Draft comments on European Security and Natural Gas Supplies

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Two distinct but seemingly contradictory trends in European natural gas markets will influence the security of natural gas supply for the foreseeable future. One such trend is the European Union's program of gas market liberalization. The other trend is the entry of foreign gas suppliers into the EU's downstream market, primarily through joint ventures with established European natural gas companies. Each of these trends, according to its advocates, contributes to supply security.

Market liberalization and supply security

The original argument presented by advocates of market liberalization was that competition yields lower prices. More recently, advocates claim that in a liberalized market, price signals will lure adequate investment in infrastructure at the appropriate times and places and thereby guarantee adequacy of supply.

When evaluating these arguments, we have the advantage of observing two markets that have been liberalized: the United States since 1978 and the United Kingdom since 1986. Global energy prices have risen since then, so it is difficult to say whether natural gas prices in the US and UK are lower today than they would have been in the absence of market liberalization. We can note, however, that spot gas prices in these markets have displayed considerable volatility.

Particularly sharp spot price upswings occurred in the United States due to cold snaps in the winters of 2000-01 and 2002-03, and again in the autumn of 2005 when Hurricane Katrina knocked out natural gas production in the Gulf of Mexico. In the UK, an exceptional price peak during the winter of 2005-06 resulted from an unanticipated decline in North Sea production and inadequate storage capacity, aggravated by a fire at the UK's largest gas storage field.

In these examples, sudden, sharp price upswings (reaching as high as double their pre-crisis values) induced fuel switching and factory shut-downs, and thereby obviated the need for government-imposed rationing. Had prices been capped and rationing

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introduced, these incidents might have been more widely perceived as examples of supply insecurity.

In theory, an expectation of sustained higher prices should induce investment in infrastructure. However, as one can observe from the petrochemical industry, competition often results in cyclical investment peaks and valleys. At times, there is a surplus of capacity and prices are driven below long-run marginal costs. This situation continues until demand catches up with available capacity, prices rise, and a wave of investment occurs, resulting in renewed excess capacity, and so forth.

Some may argue that the large number of LNG receiving terminals under construction or planned in the United States and the UK demonstrate that liberalized markets ensure adequate, timely investment in natural gas infrastructure. Indeed, since the combined capacities of these terminals vastly exceeds expected demand, some may argue that competition even guarantees that idle capacity will be available in emergencies.

Unfortunately, what we are observing is rather a speculative boom. Many of the announced projects will never be built, and to the extent that overbuilding ahead of demand occurs, the resulting low margins may serve only to deter further investment. The truth about competitive markets is that investors seek to invest in productive capacity, not idle capacity, and to the extent idle capacity temporarily emerges it is the result of cyclical aberrations.

Not only do competitive markets fail to yield sustained idle capacity, they can easily result in inadequate capacity if other regulations impede investment. The slowness of approvals of new LNG receiving terminals in Italy and the lack of construction of any new grassroots refinery in the United States in decades both illustrate the degree to which local opposition and environmental regulations can delay market responses to price signals.

To the extent that sustained idle capacity is an essential element in ensuring uninterrupted physical supplies or avoiding exaggerated price swings, idle capacity must either be imposed by regulation, or provided directly by the government. Logically and most efficiently, the need for idle capacity would be defined and regulated at the EU rather than the national level, but national governments appear reluctant to allow this to happen.

The EU Directive on natural gas supply security[2] instructed Member States to ensure supplies for household customers under specified critical circumstances, and created a Gas Coordination Group "to facilitate the coordination of security of supply measure[s]." The Directive stops far short of creating an EU-wide plan to assure that sufficient idle capacity is available when and where it is needed in a crisis.

The Directive is, in Commissioner Piebalg's words, a "watered-down" version of the Commission's original proposal.[3] "It is clear", the Commissioner stated, "that Europe

[2] Directive 2004/67/EC of 26 April 2004

[3] Andris Piebalgs, EU Energy Commissioner, "Speaking notes welcoming the agreement between Gazprom and Naftogaz", Brussels, 4 January 2006

needs a clearer and more collective and cohesive policy on security of energy supply. To date, the issue of security of energy supply is only really considered at national Member State level; but in reality we need a much greater European-wide approach on this issue."

