

Gazprom against US LNG and EU Commission - *An economist's view on natural gas competition*

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Foreword

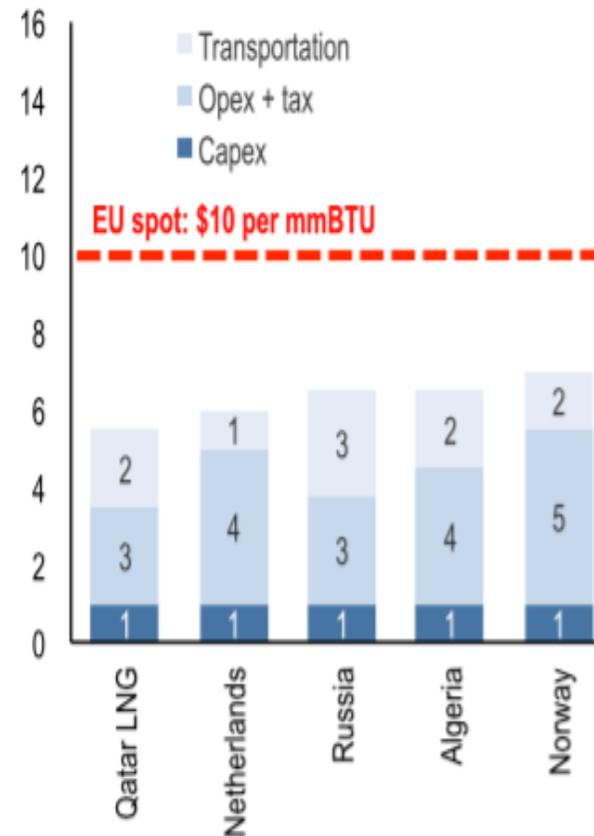
- Chair on the Economics of Natural Gas
- Sponsored by TOTAL, EDF and GRTGaz
- Founded by Dauphine University, IFP School, Mines-ParisTech and Toulouse School of Economics
- Aimed at rebalancing (French) research and education on energy economics with more focus on natural gas
- <http://www.cerna.mines-paristech.fr/Recherche/Chair-on-the-Economics-of-Natural-Gas/Presentation-and-publications/>

Introduction

- New pressures of competition on Gazprom from both the market and the law
- US and global LNG
 - LNG global supply glut
 - US ready to export LNG everywhere, including to the EU
- Forced competition by EU law
 - As a settlement in Commission v. Gazprom, a series of commitments has been proposed, including introducing competitive gas price benchmarks into price review clauses
- What will that change?

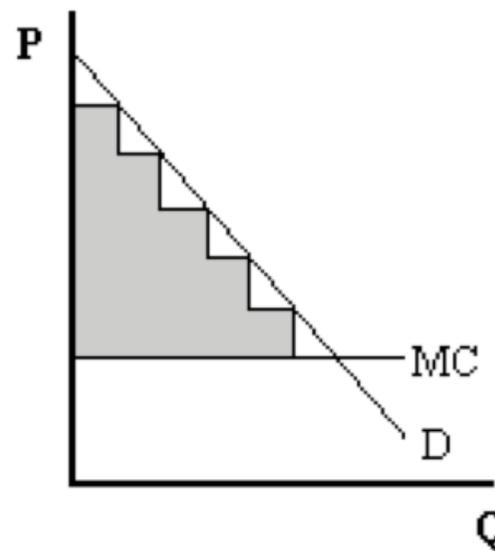
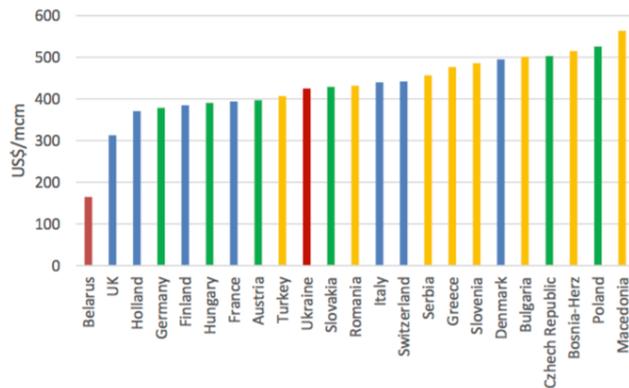
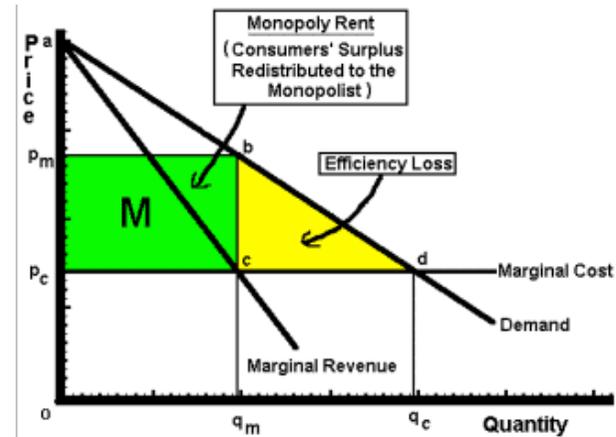
The fundamentals 1/2

- Natural gas as a commodity
 - Price cycles
 - Market price falls at short term marginal cost when capacity exceeds demand, skyrockets in case of under-capacity
 - On long period, prices are supposed to equal the long term marginal cost at equilibrium
 - Ricardian rents
 - The higher for low costs producers, zero for the marginal producer



The fundamentals 2/2

- Natural gas as an oligopoly
 - Opportunities for firms to exert market power
 - Quantity withdrawing
 - Price discrimination
 - Cartelizing



An impossible cartel

- Ten years after, the dream of Algeria, Iran and Russia is definitely over
- It was then low likely to succeed because of diverging interests and outsiders
- Today, regasification capacity in EU is high (and underused) and LNG players as potential entrants are both numerous and heterogeneous

