



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

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Key points:

- *EU continues to prepare Statement of Objections despite Gazprom's December proposals for an early settlement*
 - *Gazprom breaks record in gas exports to Europe in 2013 with 16 percent y-o-y increase in gas export volumes*
 - *Gazprom-OMV contractual adjustments 'unaffected' by EU antimonopoly investigation*
 - *Dutch gas production set to decline in 2014-15 – Could Gazprom fill the gap?*
 - *Putin outlines Russia's position regarding Ukraine: the gas debt still needs to be paid and the Russian government is prepared to work with whoever is in power in Ukraine*
 - *Nord Stream: EU and Gazprom agree on full use of OPAL pipeline*
 - *EU and Russia continue to negotiate over the application of Third Party Access legislation to the South Stream project*
 - *Gazprom plans to sign deal with CNPC (China) in May, during Putin visit to China*
 - *Gazprom completes 100 percent takeover of ArmRosGazprom (Armenia)*
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Gazprom and the EU

EU continues to prepare statement of objections despite Gazprom's December proposals for an early settlement

As reported in last month's Gazprom Monitor, in December Gazprom submitted proposals, which the company hoped would enable the settlement of the ongoing antitrust investigation. Although the EU Competition Commissioner, Joaquin Almunia, agreed that Gazprom's proposals "opened the possibility" of settling the case, sources report that Almunia has also expressed doubts about the proposal. Indeed, Almunia is reported to have told press sources "he had not received any concrete offer from Gazprom that might lead to the company settling the case without any finding of infringement or a fine that could top \$14.3 billion or 10 percent of its 2012 turnover".

When questioned on the impact of these developments on the antitrust investigation, Almunia stated, "Plan A is to continue working on the statement of objections and, when it is ready, to adopt it". A Statement of Objections is the document in which the European Commission informs the parties concerned (in this case, Gazprom) of the objections raised against them. The party will then have a chance to respond before the Commission takes a decision on whether the party is in breach of European antitrust rules.

These developments suggest that the European Commission still intends to pursue its case against Gazprom, and that Gazprom has yet to offer a solution that assuages European Commission concerns that Gazprom has a viable strategy for bringing its operations into line with current EU antimonopoly legislation.

Gazprom breaks record in gas exports to Europe in 2013 with 16 percent y-o-y increase in gas export volumes

In 2013, Gazprom exported 161.5 bcm of natural gas to Europe (including Turkey and the non-EU Balkans, but excluding the three Baltic states). This not only represented a 16 percent year-on-year increase (from 138.8 bcm), but also surpassed Gazprom's previous export record of 158.8 bcm in 2008. Gazprom was helped by a 5 bcm reduction in Norway's gas exports in 2013, which was at least partially due to technical difficulties at their giant Snohvit gas field. Gazprom's export volumes also benefitted from the discounts negotiated between Gazprom and its European partners over the past two years, which encouraged increased gas sales. Finally, some analysts also note that several of Gazprom's European customers took up to 10 bcm of gas that they had previously paid for but not taken, as part of their take-or-pay contract. Finally, Gazprom's European exports grew by 2 bcm at the expense of exports to Ukraine, with European customers taking extra deliveries of Russian gas and then re-exporting it to Ukraine. This combination of factors makes it difficult to ascertain whether the increase in Gazprom's exports is part of a trend, or simply the one-off result of a combination of favourable conditions.

Gazprom-OMV contractual adjustments 'unaffected' by EU antimonopoly investigation

In December Gazprom and the Austrian energy utility, OMV, reached an interim agreement to enable the oil-indexed prices in their bilateral gas supply contract to more closely reflect current prices on the European gas market. At the recent European Gas Conference in Vienna, the Head of OMV's Gas and Power division, Hans Peter Floren, reassured reporters that "I don't think that our bilateral contract relations are overshadowed now by the EU discussion". However, it is far from unreasonable to speculate that the EU investigation is encouraging Gazprom to offer price adjustments in a bid to maintain contracts with its traditional partners in

Europe, to the extent that Gazprom senses a weakening of its position on the European market.

