

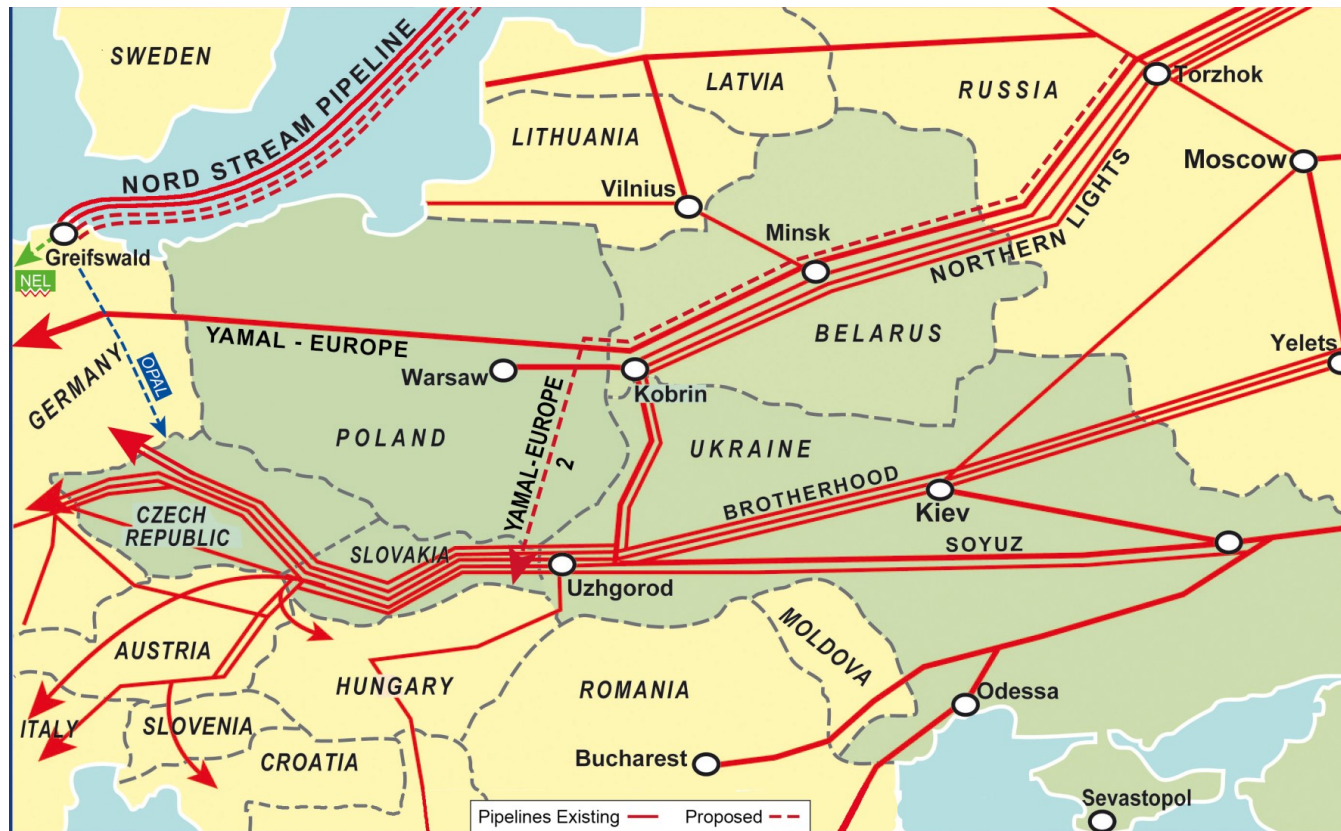
European Regulatory Challenges for South Stream: A Way Forward

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The Western CIS Pipelines



Until recently the western CIS was the only corridor for Russian gas exports to the EU, and hence crucial for EU transit (energy) security

