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

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Key points:

- *European Commission extends deadline for final decision on OPAL pipeline to the end of January 2015*
- *Gazprom and BASF abandon asset-swap agreement*
- *Gazprom resumes gas supplies to Ukraine, the first since June 2014*
    - *Background of the dispute*
    - *The importance of gas storage reserves in Ukraine*
- *Gazprom signs new gas supply and transit contracts with Belarus to cover 2015-17*
- *Russia and China sign framework agreement on second pipeline, via the 'western route'*
    - *Background of the 'eastern route'*
    - *Comparing the two projects*
- *Estonia imports first gas via Lithuania, a symbolic first step away from Russia*

On behalf of all the team here at the European Geopolitical Forum, I would like to wish all our readers a Merry Christmas and a Happy New Year. I would also like to take this opportunity to thank my colleagues here at the European Geopolitical Forum, namely, Dr Marat Terterov, Ben McPherson, Raina Meenakshi, Sergei Tretyak, and Sergei Korol. Without them, this publication would simply not be possible.

Gazprom and the EU

European Commission extends deadline for final decision on OPAL pipeline to the end of January 2015

The European Commission has again extended its deadline for a final ruling on the OPAL pipeline, to the end of January 2015. According to a European Commission spokesperson:

> The European Commission has agreed with Germany's Federal Network Agency to extend the deadline for an OPAL decision. The decision was delayed due to some technical aspects which require further consideration. It is hard to mention the date of the decision. The deadline for a decision is the end of January 2015.

The 35 bcm-capacity OPAL pipeline is one of two pipelines that connect Nord Stream with the German gas pipeline system. OPAL transports gas from Nord Stream south to Olbernhau on the German-Czech border, where it connects with the Transgas pipeline, which brings Russian gas to Germany via Ukraine, Slovakia, and the Czech Republic. At its mid-point, OPAL also connects with the Yamal-Europe pipeline, which brings Russian gas to Germany via Belarus and Poland.

Since its launch in 2011, OPAL has been subject to negotiations over third party access. Gazprom wants to use the full capacity of OPAL, as an onshore part of Nord Stream. However, the European Commission is keen to enforce third party access provisions, and force Gazprom to allow other energy companies to make use of part of OPAL's capacity.

In February 2014, the German energy regulator, BundesNetzAgentur (BNetzA), proposed a compromise solution. BNetzA press officer, Armasari Soetarto, explained that compromise:

> Under the updated agreement, OPAL Gastransport can still keep 50% of the capacity for its own use, but there is no gas release program. Instead it has to offer the other 50% to the market using the PRISMA platform, and regular third-party access rules apply.

The first auction was proposed for July 2014.

On the 10th of March 2014, in the context of the tensions 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.

Then, on the 15th of July 2014, the proposed OPAL capacity auction was cancelled and the European Commission announced its agreement with BNetzA to prolong the deadline for a decision on OPAL indefinitely.

Gazprom and BASF abandon asset-swap agreement

For more than two years, Gazprom and its partner, BASF, have been planning a major asset swap. Gazprom sought access to the downstream European gas market, while BASF sought larger shares in Russian gas fields.

The agreement, first signed in November 2012, would have seen Gazprom exchange 25 percent shares in two blocks of the Achimov deposits of its Urengoy gas field (West Siberia) for 100 percent shares in the Gazprom-BASF Wintershall joint venture gas trading and storage companies Wingas, WIEH and WIEE. Gazprom would also have received a 50 percent share in BASF Wintershall subsidiary, WINZ, which carries out exploration and gas production in the North Sea.

The deal was approved by EU regulators in December 2013.

However, the deal now appears to have fallen victim to the increased political tensions in EU-Russia relations. On the 18th of December, the Chairman of the Board of Executive Directors of BASF issued this statement:

> We regret that the asset swap will not be concluded. We will continue our cooperation of over 20 years with Gazprom in our existing joint ventures.

