

Gazprom's marketing strategy in Europe: forced though late adaptation of contractual & pricing structures to gas glut

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Presentation at the International Conference
"GAS AND NUCLEAR ENERGY FORUM 2011",
Hotel Warszawianka, Jachranka near Warsaw, Poland, 30-31 May 2011

US shale gas – a trigger of gas oversupply in Europe, 2009-2010

- Decrease of demand:
 - Global economic recession, incl. in Europe
- Increase of supply:
 - New supply projects (mostly LNG) originally destined for Europe & being developed under high oil/gas pricing environment in 2000-ies
 - US shale gas development has *de facto* closed US import market for LNG => LNG supplies originally destined for the US were redirected to Europe
- ***Result:*** Gas Oversupply in Europe

Q: What future consequences of other ingredients under gas glut?

A: Uncertainties increases...

- **Russia-Ukraine gas crises (Jan.2006 & Jan.2009):** Negative precedents => 22 days vs. 40+ years => change of perceptions =>
- **Energy forecasts:** downgrading prospects of gas demand in official & CEC-sponsored forecasts => “Demethanization (methanophobia/K.Simonov)” of EU energy forecasts = to escape from Russian gas? => competitive niche for Russian gas narrows
- **Third EU Energy Package (2007=>2009=>2014):** gas glut = increased share of spot => key developments of “designed model” under gas glut environment => over-evaluation of Anglo-Saxon model prospects within GTM & designed market => forced movement from LTGEC with gas price indexation to spot trade with futures pricing (is it possible?) => investment risks for producers/exporters increases in narrowing competitive niche

What messages energy forecasts sponsored by the Commission send to gas business (is it practical to forecast future demand volumes below already contracted volumes?)

