

PGC C – Study Group C3 (Europe and Russia) Sub-Group: “EUROPE – Pricing and Regulatory Development”

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EUROPE – a Paradigm Shift?

There is a strong momentum to change in European Gas Markets – driven by 4 factors:

- Gas Fundamentals : Long supply until 2009 followed by economic recession
- Buyers' Strategies : Seeking less exposure to long-term commitments
- Regulatory Changes : EU 3rd package liberalization agenda
- Connectivity : Physical Connections interlinking the markets

Interlinking factors result in changes in PRICING mechanisms. Transition to spot from oil-indexation trends observed.

Is this a Paradigm Shift to a new era OR just a temporary situation?

Price patterns in Europe:

- Majority (95%) of gas sold in Europe is priced at either i) gas-on-gas or ii) oil-indexation
- Clear tendency to gas-on-gas (hub pricing). The volume of gas sold under hub pricing has increased from 15% in 2005 to 28% in 2009 (Nexant data)

How did BAFA (German import price, oil dominated) and NBP (spot) move?

- Moved in same direction – until 2008 recession
- Diversion at mid-2008 caused by:
 - Demand side: Serious demand cut due to 2008 economic recession
 - Supply side: More LNG and US shale available
 - Spot prices fell well below oil-indexation since they reflect “fundamentals”
- Recovery; i.e. Convergence of BAFA and spot is observed post mid-2010 by i) demand recovery, ii) LNG pull of Japan
- Spot prices are not always “cheap” but react more aggressively and rapidly to market changes
- Supply/Demand fundamentals will continue to affect. (recession ongoing?, less domestic production, US shale and LNG effect and post-Japan nuclear trends)

Oil Indexation

For

- **Traditional** – buyers and sellers understand
- Oil is liquid and transparent
- 6-9 months lags smooth out the fluctuations in price
- If oil & gas is substitute, correct pricing
- Upstream confidence for huge investments

Against

- Oil & gas are no more substitute fuels
- Does not reflect supply/demand factors
- **Decoupled markets**

Hubs & Spot

For

- Reflects supply/demand factors in gas markets
- **Decoupled gas & oil markets**; not substitute fuels
- Transparent – no need for “secretive” LTCCs
- Accelerated upstream investment without LTCC negotiations

Against

- Hubs take time to develop and market to become confident that prices truly reflect market conditions
- **Insufficient liquidity** as a reference point
- Spot means low prices (not true over long-term)

EU Policy – target to create a “**single gas market**”.

EU 3rd Package addresses the way forward. New institutions and new rules:

- Unbundling
- National Regulatory Authorities
- Consumer Protection
- Transmission
- Network Codes
- Ten-Year Network Development Plans
- ACER (Agency for Cooperation of Energy Regulators)

***These will reinforce changes coming from
fundamentals
companies' purchasing strategies
physical interconnections***

Physical Interconnections

Expansion and Interconnection projects are ongoing throughout Europe:

For example:

- Southern Corridor (Nabucco, ITGI, TAP)
- SE Europe interconnections

As markets are physically linked, pricing patterns would also become interlinked.

Tendency to convergence is expected as arbitrage opportunities arise.

Big (45bcm) and fastest growing gas market in Europe

- Gasification started in late 80s, still immature market
- Aggressive demand growth post 2009 recession (15% growth in 2011)
- Supply gap approaching – supply security being the overriding issue

Dependent on imports – Russia, Iran, Azerbaijan and LNG

At the crossroads of all Southern Corridor projects

- Desire to become a transit/hub country
- Important for Europe's supply security and diversification
- Transit country for Azerbaijan and probably for Iraq and other Caspian resources

Challenge is to create an open, transparent gas market where the growing demand is met while hosting the big international transportation projects.

Currently dependent on long-term oil-indexed contracts but authorities watching the changes with huge interest

THANK YOU

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Gas prices - HH, NBP & BAFA 2004 - 2011 (in mmbtu)

