

**RUSSIAN GAS TO EUROPE,
ENERGY SECURITY AND ECT:
POSSIBLE RISKS AND MECHANISMS OF
THEIR PREVENTION/MITIGATION**

**Dr. Andrei A. Konoplyanik
Deputy Secretary General
Energy Charter Secretariat (Brussels)**

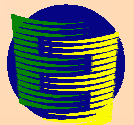
**Energy Security Roundtable,
Panel II “Transportation”,
17 March 2006, Canadian Embassy, Moscow**

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

ENERGY SECURITY =

- (1) stable, cheap & environmentally friendly energy cycle (energy value chain)
- (2) minimum volume risk + minimum price risk



GAS: DIFFERENT PROJECTS – DIFFERENT CONTRACTS

(1) New projects in mature regions with existing infrastructure, with available transportation capacities (usually less capital-intensive projects, relatively small to the existing market) =

(a) short-term contracts (“take and/or pay”) – for the duration of payback period (?)

(b) spot deals – when payback period is over (?):

- dated

- forward

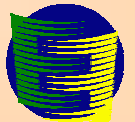
- futures

Regions: Western, Central & Eastern Europe

(2) New projects in new regions with no/lack-of infrastructure for both production and transportation (usually more capital-intensive projects [transportation – up to 80% of total CAPEX], relatively big to the existing market, or just establishing the market) =

(a) long-term “take and/or pay” contracts

Regions: Russia, CIS, Asia

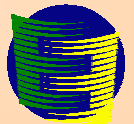


LONG-TERM TAKE AND/OR PAY GAS CONTRACTS (LTC TOP) AND PROJECT FINANCING RISKS

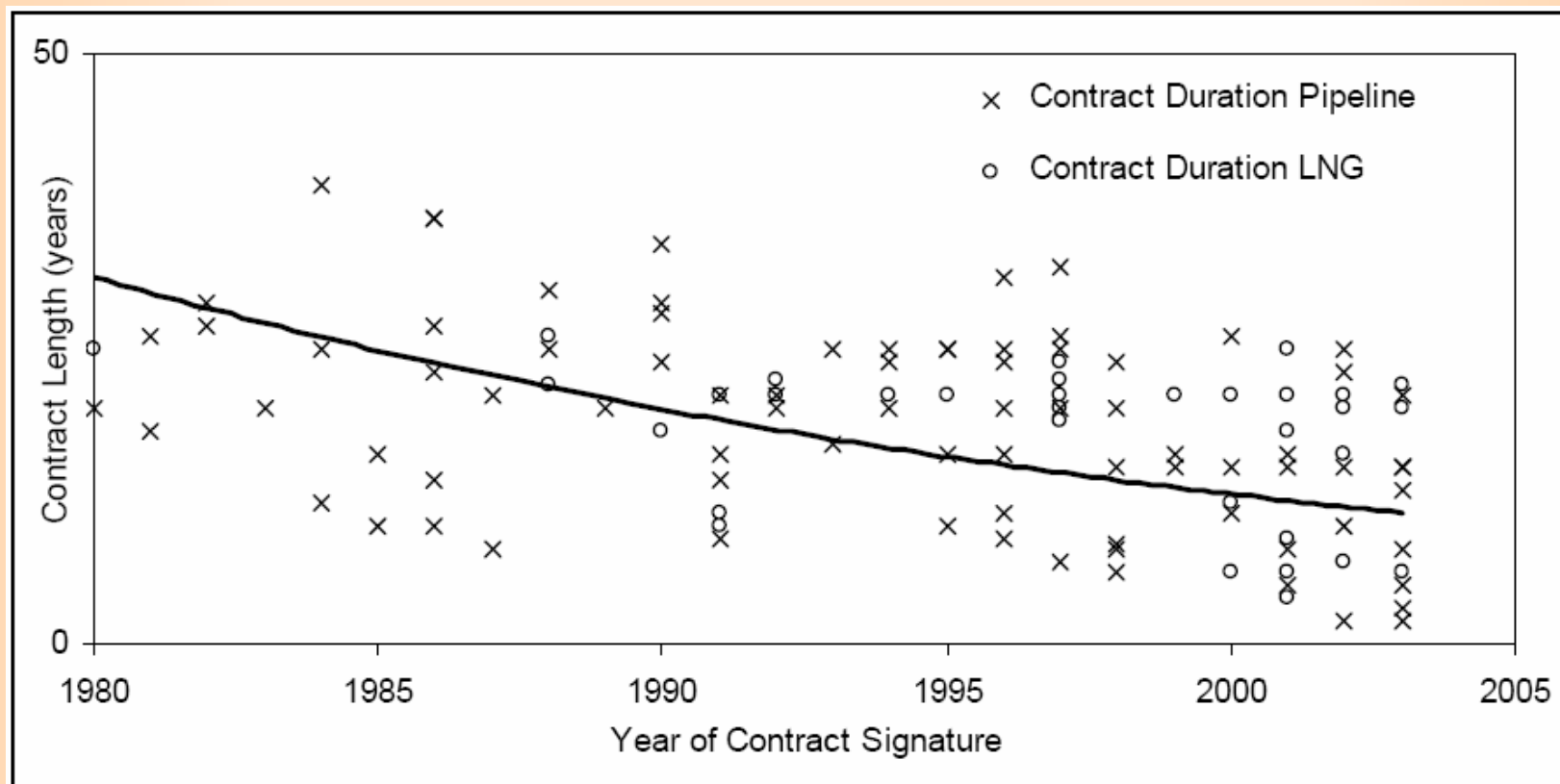
$$\text{Financing} = f(\text{revenue}) = f(\text{volume} \times \text{price})$$

