



A Snapshot of Key Developments in the External Relations of the Russian Gas Sector ¹

Key points:

- *Greece – Gazprom appears set to take part in the tender for the purchase of Greek state monopoly DEPA SA, with the aim of gaining direct access to local gas consumers*
- *Israel – Gazprom continues to negotiate some form of participation in the Israeli ‘Leviathan’ and ‘Tamar’ gas fields. A preliminary agreement for the purchase of 2-3 million tons of LNG has already been reached as Gazprom strengthens its position in the Southern European gas markets.*
- *Ukraine – European investors are losing interest in the modernisation of Ukraine’s gas transportation system (GTS), suggesting a possible Gazprom-Naftogaz deal as Gazprom seeks direct access to Ukrainian gas consumers.*
- *Ukraine – The winter dispute over the short supply of Russian gas to Western Europe via Ukraine continues as Gazprom and Naftogaz trade mutual accusations.*
- *Nord Stream – The European Commission has ruled that 33-50 percent of the capacity of the two pipelines (NEL and OPAL) which connect Nord Stream to the rest of Germany’s gas infrastructure must be reserved for Third Party Access, potentially forcing Nord Stream to operate at less than full capacity.*
- *Lithuania – Gazprom is trying to challenge the conditions of the EU Third Energy Package in court, with Lithuania the test case. Yet the most Gazprom can hope to achieve is a delay in the unbundling of Lietuvos Dujos.*
- *Lithuania – In a bid to reduce its dependency on expensive Russian gas supplies Lithuania is seeking alternative suppliers and has proposed a gas swap deal with Gazprom. However, a more realistic diversification option seems to be the construction of a new gas import pipeline from Poland.*
- *Europe – Negative operating results and the continued disparity between spot market and long-term contract prices are prompting European energy companies to seek price concessions from Gazprom.*
- *Russia – An increase in revenues from higher Russian domestic gas prices looks set to be offset by an increase in the Mineral Extraction Tax rate for Gazprom. The Ministry of Finance and the Ministry of Energy are discussing a new draft law that would deprive Gazprom of 80 to 100 percent of the potential extra profits from higher domestic gas prices.*

¹ The EGF Gazprom Monitor is completely based on Russian sources and is translated into English by Jack Sharples, PhD candidate at the University of Glasgow, Scotland, and EGF Researcher on Russian external energy policy

Greece – Gazprom ready to buy Greek state gas supply monopoly DEPA S.A.

Gazprom is likely to participate in the tender to buy the Greek state monopoly DEPA S.A. The company is one of the participants in the South Stream project and the main gas supplier to the Greek market.

Gazprom will participate in the auction through its subsidiary, Prometheus Gas, which is a parity joint venture of Gazprom and Dimitrios Copelouzos, co-owner and manager of the company. Twenty other companies are expected to take part in the auction, including Gas Natural, GdF Suez, Eni and OMV.

The Greek Government currently holds a 65 percent stake in DEPA S.A., with the remaining 35 percent held by Hellenic Petroleum, which itself is 35 percent state-owned.

Both the Greek Government and Hellenic Petroleum will sell their shares in one of two possible ways. Either 100 percent of DEPA S.A. will be sold, after which the Greek Government will retain ownership of 34 percent of the gas transmission daughter company DESFA S.A., or DESFA S.A. will be separated from DEPA S.A., followed by the separate privatisation of 100 percent of DEPA S.A. and 66 percent of DESFA S.A.

Applications for participation in the tender have been taken since the 22nd of March. Although the exact schedule for the sale of DEPA S.A. has not been officially announced, it has been reported that the participants in the tender could be selected by early August. While the sum which the Greek Government hopes to raise from the sale of DEPA S.A. is as yet unknown, it has also been reported that the sale of shares in DEPA and DESFA could generate up to \$2.6bn.

Israel - Gazprom to participate in gas field development

Gazprom's Swiss-based subsidiary, Gazprom Marketing and Trading, has signed a letter of intent to participate in the development of the Tamar offshore field, and has expressed an interest in buying LNG produced at the Leviathan offshore oil and gas field, which is being developed by the Israeli Delek Group.

