Regulatory Threats to European Energy Security

A View from Gazprom Export

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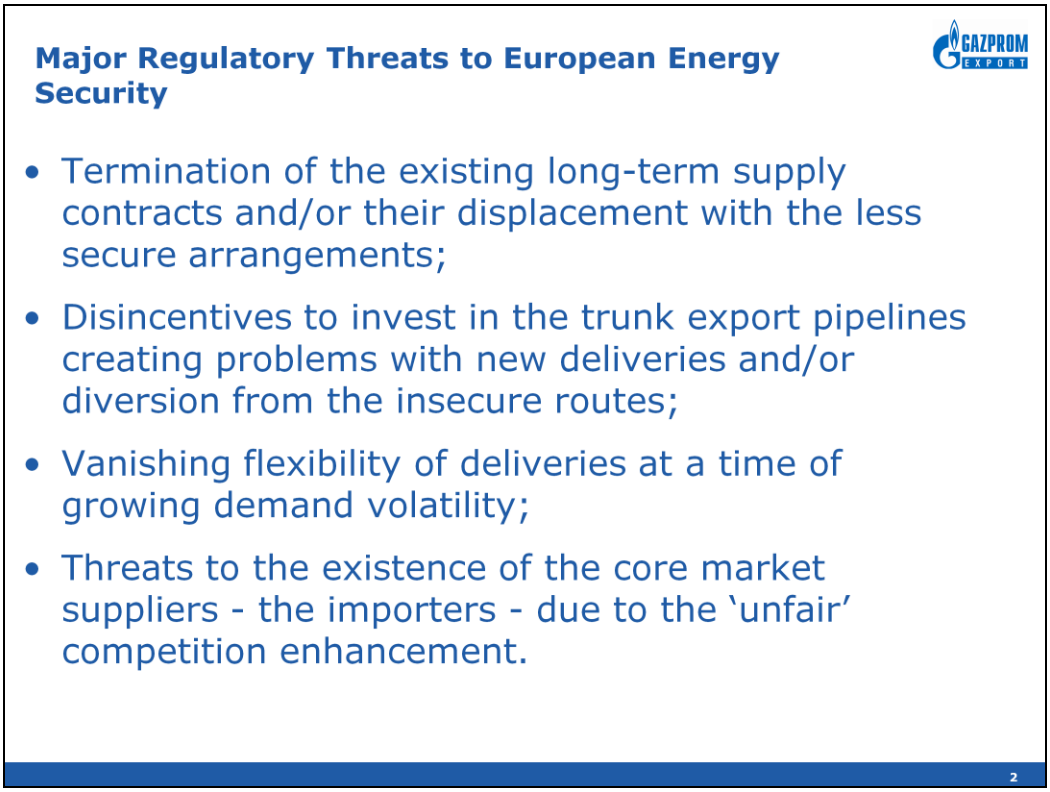

Thank you for the opportunity to open this session on the security of supply. We have been supplying gas to Europe for more than 40 years and ready to do it in the long term. That is why issues of energy security are so important to us.

The list of the existing threats to the energy security is long. Let me focus today on a very special class of threats or risks to the security of supply that was nonexistent before. I will call it regulatory threats to the European energy security.

Let me also clarify my stance from the very start. We share the goals of the reforms of the gas market is Europe aimed to bring further competition. The only thing that we may disagree with is the following: we often hear that there was no competition in the market before these reforms. However, on the supply side there was already a lot of competition on the market between Russian, Norwegian, Algerian and Qatarian gas.

We also believe that reforms are conducted with the best intentions. But as you know the devil is in the details. When the reformists do not understand fully that what they are reforming is in fact a unique and mature market already, the blueprints from the textbook do not work. Reforms intended to enhance competition actually end up in something else.

There are a number of substantial threats that Gazprom, as a supplier, is facing. These risks will also affect our consumers.

