The European Geopolitical Forum

www.gpf-europe.com

EGF Gazprom Monitor
Issue 14: July 2012

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

By Jack Sharples, EGF Associate Researcher on the external dimensions of Russian gas

Key points:

- *Gazprom suffers a setback as the Lithuanian parliament approves construction of an LNG plant at Klaipeda as part of efforts to reduce dependence on Russian gas, but agrees a gas price discount for E.On and extends contract with Moldovgaz, potentially halting Moldova's implementation of the Third Energy Package*
- *Mixed fortunes for Gazprom in Turkey as the company wins the right to sell gas to private Turkish energy companies, but suffers a setback with the announcement of a Turkish-Azerbaijani agreement on the construction of the TANAP pipeline*
- *The Nord Stream project is on schedule for the second string launch in Q4 2012. CEO Alexei Miller suggests that Nord Stream could be extended to the UK*
- *Macedonia and Respublika Srpska reiterate their enthusiasm for South Stream, but the date of final investment decision and the application of the EU Third Energy Package remain unclear*
- *Putin meets Yanukovych in Yalta but refuses demands for gas price discount*
- *More negotiations between Gazprom and CNPC, but with no breakthrough*
- *Shtokman talks delayed with a result not being expected until autumn 2012*
- *Gazprom is ranked as the world's most profitable company by Forbes, but only comes 98th of 105 in transparency rankings according to report by Transparency International*
- *Novatek begins construction of Sabetta LNG terminal in Yamal region, but claims no threat to Gazprom's export monopoly*
- *Rosneft expands its presence in the Russian gas market with an acquisition of a 6 percent stake in independent gas company Itera*

Third Energy Package and Gazprom's Partners in the EU

The Lithuanian parliament passes a law to build an LNG plant at Klaipeda as part of Lithuania's plans to reduce dependency on Russian gas; Gazprom grants a gas price discount to Germany's E.On; Moldova signs a new gas supply contract with Russia, effectively abandoning moves towards EU and European Energy Community integration.

Less than a month after the agreement to divide Lietuvos Dujos into gas transmission and gas sales in line with the implementation of the Third Energy Package (Gazprom Monitor No.13, May-June 2012), it seems that Gazprom has suffered another setback in Lithuania. On the 12th of June the Lithuanian Parliament approved a law providing for the construction of a liquefied natural gas (LNG) terminal at Klaipeda, as part of Lithuania's efforts to reduce its dependence on Russian gas imports. The Lithuanian Government has also announced an international tender for the construction of a pipeline to connect the terminal to Lithuania's gas pipeline network. These developments signal Lithuania's decision to 'go it alone', rather than wait for a resolution to disagreements with regional neighbours Latvia and Estonia over the construction of a single, larger, Baltic LNG terminal.

The Klaipeda terminal, which is planned to have a 2-3bcm per year capacity (phases 1 and 2 respectively) and to be operational by the end of 2014, was described by Lithuanian President Dalia Grybauskaite as "A real step towards energy independence". This certainly seems to be the case, given that the phase 2 capacity of 3bcm is only marginally less than Lithuania's 3.2bcm of gas imports from Russia in 2011. However, in order to ensure the economic viability of the project, the law also stipulates that 25 percent of Lithuania's future gas imports must be made via the terminal, which runs counter to the 'free market competition' ethos of the Third Energy Package.

Although Gazprom, as a shareholder in Lietuvos Dujos and Eesti Gaas, seems to have accepted the implementation of the Third Energy Package as inevitable, the measures have been repeatedly criticised, not only by senior Russian politicians (as reported in last month's Gazprom Monitor), but also by Russian energy experts, such as Andrei Konoplyanik, who disagrees with the application of the Third Energy Package to already-existing contracts and shareholdings: "In my opinion, the EU should have given a transitional period to implement the new rules until the current (long-term) contracts run out".

