



## **Why are Hub Prices in Europe Rising?**

View from Gazprom Export

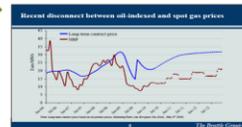
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## Take-Aways from the Previous Flame Conference

- It will take years for gas consumption in Europe to reach pre-crisis level
- Global oversupply will stay at least for a decade up to 2020
- Inflow of the new LNG and rerouted volumes from the U.S. will make European gas market even more imbalanced
- Spot prices will be lower than contract prices once and forever



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Dear conference participants,

More than a year has passed since the last Flame Conference. It is a good time to appraise how valid were the forecasts made a year ago and how they match with reality. Major take-aways from the last March 2010 Flame conference were that things for producers like Gazprom will get only worse. Summary of these take-aways is as following:

- What we often heard a year ago is that demand for gas in Europe will be in decline for years to come or be flat year-on-year;
- Global oversupply will stay at least for a decade up to 2020. U.S. are no more a destination for significant volumes as a lot of unconventional gas is coming to the market;
- Inflow of new Qatari LNG and volumes rerouted from the U.S. will lead to further imbalances;
- Growth of unconventional gas in North America has led to a clear decoupling of gas prices from oil prices. Europe spot prices are disconnected from historical oil indexation levels – and will remain so once and forever.

A year ago Gazprom was among a few optimists on gas demand in Europe perspectives. We claimed that the current recession-induced drop in European gas demand is temporary and does not herald a structural change in European gas markets. We were predicting a recovery of European gas demand by 2012.

## European Gas Demand in 2010, non FSU Europe



	2009	2010	Change , bcm	Change, percent.
Consumption	565.2	611.0	+45.8	+8.1%
Indigenous Production	307.0	311.2	+4.2	+1.4%
Net Import	264.2	288.3	+24.1	+9.1%
Storages, Net of Injections and Withdrawals	-6.0	11.5		

Source: IEA, Russian Standard Gas

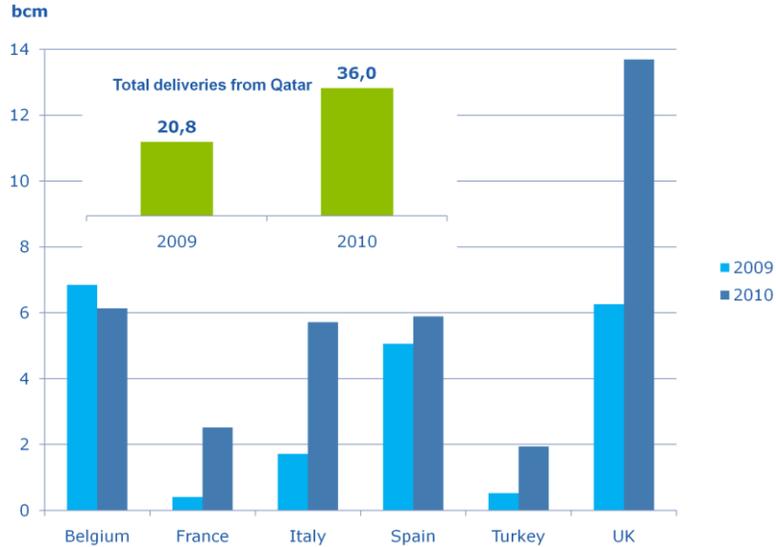
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However, the reality has beaten the most optimistic forecasts including those of Gazprom. According to data from the International Energy Agency, gas demand in Europe has not only rebounded in 2010 but hit all time highs. This happened at a time when recession is not yet over and gas glut most likely is still there. Market realities clearly contradict to a statement that we heard a year ago on future gas demand in Europe that it is currently more about recovery than growth.

There is anyway easy to find justification to the phenomenal demand growth - particularly harsh European winters.

But conventional wisdom is not capable to explain a convergence of spot and contract prices that we are witnessing now. In late November – early December 2010 spot prices soared, for the first time since the crisis, and turned up to be higher than Gazprom contract prices.

