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The European Geopolitical Forum

EGF Gazprom Monitor
Issue 49: June 2015

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

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- *Nord Stream: Gazprom announces signing of Memorandum of Intent for third and fourth lines of Nord Stream; Russia opens up possibility of non-Gazprom exports via Nord Stream through gas export auctions*
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Gazprom and the EU

European Commission extends deadline for Gazprom's response to the Statement of Objections to mid-September 2015

The European Commission has extended the deadline by which Gazprom must answer the 'Statement of Objections' issued by the European Commission in April. The deadline has been moved back by 6 weeks, from late July to mid-September.

According to the Statement, Gazprom is suspected of three sets of anti-competitive practices:

- First, Gazprom may be hindering cross-border gas sales, by preventing the re-export of imported gas
- Second, Gazprom may have imposed unfair prices on its customers, and may have used formulae linking the price of gas to oil prices in order to do so. This includes charging unreasonably high prices for some countries and lower countries for others, despite having similar supply (e.g. transportation) costs
- Finally, Gazprom may have abused its dominant position by making the supply of gas "conditional on obtaining unrelated commitments from wholesalers concerning gas transport infrastructure"

Once the European Commission representatives and representatives of national (EU member state) competition authorities have heard Gazprom's case, the European Commission will take a final decision on whether Gazprom has violated EU competition law.

Experts will undoubtedly follow developments closely over the coming months. Gazprom may choose to settle the case before it comes before the court. If it does not, the ruling will have a significant impact on the European gas market. If Gazprom is found guilty of anti-competitive practices, it will not only face a substantial fine, but also a raft of private claims from European energy companies, as discussed in the April edition of the Gazprom Monitor.

Gazprom and Gasunie sign framework agreement on small-scale LNG cooperation

On the 2nd of July, the Gazprom CEO, Alexei Miller, and the CEO and Chairman of the Executive Board of Gasunie, Han Fennema, signed a Framework Agreement on cooperation between Gazprom and Gasunie in the sphere of small-scale LNG. According to the Gazprom press release:

> The document stipulates the cooperation in the small scale LNG market in Europe, with a focus on joint projects for the construction of LNG receiving terminals, LNG filling stations and other infrastructure facilities… The parties also looked into the possibility of initiating a joint pilot project for constructing a small LNG receiving terminal in Northwest Europe. The terminal will be used for storing, shipping and selling LNG as a bunker and vehicle fuel as well as an energy source for autonomous gasification. In addition, the possibility of building LNG filling stations is also being contemplated within the project.

In signing the agreement, Miller expressed optimism at the possibility of diversifying export routes and broadening the use of natural gas in Europe, while Fennema highlighted the potentially greater role of natural gas in both maritime and land-based transport.

Nord Stream

Gazprom announces signing of Memorandum of Intent for third and fourth lines of Nord Stream

On the 18th of June the Gazprom CEO, Alexei Miller, joined representatives of E.ON, Shell, and OMV in signing a Memorandum of Intent for the construction of third and fourth lines of the Nord Stream gas pipeline. The memorandum was signed during the St Petersburg Economic Forum. The two additional lines are planned to have a combined capacity of 55 bcm per year and make landfall near Greifswald on Germany's Baltic coast – the same as the existing two lines of Nord Stream. Early indications from Gazprom are that they expect the two new lines to cost a combined €9.9bn – slightly more than the €8.5bn it cost to build the first two lines of Nord Stream.

Proposals to expand the capacity of Nord Stream have been on the table for several years. On the 8th of October 2012, at a ceremony marking the commissioning of the second line of Nord Stream, the Gazprom CEO, Alexei Miller, stated:

> Today Nord Stream shareholders examined the preliminary results of the feasibility studies for the construction of the third and fourth strings and came to the conclusion that their construction was economically and technically feasible.