- (1) LTC TOP = mechanism of «volume» risks reduction**
 - (2) LTC TOP + adequate pricing mechanism = mechanism of “price” risks reduction:**
 - prior to exchange pricing = cost-plus and escalation formulas**
 - exchange pricing = spot/futures/options + hedging**
- (1)+(2) = risk-reduction mechanism of project financing risks in long-term capital-intensive Greenfield projects, especially in new regions with no (lack of) production & transportation infrastructure**
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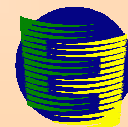
LTC TOP in gas has yet no alternative at the emerging markets



EVOLUTION OF DURATION OF LONG-TERM GAS SUPPLY CONTRACTS IN OECD EUROPE SINCE 1980



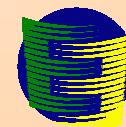
Source: C.Hirschhausen, A.Neumann. Less Long-Term Gas to Europe. A Quantitative Analysis of European Long-Term Gas Supply Contracts. [www.gasandoil.com/ogel/Vol. 3, issue 1, March 2005](http://www.gasandoil.com/ogel/Vol.3,issue1,March2005)



ROLE OF LONG-TERM CONTRACTS IN GAS SUPPLIES TO EU MEMBER-STATES: AS OF TODAY ...

	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

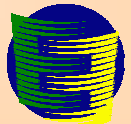
Source: ECS calculations



ROLE OF LONG-TERM CONTRACTS IN GAS SUPPLIES TO EU MEMBER-STATES: ... AND AS OF TOMORROW

Item 25: “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 [of Rome, 1958 - AK], including competition rules. It is therefore necessary to take them into account in the planning of supply and transportation capacities of gas undertakings.”

Source: DIRECTIVE 2003/55/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 26 June 2003 concerning common rules for the internal market in natural gas and repealing Directive 98/30/EC



