



# US LNG and EU Antitrust against Gazprom?

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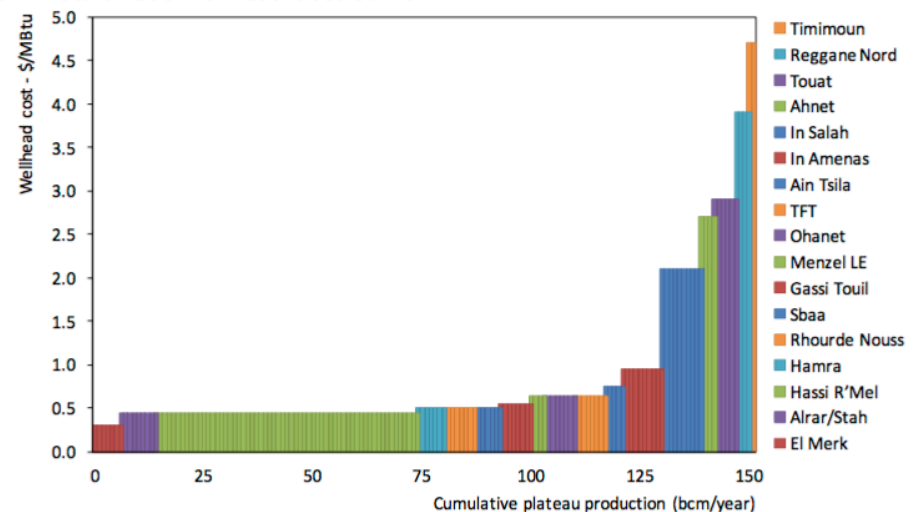
# Introduction

- New pressures of competition on Gazprom from both the market and the law since the the mid 2010s
- US and global LNG
  - LNG global supply glut
  - US ready to export LNG everywhere, including to the close EU
- Forced competition by EU law
  - As a settlement in Commission v. Gazprom, a series of commitments are entering into force, including introducing competitive gas price benchmarks into price review clauses
- What will that change for Gazprom and the EU?

# The fundamentals 1/2

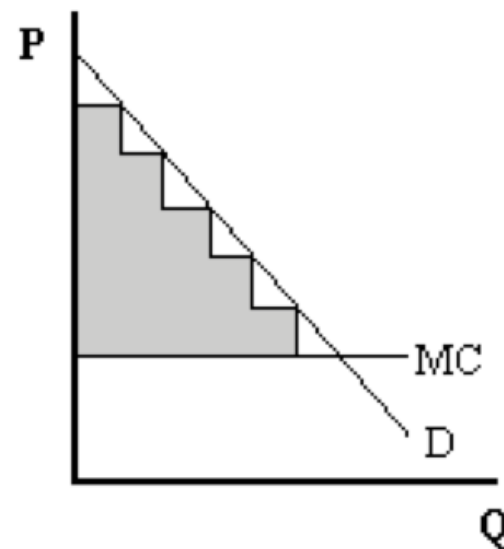
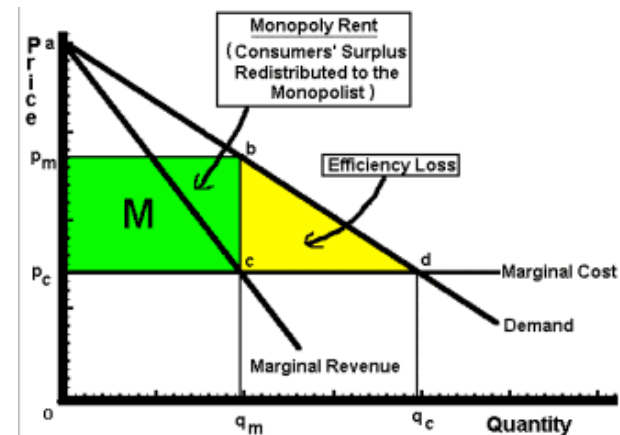
- Natural gas as a commodity and exhaustible resource
  - Price cycles
    - Market price falls at short term marginal cost when capacity exceeds demand, skyrockets in case of under-capacity
    - On long period, prices are supposed to equal the long term marginal cost at equilibrium
  - Rents
    - Hotelling or scarcity rent
    - Ricardian rent: The higher for low costs producers, zero for the marginal producer

Figure 2: Natural Gas Wellhead Cost Curve



# The fundamentals 2/2

- Natural gas as an oligopoly
  - Opportunities for firms to exert market power
    - Quantity withdrawing
    - Price discrimination
    - Cartelizing



# An impossible cartel

- Seventeen years after, the dream of Algeria, Iran, Qatar and Russia is definitely over
  - The Gas Exporting Countries Forum founded in 2001
- It was then low likely to succeed as an OPEC like cartel because of diverging interests and outsiders
- Today, regasification capacity in EU is high (and underused) and LNG players as potential entrants are both numerous and heterogeneous

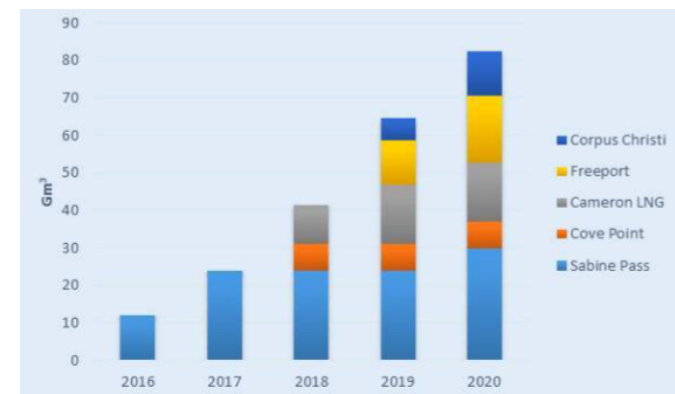
# A price war?

