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

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- *Special report on Ukraine: A tense month dominated by political relations between Russia and Ukraine, and by commercial relations between Gazprom and Naftogaz, as debts and price negotiations leave Naftogaz in a difficult situation*
- *EU antimonopoly investigation into Gazprom could be delayed by crisis in EU-Russia relations; Gazprom's deals in Germany and the UK come under renewed scrutiny in context of current international tensions*
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Special Report on Ukraine

Debts and price negotiations leave Naftogaz in a difficult situation

In the previous issue of the Gazprom Monitor (№ 33, February), we reported on the loan provided to the Ukrainian government by the Russian government and Naftogaz's debts to Gazprom. The first tranche ($3bn) of the Russian loan to Ukraine was disbursed in December 2013. On the 17th of February, Russian Finance Minister, Anton Siluanov, announced that the Russian government was preparing to disburse the second tranche, worth $2bn. By late February, Naftogaz's debts to Gazprom amounted to $1.79bn. The second tranche of the Russian loan should have been sufficient to clear Ukraine's gas debts.

How quickly things can change. The protests in Kyiv descended into violence. On the 21st of February, President Yanukovych signed a compromise agreement with the protest leaders, only to flee Ukraine 24 hours later. The Ukrainian parliament voted to remove Yanukovych as president, and scheduled elections for the 25th of May. A pro-European interim government, led by Arseniy Yatsenyuk, was formed. In light of these developments, the second tranche of the Russian loan was not disbursed.

Furthermore, Gazprom announced that the 30 percent gas price discount, granted to Naftogaz in December, would not be renewed from the 1st of April due to Naftogaz's failure to clear its debts. On the 4th of March, President Putin told reporters, "If you don't pay us and your debt is ever-increasing, there is no discount. This makes perfect commercial sense for Gazprom". With the cancellation of the discount, the price at which Naftogaz imports Russian gas is set to increase from $268 per thousand cubic metres to $360-370. During the first week of March, Naftogaz failed to meet the deadline for the payment of gas received during February. On the 7th of March, Gazprom CEO Alexei Miller warned that, "Either Ukraine settles its debt and pays for current deliveries or the risk arises of a return to the situation we saw at the start of 2009".

The combination of Naftogaz's debts to Gazprom, the prospect of the end of the discount, and the political tensions in Crimea led many European energy experts and commentators to begin questioning the security of gas transit via Ukraine. It was feared that the suspension of Russian gas supplies *to* Ukraine would also result in the suspension of the transit of Russian gas *via* Ukraine. The question of the likelihood of a suspension of gas transit via Ukraine, and its potential impact on EU member states, was addressed by Jack Sharples and Dr Andrew Judge, in an article published through the European Geopolitical Forum. That article is available here.

Scheduled talks between Gazprom and Naftogaz representatives were then cancelled, with Russian and European sources reporting that the Naftogaz CEO, Yevhen Bakulin, had been arrested on corruption charges on the 21st of March. Bakulin is suspected of being part of a group that embezzled at least $4bn during his four-year tenure as Naftogaz CEO, since March 2010. Bakulin was relieved of his position, and replaced by Andriy Kobolev on the 25th of March. Following his appointment, Kobolev told a press conference in Kyiv that a meeting with Gazprom representatives was an urgent priority: "I must hear the position of the Russian side," he said. On the 27th of March, Ukraine's Fuel and Energy Minister, Yuri Prodan, acknowledged that Ukraine's gas debts to Russia stood at $1.75bn. On the 1st of April, it was confirmed that a Ukrainian delegation would visit Moscow on the 3rd of April to discuss the issue.

As if the situation was not bad enough for Ukraine, events in Crimea are having an additional effect on the price at which Gazprom sells gas to Naftogaz. In April 2010, the Ukrainian President, Viktor Yanukovych, signed the 'Kharkiv Accords'. In return for extending Russia's lease on the Sevastopol naval base in Crimea (home of Russia's Black Sea Fleet) from 2017 to 2042, Ukraine would receive a discount of $100 per thousand cubic metres on its Russian gas imports. This discount was achieved through the suspension of Customs Duty on Russian gas exports to Ukraine, and was thus funded by the Russian government rather than Gazprom. With Crimea now *de facto* a part of Russia, the Russian Prime Minister, Dmitry Medvedev, announced that the Kharkiv Accords were no longer applicable. Even worse for Ukraine, Medvedev added that Russia might seek a refund for the amount that Ukraine saved on its Russian gas discounts over the past four years, some $11bn. Medvedev stated, "Of course these are harsh measures, but on the other hand there is no agreement, and there is the payment we did. Our Ukrainian partners must understand that one doesn't get paid for nothing". The cancellation of the Kharkiv discount could push the price of Ukraine's Russian gas imports up to approximately $470 from the 1st of April.

