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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

Key points:

- *Lietuvos Dujos prepares to extend its current gas supply contract with Gazprom in exchange for lower prices and offtake commitments; Gazprom to amend its gas supply contract with RWE following Vienna arbitration ruling; Edison is next in line for arbitration with Gazprom following the RWE ruling; Gazprom announces an upward revision of its 2013 gas export forecast and a 29 percent increase in gas exports to Europe in July 2013 versus the same period in 2012*
- *Gazprom and Naftogaz Ukraine reach agreement on reliable gas transit via Ukraine for winter 2013-14*
- *The Armenian government considers handing over its remaining stake in the country's natural gas monopoly to Gazprom in exchange for lower prices; Gazprom acquires Kyrgyzstan's natural gas monopoly, Kyrgyzgaz, and pledges substantial investment*
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Gazprom and the EU

Lietuvos Dujos prepares to extend its current gas supply contract with Gazprom in exchange for lower prices and offtake commitments

The Director of Lietuvos Dujos, Viktoras Valentukevicius, has announced that the company would be prepared to extend its current gas supply contract with Gazprom, which ends in 2015, in exchange for lower prices and lower offtake commitments. In making the announcement, Valentukevicius stated, "We're in negotiations about extending the contract while changing some parameters... It would be for a period sufficient for us to assess changes and risks in the market, I think at least five years".

The announcement comes as Lithuania's new gas grid operator, Amber Grid, began trading on the NASDAQ OMX Baltic Market. Amber Grid was formally established on the 11th of June, when Lithuania's gas transmission infrastructure was officially transferred from the vertically-integrated Lietuvos Dujos to the new commercial entity. The new entity began its operations on the 1st of August, when its gas transmission licence came into effect. The major shareholders in Lietuvos Dujos (E.On – 38.9 percent; Gazprom – 37.1 percent; and the Ministry of Energy of the Republic of Lithuania – 17.7 percent) were automatically granted equivalent shares in Amber Grid. However, debates remain ongoing over whether Gazprom (as a gas producer) will be obliged to sell its share in Amber Grid, in light of the Lithuanian Government's implementation of 'full ownership unbundling' in accordance with the EU Third Gas Directive, which denies gas producers from majority control over gas transmission infrastructure on EU territory.

The official launch of Amber Grid is contextualised by news that the European Investment Bank has approved an 87m Euro loan to the Lithuanian state-owned Klaipedos Nafta for the construction of an LNG import terminal in Lithuania, with that project scheduled for launch by the end of 2014. The terminal will consist of a floating regasification terminal (leased from the Norwegian Hoegh) and a pipeline link to Lithuania's onshore gas grid.

Gazprom to amend its gas supply contracts with RWE following arbitration ruling

On the 27th of June the International Court of Arbitration (Vienna) ruled that Gazprom had overcharged RWE through excessively high oil-linked gas prices since May 2010. As a result, Gazprom must reimburse RWE for such overpayment (thought to be around 1bn Euros) and renegotiate its gas supply contract with RWE.

The renegotiation of the contract is expected to introduce a 'spot pricing' component to the existing gas supply contract. As the RWE Chief Financial Officer, Bernhard Guenther, has stated: "We have a solution which partly replaces oil indexation by gas indexation... Going forward we will claw the small money back which we might now still lose on the remaining oil-indexed part".

The Director of Gazprom Export, Alexander Medvedev, responded positively, announcing that Gazprom was ready to amend its contract with RWE: "We'll do this within a month. We are interested in doing this quicker because amendments [to the contract] will be made before final documents are signed".

Edison is next in line for arbitration with Gazprom following the RWE ruling

The Italian energy company, Edison, has launched arbitration proceedings against Gazprom, in a bid to bring its gas supply contract "in line with market prices". The move follows Edison's successful arbitration with Sonatrach (Algeria), during which it gained price concessions. Edison is also currently undertaking arbitration with Eni (Italy), over the price of gas supplies from Libya. For its part, Gazprom is also reported to be in talks with Eni and GDF Suez (France) over the renegotiation of long-term gas contracts. The start of arbitration proceedings between Gazprom and Edison does not prevent the two parties from finding a compromise solution outside the courtroom, with Gazprom stating: "We are confident that a mutually acceptable solution will be found outside arbitration".

