The European Geopolitical Forum

www.gpf-europe.com

EGF Gazprom Monitor
Issue 21: Feb 2013

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 Gazprom expects gas prices for its European exports to fall by an average of 14 percent in 2013, as it prepares to grant $4.7bn in price discounts over the next year.*
- *Ukrainian wholesale gas importer Naftogaz refuses to pay a $7bn bill from Gazprom for unused gas in 2012, and challenges the take or pay terms of the Naftogaz-Gazprom contract.*
- *Nord Stream AG receives a construction permit for the pipeline's final onshore German section, although plans for Nord Stream's expansion are already facing delays.*
- *Gazprom increases its estimates of the cost of South Stream, with plans for extra investment in the pipeline's onshore Russian section.*
- *Gazprom takes a final investment decision on its Vladivostok LNG terminal, with the Asia-Pacific region being the target market, while yet another meeting with China's CNPC concludes without the announcement of concrete progress towards finalising Russian gas supplies to China.*
- *Gazprom's export monopoly comes under further pressure, as Rosneft President, Igor Sechin, calls for the liberalisation of Russia's gas exports.*
- *Celebrations of Gazprom's 20th anniversary are overshadowed by the passing of its former-Chairman, Rem Vyakhirev.*

Gazprom and the EU

Gazprom expects gas prices for its European exports to fall by an average of 7 percent in 2013, as it prepares to grant $4.7bn of price discounts over the next year.

According to Russian sources, 2013 is set to be another difficult year for Gazprom's European exports. In the first half of 2012, Gazprom exported gas to Europe at an average price of $413 per thousand cubic metres, while preliminary reports suggest that the overall figure for 2012 will be $386, although some sources suggest a slightly higher price of around $400. In 2013, the average export price is expected to be around $360, some 7-10 percent lower than 2012. However, the expected discounts will be far from evenly spread across Europe, in line with the significant variation in Russian gas prices for Gazprom's varied European customers. Such variation is generally linked to import volumes and dependency on Russian gas imports: European countries that import small volumes of Russian gas but are highly dependent on Russian supplies tend to pay the highest prices: In the first half of 2012, Macedonia ($564), Poland ($526), Bosnia ($515), the Czech Republic ($503) and Bulgaria ($501) all paid significantly more than the European average for their Russian gas imports, while the UK, with its flexible and diversified imports and small share of Russian gas in its total imports, paid far less ($313). For comparison, gas on the spot market in Europe currently costs around $340 per thousand cubic metres.

Furthermore, Gazprom has reportedly set aside $4.7bn for 'retroactive payments' in 2013. Such payments are essentially refunds for European energy companies that successfully argue that they have overpaid for previous gas purchases, and are willing to take a refund rather than press for formal arbitration. In 2012, Gazprom handed out $2.7bn in retroactive payments to a host of European energy companies. One of the largest recipients of Gazprom's retroactive payments in 2013 could be the Italian Eni, which is reportedly demanding a revision of the 'take or pay' conditions in its gas import contracts and refuses to rule out appealing for international arbitration. Given that Eni is considered one of Gazprom's key partners in Europe (and a key shareholder in the South Stream project), it is likely that Gazprom will offer concessions and reach an out-of-court settlement. Meanwhile, another Gazprom partner, Germany's RWE, is expecting a similar settlement to be reached in the first half of 2013.

Gazprom expects to recoup some of these losses by increasing its European gas exports from 138.5 bcm in 2012 to around 152 bcm in 2013. Although such an increase will surely depend on increased overall European gas demand and an increase in the competitiveness of Russian gas exports in relation to its competitors, both of these assumptions are far from guaranteed.

Ukraine

Naftogaz refuses to pay $7bn bill from Gazprom for unused gas in 2012, and challenges the take or pay terms of the Naftogaz-Gazprom gas supply contract.

As reported in last month's Gazprom Monitor, Gazprom has issued the Ukrainian wholesale gas importer, Naftogaz, with a $7bn bill for unused gas, in accordance with the 'take or pay' clause in the gas contract between the two companies. According to the contract, signed in January 2009 with a validity of ten years, Naftogaz must purchase at least 80 percent of the 52 bcm contracted volume, which is 41 bcm. Throughout 2012 both Naftogaz and Ukrainian government representatives criticised the contract, claiming that the price being paid by Naftogaz for its Russian gas imports was too high, and that the import volumes should be reduced. In 2012 Naftogaz imported just 24.5 bcm of Russian gas, and intends to import even less in 2013.

The Ukrainian President, Viktor Yanukovych, recently told the Ukrainian media, "We have refused to pay these fines, and now we are in negotiations". The willingness of Naftogaz to challenge the contract and its take or pay clauses mirrors the efforts by Western and Central European energy companies to reduce the price they pay for Russian gas imports, and remove the take or pay clauses for their Russian gas import contracts. Whether Naftogaz will match the success of its European counterparts in challenging contractual arrangements with Gazprom, remains to be seen, however.

Nord Stream

Nord Stream AG receives a construction permit for the pipeline's final onshore German section, although plans for Nord Stream's expansion are already facing delays.

Nord Stream AG has received a construction permit for the final section of its East-West branch of Nord Stream's onshore German section, the NEL pipeline. NEL runs from Griefswald (where Nord Stream's offshore section makes landfall) to the Rehden underground gas storage facility in western Germany. From Rehden gas will be supplied to Denmark, the Netherlands, Belgium, the UK, and the local German region. Construction of NEL began in late 2011, and its completion was planned to coincide with the launch of Nord Stream's section line in late 2012. But opposition from local residents led to a 35km-long section of NEL being re-routed. It is for this alternative route that Nord Stream AG has received permission from the German authorities.

