



Should the Russian gas sector be deregulated?

23th World Gas Conference
Amsterdam, June 2006

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Introduction

- Russia as a
 - Resource holder
 - Producer
- Supplier to
 - Europe (>25%)
 - Asia
 - USA
 - Turkey
- Exports via
 - Pipelines
 - LNG
 - Sakhalin
 - Shtokman
- High Domestic use

**BUT WHAT IS THE
ISSUE?**



Why deregulate?

- “Washington Consensus”
- Investment into production and Infrastructure
- Consumption and Efficiency
- Regulatory Capture



Investment

- Gazprom is heavily in debt, continuing most operations through securing further funds in the capital markets.
- Yet most of the resource base is old soviet deposits which are in the declining stage and require further investment
- Also to develop new fields to continue the current level of production, or to increase it as is currently planned

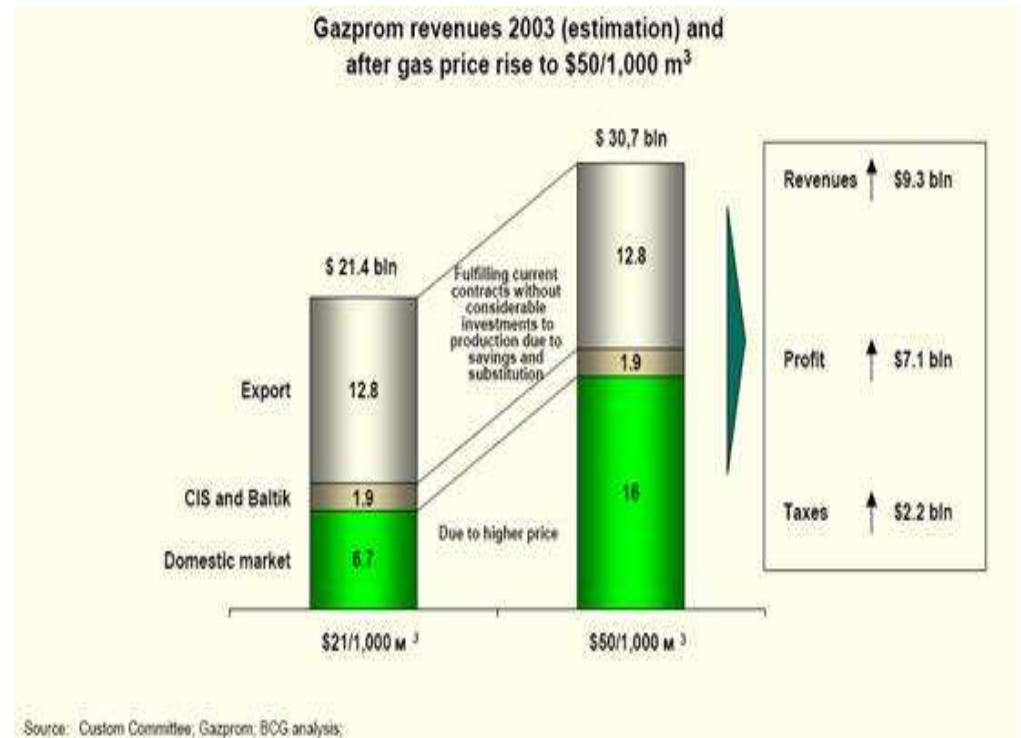


Investment

- Infrastructure is mostly soviet built and ailing
- UGTS began with the first pipelines in the 1940's
- Little investment in replacement, upgrading or maintenance
- Built and installed in a hurry, not corresponding to today' standards

Investment

- If domestic prices increased to European levels, Gazprom would increase profits by \$60bn p.a.
- If increased to only US\$50, *ceteris paribus*, Gazprom's revenue would increase by US\$9.3bn, and the subsequent increase profit would be over US\$7bn.





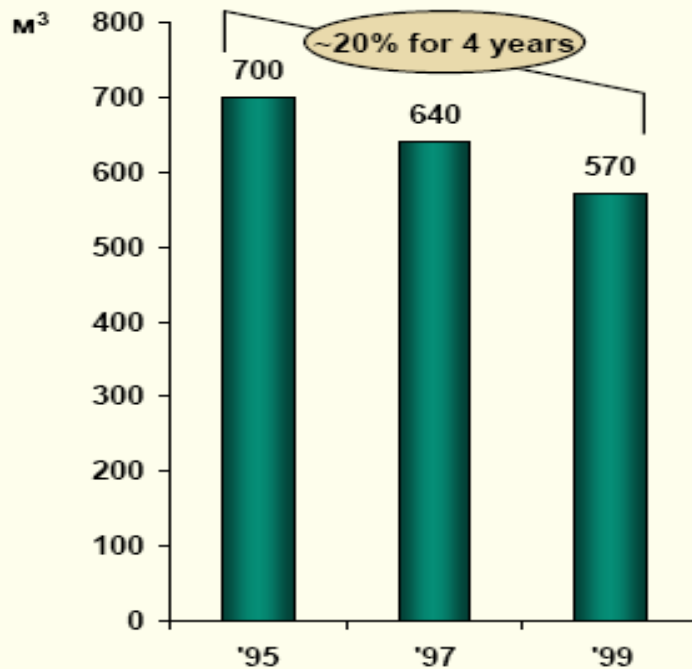
Consumption & Efficiency

- artificially low prices for natural gas means there is no incentive to conserve energy,
- which translates into a growing demand for the fossil fuel
- demand for gas grows at an average annual rate of 3 BCM.
- BCG has indicated that consumption can be substantially decreased by an increase in price and the installation of valves and meters.