It is also likely that, even though Gazprom is not under EU sanctions, European companies are becoming more nervous about entering into investment projects or asset-swaps with the Russian gas giant.

Gazprom and Ukraine

Gazprom resumes gas supplies to Ukraine, the first since June 2014

In June 2014, Gazprom halted gas supplies to Ukraine, on the basis of mounting debts, continued non-payment by Naftogaz, and disagreements over gas prices between the two parties.

On the 30th of October, the two parties agreed to a temporary solution, known as the 'Winter Package'. In return for Gazprom resuming supplies for a limited time period at a temporary compromise price, Naftogaz would repay a portion of its debts. Naftogaz would pay in advance for any gas received during this compromise period.

Although the deal envisaged gas supplies resuming in early November, Naftogaz did not make its first advance payment until the 5th of December. Gazprom then processed this payment, and resumed supplies on the 9th of December. Naftogaz had paid $378m – enough for 1 bcm.

Background of the dispute

The Gazprom-Naftogaz dispute has been ongoing for much of the past year, since Gazprom first offered a 33 percent gas price discount to Naftogaz in December 2013 – a move directed by the Russian government as a show of support for then-President Yanukovich. Bear in mind that Naftogaz was already enjoying a $100 per 1000 m^3 discount, in return for the Ukrainian government's willingness to extend the lease on the Sevastopol naval base in Crimea, home of Russia's Black Sea Fleet. It should also be noted that representatives of Naftogaz and the Ukrainian government have long criticised the non-discounted price as being higher than prices paid by Ukraine's European neighbours further west.

The December discount only lasted through the first quarter of 2014, before being cancelled by Gazprom on the grounds that Naftogaz was failing to pay for its gas supplies. Furthermore, following Russia's annexation of Crimea, the $100 per 1000 m^3 discount was cancelled, on the grounds that Sevastopol was now Russian territory, thus invalidating the discount agreement.

From the 1st of April, the price of Russian gas for Naftogaz was reported as $485 per 1000 m^3. On this date, Naftogaz's debts to Gazprom stood at a reported $2.2bn, with Naftogaz having failed to pay for its November, December, February, and March supplies.

From April to June, Naftogaz refused to pay its gas bills until an agreement on a new gas price was reached. At the beginning of June, Gazprom announced that it would only deliver gas to Ukraine that Naftogaz had already paid for. The practical result was the suspension of Russian gas supplies to Ukraine on the 16th of June 2014.

As reported in the October issue of the Gazprom Monitor, a temporary compromise was reached in the form of the 'Winter Package'. Gazprom agreed to re-start deliveries to Ukraine at a compromise price of \$378 per 1000 m^3, with the price falling to \$365 per 1000 m^3 in Q1 2015. In return, Naftogaz agreed to repay \$3.1bn of its debts in two tranches. The first tranche (\$1.46bn) was repaid immediately. The second tranche (\$1.65bn) is due by the end of 2014. Further gas deliveries from Gazprom to Ukraine (from the 1st of January 2015) are dependent on Naftogaz making its second payment.

The importance of gas storage reserves in Ukraine

On the 17th of December, Naftogaz announced that Ukrtransgaz had 13.9 bcm of natural gas in storage on the 1st of December, of which 11.5 bcm belonged to Naftogaz. According to Gas Storage Europe, the amount of gas in storage in Ukraine fell from 13.94 bcm on the 1st of December to 12.95 bcm on the 9th of December – the day that gas supplies from Russia resumed. The amount of gas in storage in Ukraine then fell to 12.14 bcm on the 21st of December.

Therefore, without gas supplies from Russia, Ukraine was withdrawing gas from storage at a rate of 1 bcm every 9 days – equivalent to 3.3 bcm every 30 days. During 12 days since Russian gas supplies were restarted, Naftogaz withdrew 0.8 bcm from storage – a rate of 2 bcm per 30 days.

