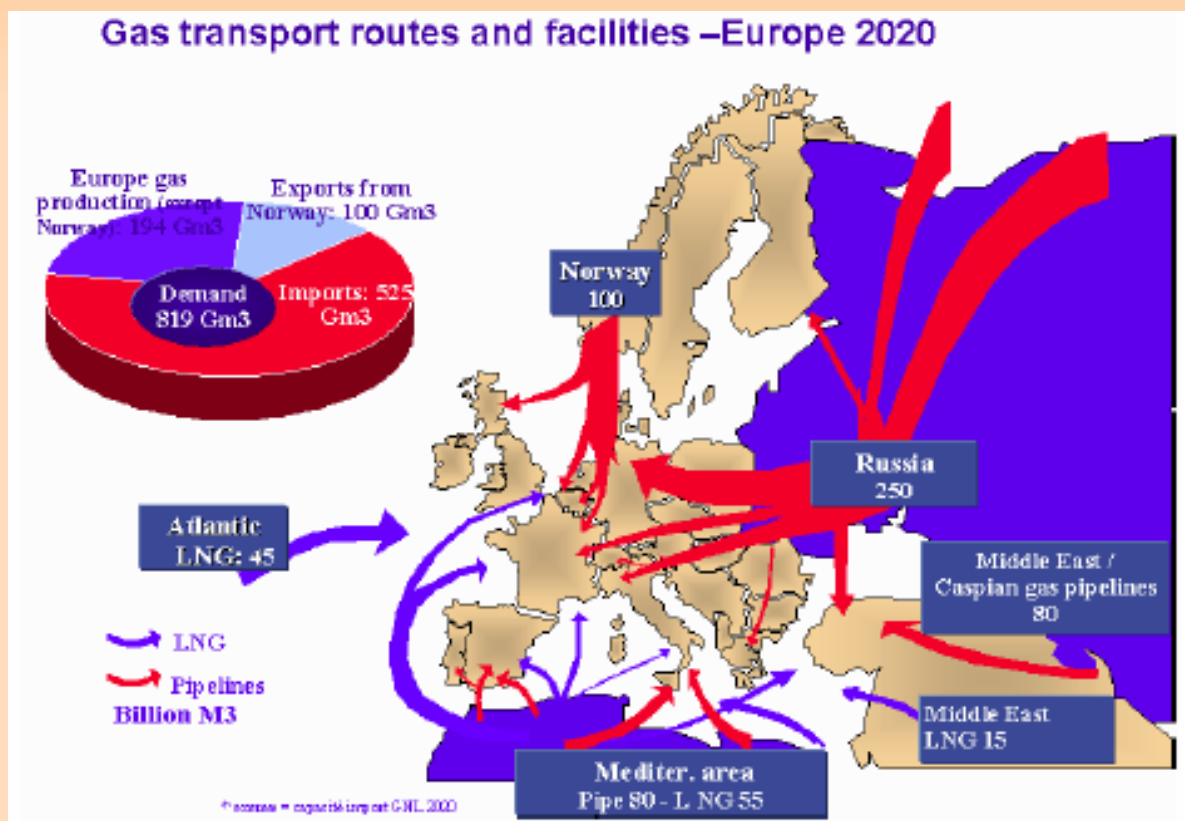


**RUSSIAN GAS TO EUROPE:  
FROM LONG-TERM CONTRACTS, ON-BORDER TRADE  
& DESTINATION CLAUSES TO ...?**

**Dr. Andrei A.Konoplianiuk  
Deputy Secretary General  
The Energy Charter Secretariat**

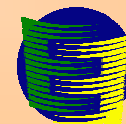
**Presentation to The 3rd EU Energy Law & Regulation Workshop  
“New Challenges for Regulation: Investment, Environment & Co-ordination”,  
23-24 September 2004, Florence, Italy**