Gazprom announces an upward revision of its 2013 gas export forecast and a 29 percent increase in gas exports to Europe in July 2013 versus the same period in 2012

In the last issue of the Gazprom Monitor (№ 25, June 2013), it was reported that Gazprom officials had predicted that Gazprom's exports to Europe (the EU plus Turkey and the non-EU Balkan states, but not including the former Soviet Union) would be 152 bcm in 2013. At company's Annual General Meeting at the end of June, Gazprom Chief Executive, Alexei Miller, announced that Gazprom's gas exports to Europe were now expected to exceed 160 bcm. It was also announced that Gazprom exported 14 bcm to Europe (including Turkey) in July 2013 – a 29 percent increase on the company's exports to Europe in July 2012.

Ukraine

Gazprom and Naftogaz Ukraine reach agreement on reliable gas transit via Ukraine for winter 2013-14

Following a meeting between Ukrainian Prime Minister, Mykola Azarov, and Russian Prime Minister, Dmitrii Medvedev, in Sochi, Ukraine's Deputy Prime Minister, Yurii Boyko, has announced that Naftogaz Ukraine and Gazprom have reached a "mutual understanding" on ensuring reliable gas transit via Ukraine during winter 2013-14.

Gazprom officials had previously expressed concern that the 7.5 bcm of natural gas stored in Ukraine's underground gas storage facilities (UGSFs) would not be sufficient to ensure that Ukraine would not need to tap in to westbound gas supplies during the winter, and suggested that the storage amount should be increased to 19 bcm.

Such additional gas will need to be purchased by Naftogaz Ukraine, as Gazprom is no longer willing to use Ukrainian underground gas storage facilities for the storage of Russian gas to ensure the continuity of gas transit via Ukraine. According to the ratings agency, Fitch, since the start of 2012 Gazprom has transferred $3.5bn to Naftogaz Ukraine as prepayment for gas transit, which Naftogaz then uses to pay for its purchases of gas from Gazprom, but the most recent payment of $1bn will cover gas transit via Ukraine until 2015. Fitch has also noted that "Gazprom's decision to halt prepayment of natural gas transit fees to Naftogaz until at least 2015 creates the potential for modest supply disruptions in South East Europe this winter due to low levels of gas in Ukraine's storage facilities".

However, at the beginning of July Ukraine's Energy Minister, Eduard Stavytskii, claimed that Naftogaz has 14 bcm of stored gas reserves, which will "easily allow" for reliable gas transit via Ukraine during the forthcoming winter. Yevhen Bakulin, the Head of Naftogaz Ukraine, has suggested that the company will have 16 bcm in storage by the end of the summer.

Former Soviet Union

The Armenian government considers handing over its remaining stake in the country's natural gas monopoly to Gazprom in exchange for lower prices

Reports that the Armenian government is considering handing over its remaining share in the country's natural gas monopoly has provoked a storm of criticism from Armenia's political opposition. Gazprom already owns 80 percent of ArmRosGazprom, which imports gas from Russia and manages Armenia's gas transmission network. Notably, ArmRosGazprom also owns the only pipeline by which Armenia could receive alternate supplies from Iran. At the end of June a Gazprom spokesperson, Sergey Kupriyanov, acknowledged the possible deal, suggesting that Armenia would benefit from lower gas prices if the deal went ahead. On the 7th of July, Armenia's Public Services Regulatory Commission raised domestic regulated gas and electricity prices by 18 and 27 percent respectively, blaming a 50 percent increase in the price of gas imported from Russia as the cause, with the Armenian government also promising to subsidise 30 percent of domestic gas prices for households. The deal with Gazprom over ArmRosGazprom is therefore aimed at curbing Armenia's rising energy bill, but does little to improve Armenia's import dependency or weak bargaining position with respect to Russia.

Gazprom acquires Kyrgyzstan's natural gas monopoly, Kyrgyzgaz, and pledges substantial investment

Gazprom has formally acquired Kyrgyzstan's natural gas monopoly, Kyrgyzgaz, for a nominal price of $1, and pledged substantial investment in the company, reported to be around $600m over the next five years. Gazprom has also assumed Kyrgyzgaz's debts, believed to be approximately $38m, which is mostly owed to neighbouring Kazakhstan and Turkmenistan. The deal gives Gazprom a stronger foothold in the region at a time when China has been strengthening its own energy relations with the countries of Central Asia.

