

**27rd round of Informal Russia-EU Consultations on EU Regulatory Topics
&
20th meeting of the EU-Russia Gas Advisory Council's
Work Stream on Internal Market Issues (WS2 GAC)**

1 July 2016

**E-Control
(Rudolfsplatz 13A, A-1010 Vienna, Austria)**

MINUTES

- 1 Opening remarks by Mr Wolfgang Urbantschitsch, Executive Director of E-Control**
- 2 Greetings / Opening remarks by Co-Chairmen**

After opening remarks by Mr Wolfgang Urbantschitsch, Executive Director of E-Control, who have welcomed the participants and once again have reaffirmed readiness of E-Control to host the GAC meetings should they take place in Vienna, both WS2 Co-Chairs, Mr Walter Boltz and Mr Andrey Konoplyanik, also welcomed the participants. Co-Chairs have informed WS2 that due to conflicting schedules neither representatives from the European Commission (Mr Klaus-Dieter Borhardt and Mr Kristof Kovacs), nor Consultations' Co-Chair from Russian side (Mr Alexander Medvedev) are able to attend the meeting (that day Mr Borhardt and Mr Medvedev participate at the meeting with Gazprom CEO Mr Alexei Miller in Saint-Petersbourg). Therefore, where possible, Mr Boltz will report on behalf of the European Commission.

- 3 State of the development of interconnection agreements in South-East Europe
(continuation of the discussion)**

Mr Boltz stated that the European Commission is keen on bringing the old existing contracts in line with the new legal framework. The matter has now taken a very positive step forward with the signing of the interim (1 July-1 October) protocol between Gazprom export and Bulgartransgaz and subsequently the interconnection agreement between DESFA and Bulgartransgaz.

Ms Zhur further informed that the European Commission took part in negotiations and that its contributions were highly appreciated.

She reported that the plan is to have a full interconnection agreement in October. In order to do that both MSs have to align their national legislations to the EU NCs, the test period shall be passed successfully and necessary contractual changes are implemented. If that is not the case, a new interim solution has to be signed. Mr Boltz stressed that in case a new interim solution has to be found, the European Commission should be included in the discussion.

Mr Konoplyanik highlighted that a 1 month delay in signing the protocol between Gazprom export and Bulgartransgaz (against the intended dates mentioned at the previous WS2 meeting on 22.04.2016) did not occur due to the unwillingness of the parties to come to an agreement, but rather due to different and sensitive commercial interests involved, related technical and operational issues and thus substantial (and in result more lengthy) negotiations.

4 EU draft legislation on Incremental capacity (TAR and CAM INC): Update on current status of the ENTSOG-managed „Reality check“ of incremental process

Mr Vitovsky reported on the past work of the reality check work group, which met 10 times since the kick-off meeting in February 2016. So far, the reality check work group has developed 7 recommendations, which were sent to the European Commission. These 5 recommendations were included in the CAM NC by the European Commission:

- Booking horizon for existing capacity: Art. 11(3) [CAM]
- Absence of/late NRA decisions: Art. 24(1)-(2) [former Art. 20b(5)-(6)] [CAM]
- Auction as a 'fall-back' from AAM: Art. 24(2) [former Art. 20b(6)] [CAM]
- Definition of Alternative allocation mechanism: Art. 3(24) [former No. (6)] [CAM]
- Application of fixed price: Art. 25(1)(b) [TAR]

The following 2 recommendations, which were sent to the European Commission on 3 June 2016, were not included in the CAM NC text.

- Risk of hampering the INC process due to the intermediary annual auction
- 20% of INC CAP to be set aside

On 28 June the reality check work group delivered 2 additional recommendations, one on the transitional arrangements (CAM NC Art. 27) and the other on the application of mandatory minimum premium (TAR NC Art. 37.3).

Regarding the Art. 27 of the CAM NC the work group raised concerns about the ambiguity of the European Commission's wording. The legal uncertainty may create the risk of delay of already started projects due to a possible re-start. Furthermore, it would increase the financial risk for involved parties due to potential delays. These risks may even lead to an abandonment of already started projects, according to the work group.

The new wording, proposed by the work group would allow a smooth transition between ongoing and upcoming projects:

"Only in the case of incremental capacity processes initiated but not completed before the application date of this Regulation, those processes shall continue in accordance with the existing legal framework, which was applicable when these processes were initiated."