In summary, then, the argument that market liberalization improves supply security requires a number of significant caveats. Considerable work remains before the necessary architecture of European gas security is in place.

Foreign suppliers' downstream ventures and supply security

The parallel but seemingly contradictory trend is the entry of foreign gas suppliers into the EU downstream market, primarily through joint ventures but also, in a few cases, independently. Many of the joint ventures involve the same large European gas transmission and distribution companies who are the targets of the EU's liberalization policy.

International natural gas trade has thrived for decades on long-term, take-or-pay relationships between exporters and importers. These bilateral relationships have been likened to a marriage, or to the two wings of an airplane, and in general they have endured and have served both parties well. With few exceptions, price renegotiations under such contracts have occurred without interruption of the flow of gas, with any agreed price changes being applied after-the-fact to gas delivered during the renegotiation period.

Cross-ownership of transportation facilities has frequently supplemented the contractual relationships. For example:

- ENI and Sonatrach jointly own the Trans-Med Gas Pipeline from Cap Bon, Tunisia to Mazara del Vallo, Sicily, in uninterrupted service since the early 1980s.
- The Japanese company Mitsui has been a partner in the Abu Dhabi Gas Liquefaction Company (ADGAS) since it was founded in 1973 to export gas to Japan.

In recent years, joint ventures up and down the gas value chain have become almost the norm in international gas trade. Some joint ventures focus on gas transportation and storage, while others include downstream marketing activities. Here are just a few examples:

- Wintershall AG formed two joint ventures with Gazprom in 1993 to market Russian gas first in Germany, and subsequently in Austria, Belgium, France and the UK
- Sonatrach jointly markets LNG in Europe in association with both BP and Gaz de France, and holds minority shares in LNG receiving terminals in Spain
- Sonatrach formed joint ventures with European partners to build two new trans-Mediterranean gas pipelines (Medgaz and Galsi)

- Sonatrach owns 30% of the gas marketing arm of the Spanish company CEPSA, and reportedly has offered to purchase 30% of the parent company from Banco Santander[4]
- SOCAR, the Azeri national oil company, is a joint venture partner in the Shah Deniz (South Caucasus) gas pipeline across Georgia to Turkey
- Qatar Petroleum, a major gas exporter, is a joint venture partner in new LNG receiving terminals under construction in the UK, Italy and Texas
- BP has reportedly offered Gazprom a share in its Atlantic LNG project in Trinidad

The Nord Stream and South Stream pipeline projects, joint ventures between Gazprom and European partners, also fall into this category. Many other examples could be cited.

Gazprom, in particular, has gone beyond joint ventures and is approaching some European customers independently. A subsidiary, Gazprom Marketing & Trading Ltd., acquired the retail natural gas business of Pennine Natural Gas Ltd. in the UK in 2006, and Gazprom has announced that its subsidiary Gazprom Marketing & Trading France, based in Paris, is selling gas directly to customers in competition with Gaz de France.

Foreign suppliers' downstream ventures have met resistance on both the national and EU level. The Spanish government initially decided to limit Sonatrach's direct marketing of gas in Spain to 1 bcm/yr (about 3% of the Spanish market), but later relented and doubled the permitted ceiling. Italian regulators blocked Gazprom's first attempt in March 2006 to form a joint venture with ENI, and the head of Italy's Antitrust Authority was quoted as calling the companies' second attempt "anticompetitive".

The European Commission is reported to be preparing to propose a series of measures that would restrict foreign ownership of downstream energy assets in the EU. According to press reports, a Commission working document suggests that the sale of EU gas and electricity assets to non-EU owners could render the EU "vulnerable to a strategy of third countries to dominate the EU markets not only in terms of supply but also by acquiring the networks".[5]

A contrasting position was UK Prime Minister Tony Blair's assurance, in February 2006, that the UK would not oppose a Gazprom acquisition of Centrica, following Gazprom's admission that Centrica was on a list of "potential acquisition targets" in the UK. According to the Financial Times, Mr. Blair believed "that Britain must stick firmly by its commitment to liberalise European markets" and "must face down the wave of "economic patriotism" shown by some EU states".[6]

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[4] Reuters UK, quoting El Mundo, Wednesday, 5 September 2007

[5] Financial Times, "Russian energy faces EU barriers", 30 August 2007. According to the article, the EU measures are to be announced on 19 September 2007.