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

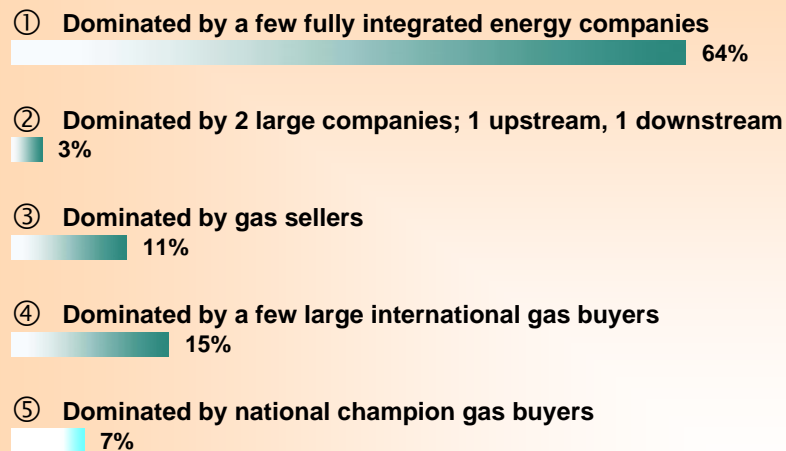


5.2 CONCLUSIONS

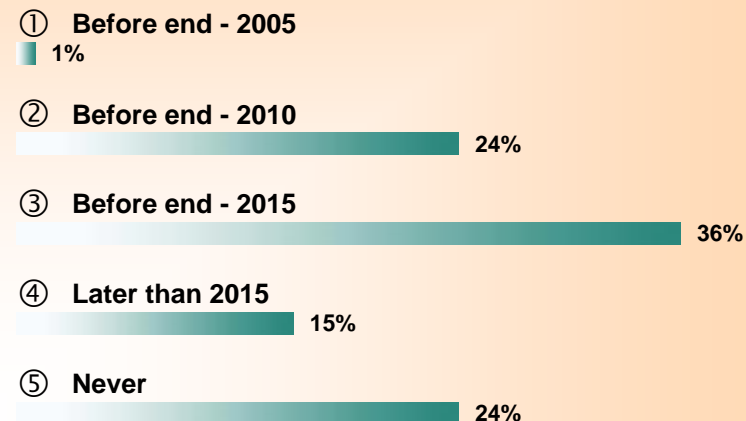
- ▲ The removal of destination clauses should be strictly tied to and be conditional upon the introduction of full and unrestricted TPA in the EU gas transmission system
- ▲ Removal of destination clauses without unrestricted transmission system TPA would give gas importers undue advantages over gas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

MFC

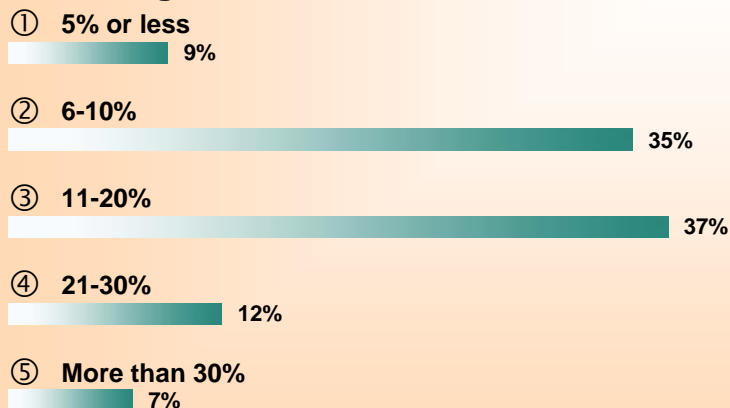
How would you characterise Europe's gas market in 10 years time?



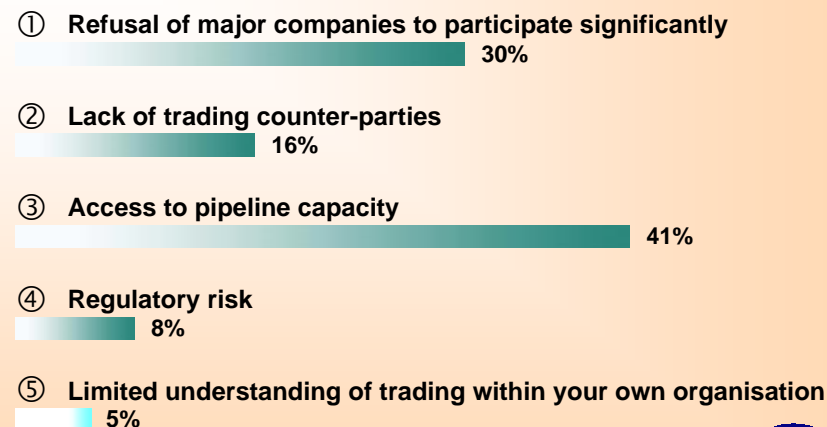
When do you believe that European long term contract gas prices will become decoupled from oil and determined by spot/futures prices?



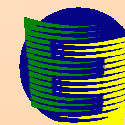
By the end of 2008 what will be the volume of gas sold at hubs as a percentage of total EU gas sales?



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



Source: Flame 2004 Conference Polling Session



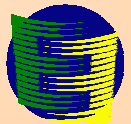
LIQUIDATION OF “DESTINATION CLAUSES” IN GASPROM’S LONG-TERM CONTRACTS TO EUROPE

2004 OMV-Gasprom deal:

No immediate negative consequences for Gazprom since its “effective” gas price in Baumgarten for deliveries to Austria is the highest compared to deliveries to other EU countries.