Major transit security incidents in the western CIS in the 2000s

TRANSIT AND/OR SUPPLY INTERRUPTIONS TO CIS

- the 1990s – all three west CIS
- **February 2004, June 2010** – Belarus
- **January 2006, March 2008, January 2009** – Ukraine
- January 2006 – Moldova

SUPPLY INTERRUPTIONS TO EUROPE

- February 2004 (< 2 days), January 2006 (3 days), January 2009 (2 weeks), June 2010 (1 day)
 - **The January 2009 gas transit crisis: the most serious security incident in the history of the European gas industry** – no Russian gas flowing to Europe across Ukraine for 2 weeks

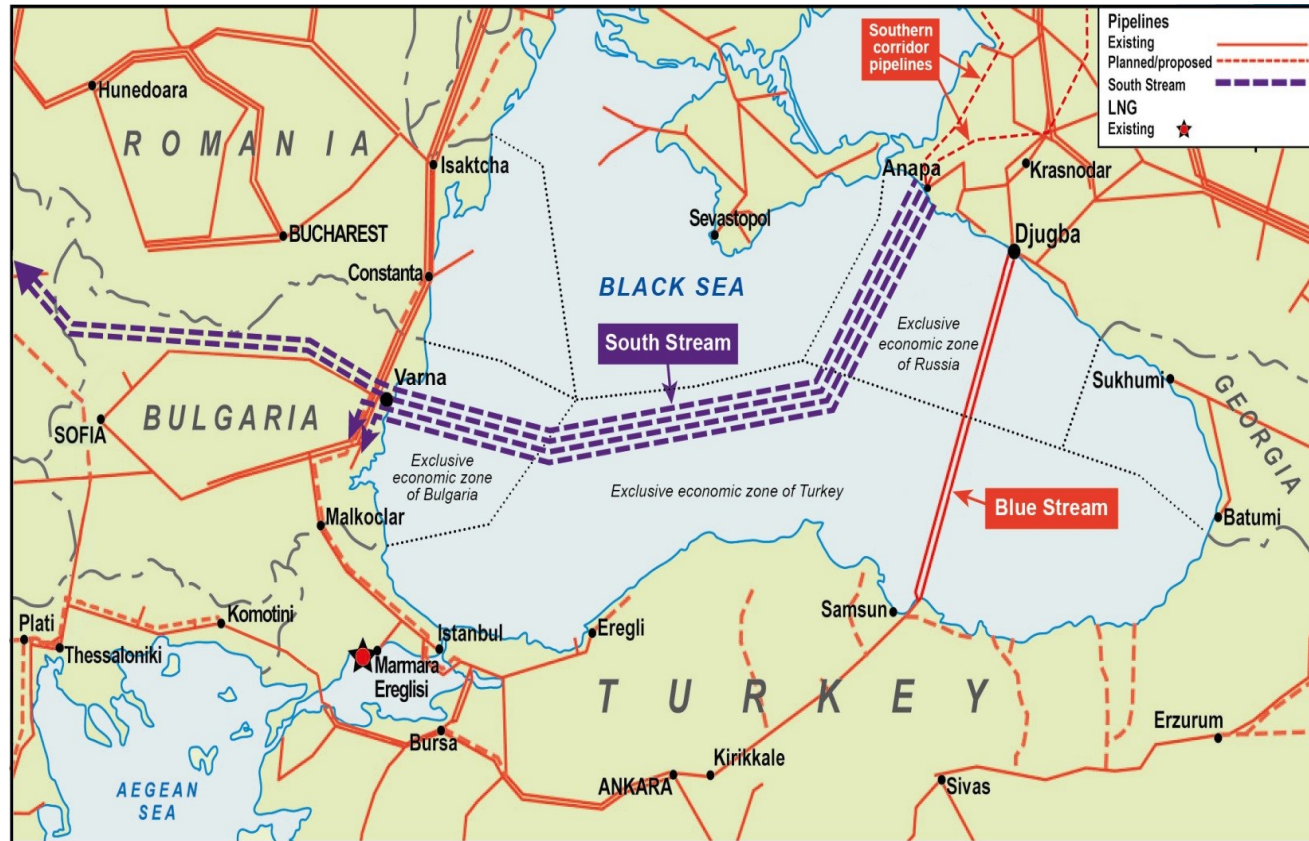
Nord Stream and South Stream are transit-avoidance pipelines and Gazprom's (very expensive!!) solution to the western CIS transit problem