Pricing Model Options for Continental Europe Gas Market or 'Quick Choice, Long Repentance'

Model	Applicable To	Description	Supplier Acceptance
Oil Indexation	Asia	• LT contracts • 100% indexed to oil • No hubs	Yes
Hybrid	Continental Europe	• Primarily, LT oil/oil product indexed contracts • Minimal gas-indexed component in LT contracts • Hub pricing	Yes
Modified	Continental Europe (?)	• LT contracts linked to gas indexes • Hub pricing	No
Hub	North America	• Near absence of LT contracts • Pricing based on supply & demand	Not the best option for Continental Europe

Today the security of the supply comes from the LT contracts. Long-term contracts provide Europeans with the security of supply and predictability of oil-indexed pricing secured from any abuse. At the same time, they provide producers with security of demand, which is necessary for the continued investment cycle.

However, what is the basis of Europe's energy security is under threat. What we are witnessing now is the concerted attempts to displace oil-indexed prices with hub-indexed prices and, as a result, demolish the existing hybrid pricing model.

There are two different strategies to bring oil-indexation to an end -- one strategy could be named 'pull' and the other 'push'.

The 'Pull' strategy is evolutionary one. It suggests that transformations of the hybrid pricing model could be carried out in a steady way, simply by means of increasing the share of the spot component in the long-term contracts at the expense of oil indexation.

The second 'Push' strategy employs arbitration as means to put an end to oil-indexation in the long-term contracts forever. Supplier obligations remain the same under the hub-linked 're-engineered' long-term contracts.

What I will try to show you is that both strategies will not be acceptable to suppliers. Existing long-term contracts are specially designed for oil-indexation. Displacement of oil indexation by hub-indexation changes a fragile balance of risks between a buyer and seller in favor of a buyer. Gazprom as seller keeps unequivocal obligation to deliver gas irrespective of the price while having no means to affect hub prices.

USA & Continental Europe Pricing Models

Fundamental Differences

1	USA	Hub price is a function of total demand and supply
	Continental Europe	Hub prices are a function of multiple examples of arbitrage
2	USA	One price at a level determined by Henry Hub
	Continental Europe	Multiplicity of prices Company supply managers determine the price of gas portfolio
3	USA	Majority of gas is sold on hubs Majority of LT export contracts incorporate diversion clause
	Continental Europe	Less than ¼ of physical trade on hubs represent primary sales The remaining volumes of gas traded come from LT contracts for pipeline gas
4	USA	High churn ratios
	Continental Europe	Churn ratio below 4 (low, but sufficient for balancing market)

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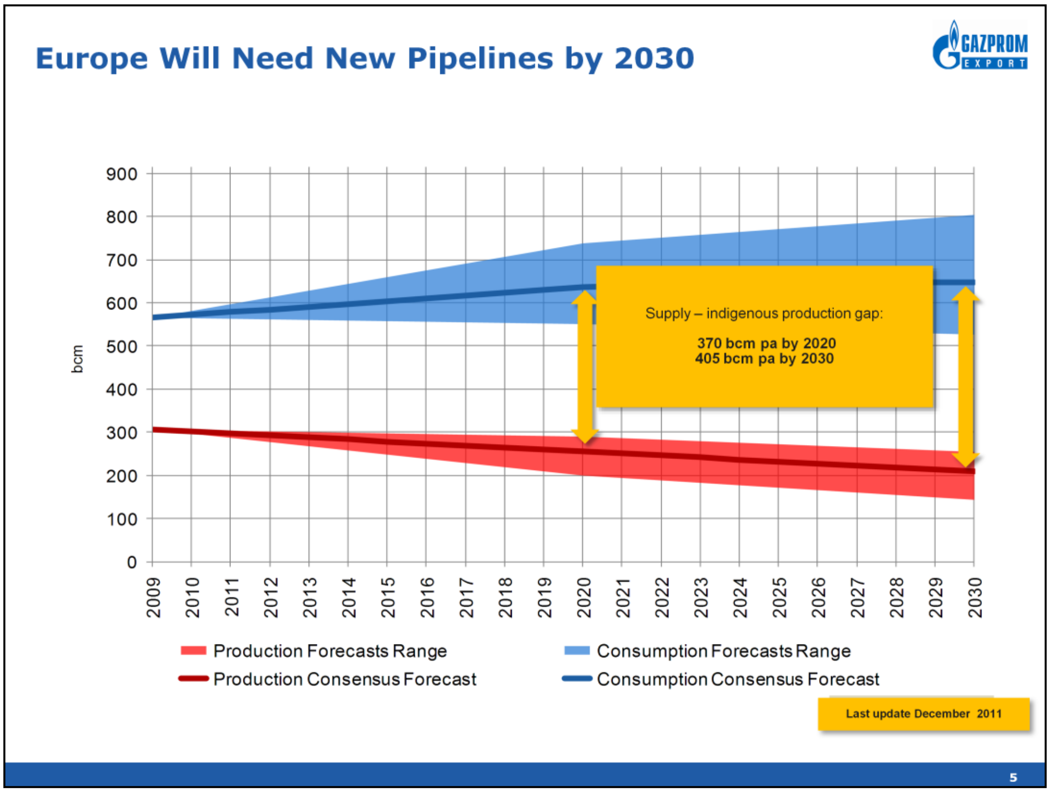
Indeed, if hubs are liquid enough, there is no need for a supplier to get into long-term contract obligations or these contracts should be structured differently from the existing ones and have the right to divert flows to other places when prices do not meet its expectations, or at least have a seller's option. Seller's option means that if prices are determined by supply and demand the shipper could not be deprived from the right to directly affect pricing on hubs, an option that not available at the moment for Gazprom.