Mr Boltz highlighted the importance of finding a compromise solution for this Article. The wording should reflect, that those projects which have been ongoing and have started under the old regime should be able to continue in the old regime if the shipper/TSO can prove that switching to the new regime would result in serious delay and may hamper the project completion. Such a wording, which includes stricter limitations (need to prove that the switching would have serious impact on the success of a project) may be a good compromise. His proposal was welcomed by several participants. Mr Boltz has volunteered to propose the draft wording for his proposal.

Participants were invited to provide concrete wording proposals to the work group. Mr Vitovsky informed that the European Commission has set a deadline for MSs to provide feedback to 8 July. The new wording should therefore be sent to the European Commission until 8 July.

Furthermore, the work group proposed a new wording for the application of mandatory minimum premium, which is foreseen in Art 37.3 TAR NC. The work group expressed concerns that the TAR NC is not clear on the possibility to apply mandatory minimum premium under alternative allocation mechanisms (AAM). Therefore, it was proposed to add AAM to the 1st sentence of the Art 37.3 TAR NC as follows:

“In case the allocation of all incremental capacity at the reference price would not generate sufficient revenues for a positive economic test outcome, a mandatory minimum premium may be applied in the first auction or alternative allocation mechanism in which the incremental capacity is offered.”

Regarding the 20% CAP to be set aside as foreseen in Art. 20d(4), Mr Vitovsky informed that Frontier Economics published a report (commissioned by ACER), that states that the application of a quota equal to 20% results in only 60% coverage of total costs by upfront commitments (in the particular case and input parameters used by Frontier Economics). The working group once more urged for a flexible approach instead of having a fixed 20% quota.

Mr Konoplyanik pointed out that the argument provided by the European Commission seems to contradict with the idea of prioritization and argued that a fixed quota does not create a stimulation of financiability. From his view, to put together (i) twice-as-high, above standard 10%, fixed 20% quota and (ii) the prioritization issue (i.e. to allocate first among the bidders the shippers with higher NPV), means that such shippers who are ready to take most of upfront costs and risks in development of new capacity (which opens the way for additional gas supplies to the EU, and thus for additional competition) are penalized for taking this additional costs and risks.

The move from a fixed 20% quota to a flexible “up to 20%” formulae would provide an opportunity for a dynamic balance between a steadily political intention of the legislators to reserve a portion of yet-to-be-created capacity for its future short term possible users (if any) and the necessity to stimulate investment by providing flexibility and thus minimizing negative effects of this pure political consideration. Mr Konoplyanik raised a question on how the dialog regarding the 20% quota with the European Commission could be best effectively further developed (notwithstanding the absence of the Commission’s representatives at the meeting).

Mr Kamphues and Mr Poillion expressed the view that key question regarding the quota still stays open: who will pay for extra 20%? Mr Kamphues proposed that this issue could be brought to the attention of the next Madrid Forum. However, he pointed out that different experiences with regard to the 20% quota can be observed. While for large projects this issue is of utmost importance, smaller projects are barely concerned by it. He therefore argued that the multiplier effect of this proposal is quite limited.

Mr Solheim indicated his preference for sticking to the fixed 20% quota since from his view it is the easy way to go forward. Mr Konoplyanik has responded to this that “easy” not always means “efficient/effective”, which seems to be in this particular case.

The second part of Mr Vitovsky’s presentation covered the current status of the virtual realistic case NL-BE-FR INC project. As the demand assessment and the offer levels and corresponding investments have already been finished, the group started with the assessment of economic aspects: reverse price, f-factor, mandatory premium as well as alternative allocation rule. In his presentation Mr Vitovsky provided a brief overview of the first preliminary results.

Mr Vitovsky concluded, that ENTSOG and the involved TSOs and the Prime Movers agreed on prolonging the INC reality check work group until September / October 2016 to finalize the process of

the NL-BE-FR INC realistic case regarding capacity allocation mechanism and economic aspects (reserve price, f-factor and minimum premium).

Concluding, it was agreed that ENTSOG will send a letter to the European Commission, informing about the results and conclusions of the work group. In addition, the Co-Chairs should also send a letter to the European Commission, which emphasises the overall positive reaction of the WS II participants to the proposals of the reality check work group. In this letter, the European Commission should be asked to take account of the findings and the positive response of the WS II. It was agreed that both letters will be sent to the European Commission before 8 July.

Mr Konoplyanik thanked all parties involved for the fruitful cooperation. The testing of a realistic case study made it possible to identify hidden particularities and hidden dangers before the law is in force. Therefore, he proposed to use such an approach also for other legislation processes and NCs.