Gazprom, which currently holds a 37 percent stake in Lietuvos Dujos and a 37 percent stake in the Estonian Eesti Gaas, is not the only foreign energy company to suffer from the implementation of the Third Energy Package in Lithuania and Estonia. Germany's E.On holds a 39 percent stake in Lietuvos Dujos and a 34 percent stake in Eesti Gaas. The close relations between Gazprom and E.On were demonstrated by the resolution of their disagreement over long-term contract prices. The agreement relates to the current gas supply contract, which runs until 2036 and covers a volume of around 600bcm in total, and represents a discount of 7-10 percent for E.On in its Russian gas purchases.

During July Gazprom did score one victory in relation to European energy integration, in persuading the Moldovan gas monopoly, Moldovgaz (50 percent owned by Gazprom), to extend its gas contract with Gazprom until the end of 2012. The previous contract had expired in December 2011, with negotiations frozen in October 2011 following Moldova's commitment to implementing the EU Third Energy Package legislation in line with Moldova's membership of the European Energy Community. The reported gas price for Moldova for the next two years will be $375 per thousand cubic metres, a discount on the Q1 2012 price of $387. There has been media speculation that the extension of the contract will result in Moldova abandoning its implementation of the Third Energy Package, although Gazprom officials deny any linkage between its contract with Moldova and Moldova's implementation of the Third Energy Package. Despite Moldova being one of Gazprom's smaller customers (importing a little over 3bcm per year), the country remains an important transit state for Russian gas deliveries to Western Europe, having transited approximately 19bcm (just under 15 percent of Gazprom's exports to the EU) in 2011.

Russia-Turkey

Mixed fortunes for Gazprom in Turkey, as the company wins the right to sell 6bcm of gas to private importers but suffers a setback as Turkey agrees to build a pipeline from Azerbaijan.

Turkey is Gazprom's third largest export destination, buying 26bcm of Russian gas in 2011. Those supplies are delivered either via the Blue Stream pipeline (capacity 16bcm) under the Black Sea directly from Russia, or via Ukraine and the western Balkans. In October 2011, Turkish state gas pipeline operator, Botas, announced that it would not be renewing its long-term contract to import 6bcm per year from Gazprom. At the beginning of July the Turkish Energy Market Regulatory Authority (EPDK) gave permission for private Turkish energy companies to import 6bcm of gas from Russia from 1st January 2013, thus making up the shortfall.

The EPDK announcement came shortly after the news on 27th of June that Turkey's Prime Minister Recep Tayyip Erdogan and Azerbaijan's President Ilham Aliyev had finally signed the long-awaited agreement to build the 2000km TANAP gas pipeline from Azerbaijan to Turkey. The pipeline is planned to bring 16bcm of gas from Azerbaijan's Shah Deniz project to Turkey's western border. Of that 16bcm, 6bcm will be sold in Turkey and the remaining 10bcm will be transited on to Europe, potentially as part of the Nabucco project. The project, planned for completion by 2018, represents another case of Gazprom customers diversifying their imports. However, it should be remembered that the while the 6bcm of Azerbaijani imports accounts for more than one-fifth of Gazprom's exports to Turkey, the 10bcm to be transited on to Europe equates to just 6 percent of Gazprom's exports beyond the Former Soviet Union, thus representing a narrow challenge to Gazprom's Turkish gas exports, rather than a broader challenge to Russia's European gas exports.

Nord Stream

The underwater sections of Nord Stream second string have been welded together ready for pre-commissioning, meaning the project is on schedule for launch in Q4 2012. Gazprom CEO Alexei Miller claims that Nord Stream could be expanded and extended to the UK in the future.

On the 29th of June Nord Stream AG announced that the underwater welding together of the three offshore sections of the second string of the pipeline had been completed. The pipeline was then dried out during July, and will be connected to the onshore sections in August. According to Nord Stream AG, the second string is on schedule for launch in Q4 2012. When commissioned, the 27.5bcm second string will take Nord Stream up to its design capacity of 55bcm.

