www.gpf-europe.com

The European Geopolitical Forum

EGF Gazprom Monitor
Issue 15: August 2012

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:

- *Gazprom and the Lithuanian Government both claim victory following the Stockholm Chamber of Commerce Arbitration Institute ruling over Lietuvos Dujos*
- *Gazprom signs contracts with four Turkish energy companies to supply 6 bcm of Russian gas from January 2013, replacing the volumes given up by Turkish state energy company, Botaş, in October 2011*
- *Nord Stream AG completes the welding of the second string of Nord Stream pipeline and requests permission to conduct research in Estonian territorial waters as part of plans for the expansion of the Nord Stream pipeline*
- *South Stream could be re-routed via Croatia, bypassing Hungary*
- *Putin and Yanukovych meet in Sochi, with Ukraine planning to reduce its Russian gas imports and hoping for an (unlikely) gas price discount*
- *Gazprom CEO, Alexei Miller, held meetings in Belarus, discussed investments in the gas transmission system of Beltransgaz and the expansion of natural gas as a motor fuel in Belarus*
- *Statoil withdraws from the Shtokman project, ceding its stake to Gazprom – Will Total follow suit?*
- *Novatek announces a breakthrough deal to supply gas to German utility company EnBW, as E.On Russia confirms that it will buy gas for its power stations from Novatek, not Gazprom, from 2013*

Third Energy Package and Gazprom's Partners in the EU

Both Gazprom and the Lithuanian government claim victory in the Stockholm Chamber of Commerce Institute of Arbitration ruling concerning the Lithuanian energy company, Lietuvos Dujos.

Lietuvos Dujos is a Lithuanian energy company currently dealing in gas imports, gas transmission, gas distribution, and gas sales. The three main shareholders are Gazprom (37.1 percent), E.On (38.9 percent) and the Lithuanian State Property Fund (17.7 percent). Gazprom's interests are represented on the five-man Board of Directors by Valery Golubyev and Kirill Seleznyev, along with two E.On representatives and CEO Viktoras Valentukevičius, who is appointed by the Lithuanian State.

The history of legal wrangling between Gazprom, Lietuvos Dujos, and the Lithuanian State is a long and complex one. In March 2011 the Lithuanian Energy Ministry appealed to the Vilnius Commercial Courts to begin a legal investigation into Lietuvos Dujos, claiming that the company's management was failing to defend the interests of the Republic of Lithuania by accepting high prices for gas imports purchased from Gazprom.

Specifically, the Lithuanian Energy Ministry requested that the Vilnius Courts order Lietuvos Dujos to: a) Remove Golubyev, Seleznyev, and Valentukevičius from their posts; b) temporarily appoint a new CEO proposed by the Energy Ministry; c) renegotiate a "fair and correct price for the purchase of natural gas" within three months; d) publish in its Annual Report information regarding revenues, expenses, investments and tariffs related to gas transit; e) to conduct future gas negotiations "in good faith, aiming at the best terms of supply and the least supply price and the highest transit service price"; and f) "to draw up and adopt effective rules for avoiding the conflict of interests that would be in line with the international practice". As of August 2012 these legal proceedings remain ongoing in the Vilnius Courts.

On the 29th of August 2011 Gazprom launched its own legal proceedings with the Stockholm Chamber of Commerce (SCC) Institute for Arbitration, arguing that an investigation by Lithuanian Courts would violate the Lietuvos Dujos shareholder agreement. Gazprom requested that the Vilnius Court proceedings and investigation be halted, and that Gazprom be awarded damages.

In December 2011 the Lithuanian Energy Ministry retracted its request for the specific dismissal of Golubyev, Seleznyev and Valentukevičius, and instead requested the application of Lithuanian Civil Code Article 2.131 (Part 1) 'The Investigation of Legal Person's Activities', which provides for a broader range of sanctions (beyond the dismissal of board members) and which would apply not only to Golubyev, Seleznev and Valentukevičius, but also to their successors on the Lietuvos Dujos Board of Directors, thus setting a precedent for relations between the Lithuanian Courts, the Lithuanian state, and Lietuvos Dujos.

On the 31st of July 2012 the SCC Arbitration Institute announced its final ruling.[1] It found that the Vilnius Court could continue its investigation, that it may oblige Lietuvos Dujos to publish information regarding gas transit in its Annual Reports, and that it may oblige Lietuvos Dujos to adopt rules for avoiding conflict of interests. However, the SCC Arbitration Institute also ruled that the negotiation of gas prices and the need to negotiate the best possible terms are covered by the Lietuvos Dujos Shareholder Agreement, and therefore cannot be ruled upon by the Vilnius Courts.

Regarding the application of Civil Code Article 2.131 (Part 1), the SCC Arbitration Institute ruled that the Vilnius Court may only apply certain provisions of the article: The Courts may oblige Lietuvos Dujos to revoke any board member decision; to revoke a board members' powers or remove that board member from the management of the company; the Courts may authorise the non-implementation of certain

[1] Full text of the Stockholm Chamber of Commerce Arbitration Institute ruling is available at: http://arbitrations.ru/files/articles/uploaded/Gazprom_v_Lithuania_Final_Award_SCC.pdf

provisions of an incorporation document or amendment of certain provisions of an incorporation document if that document breaches Lithuanian Law; and the Energy Ministry may also request that the Lithuanian Courts liquidate the company, if the company is found to be engaging in illegal activities. However, the Vilnius Court may not authorise the Lithuanian Energy Ministry to appoint provisional replacements to the Board of Directors, or transfer the voting rights of a board member, with the exception of the CEO, who is appointed by the Lithuanian Energy Ministry, as these actions would violate the Lietuvos Dujos Shareholder Agreement and circumvent the arbitration procedures provided for by that agreement.

