

Russia, EU, Ukraine, gas: whether real cooperation still possible? What prevents it today?

Prof. Dr. Andrey A. Konoplyanik,

Advisor to the Director General, Gazprom export LLC,

Professor, Chair “International Oil & Gas Business”,

Russian State Gubkin Oil & Gas University,

Co-chair, Work Stream 2 “Internal market”, Russia-EU Gas Advisory Council /

Informal Russia-EU Expert Consultations on Third EU Energy Package issues

www.konoplyanik.ru

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New post-2009 gas world & its “matrix” & “domino” effects within Broader Energy Europe

1) Post-2009 **oversupply in EU gas** due to:

a) **Demand-side** => market niche for gas narrowed in EU:

- i. overall decline = (i) economic crisis + (ii) energy efficiency
- ii. gas substitution = (oil-indexed LTC TOP) gas loses competition in end-use to:
 - heavily subsidized RES (must-run electricity)
 - cheap (dirty) imported US coal (*US shale gas domino effect #2*)

b) **Supply-side** => competition within this narrowed market niche for gas in EU increases:

- i. Qatari LNG to EU prior to Fukushima (*US shale gas domino effect #1*)

2) **Institutional** => 3rd EU Energy Package (Sept'2009):

- a) concurrent with EU oversupply which triggered upside-down gas reforms => new architecture of internal EU gas market

3) **Political** => RF-UA gas transit crises Jan'2006 & Jan'2009:

- a) 22 days over-weighted 40 years: new perceptions = new reality

=> Negative “domino effects” + “matrix effect” for EU, Ukraine, Russia & whole Broader Energy Europe based on new perceptions

EU-Ukraine-Russia responds to new perceptions/realities

- **EU:** *to diminish dominant role of Russia as major gas supplier* => through **diversification** (end-user/consumer vision)
 - **Ukraine:** *to escape monopoly of Russia as one single gas supplier* => through **diversification** (transit country vision)
 - **Russia:** *to escape monopoly of Ukraine as one dominant gas transit route* => through **diversification** (key producer/supplier vision)
- ⇒ Whether 'no return' points are reached by each party?
What motivations/perceptions?
- ⇒ Whether commonality of economic interests still exist between the three as a basis for cooperation in new environment?

New risks, new challenges, new responds, “no return” points: the EU (1)

- Perception: *as if* non-reliable future supplies to EU **FROM** Russia via Ukraine (**NOT** from Russia **VIA** Ukraine) =>
- Responds/aim: organization of new internal EU gas market architecture with *multiple supplies* & high *flexibility*
- *Multiple supplies* => *alternatives to Russian gas at:*
 - *supply side:* Regulation 994/2010 (3+ gas supply sources/MS, ‘N-1’ rule, etc.), LNG, shale gas, UGS + SOS New Strategy 2014 (CEC 28.05.2014) => increased *gas-to-gas* competition
 - *demand side:* decarbonisation => RES, energy efficiency => shrinking gas share in fuel mix => increased *gas-to-non-gas* competition
 - the loser would be a less competitive gas supplier => *perception: this will be most distant, costly to produce, oil-indexed-priced RUS gas*

New risks, new challenges, new responds, “no return” points: the EU (2)