If Russian gas supplies to Ukraine continue at their present rate, and withdrawals from gas storage remain constant, Ukraine's underground gas storage stocks will be exhausted in 6 months (the end of June 2015). If Russian gas supplies are suspended again, and the rate of withdrawal from underground gas storage returns to rates seen at the beginning of December, then Ukraine's underground gas storage stocks will be exhausted in 3.6 months (late April 2015).

For comparison, in the first week of May 2014, Ukraine held 8.5 bcm in gas storage. If Naftogaz completely exhausts its gas storage stocks over the remainder of the winter heating season (4-5 months), then by the beginning of the 2015-16 winter heating season, it will have to find an additional 8.5 bcm of gas for storage, in comparison to winter 2014-15.

To conclude, it seems that Naftogaz is currently living off gas stocks that must be replenished in the summer of 2015, if Ukraine is to avoid an uncomfortable winter 2015-16. Naftogaz may be able to survive this winter, but a long-term agreement with Gazprom must be found if Ukraine is going to avoid an even more difficult gas situation a year from now.

Gazprom and Belarus

Gazprom signs new gas supply and transit contracts with Belarus to cover 2015-17

European consumers of Russian gas delivered via Belarus can relax over the festive period, as Russia and Belarus have signed new gas supply and transit contracts. The development, or indeed its understated announcement on the 12th of December, should come as no surprise, given that the two corporate parties to the contracts are Gazprom and Gazprom's wholly-owned Belarusian subsidiary, Gazprom Transgaz Belarus. The difference from Gazprom's relations with Naftogaz could not be starker.

According to the Gazprom press release:

> The new contracts adhere to the previous gas pricing mechanisms and gas transmission tariffs, which is fully in line with the intergovernmental agreement inked in November 2011.

Gazprom acquired a 50 percent stake in Gazprom Transgaz Belarus (then known as Beltransgaz) in several stages between 2007 and 2010. Then, on the 25th of November 2011, the Russian and Belarusian governments signed agreements that saw Gazprom increase its stake in Beltransgaz to 100 percent (renaming the company Gazprom Transgaz Belarus in the process), and new gas supply and transit contracts signed to cover the period 2012 to 2014.

That deal gave Belarus a significant gas price discount in 2012, bringing the price down to $165.60 per 1000 m^3 in 2012. At the time of the deal, Gazprom also announced that in 2013 and 2014, the gas price for Belarus would be calculated in accordance with:

> The gas price for the Yamal-Nenets Autonomous Okrug consumers (established by the Russian Federal Tariff Service), the cost of gas transmission from a wellhead in the YaNAO to the Russian-Belarusian border, the cost of underground gas storage in Russia as well as Gazprom's expenses on gas marketing. It is also expected that the price formula components will be indexed to inflation.

Here it should be noted that regulated domestic gas prices in Russia are given in bands, based upon the distance from the wellhead to the consumer. Because the YaNAO region is where Gazprom produces gas, the price for YaNAO is the cheapest domestic gas price in Russia (i.e. closest to the wellhead).

Given that the latest contract extension is in line with the November 2011 agreement, it is expected that Belarus will continue to enjoy a substantial discount against European gas prices.

Although Gazprom Transgaz Belarus has not disclosed specific details of the contract, Belarusian sources have quoted the First Vice-Prime Minister of Belarus, Vladimir Semashko, as stating:

> We will use the same pricing formula. The gas price will be lower as from the 1st of January due to the Russian Rouble decline. Currently, Belarus pays $168 per 1,000 cubic meters of gas. We may have some $154-155 next year.

Gazprom in Asia

Gazprom and CNPC sign framework agreement on second pipeline, via the 'western route'

On the 9th of November, the Gazprom CEO, Alexei Miller, and the Chairman of China National Petroleum Corporation (CNPC), Zhou Jiping, signed a framework agreement on a second pipeline for the export of Russian gas to China.