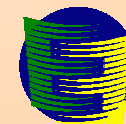
2003 EU Commission-ENI-Gasprom deal:

Negative consequences for Gasprom (?) since its “effective” gas price in Baumgarten for deliveries to Italy is lower compared to that of deliveries to Austria

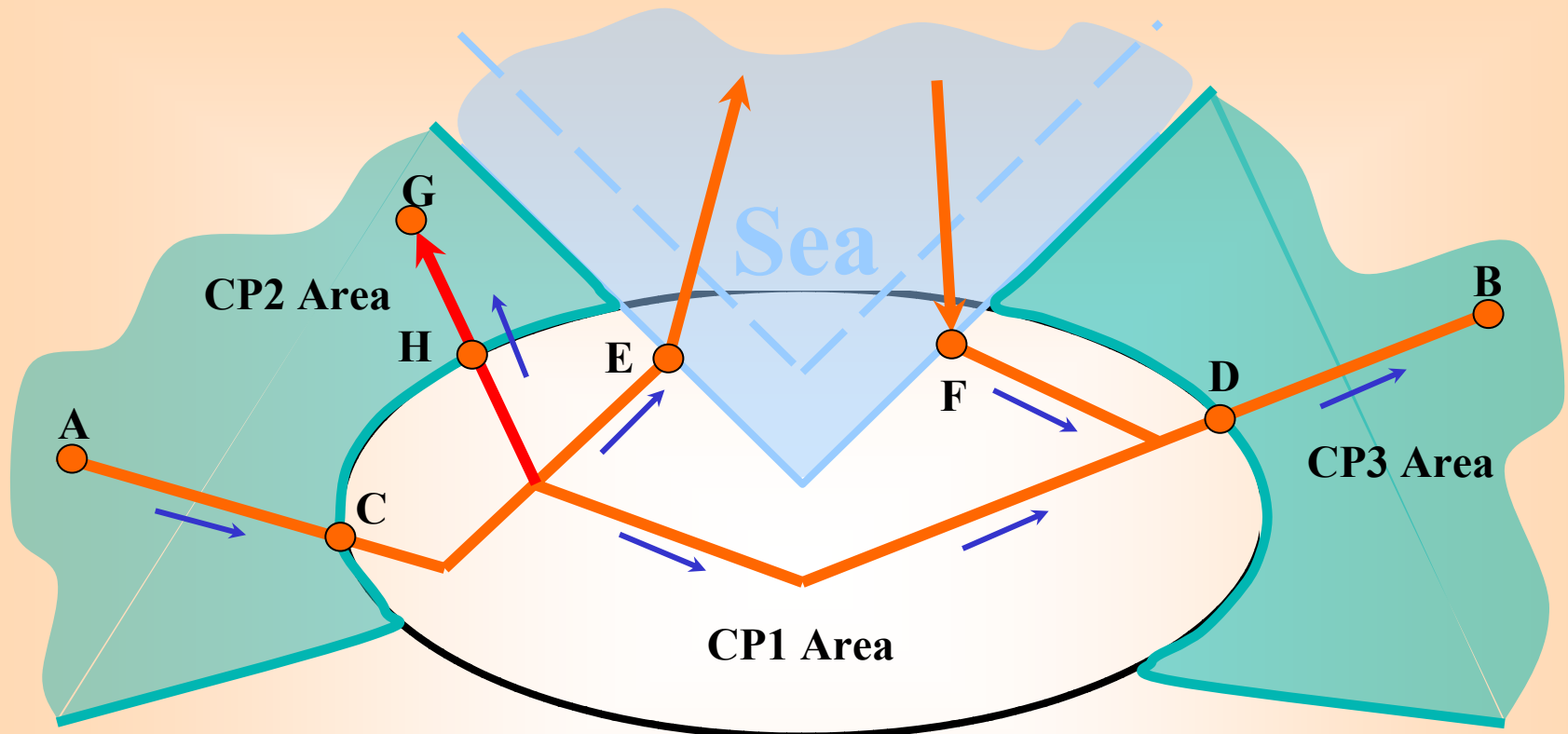


ROLE OF GAS TRANSIT FOR ITS MAIN EXPORTERS TO EUROPE

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
EXISTING EXPORTERS					
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 ...



