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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 and Lecturer in Energy Politics at the European University of St Petersburg

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The liberalisation of Russia's LNG exports

Russian Parliament approves government bill to liberalise Russia's LNG exports

In the last issue of the Gazprom Monitor, we announced that the Russian government had submitted a bill to the Russian parliament for the liberalisation of Russia's liquefied natural gas exports. In effect, the proposal would allow the state-owned oil company, Rosneft, and the independent gas producer, Novatek, to export gas from new LNG export projects. Novatek is planning to launch a new 17.5m tonne LNG export terminal at Sabetta, in Russia's northern Yamal region, in stages between 2016 and 2018, in partnership with the French energy company, Total, and the China National Petroleum Corporation (CNPC). Rosneft is planning a 5m tonne capacity LNG export terminal on the island of Sakhalin, in Russia's Far East, in partnership with ExxonMobil, to be launched in 2018. Gazprom currently holds the majority shareholding in Russia's only LNG export terminal, Sakhalin-II, in Russia's Far East, which exports approximately 10 million tonnes of LNG every year. Gazprom is also planning a 15m tonne LNG export terminal in Vladivostok, which it intends to launch in three 5m tonne stages, beginning in 2018. Taken together, these planned developments by Gazprom, Novatek, and Rosneft are aimed at doubling Russia's share of global LNG exports from 4.5 percent to 10 percent by 2020.

The Lower House of the Russian Parliament (the State Duma) approved the bill in mid-November, and it was approved by the Upper House of the Russian parliament on the 27th of November. All that remains is for the bill to be signed by the Russian President, Vladimir Putin. Once the bill has been signed, it could be implemented on the 1st of January 2014. During the passing of the bill through the Duma an amendment was proposed that would have allowed state-owned energy companies (such as Rosneft) to export LNG produced from onshore (as well as offshore) gas fields, although this amendment was rejected. This key proposition will, to a certain extent, protect Gazprom from competition, as Rosneft's ability to produce gas from offshore deposits will limit the amount of gas that it will be able to export in the form of LNG. Furthermore, even though the proposed LNG exports to the Asia-Pacific region by Novatek and Rosneft are significant and could reach 22.5m tonnes LNG, equivalent to 30.6 bcm of natural gas[1], Gazprom could capture a significant share of that market if it successfully concludes a deal with CNPC for the pipeline-based export of 38 bcm of natural gas to China – The two parties have agreed on all aspects of the deal except the final price, although experts remain sceptical about the claims of the two parties that they expect to conclude the deal by the end of 2013.

Gazprom and the EU

Gazprom's gas exports to Europe to hit five-year high in 2013

According to an official statement by a company representative, Gazprom is on course for its highest volume of gas exports to Europe since 2008, when it sold 168 bcm to European customers. The company expects to export 160 bcm to Europe in 2013, a significant increase on the 139 bcm that Gazprom shipped to Europe last year. In 2010, Gazprom exported 138 bcm to Europe, and exported 150-153 bcm to Europe in 2009 and 2011. An official statement from the company

[1] *According to BP, 1 bcm of natural gas equals 0.74 million tonnes of LNG, while 1 million tonnes of LNG equals 1.36 bcm of natural gas*

noted: "Gazprom's European gas export data reaffirms good prospects for the entire year".

The optimistic predictions by Gazprom echo the positive results reported in last month's Gazprom Monitor, where it was noted that Gazprom's European exports had risen 16 percent year-on-year. In the medium term (the next 3-5 years), the sustainability of European demand for Russian gas may well depend on LNG markets outside Europe: Whether LNG prices on the Asia-Pacific market remain high enough to draw global LNG supplies away from Europe, and the much-discussed promise of US LNG exports facilitated by the surge in US shale gas production over the last 5 years.

Regarding the former, a significant expansion of LNG import and export capacity in the Asia-Pacific region is unlikely to come online before 2016-2018, meaning that existing LNG exports will most likely continue to find their way to the Asia-Pacific region. The fact that Asia-Pacific region LNG imports (particularly those of Japan and South Korea) are still based on oil-indexed pricing, while spot pricing continues its development on the European market, suggests that the Asia-Pacific market will continue to be home to higher prices (and therefore be more attractive to exporters) than Europe for at least the short-to-medium term future.