## New LNG Deliveries from Qatar to Europe

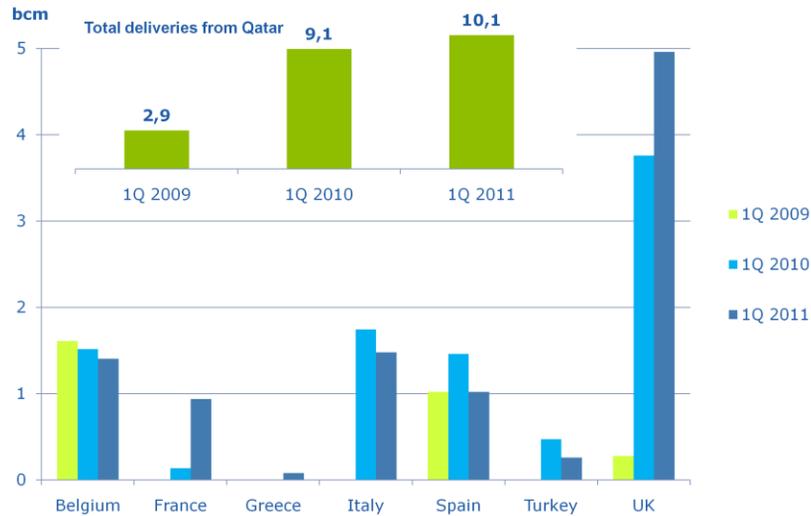


Source: Lloyd's

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The truth of the matter is that additional volumes of Qatari gas have reached the European market in 2010. But contrary to economic theory and common sense these volumes has not led to a spot price further decline but to a major increase in the hub prices. Put it in other words, the paradox is that the more Qatari LNG comes to Europe the higher is the hub-based price.

## LNG Deliveries from Qatar to Europe in Q1 2011

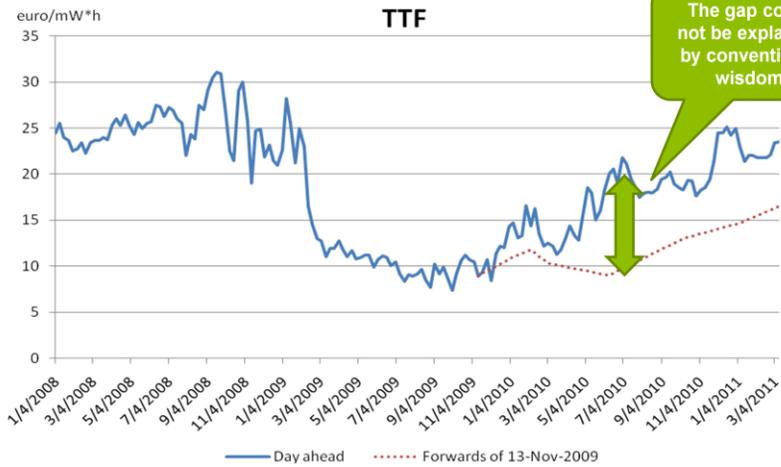


Source: Lloyd's

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The slide indicates that new LNG keeps coming to Europe in 2011. And it is a good question why the negative effect of these flows on prices was so minor? PIRA in its recent overview described this market abnormality in a following way: "given the weather-related losses in April 2011, it is somewhat surprising that the front of the curve has not fallen even faster... Both the U.K. and France continue to send out LNG from terminals at record levels with plenty of supply behind it on the water."

