

The end of a monopoly? The EU vs. Gazprom and the future of Russian gas (in Europe)

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DG COMP: “Gazprom may be abusing its dominant market position in upstream gas supply markets in Central and Eastern European Member States” (1)

- Right facts, but incorrect reasoning: there is a lot of things Gazprom can be criticized for, but don't claim him for what he is not responsible
- Gazprom as commercial entity tries to maximize economic benefits (resource rent) from the situation which it has inherited from the past
- Increasing competition in EU gas market will best force Gazprom to adapt, not the administrative attacks

CEC vs Gazprom: three ways of action => three lines of debate



RF Presidential Decree 1825 (11.09.2012) as an immediate reaction to the CEC claim ("domino" & "senior brother" effects) => to switch from diagonal to horizontal character of the "debate" (to adjust/to put on equal level "political weight" of the parties in the debate) => official RF reaction

To (try to) understand the economic background (pre-requisites) of the situation that creates the conflict of interests and thus stipulated the CEC claim against Gazprom => my line of the proposed debate

Official DG COMP procedure (dominance of legal over economic considerations)? => (most probable) continued EU action

SoS instruments within LTC & spot models

SoS	LTGEC (Groningen-type)	Spot
Volume	Guaranteed at any state of the market & long-term; minimum duration = pay-back of CAPEX in supply (new production, incl. to compensate reserves depletion + transportation)	Guaranteed only at the oversupplied market & in short-term
Price	Negotiated by 2 contract parties; adaptable (price review) though with time-lag; to cut-off the price-peaks; formula vs spot pricing / prices: (i) undersupplied markets: spot above LTC price => LTC buyers happy, (ii) oversupplied markets: spot below LTC => LTC buyers unhappy	Taken from the hubs but: (i) liquidity (Cont.EU < 5; GTM = 8, UK, TTF, benchmark = 15; HH = 400; oil = 2000), (ii) possibility to manipulate (proved at oil), (c) NWE = excessive infrastructure
Flexibility	LTGEC provides 2 products for buyers: both commodity (gas) & service (flexibility); TOP = built-in “virtual UGS” within LTGEC => flexibility for buyers available from LTC at any state of the market [<i>LTGEC with TOP (+ redirection of Qatari gas from US to EU post-2009) provided oversupply & market flexibility in EU</i>]	Spot provides only commodity (volume+price), does not provide flexibility which is to be taken from the market => if available from: (i) oversupplied market (for how long?), & (ii) UGS (CAPEX + time)

DG COMP: “Gazprom may be abusing its dominant market position in upstream gas supply markets in Central and Eastern European Member States”

- **Three** claims:
 - **two** refers to *capacity* market functioning,
 - “First, Gazprom may have divided gas markets by hindering the free flow of gas across Member States”
 - “Second, Gazprom may have prevented the diversification of supply of gas”
 - **one** refer to *commodity* market functioning
 - “Finally, Gazprom may have imposed unfair prices on its customers by linking the price of gas to oil prices”