The Nord Stream Pipelines



**Nord Stream 1 – November 2011, Nord Stream 2 – October 2012; discussion of Nord Stream 3 and 4
Gazprom, EON, Wintershall, GDF, Gasunie**

The South Stream (& Blue Stream) Pipelines



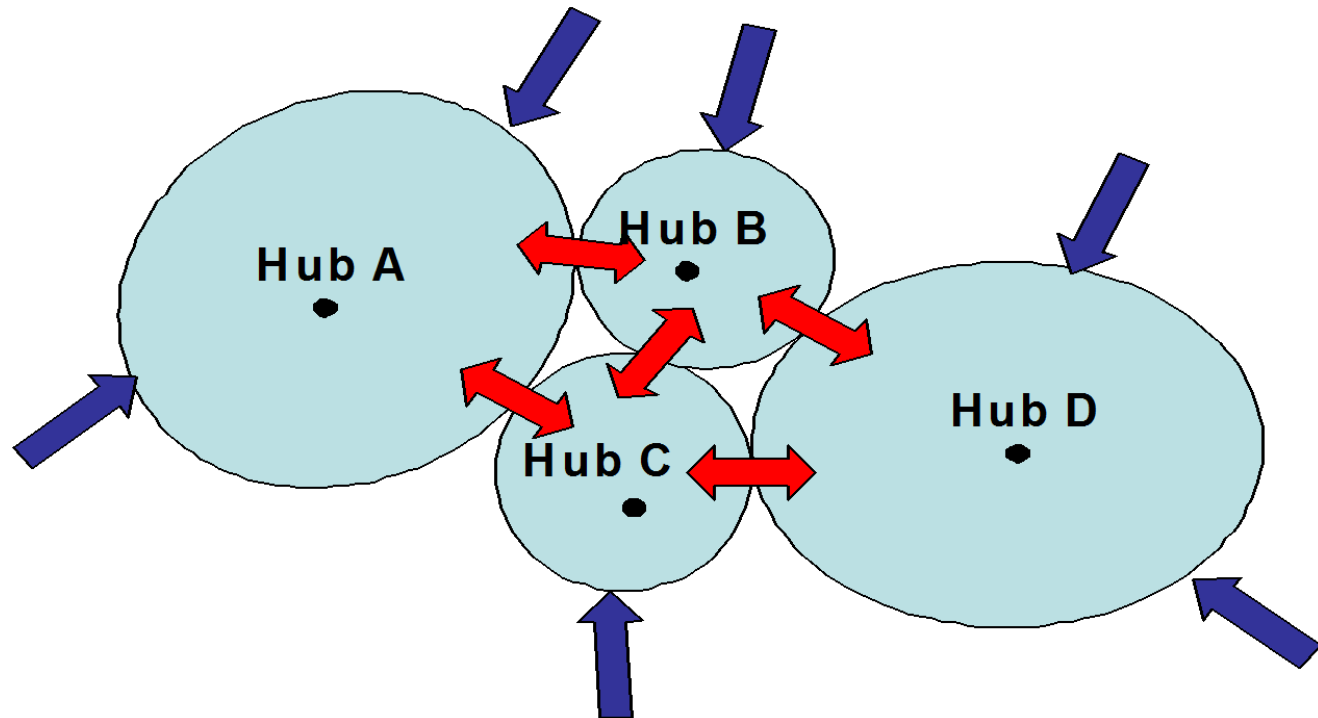
South Stream 1 – 4Q 2015; FID – Nov 2012
Gazprom, ENI, Wintershall, EDF

If South Stream is built then...