- The 2016 headlines
  - April: a tanker loaded with US gas takes the route of Portugal
  - May 2016: « We don't see to wage a pricing war » Medvedev's interview
- The ingredients
  - LNG glut
  - US LNG exports capacity

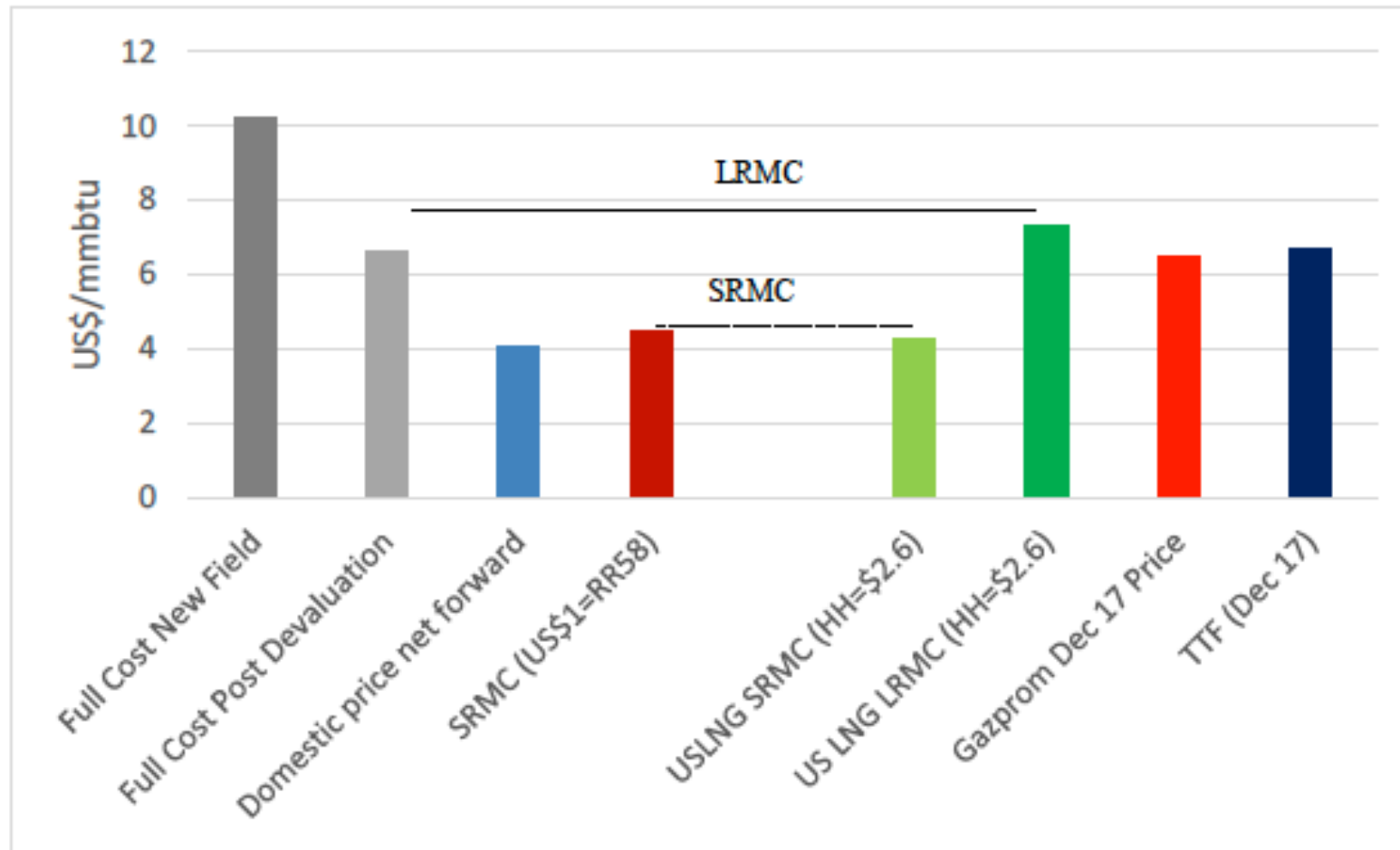
## THE WALL STREET JOURNAL.

### First U.S. Gas Shipment En Route to Europe

American LNG shipment could spark price war in Europe

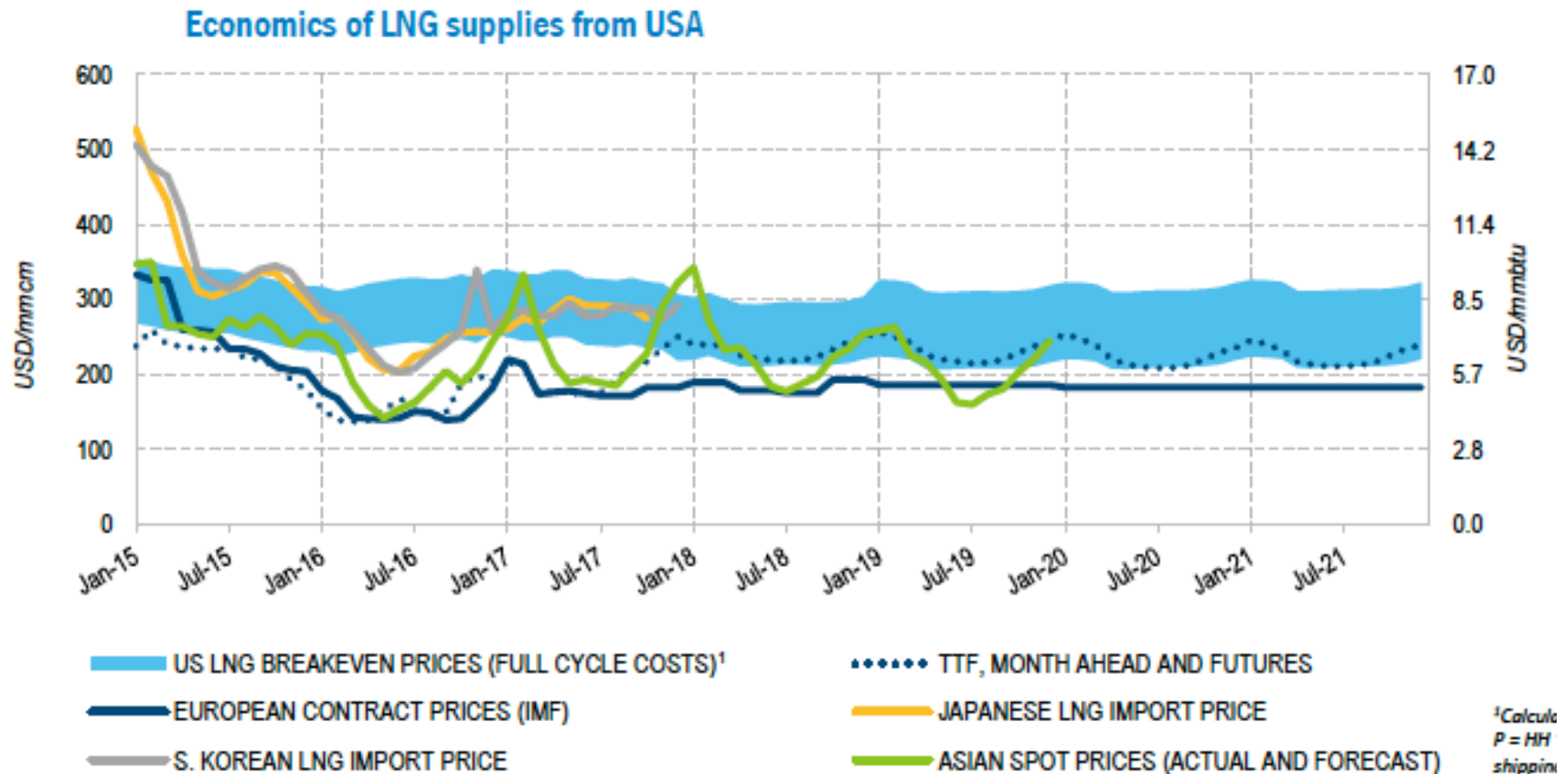


# A close but volatile cost differential between Gazprom and US LNG



(Source: Henderson and Sharples, 2018)