To help Naftogaz cope with the import price increase, the Ukrainian government announced that Ukrainian domestic household gas prices would increase by 50 percent on the 1st of May, and that utility companies will face a 40 percent price increase on the 1st of July. These increases a part of a longer-term timetable of domestic gas price increases that will continue through to 2018. On the 26th of March, acting Ukrainian PM Yatsenyuk also announced that Ukraine could diversify its gas imports by receiving up to 25 bcm per year from Europe, at prices $100 lower than that paid for Russian gas. However, this would depend on finalising a 'reverse flow' scheme with Slovakia, to facilitate access to the European gas market. Ironically, the deal with Slovakia would represent the resurrection of an EU-brokered deal that Ukrainian representatives failed to sign on the 6th of December. According to a senior Slovak official at the time, "[The] Ukrainian partners simply did not show up". If the deal is resurrected under the current Ukrainian government, we can be relatively certain that this time, they will.

The domestic price increases, combined with modest imports from the European market, will not be sufficient to solve Ukraine's gas problems. Naftogaz needs to reach an understanding with Gazprom, and their bilateral commercial relations need to be stabilised. This includes the negotiation of gas prices, transit fees, and the clearance of Naftogaz's debts. If we can be sure of one thing, it is that this complex issue will not be resolved quickly.

Gazprom and the EU

EU antimonopoly investigation into Gazprom could be delayed by crisis in EU-Russia relations

The EU Commissioner for Competition, Joaquin Almunia, has sought to calm fears that the European Commission antitrust investigation into Gazprom's practices in Central and Eastern Europe could become inextricably linked with the current tensions in the EU-Russia political relationship. In a statement to the press, Almunia noted, "These days are not the most adequate ones to have a quiet discussion on the question related with Russian gas and how the Russian gas arrives to the territory and to the markets of the EU... (But) antitrust investigations should be protected from any kind of external influences".

A spokesman for the European Commission, Antoine Colombani, told reporters that work on the case would go on, regardless of the current political climate. "We continue to work on the preparation of the draft statement of objections, which has not been finalized at this point". In response, a Gazprom spokesman, Sergei Kuprianov, said "Gazprom is ready for any decision, we are sure we have been always fulfilling all European rules". The combination of Almunia's comments and Colombani's admission that the draft statement of objections has not yet been finalised suggests that the results of the EU antimonopoly investigation into Gazprom could be delayed, at least until the current tensions have eased, lest they be interpreted as being unduly influenced by the current political climate.

Gazprom's deals in Germany and the UK come under renewed scrutiny in context of current international tensions

In 2012, Gazprom and German energy utility BASF Wintershall agreed in principle on an asset swap. The deal envisaged Gazprom increasing its share to 100 percent in the German gas storage and distribution firm, Wingas (a 50-50 joint venture between Gazprom and BASF Wintershall), in exchange for granting BASF Wintershall 25 percent stakes in two blocks of the Achimov deposits of Gazprom's Urengoi gas field in North-West Siberia. The deal was approved by EU regulators on the 4th of December 2013. The deal, and its approval by EU regulators, was examined in detail in the December issue of the Gazprom Monitor.

The deal, which is now being finalised, is causing concern in Germany in light of the deterioration of political relations between the EU and Russia. Norbert Röttgen, Chairman of the Bundestag's Foreign Affairs Committee and a leading member of Chancellor Angela Merkel's centre-right CDU party, told the Financial Times, "This is not the right response to the crisis. On the contrary, it is deepening our dependence on Russia". However, the German Ministry of Economics seems keen to play down such fears, arguing, "The Economics Ministry does not consider this barter [asset-swap] transaction to be a danger to gas supplies. Germany is and remains open to foreign investment".

In 2012, the British energy company, Centrica, also signed a deal with Gazprom for the supply of 2.4 bcm over three years. The deal marks the first time that the UK will import gas directly from Russia under a contract with Gazprom. This agreement is also coming under renewed scrutiny. Despite speculation that such supplies from Russia were already being delivered, the Head of Media Relations at Centrica, Alan McLaughlin, has stated that supplies from Gazprom will not begin until October 2014. McLaughlin added, "For context it's worth noting that last year Centrica also signed large volume gas contracts with Norway's Statoil, with Qatargas and with [U.S. LNG supplier] Cheniere Inc. The Centrica-Gazprom deal is a small contract for 2.4 bcm of gas over the three year period". For comparison, the deal with Statoil envisages supplies of 50 bcm over ten years from 2015, while the deal with Qatargas foresees supplies of 9.9

bcm over four and a half years. The deal with Qatargas replaces an existing contract, which will end this year.