In terms of the existing pricing model alternatives, a supplier can accept the American pricing model in case of hub-indexation but that is not the best option for import-dependent Europe because it undermines the security of supply.



Second threat to supply security comes from an inadequate development of the incoming export pipelines. Let we explain what kind of threat it is in more detail.

Theoretically a fight with the capacity hoarding by suppliers brings its fruit in the enhanced competition that lowers prices to the end-user. That is the rationale behind the Third energy package. But there is a side effect of the fight against capacity hoarding by a supplier as it discourages investments coming from probably the most interested party of the new pipeline construction, the shipper. Basically a supplier once he decides to bring additional volumes gas to Europe has to built a new pipeline to meet third-party-access requirements that is twice as much as he needs for his own gas.

Will Europe need new pipelines, the most secure way to deliver gas to Europe?

The next slide presents a summary of key forecasts for gas in Europe up to 2030. Gazprom Export made a composite of all the gas demand and endogenous production forecasts for the twenty years made by the leading global forecasting agencies. All these forecasts were made within the last 24 months. The collective wisdom of these forecasts indicates that demand will keep on rising while the indigenous production in Europe keeps on falling.

As a result a consensus forecast derived from the above-mentioned forecasts indicates that there is about 400 bcm gap between demand and Europe and domestic production in 2030. Let me point your attention to a fact that this is not a forecast of Gazprom, it is our aggregation of different forecasts by the agencies generally perceived be the most esteemed.

What conclusions can be drawn from this consensus forecast? The gap between demand and European production has to be met with increasing supplies of imported natural gas. Even with all the LNG in the world and Iranian gas expected to be available at that time, it will be difficult for Europe to fill this gap.

In the meantime we are already facing regulatory hurdles regarding Nord Stream where formal application one supplier restriction on access to pipeline prevents us from the efficient operation of gas pipeline OPAL, which are an integral part of Nord Stream.

In a word, referring to the enforcement provisions of the Third Energy Package and kicking the ball from one side to another, European and national authorities do not allow us to use all the capacity, even when this capacity has no other bidders! It does not and cannot make economic sense. In the name of ideological purity of the experiment with the Third Energy Package half the pipelines will remain empty, because third-party gas will not physically appear from anywhere.

We at Gazprom did our homework following the incidents of January 2009. Firstly, it has become very clear to us that we cannot make ourselves dependent on transit monopolies. We must invest in the diversification of supply routes to mitigate dangers from political interventions, technical failures, natural catastrophes, or even terrorist attacks. This is in the joint interest of suppliers and customers and it makes perfect business sense for us: we lost a lot of money while Ukraine closed its transit routes for our gas on January 6th and must insure ourselves against such risks in the future. The South Stream pipeline project is our contribution to this.

We do not want to believe that Third energy package's aim is to put discretionary tool at the hands of the European Commission to be able to hold up the South Stream pipeline project if needed to get a Trans-Caspian pipeline.