Following Gazprom's Annual Shareholder Meeting on the 29th June, Gazprom CEO Alexei Miller spoke to journalists about the potential to construct two more strings of the Nord Stream pipeline. Miller stated that a decision could be taken by the end of 2012: "As far as Gazprom is concerned, we are already decided that for us, for Gazprom, it makes sense". Miller went on to suggest that one of the new strings could be extended to the UK: "There have been signals the U.K. would be interested, both on the government and corporate level". When asked if any specific British companies were involved, Miller claimed that, although there were no specific agreements, "British Petroleum has shown an interest". However, BP spokesman Toby Odone declined to comment.

South Stream

Macedonia and Respublika Srpska are enthusiastic about participation, but the date of the final investment decision and the impact of the application of the EU Third Energy Package remain unclear.

Following a meeting with Italian PM Mario Monti on the 23rd of July, Putin expressed his support for the South Stream project: “This is a common, multi-lateral European project in which the overwhelming majority of our largest gas customers in Europe are interested… I am certain that this project will be realised”. Putin added that the currently difficult economic situation in Europe would not prevent the implementation of the South Stream project: "It is already clear to us who and at what volumes will purchase the product that will pass through South Stream along the bottom of the Black Sea to our clients in Western Europe. Projects aren't launched without preliminary contracted work".

Although they do not lie on South Stream’s intended route, both Macedonia and Respublika Srpska have expressed interest in the project. During the St Petersburg Economic Forum (21-23 June) Gazprom CEO, Alexei Miller, met with Macedonian PM Nikola Gruevski to discuss Macedonia’s participation in the South Stream project. The results of a feasibility study regarding Macedonia’s participation are expected in Q3 2012. On the 26th June the Government of Respublika Srpska (Bosnia & Herzegovina) declared South Stream to be a strategic project of national importance, with Minister of Industry, Energy and Mining, Mr. Zeljko Kovacevic, stating that the construction of South Stream will enable the gasification of all the cities and municipalities in the Republic of Srpska.

It has been reported by Russian sources that the construction of the onshore Russian section of South Stream (in the Rostov region) could begin as early as October. However, not only does this predate the expected final investment decision, there appears to be a lack of clarity around when that final investment decision will actually be taken. Whilst Gazprom officially claims that the final investment decision will be taken in November 2012 and that the first supplies will be delivered to Bulgaria by December 2015, Eni Chief Executive, Paolo Scaroni, was quoted in the Italian media on the 17th of July as stating that the final investment decision will be made ‘by the end of 2012 or early 2013’. The timing is crucial – It has been widely reported that Gazprom hopes to pre-empt the March 2013 entry into force of the Third Energy Package with respect to non-EU countries (i.e. Russia). The logic runs that if South Stream already exists on EU territory (even if only the beginnings of construction in Bulgaria) before the March 2013 deadline, the EU legislation (particularly the articles regarding Third Party Access to pipelines, such as South Stream) will not apply. However, given that the current implementation of the Third Energy Package in the EU is resulting in EU energy companies being ‘unbundled’ (such as Lietuvos Dujos, above), rather than preventing future ‘bundling’ as it were, the legislation is being applied retroactively. If this example is applied to South Stream, the deadline of March 2013 simply represents the date from which Gazprom will be guilty of breaching the Third Gas Directive (2009/73/EC) with respect to Third Party Access and (as a gas producer) being the majority owner of a subsidiary (i.e. the joint ventures with European energy companies in which Gazprom holds a 51 percent share) which operates South Stream on EU territory, thus acting as a non-independent transmission operator. With three and a half months to go before the final investment decision (according to Gazprom), South Stream’s future remains far from clear.

Russia-Ukraine

Putin visits Ukraine, but refuses to grant further gas price discount

Russian PM Vladimir Putin met Ukrainian President Viktor Yanukovych in Yalta as part of the Russian-

Ukrainian Inter-State Commission, on July 12, 2012. During the meeting, Putin refused to grant what Yanukovych (and the Ukrainian Naftogaz) have long hoped for – a reduction in the price of Russian gas. After the meeting, Putin remained optimistic: "There are issues where we have not reached an agreement but ... we will aspire to do that".