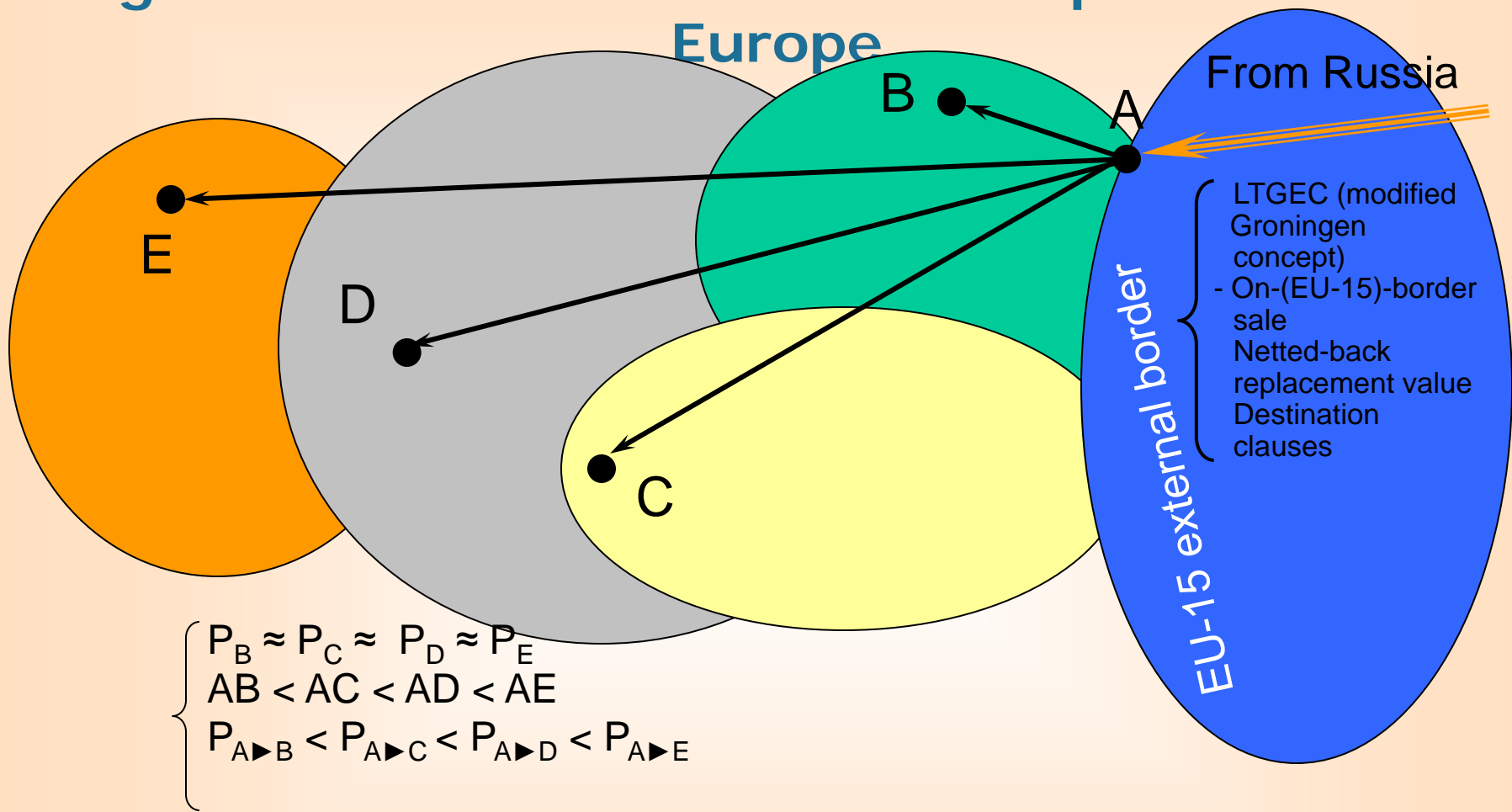
DG COMP: “Gazprom may be abusing its dominant market position in upstream gas supply markets in Central and Eastern European Member States” => *Overview*

- Gazprom today’s dominant market position in CEE/EU:
 - Result of infrastructure development (investment decisions) within different political & economic environment (Cold War) of then divided Europe - CEE/COMECON (gas industry is the most inertial: CAPEX+time)
 - It is not Gazprom who is responsible for this development made mostly in “pre-Gazprom” time, but USSR planned economy
 - USSR/COMECON: no alternative supplies, monopoly supplies from USSR to CEE/COMECON (by purpose)
 - For 40 years (since early 1960-ies till end-1990-ies) such monopoly favoured CEE (political pricing): cost plus (CEE) vs NBRV (WE) => economic ties USSR/COMECON (discounted prices for CEE) as backbone of political ties (political loyalty in exchange of economic benefits)
 - 10 years after “velvet revolutions” (collapse of COMECON), CEE import pricing moved from cost plus to NBRV (to “European formulas”), but since oil price was low (1998) - no major negative results in CEE
 - Only when situation in EU changed (economic crisis + US shale gas domino effects => oversupply => low spot prices), but high oil prices through PP-indexation hold LTGEC prices high, Gazprom’s issue was raised again

DG COMP: “First, Gazprom may have divided gas markets by hindering the free flow of gas across Member States” (1)