Meanwhile plans to expand Nord Stream with further lines, announced in October 2012, are already facing delays. The expansion of Nord Stream will reportedly be carried out by a new consortium, separate from the Nord Stream AG consortium of Gazprom, E.On, BASF Wintershall, Gasunie Nederlandse, and GDF Suez. The formation of the new joint venture, originally planned for Q1 2013, is now expected to take place in Q2 2013.

South Stream

Gazprom increases its estimates of the cost of South Stream, with plans for extra investment in South Stream's onshore Russian section.

At the ceremonial launch of South Stream in December 2012, Gazprom announced that the project would cost around 16bn Euros (including 10bn Euros for the offshore section), while Russian experts predicted that a further 10bn Euros of investment would be needed for South Stream's onshore Russian section. Those predictions have now been exceeded, with Gazprom confirming that the onshore Russian section will cost 12.5bn Euros. In addition, Gazprom is investing a further 10-12bn Euros in upgrading its domestic pipeline network, to bring gas produced in Russia's northern Yamal region to southern Russia, for transfer into the South Stream pipeline.

The upgrade of Russia's pipeline system in line with South Stream is part of a broader shift in Russia's gas production and export. As gas production at longstanding sites in Western Siberia declines, Russia's gas production is shifting north to the Yamal region. In light of this geographical shift in gas production, Gazprom is investing significant sums in new pipelines, and the upgrade of existing pipelines, in order to link Yamal gas production to the Nord Stream, Yamal-Europe, and South Stream export corridors. The upgrade of Russia's pipeline network announced this month should not, therefore, be considered as just another part of the expensive (and, according to some experts, far from financially viable) South Stream project, but as part of a broader, and much-needed, realignment of Russia's entire gas production, transport, and export system.

Asia

Gazprom takes a final investment decision on its Vladivostok LNG terminal, with the Asia-Pacific region to be the target market, while yet another meeting with China's CNPC concludes without the announcement of any concrete progress towards finalising Russian gas supplies to China.

Gazprom's Management Committee has approved the investment rationale for the construction of Gazprom's planned LNG terminal in Vladivostok. The terminal is planned to consist of three trains, each with a capacity of 5 million tonnes of LNG per year, with the first train planned for launch in 2018. The terminal will source its gas from Sakhalin, Yakutia, and Irkutsk, while the target export market is the Asia-Pacific region.

Positive news coming from the announcement of the potential for LNG exports to the Asia-Pacific region was in stark contrast to the ongoing failure of Gazprom and the China National Petroleum Corporation (CNPC) to reach a final agreement on the construction of a fixed-route pipeline for the export of Russian gas to China. As the two companies held yet another meeting of their Joint Coordination Committee, no plans for any concrete progress on a final deal were announced. Gazprom and CNPC have long been negotiating the terms and conditions of Gazprom's potential gas supplies to China, with a Framework Agreement signed in 2009, and then expanded in 2010.

And in other developments…

Gazprom's export monopoly comes under further pressure, as Rosneft President, Igor Sechin, calls for the liberalisation of Russia's gas exports. Meanwhile, celebrations of Gazprom's 20th anniversary are overshadowed by the passing of its former-Chairman, Rem Vyakhirev.

Gazprom's Russian gas export monopoly, which has been in place since 2006, has come under further pressure. Just a month after the Russian Prime Minister, Dmitrii Medvedev, suggested at the World Economic Forum in Davos that the gas export monopoly could be revoked, the President of Russia's largest oil company, Rosneft, called for the liberalisation of Russia's LNG exports. At a meeting of the Presidential Fuel and Energy Committee, Igor Sechin proposed, "I suggest the liberalization of the export of LNG produced from gas deposits located partially or fully in territorial waters, on the continental shelf, on the peninsulas of Yamal and Gydan; and that stimulatory tax and customs measures be taken". Sechin made his statement on the grounds that Russia was losing out on the potentially lucrative LNG market in the Asia-Pacific region, adding "The liberalization of LNG that we are proposing will not cause harm to our main gas producer, Gazprom, since deliveries will be made to supply fundamentally different markets. If Russian LNG doesn't go there, they (these markets) will simply be occupied by other suppliers". While Gazprom representatives have refused to comment formally on the issue, the idea seems to have found some support in Russia's political leadership. President Putin commented, "For the development of such a sector, all the conditions need to be put together. This includes the need to think through the possible gradual liberalization of LNG exporting... If we don't drive an active policy, we risk almost completely giving away this market to our competitors". Meanwhile Deputy Prime Minister, Arkady Dvorkovich, confirmed that "We've been instructed to work out the issue of liberalization, we haven't stopped discussing it". However, Dvorkovich cautioned that such a policy would not be allowed to drive down the price of Russia's gas exports: "There are many nuances here. The main thing is to provide guarantees of non-competition [between Russian gas exporters] on the same LNG markets. How to ensure non-competition is a big question".

Gazprom's current Chairman of the Management Committee, Alexei Miller, marked the occasion of the company's 20th anniversary by holding a conference call broadcast to 54 companies in the Gazprom Group, congratulating them on their successes over the last two decades. The celebrations were, however, overshadowed by the passing of Rem Vyakhirev, Miller's predecessor, at the age of 79. Vyakhirev, a close colleague of Gazprom's first Chairman of the Board, Viktor Chernomyrdin (who himself passed away in 2010), served as the first Chairman of Gazprom's Management Committee from 1993 to 2001, and Chairman of the Board of Directors from 1993 to 1996, and again from 2001 to 2002.

EGF Gazprom Monitor
Published by European Geopolitical Forum SPRL

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

Suite 1/Level 3, 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