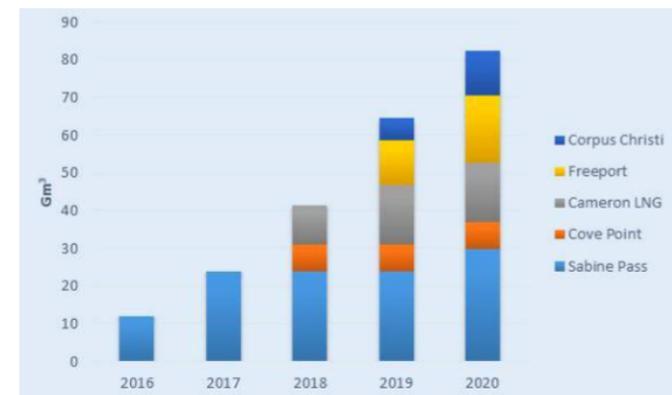
A price war?

- The 2016 headlines
 - April: a tanker loaded with US gas takes the route of Portugal
 - May 2016: « We don't see to wage a pricing war » Medvedev's interview
- The ingredients
 - GNL glut
 - US GNL exports capacity

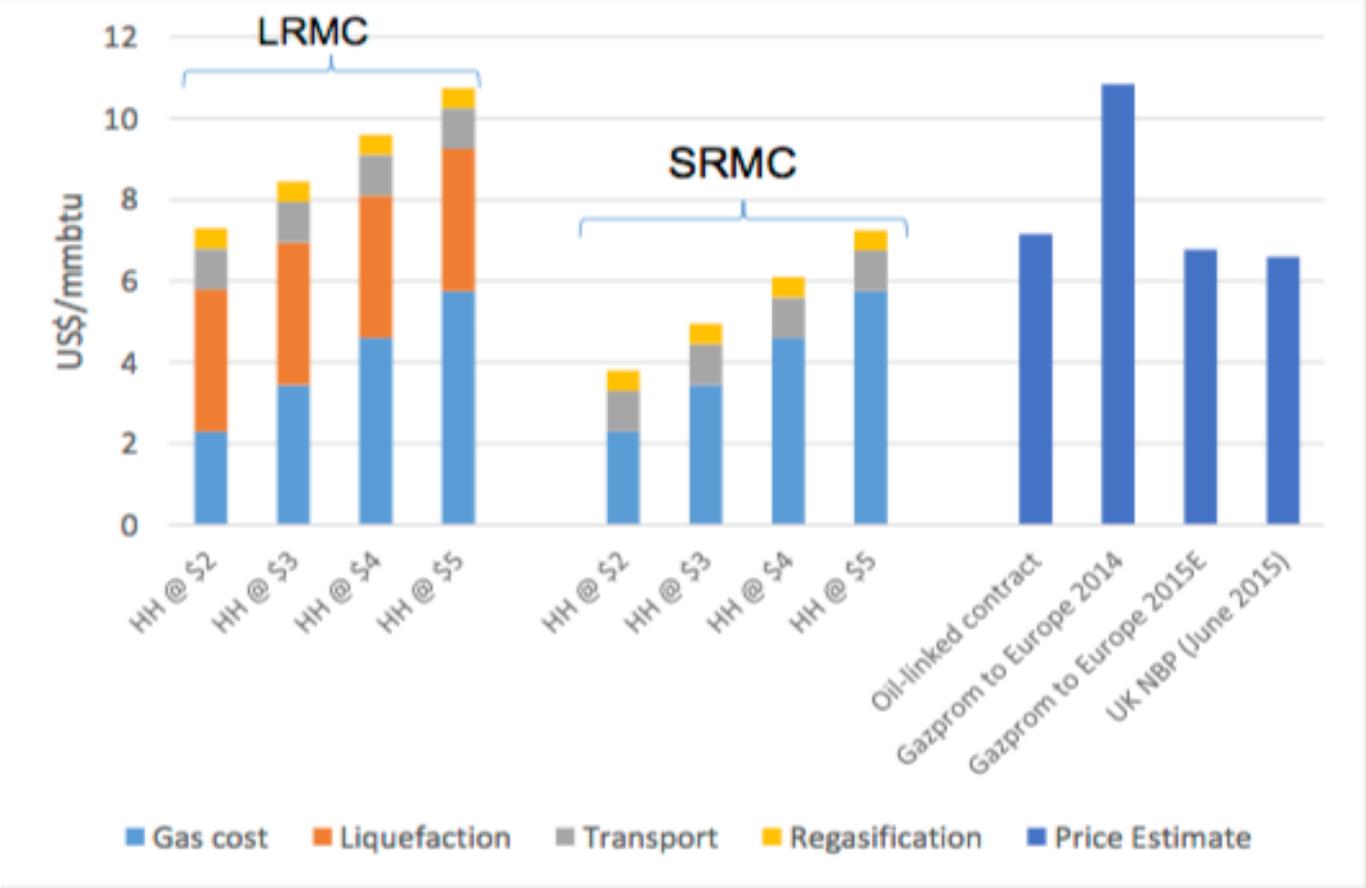
THE WALL STREET JOURNAL.