The Tamar gas field was declared discovered in 2009, and has estimated reserves of 265 billion cubic metres (bcm), of which 113-136bcm has been committed to six Israeli entities, in a bid to reduce Israel's dependency on gas imports from Egypt. Production is expected to begin in

2013. Gazprom is negotiating over the potential purchase of 2-3 million tonnes of LNG (equivalent to 2.8-4.1bcm of natural gas) every year from 2017. In November 2011 the South Korean company, Daewoo Shipbuilding and Marine Engineering, signed an agreement to construct a floating LNG terminal for the project.

The Leviathan gas field was discovered in 2010, with reserves estimated to be up to 450bcm of natural gas. American firm Noble Energy is the operator of the field (owning a 39.66 percent share in the project), while its two subsidiaries (Delek Energy - Delek Drilling and Avner Oil) each own 22.67 percent. The Israeli company Ratio Oil Exploration owns the final 15 percent. Gazprom representatives have met with representatives of Delek Group to discuss the possibility of Gazprom either buying and re-selling gas from the project or even participating in its development. Gazprom still has time to manoeuvre in the negotiations, with production not expected to start until 2016.

Although the volumes are not significant for Gazprom, Gazprom's involvement in the Israeli projects could strengthen the company's position in the region and prevent Israeli gas from competing with Russian gas on the European market. Following the discovery of the gas fields Gazprom's position in the region changed significantly and Gazprom's plan to build the Blue Stream 2 pipeline to Israel was abandoned.

Ukraine – Modernisation of Ukraine's gas transit system under consideration

European and Russian investors are losing interest in the Ukrainian gas transit system (GTS), due to the unprofitability of Naftogaz and question marks over future transit volumes from Russia to Europe.

Naftogaz announced the beginning of the modernisation of its GTS in July 2011, with total costs expected to be \$5-7bn over the next decade. The first phase was expected to take three years, at a cost of almost \$540m, including \$230m from Naftogaz and \$155m each from the European Bank of Reconstruction and Development (EBRD) and the European Investment Bank. However, further progress has stalled over a lack of reform of the Ukrainian gas market. The EBRD is unwilling to lend further to Naftogaz until the reforms render the company profitable. The hope of such reforms was raised in March 2012, when the Ukrainian Parliament passed a bill to separate the production and transportation

sections of Naftogaz. However, the bill also prohibits the privatisation of the gas transport infrastructure, potentially limiting external investment beyond loans to Naftogaz and the acquisition of minority shares Ukraine's GTS.

If the reforms are not carried through, and European institutions remain reticent about further lending to Naftogaz, the company could be forced to conclude some kind of agreement with Gazprom. Whilst recent legislation prevents the privatisation of Ukraine's GTS, Ukrainian media reports at the end of March claimed that Naftogaz was seeking a \$2bn loan from Gazprombank to pay for gas purchases, suggesting a willingness on the part of Naftogaz to seek deals with Gazprom. While Naftogaz is demanding gas price discounts of around \$9bn per year in exchange for a share in the GTS, Gazprom representatives have claimed that the purchase and modernisation of Naftogaz infrastructure (presumably including also the cost of gas discounts to Ukraine) would be more expensive than the construction 'from scratch' of South Stream, which is currently expected to cost \$21.6bn (16.5bn Euro).

There remains significant room for manoeuvre in the negotiations. In February Gazprom spokesman Sergey Kuprianov claimed that Ukraine would play 'zero role' in gas transit to Europe following the completion of the 55bcm Nord Stream and the 63bcm South Stream. Yet in March the Head of Gazprom Export, Alexander Medvedev, suggested that one string of South Stream (15.8bcm) would suffice if Gazprom obtained a share in Ukraine's GTS. Given Kiev's consideration of the GTS as a strategic national asset, a final agreement is unlikely to be reached soon.

Ukraine – Dispute with Ukraine over gas supply shortages continues

The abnormally cold weather in Europe and Russia during January and February 2012 resulted in gas supply shortages to Europe from Russia, via Ukraine. The shortages sparked mutual accusations by Gazprom and Naftogaz, each claiming that the other was to blame for the shortfall in deliveries to European consumers.

Gazprom representatives claimed to be perplexed by reports of shortages on the grounds that it had significantly increased its gas exports to Europe during the period, before accusing Naftogaz of taking substantially more than its contracted volumes, thus causing the shortfall in transit volumes to Europe. Naftogaz responded by presenting evidence that, at the height of winter, Gazprom had failed to deliver sufficient volumes to the Ukrainian border, with the result that Naftogaz faced a shortfall of 1.247bcm of

gas, thus suggesting that Gazprom was struggling to meet the upsurge in combined demand in Russia, Ukraine, and Europe.

