CHANGING GAS PRICE MECHANISMS IN EUROPE AND RUSSIA`S GAS PRICING POLICY

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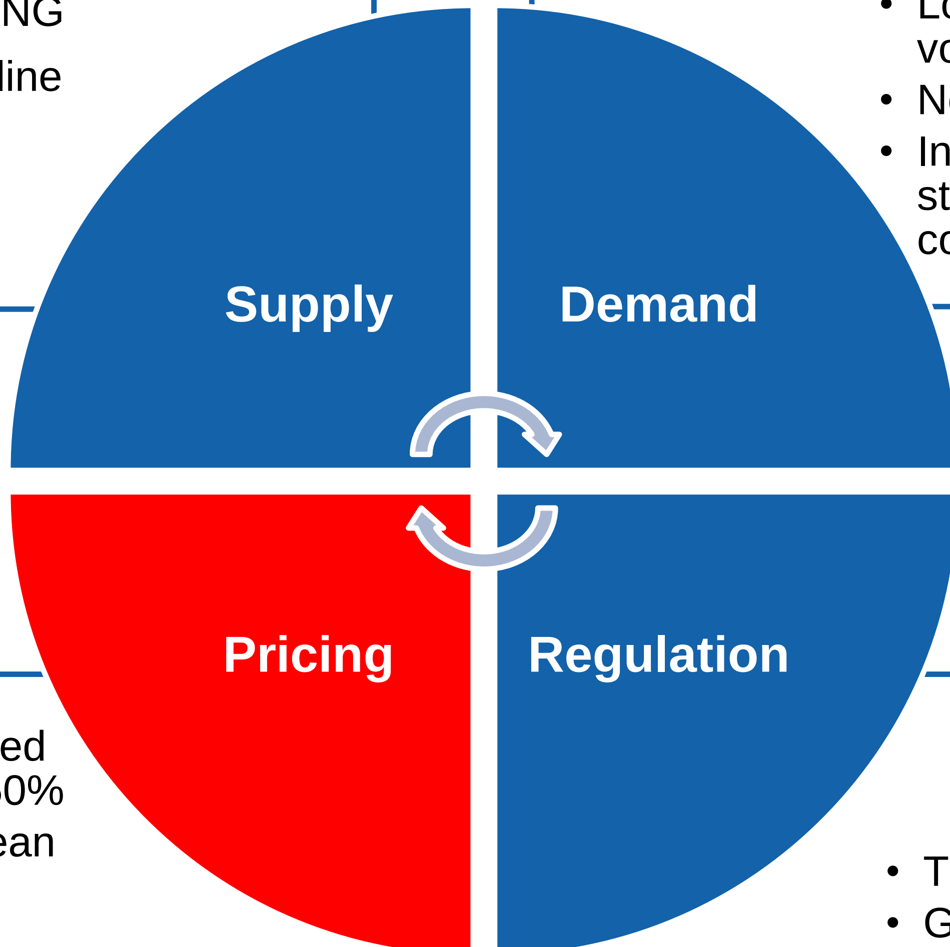
Since 2009 European gas market is undergoing deep transformation process accompanied by dramatic change of the gas pricing mechanism

- Growing supplies of LNG
- Diversification of pipeline supply sources

- Lower than contracted volumes
- No demand recovery
- In the power sector gas is strongly competing with coal



- Spot volumes increased from 15-20% up to >50%
- Majority of the European stakeholders support transition to the spot pricing

- Third Package
- Gas Target Model
- Energy Union

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Russian price strategy is in fact more flexible than declared

- In 2013 Gazprom started to implement a new price discount model with so-called retroactive payments.
- Despite Gazprom`s strident rhetoric in favor of traditional oil indexation, in actual fact numerous adjustments and contract reviews have already been made in the course of the last 5 years.
- Analysis of Gazprom`s official reports demonstrates a much more flexible negotiating position than has commonly been thought to be the case. During the period 2009 – mid-2014 as many as 58 gas supply contracts were reviewed with 39 clients (next slide), providing price discounts, easing of take-or-pay obligations and a certain introduction of a spot component.
- Calculations using Russian Customs Service statistics, Gazprom reports and the Nexant World Gas Model (which allows the assessment of contractual prices based on the prices of oil products), clearly show the increasing differential between these two prices. In fact, by 2013 Gazprom had already provided nearly on average 15% discount to its European customers compared to its pre-crisis traditional oil-linked price formulas, which has increased above 20% in 2014.