First U.S. Gas Shipment En Route to Europe

American LNG shipment could spark price war in Europe



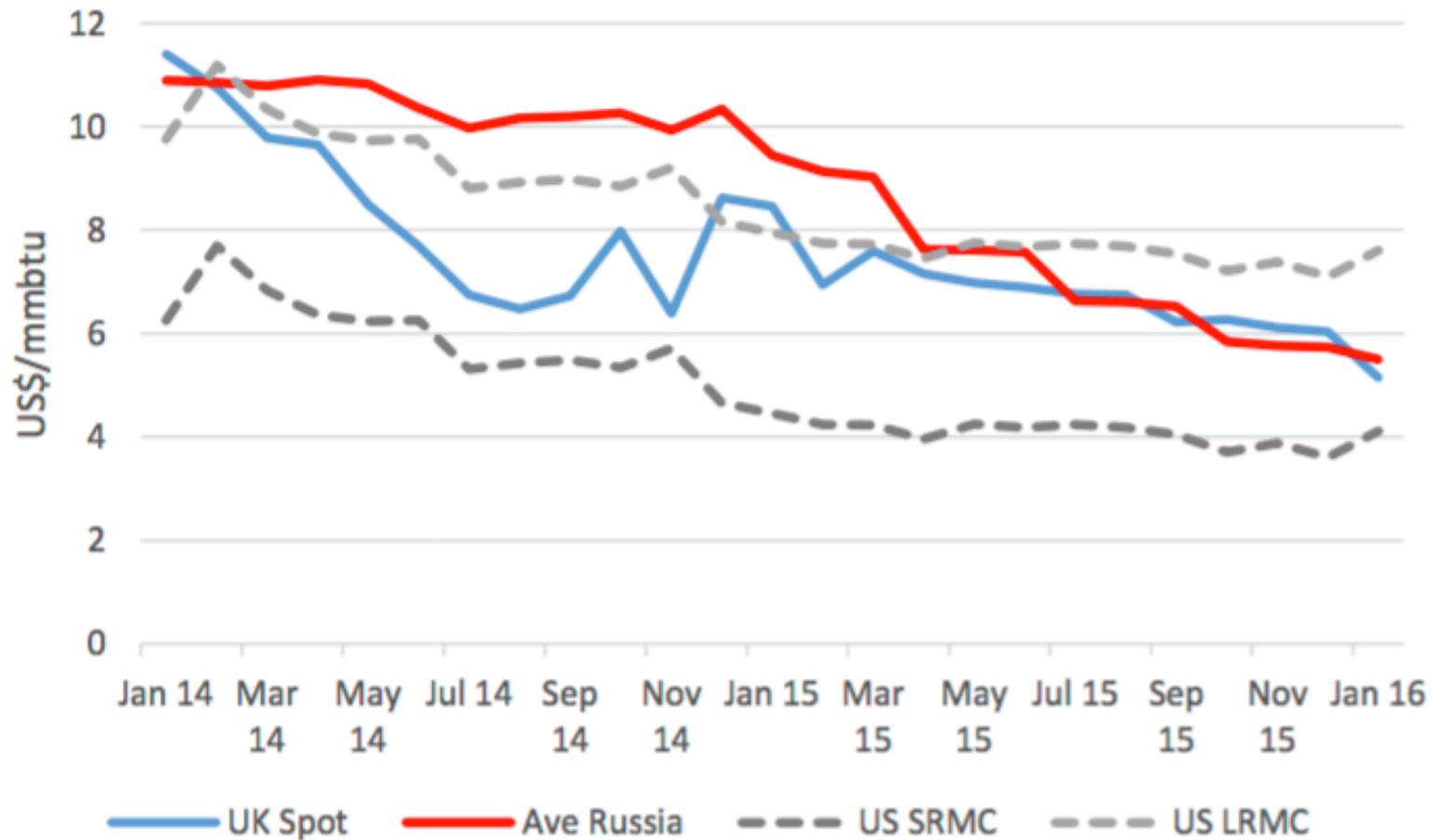
US LNG: a key competitor to Gazprom



The costs of US LNG versus European gas prices

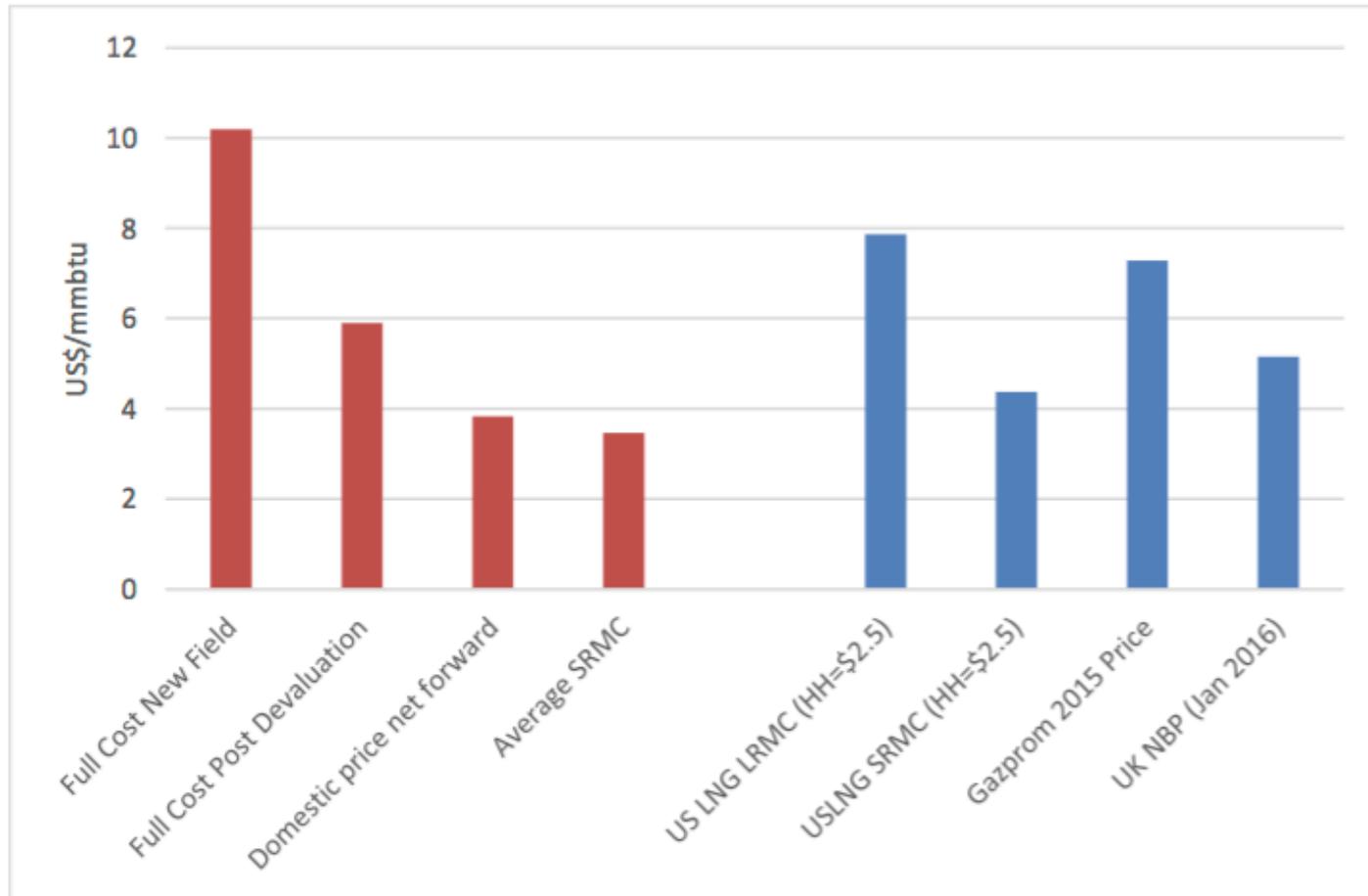
(Source: Henderson and Mitrova, 2015)