According to the Gazprom press release:

> The document reflects such conditions as the volume and terms of supply, the take-or-pay level, the location of the gas delivery point on the border. The Framework Agreement defines the schedule of compiling a gas purchase and sale agreement, a technical agreement and an intergovernmental agreement on the western route.

Gazprom has already announced the route of the pipeline: it will begin in Gazprom's gas production heartland of the Yamal-Nenets Autonomous Region, near the town of Novyi Urengoy. From there, it will head south, via Novosibirsk, into Russia's Altai Republic. It will then cross into China somewhere along the 50km (30 mile) Russia-China border – a narrow strip of land between Kazakhstan and Mongolia. Gazprom has also suggested that the pipeline will have a capacity of 30 bcm per year.

It is important to note that the signing of a framework agreement does not mean that the project is set in stone. And even if it is realised, it will not be realised quickly. The framework agreement on Russian gas supplies to China was first signed on the 13th of October 2009, yet the final agreement was only reached five years later, in May 2014, and construction has yet to begin.

Background of the 'eastern route'

In May 2014 Gazprom signed a contract with CNPC to supply 38 bcm of natural gas per year for 30 years, beginning sometime between 2018 and 2020. Gazprom plans to deliver this gas through the to-be-built 'Power of Siberia' gas pipeline, which could bring gas from new gas production projects in Eastern Siberia to China's north-eastern region. According to Gazprom projects, the 'Power of Siberia' will reach the Chinese border at Blagoveshchensk, and will then continue to join the Sakhalin-Khabarovsk-Vladivostok pipeline, enabling the delivery of gas from Eastern Siberia to Gazprom's proposed LNG export terminal in Vladivostok.

Comparing the two projects

Gazprom's two pipeline projects for the delivery of gas to China have several key differences, which make the 'western route' more attractive for Gazprom. Firstly, the 'western route' (2,600km) is shorter than the 'eastern route' (4,000km). Secondly, the western route will use existing gas production from North-West Siberia as its resource base, while the eastern route will require the development of entirely new gas production. Together, these two factors make the 'western route' far cheaper for Gazprom.

Financing also remains a major issue. At the time of the May signing of the Gazprom-CNPC deal on the 'eastern route' it was widely reported that CNPC had been prepared to contribute approximately $25bn 'up front' to help Gazprom pay for pipeline construction and gas field development, in return for a lower gas price. By autumn, that offer appeared to be off the table. Given the decline in international oil prices in H2 2014, western sanctions, and Russia's more generally parlous economic situation, Chinese loans are unlikely to be forthcoming. Indeed, we must question Gazprom's ability to finance both of these projects, even with South Stream now abandoned.

