

Gazprom and the European Union: Reshaping our partnership

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Ladies and Gentlemen,

It is a pleasure and an honour for me to speak to such a distinguished and interesting audience. I would like to thank the organizers of this forum for giving me the floor and the opportunity to speak on issues which are not only important in commercial terms, but of potentially wider significance for the relationship between the European Union and Russia.

Today we celebrate a remarkable milestone for the energy industry and for our bilateral relations: 10 years of the Energy Dialogue between Russia and the European Union. We should always bear in mind that Russia and Europe share much more than energy ties: we are organically linked by history, culture, religion, psychology and behaviour patterns, as well as by economy and trade. And energy is more than ever at the core of our economic partnership: nowhere else is our mutual interdependence and common interest in stability and security more evident. It's a relationship we need to nurture, and where we need to make sure we properly understand each other. The question now is how to further upgrade this relationship, and develop together the agenda of the future EU-Russia energy cooperation.

Today I'd like to provide you with an overview of how Gazprom and natural gas currently situate themselves in the EU energy landscape, and outline both the challenges ahead of us, and the principles on which a mutually beneficial partnership should be based.

Russia addressing Europe's energy needs

First and foremost, in today's globalised economy the economic growth and material well-being of any nation and its citizens depends on interchange and trade. Prosperity cannot be achieved by relying on purely domestic capabilities and resources. This observation is fully applicable to the rapidly expanding and integrating global market for natural gas.

In particular, according to recent forecasts of independent international consultancies, Europe's demand for natural gas will grow significantly over the coming decades, to face by 2030 an indigenous production gap of 70%. This, coupled with decreasing internal production, will force Europe to import more natural gas: 380 bcm in 2020 and 440 bcm in 2030. Whatever progress the EU achieves in moving away from fossil fuels, gas will continue to be a vital input to the EU economy for as far ahead as one can reasonably foresee.

We at Gazprom are proud of being a privileged supplier of our European partners and customers. Extracting and then shipping natural gas through the westward-bound pipeline network as long as the Great Chinese Wall, is by all standards a large-scale endeavor. One way of illustrating its scale is that despite being pumped at high pressure it takes about 5 days for a gas molecule extracted from the underground field in Siberia to reach a customer in Germany.

Russian natural gas has been flowing to European customers for more than 40 years, and this flow was steadfast, monotonously stable and uninterrupted –

throughout the Cold War and the times of economic turbulence following the demise of the Soviet Union. The only exceptions were the blockades of Russian gas exports to Europe by the previous government of Ukraine in January 2006 and 2009, which were principally motivated by a desire to put pressure on Gazprom in order to secure subsidized prices for domestic use. Fortunately, the last notorious two-week conflict was effectively solved on the basis of Ukraine's acceptance of the need to move to market prices for gas – something long urged by the EU and other international bodies – as well as to terms and conditions in line with normal international practice and European regulations.

We at Gazprom are happy to note that there is an emerging consensus that energy security fundamentally depends on co-operation. It can thrive only if all parties - meaning suppliers, transit countries and consumers – are engaged in continuous dialogue and work together in good faith. Successful business requires a robust framework of agreements to provide a level playing field and a way of resolving problems when things go wrong. For example, an effective international mechanism should always be in place to mitigate the risks of possible supply disruptions. Unfortunately, the Ukrainian transit crisis of 2009 was settled not due to but in spite of our neighbouring country having signed up to the Energy Charter and its aspiration to join the European Energy Community.

Strengthening the international framework is a task for diplomats and politicians, not energy suppliers like Gazprom. What we can do in the meantime is to ensure that the commercial and contractual structures which we put in place do serve the goals of long-term security and stability.

Energy infrastructure

And the most effective contribution energy companies can make to those goals is to provide infrastructure which meets long-term needs. It is no secret that

lessons learnt last year pinpointed the urgency of putting efforts into the diversification of supply routes to mitigate dangers from political interventions, technical failures, natural catastrophes, or even terrorist attacks.

Expanding the European gas infrastructure matches the strategic interests of both suppliers and customers. The gap between rising gas demand and falling European production, which I referred to earlier, will create an urgent need to ramp up imports. Where is Europe going to find them? Our calculations show that even with expanded capacity to import Liquefied Natural Gas, and even if you rather optimistically assume Iranian gas will be available by that time, it will not be feasible for Europe to fill this looming gap without Russia. Given the level of projected demand, we feel that there is room in the market for many projects and many suppliers. Therefore we do not see any reasons to oppose new pipelines intended to bring gas to Europe implemented by our peers in the industry, including Nabucco, TAP, and ITGI.