In summer 2013, Gazprom representatives held meetings with their counterparts from Gasunie and GDF Suez to discuss the potential expansion of Nord Stream. At the beginning of February 2014, Gazprom announced that it had reviewed the results of the feasibility study performed by Nord Stream AG (the consortium that owns and operates Nord Stream), and had come to the conclusion that:

> Based on the results of this study, the construction of one or two additional gas pipeline strings is economically viable and possible both from the technical and environmental points of view, as well as for the purposes of attracting necessary financing in the banking market.

However, at the 8th Annual European Gas Conference in Vienna in late January 2015, the Chairman of the Board of Gazprom, Viktor Zubkov, announced that Gazprom had abandoned plans for the expansion of Nord Stream, due to uncertainties over price and demand levels on the European gas market:

> When the price is decreasing… is difficult to realise these projects and sometimes it's even not possible… How can one be confidently planning long-term investments if in one year the market can drop by as much as the Nord Stream capacity? What we have now in the EU is complete chaos in the market and lack of understanding of long-term goals for both suppliers and consumers.

Interestingly, a Gazprom source also told Reuters that the decision to cancel the Nord Stream expansion was also linked to "complicated" politics in Europe, and the refusal of the European Commission to grant an exemption to Gazprom for its use of Nord Stream's onshore German sections, OPAL and NEL: "We were not allowed access to OPAL. Why build two more arms? We are not building them."

At the St Petersburg Economic Forum, on the 18th of June, the Gazprom CEO, Alexei Miller, revealed a reversal of Zubkov's January announcement – the Nord Stream expansion was back on the table.

Indeed, Miller suggested that the pre-investment and pre-design activities had continued between 2012 and 2014, the project financing (30 percent from participants and 70 percent from loans, as with the first two lines of Nord Stream) had been agreed, and that the route has now been decided, through the exclusive economic zones of Russia, Finland, Denmark, Sweden, and Germany. Furthermore, Miller claimed that the budget for Front-End Engineering and Design (FEED) had already been drawn up, and that Gazprom was ready to proceed with FEED work.

Moving forward, Miller stated that he expected the Shareholder's Agreement to be signed in September 2015 and that the two new lines would be laid more quickly than the first two lines, meaning that the third and fourth lines of Nord Stream could be commissioned before the end of 2019.

A particularly interesting point to note is Miller's insistence (Zubkov's January assessment of the European gas market notwithstanding) that the expansion of Nord Stream is justified by a growing European demand for gas imports from Russia:

> The main factor underlying the signing of these documents today is the European market environment. First of all, it is a decline in gas production in Europe and, therefore, a growing demand for Russian gas supplies… they highlight the fact that they won't make do without new volumes of Russian gas supplies… here I need to stress that the new capacities for the third and fourth strings are being constructed solely for the new volumes of Russian gas. It is not about any transit volumes or the so-called 'old' gas, it is only about new volumes. The Nord Stream-2 project is no rival to the TurkStream project.

Miller's comments echo Gazprom's justifications for the original Nord Stream project, i.e., the project is necessitated by rising export volumes, rather than a desire to 'circumvent' Ukraine. However, statistical evidence appears to contradict these claims.

Since the launch of Nord Stream's second string in October 2012, Russian gas deliveries to Europe via Ukraine have fallen in line with rising exports via Nord Stream. In 2012, gas deliveries via Nord Stream totalled 11 bcm and the transit of Russian gas via Ukraine totalled 79 bcm. In 2014, those figures were 34 bcm and 53 bcm respectively. Therefore, between 2012 and 2014, gas exports via Nord Stream rose by 23 bcm, and gas transit via Ukraine fell 26 bcm. According to IEA data, in 2012, Russian gas exports to Europe (including Turkey) via Nord Stream, Belarus, and Ukraine totalled 121.8 bcm. In 2014, that figure was 123.7 bcm.

In the context of stable export volumes, the development of the first two lines of Nord Stream clearly resulted in the re-routing of gas transit away from Ukraine to Nord Stream. Given that Gazprom's gas transit contract with Naftogaz expires in 2019, the announcement that the Nord Stream expansion will be completed in 2019 is surely no coincidence.