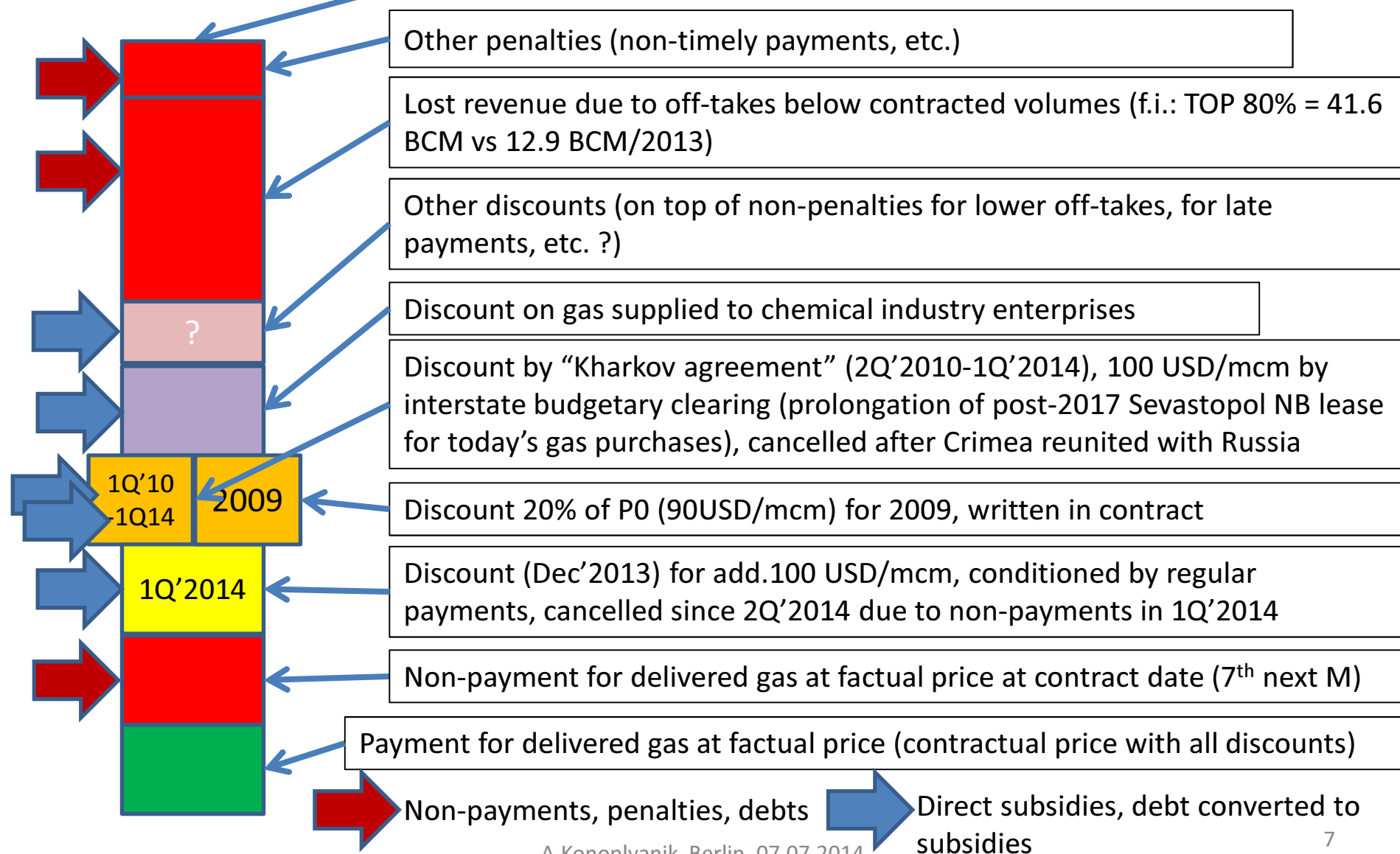
- (High) **flexibility** within EU:
 - **Capacity market** - by diminishing barriers for gas flows: CAM + CMP rules (UIOLI, SoP), interconnectors with physical reverse flows,
 - **Commodity market** – by increasing liquidity & short-termism (tradeability): spot trade, hubs, demand for softening LTGEC provisions (lower/no TOP, hub-based pricing, etc.) =>
 - Third EU Energy Package = set of legal instruments to provide **multiple supplies** & **flexibility within** EU (28) & Energy Community Treaty (**28+9**) area based on new principles of internal market organization:
 - from a RF-EU chain of 3 consecutive LTCs (1962/68-2009) – to Entry-Exit zones with VTP (hubs) (2009-onwards) => in the making:
 - New factual risks for existing RUS-EU wholesale contracts
 - Potential prospects for new forms of non-EU delivery & trade within EU
- ⇒ **“No return” point was passed by EU as a whole !!!**
- ⇒ **Search for new forms of cooperation in new EU legal & economic environment (GAC aimed on this) => But not yet?**

New risks, new challenges, new responds, “no return” points: Ukraine (1)

- **UA: Euro-integration** vs. **CIS-integration** => this “no return” point was passed in Ukraine’s **energy NOT** on 26.06.2014, **BUT de facto in 2004** =>
- Since Spring’2004 UA demanded to unbundle supply & transit contracts & to move to “European formulas” in RUS-UA gas trade:
 - UA expectations: to receive higher gas transit tariffs
 - UA reality: has received higher import gas prices
- Since 2006/2009:
 - UA disagrees on import pricing formula & price level resulted from the move to “European formulas” in **supply** =>
 - This, in turn, resulted in **transit** crises Jan’2006 & Jan’2009
 - Dilemma (to be solved): UA search for multiple supplies **led to** violation of RF-UA 2009-2019 supply contract (in volumes & payment terms) - despite RF multiple price discounts for UA to soften its transition to “European formulas”

