



What New Commercial Relationship We Drive to?

A View from Gazprom Export

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A European Gas Contract Pricing System Based on Supply and Demand is Not Sustainable

- Many market pundits are declaring that oil-indexation in European gas contracts is outdated and will soon be inevitably replaced by a pricing model based on supply and demand.
- It is time to drop some of the free-market orthodoxies of the 1990s. Now, it is clear that there are certain cases when liberalized markets cannot perform their functions properly.
 - This is the case of the European gas industry.
- Continental Europe has developed a unique hybrid pricing system based on
 the coexistence of oil-indexed contracts and gas-indexed hub prices. Under
 the existing model, oil-indexed prices play a leading and dominant role, while
 hub prices play a balancing and subordinate role. Changes in the pricing
 model that have been proposed for Continental Europe will bring the existing
 hybrid system to a collapse. These changes will inevitably lead to a
 termination of the long-term gas supply contracts as these contracts will no
 longer be able to protect the investment programs of the exporters.

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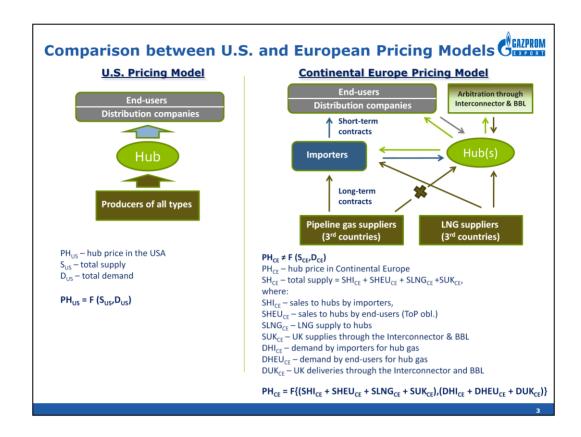
In my presentation today I will focus on those proposed changes to commercial relationship between suppliers and consumers in Europe which refer to the pricing principles.

The proposed changes in commercial relationship could be summarized in a formula -- LT supply contracts plus gas indexation.

Combination of Long-term contracts and gas indexation is ridiculous. These two elements do not co-exist well. In simple terms, if you have a liquid market there is no need for LT contracts.

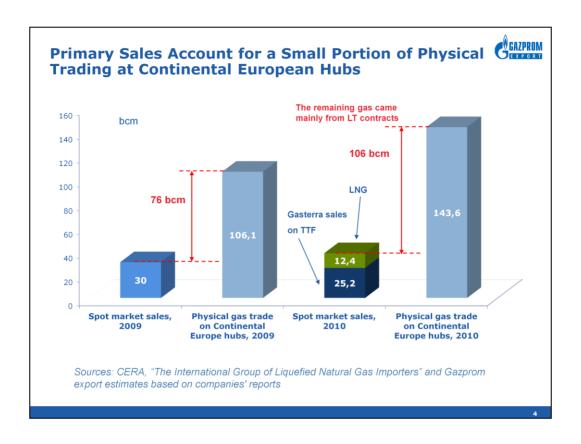
Continental Europe has developed a unique hybrid pricing system based on the coexistence of oil-indexed contracts and gas-indexed hub prices. Under the existing model, oil-indexed prices play a leading and dominant role, while hub prices play a balancing and subordinate role. This system has its own logic and even beauty. It is a pure market and a highly competitive system.

Changes in the pricing model that have been proposed for Continental Europe will bring this existing hybrid system to a collapse. These changes will inevitably lead to a termination of the long-term gas supply contracts as these contracts will no longer be able to protect the investment programs of the exporters. Let me remind you that long-term contracts are the cornerstone of the energy security of the import-dependent Europe and oil-indexation is a hedge against price manipulation by dominant suppliers. In that sense, the call for absolute use of gas indexation is a recipe for disaster for the European gas industry.

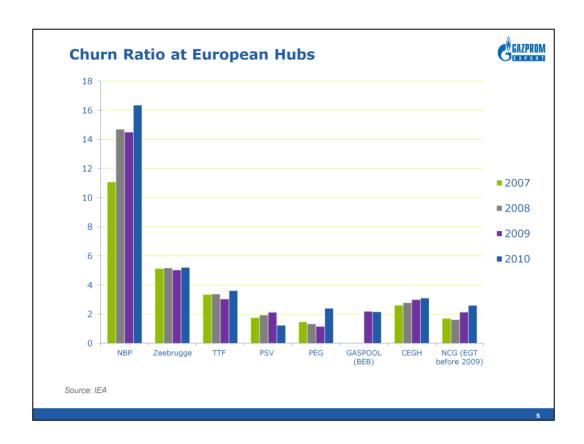


Continental gas market is unique in its it nature, it is a balancing market. Balancing nature of the Continental market has to be taken into consideration by major players, including reformers. This market is a different "beast" than the U.S. market. And it has to be treated in a way that allows long-term oil-indexed contracts and spot gas to complement each other.

