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

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Key points:

- *Gazprom Chairman of the Board of Directors Viktor Zubkov and CEO Alexei Miller retain their positions as the Gazprom Annual General Shareholders Meeting elects a new Board of Directors and approves record dividends of 8.97 Roubles per share*
- *Gazprom's Annual General Shareholders Meeting also approves Gazprom's Annual Report 2011, which marks a record-breaking year for additions to gas reserves, sales revenues, net profits, and investment in the gasification of Russia's regions*
- *The first string of Nord Stream reaches full capacity. Construction of the second string was completed in April, with deliveries scheduled to begin in October*
- *Negotiations over South Stream remain ongoing. Gazprom and the Russian Government remain publicly committed to a schedule of beginning construction in December 2012, with pipeline commissioning proposed for late 2015, although a final investment decision is not due until November 2012*
- *The development of new pipelines to bring gas from Yamal to Nord Stream, and potentially to South Stream, continues apace, with Gryazovets the main hub for the coordination of supplies from the Yamal Peninsula to European Russia*
- *As its trilateral agreement with Total and Statoil expires, Gazprom refuses to rule out the entry of a fourth participant into the Shtokman project, with Shell widely tipped for inclusion*
- *Gazprom agrees to a feasibility study for a 50 percent increase in Sakhalin-II LNG liquefaction capacity, from 10 million tonnes to 15 million tonnes, with the study set to be completed before the end of the year*
- *Gazprom responded with the threat of legal action if Naftogaz fails to take the minimum contracted volumes, but also provided an early payment of $2m in transit fees, enabling Naftogaz to fill its underground gas storage with Gazprom gas before the winter heating season*
- *Gazprom suffers setbacks in Estonia and Lithuania, while exemptions to the Third Energy Package for South Stream could take years*
- *Putin visits China, but the two sides remain far from agreement over prices for Russian gas exports to China*

Gazprom Annual General Shareholders Meeting

Gazprom's Annual General Shareholder's Meeting elects a new Board of Directors and makes decisions on agenda items, as Zubkov and Miller retain their positions as Chairman on the Board of Directors and Chairman of the Management Committee respectively.

On the 29th of June the Gazprom Annual General Shareholders Meeting took place in Moscow. A new Board of Directors was elected, with Viktor Zubkov and Alexei Miller retaining their positions as Chairman of the Board of Directors and Chairman of the Management Committee respectively. Miller also retained his position as Deputy Chairman of the Board of Directors. Andrei Akimov, Farit Gazizullin, Elena Karpel, Timur Kulibayev, Vladimir Mau, Valery Musin, Mikhail Sereda, and Igor Yusufov also retained their seats of the Board of Directors. Alexander Ananenkov was replaced on the Board of Directors by Vitaly Markelov – Markelov had replaced Ananenkov as Deputy Chairman of the Management Committee in December 2011. In a related reshuffle, Gazprom's Head of Government Relations, Viktor Ilyushin, was replaced by Vladimir Markov, while the Head of Property Management, Olga Pavlova, was replaced by Elena Mikhailova.

According to the Russian Gazeta.ru, the replacement of Ananenkov, Ilyushin and Pavlova was the result of an investigation by the Russian Ministry of Energy into the participation of energy company representatives in the commercial activities of other companies, and the December 2011 meeting between Prime Minister Putin and Deputy PM Igor Sechin concerning 'conflicts of interest' in Russian energy companies. Gazprom has refuted the claim that the dismissals were linked to the Ministry of Energy investigation or PM Putin's concerns over the issue. The Annual General Shareholders Meeting also approved Gazprom's Annual Report, Accounting Statements for 2011, and dividend amount of 8.97 Roubles per share. According to Gazprom, this is the highest dividend level in the company's history, and accounts for up to 25 percent of Gazprom's net profits in 2011.

Gazprom Annual Report 2011: Highlights and key figures

In 2011, Gazprom broke its own records for increases in gas reserves, sales revenues, net profit, and investment in the gasification of Russia's regions.