European gas prices compared to US marginal costs



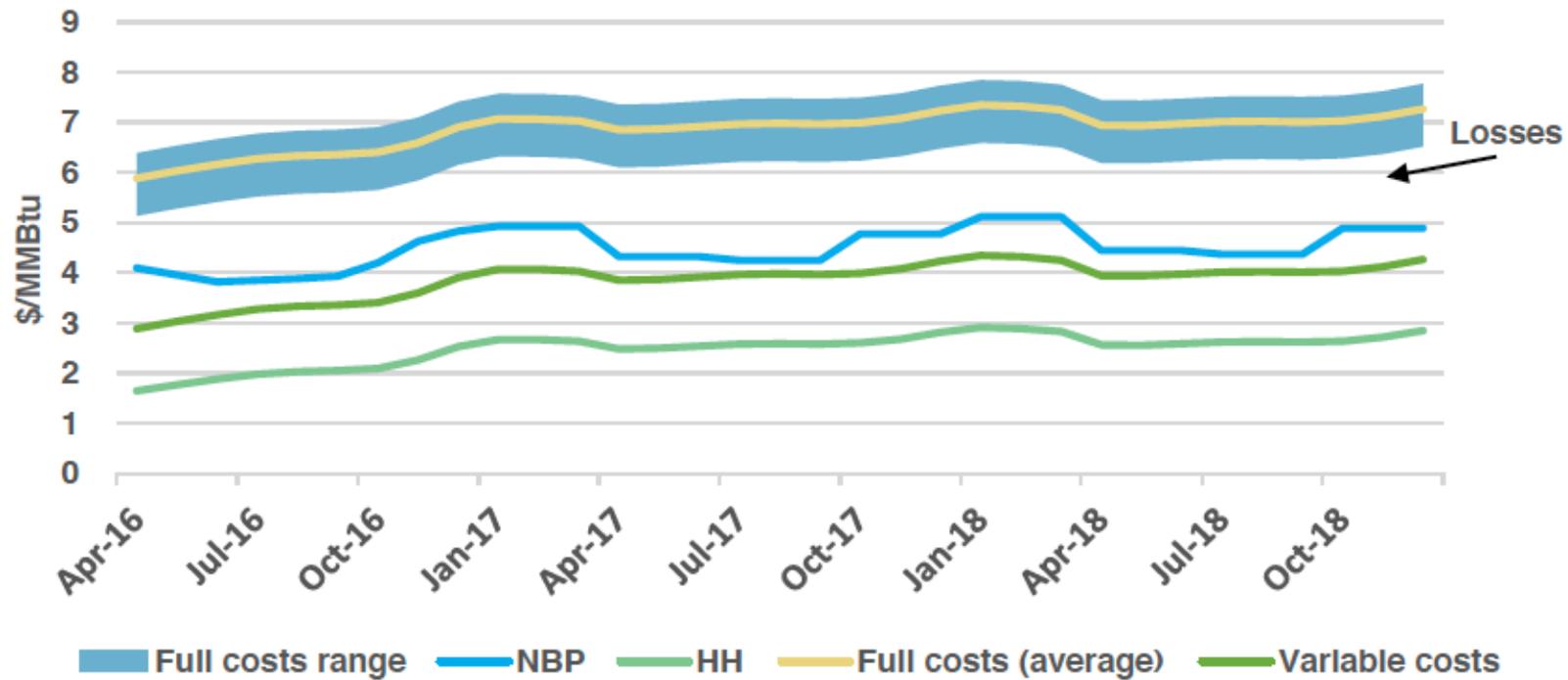
(Source: Henderson, 2016)

Gazprom costs advantage



(Source: Henderson, 2016)