South Stream

South Stream delayed in Bulgaria but Gazprom adamant that the project will be complete by 2015, as a spur to Macedonia is agreed

The schedule for South Stream initially planned for the construction permits for the Bulgarian section of South Stream to be issued by July 2013. However, the Environmental Impact Assessments have yet to be completed, and the construction permits have not yet been issued. The delay prompted Gazprom CEO, Alexei Miller, to travel to Sofia and meet with the Bulgarian Prime Minister, Plamen Oresharski, and the Bulgarian Economy, Energy and Tourism Minister, Dragomir Stoynev. Following the meeting, during which both Ministers promised their cooperation, Miller announced that Gazprom has provided 3.1bn Euros to pay for the construction of South Stream on Bulgarian territory. However, Bulgarian sources have noted that Stoynev did not go so far as to promise to support Gazprom's attempts to gain an exemption for South Stream from the Third Party Access requirements of EU Third Gas Directive legislation.

In a more promising development, it was announced on the 23rd of July that the Russian Energy Minister, Alexander Novak, and the Macedonian Prime Minister, Nikola Gruevski, had signed an agreement on the construction of a spur of South Stream to Macedonia. The spur will be a parity joint venture project between Gazprom and Macedonian Energy Resources. Initial reports suggest that the agreement will be valid for 30 years, with the further option of five-year extensions. Russian sources also suggest that the agreement requires Macedonia to institute a favourable tax and customs regime for its Russian partner, although this has not been confirmed.

Nord Stream

Gazprom Germania decides against new UGSF in Triepkendorf, but continues to investigate the possibility of new gas storage facilities near Nord Stream's landfall

Gazprom Germania, a wholly-owned Gazprom subsidiary, has announced that it will not pursue the development of a new underground gas storage facility (UGSF) in Triepkendorf, but is continuing to assess the possibility of developing such a facility in one of three locations near Lubmin, where Nord Stream makes landfall in Germany. According to a Gazprom Germania spokesperson, "We are still waiting for the results and should be able to make a decision by autumn". The assessment of potential UGSF sites in Germany is part of Gazprom's broader plan to double its European underground gas storage capacity to 5 bcm by 2015.

Gazprom continues to press for full use of the OPAL pipeline in Germany

Gazprom is continuing to press for full use of the OPAL gas pipeline in Germany, which connects Nord Stream to the Czech Republic via Eastern Germany. According to Third Party Access provisions of the EU Third Energy Package, 30-50 percent of OPAL must be reserved for booking by third parties, even though Nord Stream is currently the only source of gas for OPAL. This means that such 'third party' gas could only come from non-Gazprom Russian gas companies via Nord Stream – an unlikely proposition given Gazprom's monopoly on Russia's pipeline gas exports. According to the Director of Gazprom Export, Alexander Medvedev, "This results in Nord Stream being only half full, while in the winter we have had to use gas from storage to reach our customers... We hope that reason and logic will prevail as pipelines should not lay idle. It is also a precedent for South Stream".

Nederlandse Gasunie complains about the quality of Russian gas delivered via Nord Stream

Gazprom's Dutch partner, Nederlandse Gasunie, has issued a complaint regarding the quality of Russian gas delivered via Nord Stream. According to Russian sources, Gasunie are demanding that the gas delivered via Nord Stream have an oxygen content no greater than 10 parts per million (ppm). The Dutch company is concerned that higher oxygen levels will accelerate the corrosion of pipelines and storage equipment in the Netherland, Germany, and the UK. It has been reported that, while there is no European standard for gas quality, the European Association for the Optimisation of Energy Exchange operates on a standard of 10ppm, in contrast to Russian standards of 200 ppm.

