

“Who supplies Europe with Gas? EU-Russia Energy Relationship on Test”

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Since 2009 we are living in a new - more uncertain & risky - gas world, especially in Europe (1)

- Decrease of demand (temporary = cyclical):
 - Global economic recession, incl. in Europe
- Increase of supply:
 - New supply projects (mostly LNG) originally destined for Europe & being developed under high oil/gas price environment in 2000-ies => LNG brings liquidity & flexibility; ties-up regional markets
 - US shale gas development has *de facto* closed US import market for LNG => LNG supplies originally destined for US were redirected to Europe
- **Result:** Gas Oversupply in Europe in 2009-2010 (cyclical) =>
 - Increased competition between NG & LNG, within NG & LNG exporters, between spot & LTC gas sales, between spot gas pricing & gas price indexation => between short-term & long-term
 - Requests to key suppliers to adapt contractual structures & pricing mechanisms to current (oversupplied) state of the market => short-termism

Since 2009 we are living in a new - more uncertain & risky - gas world, especially in Europe (2)

- **Russia-Ukraine gas crises (Jan.2006 & Jan.2009):** Negative precedents => 22 days vs. 40+ years => change of perceptions =>
- **Energy forecasts:** downgrading prospects of gas demand in official & CEC-sponsored forecasts (not in business-based forecasts => window of uncertainties for gas widens) => Gas as “transition fuel” => “Demethanization” (“methanophobia”/K.Simonov) of EU energy forecasts = to escape from Russian gas? => **competitive niche for Russian gas narrows or became more uncertain**
- **Third EU Energy Package (2007 => 2009 => 2014):** gas glut = increased share of spot => key developments of EU “designed model” under gas glut environment => over-evaluation of Anglo-Saxon model prospects within GTM & designed market => forced movement from LTGEC with gas price indexation to spot trade with futures pricing (is it possible?) => **investment risks for gas producers/exporters increase within narrowing competitive niche for gas**

What messages energy forecasts sponsored by the Commission send to gas business (is it practical to forecast future demand volumes *below* already contracted volumes?)

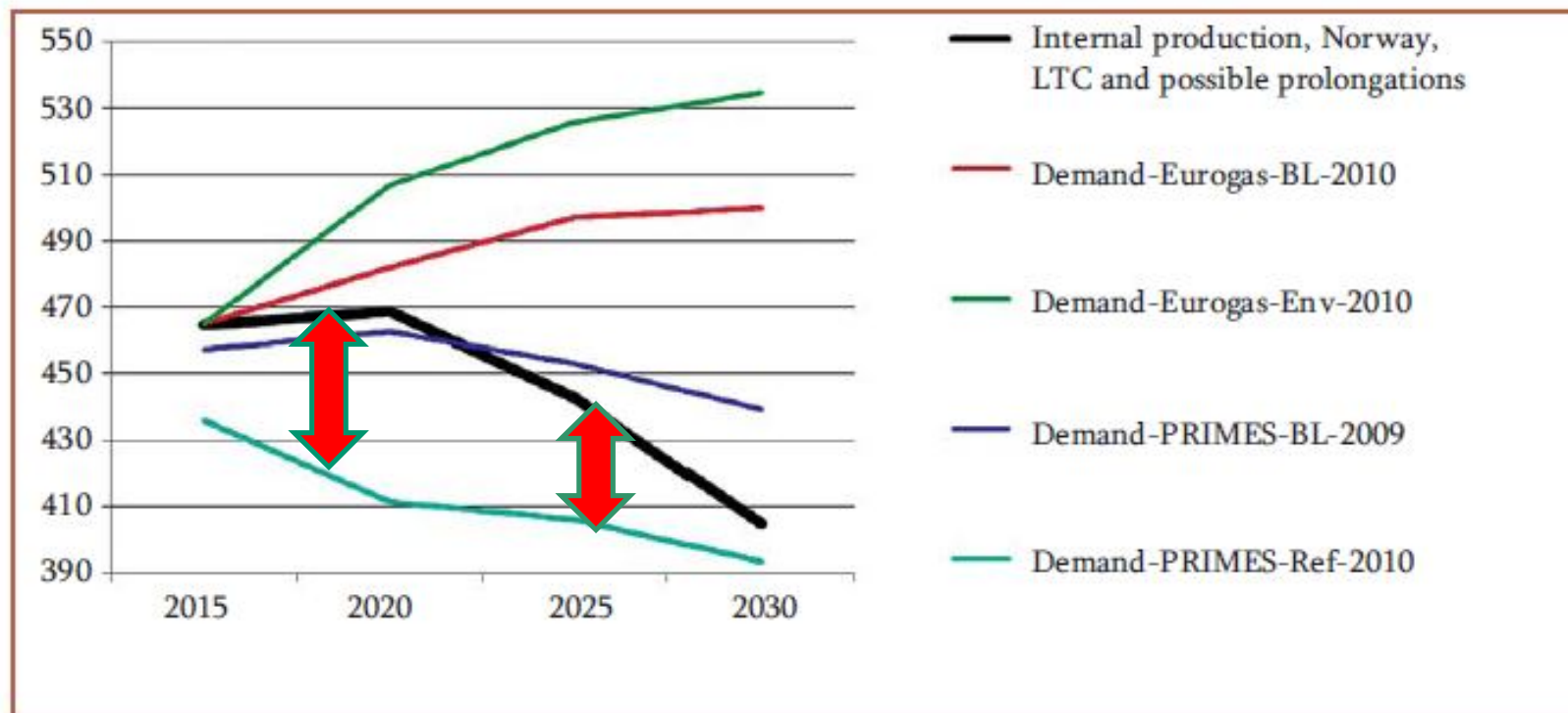


Figure 2. Potential of a new gas supply in EU-27 in 2015-2030 according to forecasts