# EUROPEAN GAS TRANSPORT ROUTES AND FACILITIES IN 2020

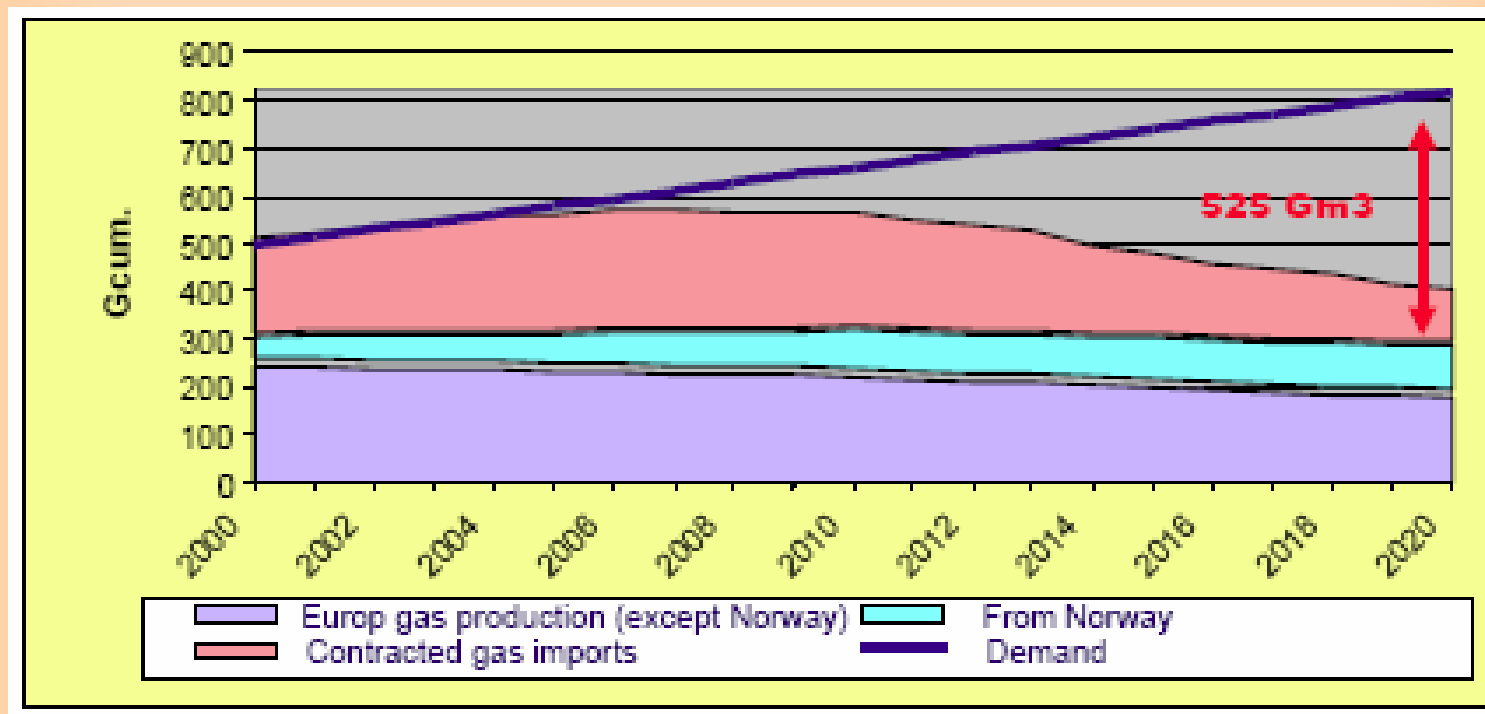


**Russia will provide (250 BCM) about a half of European import demand for gas in 2020 (525 BCM)**

**Source:** P.Cayrade. Investments in Gas Pipelines and LNG Infrastructure. What is the Impact on the Security of Supplies? - CEPS. INDES Working Papers, N3, March 2004

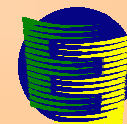


# SUPPLY, DEMAND AND CONTRACTED GAS IMPORTS



**Among 525 BCM required for import to Europe in 2020, 400 BCM are not yet contracted**

**Source: P.Cayrade. Investments in Gas Pipelines and LNG Infrastructure. What is the Impact on the Security of Supplies? - CEPS. INDES Working Papers, No.3, March 2004**



## **Current presentation: WHAT?**

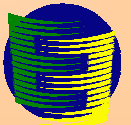
**Russian gas supplies to Europe :**

- 1. How they have been organized and why so;**
- 2. Whether and how they are being reorganized and why so;**
- 3. Whether current changes reflect exporter-importer (producer-consumer) balance of interests**

## **Current presentation: WHY?**

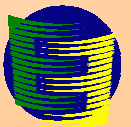
**To clearly understand economics underlying current contractual structures of Russian gas supplies to Europe in order:**

- (a) to find a balanced solution in its updating adequately to and in correlation with objective changes of the [broader European] gas market developments, and**
- (b) to provide secure and effective gas supplies to Europe [enlarging EU] within yet un-contracted import demand quantities**



# MAJOR ELEMENTS OF RUSSIAN GAS EXPORTS TO EUROPE:

- Long-term “take and/or pay” contracts
- On-border (EU-15) sales
- “Destination clauses” (territorial sales restrictions)
- Key role of transit



# LONG-TERM TAKE AND/OR PAY GAS CONTRACTS (LTC TOP) AND PROJECT FINANCING RISKS

$$\text{Financing} = f(\text{revenue}) = f(\text{volume} \times \text{price})$$

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(1) LTC TOP = mechanism of supply risks («volume» risks) reduction

(2) LTC TOP + adequate pricing mechanism = mechanism of “price” risks reduction:

- prior to exchange pricing: escalation formulas
- exchange pricing: spot/futures/options + hedging

(1) + (2) = mechanism of project financing risks reduction in long-term capital-intensive Greenfield projects, especially in new regions with no (lack of) production & transportation infrastructure