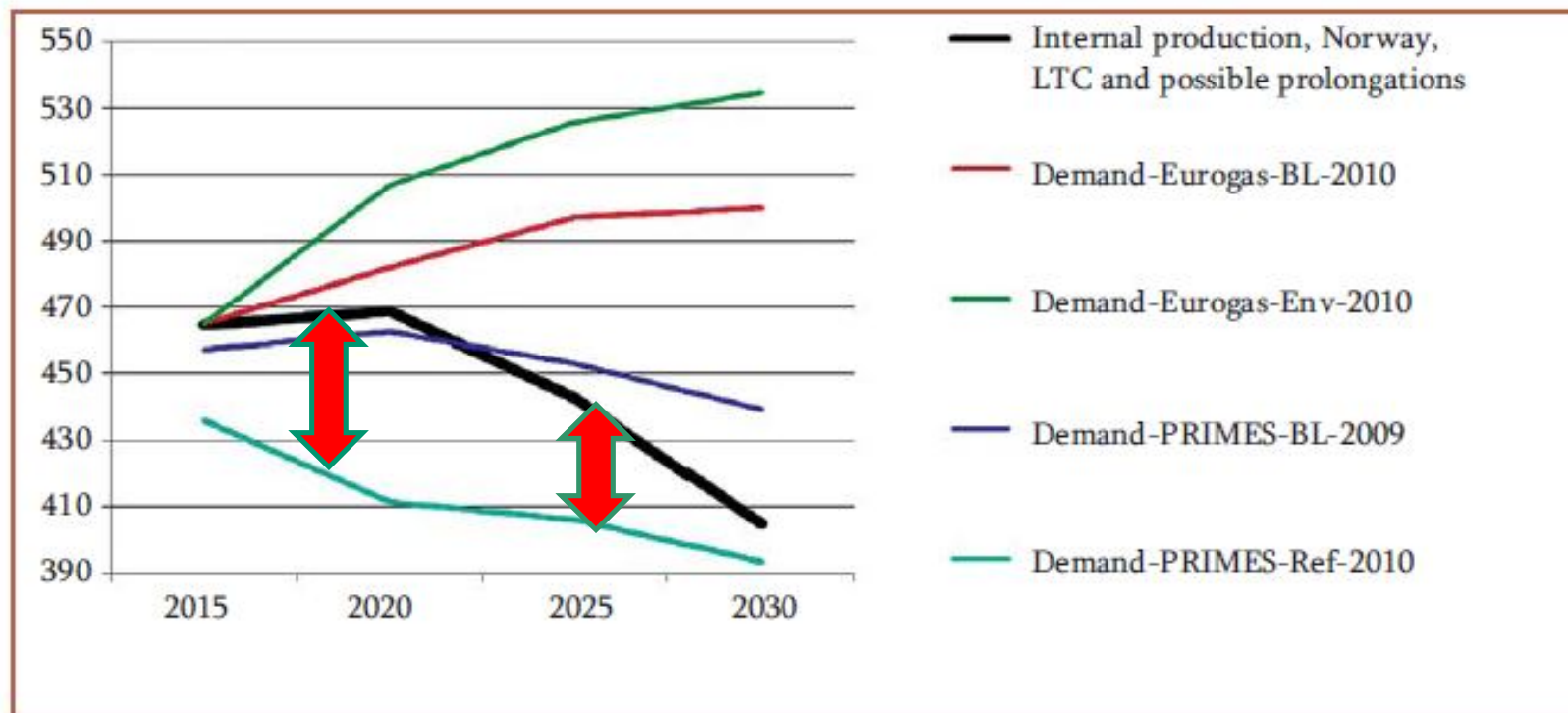


Figure 2. Potential of a new gas supply in EU-27 in 2015-2030 according to forecasts

Sources: Eurogas, 2010; EET-2030 update 2009

Note: LTC – long-term contracts  Gap between production and demand volumes