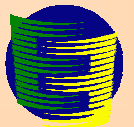
3 possibilities of energy supplies from A to B:

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

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

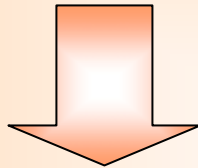
Transit:

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



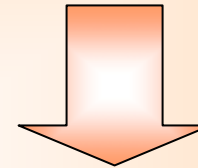
... BUT IT MIGHT BE THE CHEAPEST ONE – IF ADEQUATELY LEGALLY PROTECTED

TWO SCENARIOS OF RUSSIAN GAS EXPANSION FURTHER INTO EUROPE



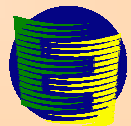
Gazprom = owner of pipeline
(construction of new pipeline capacities, purchase of pipeline companies' shares)

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



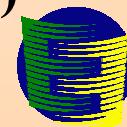
Gazprom = shipper
(from gas sales at the border to wholesale buyers/resellers → to direct sales to end-users within consumer country)

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



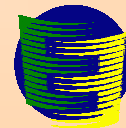
BENEFITS OF ECT ON TRANSIT

- **Freedom of Energy Transit (e.g. through fixed infrastructure)**
- **Non-discrimination:**
 - **As to origin, destination or ownership**
 - **As to pricing (“*Gas Transit Tariffs in selected ECT countries*”, *ECS, January 2006* – www.encharter.org)**
- **No unreasonable delays, restrictions or charges**
- **Non-interruption of flows until dispute is settled (conciliatory procedure – *SG letter to Russian and Ukraine as of 3 Jan., 2006*)**
- **No mandatory Third Party Access, but access to free (available – EC TP) capacity**
- **National Treatment compared to other cross-border flows:**
 - **Transit treated no less favourably than energy originating in (export) or destined for (import) transit country itself**
- **Not place obstacles to new capacity establishment, if:**
 - **Insufficient available capacity (expansion of existing capacity)**
 - **Lacking infrastructure (creation of new capacity)**



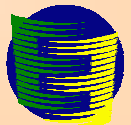
ECT TRANSIT PROTOCOL: MAJOR ISSUES ADDRESSED

- 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**



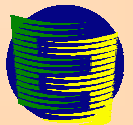
TRANSIT PROTOCOL IMPLEMENTATION: EXPECTED BENEFITS

- **Diminished risks related to transit**
- **Better financing terms**
- **Increased competitiveness of transit supplies**
- **Improved energy security (supplies+ demand+ infrastructure) => security of energy value chain**



RUSSIA'S ECT RATIFICATION HISTORY

- **Russia started ratification procedure in 1996**
- **Evolution of RF State Duma position:**
 - **1997: No – but linked to WTO accession,**
 - **2001: Russia will ratify ECT, but not yet (depending on Transit Protocol)**
- **Major Russia's substantial concerns regarding ECT ratification relates to gas transit issues**
- **Successful finalisation of Transit Protocol = key to reopen ECT ratification issue:**
 - **most recently repeated by V.Khristenko on March 14, 2006 at press-conference in Moscow**

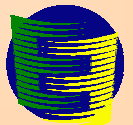


KEY ARGUMENTS AGAINST ECT RATIFICATION IN RUSSIA

– related to the substance of ECT

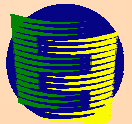
Opponents - as if:

- **ECT demands mandatory TPA to Gazprom's pipelines for cheap gas from Central Asia**
 - **No such obligation. ECT excludes mandatory TPA (ECT Understanding IV.1(b)(i)). Transit is only one of the available options (+ on-border purchases, swaps)**
- **Obligation to transit Central Asian gas through Russia at low (subsidised) domestic transportation tariffs**
 - **No such obligations (ECT Article 7(3)). Transit and transportation are different in non-EU states (it being further clarified in draft Transit Protocol)**
- **ECT will “kill” LTCs**
 - **Not true. ECT documents do not deal with LTC as such at all. Economic niche for LTCs will become more narrow due to objective reasons, but they will continue to exist as a major instrument of financing Greenfield oil & gas projects. ECT supports LTC by diminishing political and regulatory risks (sanctity of contracts).**