- **by 2015, Russian gas will be able to move to Europe via:**
 - a northern route – Nord Stream
 - a central route – Ukraine/Belarus
 - a southern route – Blue Stream/South Stream
- **Estimated spare capacity: 64-85 (2015) & 42-112 (2020)**
- **Gazprom will be able to ‘arbitrage’ between the routes, the power of individual transit countries will be much reduced and Ukraine becomes ‘transit route of last resort’**

But South Stream would need to be built and operated in a very different regulatory environment set up by the 3rd Package

GTM: vision for the European gas market



Source: 17th Madrid Forum

The 3rd Package will change the architecture of the EU gas market through unbundling of transmission assets, division of the EU into several Entry-Exit zones (each with its VTP), auctioning of existing capacity as a an EE bundle

The 3rd Package: the biggest impact is potentially on Gazprom



Number of borders crossed to reach a delivery point	Volumes, bcm/y
1	26
2	30
3	43
4	9

Source: Yafimava 2013

**Gazprom's huge volumes need to cross multiple borders/jurisdictions before they reach LTSCs' delivery points:
not comparable to any other supplier!**

Russian/Gazprom concerns with the 3rd Package/GTM

- Potential loss of capacity under existing capacity contracts (LTTCs) as a result of implementation of the EE regime, with resulting capacity holdings potentially lower (and more expensive) than capacity bookings previously held under these contracts, and hence insufficient for delivery under existing LTSCs
- Challenge of booking additional capacity across a number of EU (and non-EU) borders for delivery under existing & new supply contracts
- Questionable ability to develop & fully utilize new multi-border long-distance pipeline capacity (**e.g. South Stream**)

Possible regulatory frameworks for South Stream

- Under the 3rd Package
- Outside the 3rd Package – exemption
- In parallel with the 3rd Package – PCI status
- Under Intergovernmental Agreements
- “Bespoke” framework

Although Gazprom has solved its transit problem in the western CIS, it is yet to find a solution to its transportation problem in the EU i.e. accommodation of South Stream within the EU regulatory framework

Working under the 3rd Package: 3rd Gas Directive, Gas Regulation, Network Codes

- **Gas Directive**

- Unbundling of transmission assets (OU, ISO, ITO) and certification of TSOs
- Regulated TPA to transmission based on published tariffs, with tariffs or their methodologies fixed or approved by a NRA

- **Gas Regulation**

- Entry-Exit tariff methodology: tariffs set separately for every Entry and Exit point , not to be calculated on the basis of contract paths, transparent & cost-reflective, facilitating trade & competition, avoiding cross-subsidisation, not restricting liquidity.
- **Network Codes** for cross-zone (border) issues
 - CAM (existing capacity) + CMP: Auctions only, Firm Day-Ahead Use-It-or-Lose-It
 - **CAM amendment (incremental and new capacity): Integrated Auctions and Open Seasons**
 - Tariffs, Balancing, Interoperability

Under the 3rd Package: regulatory framework for incremental & new capacity is under development

- **Incremental and New Capacity: definitions & procedures**
 - Incremental: capacity at an existing IP on top of existing capacity
 - New: capacity at a new IP and physical reverse capacity at an existing IP
 - Procedures under considerations for both Incremental and New:
 - *Integrated Auctions (IA)*
 - *Open Seasons (OS)* – capacity across more than 2 market areas or for projects that are too complex that IA would not be appropriate
- Russia suggested the Coordinated Open Seasons procedure for new capacity but limited interest among other suppliers/shippers as no one else is building new capacity under regulated framework