Source: Russia-EU Energy Dialogue. Thematic Group on Energy Strategies, Forecasts and Scenarios. Energy Economics Subgroup. “Energy Forecasts and Scenarios, 2009-2010 Research, Final Report”, 2011, p.28

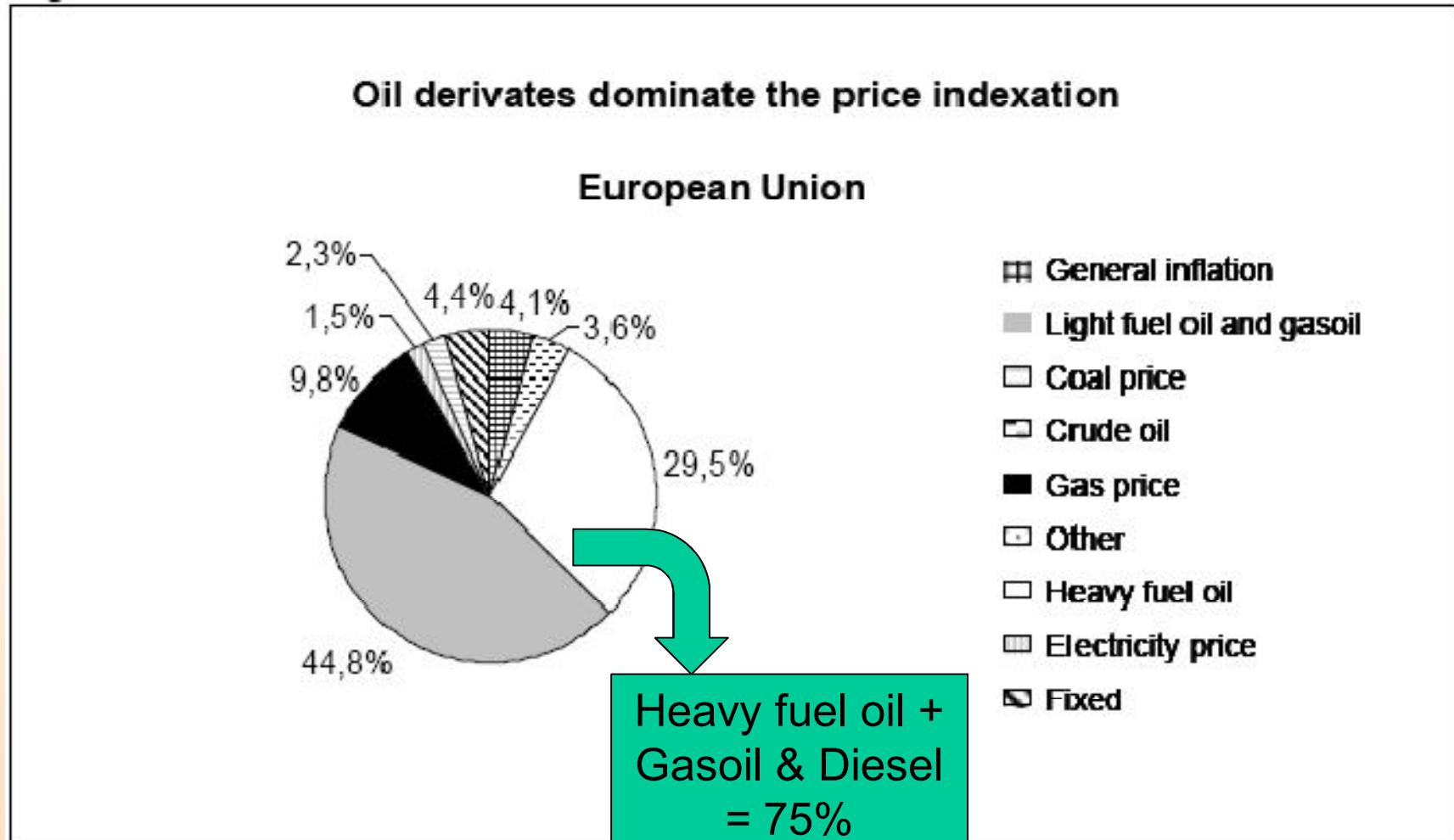
Evolution of gas pricing in Europe (1)