Sources: Eurogas, 2010; EET-2030 update 2009

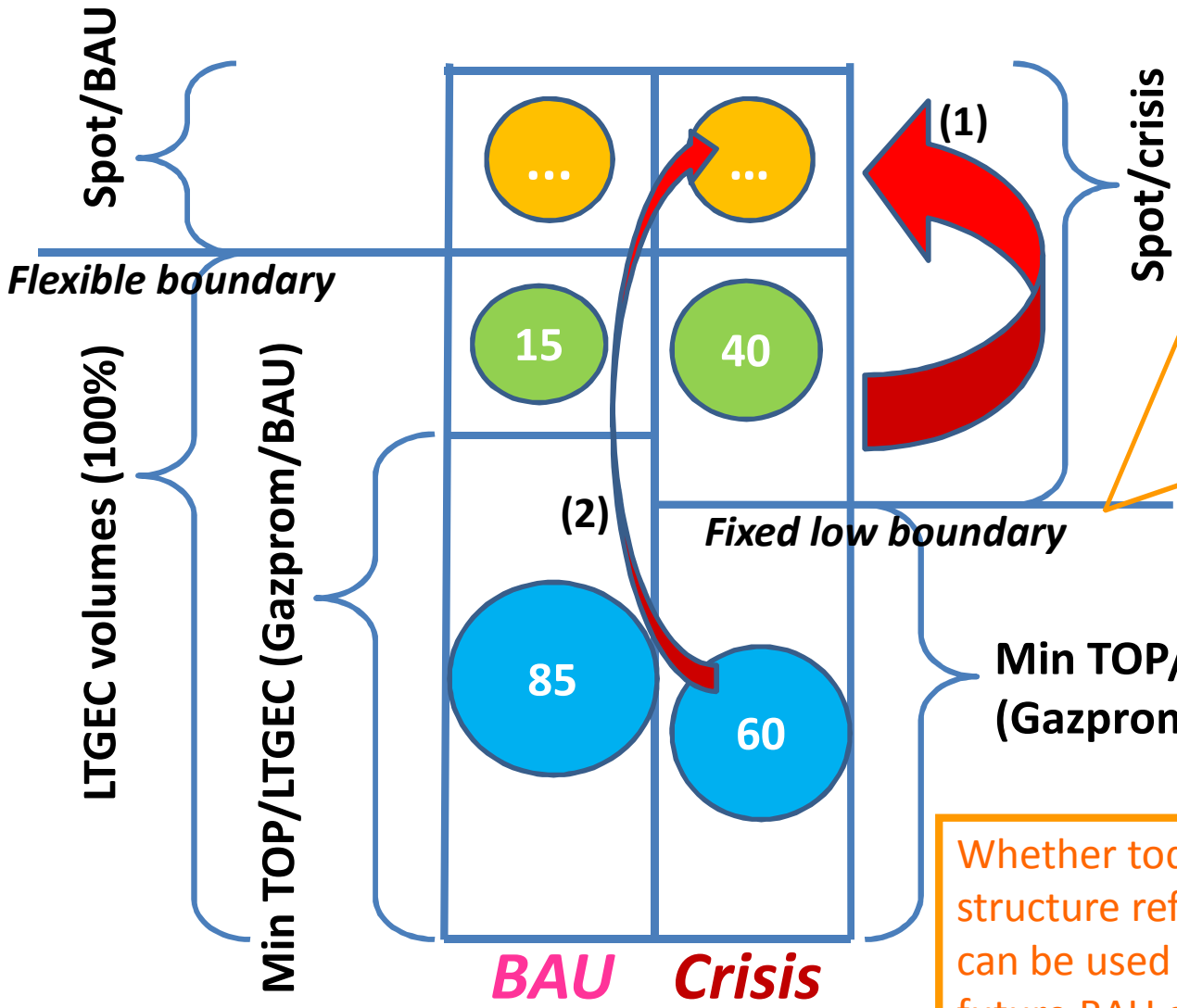
Note: LTC – long-term contracts



Negative gap between production and demand volumes

Source: Russia-EU Energy Dialogue. Thematic Group on Energy Strategies, Forecasts and Scenarios. Energy Economics Subgroup. "Energy Forecasts and Scenarios, 2009-2010 Research, Final Report", 2011, p.28

Evolution of spot/LTC gas trade under BAU/crises



During crises %% of spot increases to extreme highs due to: (1) decrease of 'Min TOP' in LTGECs - buyers' switch from LTGEC to spot purchases; + (2) spot compensates delays in contracted supplies (postponed start-ups) from new projects; during BAU %% of spot back decreases from extreme highs