According to the Gazprom Annual Report, approved by the Annual General Shareholders Meeting on the 29th June, 2011 was a record-breaking year for Gazprom. Through geological exploration, Gazprom Group added 719.8 bcm to its gas reserves, a significant increase on the 2010 figure of 547.7 bcm. Gazprom's reserves as of 31st December 2011 were 19.2 trillion cubic metres (tcm), enough for almost 40 years of continuous production at 2011 levels without the addition of new reserves. Sales revenues reached 4.7 trillion Roubles (€115 billion), a 29 percent increase on the 2010 figure of 3.66tn Roubles. Profits from sales increased by 40 percent, from 1.2tn Roubles in 2010 to 1.6tn Roubles (€39bn) in 2011.

Net profit rose 30 percent versus 2010, from 771.2 billion to one trillion Roubles (€24.4bn). Capital expenditure increased 50 percent versus 2010, from 883.3 billion Roubles to 1.3 trillion Roubles (€31.7bn). OAO Gazprom recorded net sales of 3.5tn Roubles (€85bn) (up 23 percent versus 2010), sales profits of 1.2tn Roubles (€29bn) (up 45 percent versus 2010), and net profits of 879.6bn Roubles (€21.4bn) (up 141 percent versus 2010).

In 2011, Gazprom accounted for 77 percent of Russian gas production and 72 percent of Russian gas reserves, 15 percent of world gas production and 18 percent of world gas reserves. The company produced 513 bcm of natural gas (up from 508 bcm in 2010) and 12 million tonnes of gas condensate (up from 11 million tonnes in 2010). Gazprom's gas sales in Russia remained relatively stable at 265bcm (up from 262bcm in 2010), while gas sales in the Former Soviet

Union increased by 16 percent from 70bcm to 82bcm. Foreign gas sales beyond the FSU rose almost 6 percent from 148bcm to 156.6bcm. Sales of LNG were 2.3 million tonnes - an increase of 24 percent versus 2010.

Nord Stream

As the first string reaches full capacity, testing begins on the recently-completed second string.

In May the first string of Nord Stream, launched in November 2011, reached its maximum capacity of 75 million cubic metres per day, which corresponds to the annual capacity of 27.5bcm. The construction of the second string was completed in April, and the pipeline is now undergoing testing. According to Gazprom, the pipeline will be filled with buffer gas in September and deliveries will begin in October.

Gas currently reaches Nord Stream's Russian onshore departure point at Vyborg via the newly-completed Gryazovets-Vyborg pipeline which, like Nord Stream, has a design capacity of 55bcm. Although the linear construction of Gryazovets-Vyborg was completed in 2010, the compressor stations are being commissioned in a phased manner. Thus, Gryazovets-Vyborg is scheduled to reach full capacity in late 2012, to coincide with the launch of the second string of Nord Stream.

South Stream

If it goes ahead as planned, South Stream will initially be filled with gas diverted from transit via Ukraine, and will later be filled with gas from Yamal via the Gryazovets gas hub.

During 2011 Russia signed intergovernmental agreements with Bulgaria, Serbia, Hungary, Greece, Austria, Slovenia, and Croatia. Of these seven, energy companies from all but Croatia and Slovenia have founded Joint Project Companies with Gazprom. Announcements regarding Gazprom's partnerships with Croatian and Slovenian energy companies are expected in the coming months. The shareholders in the offshore section of South Stream were confirmed in September 2011 as Gazprom (50 percent), ENI (20 percent), Wintershall (15 percent), and EdF (15 percent). The feasibility study for South Stream was completed in Q3 2011.

In March 2012 Gazprom announced that it had completed the preparation of project documents for Phase 1 of its 'Southern Corridor', the project to bring gas from Central Russia to the Russkaya compressor station on Russia's Black Sea coast in the Krasnodar region, for feeding into South Stream. Phase 1 will see a new pipeline built from the Pisarevka compressor station to Russkaya. This is notable because Pisarevka lies on the Russo-Ukrainian border and is one of seven entry points for Russian gas into Ukraine. It seems likely that the transmission of gas via Pisarevka to Russia's Black Sea coast will result in a significant reduction of gas entering Ukraine via Pisarevka. This serves to reinforce the perception that the South Stream project is designed, if not to circumvent Ukraine, then at least to pose the threat of doing so, thus forcing the Ukrainians back to the negotiating table regarding the transit of Russian gas to Europe, the price Ukraine pays for Russian gas, and Gazprom's longstanding desire for a shareholding, if not full ownership, of Ukraine's gas transmission system. It should be remembered that with the final investment decision on South Stream not due until mid-November, there remains four months for the Ukrainian Naftogaz to convince Gazprom to abandon the South Stream project and focus on improving gas transit via Ukraine.

