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Key Developments in the External Relations of the Russian Gas Sector[1]

GAZPROM: INTERNATIONAL MARKETS

Gazprom's simmering dispute with Lithuania continues

The dispute between the Lithuanian Government and Gazprom continues. As we wrote in the preceding issue of the Gazprom Monitor, the dispute flared up after the Russian monopoly refused to give Vilnius the same gas price discount that it grants to the other Baltic States.

Consequently, the Lithuanian side is forced to pay high gas prices. In response, Vilnius is trying to use the implementation of the Third Energy Package, in relation to the gas transport system of the country, as a lever of pressure against Gazprom. In the end this may bring about both a rupture in the agreement on the privatisation of Lietuvos dujos (37 percent of which belongs to Gazprom) and the separation of control over gas transmission pipelines from companies which own them.

The counter-claim of Gazprom is that for the last several years Lithuania has been taking only 50-60 percent of the gas volumes prescribed in the contract. Furthermore, in the opinion of a Gazprom representative, Lithuania pays a fair price for gas, based on a mutually-agreed formula linked to the oil basket.

However, according to European gas price benchmarks, Lithuania actually pays one of the highest prices for gas – about $350 per thousand cubic metres, compared to an average Central European price of $308 per thousand cubic metres.

If the dispute is not resolved in the next 60 days, the case may be taken to either the Stockholm Arbitration Court or Brussels as proposed by Vilnius on March 24.

Nonetheless, at the present moment talks are continuing and it seems most likely that the two sides will come to some sort of agreement by granting a series of concessions to each other. The Prime Minister of Lithuania Andrius Kubilius expressed his regret that Gazprom had "punished Lithuania", by raising gas prices by 15 percent, while at the same time offering a discount to neighbouring Baltic States, on the condition that Latvia and Estonia return to pre-crisis levels of gas purchases. According to the Prime Minister, the Lithuanian authorities did not receive such an offer. The Russian side certainly do not wish to create a precedent of investigation in Brussels. Therefore, a compromise based on a discount in gas prices in exchange for an increased volume of gas purchases, and also several concessions or a delay of the process of implementing the Third Energy Package, is entirely possible.

European consumers push for price discounts for Russian gas

The current gas price formula used by Gazprom on the European market does not suit consumers of Russian gas. The German energy company, E.ON Ruhrgas, has proposed that Gazprom change from a formula linked to oil prices to one where gas prices are linked to the prices of spot-market suppliers.

The call for a reconsideration of the gas price formula is the result of a fall of almost 70 percent in the spot prices for gas in Europe over the last two years. During this period, prices linked to the oil basket rose by 40 percent. In 2009 the spot market for gas in Europe doubled in size, while Gazprom lost part of its share in the European market and had to revise its formula, taking into account the spot component when signing contracts with consumers.

The EGF Gazprom Monitor is completely based on Russian sources and translated into English by Jack Sharples, PhD candidate at the University of Glasgow, Scotland, and EGF Researcher on Russian external energy policy

Representatives of the monopoly do not plan to fully move over to short-term contracts, despite the aspirations of E.ON Ruhrgas to set prices closer to current realities of the gas market. In Gazprom it is believed that in 2012-2013 prices on the spot market will be equal to those with contracts, therefore the company's officials do not see the point in rejecting long-term agreements for the benefit from "momentary" interests.

At the same time, analysts believe that the spot market for gas will only continue to grow, and that Gazprom will continue to lose its share of the European market. Two options remain for the company: either to consider only the long-term price trends or to change the pricing system, as happened after the crisis, when in 2009 the spot market doubled.

Ongoing crisis in Libya, new opportunities for Gazprom

According to an analytical report released by Citi Group, Gazprom has joined the group of ten global oil and gas companies which have profited from the unrest and subsequent civil war in Libya. Compared to the previous month, the profits of the monopoly grew by 10 percent, and the capitalisation of the company demonstrated higher growth compared to other company groups – from February 15, the price of Gazprom stock on the London Stock Exchange (LSE) rose from $27.25 per share to $33.65 at the end of the day on April 4, 2011.

