

Third Energy Package and its Impact on Gazprom Activities in Europe

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Thank you for the opportunity to share with you our concerns in relation to the legislative initiative known as Third Energy Package (TEP). The initiative that came into force on March 3, 2011 manifests a major transformation in the European gas market architecture, a move to a ‘Continental’ interpretation of the Anglo-Saxon liberalized gas market model. This ‘Continental’ market design has its peculiarity: it is based on enhanced unbundling and pipeline capacity congestion. Model change will affect Gazprom’s activities in Europe in many ways.

Gazprom is a holder of LT contracts with take-or-pay obligations that guarantee sales of 4 tcm of gas to Europe and revenues close 1 trillion Euros at current prices up to 2035. Portfolio of these contracts provides us with a security of demand that is crucial for LT investments that has a prevailing horizon of over 20 years. LT contracts are beneficial to the customers as they guarantee security of supply on the background of increased global competition. But we negotiated our LT contracts under the old regulatory regime. Prospects of these contracts in the new regulatory framework are not quite clear and that is a focal point of our concerns.

There are no ideal models for market structuring; each model has its inherent strengths and weaknesses. As a holders of LT contracts and a supplier Gazprom foresees at least three risks stemming from a systemic model change – 1,2) demise in property and operational rights, 3) risks of losing revenues due to pricing model adjustments.

Could these disadvantages of the new model that I will discuss later on in more detail overweight the perceived better access to pipelines and as consequence to the end users in Europe? One has to keep in mind that gas trade is a multilayer business. Clients with demand of less than, say, 100 million cubic meters per annum could have interest for our affiliated companies but not for the Gazprom Export. As a major exporter Gazprom Export deals primarily with large first tier wholesales. Gazprom holds capacity rights in the pipelines that bring gas to these large importers usually at their country's border within EU. LT transmission contracts with the offtakes at the country's border are highly valuable for us as they underpin our sales contracts.

When in September 2007 first conceptual paper on TEP came out, it left us with hope that further clarifications will leave export pipelines bringing Russian gas to Europe with the exemptions thus minimizing our risks. I personally expected that the exemptions from TEP regulations awarded to the *upstream pipelines* in September 2007 draft will be available to the Russian export pipelines too. This might have happen in case of a broad definition of the *upstream pipelines* to include pipelines exclusively destined to deliver gas from Russian production fields to the EU market. Justification for exemptions would be a need to avoid difficulties which could "prejudice the efficient, current and planned future production of hydrocarbons."

But the final draft of the TEP left us with no illusion that such exemptions could be offered. Final TEP version defined *upstream pipelines* in a narrow way: "**upstream pipeline network**" means any pipeline or network of pipelines operated and/or constructed as part of an oil or gas production project, or used to convey natural gas from one or more such projects to a processing plant or terminal or final coastal landing terminal. This and other definitions and interpretations clearly indicated that European Commission was not looking for compromise.

On February 24, at the meeting with the European Commission, Minister of Energy of Russia submitted an informal letter to Mr. Ottinger with a proposal to adjust terms of the Third Energy Package and sign an intergovernmental Agreement with Russia defining the status of cross border infrastructure. We proposed to the EU to differentiate between gas pipeline systems for the EU internal market and cross border trunks from outside," Sergei Shmatko, Minister of Energy of Russia, said. So far European Commission seems to be intransigent.

As I have mentioned already, Gazprom foresees at least three risks stemming from a systemic model change – 1,2) demise in property and operational rights, 3) risks

of losing revenues due to pricing model adjustments. Let us start with property rights.

TEP does not mention a “grandfather clause” and envisages no compensation for asset value destruction. Value destruction is due to a stressed market and NPV asset evaluation based on low regulated transmission tariffs. We believe that we have a right to demand compensation for asset value losses resulting from the forced sale of assets under option one of the unbundling clause.

Even in case Gazprom evades direct obligations to sell off gas transmission assets and remains their owner, the TEP deprives supplier of a right to manage pipelines. It is obvious that this devaluates investment made in the pipeline. Demise in property right in this case is similar to conversion from ordinary/voting to preferred/nonvoting shares in the pipeline company. When management of an asset is transferred to an independent operator that will be acting on its own account the pipeline owner turns into a financial donor obliged to execute investment decisions taken by a third party.

And finally, we should have to adjust our operational activities and renegotiate sales and transmission contracts. EU commission confirmed that it will respect LT contracts sales and transmission contracts. But when LT transmission contracts expire they will not be renewed.

System operators are required to amend their existing contracts to enable them to conform to the new Capacity Allocation Mechanisms (CAM). This clearly will have serious implications for existing capacity rights holders such as Gazprom. CAM proposes to include allocation capacity via auctions, bundling of capacity at cross border points so that it will no longer be possible to buy separate entry/exit capacity at a cross border point, combining cross border points into virtual interconnection points which will impact capacity rights, and the prohibition of separate transit capacity rights so that capacity used for transit of gas across countries or market zones will no longer be treated differently from capacity which is used for consumption within a country or market zone.

All these changes could hardly be accomplished without undermining the capacity rights of those who have booked long term; they put in danger our ability to meet customer nominations and may force us to introduce a new ‘force major’ clause into our sales contracts - ‘force major’ caused by TEP.

Sales contracts will become subject to renegotiation for other reasons too. Currently we sell a combined product - commodity plus flexibility. The existing LT booking mechanism provides for reliability of our existing LT sales contracts

and readiness of a supplier to maintain backup transmission capacities allowing to swiftly meeting the demand in pursuance of the changing intra-day nominations. From now on, instead of the right to change their nominations several times a day, our customers will be entitled to do it only once and on the day before actual supply. Restriction of re-nomination rights will have adverse affect on flexibility of deliveries. I would like to stress that taking into account seasonality and extremely uneven demand throughout a day – reliability and flexibility are of paramount importance for the gas industry.

Gazprom Group and the Russian Government are closely monitoring the implementation of the TEP. This is a necessary measure to make sure that the damage caused by this process to our Company's interests will not go beyond the bare minimum. I also hope that we will be granted the opportunity to make a significant contribution to the process of drafting the industry codes.