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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:

- *The tortuous legal wrangling between Gazprom, the Lithuanian government, and Lithuania's main gas utility, Lietuvos Dujos, continues; Gazprom set to finalise its bid for Greece's gas distribution system operator, DEPA; Gazprom could construct Baltic LNG terminal*
- *Gazprom rejects an invitation to attend a high level ministerial seminar in Brussels on Ukraine's energy market, which was jointly organised by the European Commission and the Ukrainian energy ministry; Ukraine could cede control over its gas transit pipelines in exchange for guaranteed transit and a gas price discount*
- *The construction of South Stream in Serbia will begin in late 2013 according to Srbijagas; South Stream Chief Exec, Marcel Kramer, confirms that South Stream is on schedule for financing in early 2014 and construction of the first line in 2015*
- *Gazprom and CNPC aim to sign a gas supply contract by the end of 2013; Gazprom could lose its export monopoly in the Asia-Pacific region; freight deliveries from Northern Russia to China via the Northern Sea Route demonstrate the possibilities of LNG exports from Northern Russian to the Asia-Pacific region.*
- *Rosneft steps up the pressure on Gazprom with its buyout of Itera.*

Gazprom and the EU

A new round of gas price negotiations begins between Gazprom and Lithuania, as the tortuous legal wrangling between Gazprom, the Lithuanian government, and Lithuania's main gas utility, Lietuvos Dujos, continues; Gazprom set to finalise its bid for Greece's gas distribution system operator, DEPA; Gazprom could build an LNG export terminal in the Baltic region.

At the beginning of May the Lithuanian Energy Minister, Jaroslav Neverovic, met with the Director of Gazprom Export, Alexander Medvedev, in Vilnius to kick off a new round of gas price negotiations. Neverovic announced that, "obviously the process won't be simple or fast", but is necessary because the price charged by Gazprom to Lithuania "doesn't reflect the real situation in the gas market". The European Commission is reportedly ready to step in and assist the negotiations, as a consultant or negotiation partner. During his visit to Lithuania on the 10th of May, EU Energy Commissioner, Gunther Oettinger, told the Lithuanian parliament that "It is our objective to achieve that the gas prices for Vilnius are the same as they are in Berlin or the Hague".

However, these price negotiations are taking place against a backdrop of longstanding legal wrangling between Gazprom, the Lithuanian government, and Lithuania's main gas utility, Lietuvos Dujos. In March 2011 the Lithuanian Energy Ministry requested that the Vilnius Commercial Court launch an investigation into a possible conflict of interests in Lietuvos Dujos. In August 2011 Gazprom launched its own suit with the Stockholm Chamber of Commerce (SCC) Institute for Arbitration, in an effort to block the Vilnius Commercial Court investigation on the grounds that it contravened the Lietuvos Dujos shareholder agreement. On the 31st of July 2012 the SCC Institute for Arbitration announced a complex ruling that left both sides claiming victory (see Gazprom Monitor № 15 – August 2012). In essence, the Vilnius Commercial Court investigation was allowed to continue regarding the conflicts of interest, but the negotiation of gas prices could not be ruled upon by the Vilnius Commercial Courts. Then, in October 2012, the Lithuanian government launched its own lawsuit with the SCC Institute for Arbitration, claiming that Gazprom had overcharged Lithuania by €1.5bn between 2004 and 2012. Finally, in December 2012, the Lithuanian Court of Appeals ruled that the July ruling (which prevented the Lithuanian government from suing Gazprom in national courts, in accordance with the Lietuvos Dujos shareholder agreement) was not valid, and that the Lithuanian government should be able to take action against Gazprom on the basis of the Vilnius Commercial Court ruling, when it comes. The latest stage in these developments is the launch of an appeal by Gazprom with the Lithuanian Supreme Court, in a bid to force the Lithuanian government to accept the Stockholm ruling of July 2012.

These ongoing developments have significant relevance to the recently launched price negotiations: Gazprom is reportedly willing to grant Lithuania a gas price discount if it postpones the 'unbundling' of Lietuvos Dujos, signs a new long-term gas supply contract with Gazprom, and drops the €1.5bn lawsuit with the SCC Institute for Arbitration.

In Greece, Gazprom has emerged as the likely winner of the auction to privatise Greece's national gas distribution utility, DEPA, as part of Greece's broader debt-reduction privatisation scheme. In a bid to facilitate the deal, Greece's privatisation agency, HRADF halved the amount of deposit needed to make a bid to 10 percent of the purchase price, and offered to guarantee up to €180m of any arrears to DEPA not settled by the end of 2015. Last year Gazprom made its preliminary bid of €900m for DEPA, which has been valued at around €1bn and made a profit of €106m in 2012. Gazprom's competitor in the auction, the Greek M&M Gas consortium, offered a preliminary bid of €550m. The move makes sense for Gazprom, which already provides approximately 60 percent of DEPA's gas imports. If Gazprom's bid is not approved by EU regulators, Gazprom will have its deposit returned. Greece's gas transmission network operator, DEFSA, is being auctioned separately, with the Russia's Sintez, SOCAR of Azerbaijan, and the Greek-Czech consortium, PPF-Terna, all expected to bid for DEFSA. The deadline for final bids for DEPA and DEFSA is the 29th of May.