[6] Financial Times, "Blair rules out blocking Gazprom bid for Centrica", 25 April 2006. See also: International Herald Tribune, "Russia plays energy card vs. Western investment", 12 June 2006

An objective observer, when evaluating the costs and benefits of downstream EU investment by gas exporters, must take into consideration the following elements:

- International oil and gas companies have long recognized that, once they have invested upstream, their investments make them hostage to changes in host government policies. Should not foreign downstream investors in the EU, once their investments are in place and immovable, likewise find themselves motivated to comply with EU policies and provide uninterrupted service to EU customers? In this regard, the example of Venezuela's continued supply of crude oil to its own Cities Service refineries in the United States, in spite of President Chavez' oft-stated hostility to the United States government and his desire to divert exports toward other destinations, comes to mind.

- Natural gas exporters who find themselves in direct contact with customers in the EU will, as part of their marketing program, become highly familiar with the needs of their customers. Such direct contacts will render service interruptions not merely abstract but highly personal events. The bad publicity and damage to the supplier's customer relations will be even more severe than was the case as long as a purely European company was intermediary.

- Outward foreign direct investment (FDI) from transition and developing countries is increasing rapidly. Total FDI from these countries expanded especially rapidly in recent years, reaching $210 bn or about 17% of global FDI in 2006.[7] Russia was the third largest source of FDI outflows from this group of countries in 2006.[8] As these countries' foreign investments expand, their need to protect their investments will similarly grow and their interests will be more closely aligned with those of the traditional capital exporters: the USA, Europe and Japan. As a consequence, they will become increasingly interested in negotiating bilateral investment treaties (BITs). BITs, which are by definition reciprocal, provide for national treatment of foreign investors and for international arbitration of investment disputes. The number of BITs has been expanding rapidly.[9]

<u>Which trend is more likely to yield security of natural gas supply?</u>

At the outset of my remarks, I referred to the two prevailing trends – market liberalization, on the one hand, and foreign suppliers' advances downstream, on the other – as "seemingly" contradictory. Of course, the two are not really contradictory, for the concept of market liberalization implies a free flow of investment from all sources, both domestic and foreign. Indeed, the entire premise that free markets will

[7] "World Investment Prospects to 2011: Foreign Direct Investment and the Challenge of Political Risk", Economist Intelligence Unit and Columbia Program in International Investment, 5 September 2007, p. 28

[8] *ibid.*

[9] At the end of 2006, 174 countries were parties to 2,572 BITs, up from 1,097 in 1995. The Russian Federation was a party to 52 BITs in 2004, compared with 31 in 1995. *Ibid*, p. 68, and the UNCTAD online database.

induce appropriate and timely infrastructure investment would seem to demand such free flows of capital.

In the long run, I expect that the two trends will merge, and the EU will enjoy the enhanced security benefits arising from a liberalized but regulated internal market and from exporter-importer joint ventures in infrastructure. In the near term, however, which trend is more likely to provide the greater contribution to Europe's natural gas security?

I would like to offer for discussion at this seminar the following possible response:

Taking into consideration the slowness of the market liberalization process and the apparent reluctance of Member States to cede market-regulating power to the EU, it may take awhile before the alleged security benefits of the free market will be realized. Meanwhile, the joint ventures of foreign suppliers with EU companies are advancing rapidly to implement the needed infrastructure projects. It would seem, from a security perspective, a pity to throw additional obstacles in the paths of these projects.

Moreover, in a world highly polarized by the unilateral initiatives of the only superpower, it would seem desirable for the EU to encourage individual joint venture gas projects to build commercial bridges between itself and its suppliers, and to integrate those suppliers as closely as possible into the European ways of doing business. Such linkages will have more than purely commercial consequences.

The above draft text is subject to further revision or correction. Comments on this draft are welcome.

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