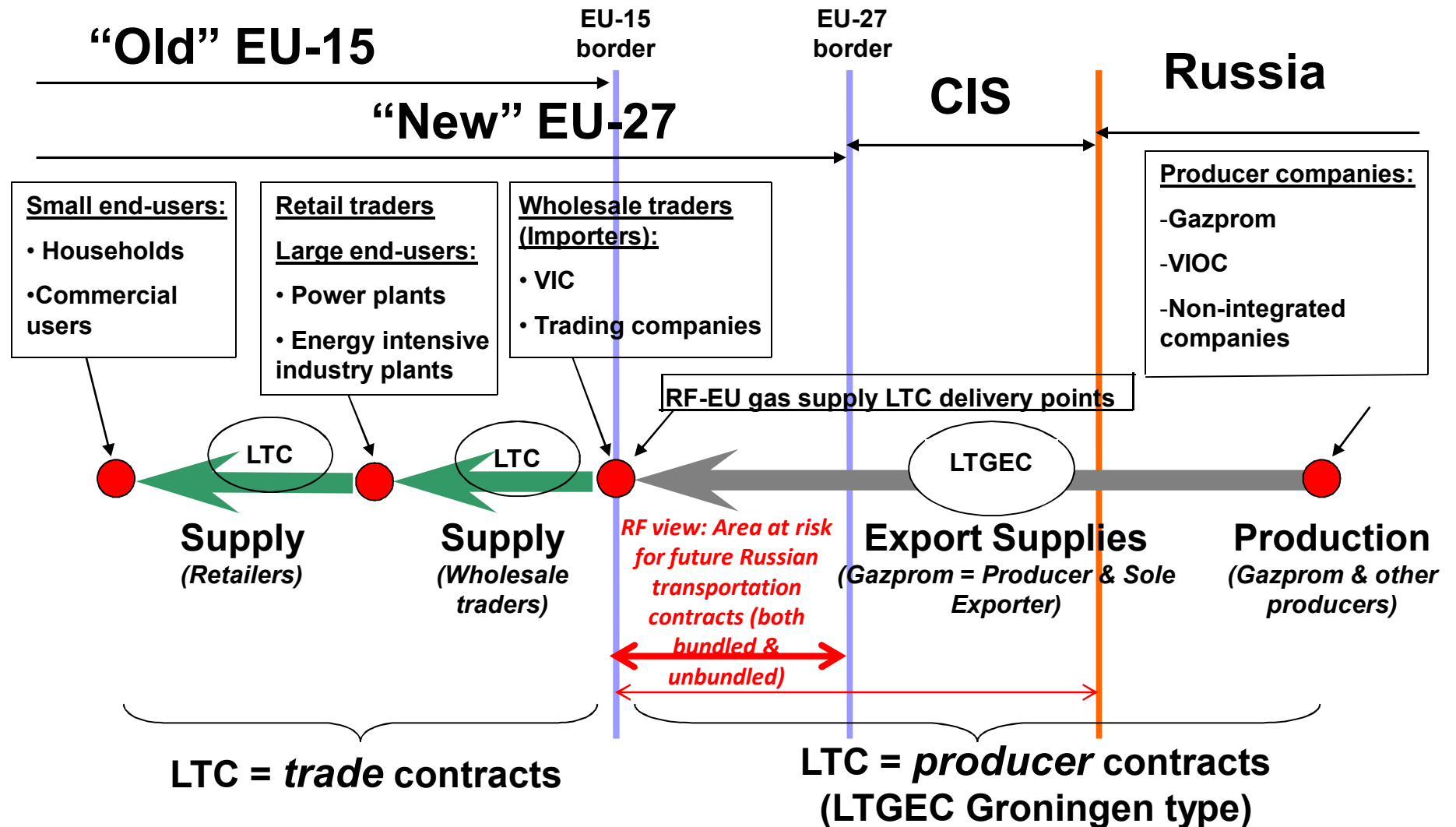
Min TOP/LTGEC (Gazprom/crisis)

Whether today's contractual gas market structure reflecting crisis environment can be used as a basis for modeling future BAU developments ?

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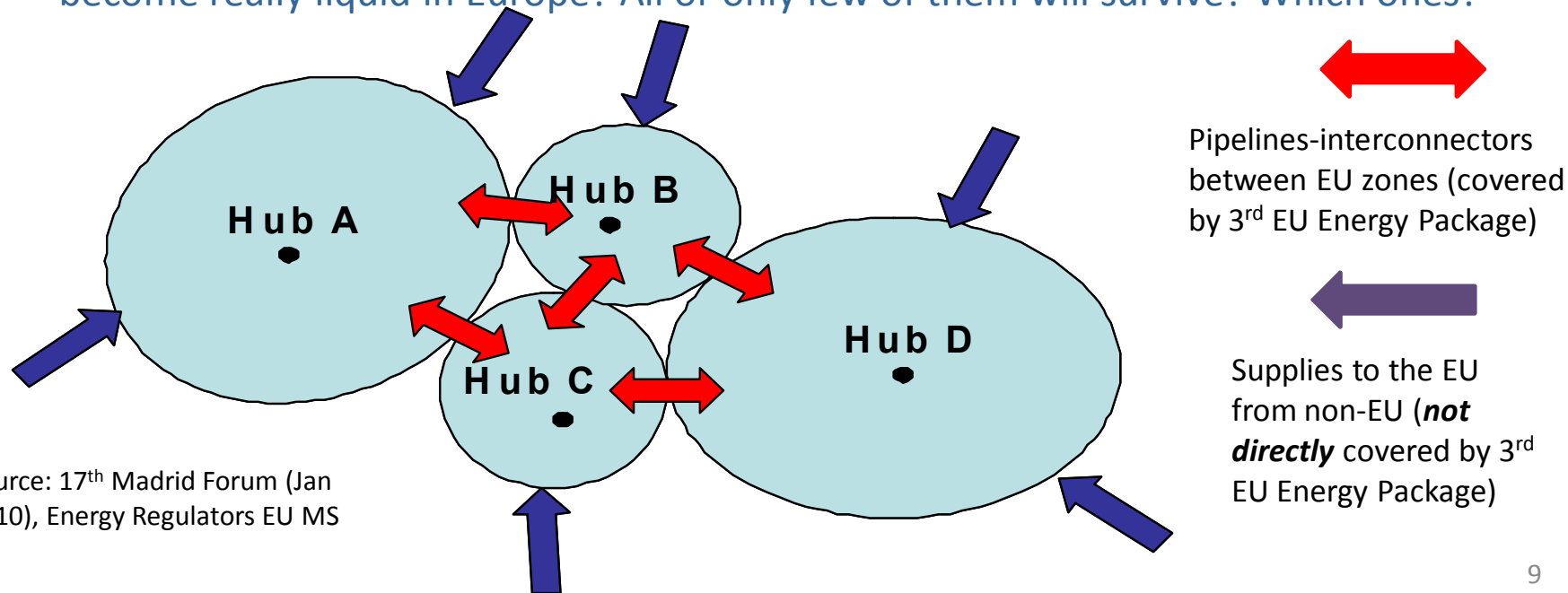
RUSSIA-EU GAS VALUE CHAIN: DIFFERENT TYPES OF LTC



