14th International Gas and Electricity Summit

Paris, October 21-22, 2009

Introductory Remarks

by

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Welcome to the 14th International Gas Summit, now renamed Gas & Electricity Summit in view of the growing convergence of gas and power issues which we have repeatedly highlighted during our past debates. As we concluded on many occasions in this room, gas and electricity developments are, indeed, intimately related.

As was the case in previous summits, the organizers of this event are inviting us to discuss a multitude of issues which are directly or indirectly related to the international gas and electricity industry. Obviously I cannot, in this brief introduction, deal with each of these no doubt related issues. Let me try, however, to create a framework which will allow us to proceed logically in our discussions in the hope that this approach will enable us to conduct an orderly

debate with the help of our speakers and your active involvement in the discussion which will follow their statements.

When we met last year, the energy markets were firmly caught in the eye of a global financial and economic storm, and some of us felt that it was inevitable that the gas industry would be affected in a profound way. This pessimistic outlook proved right. We are indeed meeting today at a moment of dramatic turmoil for the gas industry in spite of encouraging signs that the global recession may have reached or even passed its lowest point. Before I introduce our first keynote speaker, let me elaborate by addressing, in turn, the gas demand, supply and pricing developments observed since our last summit as well as their potential implications for the major industry participants.

To begin with the demand side, available data indicate a substantial decline in gross consumption this year compared to last year. For the OECD, the decline could exceed 5% or 80 bcm. This would not only be the first year-to-year decline since the early 1980s, but also the sharpest and largest decline ever recorded in the published statistics. The decline in OECD Europe is even more dramatic with a year-to-year loss reported so far at almost 8% and expected to reach 10% by year-end. This is equivalent to a yearly volumetric loss of 50 bcm, i.e. more than the total current French gas consumption.

Gas demand is falling across almost all regions, driven by lower industrial consumption and power generation. Electricity demand is also collapsing, with

a reported decline, so far this year, in excess of 5% at the OECD level, the first annual contraction since World War II. Gas is in fact losing market share in power generation - mostly to renewables - after almost three decades of continuous growth.

Turning now to the supply side, the most striking development is the confirmation of a trend highlighted during our last summit regarding the progress achieved in the development of non-conventional gas resources in the US where output rose by 7.5% last year, ten times the ten-year average and the strongest volumetric growth on record. This development has substantially reduced earlier expectations of the need for US LNG imports which were expected, only a few years ago, to account for about 30% of world incremental LNG supplies.

During our LNG session last year, we expressed the concern that this industry might be the most vulnerable to an economic downturn. In our conclusion, we pointed out the risk of a temporary LNG oversupply as a result of the expected weaker demand and the commissioning of several liquefaction projects coming on stream within approximately the same time frame. And, indeed, several stranded LNG cargoes have been sold since, at bargain prices.

Most analysts now expect that the liquefaction capacity scheduled to come on line during the next two to three years (which will add an extra capacity of 100 bcm or thereabout) will create a substantial LNG overhang. Combined with

the current excess in shipping and regasification capacity, this is bound to impose a more sober vision on future LNG trade growth which was already stagnant last year for the first time since the early 1980s.

All these developments suggest that the next two to three years will be difficult for the gas industry. They have already created a growing disconnect between oil and gas prices, as illustrated by the ongoing gap between the spot prices in the US and UK liberalized markets and the term prices still tied to oil prices in the Continental European and Asian markets. Short-term prices at market hubs and spot LNG prices have lately been running at about half the term oil-linked prices.

In the short term, with gas inventories approaching capacity limits in all major markets and the anticipated moderate recovery in gas demand, the price disconnect is expected to persist, barring an unusually cold winter or a lasting disruption in the supply system. Many analysts believe, indeed, that low gas prices are "here to stay", but some disagree, banking on lower than anticipated production from Russia and North America.

Looking at the medium term, gas demand is expected to rebound as the fundamental drivers behind gas demand growth are still present and as new power plants under construction are predominantly gas-fired. Many analysts believe indeed that gas markets will tighten again in three to four years when the current excess supply capacity will be absorbed by renewed market

expansion combined with cancellations or delays of new gas production and transportation projects.