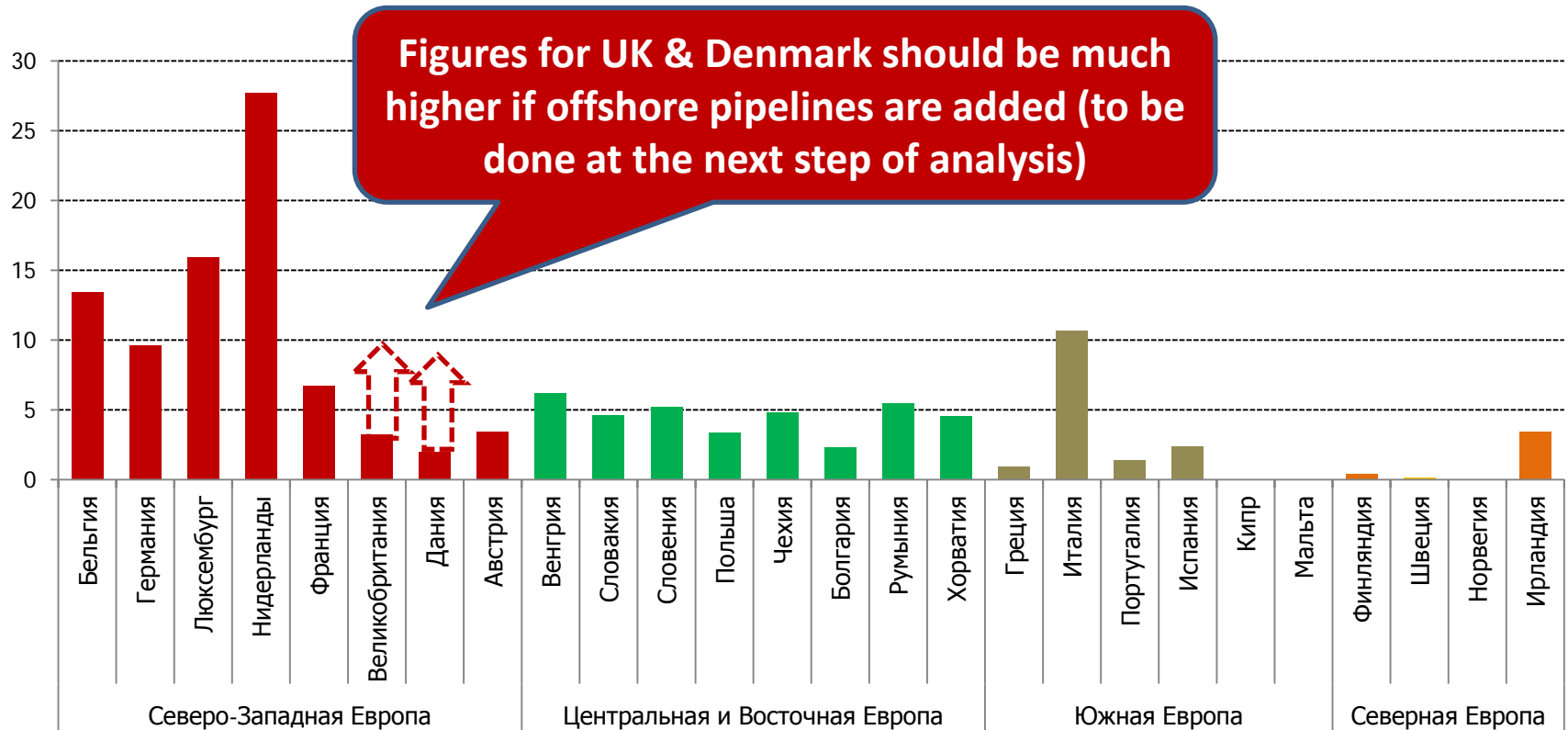
- Gazprom has not divided CEE markets – they were divided by former USSR/COMECON central planning
- “Divided markets”: if LTGEC with “destination clauses”, it were commercial realities within given architecture of EU market (no single USSR/RF export price at delivery points at EU border)
- Today’s lack of “free flows” = result of lack of diversified infrastructure (interconnectors, reverse flows, alternative routes, etc.) = result of low investment stimuli (for project financing) to invest in infrastructure in *unbundled* EU market with MTPA, spot/exchange pricing, regulated tariffs & ROR, etc.

Destination Clauses: Economically Motivated Integral Part of Soviet / Russian Export Schemes to Europe