Phase 2 of the 'Southern Corridor' project envisages the construction of a second new pipeline, from Pochinki compressor station in Nizhnii Novgorod region to the Russkaya compressor station. This second pipeline will allow the delivery of Yamal gas to South Stream, thanks to the recently-completed Gryazovets-Pochinki gas pipeline. Thus, Gryazovets looks set to be the main hub for the transmission of Yamal-produced gas to both Nord Stream and South Stream.

Although South Stream has a planned capacity of 63bcm, in early June Gazprom CEO Alexei Miller explained that the pipeline will begin with two parallel strings (as with Nord Stream), later to be expanded to four. The first two strings are reported to be 15.5bcm each – Whether the remaining 32bcm of capacity will be built will be decided at a future date.

One issue that will need to be resolved before the November final investment decision is the participation of Bulgaria. Gazprom has offered Bulgaria an 11 percent discount on its Russian gas purchases from April to December 2012 in exchange for speeding up construction progress on the Bulgarian section of South Stream. However, Gazprom may also need to pay for the construction of the pipeline in Bulgaria in lieu of future transit fees, as it has been reported that Bulgaria does not have the financial resources to finance its part of the project.

Yamal Megaproject

The co-ordinated development of Russia's internal gas transmission system continues, with the new launch of gas production on the Yamal Peninsula and the commissioning of new domestic gas transmission pipelines set to coincide with the launch of Nord Stream's second string.

With gas production set to begin on the Yamal peninsula in October 2012, Gazprom is continuing to develop the infrastructure to bring that gas to Europe via Nord Stream. Gas currently produced in the northern Tyumen' region (SRTO) is transported to European Russia using the already-existing 20.5-28.5bcm SRTO-Torzhok pipeline via Ukhta and Gryazovets. This is set to be augmented by the construction of new pipelines from Bovanenkovo to Ukhta (140bcm) and from Ukhta to Torzhok (81.5bcm). The first string of Bovanenkovo-Ukhta was completed in May 2012. During June Gazprom engineers began to feed gas into the 1240km pipeline as a preliminary step before the scheduled commissioning in Q3 2012.

The construction of the second string and eight compressor stations is ongoing, with the compressor stations scheduled for commissioning in 2012-13, and the second string of the pipeline itself due for commissioning between 2013 and 2015, depending on the development of gas production at Yamal. Construction of the Ukhta-Torzhok pipeline is nearing completion, with seven compressor stations set for commissioning in 2012/13. Finally, the original SRTO-Torzhok pipeline itself is being upgraded, with three upgraded compressor stations due for commissioning in late 2012.

Much of the gas for these new pipelines is planned to come from the Bovanenkovo gas field on the Yamal Peninsula as part of Gazprom's 'Yamal Megaproject'. According to Gazprom, the vast Bovanenkovo gas field contains 4.9 trillion cubic metres of natural gas (Category A+B+C1+C2), with an initial production capacity of 115bcm per year, rising to 140bcm by 2030. In April 2012 it was announced that pre-commissioning had been completed. In early June Gazprom CEO Alexei Miller announced that production at Bovanenkovo would begin in October 2012, initially at minimum capacity of 15bcm per year, rising to full phase 1 capacity of 115bcm per year – almost enough to supply both Nord Stream (55bcm) and South Stream (63bcm).

