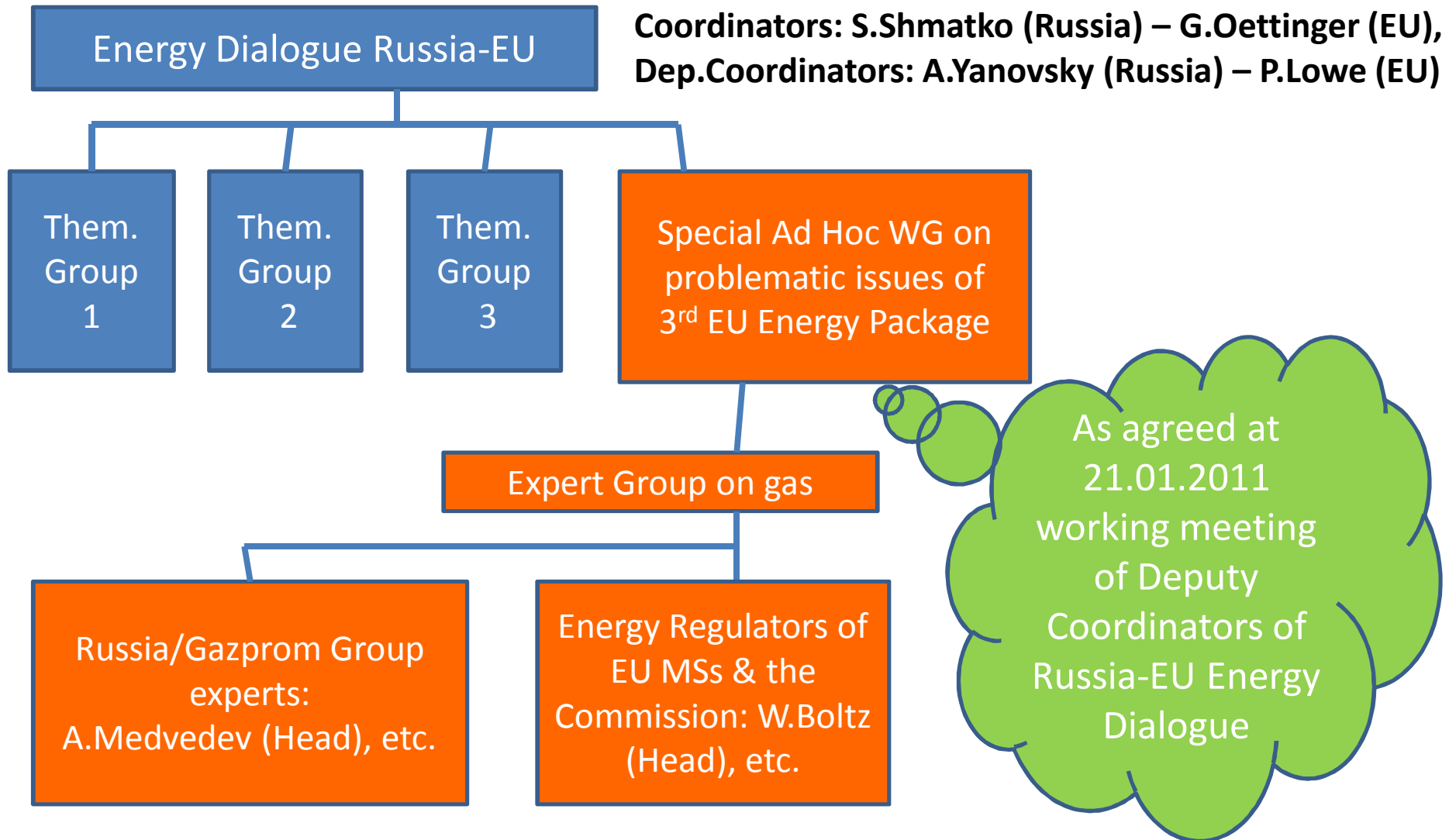
Draft conclusions: implementation of “entry-exit” system:

- ...**must not lead** to diminishment of long-term non-interruptible access to transportation capacities,
- ... **must not lead** to liquidation of existing delivery points at the market border zones,
- ...**must provide** long-term access transportation capacities for long-distance transport ,
- ...**must provide** that each investment decision regarding transportation capacities should be economically justified based on market demand on capacities (defined by regular *open season* procedure); this will provide – under correct implementation – adequate transportation capacities for long-term supply contracts; this will prevent “contractual mismatch” problem

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Work organization on problematic issues of 3rd EU Energy Package within the framework of Russia-EU Energy Dialogue



Thank you for your attention

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