#	Country	Company	2009	2010	2011	2012	2013	2014	review application
1	Austria	Centrex		1		1		1	
2	Austria	EconGas OMV		1		1	1		
3	Austria	Erdgas Import Salzburg				1			
4	Austria	Gazprom Austria (GWH Gashandel)		1		1		1	
5	Bulgaria	Bulgargaz	1				1		
6	Czech Republic	RWE Transgas (RWE Supply & Trading)					1	1	
7	Czech Republic	Vemex s.r.o.				1			
8	Denmark	DONG				1			
9	Estonia	Eesti Gaas AS			1				
10	France	GDF SUEZ		1	1		1		•
11	Germany	E.ON		1		1			
13	Germany	Verbundnetz Gas AG			1				
14	Germany	WIEH		1	1				•
15	Germany	Wingas		1	1				•
16	Greece	DEPA			1			1	
17	Hungary	Centrex Hungary Zrt.					1		
18	Hungary	Panrusgas Gas Trading Plc.					1		
19	Italy	Axpo Trading (EGL)		1		1			
20	Italy	Edison (Promgas)			1				•
21	Italy	ENI		1		1	1	1	
22	Italy	ERG		1				1	
23	Italy	PremiumGas			1		1		
24	Italy	Sinergie Italiane		1	1		1		
25	Latvia	Latvijas Gaze			1				
26	Lithuania	Lietuvos Dujos						1	
27	Netherlands	GasTerra		1		1			
28	Poland	PGNiG				1			
29	Slovakia	SPP			1			1	
30	Serbia	Srbijagas			1			1	
31	Turkey	Botas	1		1				
32	Turkey	Akfel Gaz, Avrasya Gaz, Bosphorus Gas, Bati Hatti, Kibar Enerji, Enerco Enerji, Shell Enerji A.S.						1	
33		Shell Energy Europe (SEEL)				1			
		Renegotiated contracts (by years)	2	12	13	12	9	10	

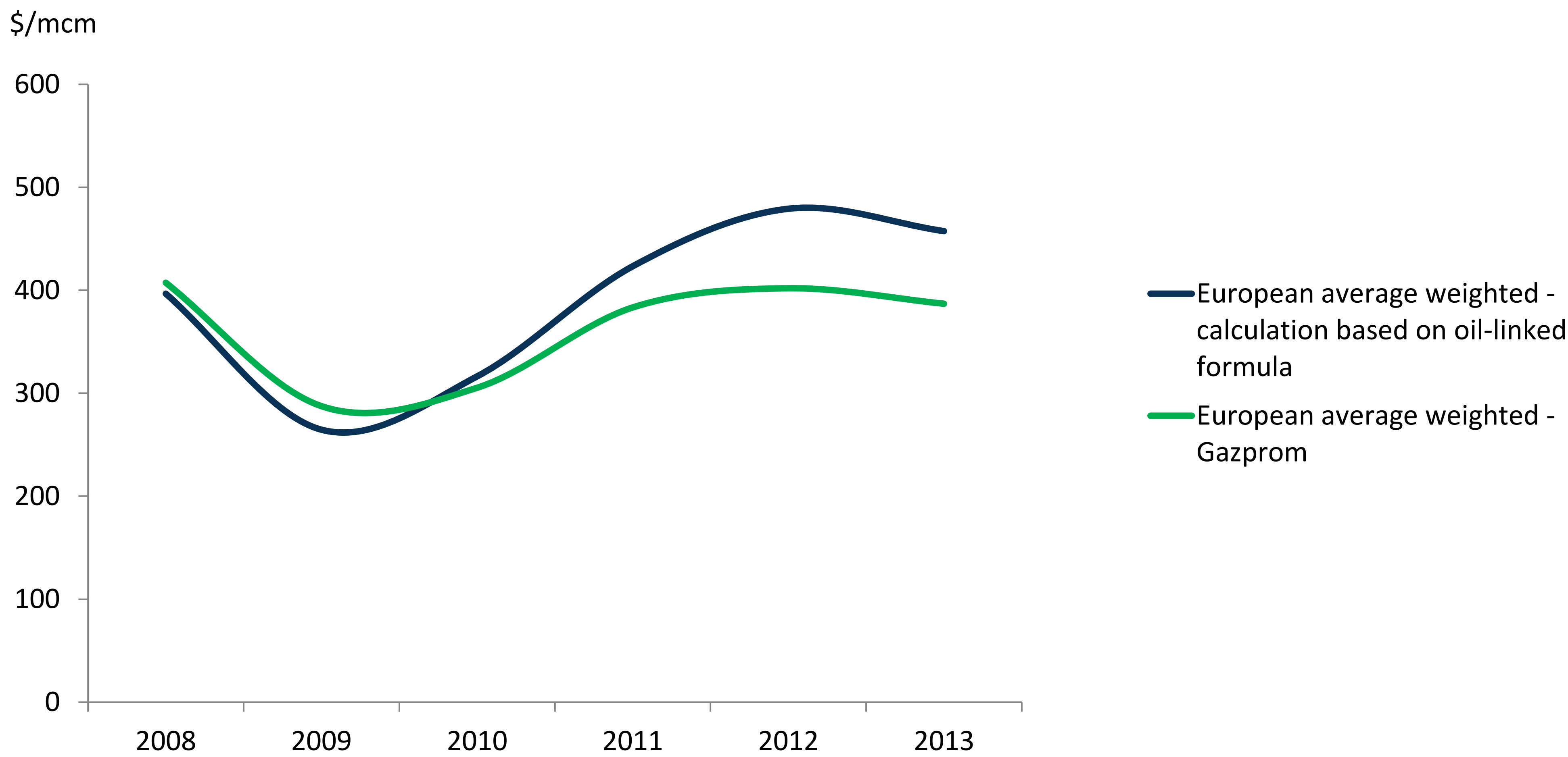
1 - Contract renegotiated according to Gazprom's data

