

**Pan-European gas co-operation: current perspectives and challenges – VII Annual International Forum «GAS OF RUSSIA – 2009» - Moscow, 17.11.2009**

dear colleagues,

during these joint Eurogas/RGS events we often speak about interdependence between our gas industries. Indeed, the reason behind our gatherings is to discuss ways to further improve the quality and scope of such long-established and rewarding interdependence.

From the first days of Russian gas exports until the very recent past we have witnessed and taken part into a story of success, one of the pillars of economic development for both Europe and Russia.

The unprecedented wave of changes to the global and European gas markets that we are experiencing is testing such interdependence like never before.

The deep effects that the global recession is having on the demand of energy, the debate on nuclear and renewables, the increased focus on structural energy efficiency, make us wonder whether the exceptional drop in European gas demand is indeed exceptional or, instead, the prelude to a totally different pattern of demand in the future.

To this crisis-induced demand destruction, we must add the significant increase in supply offer for Europe. New pipeline gas, new LNG, through new terminals in Italy, UK or France is arriving into Europe in a moment of significant oversupply.

How the Russian gas industry is faring in such troubled waters?

- Russian internal gas demand has fallen almost by 10% in the first 10 months of 2009 and Russian overall gas production fell almost by 17%. This, for a Country whose economy is still very energy intensive, is of course a big decrease but not so big as one could have imagined considering the drop in GDP. While there are already signs of some demand recovery, it is reasonable to say that the Russian internal gas market has been somehow weakened. Delays in internal gas pricing reforms are understandable from a political and social point of view but are also a further sign that the road towards full profitability for intra-Russia gas sales has become longer and steeper.

- On the export side, we are all aware of the huge drop in sales to both the near and far abroad countries.

- Various upstream or midstream projects are being postponed, in line with a worldwide trend to avoid entering into massive capital expenditure while the market is in a negative cycle.

- The drop in Russian demand for Central Asian gas is creating tensions on some national economies, deriving from a fall in gas revenues. This shows how quickly a problem of European oversupply can propagate back in the gas chain thousands of kilometres from our Countries.

- Last but surely not least, a reduction in export volumes from Russia will have some consequences on the role of Russian independent producers. If the export market shrinks, competition for the internal market will inevitably increase. While Gazprom has until now absorbed most of the Russian production cuts, this may no longer be the case should the present market downturn persist.

The Russian gas industry, even if it is the biggest single supplier of gas to Europe, risks to suffer in respect of other major players, in the current market situation:

- there could be a cost disadvantage in respect of new gas. Unfortunately, Russia is not blessed with a tiny but incredibly gas-rich national territory like Qatar. Gas is abundant of course, but extracting, treating and transporting it to the final markets require huge amounts of efforts and money. Russia is not happily managing the results of past investment decisions; is instead in the middle of a generational transition between old basins that have served it for decades and new production areas for the future.

- Russia lacks a flourishing internal demand, able to sustain growth of the gas sector when exports are more uncertain. We see this happen in some North African gas producing countries.

- Russia sometimes seems to have sent in the past mixed signals to international companies potentially interested in further involvement in its upstream and midstream projects. The recent Salekhard meeting tried to establish a new favourable climate, but there is still a feeling in the industry that more is needed.

- Russia is involved in huge projects in the midstream aimed at Europe or, for LNG, to the wider Atlantic basin. More than any other major gas supplier, Russia is exposed to the uncertainties deriving from today's market. The Russian gas industry is in front of a public relations' dilemma: how to increase the perception in Europe and worldwide to be a reliable supplier without being perceived as "overbuilders", losing contact with the reality of the markets.

- The issue of perception is, in my opinion, a very important one for the Russian gas industry. Interruptions in flows occurred last year have created a huge damage to the image of the Russian gas industry, irrespective of the actual balance of responsibilities in the crisis. European customers expect a product delivered to their doorstep. They are not interested or even informed about transit issues, therefore they will always identify problems associated with Russian gas as mainly a Russian problem.

If we want to draw some conclusions, we must start speaking, in the broader possible way, of the competitiveness of Russian gas.

We may have an issue of upstream competitiveness, needing to address the difficult target of producing new gas in difficult environments at a competitive cost.

Then we have a competitiveness issue on the perception of Russia as gas producer.

An improved dialogue with stakeholders at all levels should be actively sought in order for the special qualities of the Russian gas industry to emerge, defeating prejudices or wrongly formed opinions in Europe and elsewhere.

Finally, there is an acute issue of commercial competitiveness for Russian gas, especially in Europe, testified by the fact that Russian exports have declined much more than those of Algerians or Dutch, while Norwegian output has even increased by 8% in the first 9 months of 2009 versus the same period in 2008.

Faced with a range of supply options in their portfolios, the main European marketers have chosen to cut Russian imports first, probably because Russian gas was more expensive than other.

Such loss of appeal of Russian gas is a very strong warning for the Russian gas industry; it is a call for change, in order to adapt to a market that has so profoundly shifted in its fundamentals in such a little time.

Gazprom and its clients in Europe will need to converge towards an evolved model of relationship whose main features could be:

- a strong reassertion of the long term nature of contractual ties,
- important changes in pricing provisions, protecting but adapting oil indexation, making it competitive with spot pricing,
- a serious discussion on flexibility provisions.

A pricing approach more suitable to the needs of a changed market will also be functional to contain the assault to Europe by relatively cheap new LNG. LNG will retain its extreme logistical flexibility and hence advantage on piped gas, but appropriate changes to the contractual provisions will better level the field, and will properly take into account the security of supply premium that pipeline gas can command on the market because it is always there, even when LNG may be diverted towards momentarily more profitable regions.

Also in the past, in specific situations and markets, Gazprom has been able to show a fair deal of vision by reworking set deals.

What the European gas industry expects today and, even more importantly, what is needed by the Russian gas industry, is to maintain and reinforce its leading role in Europe and to further benefit the Russian internal market.

The European industry is ready to engage in the work needed to attain such important goals, equally beneficial for us as for Russia. On its side, the Russian gas industry has many times proved to be able to achieve astonishing results in the worst imaginable conditions, being them the permafrost of West Siberia or the remote shores of Sakhalin, so the ingenuity and courage to tackle uncharted territory are surely not in short supply here.

In moments of fast evolution and uncertainty, interdependence is a plus, not a liability; I am very confident that once again the Russian and the European gas industry will stand and prosper in the face of change.

Thank you