Despite the consternation surrounding the deal with Gazprom, this is not the first time that the UK will import Russian gas. Gazprom's gas trading arm, Gazprom Marketing and Trading Ltd. (based in London) coordinates the import of 11-12 bcm every year (about 15 percent of UK gas demand). Although this gas is purchased on European spot markets, the gas itself is very likely to be of Russian in origin.

The deals with Gazprom, Statoil, Qatargas, and Cheniere are important for the UK, which is increasingly dependent on imports to meet its domestic gas demand. Since 2000, UK gas production has fallen by an average of 8 percent per year. In 2013, net imports (39.1 bcm) were higher than domestic gas production (38.2 bcm) for the first time ever, as demand remained stable at 79.2 bcm. The impact of the combination of steady demand and drastically falling production is clear. The UK became a net gas importer only in 2004. Yet according to Sam Laidlaw, CEP of Centrica, "By 2020 we [the UK] will be reliant on imports to meet 70 percent of the country's gas needs".

Nord Stream

EU delays resolution of OPAL exemption

The Nord Stream gas pipeline, which delivers gas directly from Russia to Germany under the Baltic Sea, makes landfall at Greifswald, on Germany's Baltic coast. From there, the OPAL (36 bcm capacity) and NEL (20 bcm capacity) pipelines connect Nord Stream to the rest of Germany's gas pipeline network. OPAL connects Nord Stream to the German-Czech border, while NEL connects Nord Stream to the Rehden underground gas storage facility in North-West Germany. The OPAL pipeline is majority-owned (80 percent) by the BASF Wintershall-Gazprom joint venture, W&G (Wintershall & Gazprom), while E.On Ruhrgas holds a minority (20 percent) share. NEL is owned by W&G (51 percent), Gasunie (25 percent) and Fluxys (24 percent).

Because both OPAL and NEL are on EU territory, they are subject to the provisions of EU gas market legislation. According to the provisions of Third Party Access, a percentage of OPAL and NEL capacity must be kept free for use by third parties (i.e. companies that are not shareholders in the pipeline). For OPAL, 50 percent of the pipeline's capacity must be kept for third party users, despite W&G owning an 80 percent stake in the pipeline.

In practice, this has meant that Nord Stream operates at below full capacity, because OPAL and NEL are the only pipelines connected to the German end of the line. In 2013, just 23.8 bcm was delivered to Europe via Nord Stream, utilising 43 percent of the pipeline's 55 bcm capacity. To overcome this situation, Gazprom and its European partners applied for exemptions from EU gas market legislation for OPAL and NEL.

In February 2009, the German domestic gas market regulator, Bundesnetzagentur, granted OPAL a 22-year exemption from third party access provisions, due to its status as a cross-border (German-Czech) transit pipeline. Because NEL operates only on German territory, it was not granted an exemption. However, the OPAL exemption was not applied, because it was not confirmed by EU gas market regulators. Five years of EU-

Russian-German negotiations have failed to resolve the situation.

Article 36 of the EU Third Gas Directive sets out the conditions that must be met if a pipeline is to receive an exemption from the provisions of unbundling and third party access. These include: 1) the investment must enhance competition in gas supply and enhance security of supply; 2) the level of risk attached to the investment must be such that the investment would not take place unless an exemption was granted; 3) the infrastructure must be owned by a natural or legal person which is separate at least in terms of its legal form from the system operators in whose systems that infrastructure will be built; 4) charges must be levied on users of that infrastructure; and 5) the exemption must not be detrimental to competition or the effective functioning of the internal market in natural gas, or the efficient functioning of the regulated system to which the infrastructure is connected.

Gazprom may be able to make a strong case regarding the following points: OPAL and NEL (as part of Nord Stream) enhance security of supply; it is unlikely that they would have been built if Gazprom had not expected exemptions (given that the capacities of OPAL and NEL match that of Nord Stream); OPAL and NEL are owned by entities that are legally separate from the entity that operates the system in which they have been built (Gascade – a legally separate subsidiary of W&G), and that charges will be levied on the users of OPAL and NEL.

However, the problem faced by Gazprom is that because Gazprom is already dominant in the German gas market, EU regulators may decide that OPAL and NEL do not enhance competition on the German gas market, and indeed may harm competition by further entrenching Gazprom's dominant position. This issue must be resolved before OPAL and NEL may be granted exemptions.

On the 10th of March 2014, in the context of the current uncertainty in EU-Russia political relations and the ongoing EU antimonopoly investigation of Gazprom, the European Commission announced that it would delay its decision on granting OPAL an exemption from third party access provisions, citing the need for technical clarifications. However, an EU representative also reaffirmed that "The Commission aims for rapid clarification of the remaining issues and will work on this together with the relevant authorities".