1 - Discount made (inc. discount that is made without amendment to contract) according to Gazprom officials statements or media

Source: ERI RAS using Gazprom Annual Reports 2009-2013, Quarterly report: 1 Quarter 2014

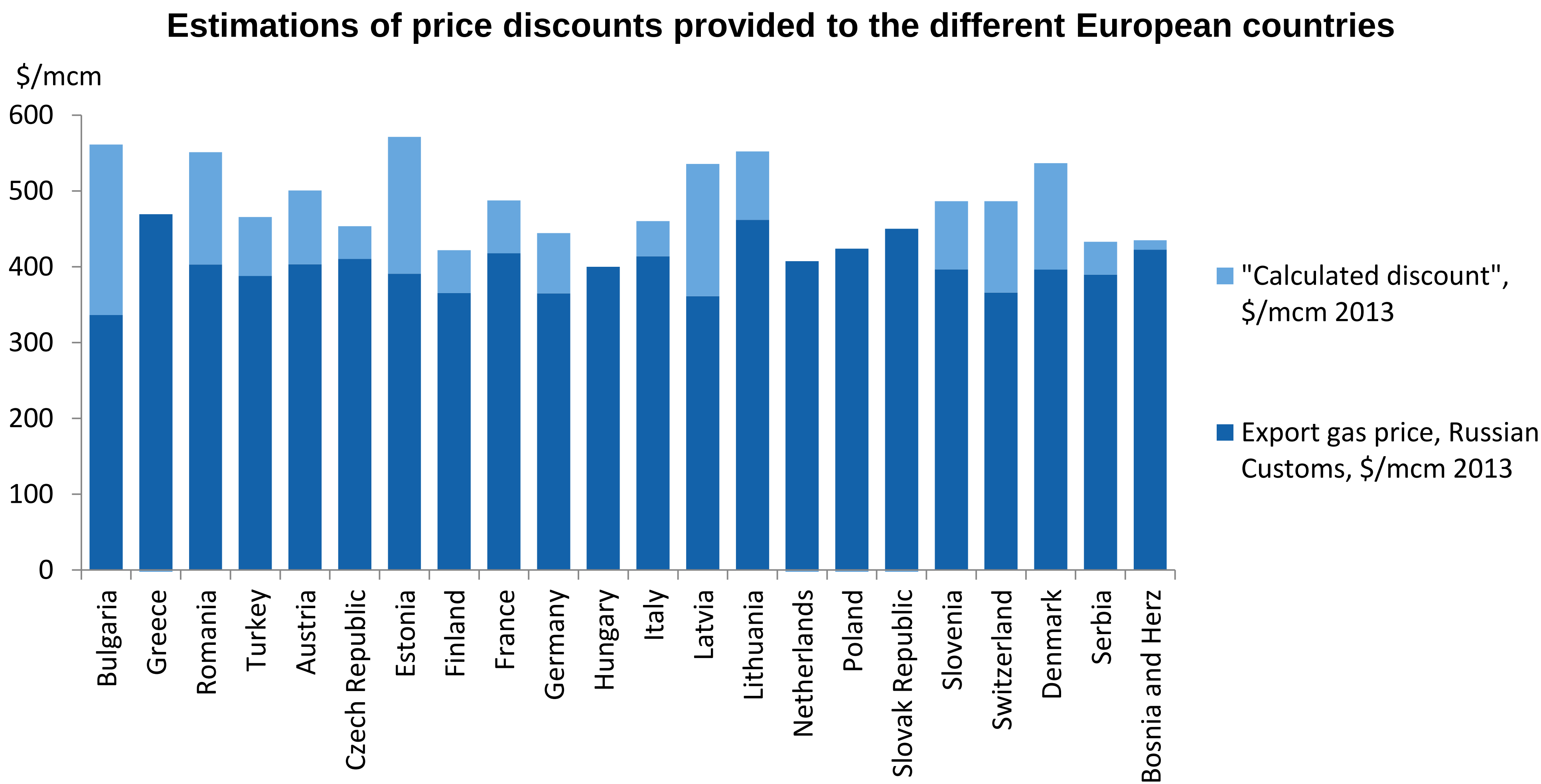
Difference between “traditional oil-indexed prices” and Gazprom prices gas reached 15-20%

