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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 and Lecturer in Energy Politics at the European University of St Petersburg

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In-depth report on the Gazprom-CNPC gas deal

Gazprom was always unlikely to achieve 'European' prices for its gas exports to China, but the deal with CNPC is crucial to the development of gas production and transportation in East Siberia and Russia's Far East

On the 21st of May, the Russian state-owned energy company, Gazprom, signed a gas supply contract with the Chinese state-owned energy company, China National Petroleum Corporation (CNPC). The deal marked the conclusion of more than a decade of negotiations between the two parties – negotiations in which the political leaders of the two countries played no small part.

The basic terms of the deal are as follows. Beginning in 2018-2020, Gazprom will supply CNPC with 38 billion cubic metres of natural gas per year, for the next 30 years. The flexibility of delivery volumes is provided for by the 'take or pay' clause in the contract. According to this clause, every year CNPC must purchase a minimum volume, measured as a percentage of the nominal contractual volume. If CNPC fails to purchase the stipulated volumes, it will face a financial penalty. Hence the term, 'take or pay'. The 'take or pay' percentage in the Gazprom-CNPC contract has not been made public. For comparison, Gazprom's gas supply contracts with European energy companies often contain 'take or pay' clauses with minimum offtake volumes of approximately 80 percent of the nominal contractual volume, although this can be as low as 50 percent. Such clauses have been increasingly challenged by European energy companies in recent years.

The price at which Gazprom will sell gas to CNPC has also not been disclosed, but reports suggest a price slightly higher than $350 per thousand cubic metres ($9.38-9.80 per Million British Thermal Units, or MBtu[1]). This is about 10-15 percent less than the current price of Russian gas at the German border ($10.79 per MBtu, or approximately $385-403 per thousand cubic metres), but slightly higher than the price of $9 per MBtu ($321-335 per thousand cubic metres) that CNPC is reported to pay for supplies from Turkmenistan. The price will vary during the lifetime of the contract, and it will be pegged to the price of a basket of oil products.

Finally, the agreement stipulates the construction of a new pipeline to bring Russian gas to North-East China (the so-called 'Eastern Route'). This pipeline will be named 'Power Siberia'. To make the contract (and pipeline) a reality, Gazprom has pledged to invest approximately $55bn and CNPC has pledged to invest approximately $22bn.

For Russia, the guaranteed sale of large volumes of gas to China is highly significant. In 2013, Gazprom exported 234.3 bcm of natural gas, of which 97 percent (228.0 bcm) was delivered by pipeline to Turkey and continental Europe (the EU, non-EU Balkan states, Ukraine, Belarus, and Moldova), while 149.5 bcm (64 percent) was delivered to the EU. The remaining 6.3 bcm was delivered to Armenia, Georgia, Kazakhstan, and Uzbekistan. The deal with CNPC will make China the world's second-largest importer of Russian gas, behind Germany (40 bcm in 2013), but ahead of Turkey (27 bcm), Ukraine (26 bcm), Italy (25 bcm), and Belarus (20 bcm).

[1] Standard conversion rates suggest that 1000 cubic metres is equal to 35.7-37.3 MBtu. Therefore, a price of $10 per MBtu is equivalent to $357-373 per thousand cubic metres.

Russia's only non-pipeline gas exports are currently delivered from the Sakhalin-II LNG export terminal in Russia's Far East. Sakhalin-II has an export capacity of 10.8 million tonnes (15 bcm) per year, with the Asia-Pacific region the target export market (particularly Japan and South Korea). Gazprom also has plans for a new, 15 million tonne (19.5 bcm) capacity LNG export terminal at Vladivostok. State-owned Russian oil company Rosneft has plans for a 5 million tonne (6.5 bcm) capacity LNG export terminal on Sakhalin Island, in partnership with ExxonMobil. The private Russian gas company, Novatek, is also building a 16.5 million tonne (21.5 bcm) capacity LNG export terminal in Russia's northern Yamal region, in partnership with CNPC and Total. All three of these new LNG export terminals are aimed at the Asia-Pacific market, and have a combined projected export capacity of 47.5 bcm per year. They are scheduled for launch between 2016 and 2020, although this could change.

The gas contract between Gazprom and CNPC will secure export of 38 bcm per year – only 10 bcm less than the new LNG export terminals combined. Together with the new export terminals, the Gazprom-CNPC deal will make a significant contribution to the geographical diversification of Russia's gas exports away from continental Europe and Turkey: if all of these projects are implemented as planned, Russia's gas exports to the Asia-Pacific region could reach 85.5 bcm. If Gazprom's exports to Europe and Central Asia remain constant, exports to the Asia-Pacific region could constitute 27 percent of Russia's total gas exports by 2020-2025.

