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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:

- *Lithuania files a €1.5bn ($2bn) lawsuit against Gazprom, claiming the Russian company has abused its position as monopoly gas exporter to Lithuania since 2004*
- *RWE Transgas wins a landmark case against Gazprom, as it refuses to pay fines for breaking the 'take-or-pay' clauses in its gas supply contract*
- *Naftogaz reaches an agreement with Germany's RWE Trading for trial gas supplies via Poland*
- *Gazprom officially launches the second line of Nord Stream, and announces plans for two additional lines*
- *South Stream gets the green light to be realised on the territories of Serbia and Hungary, with similar developments expected in relation to Bulgaria and Slovenia in November*
- *Gazprom confirms the development of the Chayandinskoe gas field and related pipeline infrastructure as part of its plan to increase LNG exports to the Asia-Pacific region*
- *Gazprom signs a contract for LNG supplies to India and announces an increase in its LNG supplies to South Korea*
- *Gazprom officially launches gas production at the Bovanenkovo gas field, as part of its Yamal Megaproject*
- *Rosneft cements its role in Russia's gas sector, but supports Gazprom's continued export monopoly*

Gazprom and the EU

Lithuania files a €1.5bn ($2bn) lawsuit against Gazprom with the Arbitration Institute of the Stockholm Chamber of Commerce, claiming the Russian company abused its position as monopoly gas exporter to Lithuania, charging unfairly high prices since 2004 and refusing to renegotiate pricing formulae thereafter.

On October 3, Lithuania filed a suit with the Arbitration Institute of the Stockholm Chamber of Commerce, claiming that Gazprom abused its monopoly over Lithuania's gas imports, overcharging Lietuvos Dujos by €1.5bn between 2004 and 2012. Lietuvos Dujos, a vertically-integrated energy company that imports gas from Russia, controls Lithuania's pipeline system and sells gas to end user consumers. It was privatised by the Lithuanian Government in 2004. Gazprom and Germany's E.On Ruhrgas acquired shares of 37.1 percent and 38.9 percent respectively in the company, with 17.7 percent remaining in the hands of the Lithuanian State Property Fund. Gazprom's interests are represented on the five-man Board of Directors by Valery Golubyev and Kirill Seleznyev. The Board is further comprised of two E.On representatives and CEO Viktoras Valentukevičius, who is appointed by the Lithuanian state.

The Lithuanian government contends that since Gazprom acquired the shares in Lietuvos Dujos, the price it charged for gas supplied to Lietuvos Dujos rose rapidly to artificially high levels. According to Lithuania's Energy Minister, Arvydas Sekmokas, prices per thousand cubic metres rose from $84 in 2004 to $497 in 2012 "due to changes in the gas price formula that were made in violation of the terms of the agreement on [the company's] privatisation". Even though the gas supply contracts were approved by the Lietuvos Dujos Board of Directors, the Lithuanian Energy Ministry claims that "these changes in the gas price formulas were also endorsed by Lietuvos Dujos management board members who had been appointed by Gazprom and who possibly acted in the interests of Gazprom rather than Lietuvos Dujos by voting for changes in the gas supply contract".

It is worthwhile to briefly recollect on this dispute, as reported in detail in the August issue of the Gazprom Monitor (№15): Gazprom and the Lithuanian government have been locked in dispute since May 2010 over plans to unbundle Lietuvos Dujos, in line with the Third Energy Package, with Gazprom claiming that such unbundling violates its shareholder interests. In March 2011, the Lithuanian Energy Ministry requested that the Vilnius regional commercial courts investigate Golubyev, Seleznyev, and Valentukevičius, claiming that the company's management was failing to defend the interests of the Republic of Lithuania by accepting high prices for gas imports purchased from Gazprom. Gazprom argued that such an investigation would be a breach of the shareholder agreement, and took the matter to Stockholm for arbitration, which ruled in July 2012 that the Vilnius court could continue its investigation, but that contractual gas prices were covered in the shareholder agreement and could not be ruled upon by the courts.

The Vilnius investigation is still ongoing. Following the collapse in European gas demand in 2009, Gazprom renegotiated its gas prices with energy companies from Estonia, Latvia, Germany, and Poland. Yet Gazprom refused to renegotiate prices for Lithuania. Finally, in September 2012, the European Commission launched its anti-monopoly investigation into Gazprom, with the company suspected of abusing its dominant position in Central and Eastern Europe. According to the Lithuanian Prime Minister, Andrius Kubilius, "the fact that the European Commission started an official inquiry into Gazprom's suspected unfair price policy in Central and Eastern Europe is of crucial importance. We have had several talks with the Gazprom management regarding this fact adding "we presented clear arguments and tried to convince them to adjust prices prior to any arbitral actions; however, to no avail".