US LNG variable costs versus NBP



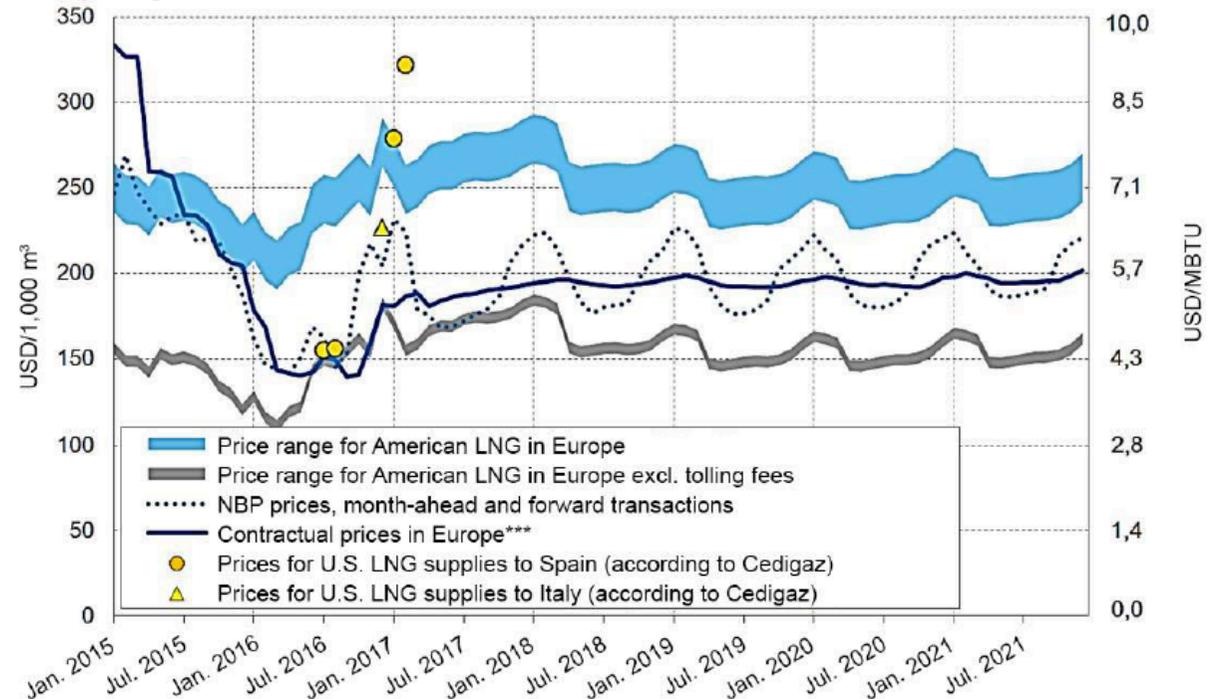
(Source: Corbeau and Yermakov, 2016)



LOW COMMERCIAL ATTRACTIVENESS OF U.S. LNG SUPPLIES TO EUROPE

In current environment, forward contract prices at European trading platforms do not cover full cost of future U.S. LNG supplies linked to Henry Hub prices

Estimated price range* for U.S. LNG supplies in Europe versus forward prices** in European gas market



* Based on Henry Hub forward prices, $P = HH * 115\% + X$, where X – costs (liquefaction, shipments, regasification)

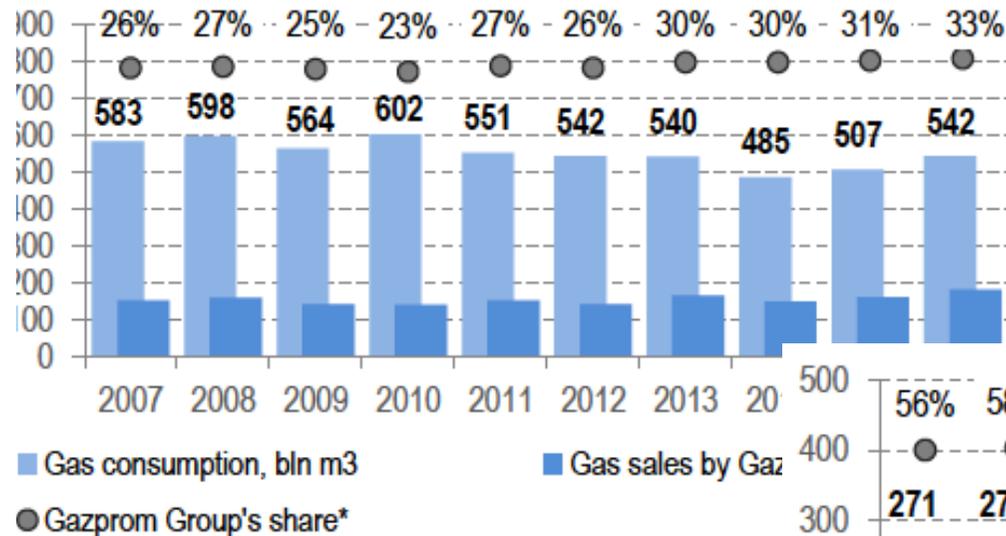
** NBP forward prices

*** Historical data: Russian gas prices, including delivery, at German border (according to World Bank), projected data: based on current forward prices of Brent and TTF