Dutch gas production set to decline in 2014-15 – Could Gazprom fill the gap?

According to the Dutch government, gas production at the giant Groningen gas field could be reduced from approximately 54 bcm in 2013 to 42.5 bcm in 2014 and 2015, to guard against further earthquakes that have sparked public demonstrations over the past year. Prime Minister, Mark Rutte, justified the decision to reduce gas production, despite the negative impact on Dutch public finances: "The studies showed that there are risks and consequences, including earthquakes... They not only cause material damage but also serious emotional damage. The cabinet understands that people are worried".

The decline in Dutch gas production could open up opportunities for Gazprom to increase its gas exports to North-Western Europe, to fill the gap left by the reduction of production at Groningen. Gazprom already has close ties with the Dutch gas company, Nederlandse Gasunie, and the regional pipeline infrastructure (both onshore and offshore) and gas storage facilities to enable such increased exports. However, with spot pricing dominant in North-Western Europe, much will depend on Gazprom's ability to offer gas at competitive prices. With a general convergence between spot prices and Gazprom's oil-indexed prices in the region at approximately \$10-11 per Million British thermal units (MBtu), increased regional sales for Gazprom over the next few years seem entirely possible.

Ukraine

Putin outlines Russia's position regarding Ukraine: the gas debt still needs to be paid and the Russian

government is prepared to work with whoever is in power in Ukraine

At the EU-Russia Summit on the 28th of January, the Russian President, Vladimir Putin, addressed the issue of Russia's gas relations with Ukraine in the context of the current anti-government protests that have not only gripped Kiev, but also spread across Ukraine.

Firstly, Putin reminded his audience that Ukraine's state-owned gas importer, Naftogaz, still owes Gazprom \$2.7bn for gas deliveries in the final quarter of 2013. Secondly, Putin noted that, despite the Russian government promising a \$15bn loan to Ukraine (of which the first tranche of \$3bn has already been delivered) and agreeing to reduce the price at which Russia exports gas to Ukraine by a third, Ukrainian officials continue to express concerns over Ukraine's ability to pay off its gas debts to Russia. "We're trying to reduce this debt by reducing gas prices and by deferring payments and the Ukrainian government has in fact asked for deferred payments and this is probably not the worse part of what's happening. It was just this morning that I was advised that Ukraine is asking for a deferral on the amounts due this year on already reduced prices," Putin said. "This would be a major challenge for our economy and for Gazprom because this particular revenue stream is already booked for potential investment".

Putin went on to explain that the terms of the Russian loan (due for repayment in 2016) and Russia's offer of gas price discounts would not be undermined if a new government came to power in Ukraine. "It's not important to us because we had a very constructive dialogue with the Ukrainian government when this government was chaired by (former prime minister and jailed opposition leader) Mrs (Yulia) Timoshenko. We talked to her about everything and this is not a taboo subject for us – so we will talk to any government in Ukraine. But what is of principal importance for us is that

the Ukrainian economy is credit worthy, that the Ukrainian economy is able to generate positive effects from its development, for the government to hold constructive changes, reforms so that we're confident we will get this money back".

The discount on the price of Russian gas for Ukraine has had an immediate effect: Sources report that Ukraine halted its imports of gas from Europe at the beginning of January, in favour of Russian imports. According to Ukraine's Energy and Coal Industry Minister, Eduard Stavitsky, Russian gas is "the most profitable [supply option] for today". This development reverses the trend of the last two years, during which time Ukraine has decreased its imports of Russian gas and favoured a gradual increase of imports from Europe via Poland and Hungary (2 bcm in 2013), while plans for European gas imports via Slovakia have now been shelved. Ukraine's gas imports from Russia, estimated at 26-27 bcm in 2013, are predicted to rise to 30-33 bcm in 2014.

