

Notes

GAC WS2 34th Plenary meeting (held online)

23 April, 14.00-15.30 CET

Welcome by the Co-Chairs:

The Co-Chairs welcomed the participants and announced the topic of the present discussion – the evolution of Russian gas supplies to the European Union. They reminded the participants that the meeting was to be held under the Chatham House rules. They have also made the following statement addressing the participants: “We are managing to keep our platform active in quite difficult times, and we are not just referring to Corona but also to the political situation. We would like to remind you that we limit our discussions to technical issues and will stay clear of any political statements. Especially also in today’s topic.”

Item 1. Introductory remarks “Evolution of Russian Gas Supplies to the EU: Long-Term Trends” by Andrey Konoplyanik

A. Konoplyanik presented his personal vision of how long-term trends translate from the past into the future touching upon non-political aspects of this issue. He has explained that in the past 30 years and through nowadays Russian gas supplies to the EU has been passing through three key groups of challenges:

- geopolitical challenges - due to post-effects of dissolution of the USSR/COMECON (Council for Mutual Economic Assistance),

- regulatory challenges - due to consecutive introduction of three EU Energy Packages which has been changing EU regulatory regime in gas which has its effects also beyond the EU, including on Russia-EU gas value chains, and

- current “green” challenges - due to new decarbonisation trends.

He explained that with the dissolution of the COMECON and the USSR the two earlier connected neighbouring gas areas (USSR/COMECON and the EU-15) with delivery points on a common border became disconnected by a number of new sovereign transit states in the Russia-EU gas value chain between producer (Russia) and consumer (the EU-15). This created first group of challenges.

Prior to dissolution of the USSR/COMECON gas in the pipe and the pipe itself from the wellhead up to delivery points was under full control of the USSR producer state. Dissolution of the USSR/COMECON enabled appearance of transit risks of objective character both for producer (exporter) and consumer (importer) states with three different facets of such risks:

- (i) legislative/regulatory/contractual risks due to sovereign character on newly established sovereign transit states and their sovereign right to regulate within their territories not necessarily taking into consideration national interests of the neighbouring third countries. This stipulated, inter alia, appearance of key “contractual mismatch” risk for the system of long-term supply contracts – the backbone of USSR/Russia-EU gas relations;
- (ii) technical risks due to the fact that now responsibility for maintenance of the transit part of the gas transportation system connecting Russia and the EU belongs to transit states, but responsibility for gas delivery to delivery points stays with producer/exporter;

- (iii) political risks which can, in addition to above mentioned ones, create risk of direct interruptions of the gas flows.

Therefore, the whole system of the USSR-EU-15 gas supplies, established in late 1960-ies, had to undergo legislative and regulatory changes in order to address this newly appeared risks.

Since 2004, the geographical expansion of the EU also resulted in exporting its *acquis communautaire* eastwards beyond the political border of the “old” EU-15 member states (and introduction in 2006 of the Energy Community Treaty has further expanded EU *acquis communautaire* beyond the border of enlarged EU to some non-EU states placed on the Russia-EU gas routes). This means that delivery points of Russian gas has moved from the external border of the EU to inside the EU (within the area of *acquis communautaire* operation) and thus part of the gas delivery chain from Russia to the EU upstream delivery points came under direct influence of evolving EU legislation. This has created the second group of challenges since liberalisation trends of the EU gas market came sometimes in conflict with acting long-term supply contracts, their historical contractual and pricing provisions.

As a respond to the new reality giving rise to new uncertainties, risks and challenges of regulatory nature, a multi-facet diversification both on the importer’s (EU) and the exporter’s (Russian) side was further pursued as a long term objective development trend and an instrument from both sides to mitigate newly appeared risks.

Similarly, the new path for decarbonisation announced by the European Union, including the EU Green Deal, has created new risks and uncertainties for natural gas, as at first the concept was based on the assumption that preference should be given to domestic RES-electrons as opposed to foreign non-renewable molecules with potential aim to reach 100% RES-based EU electrification. This idea has been adjusted after what A.Konoplyanik called the “Borchardt turn” when in January 2018 Klaus-Dieter Borchardt announced that the EU energy policy strategy will move from the concept of 100% RES-electrification to a more realistic scenario where electrification will be combined with decarbonised gases.