- **Prior to 1960-ies:** cost-plus
- **1962:** net-back replacement value (to maximize long-term resource rent – Netherlands, “Nota de Pous”)
- **1962-2009/10:** spread-over of Groningen-type LTGEC with mostly oil-indexation through broader energy Europe
- **Why “Oil-Indexation”?:** “*Indexation*” = mechanism of softening price fluctuations; “*oil*” = key replacement fuel
- **Oil-indexation in the 1960-ies:**
 - RFO (electricity generation) & LFO (households) are really key replacement fuels to gas,
 - Oil price is low and stable, so RFO & LFO,
 - Oil-indexation is a mechanism of softening *potential* price volatility of key replacement fuels => fully corresponds to replacement value philosophy at that time => easy to implement & rare adjustments

Evolution of gas pricing in Europe (2)

- **Oil-indexation nowadays:**
 - RFO & LFO are not the key replacement fuels anymore,
 - Oil price is high & volatile, does not reflect (since mid-2000's) “physical oil” fundamentals
 - Oil-indexation is softening fluctuations of oil prices, but the nature of volatile oil prices (commoditization of oil market) still in place => the gap between “oil-indexation”(contract formula) and “replacement value” (economic philosophy of formula-based gas pricing) is widening, BUT oil-indexation still easy to implement, though regular adjustments
- **Counter processes in gas market development (to increase vs. diminish price risk & volatility):**
 - Commoditization (Anglo-Saxon model, following oil market) increases risks & volatility => this stipulates
 - Development of financial instruments to mitigate these growing risks immanent to chosen EU gas target model (“designed market”) => illogical vicious circle: first to increase risks, then try to diminish them