**The CAM NC might be amended by adding a new chapter on
incremental/new capacity**

Working outside the 3rd Package: **Exemption** under Art.36

- 'major new infrastructure i.e. interconnectors, LNG and storage facilities' & 'significant increases of capacity in existing infrastructure' & 'modifications of such infrastructure which enable the development of new sources of supply' may be exempted from various provisions of the 3rd Gas Directive, incl. TPA, Tariffs & Unbundling
- Criteria & Exemption decision-making process: enhance competition in supply and security of supply, not invested unless exempted; NRA decides & the EC either confirms, asks to amend, or withdraws the exemption
- Exemption decision-making process: NRA decides on the exemption (and on rules for capacity allocation, incl the obligation to offer unused capacity to the market) and the EC may either confirm, ask to amend, or withdraw the exemption; EC decision is final & binding
- Precedents: TAP, Nabucco, OPAL

South Stream has not applied for an exemption & undermined its case by taking an FID

Exemption under Art.36: TAP and Nabucco

- **TAP exemption decision granted May 2013 for 25 years from the following provisions:**
 - TPA – for the initial capacity (10 bcm)
 - Tariffs – for both the initial (10 bcm) and expansion (≤ 10 bcm)
 - Unbundling – for the entire project
- **Nabucco exemption decision granted 2008 for 25 years, prolonged May 2013:**
 - TPA – for 50% of technically available capacity (≤ 15 bcm)
 - Tariffs – the tariff model to be reconsidered after 20 years of it results in tariffs differing by $\pm 10\%$ from EU average tariffs

It would be very difficult for the Commission to refuse an exemption to South Stream had it applied for it before taking an FID

Exemption under Art.36:

OPAL – an unlikely template for South Stream

- **OPAL, 36 bcm: problematic access to capacity in onshore extensions of Nord Stream 1 & 2**
 - German regulator BNetzA granted an exemption for 100% but...
 - the EC capped it at 50% and...
 - the EC and Russia were negotiating for more than a year a solution that would allow Gazprom to use all OPAL capacity unless wanted by any other party
 - reportedly some solution was reached in September 2013 but details have not yet been announced

Resolution on OPAL would provide an important indication of future regulatory treatment of South Stream onshore extensions but it seems unlikely to be a template for South Stream

Working in parallel with the 3rd Package:

Projects of Common Interest (PCI) – TEN-E Regulation

- General criteria: project necessary for implementing 'energy infrastructure Priority Corridors and Areas',
 - Southern gas corridor (infrastructure for the transmission of gas from the Caspian Basin, Central Asia, the Middle East and the Eastern Mediterranean Basin to the Union to enhance diversification of supply)
 - North-South interconnections in Western Europe, North-South interconnections in Central & South Eastern Europe, Baltic Energy Market Interconnection Plan
- Specific criteria: (must contribute significantly to at least one) market integration, security of supply, competition, sustainability
- The First List of PCIs was adopted in 2013 (South Stream is not on it); the next List is to be adopted in 2015
 - PCI must be evaluated in line with CBA methodology and be part of the latest available TYNDP

It would be very difficult to argue that South Stream could form part of any of these PCI Priority Corridors & Areas

Working under **Intergovernmental Agreements (IGAs)**: inside or outside the 3rd Package?

- A pipeline project could be developed on a basis of intergovernmental agreement (IGA) signed with a host country, which territory the pipeline will cross
- Such IGA might award the project a status of a 'Project of National Interest' which would create supportive regulatory framework for the project
- However, should such IGA – signed by an EU Member State – be incompatible with the 3rd Package, the European Commission could request a host Member State in question either to
 - Re-negotiate and amend the IGA in question, and bring it in full compliance with the 3rd Package, or else
 - Request to denounce the IGA
- It is not clear what the Commission powers are in respect of an IGA signed by the government of a host non-EU EnCT country

Although South Stream has signed IGAs with all the countries, which territories it will cross, these IGAs are not immune to changes

South Stream: major challengers

- Appears extremely difficult to build under the 3rd Package
- Might fall under incremental capacity framework if no specific framework for complex new capacity is developed
- Cannot be built outside the 3rd Package framework as it does not have an exemption under Art. 36 (3rd Gas Directive)
- Cannot benefit from the favourable PCI regulatory framework within the 3rd Package as it does not have a PCI status (TEN-E 2013)
- IGAs with South Stream host countries might run into difficulties as/if not compatible with the 3rd Package
- Unless a “bespoke” framework – e.g. Project of Mutual Interest status – is developed jointly by the EC and Russia, difficult to see South Stream commercially viable

South Stream might become operational in late 2015 – ahead of any EU regulatory framework for new capacity, which might (or might not) be developed later – this is a problem both for the EU-Russia gas relationship, and for EU-Russia political relationship!!