# European market is not a first choice for US LNG



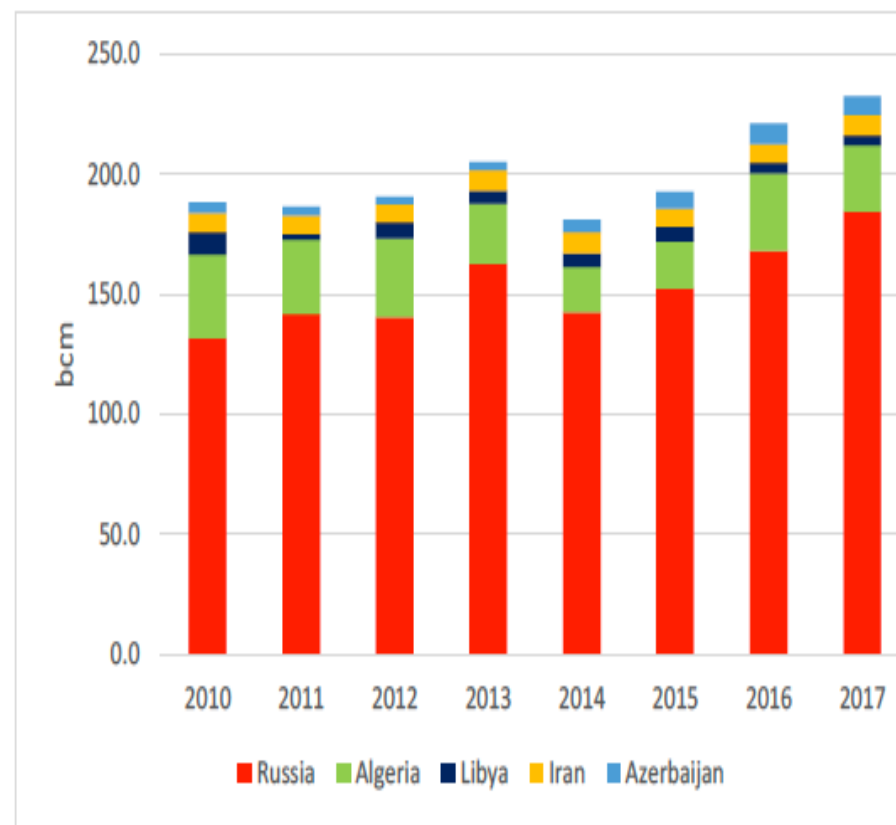
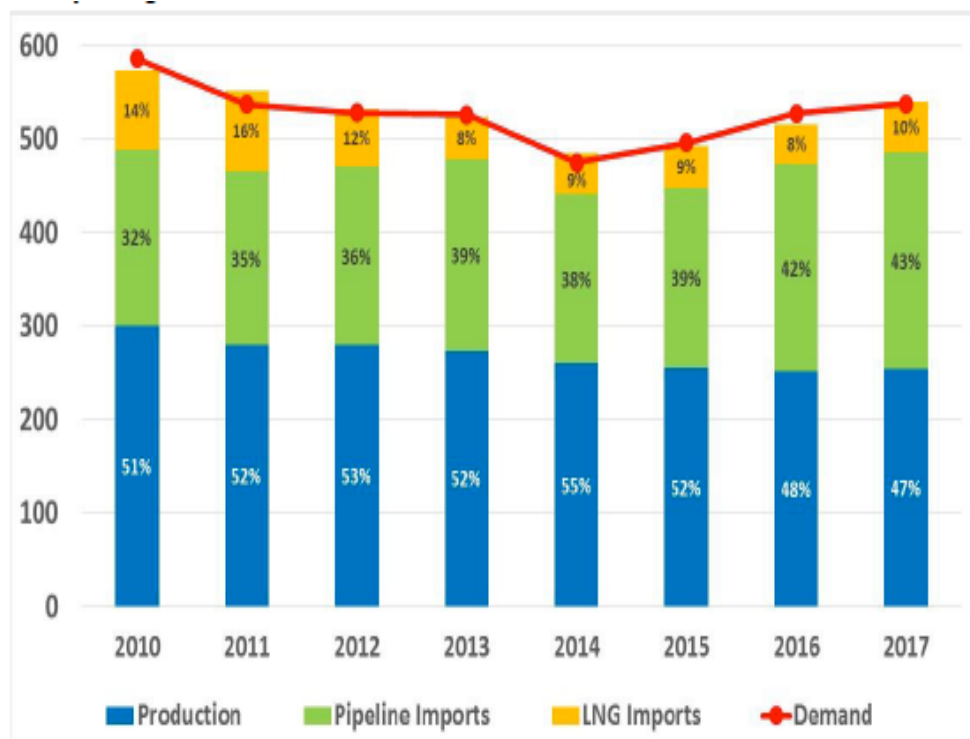
Economics of LNG supplies from the USA (copied from Gazprom Investor Day, February, 2018)



# The EU is a residual market for LNG

- Serving the Asian market first and then the EU
- The end of the gas glut and the emerging of a LNG scarcity would mean the EU will have to offer a price close to the Asian price to get gas
- A US and a Russian arbitrage between Europe and Asia/China