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

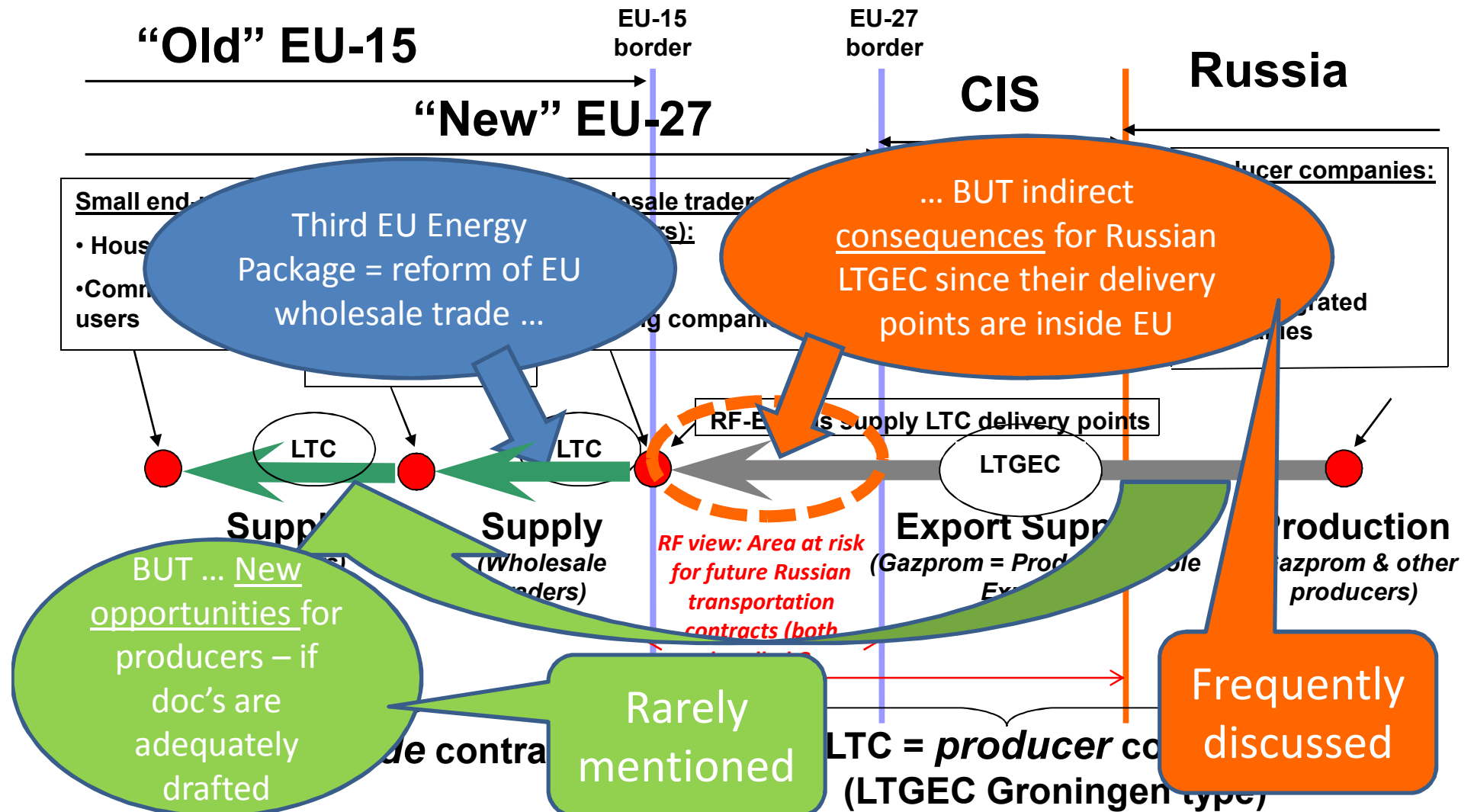
- No single (homogenous) internal EU gas market in the near future even as economic model
- All market areas to be organized as **entry–exit zones** with **virtual liquid hubs** => Towards uniform capacity allocation (“**bundled products**”) & gas pricing (“**spot & exchange pricing**”) mechanisms; still open questions (continued debate) on, *inter alia*:

- (1) **Capacity allocation**: **short**-term vs. **long**-term? At zone borders? At hubs? How to overcome uncertainties of 3rd Package (“long-term”: transportation = 1 year+, supply = 10 years+ => risk of “contractual mismatch”)? Auctions as uniform allocation mechanism?
- (2) **Gas pricing at hubs**: on **all** or just on **portion** of gas supplies? When gas hubs will become really liquid in Europe? All or only few of them will survive? 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 initially as fight against Russian LTGEC & has established a “grey zone” for them from implementation of EU legislation (problem of “contractual mismatch”, etc.)