South Stream

South Stream uncertainties intensify

At the beginning of March, Gazprom CEO Alexei Miller suggested that gas deliveries via South Stream would begin in December 2015. In a meeting with the Russian Prime Minister, Dmitry Medvedev, Miller said, "Everything is proceeding as scheduled; the construction of onshore sections of the gas pipeline was launched on the territories of Bulgaria and Serbia". This optimism was enhanced by the signing of a contract between South Stream Transport (the consortium that will own and operate South Stream's offshore section) and Saipem for the construction of South Stream's offshore section. In accordance with a contract worth €2bn, Saipem will use two offshore pipe-laying vessels to lay the first line of the section. Construction is scheduled to last from autumn 2014 to the third quarter of 2015. Saipem has experience in underwater pipeline construction in the Black Sea, having laid the offshore section of the Blue Stream pipeline just over a decade ago.

However, the project faces several uncertainties. The first is regulatory. South Stream's sections on EU territory face the same issue of third party access as Nord Stream's onshore OPAL and NEL sections. In the case of South Stream, Gazprom has ordered the construction of the pipeline to begin despite the fact that it has yet to apply for exemptions for South Stream's sections on EU territory. Gazprom's EU partners now face the difficult decision of whether to push on with the project and risk EU regulatory measures once the pipeline is complete, or whether to freeze the project and risk breaching their contracts with Gazprom. For Gazprom, the scenario of constructing South Stream and then finding that the pipeline can only operate at half capacity is not an appealing one.

In Bulgaria, the government has proposed an amendment to its 'Energy Act' legislation. According to Bulgarian sources, two Bulgarian Socialist Party MPs have tabled a proposal to redefine South Stream from a 'pipeline' to an 'interconnector'. According to Bulgarian sources, this would render South Stream (at least partly) exempt from EU third party access provisions. However, the experience of OPAL shows that this may not be the case. The EU Energy Commissioner, Gunther Oettinger, sent a letter to the Bulgarian Minister of Energy, Dragomir Stoynev, asking for clarifications regarding the draft legislation.

Finally, in early March, the Serbian Ministry of Energy suggested that delays in constructing the Serbian section of South Stream were due to the failure of Srbijagas to conduct the financial reforms necessary for it to receive the state-backed loan it needs to pay for the Serbian section of South Stream. Serbian sources reported comments of the Prime Minister, Ivica Dačić, at the Kopaonik Business Forum, "It has been postponed for 2-3 months now, and the tender invitation for contractors who will build the Serbian section of the pipeline is also late".

Asia

Gazprom CEO expects to sign contract with CNPC in May

The Gazprom CEO, Alexei Miller, told Prime Minister Dmitry Medvedev that he expects Gazprom to "sign a contract with China for the supply of 38 billion cubic meters of gas, with the term of the contract making up 30 years... We expect that the contract may be signed in May of this year". Miller added, "An agreement was reached with Chinese partners that as soon as a contract for gas deliveries from Eastern Siberia to the People's Republic of China is signed, we will immediately launch negotiations on gas supplies on the western route, where the resource base is Western Siberia, which has been traditionally a resource base for gas deliveries to Europe... In the medium term we can bring gas deliveries in the Asian direction to the amount that will be comparable with gas deliveries to Europe".

And in other developments…

Gazprom plans for access to Crimean gas deposits and plans doubling of gas production in the region

Following the referendum in Crimea and the official designation of the territory as part of the Russian Federation by President Putin, Gazprom was quick to express interest in Crimea's oil and gas deposits. In an interview with Russian state-run news organisation RIA Novosti, Crimea's First Deputy Prime Minister, Rustam Temirgaliyev, confirmed, "Gazprom was the first to file its request". About 1.5 bcm of natural gas is produced every year on the Black Sea shelf adjacent to Crimea. Russia's Prime Minister, Dmitry Medvedev, has estimated that with investment from Russian oil and gas companies, this production figure could double in the coming years. "According to expert analysis, this should cover Crimea's electricity demands... Gazprom has an initiative for this," Medvedev said, "Crimea's dependence on water and electricity supplies [from mainland Ukraine] is yet another infrastructural problem. The issue will be settled through international negotiations. We need to choose the most efficient way to meet the peninsula's needs".

A month of milestones, as Gazprom celebrates 50m tonnes of LNG exports from Sakhalin-II and 100 bcm of gas exports via Blue Stream

March was a month of milestones for Gazprom, as the company celebrated cumulative exports of 50m tonnes of LNG from Sakhalin-II since February 2009 and 100 bcm of natural via Blue Stream to Turkey since December 2002. In 2013, Sakhalin-II produced and exported 10.8m tonnes of LNG (approximately 15 bcm of natural gas), while gas exports via Blue Stream amounted to 13.7 bcm, more than half of the 26.7 bcm that Gazprom exported to Turkey that year.

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