# Gas import is increasing, Gazprom market share too



European gas balances

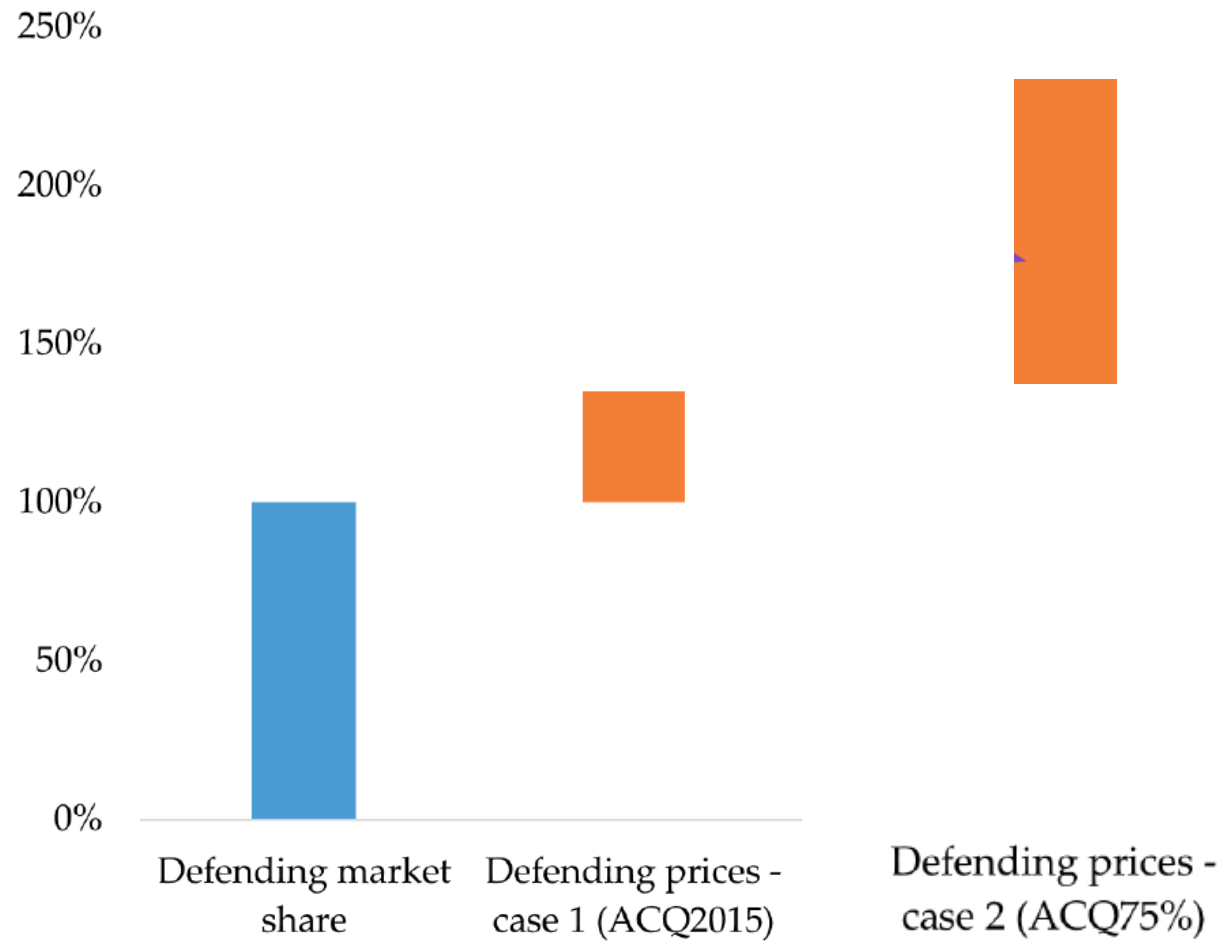
Source of gas imports via pipeline to Europe

(Source Henderson and Sharples, 2018)

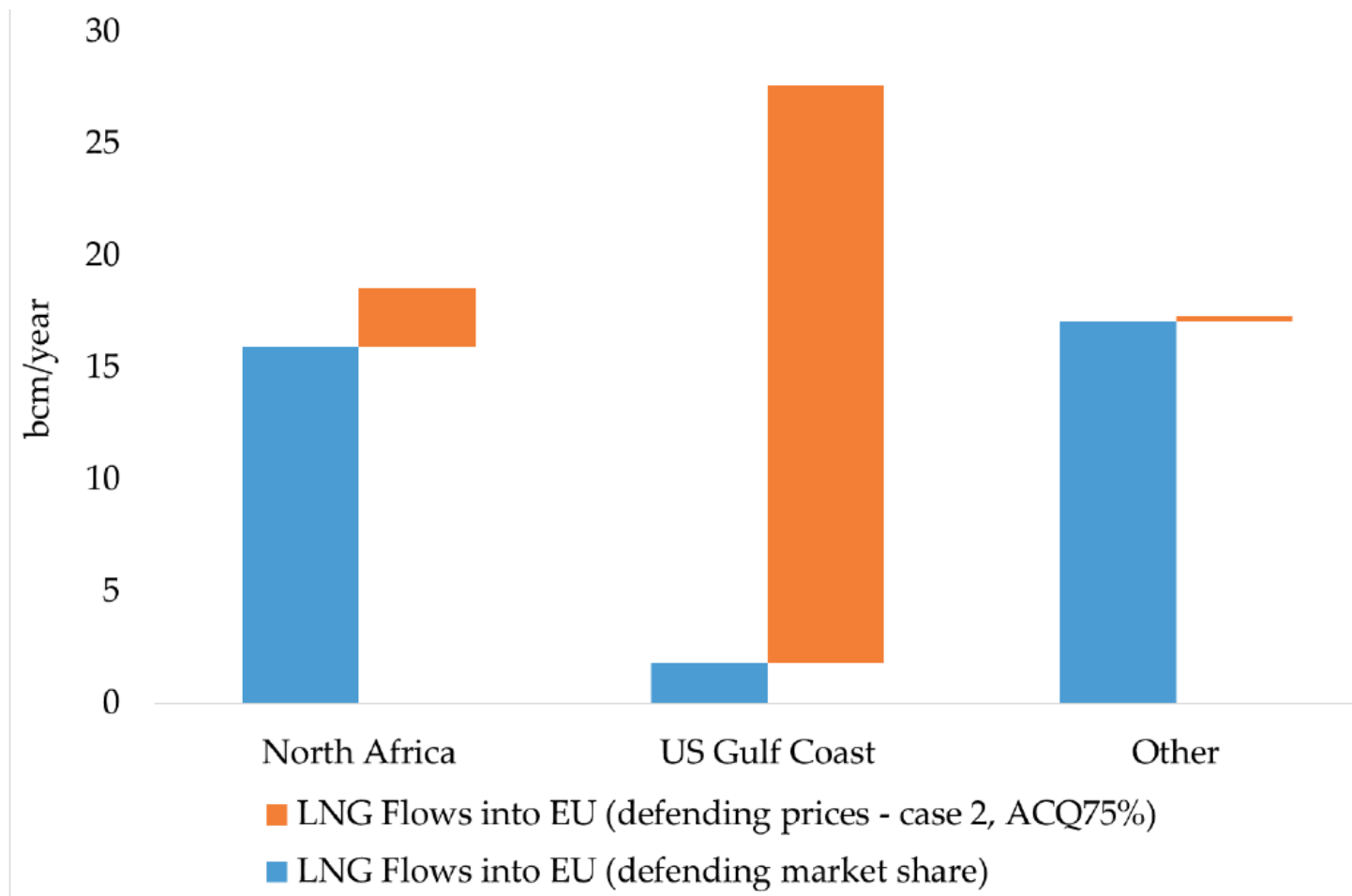
# A market share strategy?

