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# ANDREY KONOPLYANIK ON DOUBLE TROUBLE: EU ANTITRUST CASE + WESTERN SANCTIONS

Natural Gas Europe had the pleasure of discussing Russia's energy relations with Andrey Konoplyanik, Professor at the Oil and Gas Gubkin Russian State University, Adviser to Director General of Gazprom export LLC.

Prof. Konoplyanik has published more than 500 articles on energy issues both in the USSR/Russia and abroad (all available at his website - www.konoplyanik.ru), including the recent publication in three parts "The Role of 'European formulas' in the Russia-Ukraine Gas Debate" in the "European Energy Review". He also known, inter alia, as Deputy Minister for Fuel and Energy, responsible for external economic relations and direct foreign investment, in the first post-Soviet Russian Gaidar's Government in the early 1990s, Deputy Secretary General of the Energy Charter Secretariat in Brussels in the 2000s. The first part of the interview is available here.

NGE: In 2011 the World Energy Outlook published by the IEA estimated that the Russian gas industry needed to spend \$730 billion by 2035 in order to maintain current production. Do you think that Gazprom will be able to maintain its production levels and raise finance in an age of sanctions?

AK: First of all, talking about scope of supply we should take into account that Gazprom domestically is not the only player on the Russian market and it works internationally on three different regional markets simultaneously: European, domestic and now, on top of these two, Asian one as well. Gazprom has a monopoly on Russian pipeline gas export to Europe, so demand swings in Europe influence on volumes of EU demand for this company's Westward export supply. But even if the demand stagnates (as it always happens at mature markets), there is still a niche for Russian gas in the EU and need to cover the demanded quantity since domestic EU supplies are diminishing. Thus demand for Russian gas is still there which means demand for Gazprom to invest in compensation of production decline from old mature fields to cover contractual obligations. Secondly, Gazprom signed some deals in the Asian-Pacific region, first of all most recent giant Russian-China gas deal, where the high contractual volumes of prospective deliveries exist (38 BCM). That means that Gazprom needs to cover the contract liabilities and invest in Asian markets-oriented projects. The third key market is a

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domestic one where Gazprom is by law responsible for gas supplies and gasification of the country and, as the owner of huge diversified gas transportation system, has obligation to invest in its maintenance. But domestically the issue is not only Gazprom's levels of production but also production of other companies oriented mostly on the domestic market that will continue to grow in scale. All mentioned above raises the question of financing. Before sanctions most of external financing used to come from American and European markets, now this option is temporary closed. At the moment I see the possibility of Gazprom to raise necessary financial resources but the price of it will be now higher – it will depend on many factors. Anglo-Saxon financing can be substituted by Asian financial markets (Latin America and South Africa as well) and Russia's internal reserves (sovereign funds). Special financing instrument of BRICS is being developed. This new development bank operated by the BRICS states can also help Gazprom to compensate reduction of Anglo-Saxon debt finance, but not immediately now since this bank is in the state of establishment. Of course, transition period will be rather expensive because Russia and its companies used to work on the one (mostly European) financial market so adjustment to another (Asian) market will lead to increase of transaction costs. Anglo-Saxon financial system has a long history and is tried and true because of so-called "learning curve" which leads to lower rates. Me and my colleague started to make benchmarking study of these two markets and I presume Anglo-Saxon rates are lower than Asian because of the wide range of financing instruments and experience, different regulation procedures, cultures, etc. Nevertheless, in future the Asian market will (at least partially) close this gap. Rates in the Russian market will also be higher, though in case the government finances a state-owned company, financing can be done through state-owned banks and foundations at preferential rates. Then rates should be quite low (in comparative terms with Asian markets). The main point is that Russia can find a temporary substitution to temporary loss of Anglo-Saxon financing in energy and the rate difference is not extreme. But I hope that the sanctions will not last long.

**NGE:** EU officials are reviewing the antitrust case against Gazprom. So far the commission has delayed sending its charge sheet known as the Statement of Objections because of the Ukraine case. Do you think that there is still the chance of a settlement?