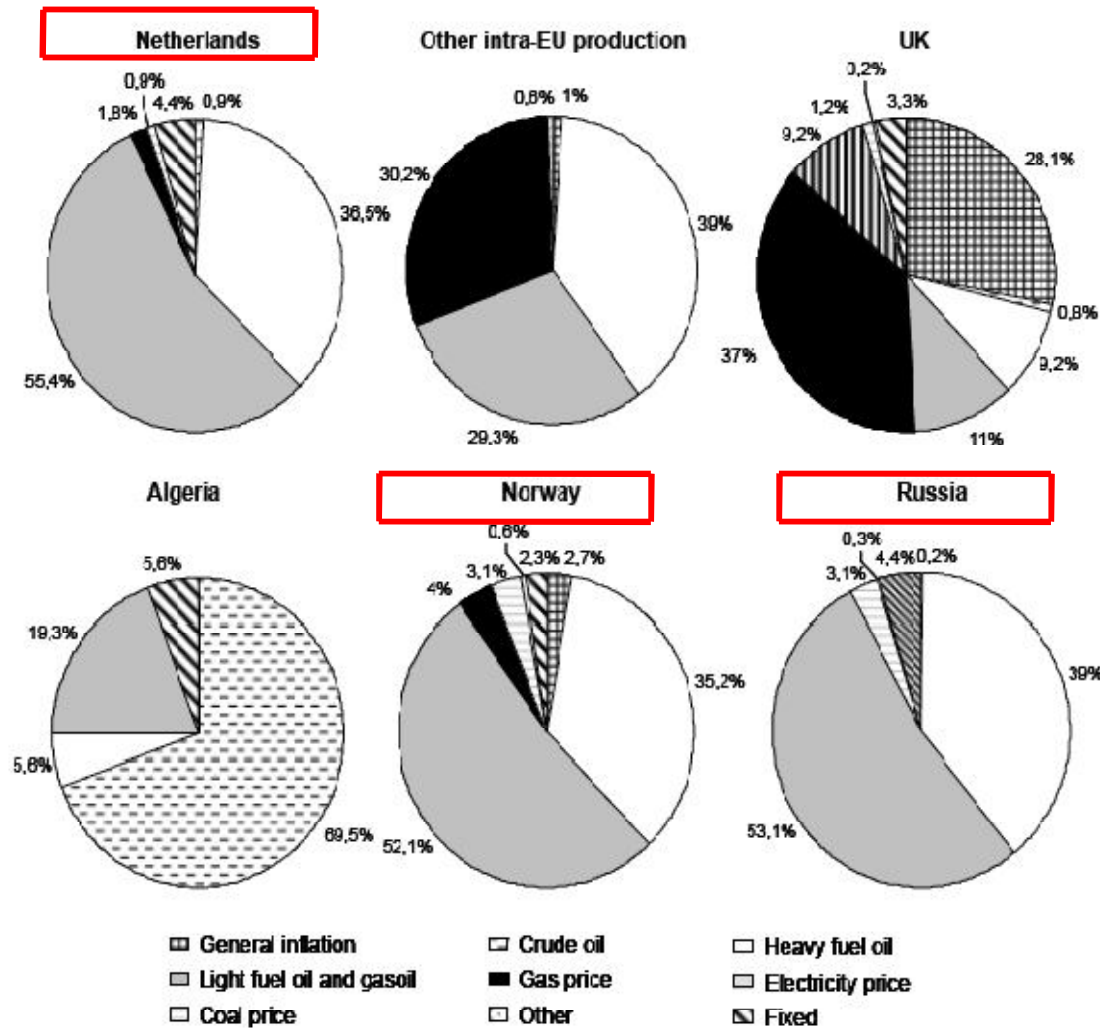
Price indexation structure in the EU



Source: Energy Sector Inquiry 2005/2006

LTGEC in the EU: Indexation by Producer

Indexation is not similar for all producing regions



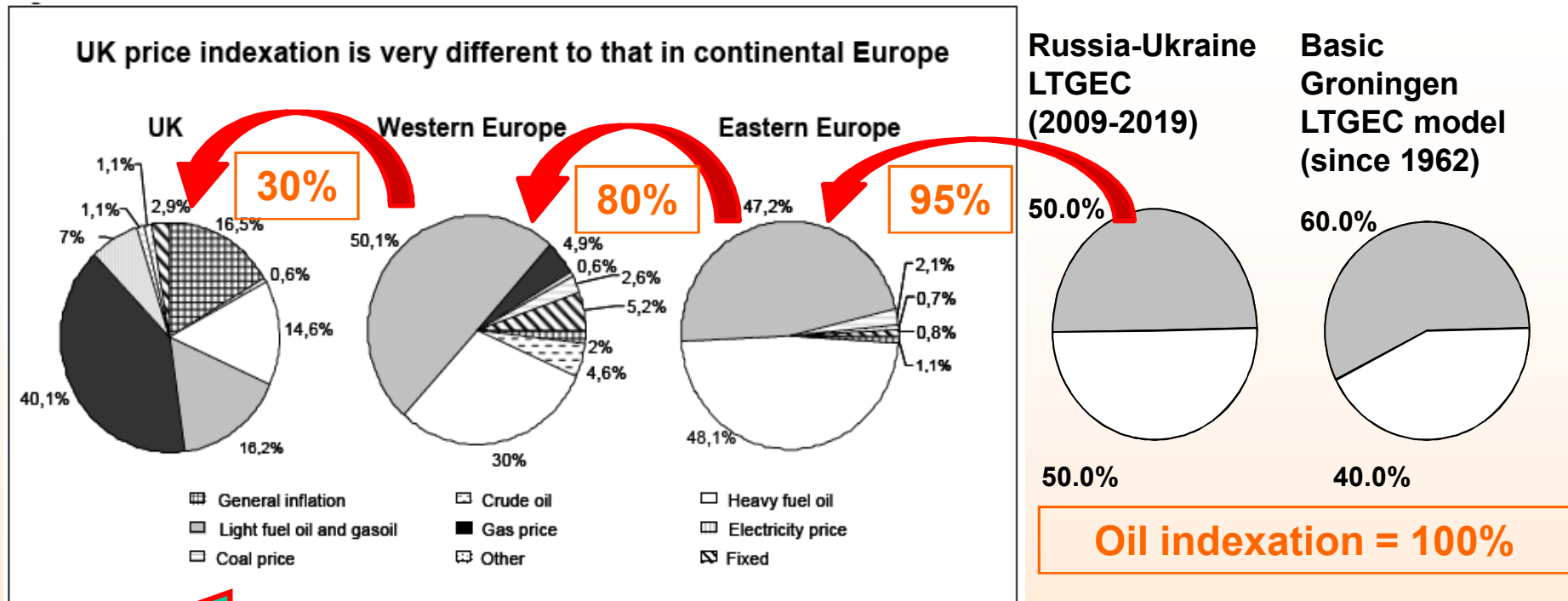
Netherlands, Norway, Russia:
 HFO = 35-39%;
 diesel & gasoil = 52-55%;
 Sum-total HFO+ Diesel & Gasoil:
 Netherlands = 92%,
 Norway = 87%,
 Russia = 92%