- An odd question for economists
  - Maximizing profits (or revenues)
  - Quantity and price are simultaneously set
- A shortcut phrasing to say that Gazprom will try to secure its long term revenues in pricing its gas between US SRMC and US LRMC?
- The Gazprom's export strategy dilemma (Chi Chyong, 2017)
  - Defending market share (i.e., price covers SRMC cost) = flooding the market with cheap gas with the aim to deter new US investments (limit pricing strategy)
  - Defending price (i.e., lowering contractual volume to force customers to buy more gas at hubs pushing up hub-based market prices) = exercising market power

# Defending price strategy is more profitable (Chi Chyong, 2017)



# But defending price strategy means more US LNG imports (Chi Chyong, 2017)

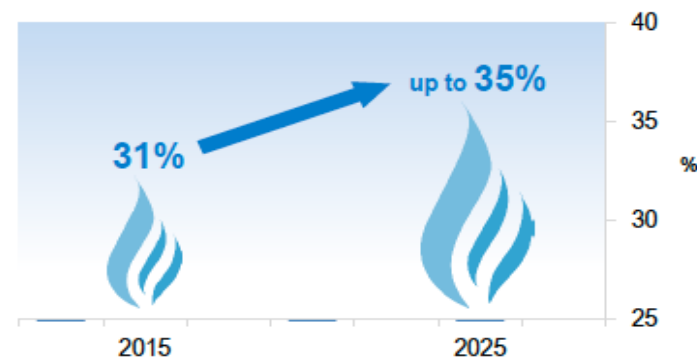


(Source: Chi Chyong, 2017)

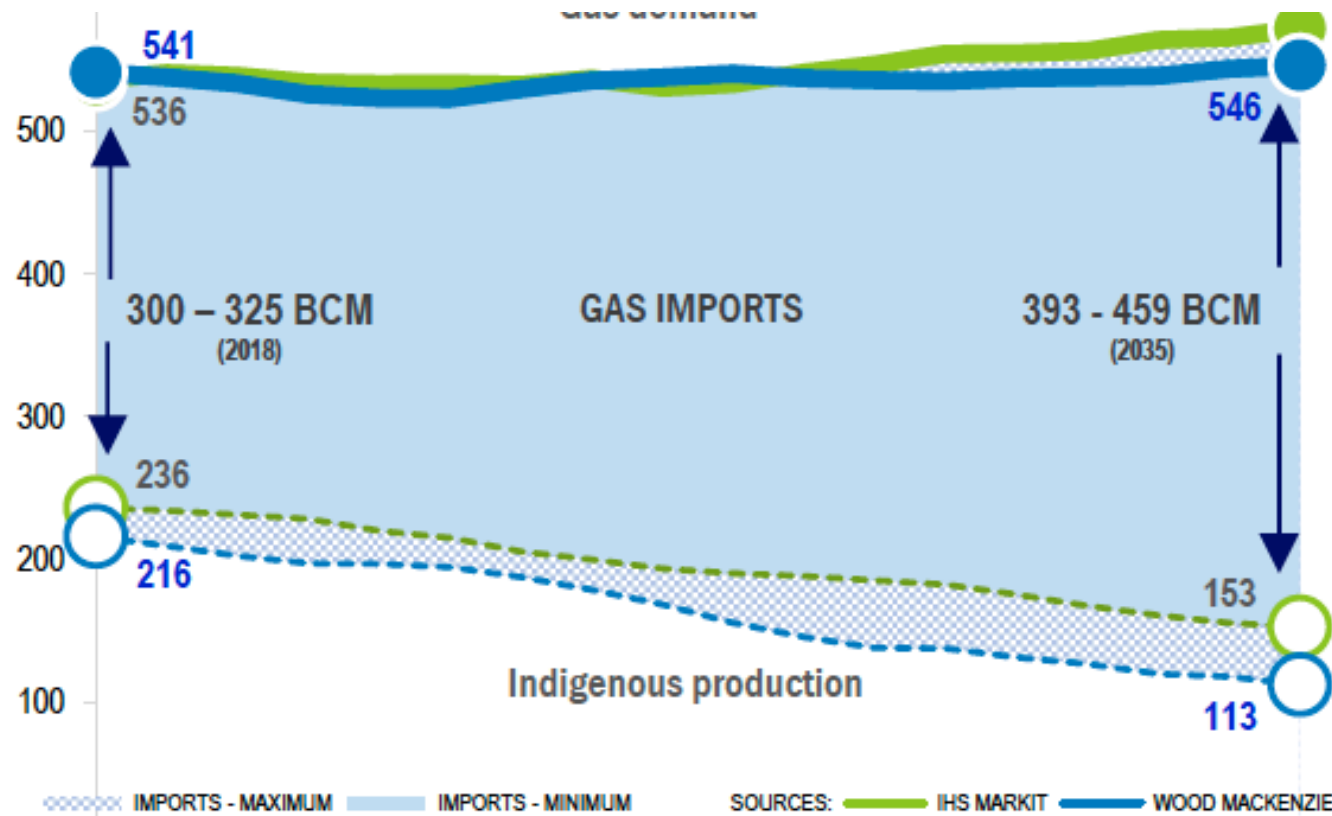
# Two effects of US LNG

- A cap on the exercising of Gazprom market power
  - about \$1.5/mmbtu (Chi Chyong, 2017)
- An increase in the EU security of supply
  - A contribution in reducing a growing EU concern on its Russian gas dependence