The current contract was signed in January 2009 as a means of ending the Russian-Ukrainian gas dispute by ex-Ukrainian PM Yulia Timoshenko, who was later jailed for 'exceeding her authority' and signing a contract which was detrimental to Ukraine's national interests. Timoshenko has appealed the sentence and claims her imprisonment is politically motivated. In April 2010 Ukraine received a 30 percent discount on its gas prices (or $100 if the gas price rose above $330 per thousand cubic metres) in return for extending Russia's lease on its Black Sea Fleet base at Sevastopol. That deal was made possible by the Russian Government forgoing the 30 percent gas export duty on gas delivered to Ukraine. Yet the Ukrainian Government and the Ukrainian Naftogaz have continued to argue that the price at which Ukraine imports gas from Russia is too high, and are seeking further discounts.

Russia is standing firm on the issue, stating that discounts will only be possible if Ukraine joins the Russian-led Customs Union, or if Naftogaz sells a significant share (or indeed all) of its natural gas transmission network to Gazprom, as Beltransgaz has done in Belarus.

The Ukrainian side is reluctant to cede control over what is regards as a strategically-important gas transmission network. However, the collapse of its free-trade deal with the EU as a result of Timoshenko's imprisonment has meant that Ukraine is being forced to consider joining the Customs Union. After the meeting with Putin, President Yanukovych told reporters: "We are not saying 'No', we are thoroughly and seriously studying these integration processes".

The approaching November 2012 deadline for Gazprom's final investment decision on South Stream is also putting pressure on the Ukrainians. If Naftogaz sold some, or all, of its gas transmission network to Gazprom, then Gazprom would most likely abandon South Stream, or at least build it in a reduced-capacity form. If Naftogaz does not agree to Gazprom's demands by November, then Gazprom could go ahead with South Stream and re-route most of its gas exports away from Ukraine, rendering Ukraine's gas transmission network virtually worthless. The summit in Yalta may have failed, but we can expect significant developments in Russian-Ukrainian gas relations before the end of 2012.

China

New round of negotiations between Gazprom and CNPC, with few tangible results

Alexander Medvedev, Director General of Gazprom Export met with Wang Dongjin, Vice President of the Chinese National Petroleum Company (CNPC), in a new round of negotiations between Gazprom and the CNPC. Although no substantial results were reached, the two sides did agree to assign a group of Gazprom's technical experts to the shale gas fields being currently developed by the CNPC. As reported in last month's Gazprom Monitor, the main obstacles remain the price at which China will buy Russian gas and the route by which that gas will be delivered. Russia is holding out for a 'European' price of around $400 per thousand cubic metres, which China is reportedly unwilling to match. Gazprom has offered to deliver gas via the western route of the Altai gas pipeline. China objects to this because it would have to transport the gas from western China to the more industrial and populated eastern part of the country. In the East, Gazprom is concentrating on the development of LNG, with its proposal to build a terminal at Vladivostok as early as 2016. Gazprom knows that of the two options, an LNG terminal offers flexibility, while the construction of a pipeline to China locks Gazprom into selling gas to China, with China being a large enough consumer to be a tough negotiator over prices. Thus, the two sides remain deadlocked. If anything is going to break the stalemate, it will be the combination of China's rapidly increasing gas demand (which grew 22 percent to 130bcm in 2011) and Russia's desire to diversify its exports away from an increasingly competitive yet slow-growing European market.

In a related development, in early July the Mongolian President called on the two sides to consider building a pipeline via Mongolia, so that Mongolia may benefit from Russian gas supplies. Both Gazprom and CNPC have yet to comment on the proposal, although it seems unlikely, given Gazprom's experiences with Ukraine in Europe, that the company would willingly introduce an 'energy poor' transit state into its strategic energy relationship with China.

Russian Arctic

Shtokman talks delayed – Result not expected until autumn 2012.

It has been announced that talks regarding the future of the development of the Shtokman gas field in the Barents Sea have been delayed again, over differences between the three current participants (Gazprom 51 percent; Total 25 percent; Statoil 24 percent), and the possibility of a new entrant into the project – widely rumoured to be Shell.