Major gas exporters to the EU: mostly oil indexation

Source: Energy Sector Inquiry 2005/2006

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



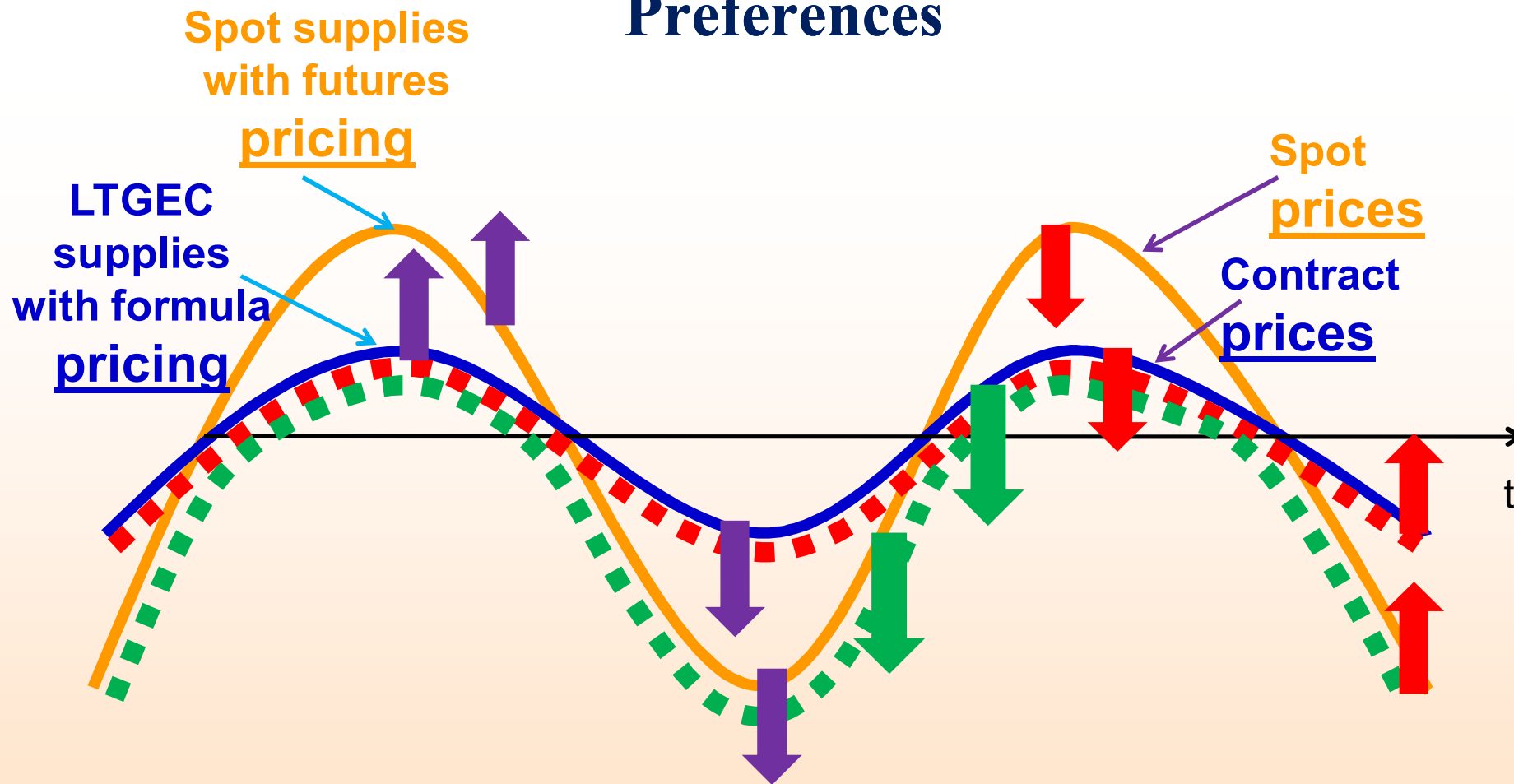
Source: Energy Economics, 2005/2006

