

The Annual Baltic Forum Conference  
**Global Crisis – National Responses**

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**ABSTRACTS**

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OK, well thank you very much for giving me the opportunity to kick off the forum.

What I'm going to try and do today is start off by talking about something with which you're probably quite familiar; talking about gas supplies and energy security matters, and actually explain how the recession could transform that, and transform a lot of the arguments in the field.

Everybody is aware of the fact that for most of Central and Eastern Europe huge amount of gas supply comes from Russia – less so in Western Europe, but increasingly so. And there is a lot of talk, a lot of it, I think, unfair on the Russians, about how powerful Gazprom is and how much gas comes from Russia. And that is seen as the model and there is a lot of concern, particularly after the Ukraine-Gazprom crisis earlier in the year, about Russian gas supplies. And this is seen as a very, very big issue. Now, my argument is, that when you look closely at this, and when you look at the recession, you begin to see that this argument and this perception is likely to be enormously changed by a series of factors, but the recession is the really major driving issue. Now if you look at Gazprom at the moment, for example, you see what is perceived as this dominant, powerful energy player. And it's clearly true that in the last few years Gazprom has been tremendously successful in many ways. But the truth of the matter is that beneath that success you've got a number of very serious problems, and these now being magnified by the recession. And the magnification of them you can see in the problem recently, of course, with the recession: there's less need for industrial supplies of gas. You see enormous demand destruction. You've also seen, because of the link between the oil and the gas price, a massive fall in the level of price that gas can obtain. It's fallen from around 400 dollars per thousand cubic meters last year to around 280-250 dollars per thousand cubic meters this year. That's an enormous fall. And the projections for this year are over 20 billions dollars losses to Gazprom alone. And meanwhile, what we're seeing as a very clever play last year that is an enormous capture by Gazprom of Central-Asian gas at European prices, now looks like a very severe problem: you've effectively bought gas at European prices from Central Asia and now there is huge loss of actual ability to sell it in the West, because of the recession, in addition to which you have got the problem that Gazprom has about 40 billion dollars worth of debt and 10 billion dollars worth of debt has to be rolled over to be refinanced this year. In addition to that you've got a collapse in your revenue, you've got huge demands for debt repayment, in addition to which Gazprom is ploughing ahead with Nord Stream, with South Stream, with Yamal, with Shtokman, with all these major capital projects, so there's huge pressure on the company.

Now, of course, the response to that is to say that, well, at the end of the day all prices are rebounding a little at the moment, so the oil price will ultimately rebound and that will allow Gazprom to pull its revenue back and all will be well. And of course, there is a lot in that story: the difficulty is that you're not looking at what's happening in the rest of Europe and looking at the effects of recession on the energy markets at Europe. And my argument is that this will fundamentally transform the energy markets and the business models which will work in Europe. And one of the business models which is affected is the dominant encumbered monopoly model adopted by Gazprom. And let me explain why: the problem is that in a recession like this, in a great recession, one of the really big issues for any state is the need for cash. You need enormous amounts of cash to fund social programs, to fund pensions, to keep things going. And one of the ways of dealing with the problem is to look at state assets you no longer need, you can sell relatively easily and still keep everything running. Now, one of the ways for a lot of European states to deal with this is to adopt energy liberalisation, because the point of energy liberalisation is that it normally involves breaking up your domestic energy companies: creating a separate energy company which runs the gas pipelines and having separate supply companies as well. Now when you do this, of course, you largely sell these off, you sell them off to the private sector and you actually generate huge amounts of returns. The experience in the UK when we broke up and sold off British Gas was that the two new companies created out of it, the generating companies and the network company were worth ten times more than they were worth when they were together. So the potential for a lot of states to generate very significant capital gains and revenues is there. And in those circumstances energy liberalisation is going

to go up the political agenda as a lot of politicians across Europe realize that energy liberalisation is one way of generating significant capital gains.