Furthermore, it is the opinion of this author that Turkish Stream will not be built at its proposed four-line, 63 bcm capacity, due to the lack of gas transportation infrastructure for delivering gas from the Greek-Turkish border to Central Europe. Instead, it appears that the first line will be built for exports to Turkey (re-routing gas currently delivered to Turkey via Ukraine, Romania, and Bulgaria). The second line may be built, in conjunction with a new pipeline from Greece to the Hungary, via the non-EU states of Former Yugoslav Republic of Macedonia (FYRM) and Serbia, as discussed in the section below on 'Turkish Stream'.

The expansion of Nord Stream, combined with the implementation of two lines of Turkish Stream, would enable Gazprom to reduce gas transit via Ukraine to zero, from 53 bcm in 2014. Given the difficulties Gazprom would face in implementing Turkish Stream at its full capacity, the revival of the Nord Stream expansion project is far from surprising. Whether the expansion of Nord Stream is actually implemented remains to be seen.

Russia opens up possibility of non-Gazprom exports via Nord Stream through gas export auctions

Russian sources report that the Russian government may have found a way to overcome its current limitations on gas exports via Nord Stream, using export capacity auctions.

Currently, Gazprom is the only gas exporter that delivers gas via the Nord Stream pipeline. Once Nord Stream makes landfall in Germany, it feeds into two pipelines, OPAL and NEL. However, because European gas market legislation prevents a single supplier from using 100 percent of a pipeline's capacity, Gazprom is limited in terms of how much gas it can pump into OPAL and NEL. This, therefore, limits how much gas Gazprom can pump into Nord Stream.

However, Russian sources report that the Russian government is considering allowing Gazprom to auction off spare capacity of Nord Stream to other Russian parties at the St Petersburg International Mercantile Exchange (SPIMEX). It is reported that Gazprom intends to hold an auction in September for 120 export 'lots', totalling 3 bcm.

In planning the auction, Gazprom is walking a tightrope between utilising spare capacity in the Nord Stream pipeline and generating new competition for its European exports. It should be noted that Gazprom has booked 100 percent of the capacity of Nord Stream (intending to use that capacity for its own gas deliveries), and is therefore committed to paying its Nord Stream partners (Wintershall, E.ON, GDF Suez, and Gasunie) regardless of the volumes actually shipped. While Nord Stream is under-utilised, Gazprom is losing money. The utilisation of Nord Stream by other parties would bring much-needed revenues for Gazprom.

An interesting point to note at this stage is that, if successful, Gazprom's plans to auction export capacity could be used in the proposed Nord Stream extension and, crucially, in Turkish Stream's European sections.

The possible expansion of Nord Stream, and its full utilisation through capacity auctions, would make it easier for Gazprom to achieve its aim of completely circumventing gas transit via Ukraine once the existing gas transit contract expires in January 2019.

According to IEA data, in the year ending on the 31st of March 2015, Gazprom delivered 31.5 bcm via Nord Stream, with the pipeline operating at 57 percent of its capacity. Gas transit via Ukraine during the same period was 51.4 bcm. If Gazprom were to implement the expansion of Nord Stream (also utilised at 31.5 bcm per year), and its gas exports to Europe were to remain stable, two lines of the Turkish Stream pipeline would be sufficient to completely replace Ukrainian gas transit.

This would involve 15 bcm of deliveries to Turkey re-routed from Ukraine to Turkish Stream, and deliveries of just 8.5 bcm to Europe via the second line. For comparison, Gazprom's 2014 deliveries to the parties interested in 'Turkish Stream', Greece, Serbia, and

FYRM totalled 3.16 bcm, while deliveries to Hungary totalled 5.33 bcm.