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

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

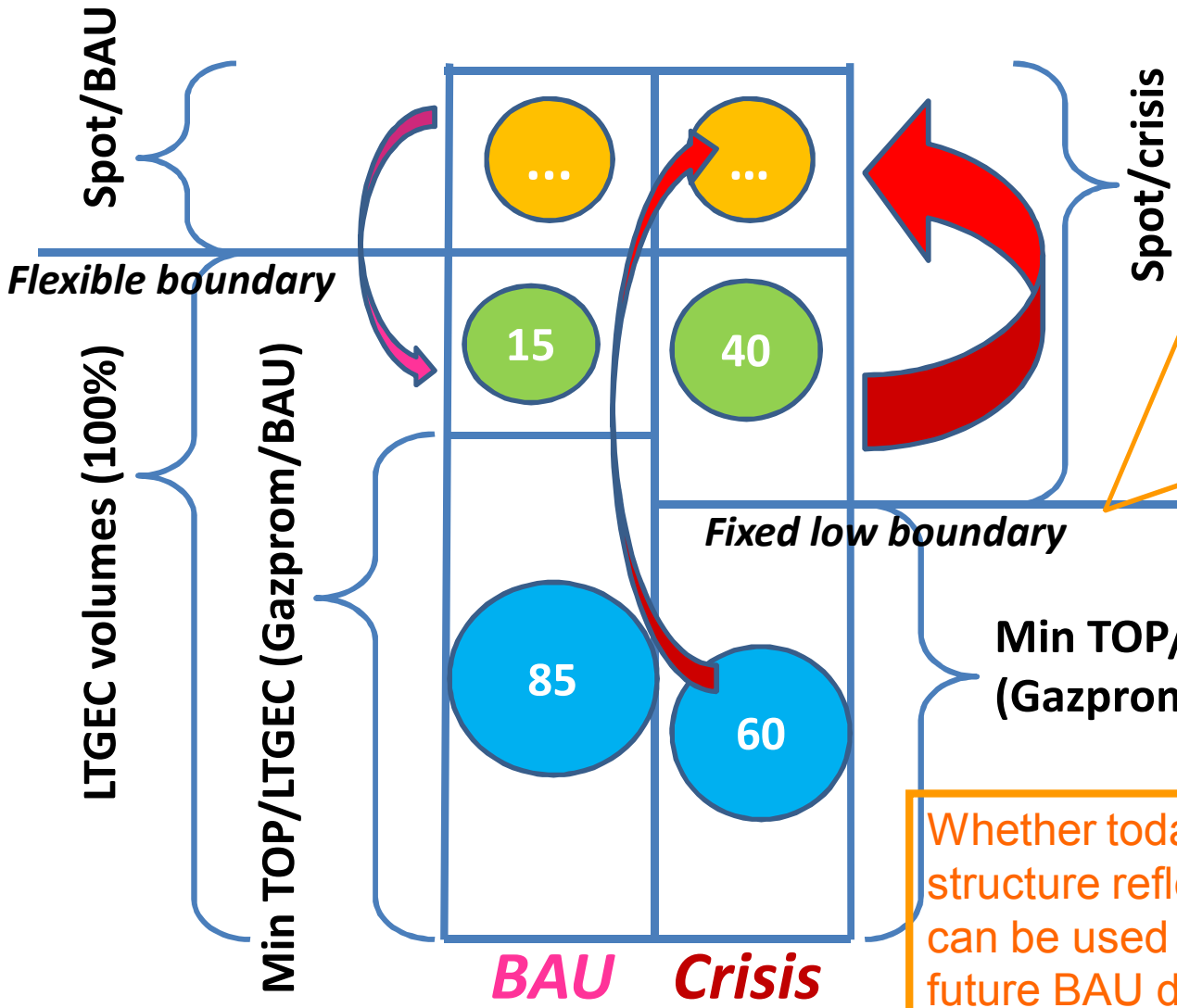
Further development (most likely): towards EE-type => WE-type => UK-type price indexation => **away from oil parity?**

