



A Snapshot of Key Developments in the External Relations of the Russian Gas Sector¹

Key points:

- *Gazprom partners raided by European Commission Anti-trust Inspectors*
- *The dispute between Moscow and Kiev continues. Ukraine knows that it has a weak bargaining position and is in no hurry to make concessions to Russia*
- *Prime Minister Vladimir Putin launched the first string of Nord Stream, meaning Ukraine is now in danger of losing its status as the main transit country for Russia's European gas exports*
- *Gazprom has signed roadmap with South Korea's Kogas for the construction of a pipeline from Vladivostok to South Korea*
- *Gazprom may suspend its project in Nigeria because of the lack of a law governing the oil and gas industry, although experts say Gazprom may have lost interest in this project because of potential difficulties in selling Nigerian gas*
- *Gazprom is looking to acquire two state-owned oil and gas companies in Kyrgyzstan*
- *The Gazprom affiliate Vemex has acquired a 51% stake in RSP Energy, marking the first time a Gazprom Group company will sell gas and electricity to Czech households*
- *Gazprom has signed a legally-binding agreement with its European partners on the implementation of the South Stream project, but has attracted criticism from the EU. According to Russian sources, EU Energy Commissioner, Guenther Oettinger, views South Stream as an attempt by Moscow to derail the 'Southern Corridor' gas supply diversification concept*
- *In line with new oil production projects in the region, Gazprom Neft is considering the construction of a new oil refinery near Murmansk*
- *Gazprom expects a doubling of the Mineral Extraction Tax by 2013.*

¹The 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

Gazprom's European partners raided by Brussels

On 27-28 September 2011 European Commission anti-trust inspectors raided energy companies in several Central and East European countries over suspected anti-competitive behaviour relating to gas supply contracts.

The EU antitrust inspectors raided companies in ten EU Member states: Germany (E.ON, RWE, Gazprom Germania), Austria (OMV, Eongas), Poland (PGNiG, TSO Gaz-System), the Czech Republic (RWE Transgas, Vemex), Slovakia (SPP), Hungary (E.ON Magyarorszag), Latvia (Latvijas Gaze), Lithuania (Lietvos Dujos), Estonia (Eesti Gaas), and Bulgaria (Bulgargas, Bulgartransgas, Overgas). The raids were carried out under Articles 101 (restriction of competition) and 102 (abuse of dominant position) of the Treaty on the Functioning of the EU (TFEU). According to an official European Commission statement, the "The investigation focuses on the upstream supply level" where the Commission suspects exclusionary and possibly exploitative behaviour.

Given Gazprom's status as the EU's largest 'external supplier', and the fact that all of the companies raided have contracts with Gazprom, it appears that contractual relations between Gazprom and the aforementioned European companies were the target of the investigation. However, similar investigations were conducted in Western Europe between 2007 and 2010, and the raids coincided with EC Energy Commissioner Gunther Oettinger's announcement that legal proceedings have been started against 18 EU Member States for failure to implement evolving EU energy legislation packages. Thus, commentators are divided over whether the recent raids are a concerted action against Gazprom, or simply a continuation of Brussels' efforts to make a liberalised EU internal energy market a reality.

The Moscow-Kiev Dispute Continues

The President of Ukraine, Viktor Yanukovich, has called on Russia to abandon the South Stream project, claiming it is cheaper and more logical to build a gas pipeline overland through Ukraine. Kiev has toned down its rhetoric in the dispute with Moscow and even reiterated its readiness to fulfil obligations to Gazprom in case of the reorganization of Naftogaz.

President Yanukovich has shown an inclination to compromise on the eve of his meeting with Russian President Medvedev. The launch of Nord Stream has clearly contributed to a softening of the Ukrainian positions. At the same time, sources in the Ukrainian government have announced that Kiev expects a reduction of gas prices to \$190-210 per thousand cubic meters and an increase in the cost of gas transit through its territory.

Although the Ukrainians understand the weakness of their negotiating position, they are in no hurry to make concessions towards Russia by joining Moscow's Customs Union project or handing over control of their gas transit system to Gazprom.

Ukraine in danger of losing its transit status

Prime Minister Vladimir Putin launched the first line of the Nord Stream pipeline near St. Petersburg, and now Ukraine is seriously threatened with the loss of its status as the main transit country for Russian gas deliveries to European consumers.

The Head of Gazprom, Alexei Miller, has once again reminded Ukraine that it receives gas more cheaply than consumers in Poland, Hungary, Turkey and Romania, and he advised Kiev to jump down from the train marked 'cheap Russian gas' before it reaches a dead end.

