The European Geopolitical Forum

www.gpf-europe.com

EGF Gazprom Monitor
Issue 16: Sept. 2012

# 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 European Commission launches an antitrust investigation of Gazprom, as the company is suspected of imposing unfair prices in Central and Eastern Europe. Gazprom claims innocence, but a Presidential Decree preventing Russian strategic companies (such as Gazprom) from disclosing information to foreign investigators without Russian government permission suggests that Moscow is concerned about the investigation.*
- *President Putin claims that the second line of Nord Stream is to be launched on 8 October, although this is yet to be confirmed by Nord Stream AG, Gazprom, or the Russian Energy Ministry.*
- *South Stream AG considers tenders for steel pipes for South Stream, as Gazprom vows to continue with the project despite the launching of the antitrust investigation of Gazprom by the European Commission.*
- *Gazprom hosts a meeting with the Chinese National Petroleum Corporation and claims 'a step forward' in long-running negotiations, although sources suggest significant disagreements remain between the two parties.*
- *As Ukraine seeks lower gas purchases (27 bcm) from Russia in 2012, a new winter dispute cannot be ruled out.*
- *Gazprom indefinitely suspends the Shtokman project, but signs a long-term cooperation agreement with Rosneft for the development of Russia's continental shelf.*
- *Gazprom and Japan's Agency for Natural Resources and Energy sign a Memorandum on the Vladivostok LNG project – with a final investment decision expected in early 2013.*

## Gazprom and the EU

*The European Commission launches an antitrust investigation of Gazprom, as the company is suspected of imposing unfair prices in Central and Eastern Europe. Gazprom claims innocence, but a Presidential Decree preventing Russian strategic companies (such as Gazprom) from disclosing information to foreign investigators without Russian government permission suggests that Moscow is concerned about the investigation.*

At the beginning of September, EU antitrust investigators formally launched their investigation of Gazprom, with the company suspected of breaching Article 102 of the Treaty on the Functioning of the European Union by abusing its dominant market position and imposing unfair prices on customers in Central and Eastern Europe. From the perspective of the European Commission in Brussels, Gazprom is suspected of three sets of anti-competitive practices: "First, Gazprom may have divided gas markets by hindering the free flow of gas across EU member states. Second, Gazprom may have prevented the diversification of the supply of gas. Finally, Gazprom may have imposed unfair prices on its customers by linking the price of gas to oil prices". Such practices restrict competition and result in higher prices for consumers. A European Commission representative said there was no deadline for completing the investigation, although it is suspected that the scale of the inquiry means that it could take several years.

The announcement of the investigation had an immediate impact, with Gazprom's shares falling 2 percent and the company losing $2bn of its capitalisation within 24 hours. Given that the standard fine for anticompetitive practices is 10 percent of the company's annual turnover, Gazprom could face with a $10bn fine. However, some Russian analysts, such as Troika Dialog's Oleg Maksimov, suggest that there is "no reason to panic" and that Gazprom could reach an out-of-court settlement before the claims are formally filed and fines are imposed.

The opening of the investigation comes a year after EU antitrust investigators raided the offices of energy companies in ten EU member states, amid concerns over their contractual relations with Gazprom. Gazprom responded to the formal launch of the investigation with an official statement claiming that "The opening of proceedings does not imply that Gazprom has acted in breach of the EU competition rules. Gazprom scrupulously abides by all the provisions of international law and national legislation in all of the countries where Gazprom Group conducts business. Gazprom Group's activities on the EU market are in full conformity with legal standards applied by other natural gas producers and exporters, this includes price formation mechanisms".

A week after the launch of the investigation, President Putin raised the stakes by signing the Decree on the Measures for Protecting the Interests of the Russian Federation in the Course of Foreign Trade Operations Performed by Russian Legal Entities. The decree states that strategic companies such as Gazprom may disclose information about their operations to foreign countries, companies, and regulators, sell foreign assets, and alter contracts with foreign entities only with the permission of the authorised Russian federal agency. The decree means that the commercial dispute with Gazprom could easily escalate into a diplomatic dispute between Brussels and Moscow.

## Nord Stream

*Putin claims that the second line of Nord Stream will be launched on 8 October, but this is yet to be confirmed by Nord Stream AG, Gazprom, or the Russian Energy Ministry.*

In a press conference following a meeting with Serbian President, Tomislav Nikolic, on 11 September, President Putin announced plans to launch the second line of the Nord Stream gas pipeline on 8 October, although such plans have yet to be confirmed by Nord Stream AG, the consortium responsible for the Nord Stream project, Gazprom, which holds a 51 percent stake in Nord Stream AG, or the Russian Energy Ministry.

The first line of Nord Stream was launched in November 2011, with a capacity of 27.5 bcm. The second line will also have a capacity of 27.5 bcm, taking the total capacity of Nord Stream to 55 bcm per year. According to Gazprom sources, the company exported approximately 133 bcm to EU Member States in 2011, including 60 bcm to countries intended as recipients of Nord Stream gas: Germany, France, the Netherlands, Belgium, and the UK. The operation of Nord Stream at full capacity will therefore reduce gas transit via Ukraine and Belarus in Gazprom's deliveries to several of Gazprom's key customers, including several of the largest and most influential EU Member States.