RWE Transgas wins a landmark case against Gazprom, as the Czech company refuses to pay a reported €386m ($500m) fine triggered by the 'take-or-pay' clause in its gas supply contract with Gazprom

RWE Transgas (a subsidiary of Germany's RWE) has a nine billion cubic metre (bcm) per year gas supply contract with Gazprom until 2035, and accounts for 88 percent of all gas imported into the Czech Republic. The 'take-or-pay' clause in the contract triggers fines if RWE Transgas imports less then 90 percent of the contractual volume. Gazprom argues that RWE Transgas had failed to offtake the required volumes between 2008 and 2011, triggering fines for €386m ($500m), which RWE Transgas refused to pay. For its part, RWE Transgas claims losses of €198.4m ($257m) in 2010 alone, due to the price difference between the gas it imported from Gazprom (index-linked to oil prices) and the price of gas on the European spot market: in order to remain competitive with other gas suppliers to the Czech market, which purchased their gas on the European spot market, RWE Transgas reportedly sold its Russian-imported gas at a loss. Unwillingness to incur further losses seems to be the reason for RWE Transgas' refusal to pay the fines.

The case was referred to the Vienna International Arbitration Centre (VIAC), which has ruled in favour of RWE Transgas, on the grounds that the Gazprom-RWE Transgas gas supply contract contains an addendum entitling RWE Transgas to reduce its obligations for gas offtake by the same amounts that the Gazprom Group directly supplies to the Czech market. A second addendum allowing Gazprom to increase the obligations of RWE Transgas up to the amount supplied by RWE outside the Czech Republic to markets supplied by Gazprom was declared invalid by VIAC, a decision which was accepted by both parties.

Several days after the ruling, an official statement was released by Gazprom Export which declared: "we take it as necessary to appeal at the Supreme Court of Austria for cancellation of this decision", on the basis that the first addendum violates EU competition law under Article 101 of the Treaty of the European Union. The statement goes on to add, "In course of our commercial negotiations we have been repeatedly approaching RWE Transgas to annul this controversial addendum because of its non compliance to the European norms. It was RWE's denial to do that that served as reason for arbitration".

According to RWE Transgas spokesperson, Martin Chalupsky, "There are two arbitrage cases against Gazprom and I can confirm that we have won one of them, which is on the so-called principal of 'take or pay'. The other still open arbitrage case, taking place in Vienna, is about making new arrangements on [contract] prices so that they reflect market levels. We expect this arbitrage to be concluded in the first quarter".

The VIAC ruling sets a worrying precedent for Gazprom. Konstantin Cherepanov, a Moscow-based investment bank analyst for USB suggests, "An avalanche of similar cases involving Gazprom's counterparties cannot be ruled out". Other Russian sources also note that Gazprom has already revised tariffs with Wingas (Germany), GDF Suez SA (France), EconGas GmbH (Austria), SPP AS (Slovakia) and Sinergie Italiane Srl. These companies account for 35 bcm in gas purchases, approximately 25 percent of all Russian gas exports to the EU.

Ukraine

RWE Trading is set to break Gazprom's monopoly over gas supplies to Ukraine, although the volumes will be small and the price will be only slightly lower than those at which Gazprom currently supplies Ukraine.

The Director of the Gas Balancing Department at Naftogaz, Paolo Afanasiev, has confirmed that RWE trading will supply one million cubic metres per day for two months from 1 November, via Drozdowicze on the Ukrainian-Polish border: "The price would be lower than what Gazprom charges now, although not much lower". Naftogaz paid $425 per thousand cubic metres in Q3 2012, with the price set to fall slightly to $417 in Q4. Such prices take into account the $100 per thousand cubic metre discount agreed with

Gazprom in April 2010 as part of the 'Gas for Fleet' deal, whereby the Ukrainian government agreed to extend Russia's lease on the naval base at Sevastopol, currently home of Russia's Black Sea fleet.