Shtokman

As its trilateral Shtokman deal with Statoil and Total expires, Gazprom refuses to rule out the entry of a fourth participant into the project

Gazprom's shareholder agreement with Statoil (24 percent) and Total (25 percent) expired on the 1st of July. With a new agreement expected imminently, the Chairman of Gazprom Export, Alexander Medvedev, refuses to rule out the entry of a new partner into the project: "The original configuration did not work. That it will change is 100 percent certain," said Medvedev, "On July 1 the old agreement ends. From July 1, it's a whole new story." It has been widely reported that Shell could be the new partner in the Shtokman project, with Statoil having reportedly suggested the inclusion of Shell in the project.

However, Gazprom is set to retain its 51 percent stake in the project, with the Chairman of Gazprom's Management Committee, Alexei Miller, stating, "New participants may appear but Gazprom's stake will not be changed." Sources have also claimed that Gazprom could lose its marketing rights to the gas produced at Shtokman under the terms of the new agreement, a claim Miller strongly denies.

The Shtokman project clearly has Russian state support: Following a meeting in late May between PM Putin, Alexei Miller, and Helge Lund (CEO and President of Statoil), Putin reportedly promised extra tax discounts for the development of the Shtokman field. Further meetings between Gazprom, Statoil, and Total representatives took place during the St Petersburg Economic Forum in late June. However, an official announcement has yet to be made regarding the future configuration of the project.

The giant Shtokman field is estimated to hold up to 3.9tcm of natural gas and 56 million tonnes of gas condensate. It had been planned for Shtokman to start natural gas production in 2016 and LNG production in 2017, with phase 1 production levels of 23.7bcm, although those timescales now look set to change

Sakhalin expansion

Gazprom agrees to feasibility study for a 50 percent expansion of Sakhalin-II LNG capacity

Gazprom has agreed to a feasibility study to expand the capacity of Russia's only LNG terminal, Sakhalin-II, from 10 million tonnes to 15 million tonnes of LNG per year. The Chairman of Gazprom's Management Committee, Alexei Miller, has said that the study would be completed by the end of the year. Gazprom's agreement to conduct the study represents a boost for its partner in Sakhalin-II, Royal Dutch Shell, which has been keen to seize a market opportunity in the region following the increase in demand from Japan as a result of the Fukushima nuclear disaster and the shutdown of Japan's nuclear capacity.

The Head of Gazprom Export, Alexander Medvedev, acknowledged the talks with Shell regarding Shtokman, but denied that they were related to the plans to expand Sakhalin-II: "They are not connected," he said.

Ukraine

Naftogaz and the Ukrainian Government call for smaller volumes and lower prices, but Gazprom refuses to renegotiate its gas supply contract

Ukraine is contractually obliged to buy 52bcm of gas in 2012 from Russia at a price of $425 per thousand cubic metres, in accordance with the contract signed between Gazprom and the Ukrainian Naftogaz in 2009. Such gas prices are indexed-linked to oil prices, which have risen strongly since the signing of that contract. As a result, both the Ukrainian Government and state-owned Naftogaz have long sought to renegotiate the contract, and secure lower prices and smaller import volumes for Ukraine's Russian gas imports. In October 2011, former Ukrainian PM Yulia Timoshenko was found guilty of abuse of office and sentenced to seven years imprisonment. She was charged with signing a contract with Russia which went against Ukraine's national interests back in January 2009. The signing of the contract signalled the end of the January 2009 Russia-Ukraine gas dispute, during which Russian gas supplies to Ukraine were suspended and Ukrainian transit of Russian gas to Europe also disrupted.

Ukraine is now actively seeking to diversify its gas sources through diversification of imports and production. At the end of April, Ukraine's Coal and Energy Minister, Yury Boyko, stated that Ukraine's offshore gas production in the Black Sea would be tripled from 1.1bcm to 3bcm. In May, Ukrainian state-owned Naftogaz signed a 'sale and purchase' agreement with the German RWE to import around 5bcm per year from Germany, beginning before the end of 2012. In June, Italy's ENI agreed to buy a 50.01 percent stake in Westgasinvest, a joint project between Ukraine's state-owned Nadra Ukrayny and Cadogan Petroleum, an independent oil and gas producer with onshore gas assets in Ukraine, which holds the rights to nine shale gas licence areas in the Lviv basin. It is hoped that Ukrainian shale gas production will reach 7-10bcm in the next 5-7 years. Also in June, Boyko announced that Ukraine was holding talks on the potential import of gas from Turkmenistan, and the import of LNG from the US and Qatar.