Producers, Consumers & Speculators Price/Pricing Preferences



- ■ ■ ■ ■ ■ ■ ■ ■ ■ Preferences of the producers / exporters / hedgers
- ■ ■ ■ ■ ■ ■ ■ ■ ■ Preferences of the importers / consumers
- ■ ■ ■ ■ ■ ■ ■ ■ ■ Preferences of the speculators

Evolution of spot/LTC gas trade under BAU/crises



%-age of spot increases to extreme high during crises due to: (1) decrease of 'Min TOP' in LTGECs & buyers' switch from LTGEC to spot purchases + (2) spot compensates delays in contracted supplies (postponed start-ups) from new projects; spot back decreases from extreme high during BAU dev'ts

Min TOP/LTGEC (Gazprom/crisis)

Whether today's contractual gas market structure reflecting crisis environment can be used as a basis for modeling future BAU developments ?

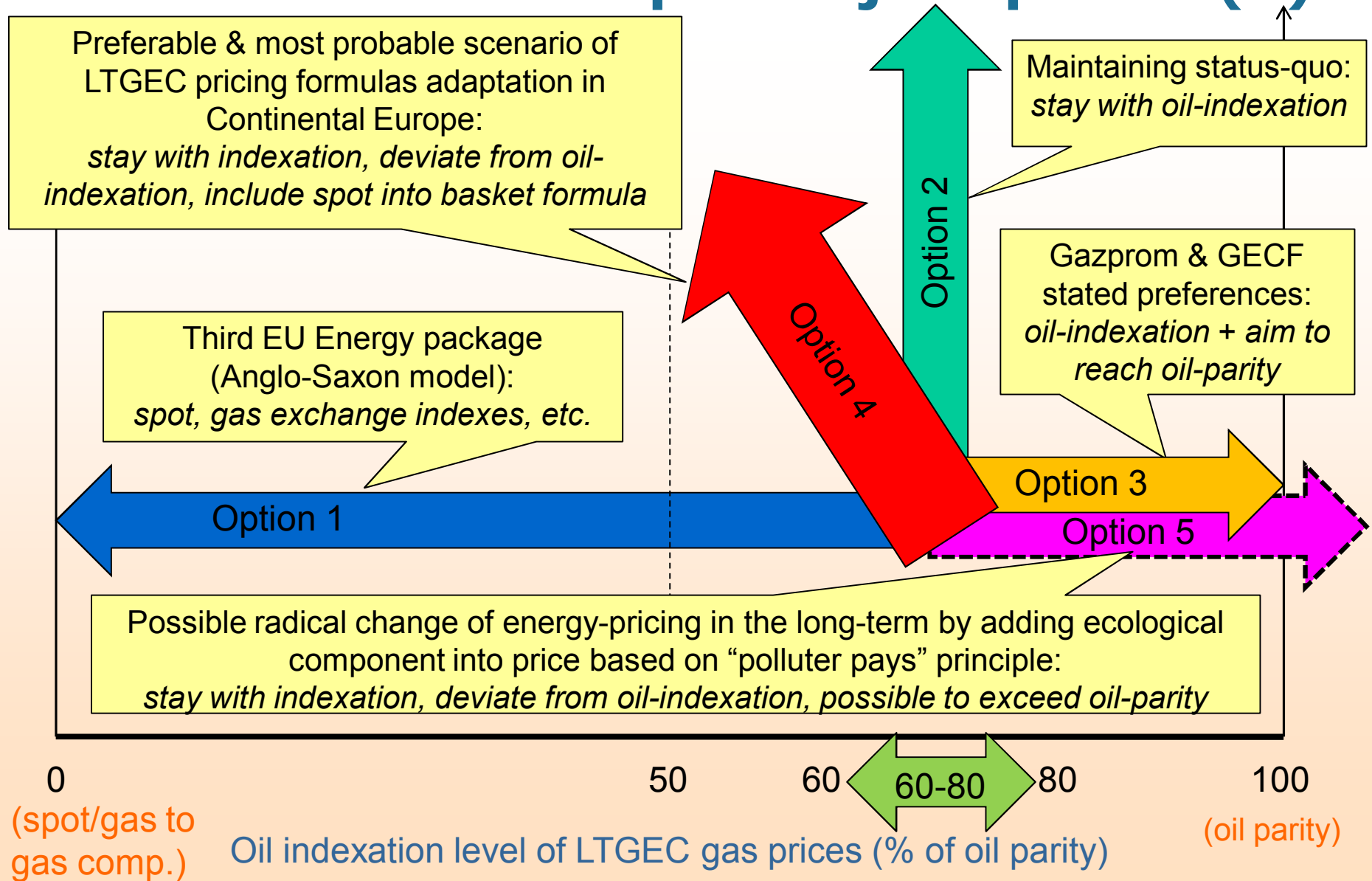
Gazprom: Evolution of contract provisions and pricing mechanisms in Europe (1)

Actions	Companies
Buyers' demands for price reviews and contract adjustments following "significant market changes"	E.On, Wingas, RWE, Botas, Eni, GdF Suez, EconGas, Gasum
Downgrading minimum TOP obligations from Gazprom's average 85%	E.ON, Botas: 90% to 75%; ENI: 85% to 60% for 3 years) => Gazprom total 15 BCM for 3 years = 5/140-145 BCM (2010) = 3.5% RF gas export volume
No penalties for violation of minimum TOP obligations	Naftogaz Ukraine, Botas; Eni, E.ON pending
Gas sales above minimum TOP obligations at current spot prices	E.ON, GdF, Eni
Adding gas-to-gas competition component into pricing formulae thus decreasing/softening oil-indexation formulae link	E.ON, GdF, Eni–Gazprom = 15% based on a basket of European gas hubs, E.ON-Statoil = 25%; Statoil average up to 30%, requests to Gazprom up to 40%

Gazprom: Evolution of contract provisions and pricing mechanisms in Europe (2)

Actions	Companies
Increasing flexibility of contractual provisions	Gazprom's "promotional package"
Recalculating base formulae price	Wingas
Direct price concessions	Naftogas Ukraine, Botas (tbc)
Manoeuvre by contract volumes within contractual time-frame + requests to cancel obligation to off-take contracted volumes within 5-year period	E.ON, Eni
Stimulating measures ("packages") for purchases in excess of (downgraded) minimum TOP	
Shorter contract durations	Sonatrach
Shortening of recalculation period/interval	possible
Shortening of reference period	possible
Some buyers files lawsuits against Gazprom over long-term prices (within price review/DS clauses)	Edison S.p.A. (AC SCC), etc.

Evolution/adaptation of gas pricing mechanisms in Europe: major options (1)



Thank you for your attention

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