GAZPROM'S SHARE EVOLUTION IN THE EUROPEAN GAS MARKET

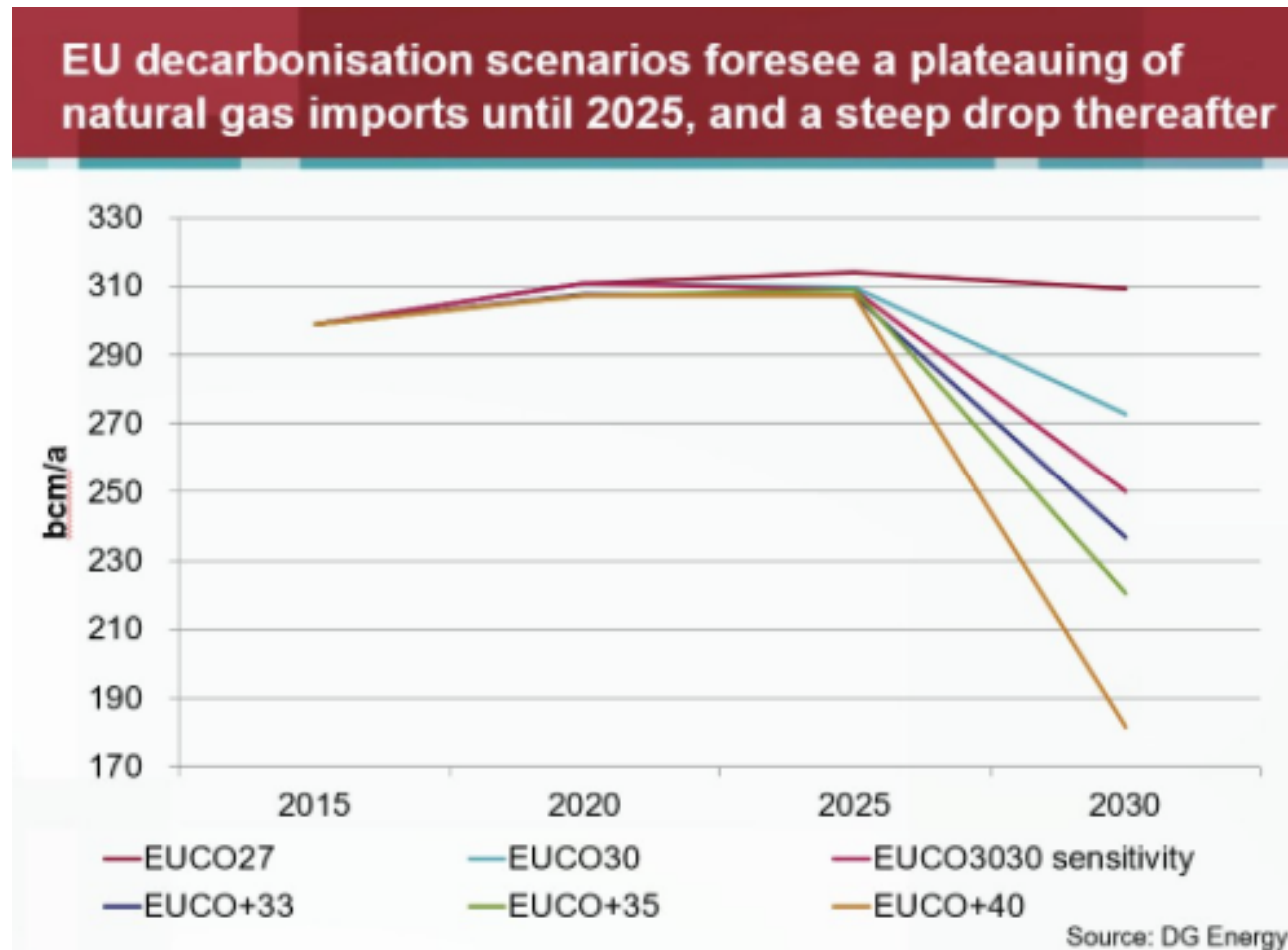


# Future of gas import in Europe 1/2



Copied from Gazprom Investor Day, February 2018

# Future of gas import in Europe 2/2



(Copied from Zachmann, 2018)



# Reducing Gasprom imports through politics and policies

- Trump's pressures to stop Nord Stream 2 and US sanctions against Russia
- EU hurdles on pipeline and transit
  - Political and regulatory issues around pipelines Opal, Nord Stream 2, Turk Stream (while supporting to maintain gas flow through Ukraine)
- Climate change and energy policy focusing on renewables and Member States are not all keen to quickly substitute coal with gas
- With the likely effects to increase the price of gas in the EU and the quantity sensible to arbitrage with Asia

# EU commission against Gazprom






# A long story

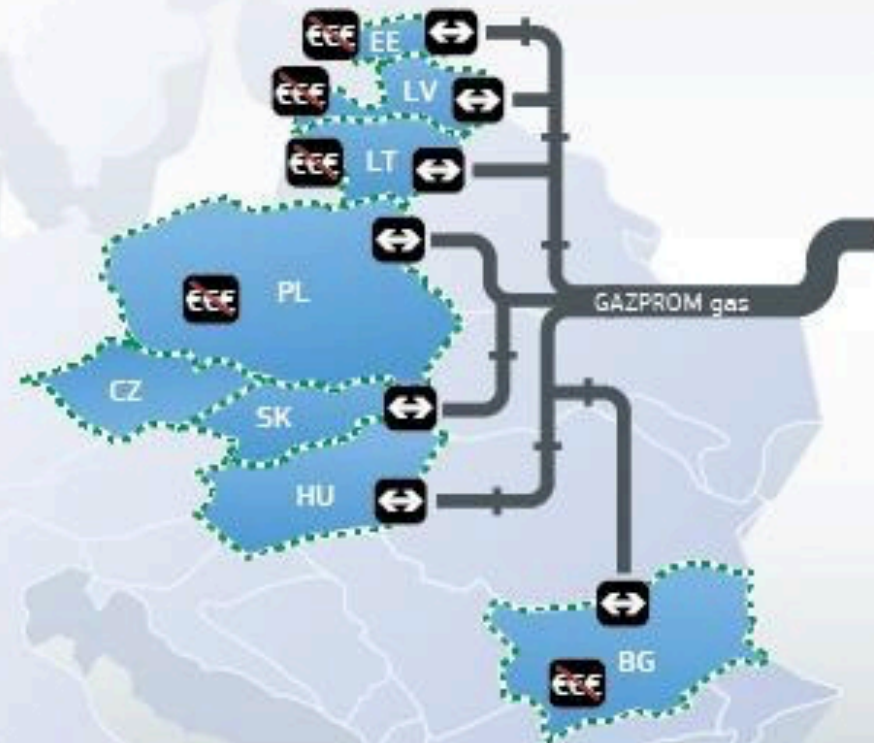
- Dawn raids carried out in September 2011
- Proceedings initiated in September 2012
- Statement of objections sent in April 2015
  - Gazprom was alleged *to hinder competition* in the gas supply market by *inter alia*:
    - imposing *territorial restrictions*, including export bans, destination clauses, and other measures in Bulgaria, Estonia, Latvia, Lithuania, and Poland
    - Pursuing an *unfair pricing policy* in Bulgaria, Estonia, Latvia, Lithuania, and Poland
- Commitments proposed by Gazprom and a market test launched by the Commission in March 2017
  - Removing contractual barriers to the free flow of gas
  - Introducing swap obligations
  - Aligning contract prices to competitive prices
- The EU Commission made binding the proposed and revised commitments in May 2018