Turkish Stream

Turkish government grants permission for Gazprom to conduct engineering surveys in its territorial waters and exclusive economic zone, but Gazprom and Botaş yet to reach agreement on gas price discount

In last month's edition of the *Gazprom Monitor*, we predicted that the attitude of the Turkish government towards the 'Turkish Stream' project would soon be much clearer, in light of the Turkish elections scheduled for early June. That prediction now appears to have been partially accurate – the governing AK party lost its parliamentary majority, and has yet to form a coalition government, resulting in a degree of political uncertainty. However, on the 22nd of June, the Turkish government somewhat clarified the situation by offering support for the Turkish Stream project, through granting Gazprom the right to conduct offshore research and engineering surveys in Turkey's exclusive economic zone (EEZ) and territorial waters.

Crucially, the permission to carry out research and surveys applies only to the first (15.75 bcm) line of the proposed four-line Turkish Stream project. The first line was proposed for the delivery of gas to the Turkish market. If Gazprom's exports to Turkey do not increase, this line will be used to re-route deliveries that are currently made via Ukraine, Romania, and Bulgaria.

A major obstacle to the Turkish Stream project that has yet to be overcome is the negotiation between Gazprom and the Turkish state-owned energy company, Botaş. As an incentive to facilitate the Turkish Stream project, Botaş is seeking a discount on the price it pays for imported Russian gas.

According to the current Gazprom-Botaş contract, if one party wishes to renegotiate the contract, they must allow six months of negotiations before they are permitted to submit a claim for arbitration. The six-month negotiation period for Gazprom and Botaş expired on Monday the 29th of June. While further negotiations are likely, arbitration cannot be ruled out.

Any further progress towards actually beginning the construction of Turkish Stream – a development much-desired by Gazprom, which already has the steel pipes and pipe-laying vessel in place – will depend on the pace at which Gazprom completes its surveys and receives permission from the Turkish government to begin construction, and the ability of Gazprom and Botaş to reach an agreement on gas prices.

Russia and Greece sign Memorandum on extension of Turkish Stream in Greece

During the St Petersburg Economic Forum, the Energy Minister of the Russian Federation, Aleksandr Novak, and the Energy Minister of Greece, Panayiotis Lafazanis, signed a Memorandum of Understanding (MoU) on the extension of Turkish Stream on Greek territory, where it will be known as the 'South European Gas Pipeline'. The company VEB Capital, a subsidiary of the Russian state-owned bank, VneshEconomBank, will own 50 percent of the joint venture and provide 100 percent of the project financing. The remaining 50 percent will be owned by a Greek party, as yet unnamed.

However, reports from Greece suggest that the MoU has opened up a rift between Energy Minister Lafazanis and Foreign Minister Nikos Kotzias – the MoU appears to suggest that a third party (i.e. Gazprom) could be allowed to book 100 percent of the pipeline's proposed 47 bcm capacity, a move that would contravene EU gas market legislation. After Lafazanis signed the MoU, Kotzias publicly stated that any Greek energy agreement cannot "go beyond the legal framework and agreements of the [European] Union".

As noted above, if Gazprom aims to expand Nord Stream and use Turkish Stream to supply South-Eastern Europe and Hungary, it would need just one 15.75 bcm line from the Greek-Turkish border to the Serbian-Hungarian border, and would use less than two-thirds of the capacity of that line, thus avoiding debates over the ability of one company to book 100 percent of a pipeline's capacity. The fact that state-owned VEB Capital is prepared to act as the Russian project partner for the Southern European Gas Pipeline on Greek territory suggests Russian state support for this solution.

Gazprom and Ukraine

Naftogaz suspends gas imports from Russia on 1st of July, having failed to make pre-payment

In a repeat of last summer, the state-owned wholesale Ukrainian gas importer, Naftogaz, has suspended its imports of Russian gas. Last summer, the suspension was triggered by Naftogaz's refusal to 'pre-pay' for its gas imports, and lasted until December 2014. This time, Naftogaz again announced that it would not pre-pay for Russian gas imports in July, and supplies duly ceased on the 1st of July.

