Antitrust: Commission opens proceedings against Gazprom
(three suspected anti-competitive practices in Central and Eastern Europe)

Comments of A.Konoplyanik,

5th Central European Gas Congress,

Prague, Hotel Diplomat, 11th September 2012

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 wrong 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

DG COMP: "Gazprom may be abusing its dominant market position in upstream gas supply markets in Central and Eastern European Member States" (2)

- 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
  - 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
  - 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
  - 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 (crisis => 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”

- 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 infrastructure (interconnectors, reverse flows, 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.
- What is “free flow”: (i) multiple supplies through multiple pipelines (both old + new), *or* (ii) multiple supplies (old + new) through old pipelines only? If (i), then CAPEX + time. If (ii) (DG COMP?), then zero CAPEX & time. Possible argumentation for (ii): utilization rate of existing EU gas infrastructure = 70% (calc.) => to receive “free” access to existing infrastructure developed earlier by others which is contractually not free?

DG COMP: "Second, Gazprom may have prevented the diversification of supply of gas"

- 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
- 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 (see my presentation 12.09.2012), where representatives of Gazprom 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
- 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"

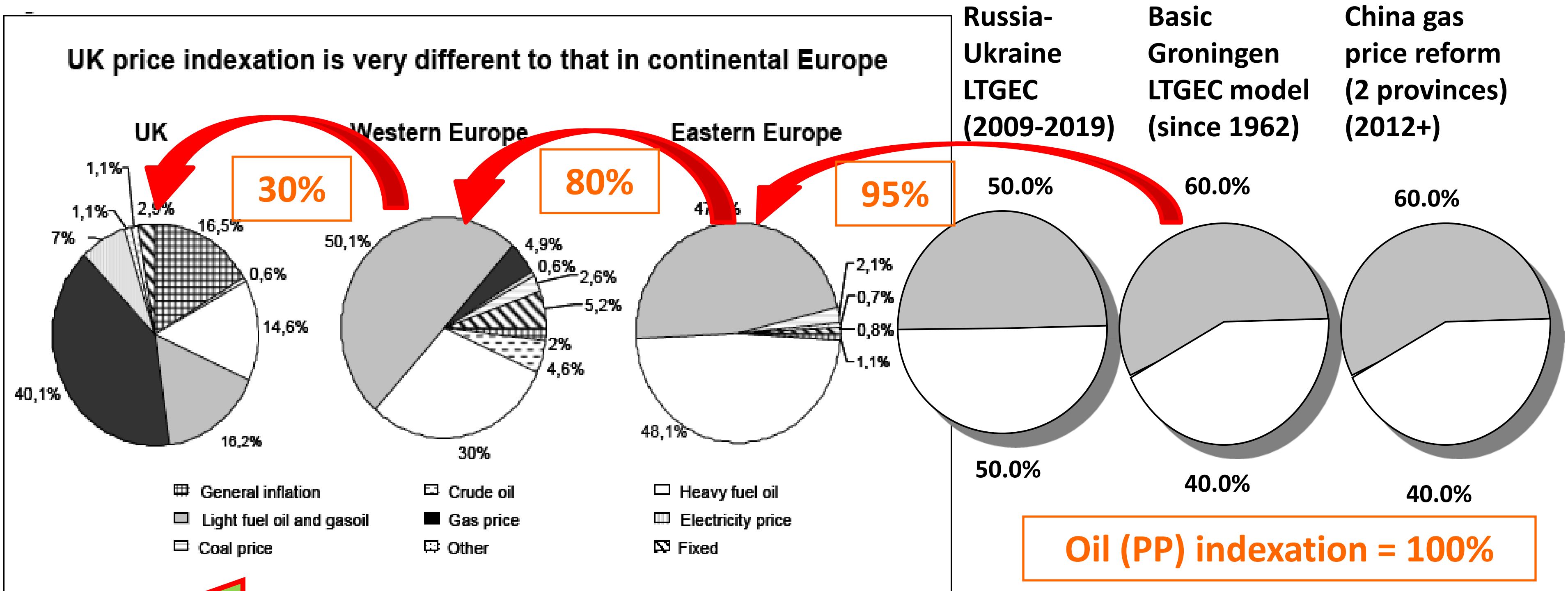
DG COMP: “Finally, Gazprom may have imposed unfair prices on its customers by linking the price of gas to oil prices” (2)

- 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: 80% (2005) to 2/3 (2009) (IGU)
    - Key EU gas exporters (Netherlands, Norway, Russia): appr. 90% (DG COMP/2005)
  - Increasing gap between contractual & physical practice, but
  - Different arguments in favour & against oil (PP) indexation (slide 8)
  - My view: slow adaptation of oil (PP) indexation, but not full conversion to spot (slides 9-10) => objective trend, not administrative pressure

Oil indexation: arguments "in favour" and "against"