Asia

Gazprom takes delivery of a second LNG tanker for the navigation of the Northern Sea Route

Gazprom has announced that it has taken the delivery of a second LNG tanker in Ulsan, South Korea. The new tanker, is named 'Yenesei River', and, according to Gazprom's official statement, is "a highly sophisticated LNG carrier with membrane tanks, cargo capacity of 155,000 cubic meters and powered by a tri-fuel diesel-electric propulsion system. Her 1A ice class and winterisation equipment allows sailing in ice conditions, including in the Northern Sea Route during open navigation". Gazprom will charter the tanker from the Greek tanker operator, Dynagas, for the next several years. The ability of the tanker, along with its sister ship, the River Ob, to traverse the Northern Sea Route is a sign that Gazprom is deeply interested in the delivery of gas from LNG export terminals in the North of Russia (such as that being constructed by Novatek on Yamal) to the regional gas market of the Asia-Pacific.

And in other developments…

Rosneft increases gas production by 186 percent versus H1 2012, providing further competition for Gazprom in the Russian gas sector

Rosneft has announced that its gas production for the first half of 2013 is 186 percent of its gas production in the first half of 2012, underlining its growing presence in the Russian gas sector. However, that increase still resulted in just 15.3 bcm of natural gas production, approximately half that of Novatek in the same period (31.3 bcm), and far below that of Gazprom, which produced 487 bcm in 2012.

The International Energy Agency (IEA) voices its support for a shift from oil-indexed to spot gas prices

The Executive Director of the International Energy Agency (IEA), Maria van der Hoeven, praised recent gas price negotiations between Gazprom and Turkish energy companies, claiming, "Turkey was quite good at negotiating the price". In particular, she referred to the issue of oil-indexation of gas prices: "What we see is a majority of the gas prices are based on oil indexes, and the question is if that's the right way to go". Such comments may not be too well appreciated by Gazprom, which continues to favour oil-indexed prices for the majority of its long-term gas export contracts, preferring to offer short-term discounts and refunds rather than change the fundamental nature of its gas contracts.

Daewoo Shipbuilding and Marine Engineering wins tender for up to 16 ice-class LNG tankers for the Yamal LNG project

Daewoo Shipbuilding and Marine Engineering has won a tender to build up to 16 ice-class LNG tankers for the Yamal LNG project. Given the reluctance of the Russian government to break Gazprom's monopoly on Russian gas to Europe, and the ability of ice-class LNG tankers to traverse the Northern Sea Route, the tankers are designed to deliver gas from Yamal to the Asia-Pacific region. The Yamal LNG project is 60 owned by the independent Russian gas company, Novatek, while the

French firm Total and the Chinese National Petroleum Corporation (CNPC) each hold 20 percent stakes. The entry of the CNPC into the Yamal LNG project (as reported in the Gazprom Monitor last month) suggests that at least some of the LNG exported from Yamal will be destined for China. This adds to the difficulty Gazprom is already facing in trying to conclude its own deal with the CNPC for the construction of a new gas pipeline to China and the beginning of large-scale pipeline-based gas deliveries.

Moscow hosts the second Gas Exporting Countries Forum (GECF)

At the beginning of July Moscow hosted the second gathering of the Gas Exporting Countries Forum (GECF). Between them, the members of the GECF account for 62 percent of global gas reserves, 64 percent of LNG trade, and 42 percent of pipeline gas trade. As intimidating as those figures may be for consumers, fears of a cartel are overblown, thanks to divisions within the GECF. For example, LNG imports from Qatar are one of the biggest challenges to Russia's gas exports to the EU.

During the summit, the Russian Energy Minister, Alexander Novak, defended the oil-indexation of gas prices, referring to it as a "fundamental principle". President Putin used the summit to criticise the pressure being placed on gas exporters by consumers, and the Third Energy Package in particular: "The pressure on exporting countries is growing. I see this as a serious challenge for all of us. First and foremost, this is an attempt to dictate economically unacceptable terms for producers on deliveries of pipeline gas, the desire to alter the principles for gas deliveries that are the basis of long-term contracts, cutting the contract price free from the price of oil and oil products as market and price indicators, lowering the level of gas volumes that must be taken up... I'm talking above all about changes in European Union energy regulation and law, the so-called Third Energy Package. The enactment of this gas directive seriously restricts the activity of traditional gas suppliers to the EU market". In doing so, President Putin reaffirmed his support for Gazprom and its unwillingness to revise its contractual system by shifting from oil-indexed to spot pricing in its long-term gas export contracts. Whether Putin will continue to offer such support if Gazprom's reticence causes it to lose market share in Europe to other gas suppliers remains to be seen.

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