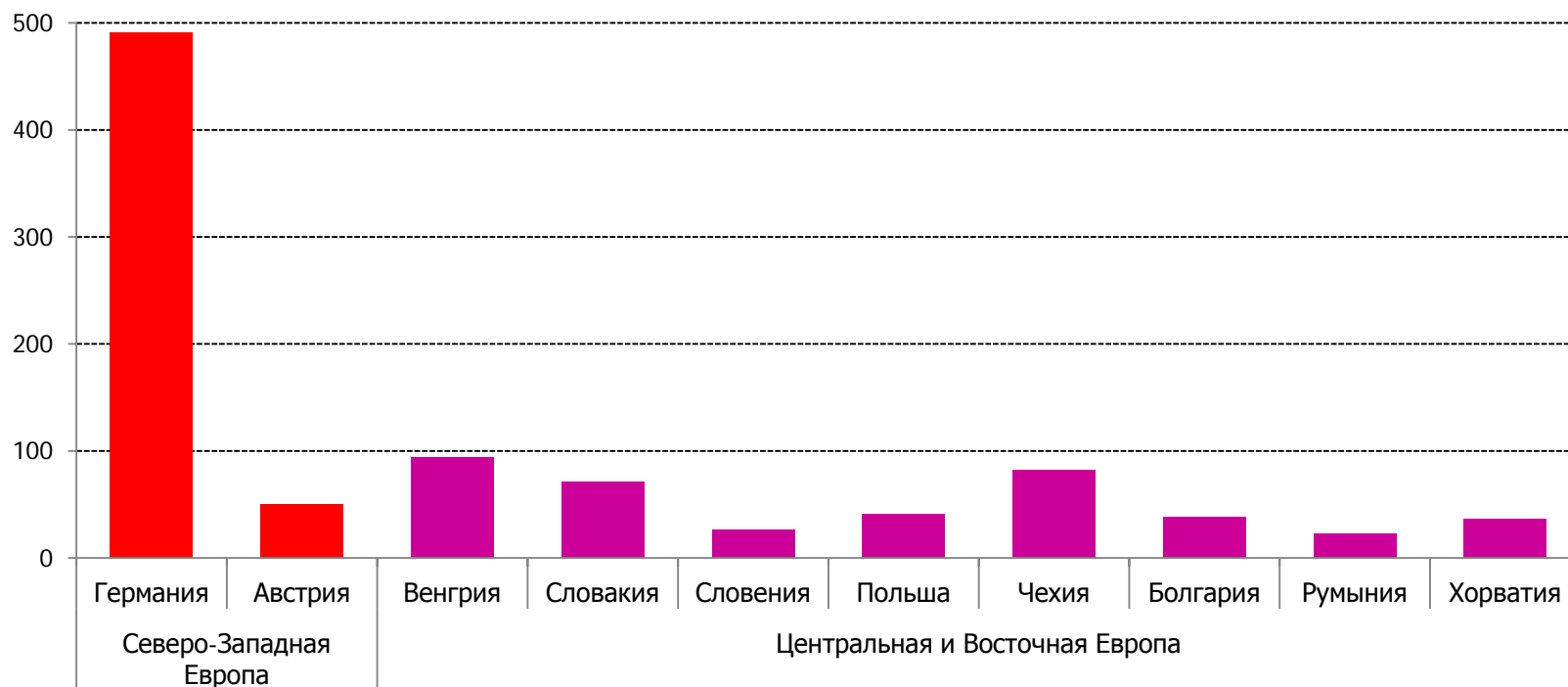
“Destination clauses” allowed gas supplier to sell gas to different buyers at different prices and other contractual terms at one and the same delivery point to protect its competitiveness at the end-use market (to prevent arbitrage by buyers)

Diversity (saturation) of gas transportation infrastructure in the EU (trunk pipelines only, km/100 km²), preliminary results



Calculations made by E.Orlova, PHD postgraduate student, Chair “International Oil & Gas Business”, Russian State Gubkin Oil & Gas University, based on the data for 2011/2012, kindly provided by ENTSOG

Diversity (saturation) of gas transportation infrastructure in CEE: (trunk plus distribution pipelines, km/100 km²), preliminary results



Calculations made by E.Orlova, PHD postgraduate student, Chair “International Oil & Gas Business”, Russian State Gubkin Oil & Gas University, based on the data for 2011/2012, kindly provided by ENTSOG

DG COMP: “First, Gazprom may have divided gas markets by hindering the free flow of gas across Member States” (2)

- What is “free flow”:
 - (i) multiple supplies (old + *new*) through **multiple** pipelines (both old + new), *or*
 - (ii) multiple supplies (old + *new*) through **old** pipelines only?
- If (i): big CAPEX + long time needed (project financing)
- If (ii) (*DG COMP preference ?*): zero CAPEX & zero time => historically preferred approach by CEC (incl. in ECT debate & on Central Asia gas supplies to EU)
- Possible argumentation for (ii): utilization rate of existing EU gas infrastructure = 70% (CEER/ERGEG calc.) => to receive “free” access to existing infrastructure developed earlier by others which is contractually *not* free? => CMP (fine), but what are other sources of gas **today** in CEE except from Russia/Gazprom?

DG COMP: “Second, Gazprom may have prevented the diversification of supply of gas” (1)

- Diversification of supply = investments in multiple supplies & suppliers, routes, energies (conv. & unconv. gases), etc.
- Gazprom can't prevent development of alternatives: LNG, shale gas, pipelines & suppliers...
- Moreover, by its pricing policy Gazprom unintentionally stipulates EU MS for diversification, esp. CEE: in case alternative gas energies will appear in EU, Gazprom's supplies, as most costly, might be the “first victims” (if not TOP & price review clauses) after LTGEC terms will expire
- Gazprom's refusal to ban TOP can not be considered as “prevention for diversification” (no unilateral decisions in bilateral contracts) => arbitrations => DG COMP intention to claim TOP & indexation as unfair practice