Gazprom is of course making its own substantial contribution, together with our European partners, to meeting the need for new gas supply infrastructure. The two major infrastructure projects of pan-European dimension we are currently engaged on, Nord Stream and South Stream, have brought together a formidable team of European energy companies which is showing a determined desire to address the future gas demand surge in the most efficient fashion. At the same time, we welcome Europe's plans to expand its interconnection and supply infrastructures, which will also contribute to enhanced security by providing more flexibility to the supply network.

A lot has been said about the costs for building South Stream and it has become the hobby-horse of some to speculate about the economic viability of the project. Let me be very clear: we are highly confident that the European energy market can and will absorb all of the volumes of natural gas that this project has to offer and that all energy stakeholders will welcome the enhanced energy security

which this pipeline will bring to our customers. If South Stream receives the same regulatory treatment as other comparable pipelines, there will be no doubt about its profitability.

We have therefore noted with great satisfaction the declaration of Energy Commissioner Guenther Oettinger that the European Union welcomes all new natural gas pipeline projects. We infer from this statement that it will be a matter of course for the European Commission to grant a level playing field for all major supply pipeline projects. And a level playing field and fair treatment is all that Gazprom needs to make South Stream happen.

Gas green credentials

We believe that South Stream can help the European Union to achieve some of its ambitious climate policy objectives. One factor which will increasingly drive demand for natural gas is that it is by far the cleanest burning fossil fuel, not least as regards CO₂ emissions. The accelerated substitution of natural gas for units now fuelled by coal and oil products should – indeed must – play a major role in cost-effectively achieving carbon reduction goals. The annual capacity of South Stream delivers enough energy to allow Europe to shelve the construction of 25 nuclear plants, to cancel the deliveries of 160 oil tankers, or to take 58 coal-fired electricity plants off the grid.

It has been calculated that only by replacing every second coal-based power plant with modern gas-turbine units, Europe could achieve practically half of its 2020 CO₂ emission reduction targets. This could be done with small upfront investments and in a short period of time. Increasing the natural gas share in the EU energy mix by just 1% would reduce CO₂ emissions by more than 3%.

Gas therefore has a crucial role in the transition to a green economy. Gas-fired power generation is not only a cost-effective way of emission abatement, it is

also complementary to renewable energy such as wind and solar in providing the necessary backup during consumption peak periods, and it protects against the vagaries of wind and weather. If such an approach was to be followed vigorously, natural gas could provide the necessary breathing space for the deployment of more mature and dependable renewable energy technologies than those currently available, thus helping to build a sustainable technology platform for the future.

And it has much more to offer in the near future, for example, if we look at the potential increased use of gas in transport. Green house gases (GHG) in this sector represent approximately 20% of energy-related carbon dioxide emissions, and this percentage is likely to increase by as much as 50% by 2030. In order to meet the goals for GHG reduction as set out by the Intergovernmental Panel on Climate Change, it is essential that transport-related emissions be significantly reduced from base-line estimates.

Natural gas for transportation

Gas has the potential to reduce the use of petroleum in transportation because in the near- and longer-term it can substitute the use of petroleum as the dominant transport fuel, both for the transport of people and goods. Beyond the well-known and well-established use of Compressed Natural Gas as a motor fuel in the EU, Gazprom is now conducting research in two very promising areas: first, on the conversion of natural gas to liquid fuels through gas-to-liquids (GTL) technology, resulting in supply of diesel fuel made from gas for direct use in vehicles [which is cleaner and more efficient than oil-derived diesel]; and, second, on developing vehicle technologies and infrastructure so that natural gas can be the primary fuel for fleet vehicles such as delivery trucks, buses, and even large 6- and 8-wheel trailer trucks.

The invitation to European investors to take advantage of the modernization program in Russia, as spelled out by President Medvedev, could focus on developing “Blue corridors” – a system of transportation networks between EU member states and Russia which offer a corridor of natural gas stations.

Long-term supply contracts

I spoke earlier about the need for robust frameworks based on shared principles as the essential foundation for secure long-term gas supplies. It is in this area that I have some concerns about the current thrust of EU energy policy and its implications for Gazprom’s relationship with Europe. The complex body of legislation on energy which the EU has put in place over recent years, including in particular the Third Energy Package, puts the emphasis on breaking up integrated supply systems based on long-term relationships in the name of creating an open internal market. We can support the goal of removing barriers to energy trade between EU countries, but from our viewpoint the approach being taken runs the risk of eroding the EU’s energy security in the longer term.