According to Mr. Miller, Ukraine receives gas at the same price as Germany, where Gazprom partially owns long-distance German gas pipelines. "Ukraine is our old partner, traditionally she had the exclusive privileges of the transit state, now they are disappearing" stated Vladimir Putin, "and our relations are becoming increasingly market-orientated", while Mr. Miller added in a half-whisper to journalists: "The key word is 'old'".

Gazprom goes to Korea

Gazprom has signed a roadmap agreement with South Korean company Kogas for the construction of a pipeline from Vladivostok to South Korea. Gazprom has not disclosed any of the terms or phases of the project implementation, but has declared the readiness of Russia's infrastructure, referring to the recently-launched Sakhalin-Khabarovsk-Vladivostok gas pipeline. The initial capacity of the pipeline is reported to be 6bcm.

South Korea receives all of its natural gas imports as LNG. Russia currently supplies 2.07bcm to South Korea as LNG. The new pipeline would allow a substantial increase in delivery volumes from Russia, with Russia aiming at 10bcm a year by 2017. However, despite the recent Memorandum of Understanding signed between Russia and North Korea on gas supplies to the Korean peninsula, the geopolitical risks of having North Korea as a transit state for Russian gas supplies to South Korea will remain significant.

Gazprom cautious on Nigeria

Gazprom may suspend its activities in Nigeria because of the 'absence of clear rules' governing the oil and gas industry, although experts suggest that Gazprom may have lost interest in the project because of difficulties with the sale of Nigerian gas.

In 2008 Gazprom and the Nigerian National Petroleum Corporation (NNPC) signed a Memorandum of Understanding, which was followed in June 2009 with an agreement to establish joint ventures. Gazprom was one of 15 companies selected by the Nigerian Government as investors in developing gas projects. Last year Gazprom announced that investment will begin after the country's general elections and the passing of the Petroleum Industry Bill (PIB). The Bill was first introduced in 2008 with the aim of improving regulation in Nigeria's oil and gas industry, but has still not been passed.

It is possible that Nigeria had already lost its attractiveness for the Russian giant. The US gas market, which could have been a destination for gas produced in Nigeria, is now inaccessible for Gazprom since its local shale gas production has caused an excess supply of natural gas in the country. In the US gas now costs \$147 per thousand cubic metres, which is almost half the European market price.

However, Gazprom has emphasized that gas production in Nigeria remains one of the priority projects of the Russian company, given that the country accounts for over one-third of Africa's gas reserves, about 5.2 trillion cubic metres (tcm), which places Nigeria seventh in the world for proven reserves. In addition, the undiscovered gas resources are thought to be a further 17 tcm.

Gazprom's 'Great Game' in Kyrgyzstan

Gazprom appears set to purchase two Kyrgyz state-owned oil and gas companies and invest in geological exploration in the country. It has been suggested that Gazprom has a geopolitical interest in the acquisition of Kyrgyz state-owned enterprises, given the small size of the country's gas reserves.

Kyrgyzneftegaz is the only Kyrgyz company engaged in geological exploration, the development of oil and gas fields, transportation, oil refining and the sale of petroleum products. Kyrgyzgaz delivers gas to consumers and provides transportation services for Kazakh gas transit in the north and Uzbek gas transit in the South of Kyrgyzstan.

Proven natural gas reserves in Kyrgyzstan are about 6 bcm. But so far little has been invested in geological exploration in the country, meaning that the reserves of Kyrgyz gas may be higher than official figures. The development of gas fields is difficult because of specific geological features and an underdeveloped infrastructure.

Gazprom's interest in the Kyrgyz assets may be based on the perceived value of Kyrgyzstan's reserves and transit infrastructure as a means for Russia to compete more successfully with Turkmenistan and Kazakhstan for Chinese consumers.

Gazprom reaching consumers in the Czech Republic

Gazprom has repeatedly stated its desire to sell as much gas as possible directly to end consumers in Europe. Gazprom already operates in the gas retail markets of Bulgaria, Austria, Czech Republic, France, Italy and the UK. In 2010 these sales amounted to less than 3% of Gazprom's total exports to Europe, or about 4.7bcm. A recent deal between Vemex s.r.o and RSP energy will further Gazprom's retail presence in the Czech Republic.

Vemex (51% owned by Gazprom Germania, a wholly-owned Gazprom subsidiary) recently acquired a 51% stake in RSP Energy which, in turn, supplies electricity and gas to households of the Czech Republic. The controlling stake was bought from different individuals. The cost of the transaction was not disclosed, though experts say the purchase was not too burdensome for the gas giant.

The Vemex deal marks the first time a Gazprom Group company will be able to sell natural gas and electricity to the Czech population. Until now, Vemex sold natural gas and electricity only to large and medium Czech customers. Gazprom's other main partner in the Czech Republic, RWE Transgas, focuses on gas transit and gas trading. For Gazprom this means access to a new segment of the Czech energy market. The EU Third Energy Package is not a barrier to such trade, since Gazprom is not acting directly but through one of its subsidiaries.