**AK:** Yes, the case was kept on ice and then unfreezed because of the sanctions. I see it as a deterrent and believe that the EU claim against Gazprom doesn't take some objective things into account. Gazprom actually had a dominant position in the markets of Central and Eastern Europe but it is not his fault but a continuation/result of historical situation that was formed during the Soviet period when all gas infrastructure for then Soviet, now Russian, gas deliveries to the EU has been developed since 1960s on the East-West direction and latitude basis. Gas supplies to these countries that were then the members of COMECON went from one source and nobody thought about competitive supplies because of the centralized economy and state planning system. Now these countries became members of the EU and pursuant to the law there should be a multiplicity of sources of supplies/suppliers. Then I have a question: after "Velvet Revolutions" in late 1980s, former COMECON countries had 15 years of preparation before joining the EU, what were they and the EU thinking about all that time regarding diminishment of their dependence on Russian gas and increase of their diversification of supplies? Since 1989 till 2004 countries had a long preparation period and it was crystal clear that the infrastructure is still the same and it doesn't allow to have the alternative supplies. Eastern Europe didn't have enough financing to change it by itself, it needed help from the Western members of the EU, because it would be illogical to wait help from the USSR or later Russia in prejudice to itself. Nevertheless, the EU didn't do anything to change the situation and Gazprom stayed the major supplier through the pipeline constructed by the USSR. What we can see now is so-called "positive discrimination" because the EU is trying to oppress Gazprom, especially since 2004 when former COMECON states entered the EU, in that pipeline instead of investing into new infrastructure. The level of density of infrastructure in the Eastern Europe falls behind of the level of the rest EU members for decades. After joining the EU this difference surprisingly only became bigger. I think there is a lack of consistency and logic in the EU actions: they want to save their money and find someone's guilty for not doing proper and economically justified things (there is no diversity without investment). As every company Gazprom is trying to get rent income from its monopoly. If the EU doesn't want Gazprom to do it, they should build alternative infrastructure and create conditions for the business competition. That was the first thing. The second one is that the EU claims that oil indexation-based pricing is not fair when there is a spot pricing available with the lower price level somewhere in the neighbourhood within the EU. I argue that it is economically justifiable to choose between spot and contract price in the market with multiple supplies, for example in the Northwestern Europe. But it is not right (not economically justifiable, though desirable from consumer/importer's viewpoint) to get the spot price level from the UK or Belgium and use it in Hungary or Bulgaria. And it is definitely not proper to use spot price levels of North-Western Europe in Ukraine with no business competition and multiple supplies. If there are multiple suppliers then the price is lower, if not - it is higher and can be oil indexed, because a supplier has an economically-motivated and legally-justified right to get the maximum marketable resource rent since he can use



EAST MED PIPELINE TO EUROPE PROOF OF DIVERGING INTERESTS BETWEEN TURKEY, RUSSIA



SOUTH STREAM CAN BE BUILT, SAYS EC PRESIDENT JUNCKER

its non-renewable resource only once. I'm not sure whether this argumentation will work with the Directorate-Generale for Competition (DG COMP) which is sometimes labelled by EU colleagues as "internal inquisition". DG COMP might just say this or that is against the competition law (how they interpret it) – and then no economic argumentation will work for them. I would draw such analogy: not many countries have gas resources – inside the EU there are Netherlands, the UK and associated member Norway, others are Algeria, Russia and Azerbaijan. This original ("primary") gas is delivered to the EU market (usually by long-term contracts with "take or pay" clauses) and re-sold at the spot market (at the hubs). The gas traded there is mostly "secondary" gas. Russia is told to supply its "primary" gas with the price of "secondary" gas defined by the resellers. You know, there is a primary market of cars and a used car (secondary) market. Russian gas is like a new car, spot gas is a used car then. Would be strange to assume that a used car (secondary) market can define the price in the primary car market.