In regard to decarbonised gases, this was followed by the Gazprom’s initiative (A.Konoplyanik called it a “three-step Aksyutin’s pathway”) proposed in July 2018 which supported the idea that the window of opportunity should be left to a spectrum of innovative technologies based on the “technological neutrality” principle thus ensuring a more balanced approach vis-à-vis the issue of decarbonised gases. Combination of “Borchardt turn” and “Three-steps Aksyutin’s pathway” has opened the way for further Russia-EU cooperative efforts in the field of gas decarbonisation which is now a mainstream of WS2 GAC activities with the aim to further develop common understanding and open window of opportunities for Russia-EU mutually beneficial cooperation in the gas decarbonisation field. And to mitigate to the tolerable level the mutual risks related to this third group of challenges.

A. Konoplyanik then in more details explained that prior to the dissolution of the USSR and dismissal of the COMECON, delivery points had been located at the COMECON-EU border, so *de facto* there was no transit within the COMECON area which was considered as the single gas export area. After the dissolution of the mentioned entities, when the producer/exporter lost the control of a part of the gas value chain, new transit risks have occurred. To minimize those, both the producer and the importer had to diversify various elements of the value chain. Here, A. Konoplyanik also mentioned that the term “diversification” has multiple interpretations, so this reservation should always be kept in mind.

On importer’s side, it was important to diversify routes and sources of supply, as well as the pool of suppliers. On exporter’s side, it was necessary to diversify routes, markets, and the pool of importers. Therefore, both sides were interested in diversifying routes which, therefore, is in the interests of all.

A. Konoplyanik further presented his vision of the nature and the three major components of transit risks in the cross-border gas value chain consisting of the three levels where bottom-up approach is applied. The first, bottom level consists of legal, regulatory, and contractual components. Here, the legal component is about each country having its sovereign law, while the regulatory component relates to the adequacy of the legal transit regime to ensure fulfilment of supply obligations, and the contractual component serves to exclude the occurrence of the contractual mismatch problem.

The second level represents the technical component, i.e. the adequacy of maintenance of the transit system to ensure technical stability and reliability of transit flows. This can be called “mismatch of responsibilities”: now responsibility for maintenance of the transit part of the gas transportation system connecting Russia and the EU belongs to transit states, but responsibility for gas delivery to delivery points stays with producer.

The third and upper level in this “risk pyramid” is about changes in political relations between the transit states and their neighbouring countries that might be the cause of interruption of supplies through a third party-transit state. Therefore, the political dimension is only a last element in the row meaning that it might give rise to crises and create interruptions to a much lesser (non-permanent) extent.

From point of view of diversification, gas flows to the European Union are coming from many sources of supplies, routes and suppliers. Russia, now facing the increasing global competition in energy markets (and thus winning its market share at the EU gas market within such global gas competition, consisting both of regional pipeline gas and global LNG), also seeks to diversify its supply corridors in close connection to the location of different resource bases, though Europe still remains the target market for Russian pipeline gas supplies.

As for US LNG, Europe only seems to be the bridge market, where gas comes when it becomes less attractive in other markets, and the aim of such supplies, especially in the eastern part of the EU, is “to kill the competitor”, i.e. create competition with Russian gas which has been historically dominating in this area due to the lack of alternative infrastructure there until nowadays.

Such multi-faceted diversification will continue in the future, and it is necessary to ensure gas business long-term adaptability to the existing and future challenges.

From the regulatory standpoint, it is necessary to find mutually acceptable responses with due account for the decarbonisation goals. Echoing to what was established in 2011 at the first GAC meeting as the “Mission of GAC” (its activity should be aimed at diminishing mutual risks and uncertainties to the tolerable level), it is necessary to consider things in the long-term perspective. The immobile cross-border capital-intensive long-distance large-scale gas infrastructure historically unites the two sides and predetermines the EU-Russia mutual dependence, so thinking long-term would bring the most benefits to both parties.

His summary message was: in the past Russia and the EU has successfully adapted their gas relations, first, to the common challenges resulted from geopolitical changes within “Broader Energy Europe” (the area covered by above-mentioned infrastructure), then, to the regulatory challenges resulted from creation of EU internal common gas market where Russia is currently present with its contractual flows to the EU. The most recent challenges refer to “green changes” in the EU in different forms and he hopes that with our common actions we will manage to address them in the most effective mutually acceptable way, based on historical experience of adaptation to the previous challenges, non-dependent short-term current political fluctuations.

A. Konoplyanik suggested that future GAC meetings would be concentrated on the long-term perspective and thanked everyone for their attention.

Item 2. Presentation “Evolution of Russian Gas Supplies to the EU: Contracts and Pricing” by Sergey Komlev

S. Komlev’s presentation focussed on the three issues around the evolution of contracts and prices: state of competition at the European market, the role of long-term contracts, and the evolution of price mechanisms.