In contrast to North America, natural gas pricing at Continental European hubs does not provide a true indication of the supply-demand balance because the Continental European market comprises a complicated structure of long-term and short-term contracts. Therefore, Continental hub pricing is not a function of total supply and demand but a function of something quite different — arbitrage of all kinds, between different contract pricing structures, between contract and spot prices, between hubs, between UK and the Continent. In fact, the market in Continental Europe is a platform for arbitrage of all kinds.



In contrast to the U.S. Henry Hub, where primary sales account for the bulk of physical trades, European hubs generally play the role of market balancer, and during the most recent crisis served as markets of "mistakes in demand assessment" rather than as full-fledged price originators. According to our estimates, less than a third of all physical trades in Continental Europe were comprised of direct sales of gas. The remaining amount was comprised of secondary or tertiary volumes sold back and forth.



The specific character of natural gas price signals in Europe is demonstrated by the extremely low churn ratios at Continental hubs. In order to produce sustainable price signals, the churn ratio has to be at least 15. In Europe, only the NBP meets this condition. Continental markets do not pass this test. Some analysts say that low churn ratios on the Continent are a reflection of the transition phase, and that, as hub markets mature, churn ratios will grow. I am pessimistic in this respect. It is not because of the lack of appetite on the side of European financial institutions to play with the forward curve. It is extremely hard to predict what the price on a balancing market will be in two or three years because these prices are not about supply and demand but rather about arbitrage opportunities. There are too many moving parts in the balancing market that must be taken into consideration. This mission looks impossible for a rational forecast to be made.

Churn ratios on Continent hubs are low and do not look likely to increase, as shown in the chart on slide 4. The market on the Continent is a paradise for the arbitrageurs already. In this sense, it is a mature market by now. In a similar way, it would be wrong to say that that pony is not a fully formed horse. It is simply another beast.



Gazprom Supports the Status Quo in Continental Europe

- The existing market structure on the Continent is satisfactory and offers win-win options for both buyers and sellers.
 - However, the balancing nature of the Continental market has to be recognized.
 - This market has to be treated in a way that allows long-term oil-indexed contracts and spot gas to co-exist and complement each other.
 - Lessons from the crisis have already been taken.
 - Our clients do not believe in the miracle of cheap spot gas anymore.
- A move to overall gas indexation in long-term contracts is unacceptable to gas
 producers, and not only because the low churn ratios at Continental European hubs
 raise doubts as to the quality of their price signals.
 - Turning to gas indexation would not change the balancing nature of the spot gas market in Europe.
 - But gas indexation would change the balance of interest in favor of importers; it would create the
 opportunity for predatory pricing at the hubs and devalue the entire supply portfolio of producers.
- A move to the American model that of hub pricing without the cornerstone of long-term contracts and direct sales by gas producers at the hubs is not a suitable option.
 - Europe is increasingly import-dependent and there are oligopolistic structures on both sides of the market.
 - There is no need to open a Pandora's Box of endless conflicts.
 - Acrimonious, rather than cooperative, relations between buyers and sellers are not in the best interest of Europeans as they undermine the long-term security of supply.

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The existing market structure on the Continent is at least satisfactory and offers win-win options for both buyers and sellers. Lessons from the crisis have already been taken. Our clients do not believe in the miracle of cheap spot gas anymore. Discount price suppliers with no gas of their own that emerged at a time of financial crisis are not able to keep their promise to deliver cheap gas to their customers. Some of these suppliers have gone bankrupt already (such as TelDaFax).

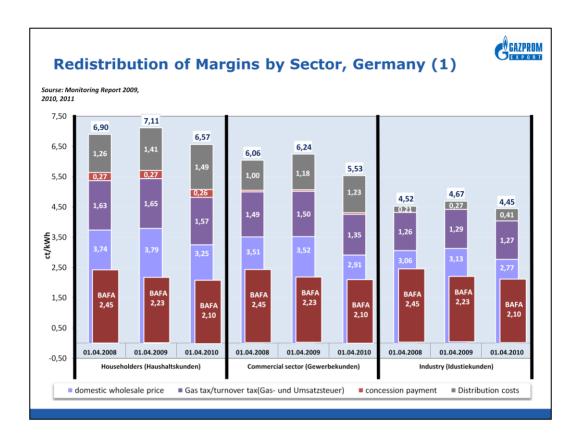
The move to gas indexation in long-term contracts is unacceptable to gas producers. This is not only because the low churn ratios at Continental hubs raise doubts as to the quality of their price signals. Transitioning to gas-indexed contracts will not change the balancing nature of the European gas market. It doesn't matter how much lipstick you put on a pig, it still remains a pig. But gas indexation will change the balance of interests in favor of importers; it will create the opportunity for predatory pricing and devalue the entire supply portfolio of natural gas producers.