Russia-Ukraine gas supply contract: contractual & factual payments vs. non-payments & subsidies

“European formula”-based market price (net-back replacement value, petroleum-product indexation)



New risks, new challenges, new responds, “no return” points: Ukraine (2)

- UA motivation to diminish dependence on RUS gas:
 - **Economic:** High import price & Gazprom justified unwillingness for price review (but price concessions) stipulated UA to search for:
 - **alternatives to RUS gas (supply side):** domestic production – onshore & offshore, shale gas, LNG import, reverse flows & UGS, and
 - **deviation from (RUS) gas (demand side):** switch gas to coal, nuclear, energy saving & improving efficiency
 - **Legal:** Euro-integration, membership in Energy Community Treaty => implementation in UA of EU energy acquis (now Third Energy Package) => **legal obligations** for alternative supplies, interconnectors, reverse flows, unbundling Naftogas, MTPA, entry-exit system => **BUT:**
 - *additional risks for existing transit via Ukraine (both for RF & EU)*
 - *conflict in UA between RF-UA supply contract (2009) & EU acquis (2012)*
- ⇒ Seems that **“no return” point is also passed** (in policy), similarity UA with EU (importer approach to diversification), adaptation will be painful for both RF & UA
- ⇒ **Search for new forms of cooperation in new UA legal (i.e. EU acquis) & economic environment (???) => But not yet?**

New risks, new challenges, new responds, “no return” points: Russia (1)

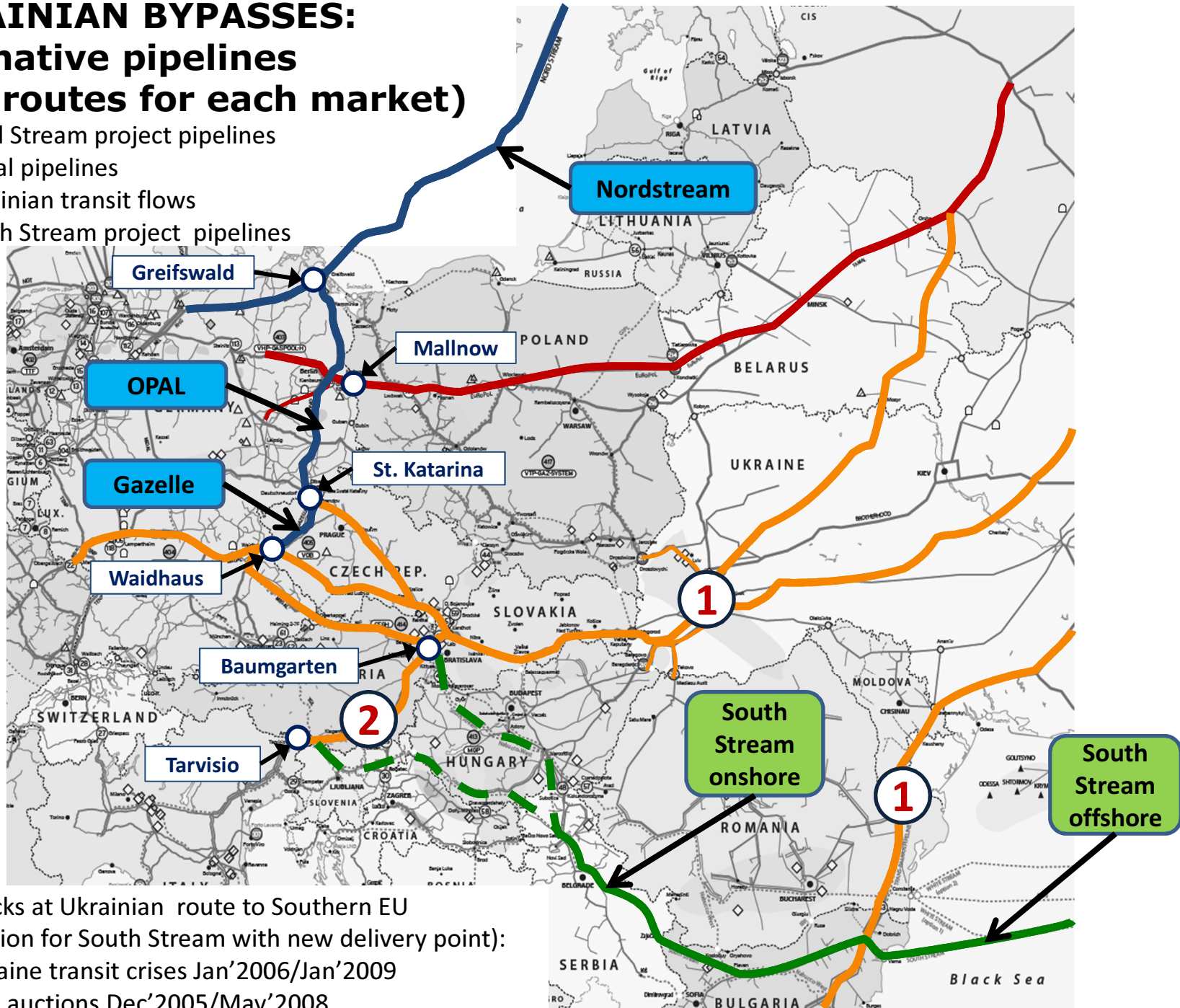
- **Supply risks** (related to RF-UA contract):
 - non-fulfillment of contractual obligations by UA (lower offtakes) = corresponding upstream CAPEX in Russia not paid back (alike: OPAL case),
 - UA lower offtakes vs UA reverse flows
- (Today's & future) **transit risks**:
 - **Today's**: not sanctioned off-take of gas in transit, but it is supplier who is responsible for gas delivery to EU delivery points (non-dependent transit problems) => risk of legal claims of EU customers (*new task for multilateral fora like ECT?*)
 - **Future**: in result of UA accession to Energy Community Treaty (risk of contractual mismatch + future of Naftogas/UA TSO, ...)
- Change of the whole transit economics for supplier if precedent-based “risk” element included => respond:
 - From “one market – one pipe” to “one market – two pipes”:
 - UA GTS + [Nord Stream/OPAL/Gazelle] => to North-West Europe,
 - UA GTS + [South Stream (offshore + onshore)] => to Southern Europe