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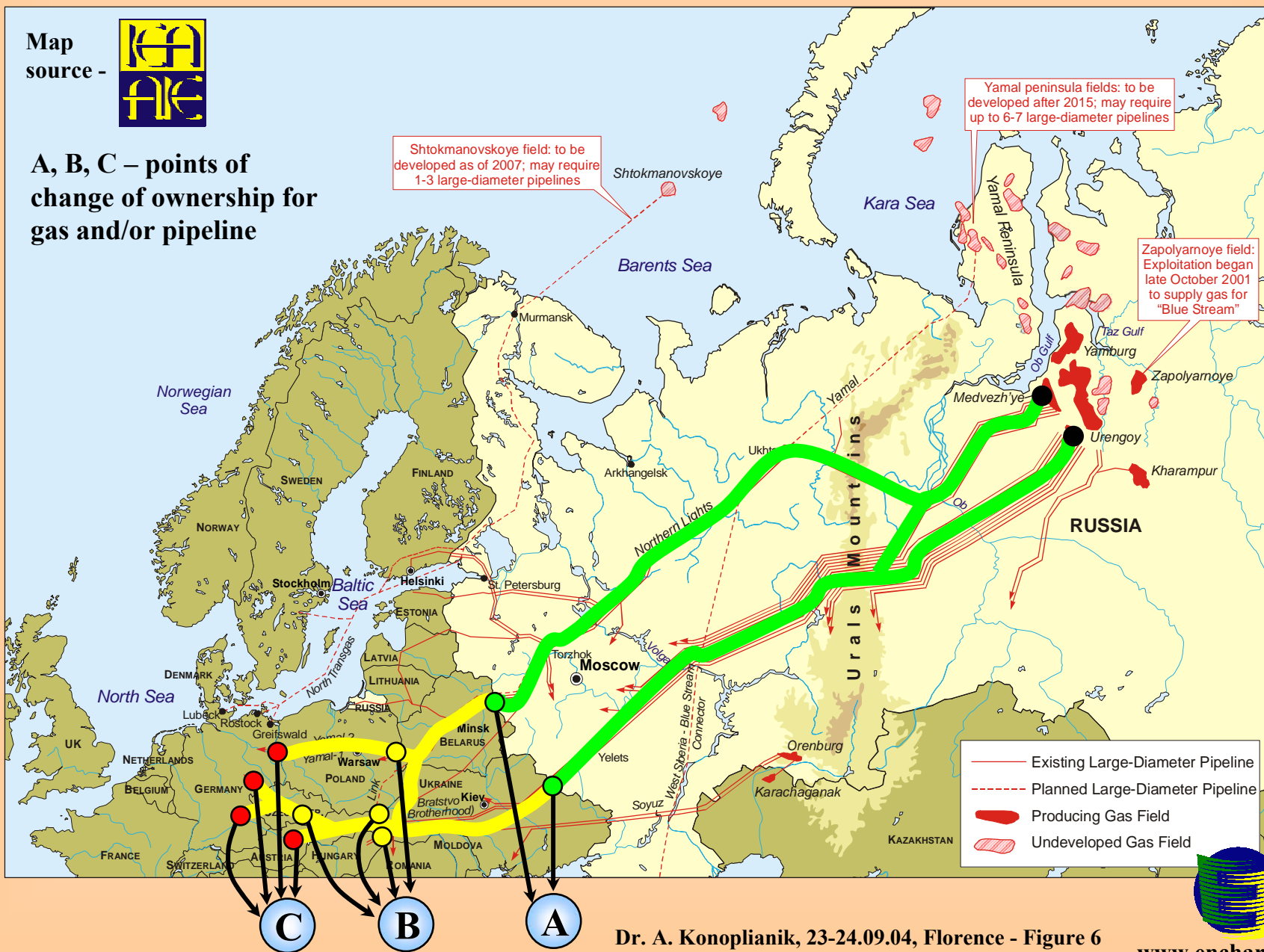
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# RUSSIAN GAS EXPORT TO EUROPE: ON-BORDER SALES AND TRANSIT ARMS

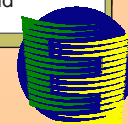
Map source -



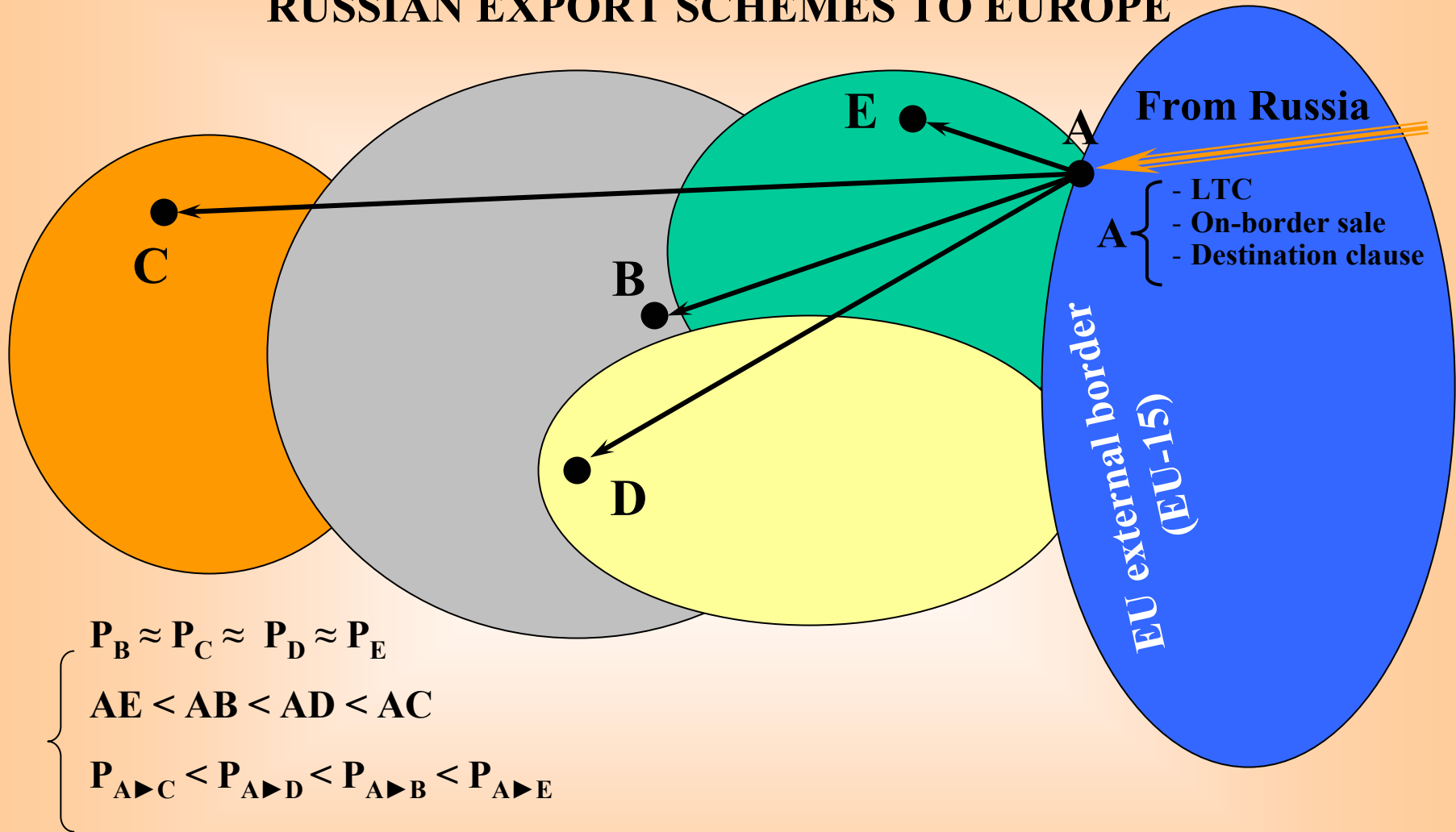
A, B, C – points of change of ownership for gas and/or pipeline