If the two-month trial is successful, RWE Trading could increase supplies to 5 bcm per year. However, even the expanded volumes are relatively small compared to Ukraine's current imports of Russian gas: Ukraine imported 44.8 bcm of Russian gas in 2011, but hopes to reduce this to 27.5 bcm in 2012 and 24.5 bcm in 2013. Ukrainian President, Viktor Yanukovych, recently announced that he will discuss the gas issue with President Putin during his state visit to Russia in November, adding that both sides "can see the unstable character of the issue and propose various kinds of approaches to it, [including] a package deal that could help to solve the problem".

Nord Stream

Gazprom officially launches the second line of Nord Stream, and proposes adding a third and fourth line.

On 8 October, just 11 months after the launch of the first line of Nord Stream, Gazprom held a ceremony to mark the launch of the second line of the gas pipeline. With each line having a capacity of 27.5 bcm per year, the total capacity of Nord Stream is now 55 bcm per year – approximately 40 percent of Gazprom's exports to the EU in 2011, and just over half of the 101 bcm transited via Ukraine in 2011. According to Ukraine's UkrTransGas, gas transit to Europe via Ukraine in the first half of 2012 fell 23 percent year-on-year to 43 bcm, as a result of the first line of Nord Stream coming into operation.

In his speech at the launch ceremony, Gazprom CEO, Alexei Miller, announced, "Nord Stream shareholders examined the preliminary results of the feasibility studies for the construction of the third and fourth strings and came to the conclusion that their construction was economically and technically feasible. By January 31 of the next year, it is planned to sign a memorandum on creating new gas transmission facilities across the Baltic Sea to Europe. One of the strings might be intended for delivering Russian gas to the United Kingdom. And we see interest in this project on the part of our British partners".

South Stream

Serbia and Hungary confirm the construction of South Stream on their territories, while final investment decisions on the project are expected from Bulgaria and Slovenia by mid-November

On 29 October, Gazprom representative and South Stream AG Chairman, Leonid Chugunov, along with Srbijagas General Director, Dusan Bajatovic, announced that the final investment decision on the South Stream project has been taken, and that construction will begin in December.

The Serbian section will be 470km long and cost €1.7bn ($2.2bn), with a capacity of approximately 40 bcm per year. According to Bajatovic, the pipeline will generate $200m a year in transit revenues for Serbia, and will be completed by 2015. Spurs to Croatia and Bosnia will supply 2.7 bcm and 1.2 bcm per year, while additional spurs to Macedonia and Montenegro are being considered. In 2011, Gazprom supplied 2.1 bcm of gas to Serbia. The security of South Stream supplies via Serbia will be enhanced by the Banatski Dvor underground gas storage facility (UGSF), which was commissioned by Gazprom and Srbijagas in November 2011. The facility can store up to 450mcm, with a daily output of up to 5 mcm.

Two days after the Serbian announcement, Gazprom Export Director, Alexander Medvedev, announced that a final investment decision had been taken on the 229km Hungarian section of South Stream, which will cost €600m ($780m) and have a capacity of 30 bcm per year. It was proposed that the Hungarian section be operational by 1 January 2016.

Bulgarian Prime Minister, Boyko Borisov, told Russian media that the final agreement would be signed on 9 November: "South Stream is an example of a project beneficial to both sides. When we met with President Vladimir Putin, I told him that we have no objections to this project and it will be signed". Russian sources have quoted Bulgaria's Minister for Economy, Energy and Tourism, Delyan Dobrev, as stating that Bulgaria will pay for its share of the South Stream pipeline completely with debt finance, which it will then pay back with incoming transit fees. A final investment decision by Slovenia is expected just following the time of this writing.

Asia-Pacific

Gazprom confirms the development of the Chayandinskoe gas field and related pipeline infrastructure to boost its natural gas exports to the Asia-Pacific region

As part of its project to develop its gas exports to the Asia-Pacific region, Gazprom has begun the second stage of its Eastern Gas Program by taking the final investment decisions on developing the Chayandinskoe gas field in Yakutia, Eastern Siberia and constructing a pipeline from Chayandinskoe to Vladivostok. The Chayandinskoe gas field reportedly holds 1.2 trillion cubic metres (tcm) of natural gas, and it is proposed that production at the field begins in 2017. A new 3200km pipeline with a capacity of 61 bcm will be built from Chayandinskoe to Vladivostok via Khabarovsk, and is slated to be operational by late 2017. According to Gazprom's provisional estimates, pre-development of the Chayandinskoe field will cost 430bn Roubles (€10.6bn/$13.75) and construction of the new pipeline will cost 770bn Roubles (€19bn/$24.6bn). The aim of the project, aside from improving gas supplies to Russia's Far East, is to export LNG from Vladivostok to the Asia-Pacific region after 2017.