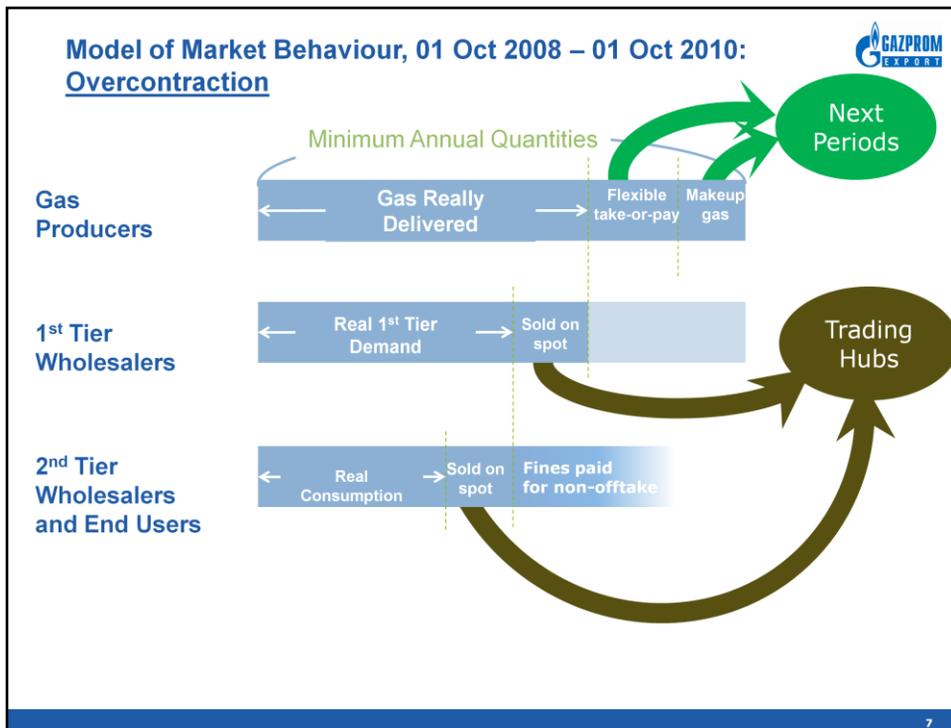
## Conventional Wisdom Expectations and Real Story



Expectations of the new wave of LNG, as seen by the historic futures of the end of 2009, were negatively affecting market player's sentiment but not the real price curve.

When at the end of the day market expectations do not match with the reality, it points to some unknown factor that affects supply and demand equation. And this factor is neglected by the market analysts.

What I would like to do today is to share with you views on the architecture of the contract relationship on the European market that to my mind produces unexpected effects on prices.



Let me make a brief excursion into history. Gas year as you all know starts on October 1. In mid 2008, market participants were expecting a tight gas market and were demanding as much gas as possible. Crisis came as major surprise and end users realized soon that they do not need the amount of gas they have ordered from the wholesale suppliers (see next slide). First-tier wholesalers in their turn were not able to meet their minimum quantity requirements.

But there is a fundamental difference in take-or-pay obligation's execution between the LT contracts that Gazprom has with its clients and short-term, one- or two-year contracts, that clients of our clients have. LT contracts offer make-up gas option (not to mention flexible take-or-pay in some cases). "Make up" gas option allows to take quantities not needed over the current year in the later years provided prepayment is made.

End users and second-tier wholesales have no right for make up gas because of the short-term nature of their contracts. They have two options – to pay fines for gas not offtaken under take-or-pay or to dump gas on the trading hubs thus decreasing their losses by the revenues from that sales.

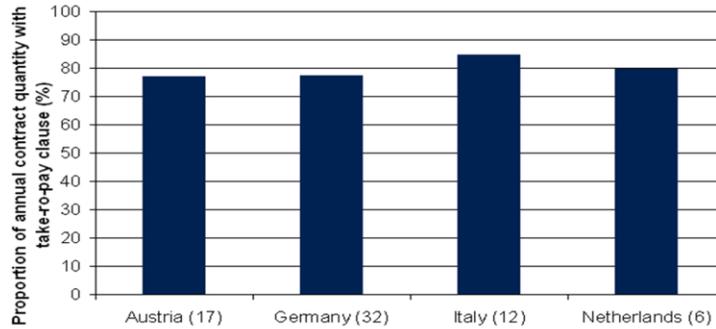
Gas volumes under take-or-pay obligations dumped on the hubs, to our mind, were creating an enormous pressure on the spot prices and were the main reason behind a divergence of spot and contracts prices.