The announcement by Naftogaz comes just 24 hours after the conclusion of EU-Russia-Ukraine trilateral gas talks in Vienna. Speaking after the talks, the European Commissioner for Energy Union, Maroš Šefčovič, said:

> Today's trilateral consultation has again shown that all parties agree on the principles needed to ensure stable and smooth gas deliveries to Ukraine and transit to the EU. The translation of these principles into a jointly agreed final framework require further work. As the meeting has shown today, the parties are still far apart. We have agreed that the Commission will put forward ideas to prepare next steps so that the next consultation could take place. We will use the summer to start preparing the next winter season.

The talks were aimed at renewing the short-term 'interim agreement' between Gazprom and Naftogaz. The interim agreement was first negotiated in late 2014, as a means of ending the suspension of Naftogaz's imports of gas from Gazprom. That agreement, known as the 'Winter Package', resulted in an interim gas price, pre-payment for Russian gas by Naftogaz, and a partial repayment of Naftogaz's debts to Gazprom. The 'Winter Package' was renewed in March 2015, with further renewals taking place on a quarterly basis. The previous extension expired on the 30th of June.

The interim agreements are central to maintaining the Gazprom-Naftogaz relationship, including Russian gas exports to Ukraine and the transit of Russian gas to Europe via Ukraine, until the results of the ongoing arbitration cases between Gazprom and Naftogaz are published. According to recent comments by Šefčovič, the arbitration cases will be concluded in spring or autumn 2016.

Naftogaz's suspension of imports from Russia comes despite Gazprom's willingness to continue its discount – sources report that Gazprom was prepared to offer a price of $247 per thousand cubic metres (mcm), suggesting a discount of $40. This equates to $6.73 per million British thermal units (mmbtu), compared to a price of $7.40 per mmbtu for Russian gas on the German border in May 2015, according to the IMF commodity price index. For further comparison, the day-ahead spot market at the Central European Gas Hub (CEGH) closed at €21.55/MWh, which equates to $6.95 per mmbtu or $254.97 per mcm.

If the prices reported are correct, Naftogaz's refusal to buy gas from Gazprom at a price of $247 does not appear to be price-driven, in the hope of purchasing gas more cheaply from Europe. Instead, the move could be indicative of Naftogaz's strategy of reducing gas imports during the summer, as it did last year, to reduce overall annual gas imports.

Rejecting the previous received wisdom that gas is much cheaper in the summer than the winter, seasonal spreads over the past couple of years suggest that Naftogaz may not be taking such a big risk, as European spot prices in winter 2015-16 are unlikely to be significantly higher than in summer 2015.

The events of 2014-15 proved that Ukraine can make it through the winter – Naftogaz injected gas into storage from the 9th of May to 21st of October, with gas stocks rising from 8.5 bcm to 16.8 bcm. On the day that Naftogaz suspended imports of Russian gas (16 June 2014), it had 13.5 bcm in storage. This year, Naftogaz suspended its imports of Russian gas two weeks later, and has 12.1 bcm in storage – 2.2 bcm less than it had one year ago, on the 2nd of July 2014.

Whilst the weather conditions over winter 2015-16 are difficult to predict, along with Ukrainian gas consumption and the availability of 'reverse flow' West-to-East gas imports from Europe, it is clear that if Naftogaz follows the pattern of last year, it will be starting summer/autumn with no Russian gas imports with even less gas already in storage. If no new agreement is reached, this fact will surely raise concerns in those European countries that depend on gas transit via Ukraine.

Gazprom in Asia

Gazprom and Shell sign Memorandum on adding third train to the Sakhalin-II LNG export project

During the St Petersburg Economic Forum, the Gazprom CEO, Alexei Miller, and his counterpart from Shell, Ben van Beurden, signed a Memorandum on adding a third train to the Sakhalin-II LNG export terminal. According to Gazprom's press release, supplies for the third train will be provided by Gazprom from its Sakhalin-III project. Miller himself noted:

> The project for constructing the third process train of the LNG plant within the Sakhalin II project can make a great contribution to Gazprom's strategy for LNG production and sales as well as to reinforcing the Company's stance in the Asia-Pacific markets.