**NGE: Do you think that the trial can last for ages?**

**AK:** Might be, because right now a guilty verdict would not be advantageous for the EU. Sanctions and every element against Russia will harm Europe, and not only because Russia-EU commercial turnover is much bigger than the turnover with the US. Let me be non-diplomatic by providing the following economic explanation of possible background for sanctions policy. From my view, sanction policy might be a purposeful activity of American establishment - and mostly against the EU. The European Union and the United States are allies, but the US get a lot of money from this alliance and get richer and richer from every conflict in the Old World and its restoration after each such conflict: the First World War, the Second World War, Marshall Plan... Providing supplies of ammunition to the countries in war to be paid off afterwards... financial assistance and loans during the Marshall Plan for payments for supplies of American goods and services (tied loans). So the US always try to solve their domestic problems, preferably (when possible) at the cost of the others... it seems that this is the case today. The US quantitative easing is almost over and the States need to get out of crisis by extension of competitive niche in global economy. New strong players appeared on the market – for the first time China became the first economy in the world, it surpassed the USA in terms of GDP (if calculated at PPP basis). Before we used to have 3 major international centers in global economy: the US, the EU and Japan. Now the world balance has changed, China and India arised. It's more complicated to climb out of crisis when a new strong player. In this situation a country can strengthen its competitive advantage in two ways: strengthen itself or get rid of the weakest. America simply removes the most vulnerable player among the new matrix – which is the EU. Neither Russia nor Ukraine can be rivals in the global competition today. Russian-Ukrainian conflict and following sanctions which strongly involved the EU which now became the part of the triangle were just a means to an end. I don't believe in the American LNG supplies to Europe and regard it as propaganda (negotiating tool to soften parameters of Russian gas supplies). An attempt to deviate from Russian gas flows to the EU leads to necessity to develop (which means time and money) more expensive and less reliable energy sources to the latter. Moreover, the whole supply logistics changes: from west to the east instead of classic scheme from the east to the west. It requires enormous investments and the change of gas delivery scheme that has history since 60s. In the end, it fatally decreases the competitive ability of the EU in global economy on top of internal EU problems.

**NGE: The Russian government has taken steps to open up the export market. Do you believe that presence of such companies as Rosneft and Novatek in the market can become bigger in the future?**

**AK:** Absolutely, and not only Rosneft and Novatek. In the process of developing oil resources all companies will have to solve the issue of APG utilization as there are not many pure oilfields. Also, when a company starts extension drilling on a new land, it can expect to get oil and finally can find gas. Companies except those three that you just mentioned can get volumes of gas extraction. Basically, the only restriction for newcomers is continental shelf, where only two state-controlled companies- Gazprom and Rosneft- have the right to develop resources. As for land, the number of gas producing companies will increase. Where will this gas go?

Here we face the problem of gas transportation reform. Government and Gazprom will have to change the rules of the game, because the gas transportation system (GTS) was sensitized to primarily Gazprom's interests. In 1997 Russia endorsed Regulation on non-discriminated access to the GTS. By the way, we did it earlier than the EU, that adopted its First Gas Directive in 1998. Despite the existing Regulation, many companies have complaint about the way Gazprom gives access to the pipeline transportation system. By law "On gas supply" (1999) Gazprom, as an owner of GTS, has the right to service its subsidiary companies on a priority basis and on discounted (transfer) transportation tariffs. So, to increase other companies share in gas supply Russia has to expand the non-discriminated access.

As for the foreign market, I think that Russian government will try to avoid competition between producers in order not to reduce the resource rent. The possible variant is that Gazprom will keep the monopoly on supply and become gas export agent for other companies. The only hindrance is that Gazprom –as an owner of the gas transportation system- carries the burden of maintenance and development of the system. Fairly enough, Gazprom suggests sharing expenses between all companies. In my opinion, the issue of the access to the market can be solved by avoiding the competition and gradual share of expenses, for example, in the form of quota allocation.

This process can't be fast, rather soft adjustment than dramatic actions. LNG liberalization started because Gazprom mostly has pipeline supplies to Europe, while projects of Rosneft and Novatek are aimed at growing Asian markets, so companies don't have straight competitive interests. Growing Asian demand can absorb both supplies of Gazprom and LNG supplies of other companies. The conflict of interests can appear in the stagnating European market. If it happens, governmental guidelines could reconcile Gazprom and Rosneft, but not directly privately-held Novatek.

Thus and so, the competition between gas originated from Russia in Europe is inevitable, even if on a small scale. The new Russian LNG producing companies will have a choice whether to go to Asian market through the Northern Sea Route, that sometimes can be complicated because of the weather conditions, or to European market. That is why I believe that we will see Novatek's Yamal LNG in Europe.

### **Marina Zvonareva**

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