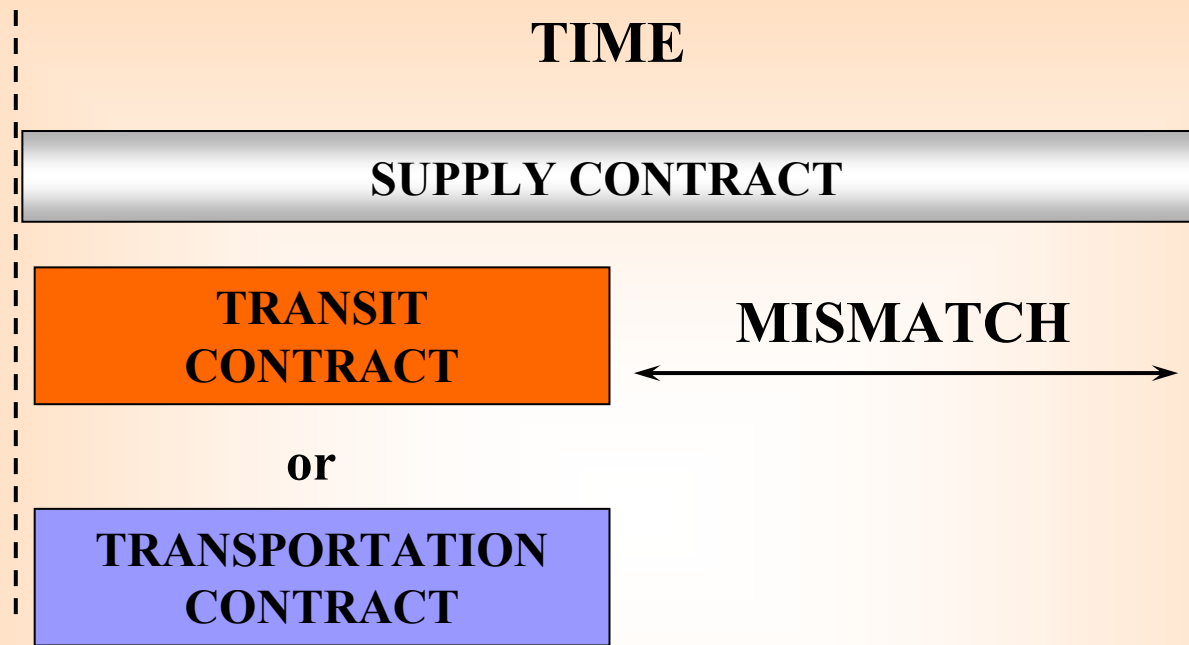


ENERGY CHARTER PROTOCOL ON TRANSIT – AND G-8 JULY'2006 SUMMIT (1)

- **G-8 states call upon Russia to ratify ECT – and to state this at G-8 July'06 Summit. But: Russia's decision on ratification depends on Transit Protocol finalisation.**
- **Multilateral phase of negotiations finished December 2002**
- **Three outstanding issues are left between Russia and EU to be solved first on bilateral level:**
 - **Contractual mismatch (supply vs. transit arrangements),**
 - **Implementation of TP within the REIO (within EU),**
 - **Transit tariffs: correlation between cost-reflectiveness and auctions as congestion management mechanisms**



MISMATCH BETWEEN LONG-TERM SUPPLY CONTRACT AND CONTRACTED TRANSPORTATION / TRANSIT CAPACITY



Mismatch between expiration dates of long term supply (delivery) contract and transit/transportation contract as integral part to fulfill the delivery contract creates a risk of non-renewal of transit/transportation contract.

Core issue: guarantee of access to transportation capacity within the duration of existing (in force) delivery (supply) contract.



ENERGY CHARTER PROTOCOL ON TRANSIT – AND G-8 JULY'2006 SUMMIT (2)

- Bilateral consultations resumed in October 2004, four rounds of unofficial expert meetings in 2004-2005, new draft version of Transit Protocol presented to the parties on October 28, 2005**
- Energy Charter Conference, 9 Dec'05 + Chairman's letter to Russia and EU, 10 Jan'06: to provide before end-Febr'06 schedule for TP finalisation in 2006**
- Expert meetings 2006: 10 March + 7 April + another in May is planned**
- Any material success possible before July G-8 Summit? Depends, firstly, on both Russia & EU...**