5 The future of long-term contracts and pricing Russia gas in Europe (continuation of the discussion)

(i) LTCs: the reality of margins distribution in the EU gas market

In his presentation Mr Komlev presented his view on LTCs and the reality of margins' distribution on the EU gas market. He pointed out, that LTCs set ceiling from prompt prices which create tension between suppliers and midstreamers, which lead to contract price downward revisions. According to Mr. Komlev, making contract and hub prices comparable simply by lowering contract prices leads to a new cycle of downward adjustments in the hub prices. He considers the currently existing hybrid pricing system as a magic circle: adjusted prices shape hub prices, which in turn settle below contract and initiate a new round of renegotiations. Furthermore, he stated several reasons why requests for lowering contract prices to prompt and below prompt levels are not justified. According to Mr Komlev:

- Hub prices represent a product of inferior quality compared to contract prices, as LTCs provide security of supply and flexibility
- Classic activities of selling gas to end-users offer utilities/ midstreamers positive margins compared not only to hub but also to import prices
- Despite growing margins in selling gas to end-users this activity is losing prominence for utilities/midstreamers
- The comparison of prompt and contract pricing does not reflect realities of the EU gas market: contract prices should be compared to historic futures/forward prices which fundamentally determine profitability of utilities/midstreamers
- Historic futures/forward prices tend to be higher than contract prices offering positive spreads to the buyers

He justified his remarks by comparing the price of imported pipeline gas and end-user prices in different European countries. He also presented the inequality of expected and actual hub prices historical behaviour compare to typical LTC. He once more highlighted the importance of LTCs which increase SoS and flexibility and underlined that Gazprom clients with an access to liquid hubs reveal no intention to discontinue their long-term commitments with the company and even tend to ask for additional gas volumes above these commitments. But anyway they want to switch to hub prices and preferably hub-minus prices assuming that they will be able to receive even higher returns than under a current hybrid price regime.

Mr Solheim disagreed with Mr Komlev's arguments and commented that not LTC, but gas hubs provide flexibility. As gas is a commodity it should be traded at competitive and liberalised markets, where the price should be based on demand and response. Many participants agreed with Mr Solheim.

Mr. Boltz concluded that even though both parties clearly have very different views, it is still very interesting to discuss this issue. He highlighted the importance of buying gas short term as markets will remain oversupplied for the next couple of years. Nonetheless, he stressed that LTCs as such are very important. The challenge is to define the right balance, so Mr Boltz.

Mr Konoplyanik mentioned that without LTC no additional liquidity in European gas markets will be available. He referred once again to Mr Komlev's argument that fixed and firm LTC obligations of suppliers create the economic fundament for forward and future gas trading in the EU backed-up by LTC guaranteed yet-to-be-delivered volumes. Therefore, he considered LTCs as a backbone for flexibility in the EU market.

6 COP 21 targets: the role of natural gas in decarbonisation and sustainability of the EU economy (and possible consequences for Russian gas)

In his presentation Mr Leonov placed the emphasis on the role of natural gas in decarbonisation and sustainability. He highlighted, that the COP 21 Agreement in Paris presents both opportunities and risks for the gas sector.

Mr Leonov mentioned that the Paris Agreement is the first multilateral agreement on climate change covering almost all of the world's emissions, and the EU became the first major economy to present its climate plan on 6 March 2015, reflecting the 2030 climate and energy policy framework and further with quite ambition and long-term targets till 2050.

According to his opinion, such initiatives create a lot of risks and opportunities for gas industry. By summarizing all of them, it could be said that reduction of level of trust to reach appropriate demand in the long-term puts under question Sustainable Development Cycle in gas sector. This concern becomes more visible when we talk about investments. The planned EU investments vary within the long-term horizon, but essential amount of them is proposed to be spent on RES and energy efficiency development. Concentration of big investments in RES development in prejudice of gas could aggravate the situation with long-term development of international gas sector which directly contradicts to the Sustainable Development goal 7 -- Ensure access to affordable, reliable, sustainable and modern energy for all.

Further on, Mr Leonov assumed that it comes as the result from not very well elaborated methodological approaches and hypothesis during calculation of "carbon trace" in some studies. Talking about the issue at the higher level it is worth to take into consideration reciprocity approach in calculation of GHG & other emissions along different energy sources' lifecycle. A lot of other emissions apart from GHG were not included in calculation methodology which is a relevant issue for RES, coal, nuclear. In result, such non-reciprocal approach in calculations creates wrong perception that oil or coal are more clean energies than natural gas in energy production per se. If manufacturing of energy equipment for "clean" energies (such as RES) and "not-clean" energies (such as fossil fuels, including natural gas) is taken into consideration with corresponding emission at the manufacturing side of the full energy cycle, then it came that the energies considered to be "clean" (RES) are not at all so clean as they have been presented for public opinion as the conclusions of above mentioned studies.