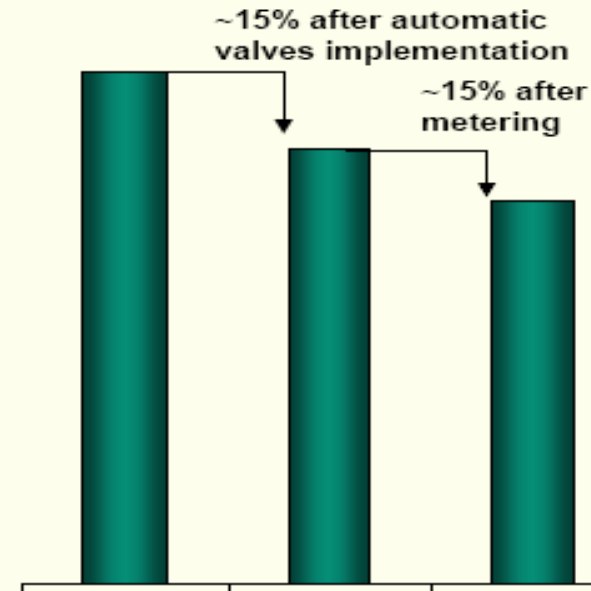
Energy consumption

Price increase => 20% savings

Automatic valves => 15% savings
 Meters installation => 15% savings



Poland gas consumption per household after price increase

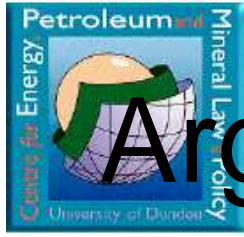


Heating consumption in Western Germany



Efficiency

- Increased gas prices would also encourage greater energy efficiency on the part of the industrial users
- stimulate other energy industries, not only increasing energy security through diversification but also creating growth in new industries, such as fuel oil and coal.
- Environmental concern?



Arguments against deregulation

- Price Deregulation
- UGTS
- Political Dogma



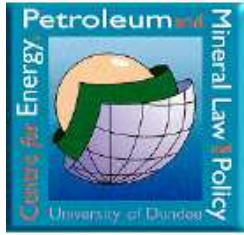
Price Deregulation

- Fair pricing and monopolist checks and balances
- Competition will prevent monopoly pricing and prevent consumer surplus erosion?
- Moot because current price below LRMC
- But under perfect competition, price = LRMC. Unaffordable for the population
- Therefore fair price \leq affordable price



Price Deregulation

- What if regulation is removed?
 - Price \uparrow , but gas vital utility so wide non-payments. Gov't must intervene.
- Deregulate the export market?
 - Independents supply only export market.



UGTS

- Incumbent's position solidified by ownership and control of transmission network
- Oil companies that produce associated gas are unable to access the pipeline despite common carriage rights.
- Unbundling of the enterprise would remove the much needed finance
- In 2004, Gazprom's investment into transportation and storage was 125bn roubles (just under US\$4.5bn)



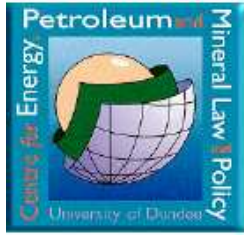
UGTS

- pipeline operation is considered a natural monopoly that shows strong signs of subadditivity
- would have to remain as either a state-owned entity, requiring the state to reimburse stakeholders, or heavily regulated, which counteracts the initial desire.



Political Dogma

- High Domestic dependence ($\approx 50\%$ energy mix)
- Government needs to maintain control esp. when prices are low.
- UK Labour Party policy has traditionally been to control the “commanding heights”
- France & Italy



Desired outcome

- Gazprom IT and sector investment
- Foreign and Independents access
 - Access to pipe network
 - Transparent tariff mechanism
 - Efficient dispute settlement mechanism
 - Reasonable rent
 - Domestic and/or export
- Industry Subsidy and the WTO



Alternative methods

- Integration and Consolidation
- Introduction of foreign partners
 - JV, Share liberalisation, New Subsoil Law
- Extending the value chain
 - Downstream (Distribution & Products)
 - New markets
- Gradual Domestic Price Increase
 - 2000: c. \$10/tcm, 2020: c. \$65/tcm
- Domestic consumer pricing band modification & Metering/Valve installation (costs?)



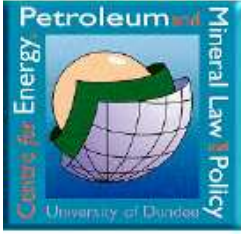
Alternative methods cont'd

- Clarify position on UGTS access
 - The FTS has clearly outlines the TPA rules for access to the UGS which have been incorporated into Federal Law.
 - The tariff for the transit of gas is also published and incorporated into Federal Law.
 - “Policy Governing the Preparation and Issuance of Permits to Independent Entities Seeking Access to Gazprom’s Gas Transportation System.”
- Foreign partners in Sakhalin, Shtokman, NEGP.
- Domestic spot market



Conclusion

- Deregulation unnecessary and impractical at this stage
- Aims can be achieved via other methods
- Some already being implemented
- Contrary to some opinions, Gazprom not stupid
- Proof is in the gas!



Acknowledgements

- Vadim Kleiner at Hermitage Capital Management