Calculated traditional oil-linked price and real Russian gas export prices to Europe



Source: ERI RAS using Nexant, Federal Customs Service of Russia, Gazprom’s Annual Reports 2008-2013

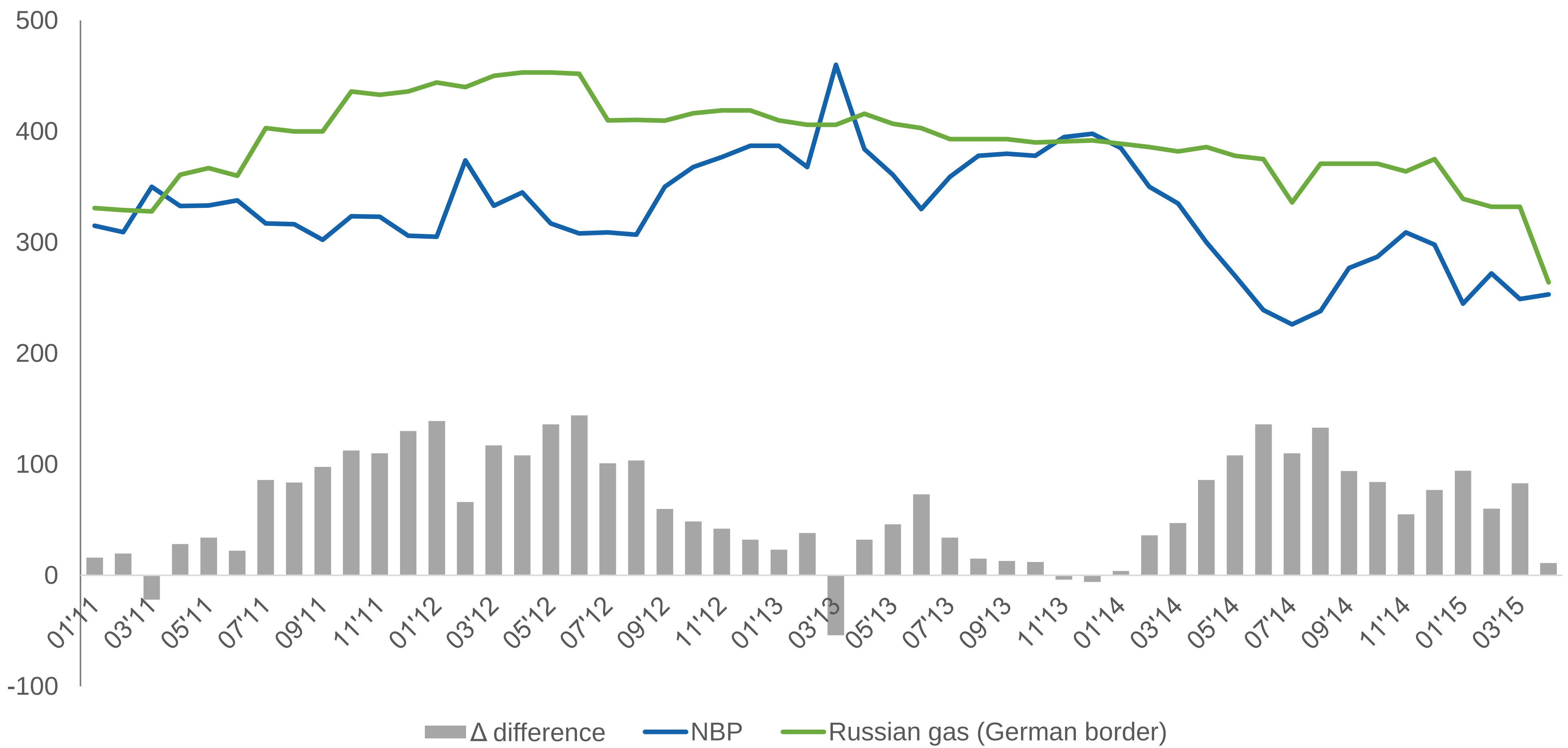
Russia's policy with regard to contract review has been based on the principal of delaying for as long as possible before providing the minimum discount acceptable to each buyer