Revisions of Daily Nominations Versus Initial

Date	Weekly Nomination	Daily Nomination (before the 6 p.m. D-1)	Revision 1	Revision 2	Revision 2	Revision 4	Last revision	Δ (last revision – daily nomination)
01.07.2009	42050	29034					29034	0
02.07.2009	43998	38390	49390				49390	11000
03.07.2009	43998	46476	45524				45524	-952
04.07.2009	43998	32447	33977	33957	32957		32957	510
05.07.2009	43998	33959	30959				30959	-3000
06.07.2009	42040	45924					45924	0
10.07.2009	42040	44280					44280	0
11.07.2009	42040	44502					44502	0
12.07.2009	42040	44538	43038				43038	-1500
13.07.2009	44580	44522					44522	0
14.07.2009	44580	44380	40380				40380	-4000
15.07.2009	44580	44513	42513				42513	-2000
16.07.2009	44580	42311	40311				40311	-2000
17.07.2009	44580	40580	38580				38580	-2000
18.07.2009	44580	38580					38580	0
19.07.2009	44580	38580					38580	0
20.07.2009	44580	44580					44580	0
21.07.2009	44580	44162	36162	40162			40162	-4000
22.07.2009	44580	40457	44457				44457	4000
23.07.2009	44580	42079					42079	0
24.07.2009	44580	43883	39883	37883	37383		37383	-6500
25.07.2009	44580	39790	36790				36790	-3000
26.07.2009	44580	35792					35792	0
27.07.2009	42040	38107	33107	38107			38107	0
28.07.2009	42040	28662	37662				37662	9000
29.07.2009	42040	37657	35657				35657	-2000
30.07.2009	42040	33528					33528	0
31.07.2009	42040	33381					33381	0
01.08.2009	37502	33910					33910	0
02.08.2009	37492	33897	32897				32897	-1000
03.08.2009	38046	40889	37199				37199	-3690
04.08.2009	38046	36973	39425	36973	38835		38835	1862
05.08.2009	38046	39826					39826	0
06.08.2009	38046	40116					40116	0
07.08.2009	38046	39795					39795	0
08.08.2009	38046	34364	29799				29799	-4565
09.08.2009	38046	32364					32364	0
10.08.2009	38046	39822	41870				41870	2048
11.08.2009	38046	39825					39825	0
12.08.2009	38046	39829	34377	36377			36377	-3452
13.08.2009	38046	39633	36633				36633	-3000
14.08.2009	38046	33834	40124				40124	6290
17.08.2009	40586	41175					41175	0
18.08.2009	40586	43842	40842				40842	-3000
19.08.2009	40586	40629					40629	0
20.08.2009	40586	41672	31672				31672	-10000
21.08.2009	40586	43619	39119	41119			41119	-2500
22.08.2009	40586	33336	36836	34336			34336	1000
23.08.2009	40586	37339	36839	34339	30489		30489	-6850
24.08.2009	40134	35342	40342	38389	40342	37342	37342	2000
25.08.2009	40134	27637	21637				21637	-6000
26.08.2009	40134	28548	31048	26548			26548	-2000
27.08.2009	40134	26628	29628	30628	28628		28628	2000
28.08.2009	40134	23670	29670				29670	6000
29.08.2009	34134	29346	39346				39346	10000
30.08.2009	34134	34351	39851				39851	5500
31.08.2009	27134	33573	39573				39573	5500

Last revision before beginning of gas day (before 8:00 a.m.)

Revisions after beginning of gas day

Decrease of final Buyers daily nominations vs. initial one

… but according to new Congestion management rules Buyer could make a nomination once before gas day