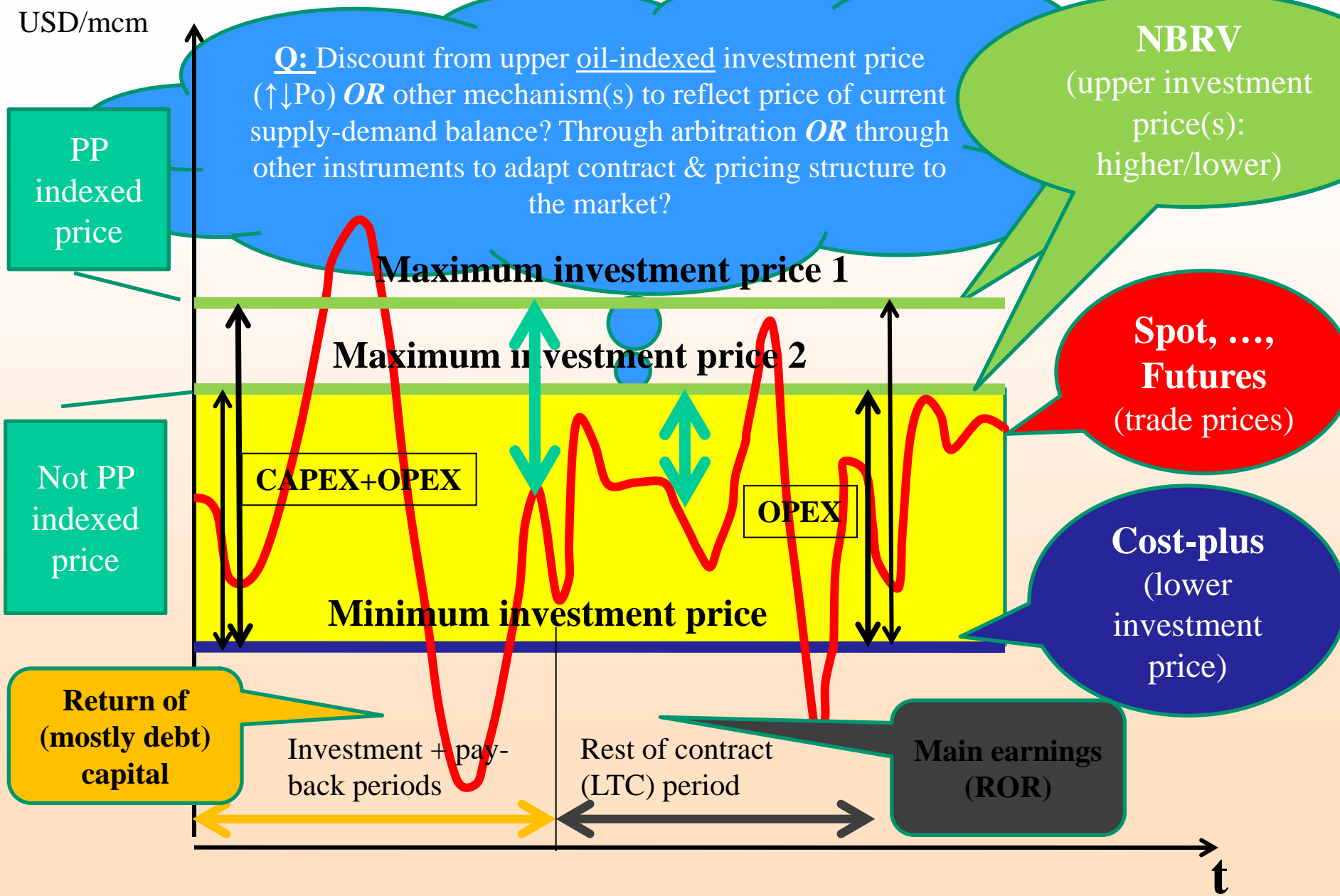
DG COMP: “Second, Gazprom may have prevented the diversification of supply of gas” (2)

- What can really prevent diversification is lack of investment stimuli (pay-back & ROR) => issue of EU internal investment climate for infrastructure development
- Diversification needs adequate infrastructure (to implement multiple choice) => to cover market demand for capacities => Third EU Energy Package provides such *potential* possibilities => we have been developing such procedures jointly within informal RF-EU expert consultations & GAC WS2, where Gazprom Group representatives actively participate

DG COMP: “Finally, Gazprom may have imposed unfair prices on its customers by linking the price of gas to oil prices” (1)

- No “unfair prices” if two commercial entities agreed on the contract => markets evolve, understandings evolve too...
- First, Cost-plus pricing/prices:
 - Minimum affordable price for producer (to cover costs + ROR)
 - Consumer has no alternative choice/supplies
 - Cost plus = “investment” pricing in non-competitive markets = “fair price”
- Then, Indexation = replacement value based pricing/prices:
 - Linking gas price to price of alternative fuels at end-use
 - Appeared in competitive markets (inter-fuel substitution & competition)
 - Maximum marketable price for producer/supplier & affordable, competitive, preferential price for consumer
 - Regular adaptation of price to support its competitive level
 - Indexation = “investment” pricing in competitive markets = “fair price”