The Gazprom-CNPC deal will also influence the geographical spread of Russian gas production. The gas that Gazprom will deliver to China will be sourced from new production at gas fields in Eastern Siberia (particularly Kovyktinskoe, Chayandinskoe, and Chikanskoe). Gazprom also intends to use gas from these fields to supply its proposed LNG terminal at Vladivostok. The new production, pipelines, LNG export terminal, and increased provision of natural gas supplies to Russian consumers in the region collectively form Gazprom's 'Eastern Gas Programme'. Without the stability of demand provided by the contract with CNPC, it would not have been commercially viable for Gazprom to develop the Eastern Siberian gas fields.

Gazprom had originally tried to convince CNPC to accept gas deliveries via Russia's Altai region to North-West China (the so-called 'Western Route'). This would have made it possible for Gazprom to supply CNPC with gas from existing production in North-West Siberia. CNPC refused, on the grounds that Chinese demand is highest in the east of the country. Gazprom's agreement to supply gas from new production via the Eastern Route is highly significant.

There are currently no pipeline connections between European Russia and Eastern Siberia. As far as the Russian gas industry is concerned, Russia will be divided between East and West, with both halves being run as almost completely separate operations. This situation deprives Gazprom of the opportunity to play its European and Chinese customers off against each other.

It is well-known that Gazprom's gas production at its longstanding fields in North-West Siberia (particularly Yamburg, Urengoi, and Medvezh'e) is declining. However, Gazprom's deal with CNPC does not mean that Gazprom will stop investing in new gas production for supply to European customers. In October 2012, Gazprom launched production at its Bovanenkovo gas field on the Yamal peninsula, as part of its 'Yamal Megaproject'. In the context of that project, Gazprom has already constructed new pipelines to bring this gas to Europe. The Nord Stream and South Stream export pipelines are key elements in Gazprom's plans to ensure the reliability of gas deliveries from Yamal to Europe.

Gazprom's deal with CNPC represents a geographical diversification of Russia's gas exports through an increase in total exports, and will not entail a reduction of exports to Europe. The most significant concern for European energy companies is whether Gazprom has the capital to simultaneously finance increased gas production in the Yamal region, the construction of the South Stream pipeline, and the implementation of the 'Eastern Gas Programme'.

Ukraine

Gazprom switches to pre-payment, and demands that Naftogaz pay up front for its June gas supplies. If Naftogaz fails to pay by the 2nd of June, Gazprom's supplies to Naftogaz to could be halted the following day.

In last month's Gazprom Monitor, it was reported that Naftogaz had accumulated a $3.5bn debt to Gazprom, following its failure to pay for gas supplies. Of that debt, $2.2bn was accumulated prior to the 1st of April. During the winter period, Naftogaz benefitted from a discounted gas price of $268 per thousand cubic metres. From the 1st of April, the discounts were cancelled, and the price rose to $485 per thousand cubic metres. Gazprom then announced that Naftogaz had imported 2.6 bcm during April. At the non-discounted price, this gas was worth $1.3bn. Thus, Naftogaz's debt to Gazprom stood at $3.5bn on the 1st of May.

On the 12th of May, the Russian Prime Minister, Dmitry Medvedev, met with the Russian Energy Minister, Alexander Novak, and the Gazprom CEO, Alexei Miller. At that meeting, it was agreed that Gazprom would switch to pre-payment in its dealings with Naftogaz. This is in contrast with the current arrangement, in which Naftogaz pays for gas after it has been delivered. Starting from the beginning of June, Gazprom will only supply Naftogaz with gas for which Naftogaz has paid in advance.

The current gas supply contract between Gazprom and Naftogaz envisages deliveries of 52 bcm per year, with 80 percent of that volume covered by a 'take or pay' clause. Therefore, Naftogaz should purchase 41.6 bcm per year, or 3.5 bcm per month, or face financial penalties. Using the stated price of $486.50 per thousand cubic metres, Naftogaz should pay $1.66bn in advance for its June gas supplies. Gazprom then announced that if this payment is not made by the 2nd of June, supplies to Ukraine will be halted before 10 am on the 3rd of June. If Naftogaz pays half of the required amount, then Gazprom will deliver a proportional amount of gas.

The situation is complicated by two factors. Firstly, Naftogaz has dramatically reduced its imports of gas from Gazprom, and clearly does not need the 52 bcm per year stipulated in the current contract. According to Gazprom's Annual Report 2013, Gazprom delivered just 25.8 bcm to Ukraine in 2013, down from 32.9 bcm in 2012. Even this reduced amount was not all delivered to Naftogaz. Reports suggest that Naftogaz imported just

12.9 bcm from Gazprom in 2013, with the remainder imported by other companies.