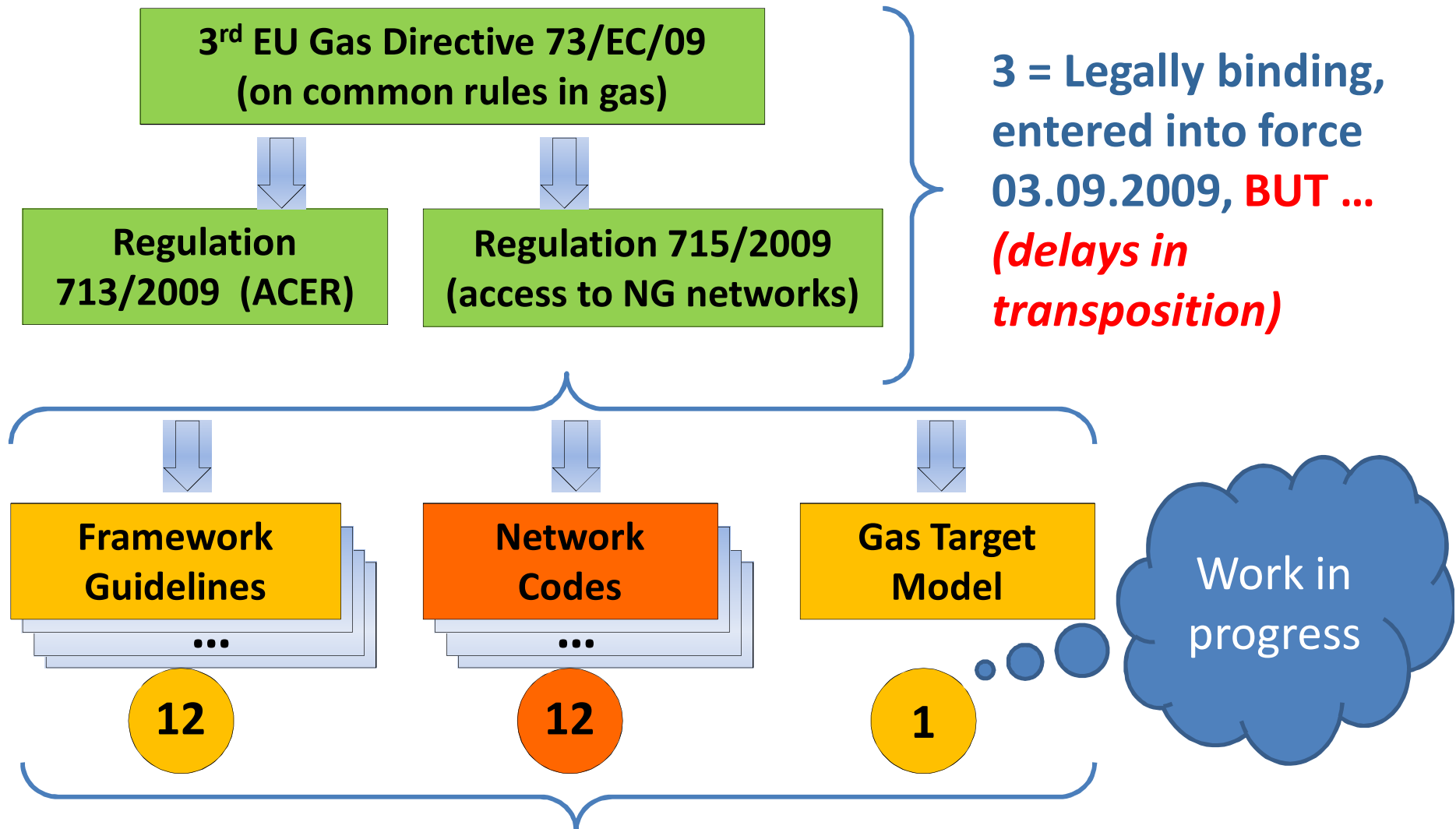
Russia's reaction on 3rd EU Energy Package

- 1) RF withdrew from ECT provisional application (coincidence?)
- 2) **“consequences”**: 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” => **BUT**: *open question*: cross-border EU-non-EU pipelines (Draft RF-EU Agreement on new export pipelines proposed by RF in Febr.2011 - ?),
- 3) **“consequences”**: 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,
- 4) **“new opportunities”**: 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 => ***new future business model with Gazprom only as supplier/shipper inside the EU => the task of informal bilateral Russia-EU expert consultations on 3rd Energy Package doc's***

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Third EU Energy Package (gas)



25 = Still need to be drafted and approved, then - legally binding (12NC) or non-binding (12FG + 1GTM), 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”.

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

3rd EU Energy Package (gas): 12FG + 12NC + 1GTM

- In the process of being drafted & discussed among MS
- EU Heads of State (28.02.2011): “speedy & full implementation” of energy market liberalization – by 2014 => how many docs 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, Russia – to explain concerns)
- Jan. 2010 – regular informal consultations started (Russian experts argued that GTM is needed) + later Russian/Gazprom Group experts began to participate in internal EU public consultations on draft FG/GTM
- Consultations participants: Russia/Gazprom Group (incl. GPE & GMT) experts + Energy Regulators of EU MS & representatives of the Commission
- 7th round of consultations (22.06.2011, Vienna) & 4th EU Workshop on GTM (28.06.2011) – big progress on incorporating Russia's justified concerns & proposals into GTM
- From Q/A at initial stages – to joint discussion on/development of draft solutions with due consideration of justified Russia's concerns
- 8th round of consultations – early October in Moscow (+ visit to Gazprom Dispatch Center to share the experience in managing large unified GTS like USSR/RF GTS, etc.)