S-curve approach for indexation in Continental Europe within contractual pricing (author's vision/proposal for discussion)



DG COMP: “Finally, Gazprom may have imposed unfair prices on its customers by linking the price of gas to oil prices” (2)

- Oil (PP) indexation:
 - since 1962 (Netherlands, Groningen-type LTGEC)
 - It took 50 year to spread it over “broader energy Europe”
 - In 1960-ies replacement fuels to gas = RFO & LFO
 - Nowadays – broader spectrum of replacement fuels (f.i. EU electricity: gas vs coal & RES, not RFO), but oil (PP) indexation is still dominant in LTGEC:
 - EU: 4/5 (2005) to 2/3 (2009) (IGU) to 1/2 (2013) (SG)
 - Key EU gas exporters (Netherlands, Norway, Russia): appr. 90% (DG COMP/2007)
 - Increasing gap between contractual & physical practice, but
 - Different arguments in favour & against oil (PP) indexation (*reserve slides*)
 - My view: slow adaptation of oil (PP) indexation, but not full conversion to spot (*reserve slides*) => objective trend, not administrative pressure

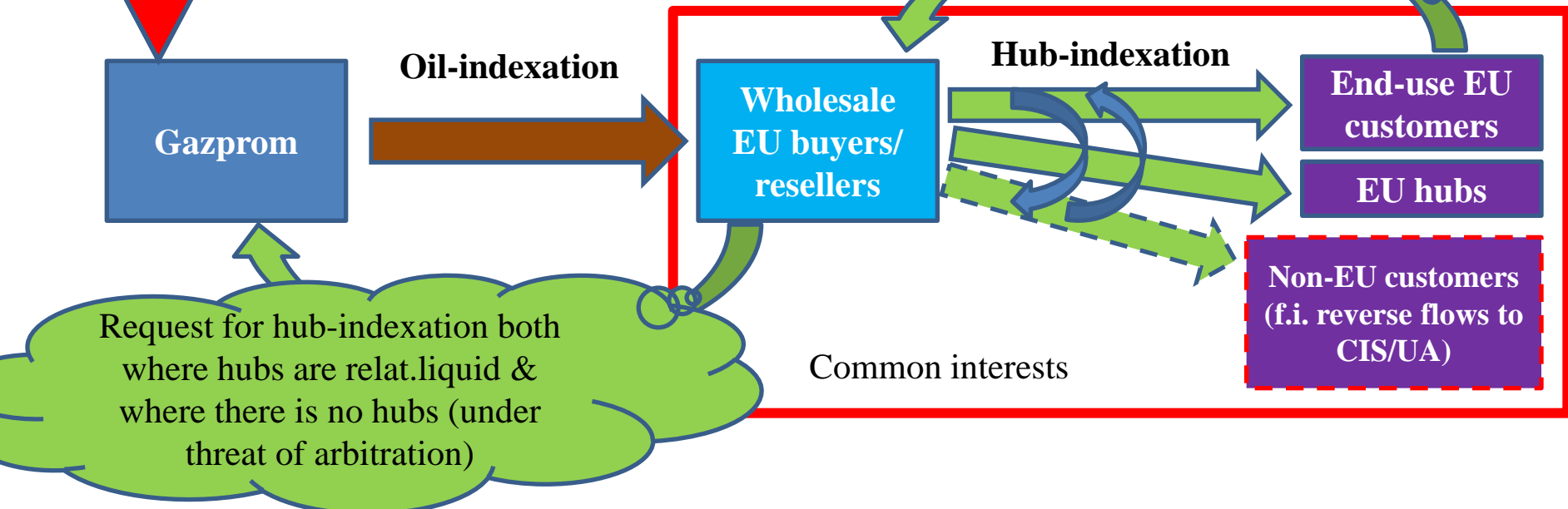
Evolution of gas value chain & pricing mechanism of Russian gas to EU (1)

Past (Pre-2009) – growing EU market



Gazprom as price-taker from OIL market

Nowadays (Post-2009) – oversupplied (in NWE segment - ?) EU market with not yet clear future trends