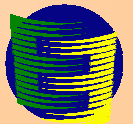
Dr. A. Konoplianiuk, 23-24.09.04, Florence - Figure 6



# DESTINATION CLAUSES = TERRITORIAL SALES RESTRICTIONS = ECONOMICALLY MOTIVATED INTEGRAL PART OF EXISTING RUSSIAN EXPORT SCHEMES TO EUROPE



“Destination clauses” allowed gas supplier to sell gas to different buyers at different prices and conditions at one and the same delivery point.





# 3.4 DESTINATION CLAUSES

## GAS PRICE ARRANGEMENTS (SCHEMATIC) FOR RUSSIAN GAS AT BAUMGARTEN



$F - F_E$  = French transportation adjustment  
 $A_E - F_E$  = French Baumgarten "discount"

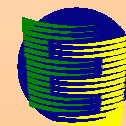
$I - I_E$  = Italian transportation adjustment  
 = Italian Baumgarten "discount"



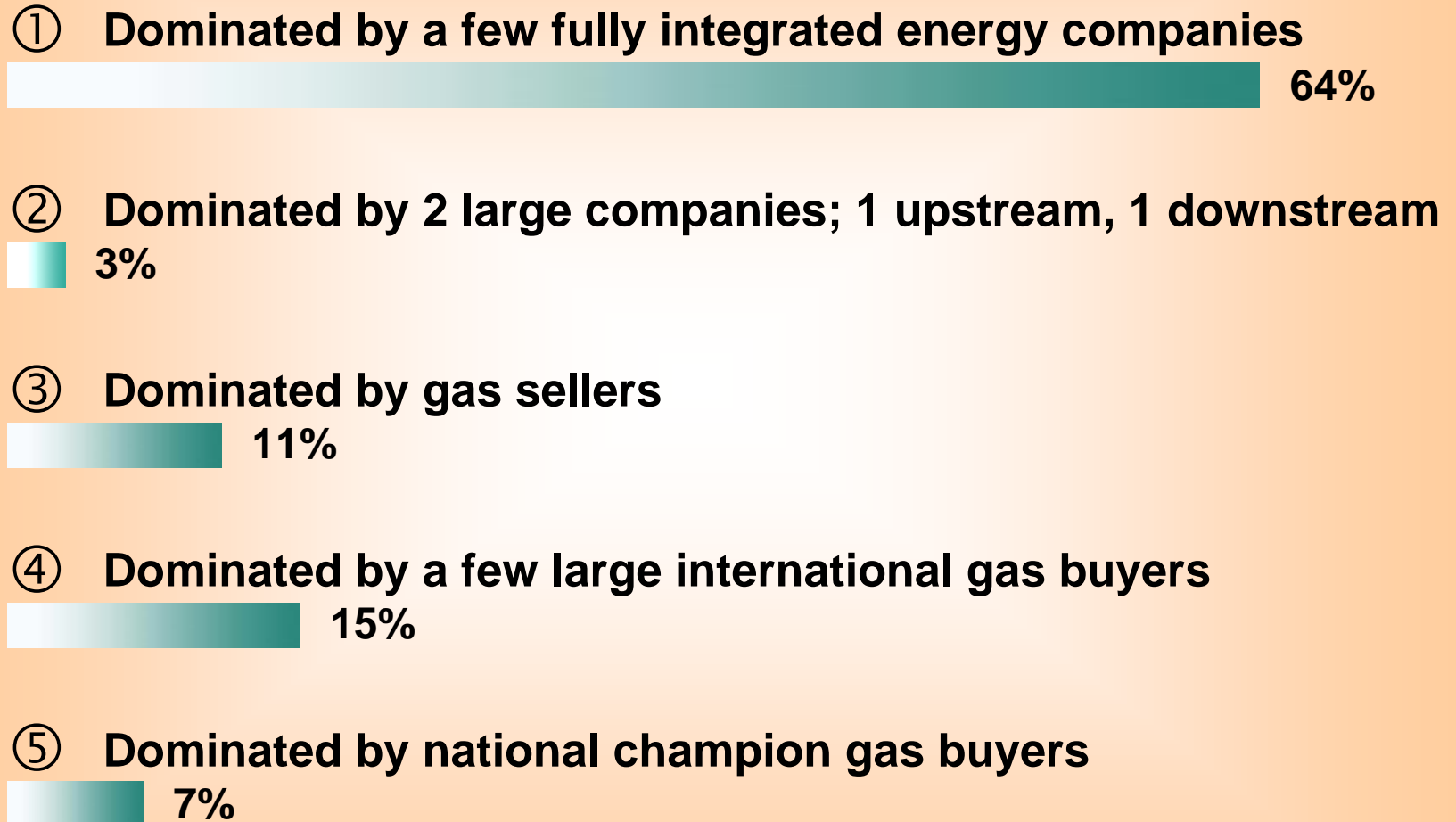
## ROLE OF LONG-TERM CONTRACTS IN GAS SUPPLIES TO EU MEMBER-STATES