## Results of Datamonitor Survey:



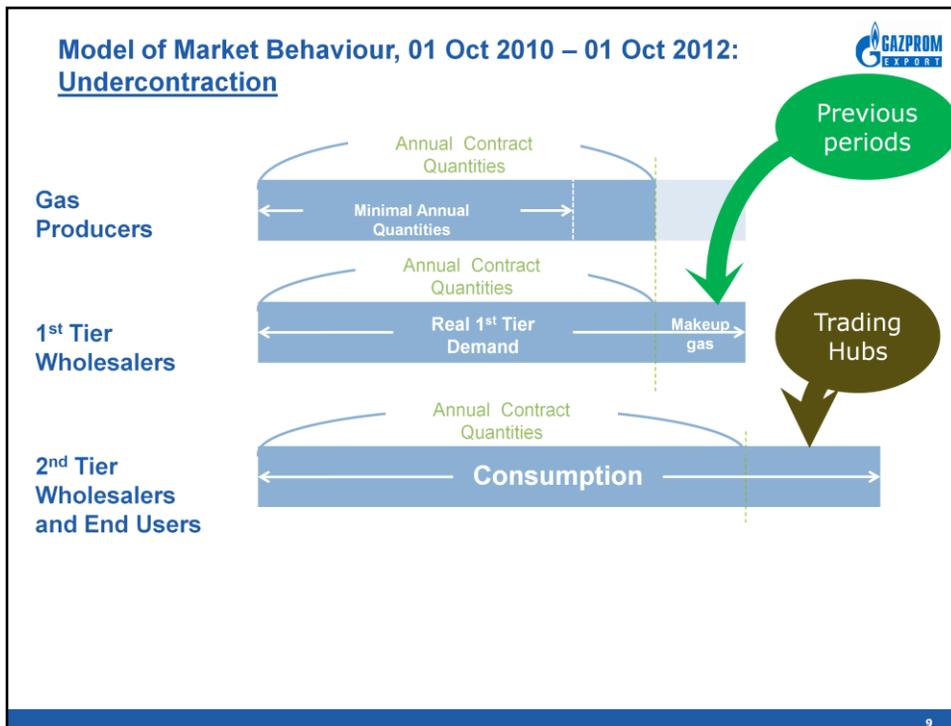
Between 70% and 80% of AQ is the average take-or-pay coverage

Q: What percentage of your annual contract quantity does the take-or-pay clause cover?



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Let me remind you, take-or-pay obligations exist not only between the exporters and first-tier wholesalers but also between the wholesalers and end users. These obligations cover up to 80% of annual contract quantities.



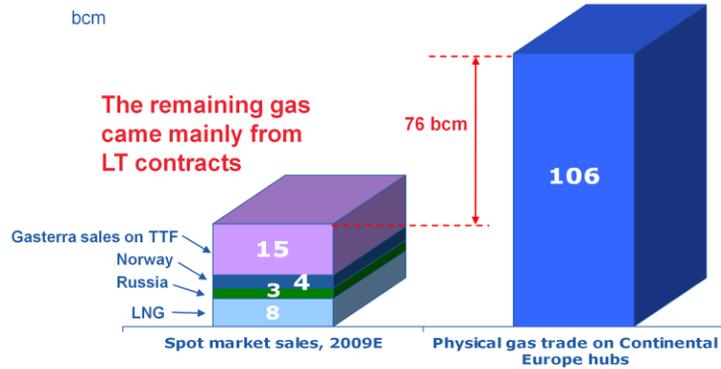
Let me return to the question what made prices strong even prior to the Fukushima and the turbulences in North Africa?

New short-term contracts came into force starting from October 1, 2010. End-users and wholesalers have done their best to minimize their contract obligations. Conventional wisdom of the market was: why should we buy expensive gas from Russia when we can get it cheap on the spot whenever we need it.

But it is true that dump or forced sales on hubs stopped. Undercontraction has led to an additional demand for spot gas originating a kind of “greenhouse affect” on prices. Our clients responded to a new market situation by increasing offtake above MAQ. Some on them have executed make-up option.