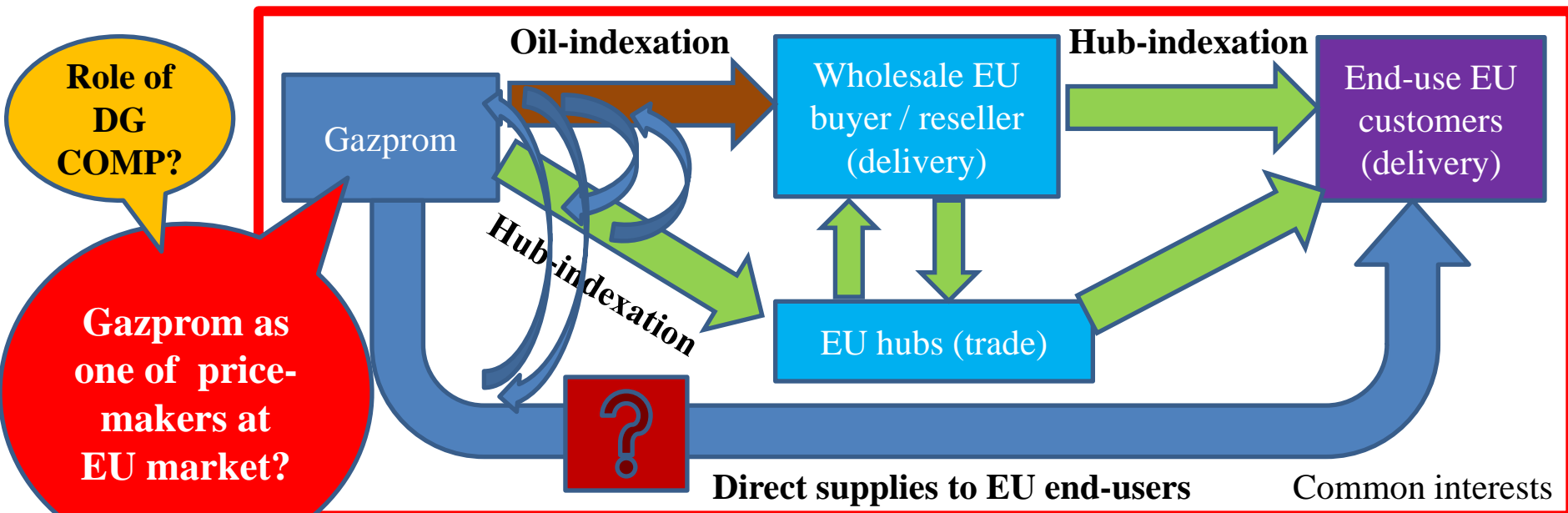
Evolution of gas value chain & pricing mechanism of Russian gas to EU (2)

Future (“NO GO” contractual scheme under any (?) supply-demand scenario)



Gazprom as price-taker from GAS BUYER'S market (with no participation on it)? => NO GO

Future (what competitive niche for oil-indexed LTC in DELIVERIES to EU?)



DG COMP: other *possible* reasons

- Economic crisis: to support domestic companies – major taxpayers (gas oversupply => low sales retail prices, high contract wholesale purchasing prices, TOP obligations to buy at high vs low spot, spark spread negative, huge losses => stimuli for arbitrations)
- Arbitrations: to create negative flavour & perceptions around Gazprom => to influence neutral & independent court decisions in favour of buyers
- To switch attention from internal EU crisis problems to “external enemy”? (populist politics, but Jan’2006 & Jan’2009 events played their role)
- DG COMP: Right facts, but incorrect reasoning & suggestions of who is responsible/guilty => wrong line of possible action not leading to mutual understanding ?

Thank you for your attention

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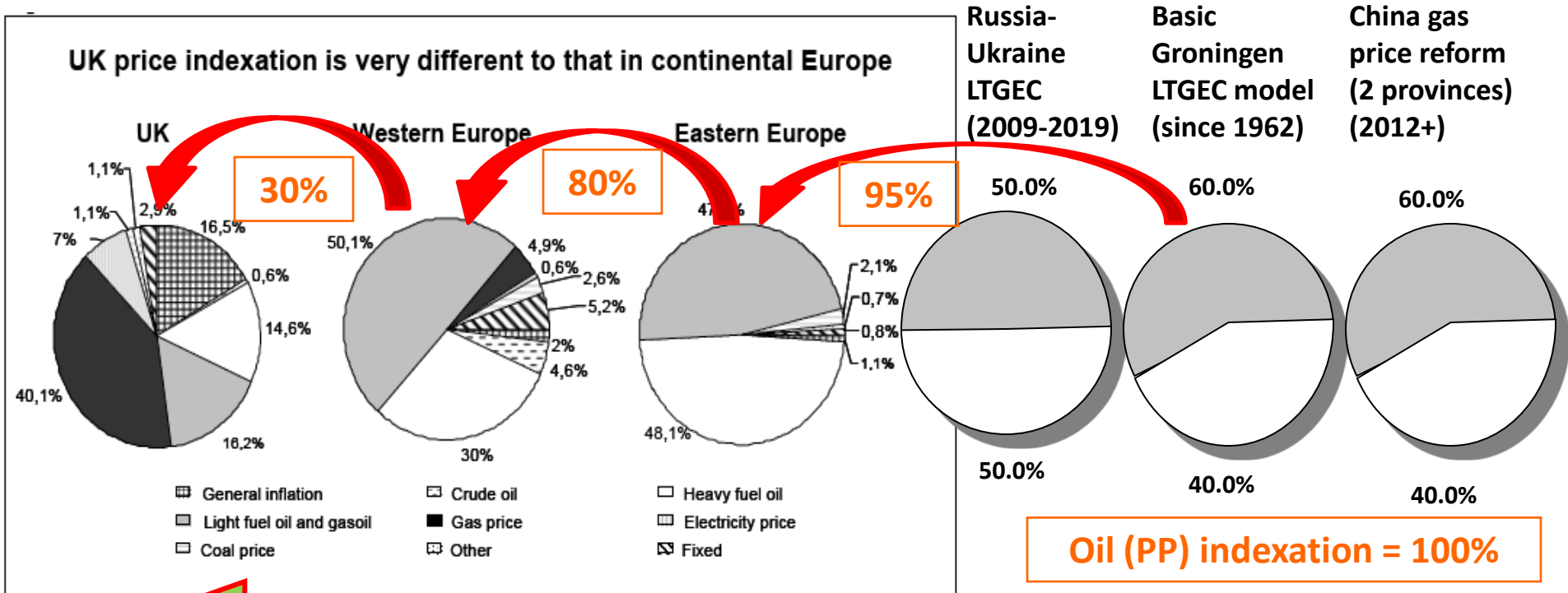
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Oil indexation: arguments “in favour” and “against”