New risks, new challenges, new responds, “no return” points: Russia (2)

- Dilemma – what to use:
 - 1) **Two routes (*new non-transit & UA transit*)** to each major market (“least radical” scenario):
 - Supply volumes to be distributed within each pair of routes, *or*
 - 2) **One only direct (*new non-transit*) route** to each major market (“most radical” scenario):
 - All transit volumes switched to new routes? => UA GTS dried up?
- Problem (*yet to be solved for South Stream*): EU acquis is not investment-friendly for new gas infrastructure projects (OPAL case, 27+ EU exemptions cases since 2003, ACER Guidance for ENTSOG Incremental Proposal, etc.) => we try to solve it under RF-EU GAC (hard task)
- Nevertheless, it seems that **“no return” point for scenario 2 is overpassed**. What economics behind it? What regulatory rules should be used to exclude negative OPAL precedent?

UKRAINIAN BYPASSES: alternative pipelines (two routes for each market)

- Nord Stream project pipelines
- Yamal pipelines
- Ukrainian transit flows
- South Stream project pipelines



Bottlenecks at Ukrainian route to Southern EU
(justification for South Stream with new delivery point):

- ① Ukraine transit crises Jan'2006/Jan'2009
- ② TAG auctions Dec'2005/May'2008

Ukraine: "transit interruption probability" index



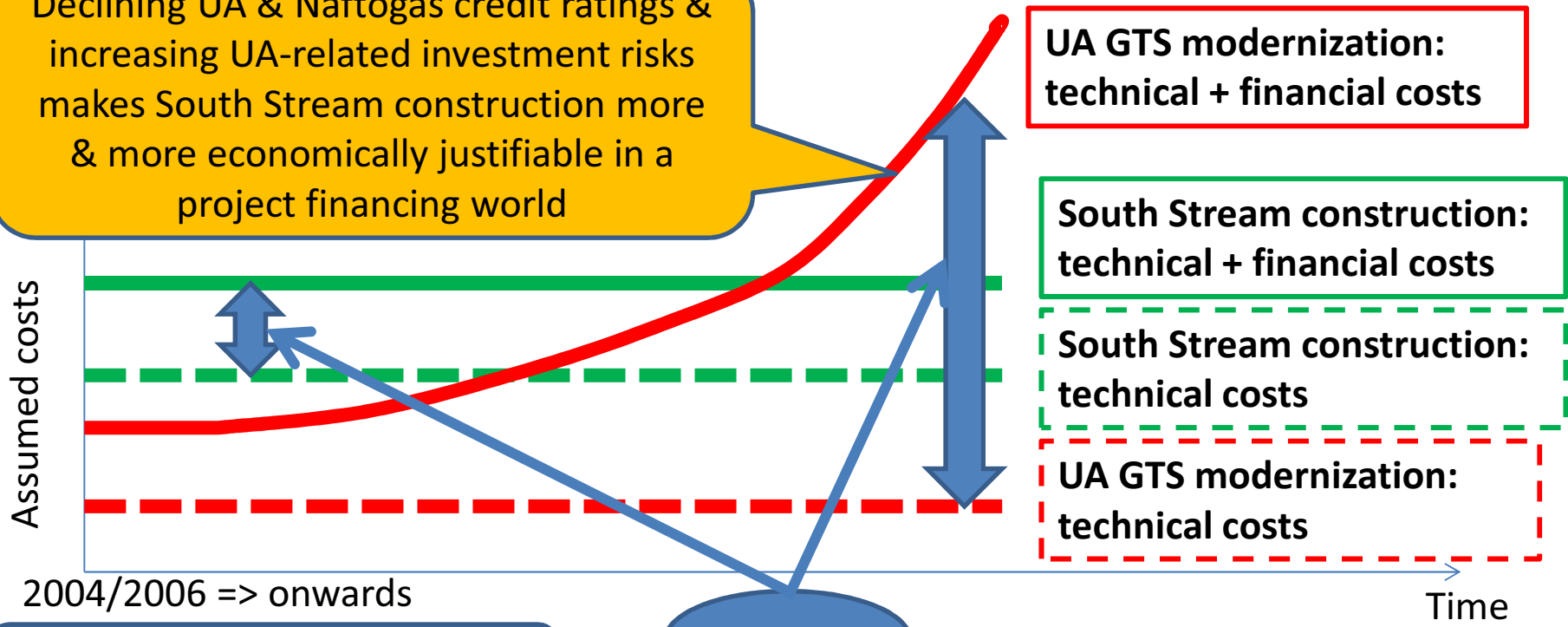
Calculations made by M.Larionova, Russian Gubkin State Oil & Gas University, Chair "International Oil & Gas Business", Master's programme 2013-2015, based on the methodology jointly developed with the author

A.Konoplyanik, Berlin, 07.07.2014

South Stream construction vs UA GTS modernization: cost comparison in project financing terms & regulatory dilemma