## South Stream

*South Stream AG considers tenders for steel pipes for South Stream, as Gazprom vows to continue with the project despite the launching of the antitrust investigation of Gazprom by the European Commission.*

The South Stream project continues to inch towards realisation. The South Stream AG consortium is presently considering tenders among as many as 20 companies for the supply of an estimated 2.8 million tonnes of 32-inch diameter steel pipes for the construction of the South Stream gas pipeline.

Gazprom also announced the formal creation of South Stream Slovenia LLC, a joint venture with the Slovenian firm, *Geoplin Plinovodi*, for the implementation of the South Stream project in Slovenia. Gazprom has now created joint venture companies with Bulgarian Energy Holding (Bulgaria), Desfa (Greece), Srbijagas (Serbia), MFB (Hungary), and OMV (Austria) for the construction of the onshore sections of South Stream. The underwater Black Sea section will be built, owned, and operated by South Stream AG, a consortium comprised of Gazprom, Eni (Italy), EdF (France), and Wintershall (Germany).

At the Sochi International Investment Forum, Gazprom CEO, Alexey Miller, also met with the President of the Republika of Srpska, Milorad Dodik, signed a Memorandum of Understanding concerning future cooperation, and discussed the possibility of building a link from South Stream to supply gas to the Republika of Srpska.

Serbian sources claim that Putin himself will be present at the launch of the construction of South Stream in Serbia on 11 December. Bulgarian sources suggest that Putin will visit Bulgaria on 9 November to finalise an agreement over South Stream. However, an agreement with Bulgaria could be complicated by a demand for 1bn Euro compensation by Russia's state-owned nuclear power plant construction company, Atomstroyexport, following the cancellation by the Bulgarian government of a contract for the construction of the Belene nuclear power plant by the Russian company. With the final investment decision still proposed for 15 November, the project faces a race against time to meet Gazprom's target of launching construction before the end of 2012.

## Russia-China

*Gazprom hosts a meeting with the Chinese National Petroleum Corporation and claims 'a step forward' in long-running negotiations, although sources suggest that significant disagreements remain between the two parties.*

Following a meeting in Moscow with a representative of China's National Development and Reform Commission, Zhang Ping, and the President of the China National Petroleum Company (CNPC), Zhou Jiping, Gazprom CEO, Alexey Miller, claimed that "Today we took a step forward". Quite what that step was, remains unclear.

Prior to the meeting, Gazprom Export CEO, Alexander Medvedev, was quoted by Russian sources as stating: "We have agreed practically on everything" with China and "there is only one point left. After that we will be able to start implementing our construction and upstream projects in Russia, and our Chinese partners will in turn start working on their part of the project".

However, Russian sources continue to suggest that disagreements remain over both price and delivery route. It is understood that while Gazprom is holding out for a European price of around $450 per thousand cubic metres, the CNPC is aiming at a price closer to $250. There remains a choice between two delivery routes: The 'Western Corridor' refers to the Altai gas pipeline, which would deliver West Siberian gas to less industrially-developed Western China through Russia's Altai region, while the 'Eastern Corridor' would deliver gas from new gas fields in East Siberia and Russia's Far East to China's more industrially-developed East. It seems that Russia favours the former, while China favours the latter. The implementation of the Western Corridor route would enable Gazprom to play European and Chinese customers off against each other in the export of West Siberian gas, while the implementation of the Eastern Corridor would lower the transportation costs for China as it would not have to transport gas from Western to Eastern China, and it would give China greater leverage as the major consumer of gas from Russia's Eastern Gas Programme. Furthermore, Russian reports suggest that Gazprom wants their Chinese partners to pay for the gas up front, in order to meet up to 40 percent of the cost of the construction of the pipeline.

With Gazprom asserting that although both routes could eventually be implemented, neither pipeline project would begin until the CNPC had signed a bilateral gas purchase and sale agreement, it seems that the prospects for Russian gas deliveries to China hinge on a significant concession by one, or both, parties.

## Russia-Ukraine

*As Ukraine seeks lower gas purchases (27 bcm) from Russia in 2012, a new winter dispute cannot be ruled out.*

Ukrainian Energy and Coal Minister, Yurii Boiko, announced that Naftogaz Ukraine (the wholesale importer of Russian gas in Ukraine) has requested Gazprom to lower its annual gas purchases to 27.5 bcm in 2012 and 24.5 bcm in 2013. In the first seven months of 2012, Ukraine imported around 19 bcm, almost 40 percent less than in the same period in 2011. According to the current Naftogaz-Gazprom contract, Ukraine's gas imports from Russia should be 52 bcm per year in 2012 and 2013, with the option of reducing purchases by up to 20 percent before the 'take-or-pay' clause kicks in. Therefore, the minimum that Ukraine should be able to purchase is 41.6 bcm. Gazprom has yet to respond to the Ukrainian request, but has voiced concerns that Ukraine is failing to stockpile enough gas to ensure the rise in Ukrainian winter demand and extra transit via Ukraine due to increased European winter demand. Naftogaz has responded by claiming that its stockpile of 17.5 bcm, set to increase to 21 bcm by December, will be sufficient.