"In favour"	"Against"
1. Worked out in practice for 50 years => convenient for users 2. Narrows corridor of price fluctuations, increases price predictability, minimizes investment risks 3. Convenient tool for financial institutions => hedging => provides debt financing 4. Transparent and understandable pricing mechanism (at least for professionals) 5. Professional, homogenous, stable and narrow circle of market participants 6. Proposed alternative (spot/futures) is not better: low liquidity (EU), high possibility for manipulations	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) fuel 3. 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) market 5. Confidentiality, thus closed and non-transparent for the public 6. Currently: higher contractual prices compared to spot transactions

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



Source: Energy S … 2005/2006

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

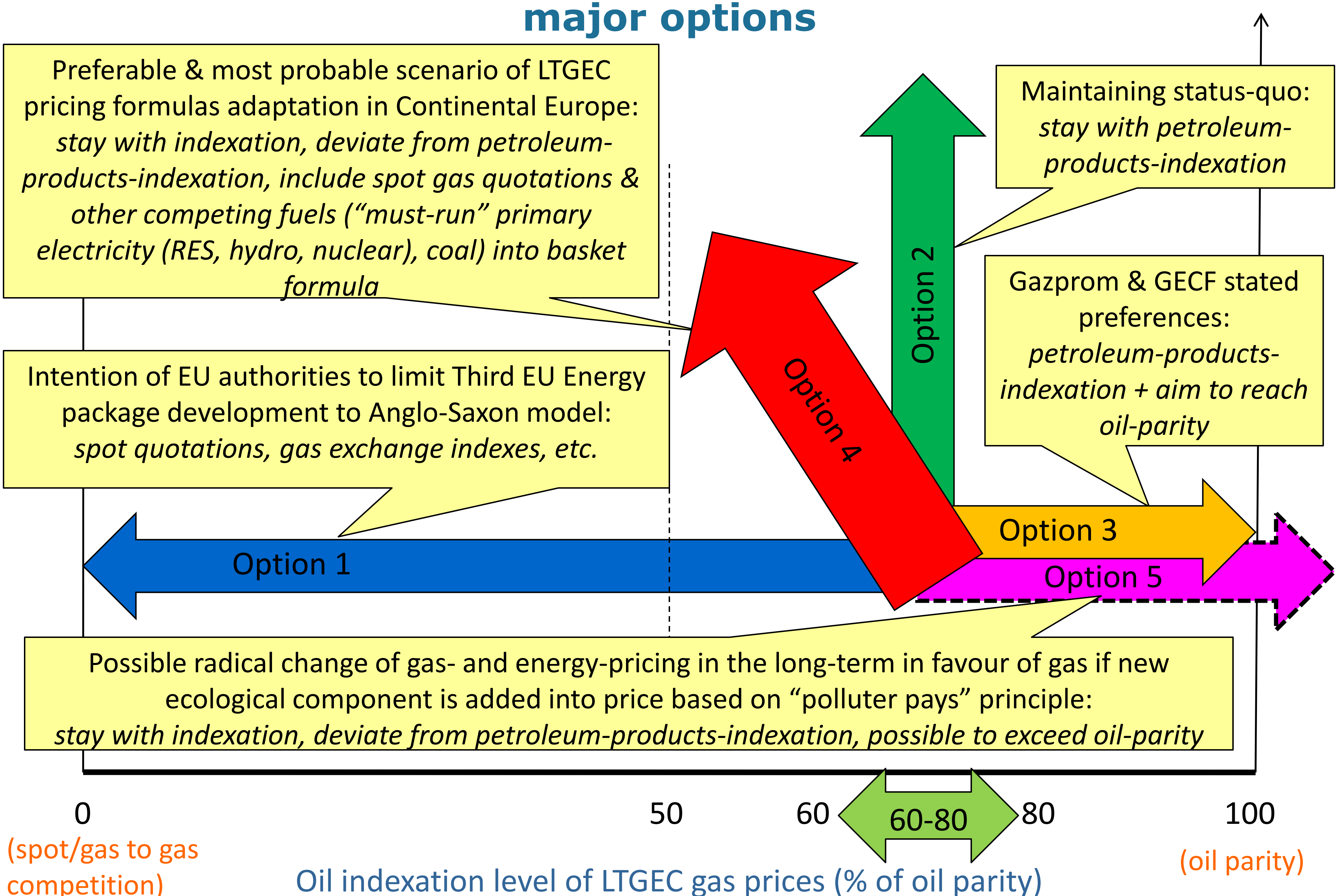
Russia-Ukraine 2009 LTGEC structure rationale: more practical (understandable & sustainable) to start with less sophisticated pricing formula => similar to basic Groningen formula

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



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 wrong reasoning & wrong suggestions of who is responsible/guilty => wrong line of possible action?

Thank you for your attention

www.konoplyanik.ru

andrey@konoplyanik.ru