# A long list of legally binding commitments

- Gazprom has to remove barriers to the free flow of gas in Central and Eastern Europe (8 years duration)
  - Contractual barriers
  - Transfer of control from Gazprom to the Bulgarian operator of the gas transmission infrastructure
- Gazprom has to take active steps to integrate gas markets in Central and Eastern Europe (8 years duration)
  - Swaps to and from isolated markets (i.e., virtual interconnections with Baltic States and with Bulgaria)
  - Fixed and transparent service fees for the delivery
- Gazprom is committed to a structured process to ensure gas prices in Central and Eastern Europe (8 years duration)
  - Customers can demand lower price when their price diverges from competitive Western European price benchmarks
  - New gas price must be set in line with price level in competitive Continental Western European gas markets
- Removing demands obtained by leveraging of market position (15 years duration)
  - No damages imposed to Bulgaria for the cancellation from South Stream project

## GAZPROM obliged to enable free flow of gas at competitive prices

-  No restrictions on cross-border gas flows
-  Upon request must deliver gas to/from markets lacking interconnections with EU neighbours
-  Upon request must adjust gas price in line with competitive Western European benchmarks



(European Commission Press Release, 2 May 2018)

# Issues

- Law
  - Is there an infringement to Article 102 of TFEU or not?
    - Market partitioning
    - Unfair prices
  - Was the Commission right to adopt a commitment decision rather than a prohibition decision (Article 9 versus Article 7 of Regulation 1/2003) ?
- Economics
  - Is it a win-win deal?
  - Strong effects or lip service?
  - Could implementation fail?

# Article 102 of TFEU

## Abuse of dominant position

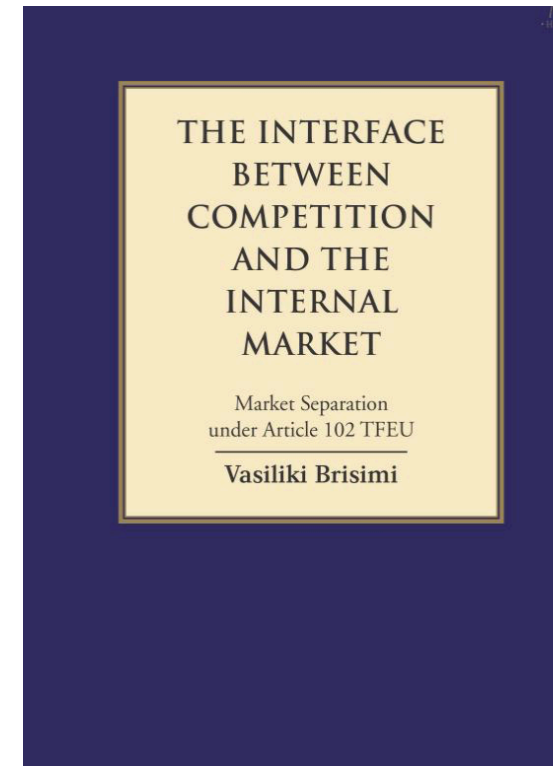
Any abuse by one or more undertakings of a dominant position within the common market or in a substantial part of it shall be prohibited as incompatible with the common market insofar as it may affect trade between Member States.

Such abuse may, in particular, consist in:

- (a) directly or indirectly imposing **unfair purchase or selling prices or other unfair trading conditions**;
- (b) limiting production, markets or technical development to the prejudice of consumers;
- (c) **applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage**;
- (d) **making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.**

# Market partitioning

- Under Article 102 (or Article 101)
  - Both an economic goal and an integration goal
- Restriction by object (≠by effect)
- Evidence: resale restriction at least in a Lithuanian contract
- High fines, potentially
- Strong ECJ case law against territorial restrictions





# Article 102 (a): Excessive pricing



*« [...] in its practice, the Commission has been extremely reluctant to make use of that provision against (allegedly) high prices practiced by dominant undertakings. Rightly so in my view. »*

EU Court of Justice Advocate General Wahl (6 April 2017)

# Rationale

- For being cautious
  - The acquisition of a dominant position is an incentive to innovate and a reward for more efficient firms
  - It is the role of markets (or sometimes of sectoral regulators) not antitrust authorities to set prices
  - Antitrust is supposed to deal with efficiency not redistribution
- Key ECJ judgment: United Brands (1978)
- Excessive pricing enforcement action on the rise, recently (especially in the pharmaceutical sector)
- Specific circumstances (Motta and de Streel, 2007)
  - High and non transitory entry barriers leading to a super-dominant position
  - Super-dominant position must be due to current/past exclusive/special rights
  - No sector-specific regulator has jurisdiction to solve the matter

# Assessing excessive pricing

## United Brands test

- a) “whether the difference between the costs actually incurred and the price actually charged is excessive ”
- b) “if the answer to this question is in the affirmative, whether a price has been imposed which is either unfair in itself or when compared to competing products ”

# A few « illustrations » in the Gazprom case

shown in the graph below.