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

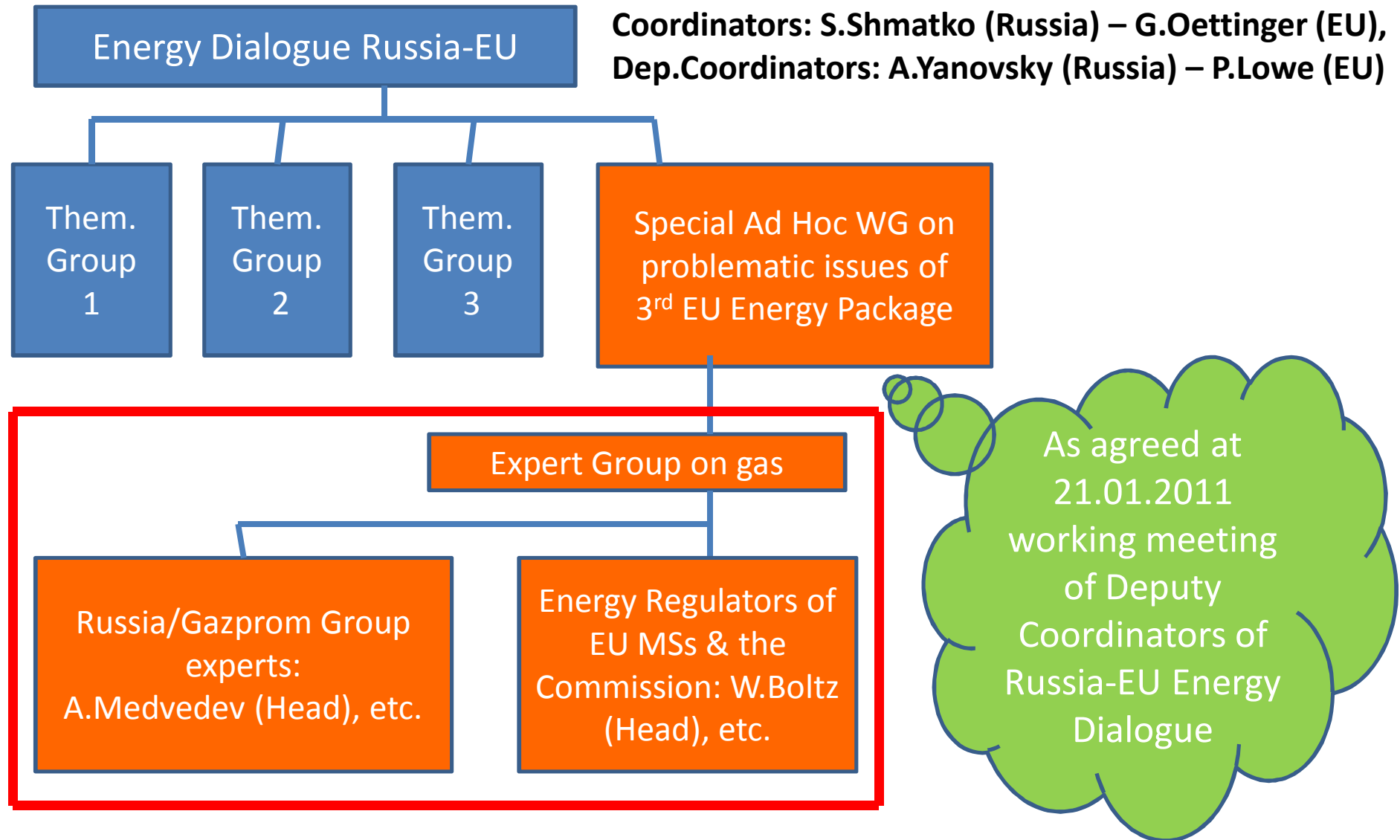


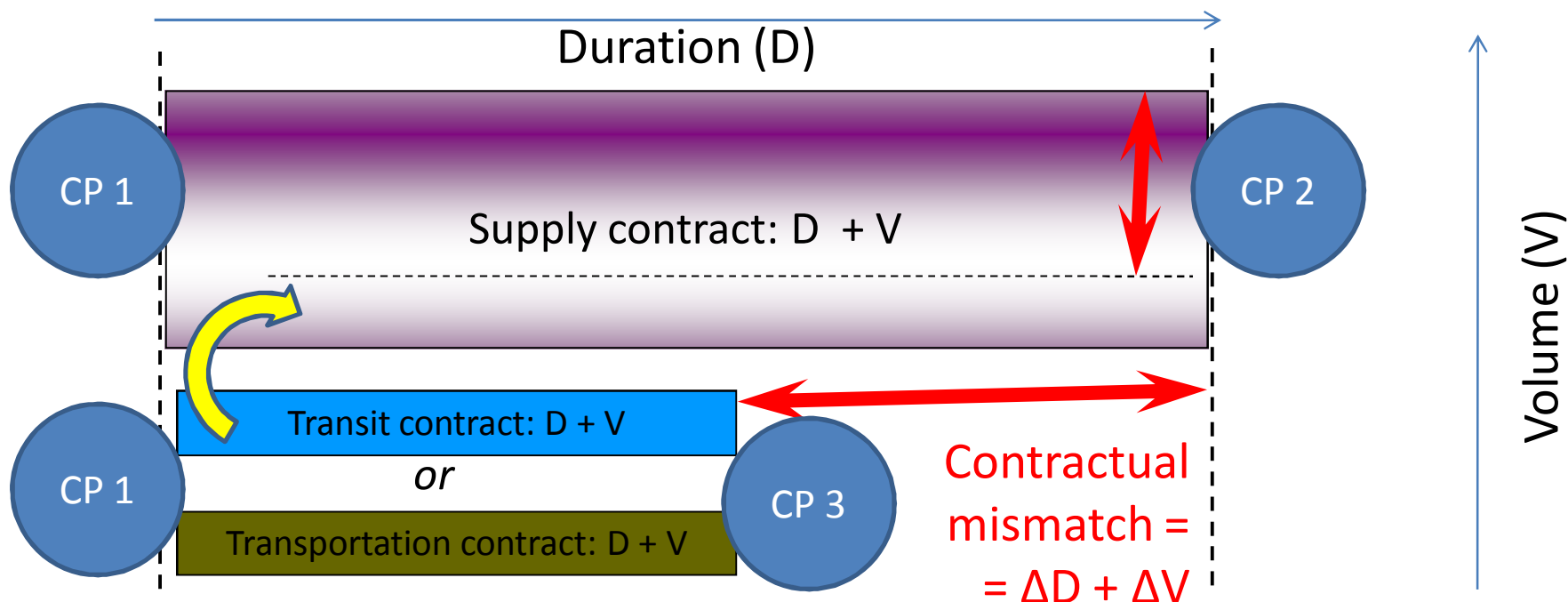
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Key provisions of the EU Gas Directives (1998/2003/2009) and some objective problems they have created (case of investments)

Key provisions 2 nd , 3 rd EU Gas Directives	Problems they creates (incremental risks for trade & investment)
Segmentation of VIOC (unbundling)	Independent (separate) development of commodities & capacities markets => risk of "contractual mismatch" (long-term supply vs transportation contract: correlation in duration & volumes) => long-term access to transportation capacities
Regulated TPA (MTPA) to gas transportation infrastructure	Bankability of investment projects (MTPA discriminates project financing) => risk of underinvestment
Switch from LTGEC with price indexation to spot trade with futures trading	Increases price volatility & diminishes price predictability (price loosing its guidance for long-term & capital-intensive investment decisions) => risk of underinvestment create risk of undersupply => risk of price increase for end-users