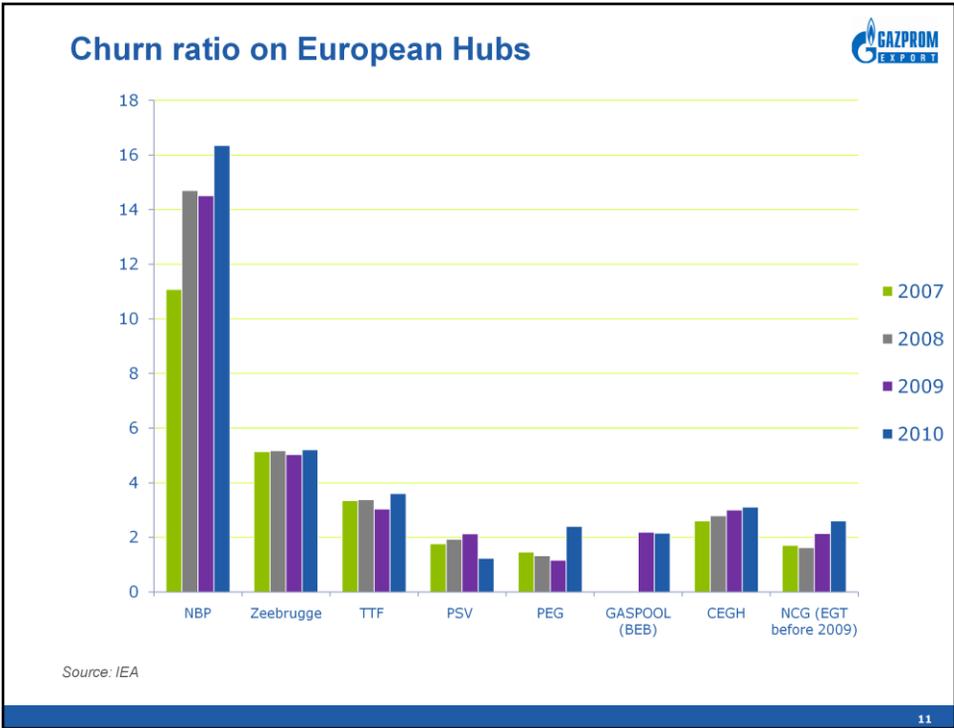
If my assessment of the spot prices behavior is correct, it means that at least for the next two years, a duration of the existing supply contracts, spot prices will stay high, on par with the contract prices.

## Primary Sales Account for a Small Part of Hub's Physical Trading in Continental Europe



Source: IEA, CERA, Wood Mackenzie and Gazprom export estimates based on companies' reports

Why undercontraction or overcontraction factor is so important for the European market? In contrast to the American spot market where there are no long-term contracts, European market has a complicated internal multi-tier contract structure where holders of LT contracts have to deal with holders of short term contracts with their different terms and provisions. This is a result of Europe's import dependency that will be only growing with time. In contrast to the U.S. Henry Hub where primary sales account for the bulk of physical trade, European hubs play a role of the balancing markets, a so called markets "of mistakes" in demand assessment rather than a full-fledged price originator. According to our estimates for 2009, less than a third of physical trades in Continental Europe is conducted with the new gas. The remaining is secondary volumes sold back and forth.



Low and not growing churn ratios support a conclusion of the balancing role of the European Continental hubs.

## Take-Aways

- We do not know much about the European gas market
- Analysts must understand first how the European gas market works and only then give recommendations
- Regulators must have knowledge about what they are regulating prior to imposing drastic changes to the existing market structures

My conclusions are rather banal. We do not know much about the European gas market. Unexpected growth of the European spot prices at a time of a perceived gas glut is a good example.

Analysts must understand first how the European gas market works and then give recommendations. American textbooks could not be directly applied to explaining developments on the European gas market scene. Relations between oil and gas prices are much more deep and complex than some can even imagine. Mistakes made on recommendations that we heard last year and that proved to be incorrect cost some of our clients a lot, and it strained our relations with them. It is time to stop perverting end-users with an illusion that spot gas is cheap by definition.

And finally, regulators must have knowledge about what they are regulating prior to imposing drastic changes to the existing market structures.

**THANK YOU FOR YOUR ATTENTION!**