Regarding potential US LNG exports, the US Department of Energy has thus far approved permits for just 4 of 22 applications by US energy companies for LNG export terminals. This regulation is driven by fears that allowing US energy companies to export LNG could drive up domestic gas prices, as producers sell their gas at higher prices on export markets rather than at lower prices domestically. US Henry Hub gas prices are currently around \$3-4 per million British Thermal Units (Btu). By comparison, LNG prices in Europe are around \$10, and in the Asia-Pacific around \$18. Given that it would take at least three years from the granting of an export permit to construct and bring online an LNG terminal, a significant expansion of US LNG export capacity cannot be expected before 2016.

Therefore, the level of European demand for Russian gas imports over the next 3-5 years will depend significantly on European gas production and consumption. However, after this period, developments in the US and Asia-Pacific region will have a far greater impact on Russia's European gas exports, which cannot be predicted with any degree of certainty.

Novatek emerges as a new supplier of Russian gas to Europe by signing LNG contract with Spanish Fenosa

In a landmark deal, Novatek has emerged as a new supplier of Russian gas to Europe. At the beginning of November, it was announced that the Spanish energy company, Fenosa, had signed a 20-year LNG supply contract with Novatek for gas supplied from Yamal LNG, the LNG export joint venture of Novatek, Total, and the China National Petroleum Corporation that is currently constructing an LNG export terminal on Russia's northern Yamal Peninsula. The contract stipulates deliveries of 2.5m tonnes of LNG (3.4 bcm of natural gas) per year from 2016. Although the volume is small, it is symbolic for two reasons: Firstly, it is the first time that a producer other than Gazprom has secured a gas export contract with a European energy company. Secondly, it is the first time that Spain will import natural gas from Russia. This is exactly the type of deal that the Russian government had hoped for when it announced the breaking of Gazprom's export monopoly through the liberalisation of Russia's LNG exports, with the express intention that those LNG exports should only be delivered to countries that do not already receive pipeline gas deliveries from Gazprom.

Gazprom-Lithuania dispute reaches Court of Justice of the European Union

A recurring feature of Gazprom Monitor publications over the past two years has been the dispute between Gazprom and the government of Lithuania, which has resulted in protracted arbitration proceedings. Those proceedings have now reached the Court of Justice of the European Union (also known as the European Court of Justice, or ECJ).

The dispute has two roots: Firstly, the decision by the Lithuanian government to pursue full ownership unbundling of its national energy utility, Lietuvos Dujos, into separate gas import transportation, and gas sales operations, in accordance with the EU Third Gas Directive. Gazprom, which owns a 37 percent share in Lietuvos Dujos, was deprived of management of Lithuania's gas transportation system even though it retained a 37 percent share in the new spin-off company, Amber Grid, which now manages the pipeline system. Gazprom claims it was forced into accepting the unbundling of Lietuvos Dujos. Secondly, the government of Lithuania claims that board members of Lietuvos Dujos, backed by Gazprom, had been driven by conflicts of interest to allow Lietuvos Dujos to sign disadvantageous contracts that led the Lithuanian company to pay excessively high prices for its Russian gas imports. The Lithuanian government then instigated an investigation into Lietuvos Dujos. This investigation was challenged by Gazprom in the Stockholm Commercial Court (SCC) Arbitration Institute as a breach of the shareholder agreement. The SCC Arbitration Institute ruled partially in Gazprom's favour, and ordered Lithuania's Energy Ministry to limit the scope of its investigation. Gazprom then asked the Lithuanian Supreme Court to enforce the SCC Arbitration Institute ruling. The Lithuanian Supreme Court has now referred the matter to the Court of Justice of the European Union, to clarify the relationship between the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards and EU law. In particular, they wish to resolve the issue of whether the New York Convention would oblige the Lithuanian Supreme Court to enforce the SCC arbitration ruling even if it were in breach of EU law because the enforcement would limit the right of the Lithuanian Supreme Court to rule on its own jurisdiction.