Source: ERI RAS calculations using Nexant and Federal Customs Service of Russia

As a result of all these price discounts, by the end of 2013 Russian contract price at the German border equalled NBP and Gazprom managed to restore its market share to the pre-crisis level of 30%

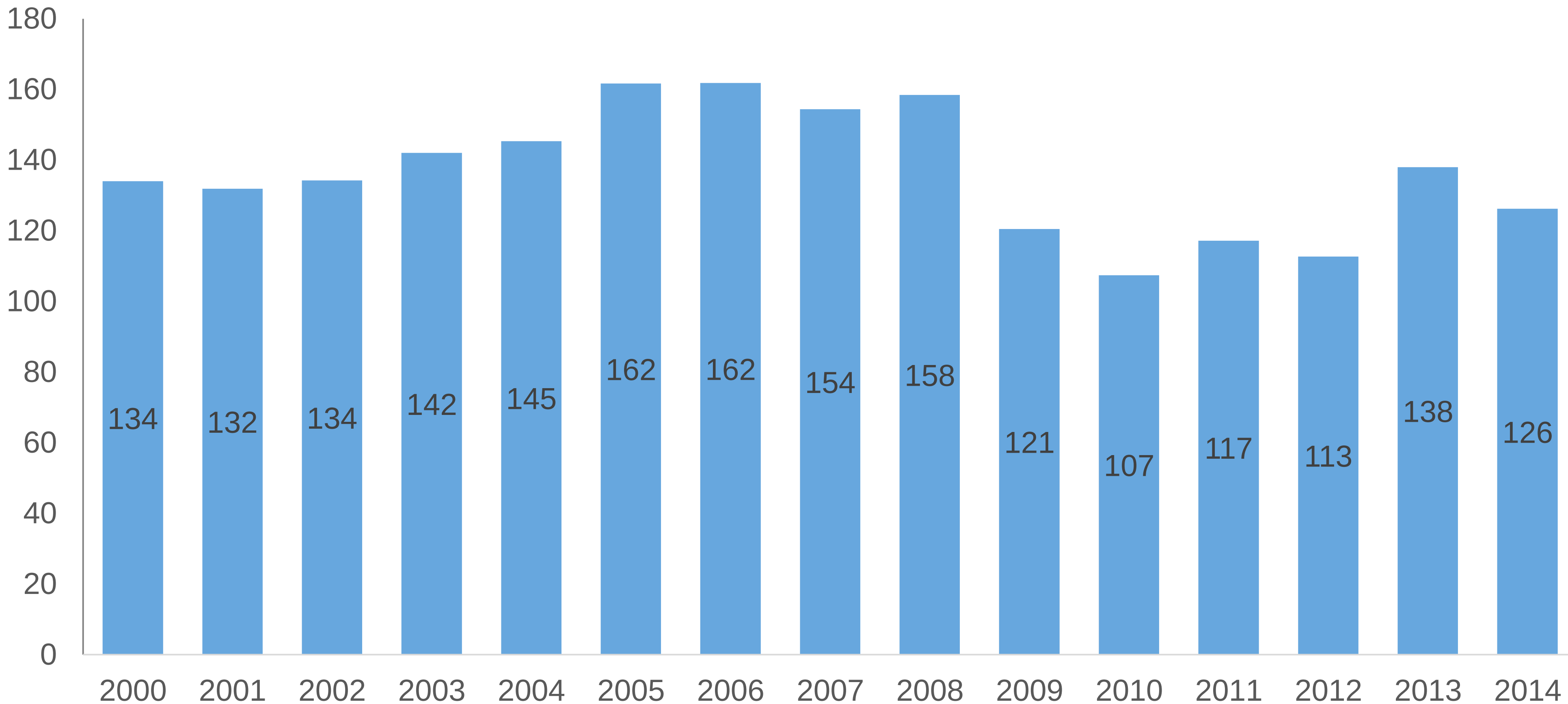
European spot and oil-linked gas prices



Source: ERI RAS using Bloomberg and IMF.