Sources: Bloomberg, Cheniere Energy, WoodMackenzie, World Bank

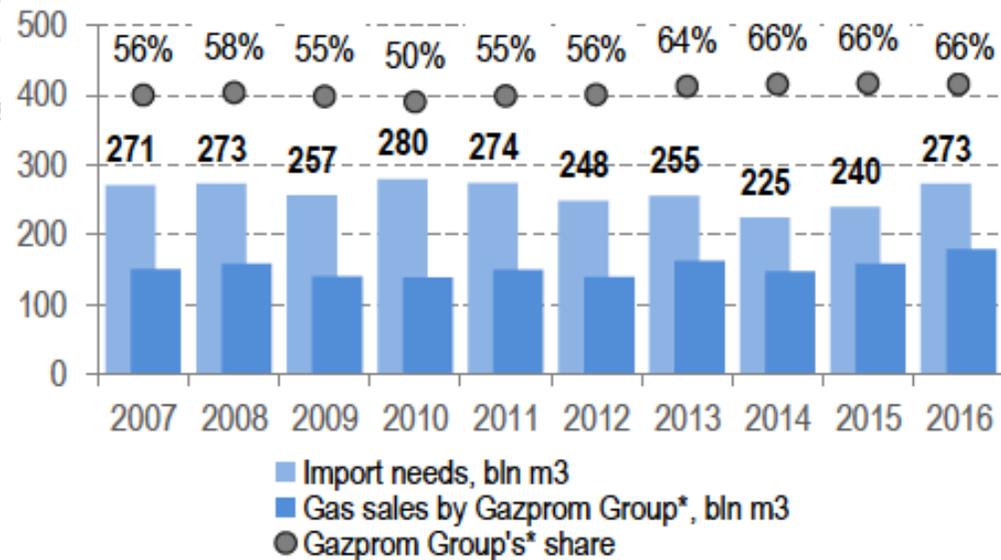
Copied from A. Medvedev, Press Conference, June 6, 2017

Gazprom's market shares



(Source: A. Medvedev, Press Conference, June 6, 2017)

Gazprom's share in EU gas consumption

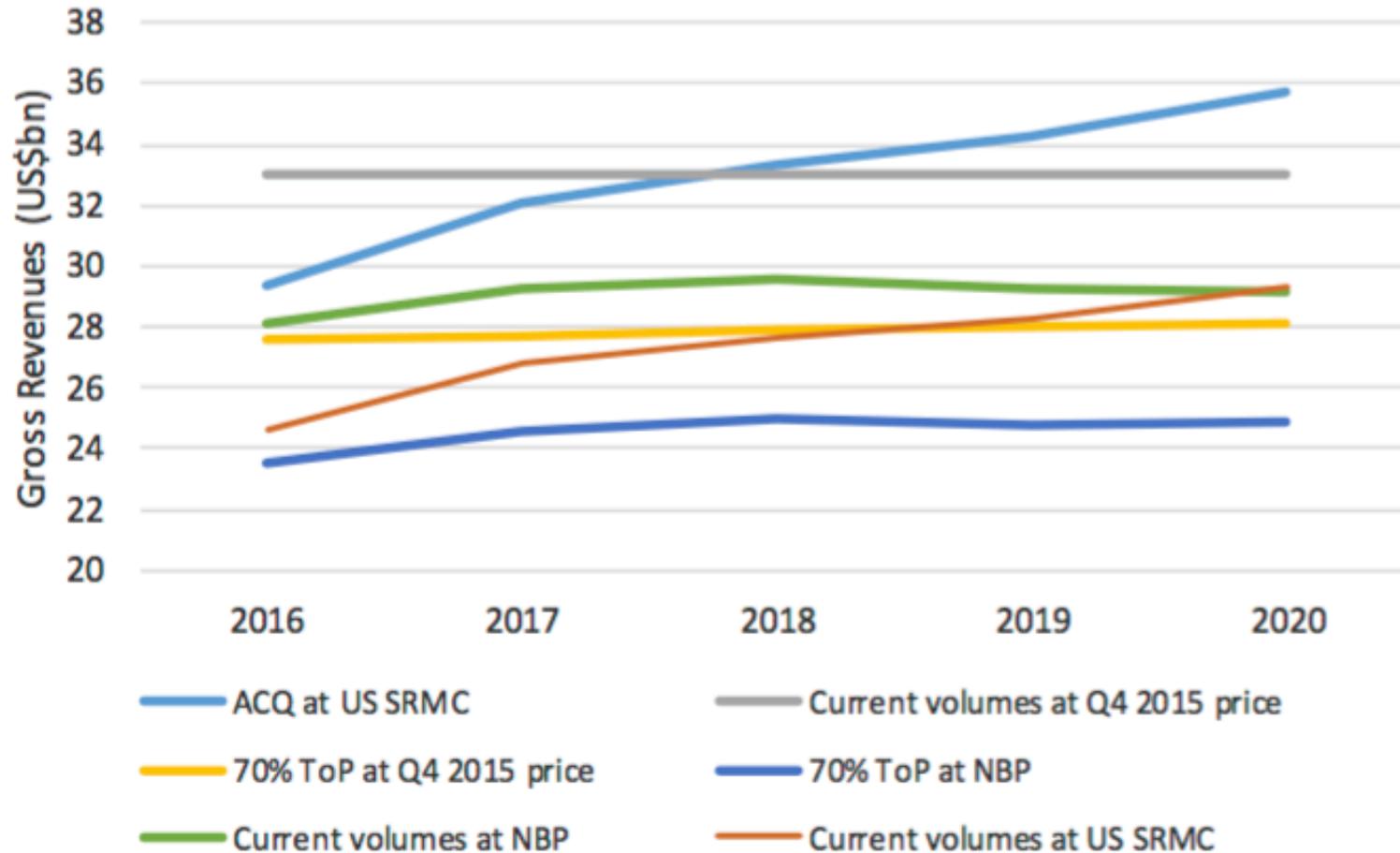


Gazprom's share in EU gas imports

A market share strategy?