The wave of unrest in the Arab world, which started with the revolution in Tunisia, has led to a significant growth in energy prices over the last two months. Civil war in Libya turned out to be a real "gift" for Gazprom. Under the government of Muammar Gaddafi, Tripoli had become a stable supplier of energy resources to the EU, primarily to Italy. The situation which has emerged in Libya seems to be one of a stalemate – further production of resources and their export capacities to a range of countries in the near future does not seem possible, but the lack of a clear-cut NATO strategy on what to with Libya after the end of military operations, creates additional instability. In the short-term, Gazprom has the chance to take the place of the North African supplier.

Thus, since the beginning of March, Gazprom's deliveries of gas to Italy have been increased from 30mcm to 48mcm per day. The expansion of export volumes does not present a problem for Gazprom from a technical point of view. In fact, since the beginning of the war in Libya, Gazprom has increased its exports by 19 percent. These additional deliveries represent a potential profit of around $3.5bn based on an average price of £352 per 1000 cubic metres of natural gas.

Against a background of instability in the gas-producing states of North Africa and the Middle East, the subsequent growth of delivery volumes and the conclusion of long-term contracts depend on the pricing policies of Gazprom. At the moment, Russian gas is expensive for European consumers in comparison with LNG from mainstream (LNG) suppliers such as Qatar.

And more opportunities in Japan ?

The catastrophe in Japan has not brought short-term dividends for Gazprom. The package formulated by the Russian Government for energy assistance to Tokyo mainly contains proposals for the inclusion of Japanese participants in long-term projects of Russian oil and gas companies, such as the development of the Chayanda and Kovykta deposits. As far as operational measures are concerned, only a growth in LNG deliveries is mentioned.

The aim of the proposals is to ease the devastating effects of the tsunami in Japan, which substantially damaged the energy sector of the country. To this end, a tanker with 65,000 tonnes of LNG was despatched to the country. At the request of the Japanese side, deliveries will be increased, although it is not entirely clear where the gas will come from given that the possibilities of LNG deliveries from Sakhalin-3 are limited. Russian Prime Minister Vladimir Putin has already proposed increasing deliveries of pipeline gas to Europe to 60mcm per day, leading to a surplus of LNG on the European market which could be redirected to Japan.

At a recent meeting with the Japanese Ambassador to Russia, Masaharu Kono, Russian Deputy Prime Minister responsible for energy, Igor Sechin, declared that Russia is expecting to attract Japanese partners in order to speed up the development of the Kovykta and Chayanda deposits, which belong to Gazprom. China had previously been considered the main candidate for the development of these deposits.

However, talks with China have stalled due to the obstinacy of Beijing on the question of gas prices. As such, the conclusion of an agreement with Japan would be advantageous to Gazprom given the need to attract investment for both the Yakutia-Khabarovsk gas pipeline and the implementation of LNG projects, and also given Gazprom's desire to exert pressure on China. The emergence of an alternative client in the Asia-Pacific region may spur Beijing to accelerate the process of negotiations and agree to a number of concessions, as these negotiations have already lasted more than ten years.

It is expected that Japan's gas needs in the short-term future will increase by 20-30 percent to 110bcm per year, which means that Tokyo may need an additional 15bcm of gas. Given that demand for LNG on the international markets has been rebounding during 2010, resulting in a tighter gas market at present, Gazprom will once again become well placed to capture a greater (future) share of the Japanese market.

Gazprom pushes for lower transit tariffs for South Stream in Serbia

Statistics regarding the income which Belgrade will receive from gas transit via the Serbian section of South Stream were announced for the first time during Vladimir Putin's visit to Serbia on March 23. In particular, the Serbian Environment Minister Oliver Dulich announced that Serbia will receive around 100 million Euro annually for the transit of gas across its territory. The volume of such gas will be around 36bcm.