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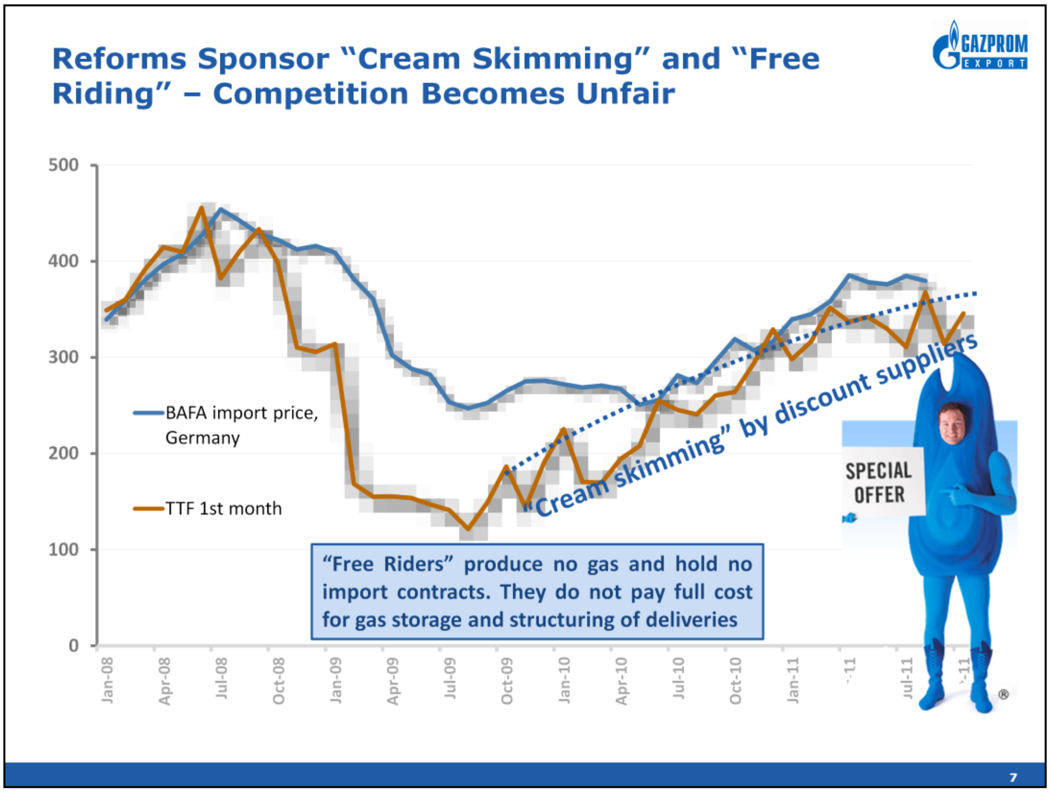
Vanishing flexibility of deliveries at a time of growing demand volatility is another regulatory threat to the security of supply that I would like to address today. At present Gazprom is selling something more than gas. It a highly valuable product for the whole industry named flexibility of the deliveries. In many cases, as shown on the chart, flexibility implies revision of the daily nominations 3-4 times over a gas day depending on a volatile demand.

With the new legislation in place all market participants need to adapt to the new environment. Vertical disintegration leads to competition for transit capacity. ‘Use-it-or-loose-it’ procedures and bundled capacity products are instruments making easier access to the pipelines. But a shipper as a consequence of loosing guaranteed access to pipelines is forced to decrease flexibility of supply contracts or introduce minimum daily floors in order not to lose the previously booked capacity. Inability to provide flexibility needed by the consumers

We hope European regulators will hear our concerns that would allow our clients to keep on benefiting from the existing flexibility of our contracts.



And finally, so far, competition enhancement policies have only divided European gas market participants. There are market participants who are able to source small volumes of gas on the hubs. These market players have no import contracts, bring no gas to Europe under long-term arrangements, and are not responsible for gas storage and deliveries structuring. And what is most ridiculous – European reformists refer to these market dwarfs as price-makers. Advantages without responsibilities for this group of players results in unfair competition. If market reformists are not pursuing an implicit aim of pushing the importers out of business, what they must do is to protect these holders of long-term contracts from unfair rules of the game.

Participants of end-user supply tenders should meet strict qualification standards including a requirement to have import contracts. That qualification is also important for security of supply purposes as many discount suppliers without import contracts have already gone out of business (like TelDaFax in Germany) because they were not able to keep their promise to deliver cheap gas when hub prices start to converge with contract prices.

Importers in their turn have to think twice when trying to over compete the 'cream-skimmers'. If a coffee-shop owner sells a cup of coffee cheaper than the price of the imported coffee beans it is made of, this marketing policy is at least unwise. Why should it be different for gas?

CONCLUSION

Europe has to do its best to make its market attractive to producers from the third countries. Gazprom is not against structural reforms aimed at increasing security of supply, but it should be done in full understanding of the realities of the European gas market in order to mitigate unexpected side effects of the reforms that work against their initial aim. We need smart reforms.

THANK YOU FOR YOUR ATTENTION!