As regards the state of competition, S. Komlev used the latest report available from ACER to demonstrate that within the last decade the EU made a sound progress in enhancing the state of competition on its energy market, and the role of the single supplier has been significantly reduced. For example, according to the above-mentioned report, only 5 EU countries had less than 3 suppliers, and ACER supply index is at the moment close to the EU target, with several exceptions in the Eastern European countries. He also referred to the fact that in 2018, Gazprom took commitments to address all possible concerns that the European Commission had with respect to the company’s business in the EU territory. He reminded the participants that the European Commission terminated the investigation after coming to the conclusion that there was no infringement on Gazprom’s side.

S. Komlev explained that Gazprom export¹ always keeps monitoring the situation with the market concentration and competition using Herfindahl–Hirschman index (HHI) to measure the size of supplies and the amount of competition between the suppliers. Based on the information available for the last 4 years, if all supplies are taken into consideration, the index would be less than 2,000 points thus demonstrating a moderate level of concentration. Europe’s HHI index slashed nearly 1000 points over the last 4 years and approaches ‘moderate concentration’ terrain for the external supplies due to the huge LNG inflow. It also should be mentioned that with the declining indigenous production in Europe, LNG becomes the main competitor of Russian pipeline gas, which will help Europe retain the moderate level of concentration on its markets.

S. Komlev suggested that there are certain lessons that can be deduced from 2020. Since LNG spot deliveries are very price-sensitive, when prices on the European gas market dropped, this destination stopped being attractive to LNG suppliers as most of them would have been unable to return their cash costs. Therefore, much of LNG went to Asian markets not returning to Europe when market conditions approved. It demonstrated that, from the standpoint of security of supply, such spot deliveries were less reliable and could cause disruptions. In its turn, Gazprom, being a low-cost producer, was moderately affected by such changes in prices and managed to keep gas supplies without any major changes during these times.

Speaking of long-term contracts, S. Komlev stressed that the Third Energy Package provided a formal opportunity to trade gas based on spot deliveries. Now there is a clear trend of increasing LNG spot deliveries to Europe, and their total share in all LNG deliveries was about 20 % in 2020. According to available information, around 80% of deliveries are still covered by long-term contracts. However, long-term contracts are still in high demand in Europe and their average length is around 23 years.

Gazprom export has been also increasing spot deliveries in its portfolio and their share in 2020 was about 10-11% of total gas supplies to Europe, which demonstrates the high level of flexibility that the

¹ Gazprom’s subsidiary in charge of gas export supplies

natural gas market offers. However, it is still important to emphasize the significance of long-term contracts, which allow monetizing the long-term arrangements between the buyer and the seller, maximising the value of trading, improving security of supply, and minimizing the related risks.

Speaking of transformations in the pricing model for the European gas, S. Komlev referred to the wholesale gas survey 2020 published by IGU, according to which the share of gas sold under oil indexation decreased to 22% in 2019. If compared to 2005 levels, this is a dramatic change. Pricing mechanisms are clearly shifting towards gas-to-gas competition, which share in constantly increasing at the EU continent. He also mentioned that following the European trends, a significant share of Gazprom export sales are made using short term forward prices (e.g. day-ahead or month-ahead) and also using other instruments of the forward market with high longevity (quarter-ahead, season, year-ahead).

He observed that, despite the appearance of liquid hubs in Europe, the share of oil indexation still remains relatively high. In his vision, this can be explained by the fact natural gas prices are formed by both gas-to-gas and gas-to-substitute competition. The second form of competition pulls the European prices within a corridor with a ceiling set by parity with oil prices. So, despite all changes on the European gas market in terms of pricing mechanisms, during the period of 2010-2021 the correlation with oil prices, e.g. year-ahead prices on TTF and oil indexes, remained strong.

By way of concluding his presentation, S. Komlev said that Europe has successfully moved from oil indexation to hub pricing. But, in 2020, there was an extreme volatility of prices. If to compare January 2019 and May 2020, day-ahead prices dropped by 7.6 times. And then, in a short period of time they skyrocketed by 9 times. And it is important to understand what stands behind this enormous volatility. In 2021, the difference between year-ahead and day-ahead prices was on average 70%. That means that the market works in a way that provides conflicting signals and, among other things, may create problems for the industry as a whole. With a market, where the prices may change so dramatically within a short period of time, that makes investors cautious from investing in the industry. With this, S. Komlev finished his presentation and thanked everyone for attention.