Gazprom signs a contract to supply LNG to India and announces an increase in its LNG supplies to South Korea

Gazprom's announcement of its Eastern Gas Program plans coincided with the news that it had signed a contract with India's GAIL to supply 2.5 million tonnes of LNG (approximately 3.5 bcm) per year for twenty years, from 2018-19 onwards. The contract was signed by Gazprom Marketing and Trading Singapore, which will supply a mixture of Russian-produced LNG and LNG sourced from the world market.

The gas delivered by Gazprom will be priced according to an oil-indexed formula, and will be delivered to Indian LNG import terminals at Dahej, Dabhol and Kochi. According to CEO Alexei Miller, Gazprom considers India "one of the most booming markets in the region", while GAIL Chairman, B. C. Tripathi, stated, "The deal with Gazprom reinforces GAIL's commitment to facilitate the development of the Indian market. The deal also marks our efforts to create a well-diversified and secured supply portfolio".

On October 9, Gazprom Marketing and Trading (GM&T) Singapore also signed a sale and purchase agreement with South Korea's KOGAS to supply one million tonnes of LNG in eight shipments during 2013-14. The gas may not come from Gazprom production, but could instead come from GM&T Singapore's trading portfolio. The agreement represents an addition to the 1.5 million tonnes per year of LNG supplied by Gazprom to KOGAS from the Sakhalin II project. KOGAS is South Korea's largest gas company, and the largest importer of LNG in the world. GM&T CEO Vitaly Vasiliev confirmed that, "KOGAS is a key strategic partner of Gazprom and we are very pleased to have concluded this medium-term agreement that extends our well-established relationship".

Russian Arctic

Gazprom begins gas production at the Bovanenkovo gas field on the Yamal Peninsula, with plans to produce 46 bcm in 2013.

Forty years after its discovery by Soviet scientists, the giant Bovanenkovo gas field on Russia's northern Yamal Peninsula has been commissioned by Gazprom, as part of the company's Yamal Megaproject. Declining gas production in the traditional gas-producing region of Western Siberia is necessitating the expansion of large-scale gas production to the new gas-producing regions of the Yamal Peninsula, Eastern Siberia, and Russia's Far East. According to

Gazprom official statements, Bovanenkovo is the largest gas field on the peninsula, with reserves of 4.9 tcm. Production will be 46 bcm in 2013, rising to the design capacity of 115 bcm by 2017, with the potential for further increases to 140 bcm in the future. Gas from Bovanenkovo will be used to supply the Nord Stream gas export pipeline, as well as Russia's domestic needs.

And in other developments…

Rosneft cements its role in Russia's gas sector, but supports Gazprom's export monopoly

Rosneft has cemented its role in Russia's domestic gas market by signing an $80m contract to provide 35 bcm of gas per year to Russian electricity producer Inter RAO over 25 years, from 2016 to 2040. In an official statement Rosneft President, Igor Sechin, stated, "Rosneft has significant reserves of gas so producing and selling this gas is a priority in terms of generating additional profit for Rosneft shareholders. Concluding an agreement to supply gas directly to Russia's largest generating utilities is the most effective way to monetise our reserves".

The deal is part of Rosneft's broader strategy of expanding its gas business. In August, it merged its gas operations with those of the independent gas company, Itera, with Rosneft taking majority control of the joint venture. Rosneft's recent acquisition of TNK-BP gave it control over the TNK-BP subsidiary, Rospan, which is expected to produce 3.5 bcm this year, but has the potential to increase annual production to some 16 bcm by 2020.

Rosneft's victory represents a significant blow to independent gas producer Novatek, which supplied Inter RAO from 2009, having taken the contract from Gazprom. Following the announcement, Novatek's shares fell 8 percent on the Moscow stock exchange.

Novatek co-owner, Gennady Timchenko, has called for an end to Gazprom's monopoly on Russian gas exports, arguing that, "Novatek wants to be present on the European gas market, while the Europeans want to see not only Gazprom supplying them with gas". However, Rosneft President, Igor Sechin, asserted that he supports Gazprom's continued monopoly over Russia's gas exports: "Gazprom can export gas and we support this setup. I believe that it would be harmful to shake up the organisation of a single export channel".

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