However, recent months have seen a slight increase in gas deliveries. In addition to the 2.6 bcm Gazprom delivered to Naftogaz in April, Gazprom delivered a further 2.7 bcm to Ukraine between the 1st and 24th of May, suggesting a full-month delivery volume of 3.5 bcm. Again, not all of that gas was delivered to Naftogaz, making it reasonable to estimate that Gazprom's deliveries to Naftogaz in May remained at their April level.

The second complication is that Naftogaz is entirely unwilling to pay the non-discounted price for supplies from Gazprom. In a recent interview with Reuters, the Ukrainian Energy Minister, Yuri Prodan, stated that $268.5 per 1,000 cubic metres would be "a market and a fair" price for gas, which Kiev is able to pay. Such a price would leave Naftogaz paying just $725m for the delivery of 2.7 bcm in June – far below the $1.66bn requested by Gazprom. However, this price is significantly below the price of Russian gas at the German border, which currently stands at $385-403 per thousand cubic metres. At that price, Naftogaz would need to pay $1-1.1bn for June supplies of 2.7 bcm.

Despite the fact that Ukraine has now received the first tranche of its IMF loan, it is unlikely that Naftogaz will pays its debts until the issue of price has been resolved. If Naftogaz pays the debts for April and May as requested by Gazprom, this will require Naftogaz to accept the price of $486.50 per thousand cubic metres for gas delivered during these months. It is more likely that Naftogaz will offer to settle its debts accumulated prior to the cancellation of the discount, and continue negotiations over the remaining debts and new gas price.

Furthermore, Naftogaz has repeatedly claimed that the terms of the current gas supply contract (signed in the midst of the January 2009 Russia-Ukraine gas dispute) are unfair, insofar as they commit Ukraine to buying more gas than it needs and commits Ukraine to paying a gas price far above the European average. It is on this basis that Naftogaz has threatened to take its case to international arbitration, in a bid to secure lower prices and lower stipulated offtake volumes.

Both sides bear responsibility for the current situation. Naftogaz cannot continue to expect politically-motivated discounts on the price of gas it imports from Russia. Furthermore, Naftogaz needs to dramatically improve its payment discipline. At a price of $350 per thousand cubic metres, Naftogaz's debts of $3.5bn equate to the non-payment for 10 bcm of gas supplies from Gazprom. For comparison, Gazprom supplied 12.9 bcm to Poland, 7.9 bcm to the Czech Republic, 6 bcm to Hungary, and 5.5 bcm to Slovakia in 2013. The political unrest in Ukraine since last November may be a mitigating factor, but the fact that Naftogaz continued to accumulate debts even when it was benefitting from a heavily-discounted gas price remains a concern.

For its part, Gazprom's imposition of a price so far above the regional average has added bitterness to the dispute and left the price mechanism open to challenge. Naftogaz would have found sympathy from European partners much harder to come by if it had refused to pay the same price as its regional neighbours. Regarding the import volumes, between 2006 and 2008, Naftogaz imported an average of 58.1 bcm per year from

Gazprom. Therefore, the contractual volume of 52 bcm seemed reasonable at the time. However, the contract was concluded just as the effects of the financial crisis hit Ukraine. The impact on Ukraine's economy led to a dramatic reduction in Ukrainian gas consumption. Between 2009 and 2013, Ukraine has imported an average of just 36.1 bcm from Gazprom. The current contractual volume is simply no longer reflective of Ukraine's gas consumption and import needs.

The current situation will only be resolved when Naftogaz pays its debts and improves payment discipline, when Gazprom agrees to lower the contractual volume, and when both sides agree to a gas price netted back from the price of Russian gas at the German border.

On the 26th of May, the European Union Commissioner for Energy, Gunther Oettinger, met with the Russian Energy Minister, Aleksandr Novak, and the Ukrainian Energy Minister, Yurii Prodan. Following that meeting, the European Commission released a statement, detailing its proposed solution to the dispute:

> The following solution is proposed subject to confirmation by Russian and Ukrainian authorities and gas companies by Wednesday 28 May 2014:
>
> *"Naftogaz commits to pay an amount of 2 billion US-Dollars by Friday 30 May 2014 and 500 million US-Dollars by Saturday 7 June as partial payments of the outstanding bills covering the period from November 2013 till March 2014 as well as the months of April and May 2014. These amounts have to be paid to the Gazprom bank account.*
>
> *Upon receipt of the first payment the consultation on the new gas price as of April 2014 shall start. Gazprom agrees to continue to supply gas for June without insisting on prepayment."*
>
> *Subject to the endorsement of these steps, a third round of political talks could take place on Friday 30 May 2014.*

This will require compromises from both sides, but even with such compromises, the resolution of this dispute remains in the interests of all parties. With the deadlines for Naftogaz's pre-payment and acceptance of the EU proposal approaching, the coming days and weeks will be critical for resolution of the Gazprom-Naftogaz dispute.