Nord Stream – European Commission concerned about the 'expansion' of Nord Stream into Germany

The European Commission rules that Third Energy Package legislation concerning Third Party Access must be applied to the NEL and OPAL gas pipelines that connect Nord Stream to the rest of Germany's gas infrastructure, theoretically limiting Nord Stream volumes to two-thirds of capacity.

Just months after the triumphant launch of Nord Stream, Gazprom faces a challenge to its Northern European gas exports. In mid-March the European Commission announced that the operators of the NEL (Northern Germany Natural Gas Pipeline) and OPAL (Baltic Sea Pipeline Link) pipelines that connect Nord Stream to the rest of Germany's gas pipeline infrastructure must reserve 33-50 percent of the capacity of those pipelines for Third Party Access, as stipulated in the EU Third Energy Package.

NEL is 51 percent owned by Wingas (a Wintershall-Gazprom joint venture) in cooperation with E.ON, Gasunie, and Fluxys – the first two also being participants in Nord Stream AG – and is scheduled for inauguration in late 2012. NEL will connect Nord Stream with gas pipeline infrastructure in Northern Germany and allow the onward flow of gas to European countries further west (Netherlands, Belgium, UK), with a planned capacity of 20bcm. OPAL runs south from Greifswald to the German-Czech Border with a capacity of over 35bcm, and was completed just time for the inauguration of Nord Stream. OPAL is 80 percent owned by Wingas and 20 percent by E.ON.

Given that the combined capacity of NEL and OPAL is 55bcm – exactly that of Nord Stream – the European Commission ruling theoretically means that Nord Stream cannot be used at full capacity. However, given that gas cannot physically enter the NEL and OPAL pipelines other than via Nord Stream, the ruling seems a matter of principle rather than practicality, as the European Commission appears to be taking a stand against Nord Stream's 'expansion' into German territory. Whether Gazprom intended for Nord Stream to be used at full capacity, in light of Gazprom's recent acquisition of Beltransgaz and the ongoing developments regarding Ukraine and South Stream, remains another matter.

Lithuania – Gazprom seeks to set a precedent in Lithuania

Gazprom is challenging the implementation of the Third Energy Package in Lithuania, but is likely to achieve little more than a delay in the unbundling of Lietuvos Dujos.

On the 27th of February the Head of Gazprom Export, Alexander Medvedev, met with the Lithuanian Prime Minister, Andrius Kubilius, and the European Commission Director General for Energy, Phillip Lowe, to discuss the implementation of the Third Energy Package in Lithuania. The sides then agreed a roadmap for cooperation in the gas sphere. The next day Kubilius announced that Lithuania would implement the separation of the country's gas transport and distribution system in accordance with the Third Energy Package by the end of 2014. The system is currently operated by Lietuvos Dujos, in which Gazprom owns a 37 percent stake. This was swiftly followed by Gazprom's announcement that it would seek international arbitration for the defence of its investments in Lithuania at the UN Commission on International Trade Law (UNCITRAL) in Vienna.

Gazprom representatives claimed that the agreements reached with representatives of the European Commission and Government of Lithuania on the 27th of February have not been honoured, but also offered to withdraw the lawsuit if the decisions reached on the 27th of February are implemented before the next Lietuvos Dujos shareholders meeting. However, even if Gazprom does press ahead with the arbitration claim, it is unlikely to result in the reversal of the decision to unbundle Lietuvos Dujos. The move seems therefore designed to delay the unbundling and put pressure on Vilnius regarding the conditions of the unbundling, given that the terms of the Third Energy Package do not preclude Gazprom from minority shareholdings in any of the new companies created as a result of the unbundling of Lietuvos Dujos.

Lithuania – Lithuania proposes swaps to Gazprom

In a bid to reduce its dependency on expensive Russian gas supplies Lithuania is seeking alternative suppliers and has proposed a gas swap deal with Gazprom. However, a more realistic diversification option seems to be the construction of a new gas import pipeline from Poland.