“In favour”	“Against”
<ol style="list-style-type: none">1. Worked out in practice for 50 years => convenient for users2. Narrows corridor of price fluctuations, increases price predictability, minimizes investment risks3. Convenient tool for financial institutions => hedging => provides debt financing4. Transparent and understandable pricing mechanism (at least for professionals)5. Professional, homogenous, stable and narrow circle of market participants6. Proposed alternative (spot/futures) is not better: low liquidity (EU), high possibility for manipulations	<ol style="list-style-type: none">1. Conservation without changes does not correspond to evolution of “replacement value-based” mechanism within LTGEC (based on inter-fuel competition)2. Liquid fuel ceased to be a replacement fuel for gas in industry, electricity generation, but just a reserve (back-up) fuel3. Withhold gas price below oil parity (price of oil in energy equivalent)4. Links gas price to highly liquid, but manipulated and unpredictable futures oil (oil derivatives) market5. Confidentiality, thus closed and non-transparent for the public6. Currently: higher contractual prices compared to spot transactions

LTGEC in Europe: Indexation by Region - Historical Evolution from Less to More "Liberalized" Markets



Source: Energy Services, 2005/2006

Evolution of LTGEC pricing formula structure: from more simple to more complicated

Russia-Ukraine 2009 LTGEC structure rationale: more practical (understandable & sustainable) to start with less sophisticated pricing formula => similar to basic Groningen formula

Further development (most likely): towards EE-type => WE-type => UK-type price indexation =>

away from oil indexation & oil parity?

China gas pricing reform – same approach (to basic Groningen formula)?

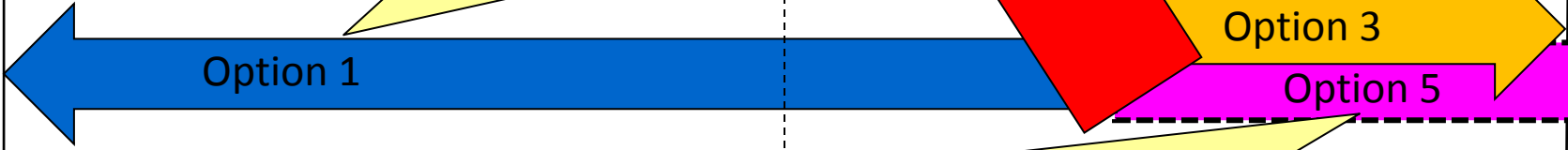
Evolution/adaptation of gas pricing mechanisms in Europe: major options

Preferable & most probable scenario of LTGEC pricing formulas adaptation in Continental Europe: *stay with indexation, deviate from petroleum-products-indexation, include spot gas quotations & other competing fuels ("must-run" primary electricity (RES, hydro, nuclear), coal) into basket formula*

Intention of EU authorities to limit Third EU Energy package development to Anglo-Saxon model: *spot quotations, gas exchange indexes, etc.*

Maintaining status-quo: *stay with petroleum-products-indexation*

Gazprom & GECF stated preferences: *petroleum-products-indexation + aim to reach oil-parity*



Possible radical change of gas- and energy-pricing in the long-term in favour of gas if new ecological component is added into price based on "polluter pays" principle: *stay with indexation, deviate from petroleum-products-indexation, possible to exceed oil-parity*

0 50 60 60-80 80 100

(spot/gas to gas competition)

Oil indexation level of LTGEC gas prices (% of oil parity)

(oil parity)