The reality is that Europe’s energy safety net does not result from numerous small investment decisions, as in the United States. Whatever niche shale gas may eventually find in Europe, the bulk of Europe’s future gas supplies are to be found in large foreign gas fields which require tens of billions of dollars of investment capital for development, gas processing and pipeline and LNG transportation infrastructure. Once built, these international supply chains typically require decades of stable gas sales revenue to show a worthwhile return. To attract the necessary finance, these projects need a greater degree of predictability and certainty over the amounts of gas they are to deliver, and the prices to be realized, than shorter-term industrial investments. And remember we are talking about energy supplies, a fundamental necessity for industry and domestic consumers. This is why Gazprom, like other major gas exporters, continues to advocate long-

term contracts based on predictable volumes and predictable prices linked to oil-indexation.

In the specific conditions of the European gas market, where the bulk of supplies depend on expensive fixed pipeline infrastructure linked to single suppliers as a matter of geography, oil price indexation offers safeguards to both parties. The formulas are transparent and objective and the results are verifiable. They cannot be manipulated by either the seller or the buyer. A gas supply system not built around long-term arrangements is bound to be inherently more volatile and unpredictable. It might be more exciting for market traders, but it will deliver much less security for producers, consumers and serious investors.

Third energy package

The other aspect of concern to us is the third energy package implementation, and in particular the issue of capacity rights. We believe indeed that it is of crucial importance that capacity rights for companies who have the ability to successfully and continuously supply the market are fully upheld. All shippers with capacity rights should be able to manage their flows to supply customers, otherwise we would find ourselves in a paradoxical situation in which suppliers that have committed to certain volumes with end users would not be able to honor their commitments because of legislative hindrance. Without assurance on this point, shippers will not make the long term bookings which network companies need in order to justify investment in infrastructure.

Moreover, as for unbundling, we believe that an integrated system, alongside long-term contracts, offers the best basis for effective supply management and for raising the investment needed to build badly-needed new capacity. We suspect that breaking the system up could prove counter-productive, whatever the presumed benefits of the change. Waving the legislative wand to overturn long-

established ownership rights in respect of vital infrastructure assets, which in some cases are protected by bilateral intergovernmental agreements, is bound to raise some difficult questions. Existing owners have a right to be compensated for the full value of the assets in terms of their future revenue potential. In this context it is a little ironic to see countries which have successfully privatised their gas supply systems re-nationalising parts of them in the name of EU liberalisation policy.

We are also concerned that the new independent network operators could serve their own interests rather than those of consumers and suppliers, using assets which we the suppliers have financed and built in order to generate revenues from their regulatory functions. None of this will in our view be conducive to the large investments in supply infrastructure which, as the European Commission keeps reminding us, Europe badly needs.

All in all, we expect the new regulations intended to ensure Europe's energy security to have a sound economic rationale which will not confuse and perplex operators by shifting the balance of power in favor of speculative traders and intermediaries at the expense of the providers and our ultimate customers.

We hope to be able to work closely with national regulators and the EU institutions to ensure that the implementation of the Third Energy Package proceeds as smoothly as possible as regards gas supplies

Looking at the future...

Today, as I stand here as a representative of a global gas major, I would like to share my belief that together with the European partners and peers we have the intellectual potential and willpower to tackle in earnest all the arising challenges for the sake of maintaining sustainable and efficient energy cooperation with and within Europe. Finally, we have all the good reasons to expect the emergence of a

European energy system that does not mistreat the proven business models and is economically responsive to market needs, environmentally compatible, and technically and politically secure.

As for Gazprom, we shall do our bit. I can assure you that we are truly committed to enhanced energy security of Europe. One of the founding fathers of the European Union, Robert Schuman, speaking in Strasbourg in May 1949, observed that “The European spirit signifies being conscious of belonging to a cultural family and to have a willingness to serve that community in the spirit of total mutuality.” That spirit is what Gazprom aspires to in its partnership with Europe, a set of customers we are privileged to supply. My sincere hope is that neither prejudice nor misperceptions will tarnish or undermine the existing meaningful partnership between purveyors of natural gas from Russia and our European peers and customers.

Thank you for your attention!