Although the dispute may seem complex and technical in nature, the ruling by the ECJ will have significant repercussions for future energy disputes and their arbitration in the European Union. It will therefore be eagerly anticipated not only by Gazprom and the Lithuanian parties, but also by all those who have an interest in commercial dispute resolution in the European Union, energy-based or otherwise.

Ukraine

Gazprom warns Europe over Ukrainian gas transit, as Naftogaz Ukraine briefly suspends gas purchases from Gazprom and Ukraine fails to sign an Association Agreement with the EU

Following on from the announcement on October 29th by Gazprom that Naftogaz Ukraine had failed to pay an $882m bill for its August imports of Russian gas, the ongoing verbal dispute between Ukraine and Russia over natural gas continued into November. Between the 8th and 14th of November, Naftogaz Ukraine suspended its gas imports from Russia, relying instead on gas from its own storage facilities. This move undoubtedly reduced the amount of gas that Ukraine will have in storage for the winter, which last month was estimated at 17 bcm. Despite the resumption of Naftogaz's purchases of Russian gas, the Gazprom Deputy Chief Executive, Vitaly Markelov, claimed that the situation was "A catastrophe... In these conditions, the winter transit of Russian gas won't be possible because storage won't be enough to compensate for Ukrainian consumer drawdowns". Markelov later added, "For uninterrupted transit, they should have pumped 21.5 billion cubic metres".

The issue of Naftogaz's debt to Gazprom must surely have played on the mind of the Ukrainian President, Viktor Yanukovych, and the Ukrainian Prime Minister, Mykola Azarov, during the month leading up the EU Eastern Partnership Summit in Vilnius on the 29th of November, at which Ukraine was scheduled to sign an Association Agreement with EU. However, the signing did not take place, triggering massive protests on the streets of Kiev. The decision not to sign the Association Agreement was probably at least partially linked to Ukraine's economic ties to Russia, and Russia's offer of gas price discounts and loans should Ukraine instead choose to join the Russia-led Customs Union (of Russia, Belarus, Kazakhstan, and new member, Armenia). By contrast, the EU offered Ukraine a macroeconomic loan of 600m Euros, which President Yanukovych dismissed as 'inadequate', instead claiming that Ukraine would need 20bn Euros a year from the EU to bring its economy up to European standards. Once again, Russia-Ukraine gas relations are playing a key role in European politics.

South Stream

Gazprom starts work on Serbian section of South Stream

On the 24th of November a launch ceremony near the village of Sajkas, in Serbia's South Backa District, marked the beginning of the construction of the South Stream pipeline on Serbian territory. Watching the launch via a video link from Belgrade were the Gazprom Chief Executive, Alexei Miller, the Serbian President, Tomislav Nikolic, the Serbian Prime Minister, Ivica Dacic, the Russian Energy Minister, Alexander Novak, and the Director General of Srbijagas, Dusan Bajatovic. During the ceremony, Novak read out a prepared statement from President Putin: "Cooperation between Serbia and Russia on the South Stream project fits within a framework of constructive partnership of our two states which is based on long lasting traditional friendship".

The Serbian section of South Stream will be 450km long, and will cost around 2bn Euros. It will also include spurs to Croatia and to Respublika Srpska (part of Bosnia-Herzegovina). The Serbian section of South Steam is being constructed, and will be owned and operated, by the joint venture, South Stream Serbia, in which Gazprom holds a 51 percent stake and Srbijagas a 49 percent stake. The Serbian section of South Stream also has access to the Banatski Dvor underground gas storage facility, which has a capacity of 450 million cubic metres, and a daily delivery capacity of 5 million cubic metres. Russian gas is delivered to Serbia under a ten-year contract signed in March 2013, with Gazprom supplying 1.5 bcm per year to Serbia.

The South Stream pipeline as a whole, which will run over 900km under the Black Sea from Russia to Bulgaria, and then a further 1500km on to Italy via Serbia, Hungary, and Slovenia, will cost an estimated 17bn Euros. The first gas supplies via South Stream are scheduled for late 2015, with the pipeline expected to reach full capacity in 2018.