In an effort to reduce its expenditure on Russian gas, Lithuania is looking for alternative suppliers who are prepared to supply gas to the country at lower prices. Such endeavours appear to have yielded some success, since Lietuvos Energija has announced that it has found a

European company, which offers 'more favourable' conditions in comparison with Gazprom. The name of the potential supplier has not been revealed, but it is known that the Lithuanian company had conducted searches in Western Europe and Scandinavia. It has only been reported that deliveries could begin in 2013, and that intake of gas will take place on the German-Polish border.

The main problem for Lithuania lies in its geographical position – gas deliveries direct from Western Europe are not possible, as Belarusian pipeline operators are refusing to reverse the flows to enable deliveries from Poland to Lithuania via Belarus.

To overcome this problem Lietuvos Energija has proposed a swap deal with Gazprom. According to the Lithuania Tribune, the Lithuanian side has offered "to pay for gas that is supplied to Lithuania with gas that Gazprom pumps to Western Europe which Lithuania can obtain at 'more favourable conditions'". However, there is little probability that Gazprom would agree to such conditions. The benefits for Gazprom are questionable, and the volumes of deliveries being discussed are comparatively small – specialists estimate them to be 300m cubic metres of gas per year.

In this situation the more realistic option seems to be the building of a new pipeline between Lithuania and Poland, referred to as the Gas Interconnection Poland - Lithuania (GIPL), with a length of 560 kilometres and capacity of up to 2.3bcm of gas per year, representing more than half of Lithuania's gas needs.

Gazprom – Gazprom forced into discounts for European energy companies

The continued disparity between European spot market and long term contract gas prices has prompted European energy companies to seek discounts from Gazprom.

In early March Germany's RWE reported an operating loss of around 800m Euro in its sales and supply sectors, according last year's operating results. These losses were almost 40 times those of 2010 (around 21m Euro). One of the reasons for the losses was the substantial difference between the price of gas bought according to long-term contracts and the prices at which RWE sells natural gas to its customers.

Gazprom accounts for around 30 percent of RWE's long-term contract imports (7bcm of a total of 24bcm), while the average price of long-term contract supplies was 15 percent



higher than the spot price (\$381 and \$330 per thousand cubic metres respectively).

The significant difference between long-term contract and spot market gas prices has continued into its fourth consecutive year, prompting European importers to seek substantial discounts from Gazprom. RWE has already filed a claim for international arbitration on gas prices, with the result expected in 2013. Gazprom is gradually changing its position and making concessions, in a bid to retain its share of European gas imports in the face of increasing competition from LNG supplies sold at spot market prices. Hence, Gazprom has already lowered its gas prices for companies such as GDF Suez, Wingas, SPP, Botas, Sinergie Italiana, Ecomgas, and ENI, while RWE appears to be next in line for a discount. However, even the 10 percent discount sought by the German company will not be sufficient to cover the losses caused by the difference between gas import and gas sale prices: According to company forecasts RWE looks set to finish 2012 in the red.

Gazprom – Increase in domestic prices to be balanced by increase in tax burden

Increased revenues resulting from the equalisation of domestic and export gas prices could bypass Gazprom and go straight to the Russian state, thanks to an increase in the Mineral Extraction Tax (MET).

Domestic Russian gas prices, currently around \$100 per thousand cubic metres, are set to rise to \$160. However, the increase in revenue will be offset by an increase in the rate of Mineral Extraction Tax (MET) paid by Gazprom. The exact increase is not yet known, and two key ministries involved in setting the new rate have yet to agree on the new rate.

The Ministry of Economic Development is insisting that 100 percent of Gazprom's extra profits resulting from the increase in domestic gas prices should be taken in tax. Conversely, the Minister of Finance, Anton Siluyanov, has proposed a rate of 80 percent of Gazprom's extra profits. Even the figure of 80 percent would mean an extra 50bn Roubles (\$1.7bn) of tax revenue from July next year. The MET rate already doubled in November 2011 from 237 Roubles per thousand cubic metres to 509 Roubles per thousand cubic metres.

Gazprom currently covers the cost of its investment programmes in Russia almost entirely on the basis of export earnings. Domestic gas sales account for almost 60 percent of Gazprom gas sales by volume but only around 30 percent of gas sales by revenue. Gazprom had hoped to lessen its dependence on exports through the increase in domestic gas prices. Given the number of investment projects in Russia and their high costs (including the gasification of Russia's regions and the upgrading of infrastructure), Gazprom runs the risk of lacking the funds to implement these projects.

End of EGF Document

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