No question that South Stream would be built. Dilemma for South Stream – which one of four possible regulatory scenarios will finally work, based on: (i) on existing IGAs w EU MSs, (ii) draft RF-EU infrastructure agreement, (iii) Art.36 exemption, (iv) Third Energy Package rules now being developed (amended CAM NC/ENTSOG Incremental Proposal)

Declining UA & Naftogas credit ratings & increasing UA-related investment risks makes South Stream construction more & more economically justifiable in a project financing world



**UA GTS modernization:
technical + financial costs**

**South Stream construction:
technical + financial costs**

**South Stream construction:
technical costs**

**UA GTS modernization:
technical costs**

Trilateral effect: $[R(\text{country}) \times R(\text{company}) \times R(\text{project})]$

LIBOR+

What prevents today's cooperation between Russia, EU, Ukraine in gas?

- What forms of real (mutually beneficial) economic cooperation in new gas environment in Broader Energy Europe possible, if:
 - EU & Ukraine seem to consider Russian gas as major threat to their energy security => aim to deviate from it
 - EU introduced two levels of sanctions on Russia & threatens to introduce its third level (whether not de facto introduced it already by not allowing on 10.03.2014 utilization of 100% OPAL capacity?)
 - Ukraine does not pay even for already delivered gas, does not follow contractual discipline re TOP, etc. (*pacta sunt servanda*)
 - EU & Ukraine seem not be independent in their decision-making; they are united against Russia in the interest of fourth party & against their own economic interests
 - Ukraine making war against its own people (genocide)
- ⇒ What strange type of cooperation this would be?
- ⇒ So: first of all, stop sanctions against RF + **STOP WAR AGAINST ITS OWN PEOPLE IN UKRAINE!!!**

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attention!**

**www.konoplyanik.ru
andrey@konoplyanik.ru
a.konoplyanik@gazpromexport.com**