Nord Stream

EU and Gazprom agree on full use of OPAL pipeline

Once it reaches the German coast at Griefswald, the Nord Stream gas pipeline (with its capacity of 55 bcm per year) is connected to the German gas pipeline system by two pipelines: OPAL (35 bcm) and NEL (20 bcm per year). As has been examined in previous issues of the Gazprom Monitor, the application of EU gas market legislation concerning Third Party Access to OPAL and NEL have caused a serious headache for Gazprom, with such legislation requiring that 50 percent of the capacity of OPAL and 35 percent of the capacity of NEL are left available for use by other (third party) gas suppliers. The net result is that Nord Stream (whose only outlets are OPAL and NEL) has also been operating at half capacity, delivering approximately 23.5 bcm in 2013.

At the recent EU-Russia Summit in Brussels, Russian President, Vladimir Putin, was able to deliver the good news that a resolution to the situation had been found. "We had certain problems about the Nord Stream's continuation, the Opal pipeline system in Germany. We have agreed that it should be used not at 50 percent [of its capacity], but at 100 percent. So progress has been achieved on certain very complicated issues". Given that Russia's gas exports are predicted to increase by no more than 5-10 bcm in 2014 compared to 2013, the utilisation of Nord Stream at full capacity would surely entail a reduction in the transit of Russian gas via Ukraine of 15-20 bcm. Yet even this reduction would still leave Ukraine as the single largest transit state for Russia's European gas deliveries. For comparison, Russia exported 161.5 bcm to Europe (including Turkey) in 2013, of which 86 bcm was delivered via Ukraine. The remainder was delivered by Nord Stream (23.5 bcm), Blue Stream (to Turkey only – approximately 14 bcm), and Belarus (Yamal-Europe pipeline – approximately 33-35 bcm), in addition to smaller, direct deliveries to Finland and the Baltic states.

South Stream

EU and Russia continue to negotiate over the application of Third Party Access legislation to the South Stream project

Despite the legal objections to the South Stream project voiced by EU representatives, and reported in last month's Gazprom Monitor, the Russian government has reiterated its unwillingness to renegotiate its intergovernmental agreements on South Stream. At a meeting between the EU Energy Commissioner, Gunther Oettinger, and the Russian Energy Minister, Alexander Novak, in Moscow on the 17th of January, the two sides agreed to create a joint working group to address the legal and technical aspects of South Stream. Following

that meeting, official Russian sources reported optimism that a compromise could be reached, with Russia's Deputy Energy Minister, Anatoly Yanovsky, claiming that "South Stream can function normally under European Commission laws".

However, during the press conference at the close of the EU-Russia Summit on the 28th of January, President Putin sounded a more cautious note, and refused to be drawn on the impact of the Third Energy Package on the South Stream project. "I will not go into the Third Energy Package again now; you are aware of Russia's position. We touched on these issues, and I hope that here, too, we will find acceptable solutions due to our mutual interest in broadening cooperation in energy".

Meanwhile, sources suggest that construction permits for the Bulgarian section of South Stream are expected to be issued in March, with construction scheduled to begin in June.

The South Stream pipeline as a whole, which is planned to run over 900km under the Black Sea from Russia to Bulgaria, and then a further 1500km on to the Slovenian-Italian border via Serbia and Hungary, will cost an estimated 17bn Euros. According to Gazprom, the first gas supplies via South Stream are scheduled for late 2015, with the pipeline expected to reach full capacity of 63 bcm in 2018.

Asia

Gazprom plans to sign deal with CNPC (China) in May, during Putin visit

Gazprom's negotiations with the China National Petroleum Corporation (CNPC) remain ongoing, despite previous optimism that a deal would be concluded by the end of January. At the beginning of September 2013, it was reported that the two sides had agreed on the route (from Eastern Siberia to Northeast China), the

volume of deliveries (38 bcm per year), the start date for deliveries (2018), and the duration of the contract (30 years). This left only the basic price to be negotiated, with the Head of Gazprom Export, Alexander Medvedev, expressing optimism that the deal would be concluded before the Chinese New Year (29th January).