	Italy	France	Germany	Spain	Belgium	Greece
Total supplies in 2002 (BCM)	72.5	44.2	94	23	17.5	2.1
Share of imports in total supply (%)	80	96	82	99.5	100	100
Share of LTC in total supply (%)	NA	94	NA	44	91	100
Average residual duration of contracts (years)	14	15	11	NA	NA	13

**Source: ECS calculations**

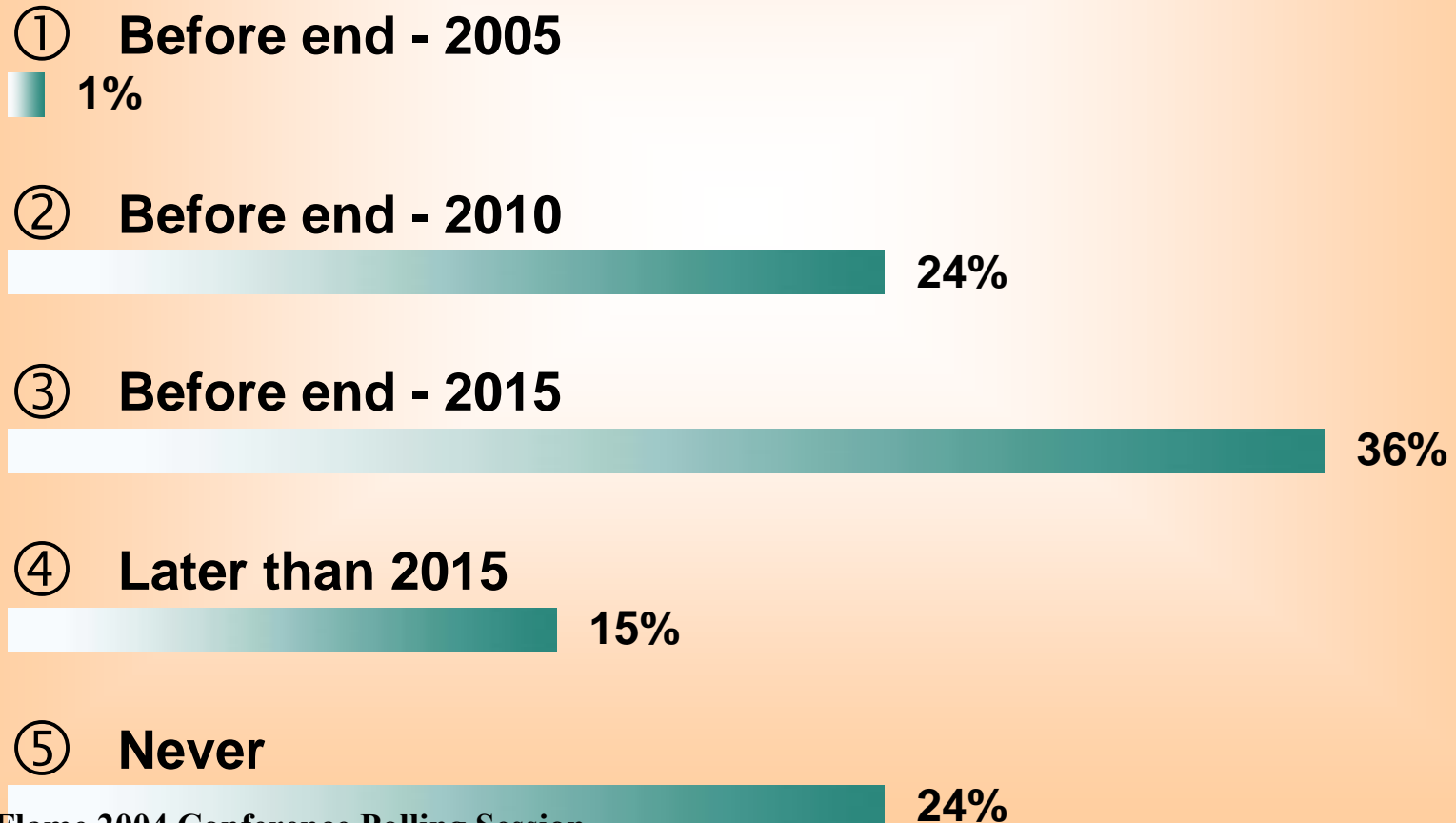


# How would you characterise Europe's gas market in 10 years time?



Source: Flame 2004 Conference Polling Session

# When do you believe that European long term contract gas prices will become decoupled from oil and determined by spot/futures prices?