Sakhalin-II is Russia's first (and, so far, only) LNG export terminal, with an annual capacity of 9.6 million tonnes of LNG. The Sakhalin-II project is operated by the Sakhalin Energy consortium, which consists of

Gazprom (50 percent plus one share), Shell (27.5 percent minus one share), Mitsui & Co. (12.5 percent) and Mitsubishi Corporation (10 percent). The proposed expansion will add 50 percent to the export capacity of Sakhalin-II. Miller and Van Beurden signed a roadmap for the expansion of Sakhalin-II in February 2014, and an agreement to conduct Front-End Engineering and Design was signed in September 2014. Given the uncertainties over Gazprom's plans for its proposed Vladivostok LNG export terminal, an expansion of Sakhalin-II could be Gazprom's only increase in LNG export capacity in the next 5 years.

The signing of the agreement is particularly noteworthy, given Shell's recent acquisition of the natural gas exploration and production company, BG Group, which is highly active in the international LNG market.

The agreement is also indicative of Gazprom's deepening partnership with Shell, which also involves Shell's participation in proposals to expand the capacity of the Nord Stream pipeline, as discussed earlier in this issue of the Gazprom Monitor.

Yamal LNG clinches two new LNG export deals as it seeks to pre-sell its export volumes

Meanwhile, in early June, Gazprom's major competitor in Russian LNG exports, the Yamal LNG consortium, announced that it had secured two more contracts for export from its LNG terminal on the Yamal Peninsula, which is currently under construction.

On the 4th of June Novatek announced that Yamal LNG had secured a contract to deliver 0.9 million tonnes of LNG per year "for more than 20 years" to Shell, Gazprom's strategic partner. That deal was announced 48 hours after Yamal LNG had reached agreement with ENGIE (formerly GDF Suez) to supply 1 million tonnes of LNG per year for 23 years.

In October 2013, Novatek signed an agreement with the Spanish energy company, Fenosa, to supply 2.5 million tonnes of LNG per year on a "long-term" basis. In May 2014, CNPC agreed to purchase 3 million tonnes per year for 15 years. In January 2015, Gazprom agreed to buy 2.9 million tonnes per year for 20 years. Thus, 10.3 million tonnes of the proposed 16.5 million tonne capacity has already been contracted – this means that the first two trains are fully contracted, and we can expect further contracts to be signed in the coming years as Yamal LNG moves towards its full export capacity with a third train.

The independent Russian gas company, Novatek, holds a 60 percent stake in Yamal LNG, while Novatek's partners, Total and CNPC, each hold stakes of 20 percent. The project is due to launch deliveries in 2017, with full capacity of 16.5 million tonnes (three LNG trains) to be reached in 2021.

China officially launches construction of 'Power of Siberia' gas pipeline, as Gazprom and CNPC discuss possibility of Rouble-Yuan denominated contracts

On Monday the 29th of June, the China National Petroleum Corporation (CNPC) held a ceremonial first welding of the Chinese section of the Power of Siberia gas pipeline, near the Chinese city of Heihe in the northern Heilongjiang province, which borders Russia.

The pipeline is scheduled for completion in 2018, and could deliver up to 38 bcm per year from Russia to China. Taking part in the event via video link, the Russian Prime Minister, Dmitrii Medvedev, said:

> I am sure that soon we will reach final agreement on building the second Russian-Chinese pipeline for gas deliveries via the Western route.

Earlier, the Gazprom CEO, Alexei Miller, had revealed that Gazprom and CNPC were discussing the use of the Rouble and Yuan (as opposed to the US Dollar) in the pricing of Russian gas deliveries to China via the 'Western route' through Russia's Altai province. However, uncertainties over the stability of the value of the Russian Rouble could undermine such a move.

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