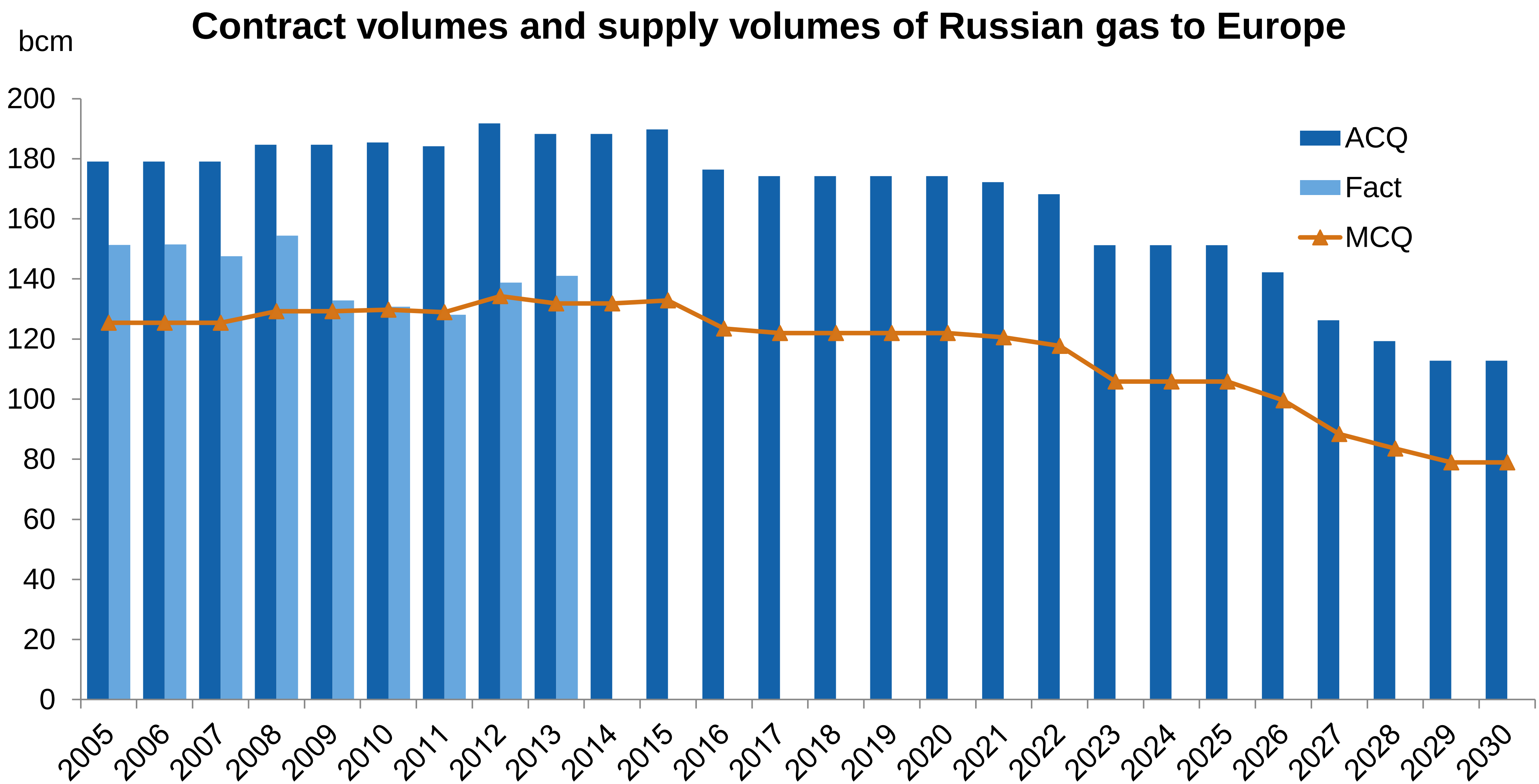
But in 2014 the volumes dropped again for the geopolitical reasons

Russian gas exports to Europe in 2000-2014, bcm



Source: Central Bank of the Russian Federation

Existing long-term contracts guarantee stable sales volumes for Russia until at least 2022



Sources: Cedigaz, NEXANT, Russian Custom Service, ERI RAS.