Source: Flame 2004 Conference Polling Session

# By the end of 2008 what will be the volume of gas sold at hubs as a percentage of total EU gas sales?

① 5% or less



② 6-10%



③ 11-20%



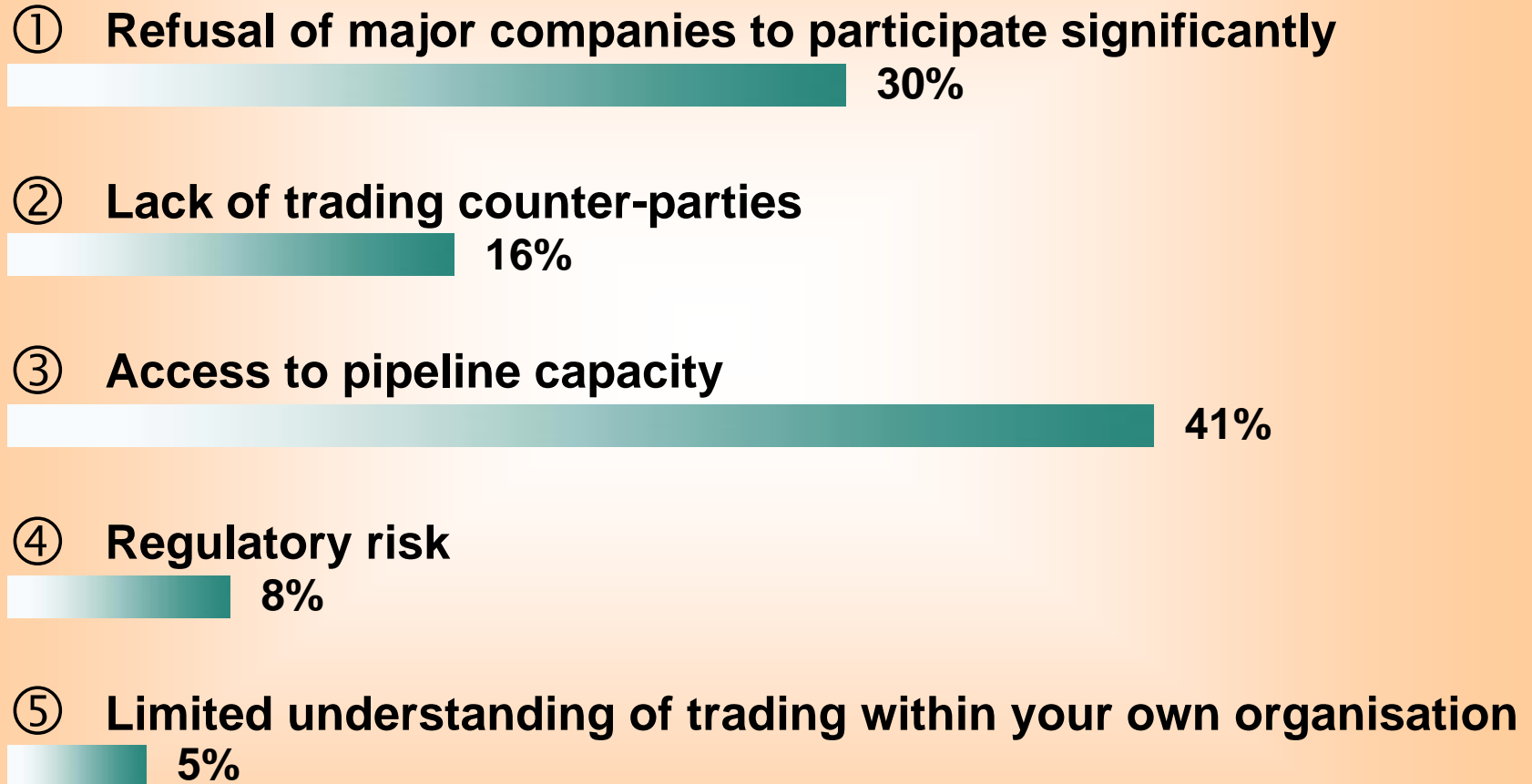
④ 21-30%



⑤ More than 30%



# Why do you think that traded markets across Europe lack liquidity?



Source: Flame 2004 Conference Polling Session

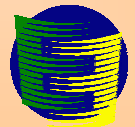
Dr. A. Konoplianiuk, 23-24.09.04, Florence - Figure 13

# EU POSITION ON LONG-TERM CONTRACTS

**Item 22: “Long-term contracts will continue to be an important part of the gas supply of Member States and should be maintained as an option for gas supply undertakings in so far as they do not undermine the objectives of this Directive and are compatible with the Treaty, including competition rules.”**

**Source: DIRECTIVE 2003/55/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL (26 JUNE 2003)**

**concerning Common Rules for the Internal Market in Natural Gas and Repealing Directive 98/30/EC**



## 2004 OMV - GAZPROM DEAL

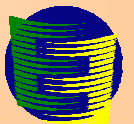
**Russian gas supply to Austria: 5.5 BCM/y = 2/3 of domestic demand. LTC with delivery point at Baumgarten. Destination clauses: restriction to use gas in Austria only**

**In May 2004 OMV and Gazexport has agreed to roll-over existing gas supply contracts to 2012 and up to 6.5 BCM/y:**

- **Pricing formula changed: current price reference benchmark switched from official German Wiesbaden index to Rotterdam oil product prices;**
- **Contracts has been adjusted to the conditions of the liberalized gas market, i.e. “destinations clauses” are scrapped and OMV is no longer restricted to using gas in Austria;**

### **Conclusion:**

**No immediate negative consequences for Gazprom since its “effective” gas price in Baumgarten for deliveries to Austria is the highest compared to deliveries to France and Italy.**