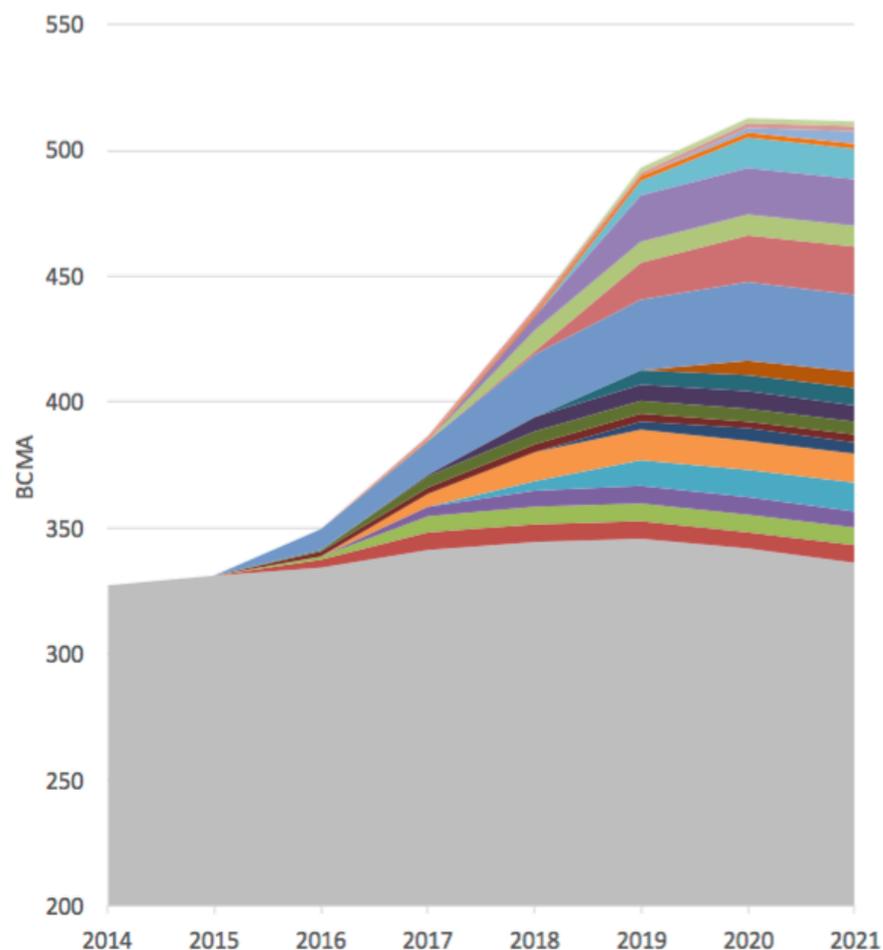
- An odd question for economists
 - Maximizing revenues or profits
 - Quantity and price are simultaneously set
- A shortcut phrasing to say that Gazprom will try to secure its long term revenues in pricing its gas between US SRMC and LRMC?

Ranges of Russian gas exports revenues at various volumes and prices



(Source: Henderson, 2016)

«Not Russian gas versus US LNG but Russian gas versus LNG » (J. Stern, 20 June 2017)



Many uncertainties:
EU gas demand,
Asia LNG demand,
(especially in China),
Oil Price

New capacities (Source: Rogers, 2017)

The EU legal competition pressure on Gazprom

- From EU energy law
- And from competition law: Article 102 of TFEU

Any abuse by one or more undertakings of a dominant position within the common market or in a substantial part of it shall be prohibited as incompatible with the common market insofar as it may affect trade between Member States.

Such abuse may, in particular, consist in:

- (a) directly or indirectly imposing **unfair purchase or selling prices or other unfair trading conditions;**
- (b) **limiting production, markets or technical development to the prejudice of consumers;**
- (c) applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;
- (d) making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.

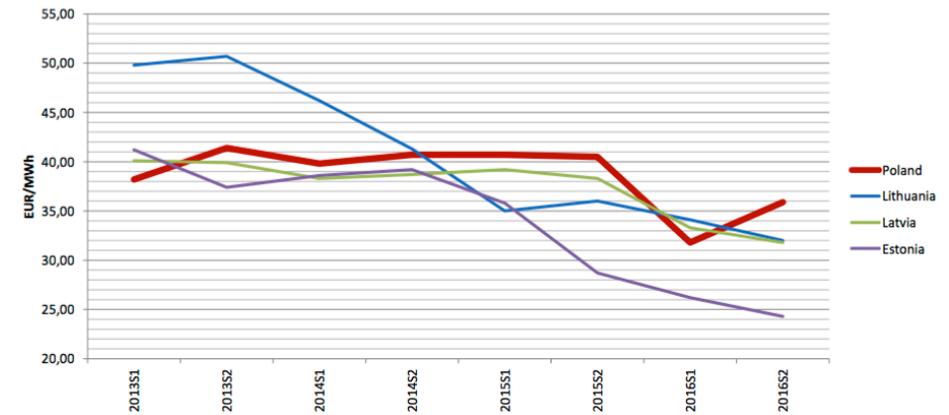
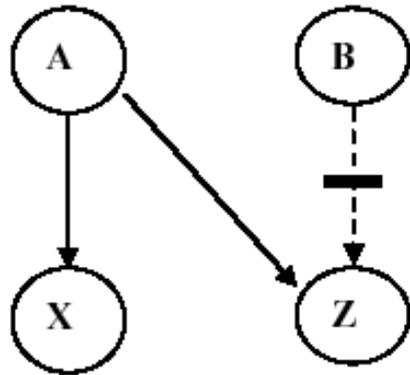


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- € 2,5 billion fine
- Exclusionary abuse of dominant position
- Google shopping prominent placement has foreclosed competition

- No fine, no formal Art. 102 decision
- Accepted settlement
- Exploitative abuse of dominant position