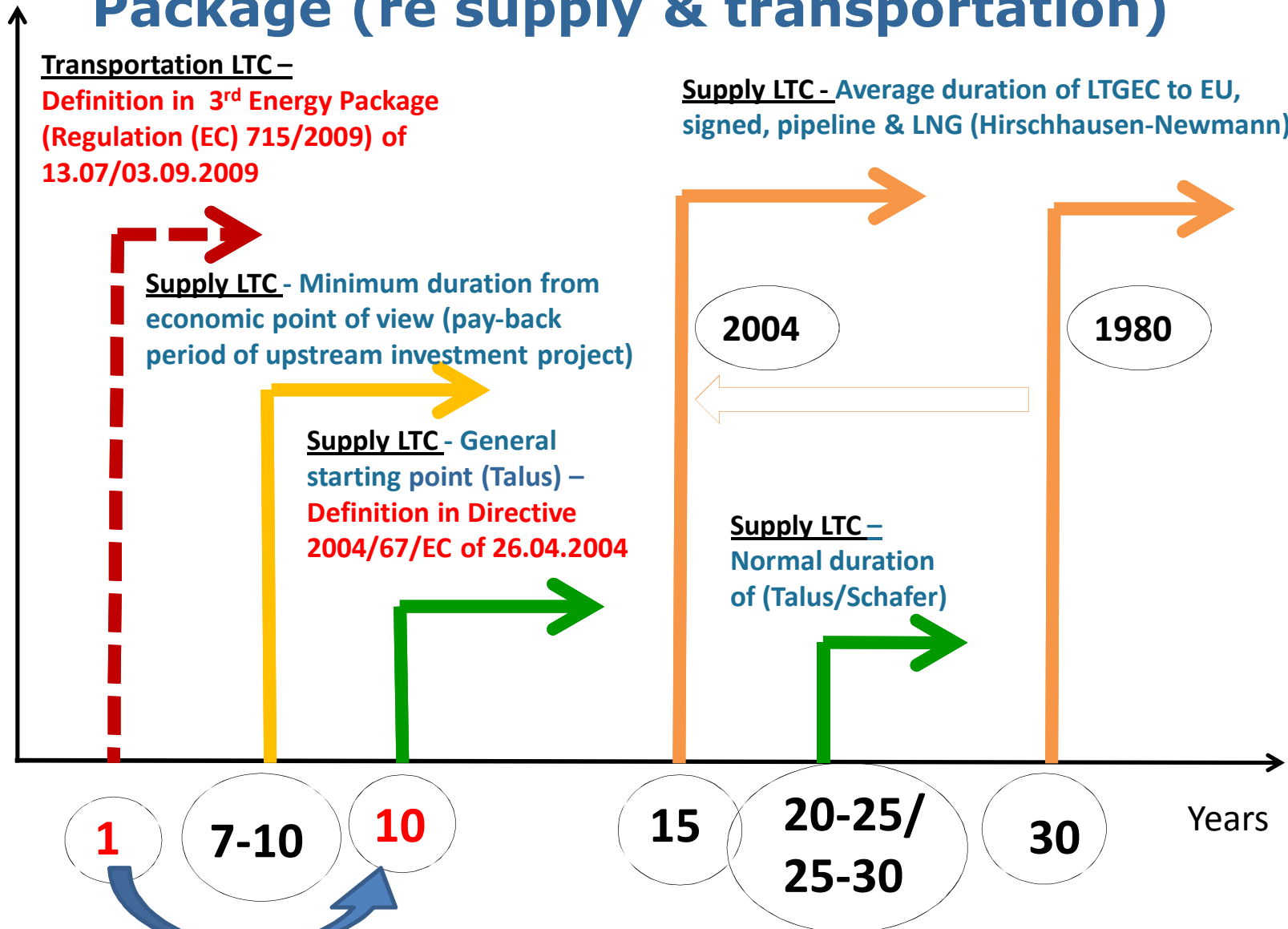
Contractual Mismatch Problem



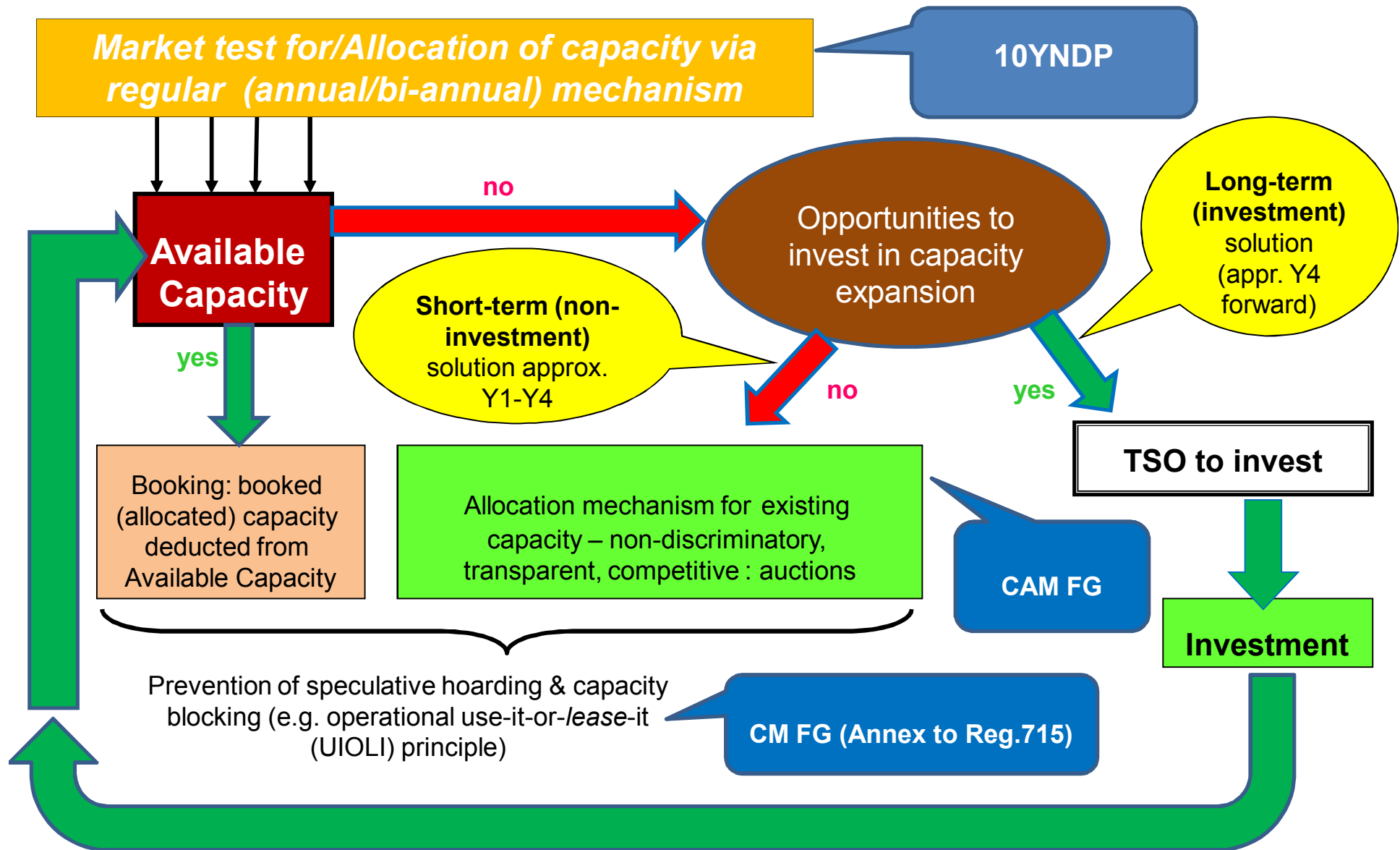
Contractual mismatch: correlation needed between duration/volumes (D/V) of long term supply/delivery contract (LTGEC; CP1-CP2) and transit/transportation contract (CP1-CP3); the latter is integral part to fulfill the delivery contract => risk of non-renewal transit/ transportation contract => risk of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



Open Season as Universal Mechanism of Long-, Medium-, and Short-Term Allocation of Capacity (draft proposal of Russian experts)



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)

Russia-EU & 3rd EU Energy Package (2007 => 2009 => 2014): two stages in relations (dominant features)

- **2007-2009: mostly political confrontation ?**
- **2010-2014: mostly professional (technical) cooperation aimed at diminishing risks & uncertainties for all participants of cross-border gas value chains destined for the EU ?!!!**

Thank you for your attention

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