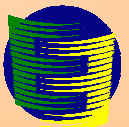
## 2003 ENI - GAZPROM DEAL

**Russian gas supply to Italy: 16.9 BCM/y = 1/4 of domestic demand. LTC with delivery point at Baumgarten and further to Italy via TAG pipeline. Destination clauses: restriction to use gas in Italy only.**

### **2003 EU Commission-ENI-Gazprom solution:**

- **Delete destination clauses from all *existing* gas supply contracts. Two delivery points (new contracts) instead of one (existing contracts). ENI free to re-sell gas to any destination, incl. outside Italy;**
- **ENI committed to offer significant gas volumes to customers outside Italy over 5-year period starting 01.10.2003. If not sell sufficient volumes during first half of the period – auction at Baumgarten;**
- **Refrain from introducing ENI consent clauses in new contracts in Italy;**
- **ENI to promote capacity increase (2008-2011) of its majority-controlled TAG pipeline (100% of Russian gas to Italy) and to promote an improved TPA to use TAG for transit.**

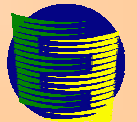
Source: Commission press-release on territorial destination clauses with Gazprom and ENI, IP/03/1345, 06.10.2003/  
Commission Staff Working Paper “Energy Dialogue with Russia. Update on progress”, 28.01.2004, SEC (2004)114,  
Annex 6; ECS estimates



# 2003 ENI - GAZPROM DEAL (continued)

## Conclusion:

- **Negative consequences for Gazprom since its “effective” gas price in Baumgarten for deliveries to Italy is lower compared to that of deliveries to Austria?**
- **Has ENI received undue advantages?**
- **Whether the deal is balanced (“destination clauses” deleted from existing contracts, while TAG capacity improvements and TPA are delayed to 2008-2011)?**
- **Whether incremental “profit-sharing” mechanism (similar to Algerian LTC model) would be more fair solution?**



## 5.2 CONCLUSIONS

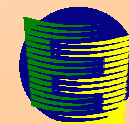
- ▲ The removal of destination clauses should be strictly tied to and be conditional upon the introduction of full and unrestricted TPA in the EU gas transmission system
- ▲ Removal of destination clauses without unrestricted transmission system TPA would give gas importers undue advantages over gas exporters