At the end of June Boyko announced that Naftogaz had reached an agreement with Gazprom to reduce gas purchases to 27bcm for 2013. Gazprom reacted strongly to that announcement and threatened to sue Naftogaz in accordance with the 'take-or-pay' clauses in their bilateral contract, if Naftogaz's purchases fall below the minimum contracted volume of 41bcm. Gazprom's Alexei Miller stated that; "The contract signed with Ukraine still stipulates Russian gas supplies at 52 billion cubic meters. We act firmly under terms of the contract and have no agreements to reduce supply volume." Miller went on to add; "We do not see any reason to adjust [gas] prices. The prices are absolutely market based, and price for Ukraine is considerably lower than for some European countries."

Although Gazprom refuses to renegotiate its contract with Naftogaz, the Russian company has provided a $2bn advance payment for transit fees, which will enable Naftogaz to buy Russian gas for injection into underground storage, in preparation for the winter heating season.

Third Energy Package

Gazprom suffers setbacks in Lithuania and Estonia, exemption for South Stream unlikely in the near future

At the beginning of June Estonia's parliament passed revised legislation in line with the EU Third Energy Package, requiring national energy firm Eesti Gaas to sell its gas distribution network by 2015, or face a fine and the nationalisation of the network. Gazprom is the largest shareholder in Eesti Gaas (37 percent), followed by Germany's E.On (33.7 percent), Finland's Fortum Oyj (17.7 percent), and Latvia's Itera Latvija (10 percent).

The move comes a week after Gazprom and E.On reached an agreement with the Lithuanian Energy Ministry to divide Lietuvos Dujos into gas sales and gas transmission companies. According to Energy Research Institute expert Yury Korolchuk "The intelligent word 'divided' really means that Gazprom was simply removed from managing the Lietuvos Dujos and was told to just sell gas".

Whilst Gazprom has been hoping for an exemption from the Third Energy Package to be applied to South Stream, Deputy Head of Gazprom Export, Alexander Golubnichiy, stated in an open interview that "We have a legal opportunity to do so. Commissioner Oettinger indicated the European Commission will look at the possibility of granting South Stream those exemptions. The main problem is that giving us such exemptions will take from four to eight years. And this is too long for South Stream".

Russia's Ambassador to the EU, Vladimir Chizhov, criticised the Third Energy Package on the eve of the EU-Russia Summit near St Petersburg at the beginning of June: "There is a paradox now in the EU energy market. We see that major companies involved in infrastructure projects are prepared to invest only in those projects, which are guaranteed to be exempted from the provisions of the Third energy package," he said. "This is a clear indication that this particular set of rules runs counter to the interests of business and I would add, of consumers, too." However, developments in Estonia and Lithuania suggest that, rather than backtracking, the EU is gaining momentum with the implementation of its energy legislation.

Chizhov's criticism was echoed by Prime Minister Putin following the summit, who said that it should not be applicable to deals signed previously: "This, and other documents of the kind, should not be back dated to the contracts that were signed before the decision on the third energy package came into force."

China

Putin visits China, but gas price remains a great wall between the two sides

Despite Russian PM Vladimir Putin's visit to China and the eighth round of bilateral energy dialogue negotiations at the beginning of June there is still no breakthrough in negotiations over Russian gas exports to China. Prior to Putin's visit, Deputy Russian PM, Arkady Dvorkovich, made it known that "There is no agreement on a gas price. [The parties] will try to come to agreement but I doubt that the document will be signed [during Putin's visit]." The largest stumbling block remains the price at which China will buy Russian gas: The Russian side is seeking a 'European' price of $400 per thousand cubic metres, while the Chinese, who are reportedly intending to buy up to 68bcm per year, are only willing to pay $250 per thousand cubic metres.

The failure to reach agreement is a disappointing one for Gazprom, given that China represents a potentially huge export market for Russian gas. In a report published at the beginning of June by the International Energy Agency (IEA), China's natural gas consumption could double in the next five years, thus accounting for a quarter of global new gas demand during that period.

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