Russia has a choice:
1) post-facto adaptation

Post-facto adaptation by providing limited concessions to its buyers. In this way, Russia can continue to focus on price maximization, staunchly refuse to move to spot pricing, employ the tactic of minimal price concessions, or defend its position on oil indexation in arbitration and even go for further reduction of delivery volumes for the sake of maintaining the pricing principle. The following arguments work in favour of this strategy:

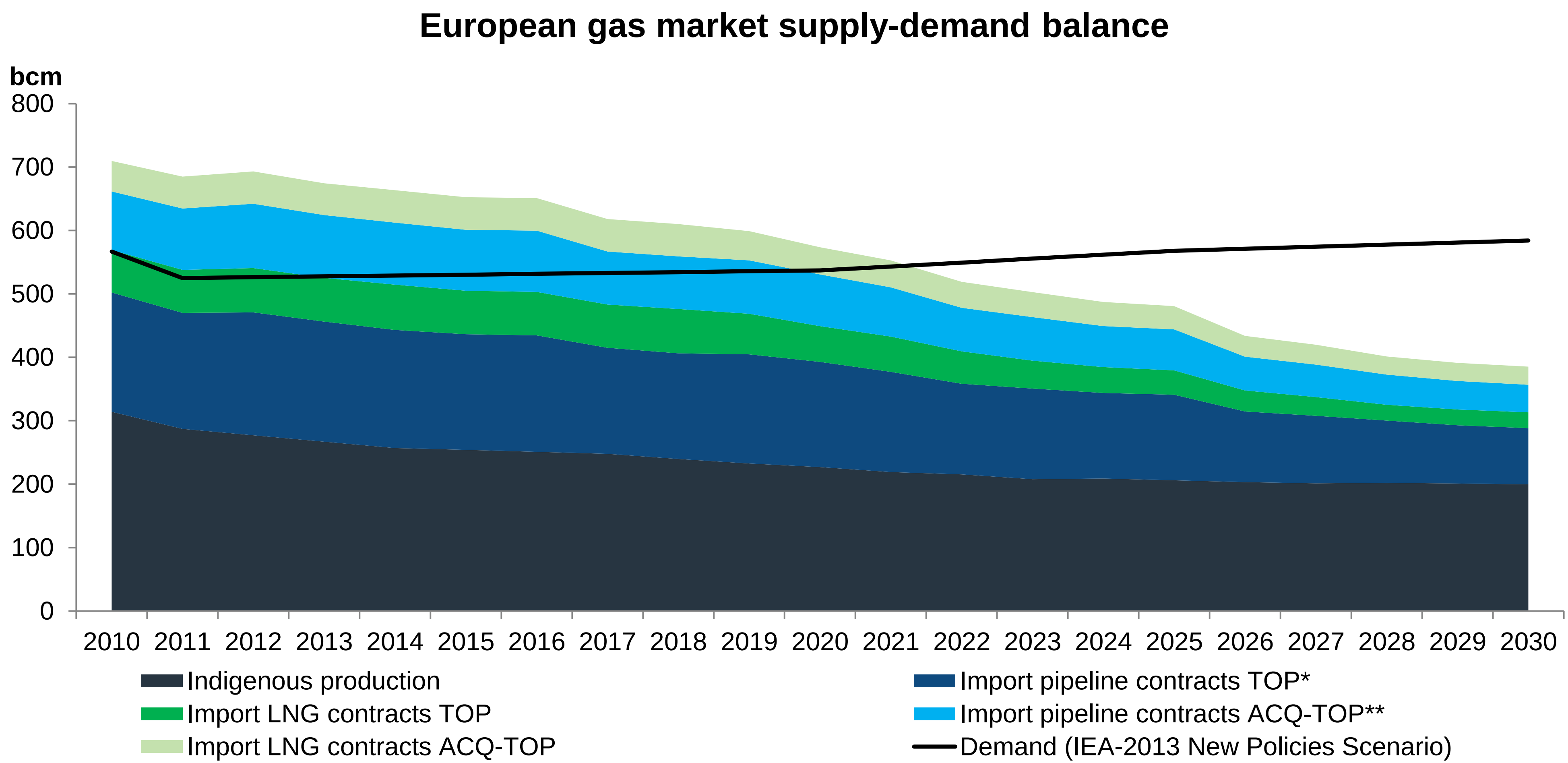
- A global LNG surplus is not expected for the next several years, and consequently the absence of any gas glut on the European gas market in the medium term will most likely narrow the gap between oil-indexed and spot prices;
- With higher prices, even lower export volumes guarantee growth in revenue;
- Gazprom's major contracts only expire after 2022, before that time annual contracted quantities exceed 160 bcm, and even minimal contractual quantities guarantee Russia approximately 120 bcm of annual gas export to Europe (equal to the level of 2009 supplies);
- The intensity of any conflict can be somewhat mitigated by further individual concessions by Gazprom to its major buyers;
- Arbitration lasts several years, during which time deliveries continue to be made based on previous conditions;
- Gazprom really needs oil indexation for project financing.