MFC

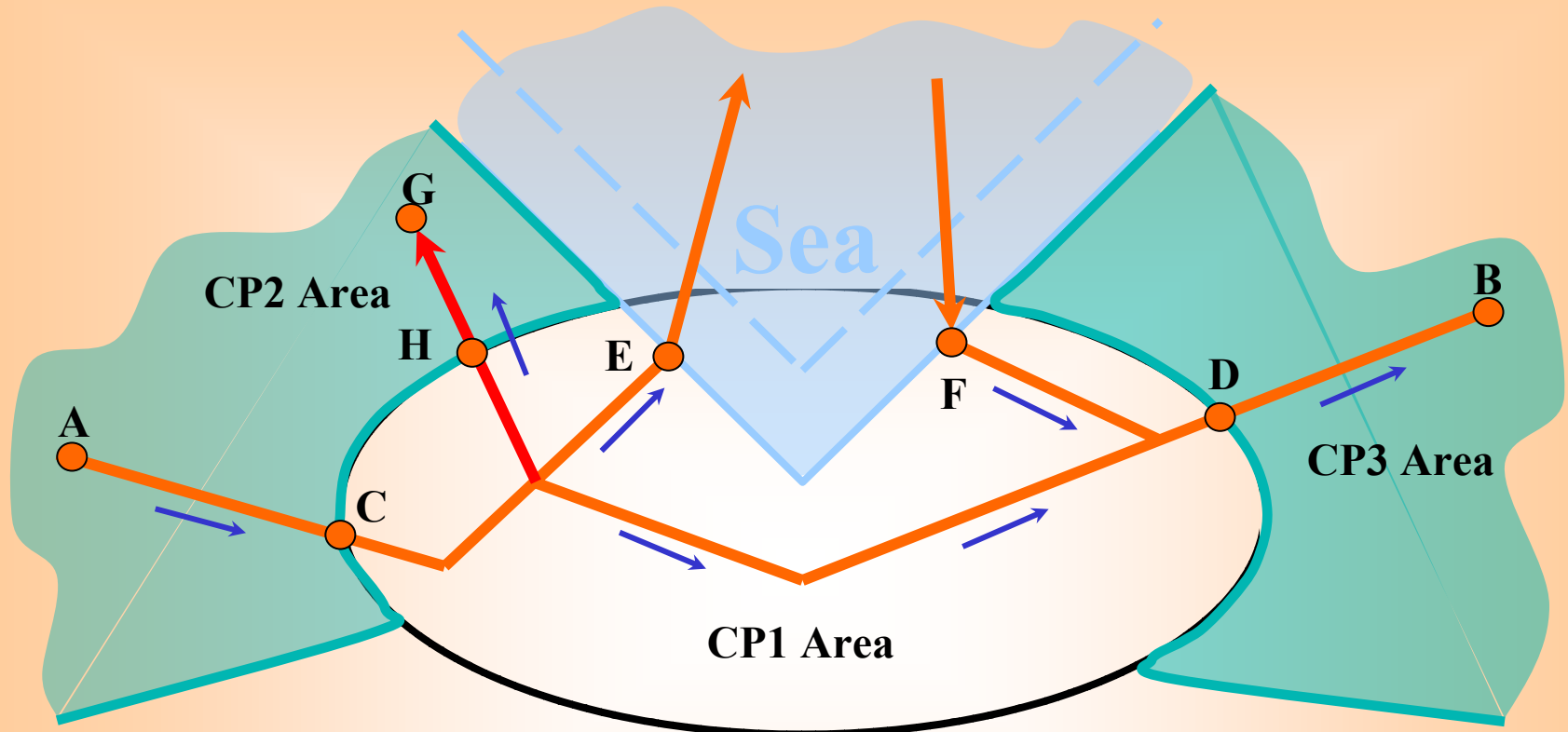


# ROLE OF GAS TRANSIT FOR ITS MAIN EXISTING EXPORTERS TO EUROPE (1999)

Country-exporter	Direct supplies, % of volume of exports	Transit through the territory of: % of volume of exports			
		one country	two countries	three countries	four countries
<b>EXISTING EXPORTERS</b>					
Netherlands	76,2	13,8	10,0	-	-
Norway	67,7	7,5	21,4	3,4	-
Algeria	44,9	14,8	9,6	24,3	6,4
Russia	39,5	9,4	11,4	28,1	11,6



# TRANSIT IS NOT THE ONLY OPTION ...



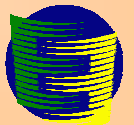
## 3 possibilities of energy supplies from A to B:

No transit (on-boarder sales at C, D):

RUF-EU, Turkmenistan-RUF, Kazakhstan-RUF, Algeria-Italy, Algeria-Spain;

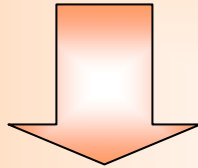
Transit:

- through the pipe owned/leased by shipper: France-Germany, Norway-France, Italy-Austria; planned RUF-CIS/EE;
- through the pipe not owned by shipper



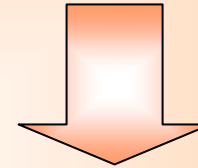
# ... BUT IT MIGHT BE THE CHEAPEST ONE – IF ADEQUATELY LEGALLY PROTECTED

## TWO SCENARIOS OF RUSSIAN GAS EXPANSION FURTHER INTO EUROPE



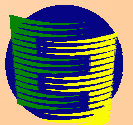
1) Gazprom = owner of pipeline  
(construction of new pipeline capacities, purchase of pipeline companies shares)

- More expensive
- Decreasing rights of pipeline owners on decisions for transit/ transportation conditions according to EC legislation



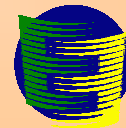
1) Gazprom = shipper (from gas sales at the border to wholesale buyers/resellers → to sales to final consumers within country)

- Less expensive
- Increasing rights of transporters on decisions... according to EC legislation



# **ECT TRANSIT PROTOCOL: MAJOR ISSUES ADDRESSED**

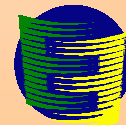
- 1. Obligation to observe Transit Agreements**
- 2. Prohibition of unauthorized taking of EMP in Transit**
- 3. Definition of Available Capacity in Energy Transport Facilities used for Transit**
- 4. Negotiated TPA to Available Capacity (mandatory TPA is excluded)**
- 5. Facilitation of construction, expansion or operation of Energy Transport Facilities used for Transit**
- 6. Transit Tariffs shall be non-discriminating, objective, reasonable and transparent, not affected by market distortions, and cost-based incl. reasonable ROR**
- 7. Technical and accounting standards harmonized by use of internationally accepted standards**
- 8. Energy metering and measuring strengthened at international borders**
- 9. Co-ordination in the event of accidental interruption, reduction or stoppage of Transit**
- 10. Protection of International Energy Swap Agreements**
- 11. Implementation and compliance**
- 12. Dispute settlement**





# ECT TRANSIT PROTOCOL DEVELOPMENTS

- **April 1, 1998 – G8 Energy Ministerial in Moscow with transit as one of three key issues discussed (Transit paper submitted by ECS);**
- **April 23-24, 1998 – ECC asked the Working Group (Preparatory) to follow up;**
- **June 4-5, 1998 – first transit-related discussion at (Preparatory) Working Group meeting;**
- **December 3-4, 1998 – ECC decision on TP negotiations;**
- **February 1-2, 1999 – ECT TP negotiations started;**
- **December 17-18, 2002 – multilateral phase of ECT TP negotiations finished with three outstanding issues left open between RF and EU to be settled by two in the course of bilateral consultations:**
  - **auctions as method of establishing transit tariffs,**
  - **Right of First Refusal,**
  - **REIO clause;**
- **June 10, 2003 – working compromise between RF and EU delegations reached on the text of ECT TP to be approved by the capitals;**



## **ECT TRANSIT PROTOCOL DEVELOPMENTS (cont'd)**

- **June 23, 2003 – RF statement to continue work on three outstanding issues;**
- **October 2003 – “Lamy package” presented in RF-EU bi-laterals on RF accession to WTO with demands on transit differing from those in ECT TP;**
- **December 1, 2003 – RF statement on decoupling of WTO and ECT TP negotiations and to bring transit debate back to ECT forum;**
- **May 21, 2004 – RF-EU WTO negotiations concluded;**
- **June 15, 2004 – RF and EU stated their readiness to re-start ECT TP bi-laterals;**
- **October 1, 2004 – new round of RF-EU bi-lateral consultations on ECT TP finalization to take place. Major expected item for debate: implementation of RFR (or adequate instruments providing transit supply security for shippers) within the territories of new EU member-states where transit of Russian gas has been historically taken place and where (since May 1, 2004) transit would not exist under “REIO clause” provisions of ECT TP.**