One of the main reasons for Ukraine's desire to reduce its Russian gas purchases is the increase in gas import prices in recent years. The contract signed in January 2009 (for which former Ukrainian Prime Minister, Yuliya Timoshenko, is now in prison) gave Ukraine a short-term gas price discount before a shift to 'market' prices. A further discount was received in April 2010, when the Ukrainian government agreed to extend the lease of the Sevastopol naval base to Russia's Black Sea Fleet. However, rising oil prices since 2009 have led to a significant increase in gas prices. In Q1 2011 Naftogaz paid $264 per thousand cubic metres for its Russian gas imports. By Q3 2012 the price was $426.

There remains the possibility that Ukraine could increase its Russian gas imports to the contractual level in return for price discounts, and Ukraine could certainly feel all the more entitled to press for such discounts following the launch of the EU antitrust investigation of Gazprom, but Russia remains adamant that such discounts will only be granted when Ukraine makes a political concession to Russia, such as joining the Russia-Belarus-Kazakhstan Customs Union.

With the dispute rumbling on towards winter, and Ukrainian experts such as Valentyn Zemliansky, an independent expert and former Naftogaz of Ukraine press secretary, claiming "Gazprom is actually trying to pull Ukraine into a new gas conflict this winter", Europe would do well to take note and prepare for possible disruptions in its Russian gas supplies.

**Russian Arctic**

*Gazprom indefinitely suspends the Shtokman project, but signs a long-term cooperation agreement with Rosneft for the development of Russia's continental shelf.*

In the previous issue of the Gazprom Monitor (№ 15 – August 2012), we reported that Statoil had ceded its stake in the Shtokman offshore gas project to Gazprom, citing rising costs and a lack of progress. It seems that that opinion is now shared by Gazprom, which announced that the Shtokman project would be delayed 'indefinitely'. According to Vsevolod Cherepanov, Head of Gazprom's production department, "All parties have come to the conclusion that financing is too high to be able to do it for the time being".

Since the announcement, the third partner in the Shtokman project, France's Total, has insisted that it remains interested in the project. However, a more realistic project for Total at the moment is its partnership with the Russian independent gas producer, Novatek, for the production of LNG on the Yamal Peninsula: a tender for the construction and operation of a fleet of LNG vessels was announced by the Novatek-Total consortium, Yamal LNG, at the end of September.

For Gazprom, the indefinite postponement of the Shtokman project will allow the company to focus on its own Yamal project, which, like Shtokman, will eventually involve offshore gas production in Arctic seas off Russia's northern coast. To this end, Gazprom has signed a cooperation agreement with state-owned oil company Rosneft, which has been developing projects in Russia's Arctic Kara and Barents Seas since 2010. According to Gazprom, the agreement "stipulates further partnership between the companies in searching for the most effective methods, ways, and solutions to enhance the Russian Federation continental shelf exploration as well as to develop and replenish its resource base".

The announcement of the Gazprom-Rosneft partnership comes as the pair faces the possibility of increased competition on Russia's Arctic shelf. Under current regulations, Gazprom and Rosneft are the only companies allowed to develop natural resources on Russia's continental shelf. But Russian Natural Resources Minister, Sergei Donskoi, recently proposed giving private energy companies exploration licences without tenders, in a bid to attract up to $1 trillion of foreign private investment by 2020. However, Russian sources suggest that Gazprom and Rosneft's dominant position would be assured by 51 percent stakes in any production licences in a region regarded as strategically important by the Russian Government.

**In other developments...**

*Gazprom and Japan's Agency for Natural Resources and Energy sign a memorandum on the Vladivostok LNG project – with a final investment decision expected in early 2013.*

During a summit of the Asia Pacific Economic Cooperation (APEC) forum, Gazprom CEO, Alexey Miller, and the Director-General of the Japanese Agency for Natural Resources and Energy, Ichiro Takaha, signed a memorandum on the Vladivostok LNG project. The signing of the memorandum was attended by Russian President, Vladimir Putin, and Japanese Prime Minister, Yoshihiko Noda.

The $7bn project aims to produce 10 million tonnes of LNG per year by 2016, although some sources have reported that capacity production may not be reached until 2020. According to Miller, Japan (70 percent) and South Korea (30 percent) are the target export markets. Japan is the world's largest LNG importer with annual imports of 83 million tonnes, while South Korea is world's second-largest LNG importer, with imports of 36.5 million tonnes in 2011. The consortium developing the project comprises Gazprom and the two Japanese companies, Itochu Corp. and the Japan Petroleum Exploration Co. Russian sources suggest that a final investment decision on the project will be taken in early 2013.



EGF Gazprom Monitor
Published by European Geopolitical Forum SPRL

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