Gazprom and the EU

EU antitrust damages directive approved by European Parliament, and passed to EU Council of Ministers for final approval

In a development that could have a significant impact on the EU antitrust investigation into Gazprom's activities in Central and Eastern Europe, a new EU directive on antitrust damages has been passed to the EU Council of Ministers for final approval. The draft text is available here.

According to a recent EU press release:

> Any victim of an antitrust infringement has a right under EU law to obtain compensation from the infringers for the harm suffered (e.g. higher prices, lost profits…). The Court of Justice of the European Union (Court of Justice) has repeatedly held that this right is a matter of effective enforcement of EU antitrust rules. However, to date few victims have brought actions, and even fewer of them obtained compensation in the end, due to substantive and procedural obstacles. The Directive will make it easier for consumers and businesses to obtain compensation.

The press release also states, “The proposal has the objective of ensuring the effective exercise of the EU right to compensation for harm suffered as a result of a competition law infringement, and to optimise the interplay between private actions for damages and public enforcement of EU competition law by the Commission and national competition authorities”.

This directive has relevance for the Gazprom investigation, insofar as it could significantly increase the likelihood of European energy companies pursuing private claims against Gazprom in pursuit of compensation for lost profits caused by Gazprom’s alleged anticompetitive practices. Such private pursuits of compensation would be in addition to public enforcement of EU competition law by the European Commission.

Following approval of the directive by the EU Council of Ministers, EU Member States will have two years to transpose the directive into national legislation. It is highly likely that this process of transposition will proceed rather quickly in those Member States that host energy companies that have expressed their dissatisfaction with Gazprom’s pricing practices.

Lietuvos Dujos Pricing

Gazprom and Lietuvos Dujos reach agreement on gas price for Lithuania in the region of $370 per thousand cubic metres, as Lithuania continues to negotiate for alternative supplies

It has been announced that Gazprom and the Lithuanian gas supply company, Lietuvos Dujos, have concluded their negotiations on a new gas price for Gazprom’s supplies to Lithuania. Prior the announcement, the Lithuanian Prime Minister, Algirdas Butkevicius, had said he expected Gazprom to lower the price by around 20 percent. This rate of discount was subsequently confirmed by the Deputy Head of Gazprom's Department of Legal Support for External Economic Activities, Dmitrii Khandoga. Sources report that data from energy market regulators showed that Lietuvos Dujos paid around $465 per thousand cubic metres for Russian gas supplies in late 2013. Therefore, the 20 percent discount would bring this price down to $372.

When the reduced transportation costs are taken into account, this brings the price for Russian gas supplies to Lithuania broadly in line with the price of Russian gas at the German border. The discount will remain valid until the end of 2015, when Gazprom’s long-term contract with Lietuvos Dujos expires. Gas imported by Lietuvos Dujos accounts for approximately 40 percent of the gas delivered to the Lithuanian market, including that of almost 100 percent of Lithuanian household consumers. In 2013, Gazprom exported 2.7 bcm to Lithuania.

Litgas, the gas-trading arm of the state-owned Lithuanian energy company Lietuvos Energija, is also conducting negotiations with several potential LNG suppliers for the supply of 0.5 bcm per year (the equivalent of 6-7 LNG cargoes) for five years, starting in 2015. Reports suggest that Litgas is close to signing a contract with Statoil. Statoil sources confirmed that talks were at an advanced stage: "We want to finalise the deal as soon as possible, with the first deliveries starting in January 2015" said Morten Eek, a spokesman for Statoil. Such deliveries will be made possible by the installation of the ‘Independence’ floating LNG terminal in Klaipeda harbour. The terminal will be leased for 10 years from Norwegian company Höegh LNG. If used at full capacity, 'Independence' could completely replace imports from Russia, with its regasification capacity of 4 bcm per year. According to the owner-operator of the LNG terminal, Klaipedos Nafta, the terminal could be used as a base to import larger amounts of LNG and then re-export smaller cargoes to neighbouring Baltic states in the future, thus contributing to regional energy security.