Summarizing the different aspects of natural gas role in decarbonisation and sustainability of the EU economy, Mr Leonov has underlines that under the cover of COP-21 there is no place to hide.

As an example of Mr Leonov's presentation, Mr Romanov

informed the participants about the process related to the study on actual GHG data for diesel, petrol and natural gas, which was commissioned by DG ENER (Exergia-Study). As agreed at the last GAC WS II, the European Commission organised – on the request of Gazprom - a workshop with the consultants of the Study (Exergia / Don O'Connor). Gazprom very much appreciated the opportunity of this meeting with the consultants. At the meeting the European Commission (DG ENER; C2) was informed about a new study that was launched to update results by using actual measured data from gas industry instead of assumptions and calculations based on coefficients. Results are expected in September 2016. Gazprom is committed to best practice and is subject to strong regulatory requirements related to toxic and GHG. Thus Gazprom welcomes any initiatives and is open for consultations and transparent on its methane emission management.

Mr Sudarev called for the need to critically assess metrics, assumptions and data used for calculating GHG emissions. He stressed that the use of wrong data can lead to wrong policy decisions. Mr Sudarev raised concerns that several studies published within the last years may have used wrong methodology and data, which resulted in misleading study results. By way of examples he listed the Pöyry study on the comparison of GHG emissions from hard coal-fired power plants and gas-fired power stations incl. indirect emissions (2016) and the finding of the US Department of Energy on LC GHG perspective on exporting LNG from the US (2014).

Mr. Sudarev presented also the key findings of the recent Study (2016) of the Karlsruhe Institute of Technology (KIT) that reveals clear relationship between oil and gas production in the USA and increase in atmospheric methane. At least 40% of the worldwide methane concentration increase after 2007 results from the growing production of oil and gas in the northern hemisphere. KIT has stressed in the study that their scientific findings contradict to official estimates of the US Environmental Protection Agency that reports constantly low or decreasing methane emissions from oil & gas sector during the past ten years.

Concluding, Mr Sudarev underlined that the key weak point in the Life Cycle Analysis of natural gas - the methane leakage - originally emerged from the US shale phenomenon has been transferred on the whole natural gas in an exaggerated form. In his opinion, there is a strong need for a reliable assessment on a stand-alone basis for different gas sources with possible classification of natural gas of different origin.

The suggested by Mr Sudarev possible next steps in respect of natural gas role in the achievement of the COP-21 targets were discussed and commented as follows. In general the participants shared the speakers' view on the alarming signs triggered by a variety of studies aimed at diminishing the ecological benefits of natural gas. Acknowledging a standing serious threat to the position of natural gas in the European energy balance the participants called for urgent actions to counter the negative tendencies.

1. Build-up a dialog on methodological aspects of the ETS revision and its influence on the future structure of the EU energy market.

The co-chairs (Mr. Boltz and Mr. Konoplyanik) are intending to check if the work on the methodological aspects corresponds to the scope of work of the WS 2 or it should be better to be carried out by the WS 1. Mr. Boltz stressed the importance of providing some solid and scientifically proved argumentation, he argued nevertheless skeptically if any gas industry related associations / institutions were appropriate for defending natural gas and its environmental benefits.

2. Revision of EU-Russia energy road map 2050 with the focus on the most effective way of securing the Sustainable Development and achieving of COP-21 objectives (complimentary usage of natural gas and RES).

Mr. Konoplyanik named this initiative as positive one, but expressed his doubts about the immediate results to be achieved here. Taking into account the actual circumstances it is difficult to rely in this respect on such a strategic document as EU-RF energy road map. Mr. Sudarev pointed out that after signing of the COP-21 Russia has also launched a corresponding working process on the revision of the regulation of GHG emissions and that it opens a field for cooperation between both sides to synchronize (where reasonable) the processes and to harmonize respective standards and norms.

3. Working out of the unified methodology of GHG emissions calculation for the gas infrastructure: exploration, production and transportation.

Mr. Kamphues welcomed and supported the initiative, he advised to contact GIE, as a body actively engaged in the corresponding activities. Regarding the implications for some constant tasks of the ENTSOG, such as the coordination of TYNDP, a joint work on elaborating carbon footprint of the envisaged infrastructure would make sense. The first thing to be done is still to contact GIE and explore their possible attitude to the idea and readiness to be involved in the cooperation process. In order to support the entire issue of the role of gas in decarbonization and the Sustainable Development of the EU economy, the co-chairs agreed to address it with some supportive explanations based on the first findings from the corresponding presentations to the Chairmanship of the GAC in order to sensitize the both sides and to urge to a closer cooperation in this field with the potential aim to restart GAC meetings with this issue on the agenda. The ambitious goal might be to check whether such restart would be possible already in October this year back-to-back with next WS2 GAC/Consultations meeting planned to be held in October 2016 in St. Petersburg.