Taking into consideration the length of the Serbian section of the gas pipeline (470km), the transit rate will be $1.70 per 100km per 1000 m3. In comparison, Gazprom's transit rate in Poland is $2, and in Ukraine it is $2.50. If Gazprom succeeds in reaching an agreement with the remaining participants in South Stream on such low tariffs, the gas pipeline will have every chance of becoming one of the most profitable for the company. The low rate also is explained by the fact that higher tariffs are used to fund the refurbishment or expansion of older gas pipelines, while such expenditures will not be necessary on the new gas pipeline. At the same time, discounts on the gas which will be sold to Belgrade will also compensate for these low rates.

Putin's visit to Belgrade was unexpected for the Serbian side on account of the fact that Russian Foreign Minister Sergey Lavrov was expected to visit the country in April 2011, and Serbian President Boris Tadic was to visit Moscow in June 2011. Among the probable reasons for Putin's trip to Belgrade was the desire of the Russian side to confirm their intentions of completing the construction of the South Stream project within the previously stated time-frame and beginning deliveries in 2015 in accordance with agreements which had already been reached.

Yet uncertainty continues to cloud Russia's energy cooperation with Turkey

During the talks with Turkey on March 16, the Russian side had let it be known that it did not exclude the possibility of abandoning South Stream, if it could not reach agreement with Ankara on the issue of gas prices. After the talks, Igor Sechin announced that Moscow was seriously considering alternative possibilities for the transport of gas – for example, the construction of LNG terminals which would allow a significant reduction of costs in comparison with the implementation of South Stream. Sechin suggested that the construction of an LNG plant on the Black Sea could be "one alternative to the pipeline variant". In August 2009, Putin and Turkish Prime Minister Recep Erdogan had agreed that part of South Stream would pass through the territorial waters of Turkey. But further agreements on the matter were not reached. The Turkish side failed to keep their promise to grant permission for the pipeline's construction by November 1, 2010, despite the fact that Moscow granted a series of concessions to Ankara: The construction of a nuclear power plant in Turkey on profitable conditions for the Turkish side and the construction of the Samsun-Ceyhan oil pipeline to the detriment of the Burgas-Alexandropolos oil pipeline.

Nonetheless, the announcement of the possible rejection of South Stream appears to be a bluff, designed to put pressure on Turkey. However, Ankara well understands that the potential transport of LNG through the congested Bosporus Strait has its own limitations, while the cancellation of arrangements reached earlier with the South Stream participant countries would seriously damage Russia's reputation. In the end, Istanbul has time on its side, while the desire to accelerate the process of negotiations with the aim of adhering to the announced time-frames for the construction of South Stream compels Moscow to make further concessions.

South Stream remains an attractive project for European energy giants

Gazprom is continuing to attract European oil and gas companies to the South Stream project: The German Wintershall has become a new partner of the monopoly. The German company will receive a 15 percent stake in the project on account of a reduction in the ENI stake, while Gazprom retains its 50 percent stake. Wintershall's capital investment has been valued at around 2 million Euro. The agreement also envisages the conclusion of long-term agreements on the purchase of gas, which, according to a Wintershall representative, will be used for direct deliveries to consumers in Southern and Eastern Europe.

In this case, the entry of the new participant will bring quick political dividends to the project as the participation of large European companies may encourage the EU regulators to look more favourably upon the project. This is especially important, given that one of the key aims of the project is to receive Trans-European Network (TEN) status, which would see South Stream designated as an EU priority project. Moreover, in its European partners Gazprom has found reliable long-term consumers of gas, who in turn expect multi-million discounts when concluding long-term contracts.

According to arrangements already reached, the French Électricité de France (EdF) will join the project before the end of the year, while talks are continuing concerning the entry of other participants into the project.