Russia has a choice:
2) strategy of anticipatory adaptation

The alternative is a **strategy of anticipatory adaptation** and a transition to spot pricing. Russia can agree with buyers to a “buyout” of long-term contracts and then set up simultaneous price and volume optimisation, depending on current market conditions. In this case, in order to maintain its market position, Gazprom has to agree to prices that will ensure the competitiveness of its gas in the power sector (6-7 $/MBtu) and ensure greater flexibility in supplies. This option is fraught with higher volatility, though it does have the following advantages:

- The possibility of profitably “trading off” changes to contractual terms in exchange for financial compensation (as was done in the review of contracts in the UK in the deregulation period):
- More favourable conditions for obtaining assets downstream (such as in gas-fired generation);
- An increase in Russian export volumes and European market share (if not restricted for the geopolitical reasons);
- If finally Russia should chose (or is forced) to move completely to spot-based pricing, Gazprom with its dominant position in the market fluctuating at around 30% of total European gas consumption (and far exceeding this level in certain countries, especially in Central and Eastern Europe), will be in a good position to manipulate prices through higher or lower supply volumes.

…but European gas market is going to be tight until at least 2015-2016 as LNG is diverted to Asia; post 2016 very limited new supplies will become available and there will be an additional call on the over-take-or-pay volumes: an opportunity for Russia to enhance its position



**TOP – take-or-pay obligatory supply volumes*

**ACQ-TOP – over-take-or-pay supply volumes*

(ERI RAS calculations using Nexant World Gas Model 2014 Database, IEA 2013)

Oil indexation vs. gas indexation: "a bird in hand is worth two in the bush" approach

Oil indexation	Spot indexation
▪ Disappearing gas glut on the European gas market in the medium term – gap between oil-indexed and spot prices already started to narrow ▪ Gazprom will face next price reopening only after 2015, and contract expiration – only by 2022 ▪ With high oil prices even lower volumes are providing high revenue ▪ New projects demand high prices (they have negative margins under spot prices, given that they have to pay export duties) and oil indexation is more convenient for the project financing ▪ Russian Government needs the money right now	▪ Strong pressure from the customers side ▪ Investigation of the European Commission against Gazprom`s pricing ▪ Gazprom could demand financial compensation for contract review + 3rd Package exemption for the South Stream and NEL + transitional period for price adjustments + European-level financial support for its mega-projects (like EBRD and other European financial institutions) ▪ Gazprom could become a dominant player manipulating the spot market by adjusting its supply volumes

There are strong commercial reasons for Gazprom to protect the oil indexation at least during the next 3-5 years

Conclusions

- European gas pricing system has changed considerably during the last 5 years, but further changes from the hybrid pricing model to spot price domination might take longer time.
- Russia is adapting to the dramatic changes occurring in the European gas market, though in a “concealed” manner; formally adhering to the principle of oil indexation, while de-facto providing strong price discounts and linking pricing to spot prices via the retroactive payments model.
- The price concessions provided by Gazprom contributed to recovering of its gas exports volumes to Europe in 2013, though political events in 2014 and the desire to reduce dependency on Russian gas virtually nullify all these achievements. Nevertheless at least in the next 5-7 years the position of Gazprom in the European market is completely guaranteed by LTCs.
- In the longer term, with the growth of alternative supply, primarily with the coming wave of LNG glut, Russia will have to enter into price competition with the new suppliers, provide additional discounts and introduce an explicit spot price component.

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