Producers will be running intolerable risk of gas price erosion because there is virtually no force in Europe interested in preserving the value of natural gas. Producers in the EU (Dutch and British) are definitely not interested is selling gas below cost albeit it is lower than for suppliers from the third countries due to their high transportation and liquefaction costs. Indigenous producers have easy access to the hubs and can buy gas to meet their contract obligations when hub prices drop too much. Production could be resumed in a swing mode when prices are higher than their costs.

Pipeline producers from the third countries do not have easy access to the hubs and that puts them in a disadvantaged position.

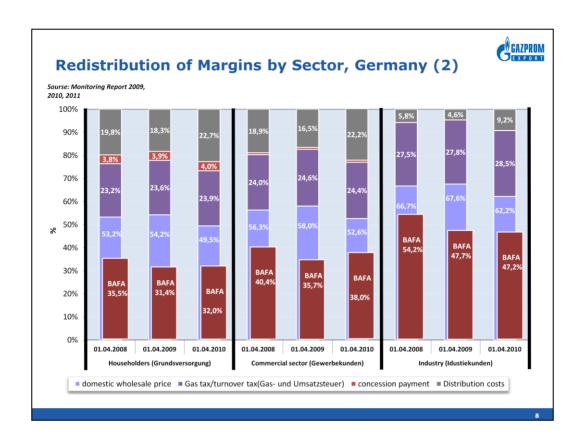
If the oil-linked benchmark price ceases to exist, exporters will be forced to accept prices irrespective of how low they are without any leverage to influence these prices. Unjustified demands of gas importers that producers should be fully responsible for price risks in long-term contracts change the fragile balance of interests between buyer and seller. Pushing these demands will lead to nothing else but the demolition of long term supply contracts. Indeed, if markets are liquid enough, there is no need for long term supply contracts.

But a move to the American model – that of hub pricing without long-term contracts and direct sales by natural gas producers – is not a suitable option either. As a matter of fact, Europe is increasingly import-dependent and there are oligopolistic structures on both sides of the market that will end up opening a Pandora's Box of endless conflicts. Acrimonious, rather than cooperative, relations are not in the interests of Europeans, as they will undermine the security of supply.



One of the major arguments in favor of hub pricing is that lower prices originating on the hubs are transferred throughout the value chain to the benefit of end users of all kinds – household, commercial and industrial. Is it really the case?

A snapshot of the German gas market for the beginning of April over the last three years provided by national regulator Bundesnetzagentur indicates that results of price competition enhancement bring conflicting results. In 2010 as in 2009, major beneficiaries of competition between exporters and domestic wholesalers were distribution companies whose share of the margins increased in absolute and relative terms. Distribution companies' average prices gained 18 percent in sales to households, 23 percent in sales to commercial users, and 95 percent in sales to industrial users. Snapshots of the German gas market do not support the statement that low hubs prices are transferred throughout the value chain to the benefit of end users. To conclude: the unintended consequence of competition between exporters and importers is the growing margins of distribution companies.



So far, the competition enhancement policy has only divided European gas market participants. They all got involved in a vigorous fight to preserve their historic margins. That is a positive development, that is how competition works, one may say. But competition does not work if it deprives producers and importers of reasonable margins and brings gas prices below a level that supports the investment cycle in the gas industry. Not to mention when it provides only modest benefits to end users, if any. Reformists should be careful when giving competitive advantages to one group of market participants at the expense of another. They should clearly understand that they are reforming a unique market that is in fact a balancing market.

In the old system, the benefits of arbitrage manifesting themselves in lower spot prices were available to a small group of importers. Now these benefits are available to a broad group of market players that have no import contracts and bring no gas to Europe under long-term arrangements. Advantages without responsibilities for this group of players result in unfair competition. What the market reformists have to do is protect long-term contracts and importers, the holders of these contracts, from unfair rules of the game. One solution could be an introduction of a minimum wholesale price for supply tenders initiated by the distribution companies. This price must be no lower than the recent BAFA price plus reasonable costs of storage and transportation to the distribution companies. Importers with long-term contracts, all other terms being equal, would have an advantage over suppliers without imported gas at these tenders.

Anecdotal experience gives us no evidence that hub pricing is better than traditional Dutch-formula oil-indexed pricing. Transparent, easy to understand, competitive and fair, as liberal determinists say. I strongly doubt that what we get as a result of hub pricing is easy to understand and fair. The basic problem in developing commercial relations in gas is how to preserve long-term oil-indexed contracts and enhance competition on the internal EU market.

Thank you for your attention.