Asia

Gazprom representatives remain confident that Gazprom will conclude a contract with China National Petroleum Corporation (CNPC) before the end of 2013

In the previous edition of the Gazprom Monitor (№ 29, October 2013), it was reported that the Russian Energy Minister, Alexander Novak, had announced his expectation that Gazprom and the China National Petroleum Corporation would conclude their long-running negotiations over the delivery of Russian gas to China via a yet-to-be-built pipeline before the end of 2013. Novak's optimism is apparently shared by Gazprom officials, who earlier this month reiterated their own confidence that the deal would be concluded before the end of the year. As reported in last month's Gazprom Monitor, it seems that "in principle, everything was agreed, except the price... Given the scale of the undertaking, which would make China the single largest importer of Russian gas in the world, and the pace at which global LNG trade and shale gas production is developing, it is hardly surprising that both sides are taking a cautious approach to the negotiations". However, experts and commentators from various sources are expressing scepticism that the deal will be finalised in the next month to meet the parties' self-imposed deadline. Given Gazprom's limited access to the global LNG market, increasing competition on the European gas market, and competition among exporters for the right to meet some of China's rapidly growing gas demand, it could be concluded that the existence of a deadline for the conclusion of negotiations may have the effect of causing Gazprom's representatives to make more concessions that their counterparts from the CNPC. However, no matter what concessions may have to be made in order to conclude the negotiations, once a conclusion is reached it will undoubtedly be hailed as a victory for Gazprom in securing a significant share of a valuable export market.

Gazprom founds joint venture with PetroVietnam for the development of gas as a transportation fuel

On the 12th of November the Gazprom CEO, Alexei Miller, and the CEO of PetroVietnam National Oil and Gas Group, Do Van Hau, signed an agreement to create a 50-50 joint venture to develop the use of natural gas as a transportation fuel. During the ceremony, which was witnessed by the Russian and Vietnamese Presidents, Miller noted "The joint NGV (Natural Gas Vehicles) initiative in Vietnam is Gazprom's first project of a kind in the promising Asia-Pacific market. The project will contribute to further boosting the economic efficiency of Gazprom's business, expanding its geography in Asia-Pacific as well as diversifying the Company's output". The agreement specifically includes a proposal to convert public transport in the Vietnamese capital, Ho Chi Minh City, to run on compressed natural gas (CNG).

The agreement comes just weeks after Warsaw's city transport authorities, Miejskie Zakłady Autobusowe (MZA), announced plans to add another 35 LNG-powered buses to their fleet, in cooperation with Gazprom Germania (a wholly-owned Gazprom subsidiary) and the Polish bus manufacturer, Solbus. Following the announcement, Timo Vehrs, the Director Business Development of Gazprom Germania, told the press "Natural gas is becoming increasingly important as a fuel for public transport, since it provides clear economic benefits and reduces significantly emissions. Consequently we want to convince more customers of the attractiveness of natural gas as a motor fuel together with our polish partner Solbus".

And in other developments…

Tug-of-war over Severenergia symbolic of the competition between Rosneft, Gazprom, and Novatek

On the 20th of November, Yamal Development (a 50-50 joint venture between Gazprom Neft and Novatek) agreed a $3bn deal to buy Eni's 60 percent stake in Arctic Russia, which holds a 49 percent stake in Severenergia. This will take the share of Yamal Development in Severenergia up to 80.4 percent. The agreement follows Rosneft's $1.8bn purchase of a 40 percent stake in Arctic Russia from another Italian energy company, Enel, giving Rosneft a 19.6 percent stake in Severenergia. The agreement was announced on the 24th of September, and was finalised on the 13th of November.

Severenergia holds four exploration and production licences in Russia's Yamal-Nenets Autonomous Region, which is an oil and gas-producing region traditionally dominated by Gazprom and Novatek. The tug-of-war over Severenergia therefore represents an attempt by Rosneft to gain influence in its rivals' back yards, just as Gazprom and Novatek's response represents their attempts to maintain their dominant positions in the region. In this sense, Severenergia is symbolic of the broader competition between the three companies for prominence in Russia's oil and gas sector.

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

Avenue Du Manoir D'Anjou 8
Brussels 1150 Belgium
Tel: +32 496 45 40 49
info@gpf-europe.com
www.gpf-europe.com
www.gpf-europe.ru