Figure 27: Gazprom's costs and average net CEE5 prices (without export levy) and mark-ups

Year	Cost per MWh	CEE price per MWh	Mark-up
2009			
2010			
2011			
2012			
2013			
Average			

Figure 28: Gazprom's net CEE5 prices (without export levy) relative to costs by country

Year	
2009	
2010	
2011	
2012	
2013	
Average	

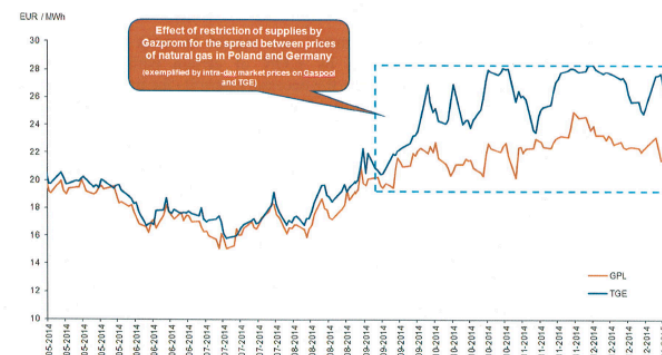
Figure 34: Gazprom's contract prices net of transport costs – CEE5 relative to Germany (only Wingas)

Year	
2009	
2010	
2011	
2012	
2013	
2014	
Average	

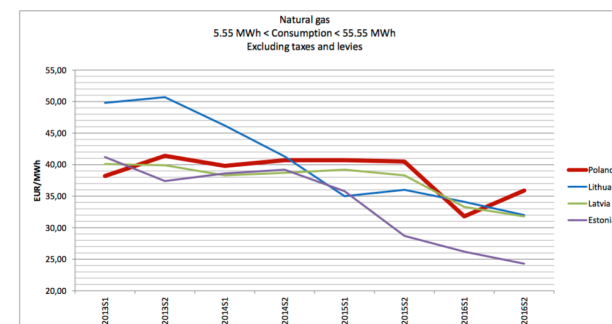
Figure 17: Gazprom's calculated average cost of gas

Year	Cost per MWh
2009	
2010	
2011	
2012	
2013	

Graph 3: Comparison of gas prices on Polish (TGE) and German (GPL) gas markets (2014-2015)



## PGNiG Complaint (2017)



## Statement of Objections (2015)

# Prohibition or Commitments decision?

## Article 7: Finding and termination of infringement

Where the Commission, acting on a complaint or on its own initiative, finds that there is an infringement of Article 101 or of Article 102 of the Treaty, it may by decision require the undertakings and associations of undertakings concerned to bring such infringement to an end. For this purpose, it may impose on them any behavioural or structural remedies which are proportionate to the infringement committed and necessary to bring the infringement effectively to an end. Structural remedies can only be imposed either where there is no equally effective behavioural remedy or where any equally effective behavioural remedy would be more burdensome for the undertaking concerned than the structural remedy

## Article 9: Commitments

1. Where the Commission intends to adopt a decision requiring that an infringement be brought to an end and the undertakings concerned offer commitments to meet the concerns expressed to them by the Commission in its preliminary assessment, the Commission may by decision make those commitments binding on the undertakings. Such a decision may be adopted for a specified period and shall conclude that there are no longer grounds for action by the Commission.
2. The Commission may, upon request or on its own initiative, reopen the proceedings: [...] (b) where the undertakings concerned act contrary to their commitments [...]

# Pros and cons

- A prohibition decision would have made restructuring (sales of Gazprom assets, gas releases) possible (instead of increasing competition between Gazprom gas and Gazprom gas)
- Case law enrichment
- Private damages easier to get
- But a long and uncertain process
- A commitments decision provides an immediate remedy
- It does not exclude fines in case of non compliance
- To a some extent, private parties can rely on the Statement of Objections and the Infringement Decision to get damages from litigation
- But it transforms antitrust authorities into regulators

# A win-win deal for both, of course

- No fines, no formal recognition of the abuse, no restructuring (e.g., gas release)
- Not costly commitments
  - Affected countries are small consumers
  - Most commitments would have taken place anyway although latter
- Better relationship with the largest current and future export market
- Better perspectives of reasonable accommodation from the Commission on other issues (e.g., Nord Stream 2)
- Faster process and lower uncertainty
- Gazprom alleged anticompetitive behavior is stopped
- Easy sanctions in case of non compliance
- EU gas market integration achieved in Central and Eastern Europe
- Better relationship with the current and future largest supplier of gas to the EU



# Redistributive effects

- Citizens of Eastern and Central European Member States are able to get more rapidly a lower price
- Socialization of costs
  - European gas consumers have been contributed to finance assets for security of supply (e.g., LNG terminals) which are less (or no longer) useful
  - European tax payers will not benefit from a fine contributing to the EU budget



# Possible failures in implementation

- As usual, compliance will be ensured by a monitoring trustee
  - Delegation of monitoring saves DG Comp resources but increases the risk of capture
- More specifically, compliance will also depend on the arbitration
  - Will customers trigger the arbitration knowing its risks and costs?
  - Will the arbitrators interpret similarly the price alignment to Western competitive markets?

# Concerns on market segmentation

## 1/2

- « For the entire duration of these Commitments Gazprom undertakes that (i) it will not apply any Clause Restricting Resale or Territorial Restrictions and that (ii) it will not introduce any new Clause Restricting Resale or Territorial Restrictions in any existing Contract on Gas Supply [...]”
- Have not these restrictions already been removed from the contracts? They should have ceased when the new countries joined the EU
- So what is the effect? A lip service?
- It seems that DG Comp found at least one such clause in a Lithuanian contract. A likely valid reason to impose a big fine

# Concerns on market segmentation 2/2

- Changes of delivery points
  - « Existing customers shall be entitled to request a change of the Original Delivery Point(s) provided in a relevant Contract(s) on Gas Supply to entry point at Negru Voda at the border of Bulgaria and Romania or to entry point Kotlovka at the border of Lithuania and Belarus [...]”
- A kind of virtual pipeline or swap deals to increase competition and gas flows to the Baltics and Bulgaria
- But only between Gazprom gas and Gazprom gas, swap volumes are still Russian gas...
- With service fees set by Gazprom which have been viewed not unjustified and high but have been reduced after the market test
- In any case a small market size (about 8 bcm in 2016)

# Concerns on prices

- A new trigger for a price review will be added into contracts
  - Before the market test, two references: (i) *“prices at the relevant generally accepted liquid hubs in Continental Europe”* (ii) *“the price level in the European gas markets”*
  - After the market test: *“the price level in the competitive Continental Western European gas markets”*, with an explicit reference to *“liquid gas hubs in continental Europe such as TTF and NCG”*
- Not a precise enough methodology
- Indexation to oil price not excluded
- A nest for litigation
- Why not setting a clearer methodology to help the monitoring trustee and the arbitration tribunal?

# Takeaways

- Gazprom is able to credibly sustain a long price war, if necessary, but a price war is very low likely
- US LNG puts a cap on Gazprom's prices (and Asian LNG sets a floor)
- EU antitrust law provides an additional competitive pressure to Gazprom
- US LNG improves the EU security of supply
- EU restrictions on Gazprom imports mean erecting barriers to a competitive supplier (and a low carbon source of energy)
- Gazprom's strategy is likely not to defend its price in exercising its market power even if it would be more profitable
- Gazprom versus LNG not Gazprom versus US LNG