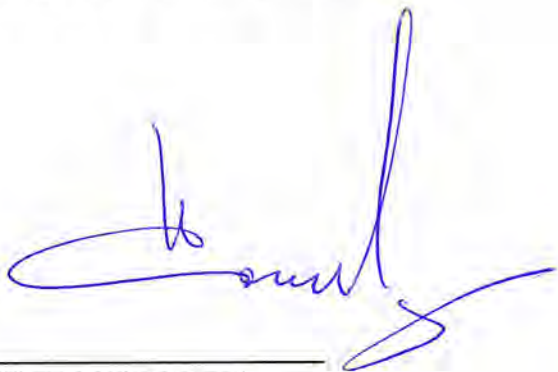
7 Any Other Business / Concluding remarks / Next meetings

It was agreed to organise next meeting of WS2 GAC, based on Mr Medvedev kind invitation that he has expressed at the previous WS2 meeting, in Mid-October in Saint-Petersbourg to be hosted by Gazprom Group (particular date to be agreed upon later).

Both Co-chairs thanked the participants for their active participation, signed the Minutes of the last GAC WS II meeting, and closed the meeting



Co-Chair Mr Boltz



Co-Chair Mr Konoplyanik

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20th meeting of the EU-Russia Gas Advisory Council's
Work Stream on Internal Market Issues (WS2 GAC)**

01 July 2016

10:30 – 16:30

E-Control

Rudolfsplatz 13A, A-1010 Wien, Austria

AGENDA

Time	Items	Presenters
Morning Session 10:30-13:00	1. Opening remarks by Mr Wolfgang Urbantschitsch, Executive Director of E-Control	W.Urbantschitsch
	2. Greetings / Opening remarks by Co-Chairmen	W.Boltz, A.Konoplyanik
	3. State of development of interconnection agreements in South-East Europe (continuation of the discussion): (i) view of Gazprom export (GPE) (ii) view of EU/NRAs	A.Zhur (GPE),
	4. EU draft legislation on Incremental capacity (TAR and CAM NC): Update on current status of the ENTSOG-managed "Reality check" of Incremental process	J.Vitovsky (ENTSOG) et al
Lunch 13:00-13:45		
Afternoon Session 13:45-16:30	5. The future of long-term contracts and pricing Russian gas in Europe (continuation of the discussion): (i) LTCs: the reality of margins distribution in the EU gas market	S.Komlev, A.Gnatyuk (GPE)
	6. COP-21 targets: the role of natural gas in Decarbonization and Sustainability of the EU economy (and possible consequences for Russian gas)	D.Leonov (GP), N.Sudarev (GP Germany), K.Romanov (GP)
	6. Signing the Minutes of the WS2 meeting of 22.04.2016	W.Boltz, A.Konoplyanik
	7. Any Other Business / Concluding remarks / Next meetings	W.Boltz, A.Konoplyanik

Participants

Boltz Walter	Co-Chair of WS2
Cherniy Boris	Saint-Petersburg International Merchandise Exchange (SPIMEX)
Dickel Ralf	Energy Consulting
Gnatyuk Alexey	Gazprom export
Gudkov Ivan	Gazprom
Gusenbauer Vera	E-Control
Ischia Alessandro	E-Control
Kamphues Stephan	ENTSOE, Co-Chair of WS3
Komlev Sergey	Gazprom export
Konoplyanik Andrey	Gazprom export, Russian State Gubkin Oil & Gas University; Co-Chair of WS2
Leonov Denis	Gazprom
Loudon Margot	Eurogas
Mazilov Vladimir	Gazprom export
Mourtzikou Angeliki	RAE
Orlova Ekaterina	Institute for Energy & Finance
Painz Bernhard	E-Control
Poillion Christophe	GRTgaz
Romanov Konstantin	Gazprom
Rossi Maria Anais	Eni
Sedláček Milan	eustream
Shtilkind Theodore	Russian Energy Ministry; Co-Chair of WS3
Solheim Steinar	IFIEC Europe
Steiner Gottfried	CEGH
Sudarev Nikolay	Gazprom Germania
Sukhotskaya Anna	Gazprom export
Timofeev Ivan	Gazprom export
Yafimava Katja	Oxford Institute for Energy Studies
Zhur Anna	Gazprom export