But this is small comfort to buyers, currently stuck with oil-linked prices under long-term take-or-pay contracts, who are having difficulty today competing with much cheaper spot- priced gas. Weak oil fundamentals may bring oil (and, hence, oil-linked gas) prices down, but this will not be caused by competition from low-priced gas. Indeed, little oil remains to be backed-out from power generation, and fuel-switching for transportation is expensive and will take a generation to have a meaningful impact.

The most crucial question that the gas industry is facing today is how the gas exporting countries will react to confront a potential dramatic loss in their export revenues at a time when most of them are already under the pressure of lower oil revenues? Will they restrain exports to support prices, or will they adopt a more flexible pricing approach to protect market share?

In my view, the most sensible action would be a coordinated approach of the major exporters to restrain production and exports. Simple arithmetic shows that, in terms of total export revenues, gas exporters have a clear incentive to defend price rather than maximize volume.

However, a coordinated exporters' action to reduce production the "OPEC way" is not in the cards. Unlike OPEC, the Forum of Gas Exporting Countries, which

was formally established last December in Moscow, has no explicit objective yet to manage production and exports, and even if it had, member countries are unlikely, in the current circumstances, to adopt a unified approach in view of their widely different situations. Russia for example has never voluntary cooperated with OPEC on output restraint, so it is difficult to envisage Russia participating in coordinated export restraint. More generally, it is unlikely that LNG exporters would restrain production in order to benefit competing pipeline gas exports.

A failure to constrain exports may lead to a price war and to a potential price collapse in liberalized markets -- down, perhaps, to the marginal cost of less than $ 2/mmbtu -- which would exacerbate the prevailing two-tier price system. Will the major exporting countries adopt, instead, a more flexible pricing approach?

Here again, major gas exporters are unlikely to agree on a unified approach to deal with the present dual-price situation. Some may accept a relaxation of take-or-pay terms and/or extended deferral of make up gas. Some may accept to renegotiate existing contracts involving quid pro quos, such as supplemental short-term spot priced gas that can be rolled in. And some may even offer access to additional long-term supplies and/or preferential access to future upstream opportunity in return for customers' loyalty. But while each exporter will probably pursue its own form of compromise, I believe that exporting

countries will, by and large, first insist on strict application of existing contracts and resist abandoning the linkage of oil and gas prices.

The fundamental question, not only for the major gas exporting countries, but also for the gas industry in general, is how to preserve this linkage in the face of the current and expected gas surplus which most analysts see as a transitory phenomenon and not as a long-lasting structural development. As I said, gas demand will eventually rebound in almost all scenarios of future economic growth and under almost any rationale climate change regulations. The anticipated downturn in the LNG industry and in the power generation sector may turn out to be no more than a hiatus in the long-term potential growth of this premium fuel. Most analysts are already warning us that the long-term gas demand may be supply-constrained again in view of the expected likely delays in infrastructure developments and inadequate investments.

In this respect, the gas-to-oil price linkage has proved its usefulness in providing a relative stability in gas prices (compared to oil prices) under take-or-pay contracts and was so crucial in ensuring future infrastructure development and long-term supply security. Preserving the linkage will require the cooperation of all major market players:

- **First**, the exporting countries, by reducing exports to balance the market. If this is not done, then the only way to protect the oil linkage would be to adjust

temporarily the base price to reduce buyers' incentive to switch from term to spot trade;

- **Second**, the buyers, by honoring their contractual or renegotiated take-or-pay obligations to avoid confrontation and international arbitration;

- **Third**, the importing countries, by refraining from taking any regulatory measures which would exacerbate the current disconnect between oil and gas prices, thus jeopardizing their long-term gas supply security.

This may be a tall order of what needs to be done. But let's see how our speakers' perspectives have changed on this issue from our discussions last year when the consensus was that "gas prices will continue to track changes in oil and product prices".

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