Moscow-based oil & gas analyst at Alfa Bank, Maria Yegikyan, explained that tax exemptions and the choice between producing pipeline gas or LNG were two of the main points of discussion between the project participants: "Tax exemptions were the main issue that was pending final investment decision for Shtokman. The partners were expecting to get tax breaks for the field and although government officials have on several occasions indicated that tax breaks for Shtokman were expected to be introduced, no decision on that matter has been taken yet" Yegikyan said. "Another reason for a delay in a new agreement among Shtokman's shareholders is the project's reform as partners are switching from pipeline gas production to LNG (liquefied natural gas)".

Regarding Shell's activities in Russia, Chief Executive Peter Voser said "We are interested in doing more gas projects in Russia… We are in talks with various players in the country, including Gazprom". When asked if that meant that Shell would be joining the Shtokman project, Mr Voser replied only that "Discussions are ongoing. I can't comment on any more details."

A resolution to the negotiations between current and potential partners should not be expected until later this year, according to Gazprom CEO, Alexei Miller, "At the present time we are conducting final consultations on the configuration and conditions of the Shtokman project, which we expect to conclude by the beginning of autumn".

Whilst the content of discussions between Gazprom and its foreign partners are not known, a report on the transparency of the world's 105 largest publicly traded companies, recently released by Transparency International, offers potential insight into differences between their corporate cultures. According to the Barents Observer, "Transparency International scores companies in all business spheres from 0-10 based on their disclosure of information important for investors and the general public: where they pay their taxes, their corporate structures and what they are doing to prevent corruption. Gazprom is ranked 98th with 2.8 points, while Norway's Statoil oil and gas firm is at the top with 8.3 points".

And in other developments…

Gazprom ranked world's most profitable company in 2011, according to Forbes; Gazprom's export monopoly under threat from Novatek?; Rosneft *expands its presence on the Russian gas market, buying a share in Itera*

According to the latest edition of Forbes magazine, Gazprom was the world's most profitable company in 2011, overtaking ExxonMobil. Gazprom's profit of 1.3 trillion Roubles ($44.6bn) in 2011 represents a 35 percent increase on 2010. In a separate report, Forbes also listed Gazprom as second only to Saudi Aramco in its list of the 25 largest oil and gas companies in the world.

On the 23rd of July, Russian sources reported that Novatek has begun construction of its 1 trillion Rouble ($30bn) LNG terminal at Sabetta. The terminal is scheduled to begin operations in 2016 with an initial capacity of 5 million tonnes of LNG, rising to 30 million tonnes by 2018. Given Gazprom's legal monopoly on Russian gas exports, Gazprom has agreed to formally handle the export of Novatek's Yamal LNG. Gazprom owns a 10 percent stake in Novatek, while French company Total owns 15 percent.

Novatek is also reported to be expanding its international activities with an agreement to supply Energie Baden-Württemberg (EnBW) with 2bcm per year of gas through its trading unit, Novatek Gas and Power. At the opening ceremony for the Sabetta LNG terminal Novatek CEO Leonid Mikhelson declined to confirm the deal, stating only that Novatek Gas and Power was created for gas trading purposes, that Novatek posed no threat to Gazprom's export monopoly, and that no-one was considering changing Russia's law on gas exports.

Rosneft expanded its presence on the Russian natural gas market with its acquisition of a 6 percent share in independent producer, Itera. Rosneft produced 12bcm of gas in 2011 – the same amount as Itera. In February Rosneft filed a request with Russia's Federal Antimonopoly Service (FAS) for permission to acquire a stake of up to 51 percent in Itera, suggesting that in the long term Rosneft is aiming for a larger shareholding

EGF Gazprom Monitor
Published by European Geopolitical Forum SPRL

Director and Founder: Dr Marat Terterov
Email: Marat.Terterov@gpf-europe.com

Avenue Du Manoir D'Anjou 8
Brussels 1150 Belgium
Tel/Fax: +322 770 1001
info@gpf-europe.com
www.gpf-europe.com
www.gpf-europe.ru