Finally, the Lithuanian government strengthened its hand in relations with Gazprom (a 37.1 percent shareholder in Lietuvos Dujos and the owner-operator of Lithuania's gas pipeline network, Amber Grid) by agreeing to buy out the other major shareholder in Lietuvos Dujos – the German energy utility, E.On. Reports suggest that state holding companies have agreed to pay $200m for E.On's 38.9 percent shares in Lietuvos Dujos and Amber Grid, and its 11.8 percent share in Lithuania electricity generator Lesto. The remaining significant shareholder in Lietuvos Dujos and Amber Grid is the state-owned Lietuvos Energija (previously 17.7 percent). Following the deal, Lietuvos Energija will hold 56.6 percent of the shares of Lietuvos Dujos and Amber Grid – under Lithuanian law it must then make an offer to buy out the remaining shareholders (i.e. Gazprom). As a gas producer, Gazprom must sell its share in Amber Grid or risk losing voting rights, in accordance with the Lithuanian government's implementation of the unbundling provisions of the Third Energy Package.

Eni Contract

Eni signs landmark agreement with Gazprom to switch to spot pricing in existing long-term gas supply contract

During the Economic Forum in St Petersburg, representatives of the Italian energy company, Eni, signed a landmark deal with Gazprom. The deal revised the pricing formula in Gazprom's long-term gas supply contract with Eni, switching from oil-indexation to spot pricing (linked to Italy's gas trading hub, the Punto di Scambio Virtuale, or PSV). The revised formula will be back-dated to the beginning of 2014. Reports suggest that the revisions will also allow Eni to recover gas it has already paid for but not received under take-or-pay contracts. According to the Eni press release, "The agreement involves a reduction in supply prices and an important change in the price indexation to fully align it with the market".

Last year, an arbitration ruling in favour of the German energy utility, RWE, ordered Gazprom to revise its long-term gas supply contract with the German company by dropping 'take or pay' provisions and introducing a spot-price component into the pricing formula. However, the deal with Eni is the first time that Gazprom has agreed to switch completely to spot pricing in one of its long-term gas export contracts.

South Stream

South Stream could get a 32 bcm spur to Austria, from Hungary

On the 14th of May, the Gazprom CEO, Alexei Miller, met with the Hungarian Prime Minister, Viktor Orban. Given that front-end engineering design (FEED) is currently underway in Hungary, Gazprom reports that the Russian and Hungarian parties agreed to investigate the possibility of splitting the Hungarian section to allow a spur to Austria, while retaining the originally-planned route to Tarvisio in Italy via Slovenia. The spur to Austria would end at the Baumgarten gas hub. According to the Gazprom press release, “The meeting participants expressed their confidence that the choice of the gas pipeline route wouldn't affect the project schedule and first gas would be supplied via the Hungarian gas pipeline section in early 2017”. In terms of the timescale for gas deliveries to Austria, Gazprom plans to obtain all the required construction permits before the end of 2015. First gas supplies to Austria are scheduled for 2017, with the Austrian section reaching full capacity by January 2018.

And in other developments…

Gazprom Marketing and Trading Ltd and CNPC each agree to buy 3 million tonnes of LNG per year for the next 20 years from Novatek’s Yamal LNG project

On the 23rd of May, Gazprom announced the signing of a Heads of Agreement between Gazprom Marketing and Trading Ltd (GM&T) and Yamal Trade (a 100 percent subsidiary of Yamal LNG). The deal provides for GM&T to purchase 3 million tonnes (4 bcm) of LNG per year for the next 20 years from the Yamal LNG project. The price of the LNG supplies will be oil-indexed, and will be supplied ‘free on board’. According to the Gazprom press release, “Free on board is [a term] stipulating that the seller is responsible for getting goods onto a ship and pays export duties. The buyer pays the cost of marine freight transport, cost of goods and arranges their transportation after arrival”. The target market is the Asia-Pacific region.

The announcement comes just days after Novatek announced that it had also signed a 3 million tonne per year, 20 year, oil-indexed LNG supply contract with the China National Petroleum Corporation (CNPC). The two contracts with Gazprom and CNPC mean that supplies from the first LNG train are already contracted for the long term.

The Yamal LNG shareholders are Novatek (60 percent), Total (20 percent), and CNPC (20 percent). The Yamal LNG terminal will have three 5.5m tonne capacity LNG trains, giving a total 16.5 million tonne (21.5 bcm) export capacity.

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Director and Founder: Dr Marat Terterov
Email: Marat.Terterov@gpf-europe.com

Avenue Du Manoir D’Anjou 8
Brussels 1150 Belgium
Tel: +32 496 45 40 49
info@gpf-europe.com
www.gpf-europe.com
www.gpf-europe.ru