DOMESTIC MARKETS

Liberalisation of the Russian domestic gas market remains unlikely

Experts working on Russia's state-driven energy strategy through 2030 have reached the conclusion that in the present environment, liberalisation of the Russian gas market makes no sense. One of the main reasons for the rejection of liberalisation is the absence of competition and the lack of access of independent producers to gas pipelines, which are controlled by the Gazprom. The Russian government, together with Gazprom management, continues to maintain the position that liberalisation of the gas market would result in severe inflationary trends in the gas market which would primarily be burdened on consumers.

A recent report prepared on this subject by gas experts at the Russian Academy of Science (entitled 'The Russian Natural Gas Market and the Prospects for Its Liberalisation'), concluded that:

...without the breaking up (unbundling) of Gazprom, the only effective market could be a dual-sector arrangement, with the regulated sector being administered by Gazprom and the free sector being open to independent producers and suppliers. Therefore, sufficient capacities of producers and their priority access to the gas transport system represent the necessary conditions for the liberalisation of prices. For the time being, a similar situation will not be achieved in the internal gas market, while the state continues to impose strict tariffs.

Although the final recommendations of the work going into the Russian energy strategy through 2030 are currently not due until the end of the year, Prime Minister Vladimir Putin has already been actively pushing for early implementation of some of the suggestions currently being developed by Russian energy experts (with respect to the energy strategy). In early February, Putin raised the question of the deficit in gas transport capacity – his position being underscored by the view that Gazprom's continued denial of independent gas producers' requests for access to the Gas Transmission System (GTS) is becoming increasingly groundless. This gave credence to suggestions that a change in legislation in order to deprive Gazprom of its monopoly over the pipeline system may be in the making. Nonetheless, surveys of independent producers suggest that even after these critical remarks, aired by arguably Russia's top decision maker, Gazprom's monopoly over the Russian pipeline system remains highly unlikely – and raising the issue with the company's management, in view of the Prime Minister's remarks, is pointless.

Gazprom's acquisition of the giant Kovykta gas deposit in East Siberia

On March 1 Gazprom unexpectedly took part in an auction for the sale of the giant Kovykta deposit in East Siberia, which belongs to RUSIA Petroleum. The price offered by Gazprom (22.3bn Roubles) turned out to be far higher than the 15.9bn Roubles offered by the next placed bidder, Rosneftegaz, and hence the auction was won by Gazprom. The company also plans to buy back from the East Siberian Gas Company (the main shareholder of which, as in the case of RUSIA Petroleum, is TNK-BP) a gas pipeline for deliveries from the Kovykta deposit. The deal, if reached, will cost Gazprom 35bn Roubles (taking VAT into account).

The main shareholders of RUSIA Petroleum are TNK-BP (62.9 percent), OGK-3 (24.99 percent) and the administration of Irkutsk Oblast (10.78 percent). In the past, Gazprom had made attempts to buy the company. In 2007, an agreement was reached between Gazprom and TNK-BP on the purchase of RUSSIA for around $1bn, but due to the crisis which followed, these plans were not realised. In the summer of 2010, the company gave a statement regarding possible bankruptcy, and in October it was recognised as insolvent. Subsequently, an auction was set for its assets.

As the main shareholder and creditor of RUSIA Petroleum, TNK-BP benefits most from the present deal. At the same time, OGK-3, having bought shares in the company for $576 million in 2008, can claim 2.6bn Roubles as a result of the sale of RUSIA, and not $750 million, as would have happened in the event of the purchase of assets by Rosneftegaz. The Board of Directors of Rosneftgz is headed by Igor Sechin who also holds an analogous position in Inter RAO EES, the company which acquired control over OGK-3. Gazprom has already begun to actively scout for foreign partners for the development of deposits. Against the backdrop of predictions regarding the coming energy deficit in Japan, Japanese companies have put forward proposals for the joint development of Kovykta.

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