Russian sources report that Gazprom is considered resurrecting a project to build an LNG export terminal on Russia's Baltic coast at Primorsk. The project, which was abandoned in 2007 as unprofitable, could be revived as a means of delivering gas to the EU. If the project is implemented, Gazprom will benefit from EU gas market legislation on Third Party Access, which would give Gazprom's LNG deliveries access to existing LNG import terminals across the EU, including in Spain and Portugal, to which Gazprom does not currently supply gas. However, neither Gazprom nor the owner of the existing Primorsk port, Summa, have commented on the reports, while the Leningrad regional government claims to be unaware of such a project. In response to this speculation, Gazprom CEO, Alexei Miller, cryptically told the Russian media in Tomsk; "We will have another fundamentally new project that you do not know of yet". An official announcement is expected soon.

Ukraine

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On the 3rd of May Gazprom boycotted a high-level presentation of Ukraine's energy market which took place in Brussels and was jointly organised by DG Energy (the European Commission) and the Ukrainian energy ministry. Marlene Holzner, spokesperson for EU Energy Commissioner, Gunther Oettinger, announced after the event that "The Commission continues to offer engaging in talks on a trilateral consortium (for the modernisation of Ukraine's gas pipeline network), if all three parties - EU companies, Ukraine and Russia - are interested". Oettinger himself later told a press conference that "At the end of this process, it must be a win-win-win effect because Russia was, is, and will be the most relevant gas exporter to the European market".

Ukrainian law currently forbids the leasing or privatisation of Ukraine's gas pipeline network. A bill proposing amendments to this law was tabled in late April but the final vote, scheduled for the 21st of May, was indefinitely postponed. However, following talks between the Ukrainian President, Viktor Yanukovych, and the Russian President, Vladimir Putin, in Sochi on the 26th of May, Russian and Ukrainian sources began reporting that Ukraine was willing to cede control over its main gas transit pipelines to Russia in return for a discount on the price it pays for Russian gas imports and guarantees of future transit volumes via Ukraine. In the first quarter of 2013 Ukraine paid $406 per thousand cubic metres of Russian gas, and wants to see that price reduced to $260-280 per thousand cubic metres. As part of the deal, control over Ukraine's local gas distribution pipelines could go to the East European Fuel and Energy Company (VETEK), a Ukrainian company controlled by the businessman, Sergei Kurchenko. However, such a deal could yet hinge on Ukraine's willingness to join the Russian-led Customs Union of Russia, Belarus, and Kazakhstan, a summit of which took place on the 28-29th of May. Reports suggesting that Ukraine is willing to accept 'observer' status have yet to be confirmed, while it is far from certain that Russia would accept 'semi-membership' as a reason for an integration-based discount on gas supplies to Ukraine.

Finally, Ukraine's monopoly wholesale gas importer, Naftogaz, has announced that it expects to import 27 bcm of gas in 2013, of which 18 bcm will be purchased from Gazprom. The 2013 volume is set to be less than half the volume of Russian gas imported by Naftogaz in 2008 – the year before the gas dispute and dramatic decline Ukrainian gas demand caused by the impact of the financial crisis. In a bid to cope with reduced gas demand and the high oil-indexed price of Russian gas imports stipulated by contract signed in January 2009, Naftogaz has steadily sought to decrease its gas purchases from Gazprom. This breaches the 'take or pay' clause in the existing Naftogaz-Gazprom contract, which allows for a maximum 20 percent reduction in Naftogaz purchases in comparison to the contracted volumes. Gazprom threatened Naftogaz with a $7bn fine for this breach of contract, but has yet to enforce it. Any new deal that provides a discount on imports from Gazprom could result in an increase in Gazprom's share of total Ukrainian gas imports.

South Stream

The construction of South Stream in Serbia will begin in late 2013 according to Srbijagas; South Stream Chief Exec, Marcel Kramer, confirms that South Stream is on schedule for financing in early 2014 and construction of the first line in 2015.

According to the Director-General of Srbijagas, Dusan Bajatovic, construction of the Serbian section of South Stream is set to commence in late 2013: "Documents have been prepared, all contracts signed and the final route gas been determined for both the main pipeline and extensions to Croatia and Republika Srpska (Bosnia-Herzegovina)". Following the official confirmation of the project by Srbijagas on the 30th of June, tenders will be held for the supply of pipes and compressors. Bajatovic also suggested that the construction licences would be received by late autumn 2013, to allow construction to start.