Now the point about this is that if you have energy liberalisation, you create lots of incentives for the development of new inter-connectors and you create the possibility of a lot more gas coming in from elsewhere. In other words you widen the market, and as a result of widening the market and allowing new gas in from elsewhere you create competitors to Gazprom. So one of the points about recession is that it could act as a means to encourage liberalisation and create more competition for Gazprom.

Now the second problem is this, and this is largely from the United States, and it's the development of what is known as unconventional gas. And conventional gas, I'm sure you're probably aware – you have a gas-well, lots of trapped gas, you drop a gas-well down and extract the gas. Unconventional gas is gas locked, for example, in a rock shell, in impermeable rock formations. Now, traditionally that's not been accessible, however, in the last few years some American companies largely based in Texas have found ways of cracking impermeable rock formations and extracting gas relatively cheaply.

The consequence of this has been enormous. Currently unconventional gas from rock shell, tight sands and colbert methane makes up about 40% of US gas supply. Last year US gas production increased 99% because of the unconventional gas. The point about it is that in Western Europe alone there is approximately 30 trillion cubic meters of gas from unconventional gas sources. That is the equivalent of two-thirds of the total Russian reserve. Now the point about it is that already this has attracted tremendous interest: Exxon, Shell, OMV and MOL are all busily checking out a lot of the unconventional gas resources. Now, not all of that will be accessible, but a significant amount of that will be, and the point is that again, the recession creates a massive incentive for that gas to be exploited, because clearly if you can access that gas, generate significant gas supply from it, you provide tax revenue for the state. So you can see that in the next five years we can expect very substantial development of unconventional gas across Europe. And in those circumstances what we're likely to see is that gas coming on stream, the states being very keen to issue exploration and production licences, which is already beginning to happen, and a very substantial gas supply developing.

So the consequence of all of this is that you begin to see a very different shape to European gas markets, a much more liberalised gas market, incentivised by recession, alternative sources of gas supply, particularly unconventional gas, pushed by the states because it will generate them substantial tax revenues. In addition to which, one of the other points about it is that a lot of major energy companies have invested enormously in liquid natural gas. The initial idea was that a lot of LNG would go to the American market, but now with unconventional gas they won't need it, so in addition to the shell gas and unconventional gas supplies, you got to have a lot of LNG heading for Europe as well. So you got the unconventional gas, you got the LNG; you got a much more liberalised European marketplace. Meanwhile, Gazprom has been substantially battered by the recession and it will find itself post-recession in a market in which there is a significant degree of strong competition from elsewhere.

Now, this does not mean that Gazprom is in any way finished. My argument is, in fact, and I've met many people from Gazprom over the years and many of them are very, very bright and capable and I'm sure they're capable of transforming Gazprom and the Russian gas companies round to deal with this threat. But it will involve fundamentally changing the business model. It will involve massively increasing gas production so that you can compete on the European market, and the basics of gas-to-gas competition, and will require a much more commercial market approach, which would suggest, for example, that the Russian state will have to look at issues again, like, for example, energy liberalisation – would it be better to have the Gazprom restructured, so that you can encourage lots of smaller companies to come in and exploit the cheaper gas supplies, gas deposits in secondary markets? Is there an argument, in fact, for a green transit protocol on the energy charter treaty, because if you do that you can cut your costs of getting your gas to market by potentially using the Ukrainian network? It raises questions of whether or not you'd really want to build Nord Stream & South Stream, because they're rather expensive and would reduce your price competition on the European market. All of those issues come in, but Russia is quite capable of countering these threats by transforming its approach to running the gas market. But my point is that the recession is likely to change very significantly the model we've been used to on the gas market in Europe for the last decade or so. And that you can see it is the recession which is acting as the major driver of this, forcing governments to look at issues which they've not really been wanting to look at before, like the unbundling and privatisation of the energy companies, and also being far more willing to open up these shell gas deposits in a way they've not really thought of before. So all of this recession-context is providing a basis for enormous amount of change. So, to some degree, you know, OK, I've gone in one particular market and looked at it in some detail, but I think it does show you the way that

recession can fundamentally transform a market and our perceptions of how the market operates. And hopefully that provides some basis for further discussion as we go along.  
Thank you.