However, the two sides have failed to conclude their negotiations, and the deadline has now been pushed back to May, timed to coincide with the visit of Russian President, Vladimir Putin, to China. The two sides are reported to be closer than ever on pricing talks: In 2013, Gazprom received an average border price of \$10.60 per MBtu (\$380 per thousand cubic metres) from its European gas sales, while China is currently estimated to pay approximately \$9 per MBtu for its supplies from Turkmenistan.

Sources close to the talks suggest that if CNPC were prepared to make substantial up-front payments (as it did in its oil deal with Rosneft), Gazprom could be convinced to bring the price down to \$9.80 per MBtu (\$350 per thousand cubic metres). This would not only make Russian gas broadly competitive with Turkmen gas, but would also make deliveries from Gazprom competitive with current benchmark LNG prices in Asia (\$16-17 per MBtu).

The importance of the pricing negotiations becomes clear when the sheer scale of the deal is considered. Annual delivery volumes of 38 bcm per year over the lifespan of a 30-year contract translate into total gas deliveries of 1.14 trillion cubic metres. A price increase or decrease of \$50 per thousand cubic metres therefore equates to a difference of \$57bn over the course of the contract, or \$1.9bn per year. In this light, it is hardly surprising that it could take the political will of the Chinese and Russian Presidents to push this deal over the line.



And in other developments...

Gazprom completes 100 percent takeover of ArmRosGazprom (Armenia)

Gazprom and the government of Armenia have finalised the increase in Gazprom's share in the Gazprom-Armenian joint venture, ArmRosGazprom, from 80 percent to 100 percent. The company will now be known as Gazprom Armenia. The deal had several related components. Firstly, in December 2013 ArmRosGazprom signed a new, 2.5 bcm per year gas supply contract with Gazprom for 2014-2018, with prices linked to domestic Russian gas prices. This new contract was made possible by the agreement of the Armenian government to join the Russian-led Customs Union of Russia, Belarus, and Kazakhstan. Secondly, Gazprom reports that, "The funds received from the share issue were allocated for purchasing and constructing the fifth power unit at the Hrazdan Thermal Power Plant (TPP) as well as gas infrastructure facilities in Armenia. In December 2013, the fifth power unit (480 MW) at the Hrazdan TPP was brought into the commercial operation. The said unit operated in a pilot mode from January 2012 and produced over 2 billion kWh of electricity". Finally, Armenia represents a promising market for the use of Compressed Natural Gas (CNG) as a transport fuel, with Gazprom CEO, Alexei Miller, noting that Armenia has

more CNG filling stations than Russia. With this deal, and its related components, Gazprom has cemented its control over the Armenian gas market and the Russian government has scored a political victory in tempting Armenia into the Customs Union, in exchange for price discounts provided by Gazprom.

Gazprom adds fifth tanker to its LNG carrier fleet

Following a naming ceremony at the O&S Shipyard in Jinhae (South Korea), Gazprom has taken delivery of a new LNG carrier, the fifth in Gazprom's fleet. The new tanker, named 'Veliky Novgorod', will be the largest in Gazprom's fleet, with a capacity of 170000 cubic metres. Crucially, the vessel is certified as an Ice2 class vessel, and can operate in low temperature conditions. Therefore, it will be able to traverse the Northern Sea Route (between Europe and Asia along Russia's northern coast) during the summer 'open water' season. Gazprom expects to take delivery of a similar carrier – to be named 'Pskov – in September 2014. According to the Head of Gazprom Export, Alexander Medvedev, "The Veliky Novgorod and Pskov tankers allow Gazprom to increase the scope of its trading operations and enhance its positions in the global LNG market".

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