South Stream: a way forward

Exemption

- **European Commission:**
 - “...if South Stream comes and says: ‘We want to have an exemption,’ we will look at that. But so far we have not got this... ”
[Marlene Holzner, spokeswoman for Commissioner Oettinger for New Europe, 15.11.13]
- **South Stream has not applied for an exemption**

Making a room for South Stream in the Third Package?

- **Development of the Coordinated Open Seasons procedure?**

“Bespoke” framework

- **A Project of Mutual Interest status?**
 - **Criteria? How different it would be from exemption criteria under Art. 36 or under PCI? Can PMI be just another name for an exemption?**
- **Bilateral EU-Russia infrastructure agreement?**

Uncharted waters: much wisdom and diplomacy on both sides will be needed to prevent a situation when South Stream arrives at the Bulgaria shores and no regulatory framework for it is in place

Is Ukraine a secure transit corridor?

UKRAINE:

- if no concession on price then arbitration, revision, liquidation /reorganisation; 'No' to a bilateral Gazprom-Naftogaz JV, with Brussels (more then ever) hesitant about trilateral JV

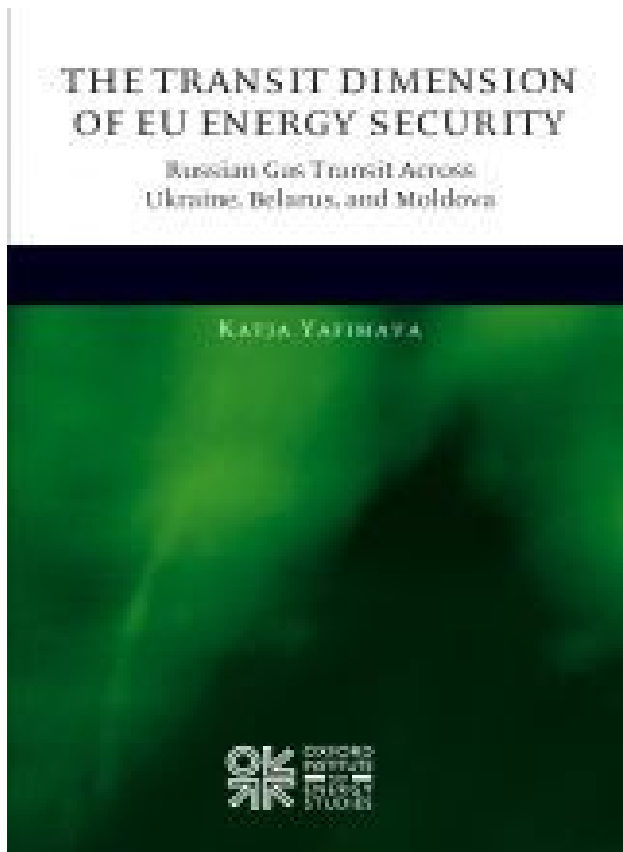
RUSSIA & Gazprom:

- Price concession only if (partial) network ownership, storage, increased access to market, membership in the CU/SES
- \$7 bn bill for TOP failure (27 instead of 41.6 bcm) in 2012
- Missed payment for August 2013 actual deliveries – Gazprom has a contractual right to invoke a pre-payment clause

EC: never stated unreliability of the Ukrainian corridor

Gazprom made no concessions yet, Ukraine has not abrogated the Jan 2009 contract, and it is not likely (but not impossibly) to do so.

Any new transit crisis would provide Gazprom with extra justification for South Stream and strengthen its argument that South Stream within the EU regulatory framework



Thank You!
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