Meanwhile the Chief Executive of South Stream, Marcel Kramer, has publicly confirmed that the South Stream project will definitely be implemented, and that it was on schedule: "The decision to invest has been taken. The shareholders have instructed us to work toward the first pipeline being in place by the end of 2015, and that is the schedule we are working on... It's a reality". According to Kramer, the financing of the project will be confirmed in late 2013 or early 2014, a stage he refers to as "That is the ultimate acid test for the viability of a project like that". If the project is implemented on schedule, construction of the offshore section will begin in 2014, with the launch of the first line in 2015. Work on the onshore Russian section has already begun, with the launch of the construction of the Kazachaya compressor station in Russia's Krasnodar region. From Kazachaya, gas will be pumped to the Russkaya compressor station on Russia's Black Sea coast, where it will be fed into the offshore section of South Stream.

Asia

Gazprom and CNPC aim to sign a gas supply contract by the end of 2013; Gazprom could lose its export monopoly in the Asia-Pacific region; freight deliveries from Northern Russia to China via the Northern Sea Route demonstrate the possibilities of LNG exports from Northern Russian to the Asia-Pacific region.

Following the signing of a Memorandum of Understanding last month by Gazprom and the Chinese National Petroleum Corporation (CNPC), Russian sources suggest that the two sides could sign a gas supply agreement before the end of 2013. However, while the route of the proposed pipeline (from Russia's Far East to North-Eastern China) and the supply volumes (68 bcm per year) have reportedly been agreed, the major stumbling block remains the price at which Gazprom will sell gas to the CNPC. The deal will most likely be facilitated by Gazprom accepting a slightly lower price than the average for LNG in the Asia-Pacific region, in light of Gazprom's predicted increases in gas production in Eastern Siberia and Russia's Far East, and desire to dramatically increase its exports to the Asia-Pacific region.

In addition to gas exports to China, Gazprom also has an eye on increasing its LNG exports to the Asia-Pacific region, through a proposed new LNG export terminal in Vladivostok with Japanese participation (Gazprom Monitor № 23 – April 2013). However, reports and speculation abound in Russia that Gazprom could soon lose its export monopoly – at least in the sphere of

LNG exports to the Asia-Pacific region. Both Novatek and Rosneft are actively lobbying for the export monopoly to be lifted: Novatek is currently developing an LNG export terminal at Sabetta in Russia's Yamal region, while Rosneft is in talks with ExxonMobil about the possibility of constructing a new LNG export terminal in Russia's Far East, perhaps on Sakhalin island. Therefore, the potential deal with CNPC would shield Gazprom from some of the competition on the Asia-Pacific LNG market, including that from other Russian energy companies.

In the summer of 2013 the Urals Federal District authorities intend to make their first commercial freight deliveries to China via Russia's Northern Sea Route. Following the success of the Gazprom-chartered LNG delivery from Norway to Japan in December 2012 - the first such delivery made during winter – the summer 2013 delivery will further highlight the possibility of sea-based deliveries from Northern Russia, home of the Yamal LNG Project (Novatek-Total) and the Yamal Megaproject (Gazprom), to the Asia-Pacific region.

And in other developments…

Rosneft steps up the pressure on Gazprom with its buyout of Itera.

Rosneft has stepped up the pressure on Gazprom in Russia's gas sector with its buyout of Itera, once Russia's second-largest gas producer. The $3bn deal sees Rosneft increase its stake in Itera from 51 percent to 100 percent. The two companies had already formed a joint venture to produce 13 bcm of natural gas in 2013. The move is part of Rosneft's long-term strategy of increasing its gas production up to a potential 100 bcm in 2020 – a strategy boosted by Rosneft's buyout of TNK-BP in March, which deal gave Rosneft control over the gas-producing subsidiary, Rospan. In addition to increasing its gas production and lobbying for Gazprom's export monopoly to be lifted, Rosneft has begun to challenge Gazprom on the domestic market. In October last year Rosneft signed a major gas supply deal with Russia's largest electricity generator, Inter RAO (Gazprom Monitor № 17 - October 2012). Russian sources suggest that Rosneft is seeking to increasing its share of the domestic Russian gas market from 9 percent in 2012 to 19-22 percent by 2020, with gas production rising from 40 bcm in 2013 to 60 bcm in 2016, and 100 bcm in 2020. For comparison, Gazprom produced 487 bcm in 2012. Therefore, Rosneft's buyout of Itera should be seen as part of a broader development of Rosneft gradually increasing its presence in Russia's gas production, domestic sales, and (potentially) exports, thus beginning to challenge Gazprom's longstanding dominant position.

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