Item 2. Presentation “Evolution of Russian Gas Supplies to the EU: Development of Electronic Trading Platform” by Yury Diyachenko

Y. Diyachenko started his presentation by explaining that in 2016-2017 Gazprom export already had an idea of marketing gas to European customers through a closely correlated electronic sales platform (ESP) as an alternative channel.

The main goal was to focus on products that are closely related to products on hubs to make it easier for customers to trade volumes offered through the ESP on the hubs. In 2018, the sales platform was launched and the first trading operations took place. Originally, bilateral sales agreements were the only way to trade. As time went on, the amount of bilateral agreements was growing exponentially, so more convenient framework agreements were introduced that were later signed with the majority of customers. In 2020, the first gas electronic platform index was issued. In 2019, the first transaction in Roubles was performed with a large European utility.

Y. Diyachenko explained that, to a large extent, the ESP is driven by customers’ preferences to which it constantly adapts, so this is a very dynamic business. In fact, the dynamics of sales through the ESP is constantly changing. For example, in 2020, when prices collapsed, there was a jump in volumes. In

2021, the situation went back to normal and regular volumes continued to be traded in addition to long term transactions, as planned.

Lately, the ESP has expanded geographically as well, offering new instruments and options, such as formula pricing and one-click sessions. In 2019, about 61% of sales at the ESP were spot trades.

Future plans include elimination of paperwork and development of a mobile application.

Y. Diyachenko said his closing remarks and thanked the participants for their attention.

There were several interventions from the participants. One of them mentioned that he disagreed with S. Komlev's statements regarding security of supply, e.g. when assessing the LNG price of below \$2/mbtu as being less save. He also said that it probably makes sense to take the pandemics situation into account when analysing the prices in 2020. It was also mentioned that 2020 demonstrated that US LNG was able to provide competition for gas in Europe.

Another participant observed that even if diversifying routes of supply can be said to be a common denominator for Russia and the EU, historically in Europe diversification consists of the three elements, another two being diversifying suppliers and sources. Therefore, it would not be correct to concentrate on routes only. It was also said that, despite the advantages of the long-term contracts that were mentioned by S. Komlev, they still do not guarantee that there would be no gas disruptions, as public records show that since 2004 seven disruptions of gas flowing into EU member States from Russia have in fact taken place. Experience shows that, to manage such crises, communication between contract parties regarding the reasons and the estimated time of the disruptions is of paramount importance.

In his turn, A. Konoplyanik replied that a fair comment was made regarding diversification. He repeated, however, that there is indeed no established term for diversification which opens up different ways to interpret it. Most in the EU would consider "diversification" as consisting of all three facets be in place at once. While in the generally accepted international practice by "diversification" it is understood the presence of at least any one facet of it. This is why he has aimed in his presentation not on what disunite the parties in the debate (whether three or one facet should be considered for "correct" definition of the term) but what really unites Russia and the EU within their diversification policies – their objective interest in diversification of delivery routes as a means of mitigation of transit risks.

Y. Diyachenko was asked how big changes in traded volumes are managed and how the decisions are taken. To this he replied that the portfolio is largely balanced by using volumetrics. Also, when there is a striking difference in volumes, prices are balanced depending on the customer's position, their geographical location, the spread from the nearest liquid tradable hub, the applied transport calculations, etc. It is also important to ensure that there is always a healthy number of customers and not just one customer present in the market. For longer term products (i.e. 2-3 years), the decision would depend on the customer's location, also using the spread between the most liquid hub and the location. Answering the question whether it could happen that there is gas available but not being sold, Y. Diyachenko replied that there are cases when the pricing is not right for the company while its goal is certainly to maximise the profit as a duty to the company's shareholders. It may happen that prices at the ESP are comparable to the long-term prices or even lower, but the ESP is not about giving discounts to the market, so the decisions are always driven by the given market conditions.

S. Komlev also replied to the above comments and mentioned that he does not specifically advocate for long term contracts but rather insists that there should exist a sound combination that would allow protecting the system against the risk of supply disruptions.

There was also a question to A. Konoplyanik whether he considered Russia's turn to Asian markets to lead to complementarity or substitutability of markets (in sense that it will in the future substitute supplies to Europe), as sometimes speculated by some observers. To this A. Konoplyanik replied that he rather sees the three markets (Asia, Russia, and Europe) to become connected by infrastructure, so it is totally about complementarity and not substitutability.

No further questions followed. The Co-Chairs closed the meeting and thanked everyone for their active participation. They also announced that the next meeting is planned to be held on Friday, 28th May and it will be dedicated to the discussion of LNG and green LNG perspectives.