A fly in the ointment for South Stream

On 16 September 2011, Gazprom, together with the Italian company ENI, EdF of France and Germany's Wintershall signed a legally-binding shareholders' agreement to implement the South Stream gas pipeline construction project. Gazprom will retain its 50% share, ENI will have 20%, and EdF and Wintershall will receive 15% each. This shareholders' agreement significantly "ups the stakes" on the South Stream project, with investment plans to be presented to project financiers by the end of the second quarter of 2012. The project is scheduled for launch in 2015.

Brussels, however, started to put pressure on the project participants on the eve of the aforementioned agreement. Russian sources suggest that EU Energy Commissioner, Guenther Oettinger, views South Stream as an attempt by Moscow to hamper the realisation of the 'Southern Corridor' project: the EU's energy supply diversification concept flagship, which aims to bring natural gas from various Caspian sources to Europe via several pipeline projects.

Oettinger has warned Russia about the unacceptability of putting political pressure on Turkmenistan and Azerbaijan (two of the envisaged supply countries for Southern Corridor gas) and made it clear to the Russian side that Europe will only increase gas purchases from Russia if Gazprom's share in the European energy market decreases.

The regasification of Europe

According to Central Dispatch Administration of the Fuel and Energy Complex (TsDU TEK) Russian gas exports in the first ten days of September fell by an average of 13%. The reduction of gas production and export does not come as a surprise to the market. The export growth rate has slowed since July, while in the

last ten days of August it almost stopped growing, reaching only 1.5%. Gazprom's (summer time) production fell to its lowest level during mid-August and reached 991.7 million cubic meters (mcm) per day. In August exports slightly exceeded the 2010 level and amounted to 11.03 billion cubic meters.

The main reason for falling gas exports is high prices. In August they exceeded \$400 per one thousand cubic meters. The spot market price, which generally reflects the trend of the market for the near future, was \$344 per thousand cubic meters. Experts consider that in first six months of 2011 the growth in exports was mainly due to European consumers trying to pump as much gas as they could into underground storage while prices were lower. Demand for Russian gas in the second half of the year is therefore expected to be significantly weaker than in the first.

ENI's plans to resume gas supplies to Italy from Libya may be exacerbating the decline. Such supplies were stopped at the end of February due to the war in Libya. This resulted in a sharp increase in Gazprom's exports to Italy, which had declined in recent years.

Refinery construction in Murmansk justified by new oil production projects

Gazprom Neft is considering building a new refinery in the Murmansk region. Until now the company had sufficient refining capacity in the region. But new oil production projects, including the Prirazlomnoye project in the Barents Sea, justify the construction of a new refinery. The main question is the amount of investment. Gazprom Neft has suggested that it could increase its refining capacity in the region by five or ten million tonnes. In the first case investment could reach \$3-4 billion, whilst in the second it could reach \$6-7 billion.

The main product of the refinery will be diesel fuel. If Gazprom keeps within the declared budget and build a plant which produces high-quality fuel the project is most likely to be profitable. Such an outcome is underscored by the demand for Russian diesel in Europe and the favourable nearby location of Murmansk as an export oriented sea port.



Gazprom expects a doubling of the mineral extraction tax

According to the Russian Ministry of Finance, Gazprom can expect a doubling of the Mineral Extraction Tax (MET). The tax rate for gas producers is currently 237 Rubles per 1,000 cubic meters. From 2012 Gazprom and the companies it controls can expect to pay 509 Rubles. In 2013 this could increase to 582 Rubles, and in 2014 up to 622 Rubles. At the same time the tax for the remaining gas companies will increase in line with inflation.

At the beginning of this year the Ministry of Finance was instructed to collect an additional 150 billion Rubles from the gas industry in 2012. Gazprom's leadership convinced government officials to revise their forecast of gas export prices, as the Ministry of Finance was too conservative in previous calculations.

A revision of the export price was carried out. On account of the revised forecast additional budget revenues in 2012 will be 150.7 billion Rubles, and in 2013 - 126.7 billion. But the MET for Gazprom and its daughter companies will also be raised in order to bring into the treasury an additional 122.7 billion Rubles in 2012, and 169.6 billion in 2013.

This is not the first raid on Gazprom. Earlier this year the government announced its intention to raise its Russian state tariffs by 15% from the 1st of January 2012. On the 12th of September, following the budget committee meeting, Prime Minister Vladimir Putin said that the increase for Gazprom will remain within the 15% limit and will apply only from the 1st of July. For Gazprom this will mean a financial a loss of about 60 billion Rubles.

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