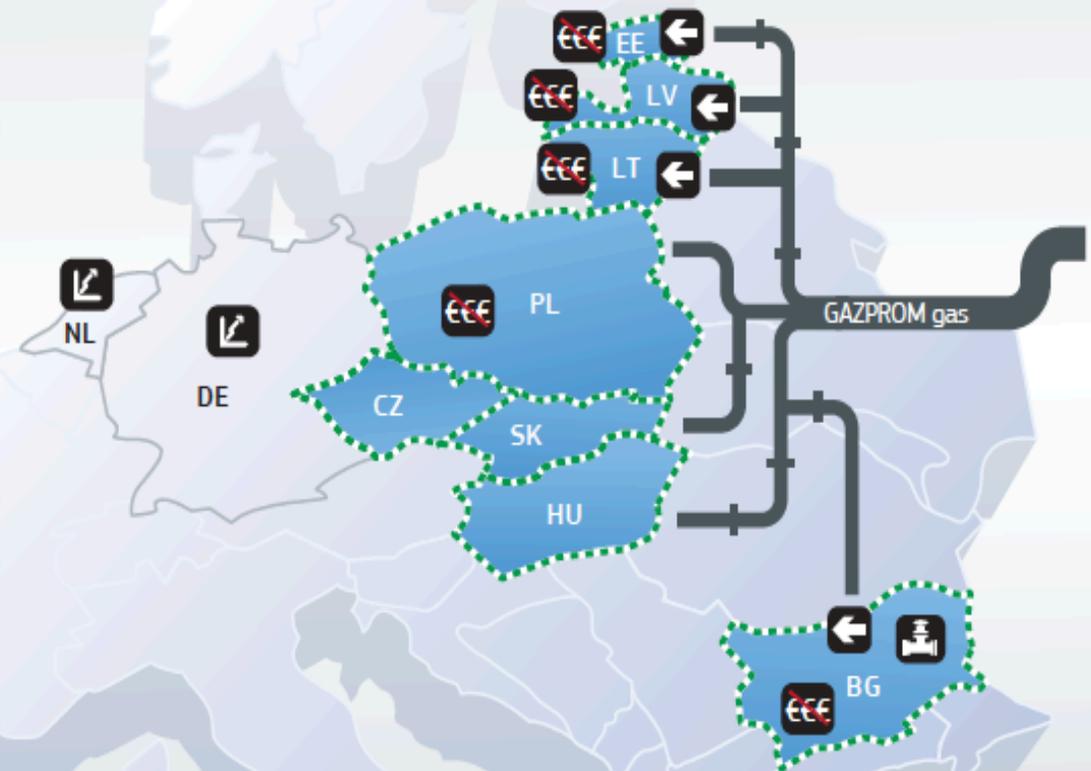


EU commission against Gazprom

- Proceedings initiated in September 2012
- Statements of objections sent in April 2015
 - Gazprom was alleged to *hinder competition* in the gas supply market by *inter alia*:
 - imposing *territorial restrictions*, including export bans, destination clauses, and other measures in Bulgaria, Estonia, Latvia, Lithuania, and Poland
 - Pursuing an *unfair pricing policy* in Bulgaria, Estonia, Latvia, Lithuania, and Poland
- Looking for a settlement in March 2017
 - Gazprom has proposed a series of commitments
 - On-going market test

GAZPROM's proposed measures to remedy competition concerns

-  Allowing cross-border flows of gas
-  Ensuring competitive prices, linked e.g. to liquid hubs 
-  Enabling interconnections
-  Providing flexibility to divert gas to this delivery point



Is Margrethe Vestager right?

"We believe that Gazprom's commitments will enable the free flow of gas in Central and Eastern Europe at competitive prices. They address our competition concerns and provide a forward looking solution in line with EU rules. In fact, they help to better integrate gas markets in the region.

This matters to millions of Europeans that rely on gas to heat their homes and fuel their businesses.

We now want to hear the views of customers and other stakeholders and will carefully consider them before taking any decision."



Concerns on market segmentation

1/2

- « For the entire duration of these Commitments Gazprom undertakes that (i) it will not apply any Clause Restricting Resale or Territorial Restrictions and that (ii) it will not introduce any new Clause Restricting Resale or Territorial Restrictions in any existing Contract on Gas Supply [...]”
- Have not these restrictions already been removed from the contracts? They should have ceased when the new countries joined the EU
- So what is the effect? A lip service?
- It seems that DG Comp found at least one such clause in a Lithuanian contract. A likely valid reason to impose a big fine

Concerns on market segmentation 2/2

- Changes of delivery points
 - « Existing customers shall be entitled to request a change of the Original Delivery Point(s) provided in a relevant Contract(s) on Gas Supply to entry point at Negru Voda at the border of Bulgaria and Romania or to entry point Kotlovka at the border of Lithuania and Belarus [...]”
- A kind of virtual pipeline or swap deals to increase competition and gas flows to the Baltics and Bulgaria
- But only between Gazprom gas and Gazprom gas, swap volumes are still Russian gas...
- With service fees set by Gazprom which are not justified and seem high
- In any case a small market size (about 8 bcm in 2016)

Concerns on prices

- A new trigger for a price review will be added into contracts
 - « The prevailing price level resulting from the Contract does not reflect the development of the European gas markets as reflected, inter alia, in the development of the average weighted import prices in Germany, France and Italy and/or the development of the prices at the relevant generally accepted liquids in Continental Europe »
- Not a precise enough benchmark
- Indexation to oil price not excluded
- A nest for litigation
- Why not setting a clear methodology to help the monitoring trustee and the arbitration tribunal?

What's next?

- Will third parties invited to comment on the Gazprom commitments express and substantiate their dissatisfaction?
- Poland's reaction
 - « [The proposed commitments] may not make any significant contribution to change the situation that triggered the Commission action in 2012. We consider the Commission's acceptance of those commitments as highly insufficient »
 - Will Poland sue the Commission beyond the Court of First Instance?
- Fining is still a credible threat and might be decided (like in the Google case where the Commission initially intended to find a settlement)

Takeaways

- OPEC-like cartel is definitely unachievable
- Gazprom is able to credibly sustain a long price war, if necessary
- US LNG puts a cap on Gazprom prices
- Gazprom versus LNG not Gazprom versus US LNG
- Gazprom's strategy to maximize revenues not to defend a market share
- EU law provides an additional competitive pressure to Gazprom which can still increase in the coming years