And in other developments…

Estonia imports first gas via Lithuania, a symbolic first step away from Russia

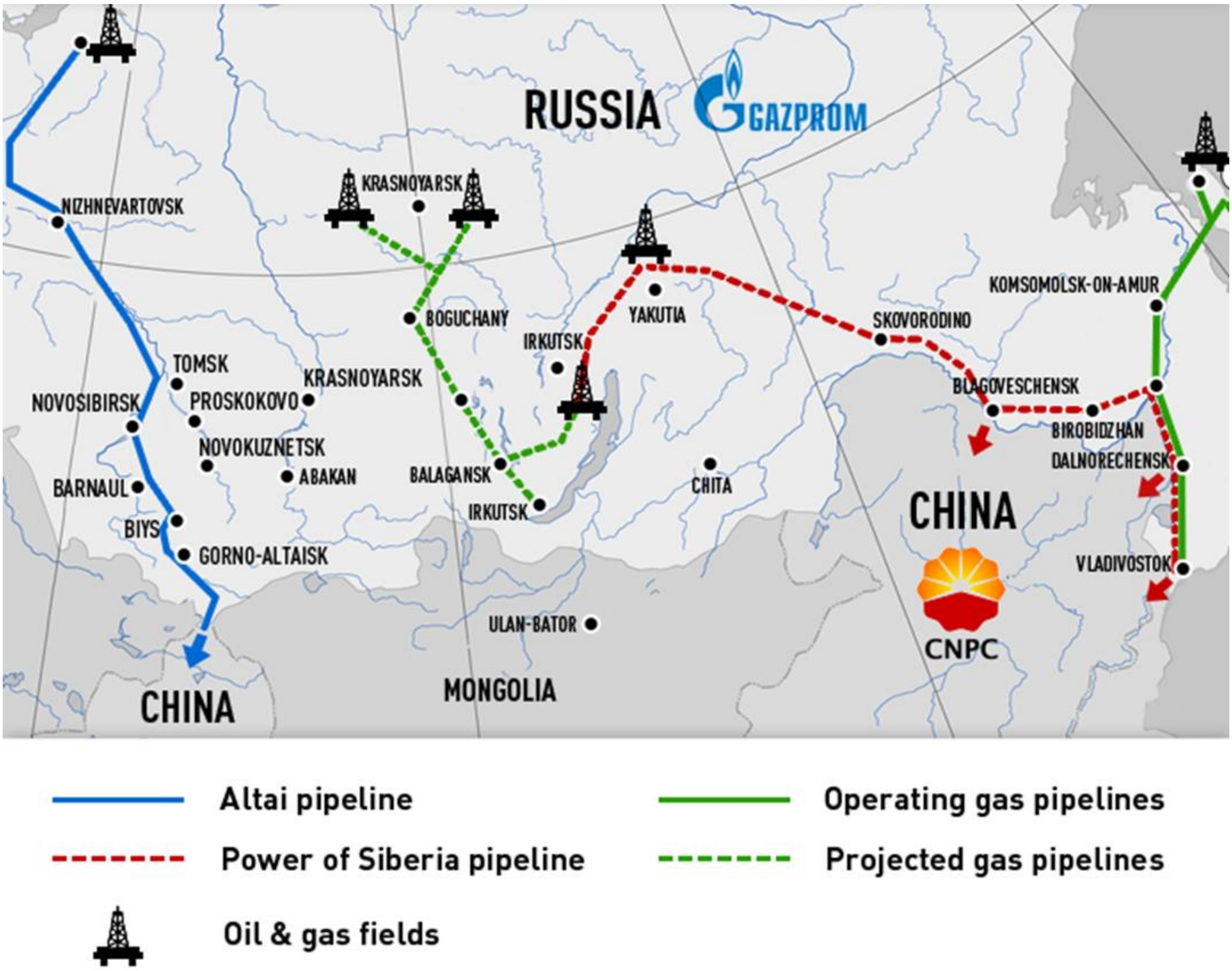
During the first week of December, Estonia imported 100,000 cubic metres of natural gas from the Lithuanian LNG import terminal, via Latvia. In doing so, Estonia took its first, albeit very small, steps towards ending its total dependence on Russian gas supplies. The energy trader, Baltic Energy Partners, supplied the gas to large-scale Estonian consumers. In doing so, they broke the monopoly of Eesti Gaas, which imports all of its gas from Gazprom. Estonia consumed 700m cubic metres of natural gas last year, all of which was imported from Russia.

Latvia could play a crucial role in the development of the Baltic gas market, as the country has large gas storage facilities with a capacity of 2.3 bcm and a maximum daily withdrawal rate of 30 million cubic metres per day. This could be enough to allow LNG imported via Lithuania to make a real difference to the Baltic gas market.

The Lithuanian gas company, Litgas, currently has a contract to buy 0.5 bcm per year of LNG from Statoil, although the Lithuanian LNG terminal has an import capacity of 4 bcm per year.

In 2013, Gazprom sold 0.7 bcm to Estonia, 1.1 bcm to Latvia, and 2.7 bcm to Lithuania.

Appendix: Map of proposed 'eastern' and 'western pipeline routes from Russia to China



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