Given the complexity of the ruling, it is hardly surprising that both sides have claimed victory. According to Gazprom, the Arbitration Institute "settled most of Gazprom's claims against the Ministry of Energy of the Republic of Lithuania... and protected the rights of Gazprom as a shareholder of Lietuvos Dujos, having declared that the case filed with the Vilnius Court of Commercial Arbitration partially violated the Lietuvos Dujos Shareholders Agreement". Conversely, the Lithuanian Energy Ministry claimed that the ruling "confirmed the right for Lithuanian Government to initiate an investigation concerning Lietuvos Dujos' activities in the Vilnius District Court. Also, the arbitral tribunal dismissed all of Gazprom's claims for damages".

Whilst Gazprom may be publicly relieved that the Courts will not be allowed to order the renegotiation of gas prices and that the shareholder agreement remains the basis for negotiations between the interested parties, the Russian company will no doubt be privately concerned about the ongoing Lithuanian investigation into its representatives on the Lietuvos Dujos Board of Directors, and the potential ramifications of that investigation.

The Gazprom-Lietuvos Dujos-Lithuanian Energy Ministry dispute takes on even greater significance when one considers that it is contextualised by a dispute between the same three parties over the 'unbundling' of Lietuvos Dujos in line with the Gas Directive of the EU Third Energy Package, which seeks to reduce gas prices and facilitate intra-EU gas trading by separating gas production, transmission, and sales, and increasing competition and market access at all levels.

Of the three options for reorganising vertically-integrated energy companies such as Lietuvos Dujos, the Lithuanian Government has chosen the strictest – full ownership unbundling – as announced by the Lithuanian Energy Ministry in May 2010. On the 31st of May 2012 Lietuvos Dujos itself announced that it had submitted a proposal for the unbundling of the company. Lietuvos Dujos will continue to act as a gas importer and wholesale gas supplier, while a subsidiary of Lietuvos Dujos will be established for the distribution and sales of gas to final consumers by the 31st of October 2014. An entirely new company will be created to own and manage Lithuania's gas transmission network by the 31st of July 2013. Unofficial sources suggest that whilst Gazprom and E.On will remain shareholders in Lietuvos Dujos and the subsidiary company, the Lithuanian state could take back control over the country's gas transmission network through Litgrid, the owner of Lithuania's electricity transmission network.

During the drafting of the Lietuvos Dujos unbundling plan in February 2012, Gazprom claimed that it was being pressured into voting for the unbundling of Lietuvos Dujos, with the Lithuanian authorities threatening sanctions against Lietuvos Dujos and a review of the privatisation of the company. On this basis Gazprom filed a suit with the UN Commission in International Trade Law (UNCITRAL). At the end of July the members of the tribunal and the representatives of the claimant (Gazprom) and respondent (The Republic of Lithuania) were confirmed. The results of the tribunal are eagerly anticipated, as the tribunal represents an important test case for the implementation of the EU Third Energy Package legislation.

For Lithuania, the unbundling of Lietuvos Dujos presents a strategically important opportunity to reduce Gazprom's control over the country's gas supplies by excluding the Russian company (a gas producer) from control over the country's gas transmission network.

The unbundling of Lietuvos Dujos is part of a broader 'National Energy Independence Strategy' approved by the Lithuanian Government in May 2012, which foresees the construction of an LNG terminal, the construction of a gas pipeline connection with Poland, and increased underground gas storage capacity by 2020, and the development of the country's shale gas reserves by 2030, alongside developments in renewable energy and the construction of a new nuclear power plant at Visaginas.

Russia-Turkey

Gazprom signs contracts with four Turkish energy companies to supply 6 bcm of Russian gas from January 2013, replacing the volumes given up by Turkish state energy company Botaş in October 2011.

In the last issue of the Gazprom Monitor (№14 July 2012) we reported that the Turkish Energy Market Regulatory Authority (EPDK) had granted permission to private Turkish energy companies to import up to 6 bcm of Russian gas, thus replacing the export volumes lost when Botaş decided not to renew its long-standing contract with Gazprom. The decision of state-owned Botaş to reduce its gas purchases and allow private energy companies to increase theirs is part of a broader ongoing programme of liberalisation of the Turkish gas market.

In August, Russian sources reported that Gazprom Export had signed supply contracts with four Turkish energy companies, for the import of a combined 6 bcm per year. According to Turkish sources, those four companies are Akfel, Bosphorus Gaz (51 percent owned by Gazprom Germania, a 100 percent Gazprom-owned subsidiary), Kibar Holding and the newly founded Batı Hattı A.Ş. The contracts will come into effect from the 1st of January 2013, with the gas being delivered via Ukraine, Moldova, Romania and Bulgaria to western Turkey (the so-called Western Line).

Further deals with other private Turkish energy companies are expected in the near future, which could take the volume of Russian gas deliveries to the Turkish private sector up to 10 bcm per year.

Nord Stream

Nord Stream AG completes the laying of the second string of Nord Stream pipeline and requests permission to conduct research in Estonian territorial waters as part of plans for the expansion of the Nord Stream pipeline

On the 29th of August Gazprom announced that the welding of the second string of the Nord Stream gas pipeline had been completed, and that testing of the pipeline with 'cushion gas' would take place over the following days. The project thus remains on schedule for a second-string launch in Q4 of this year.

On the 22nd of August Nord Stream officially submitted a request to the Estonian Ministry of Foreign Affairs to conduct research in Estonian territorial waters. With Nord Stream AG considering expanding the pipeline, a spokesperson for the company has claimed that the two new pipelines could not be laid in parallel to the existing pair, raising the possibility of building the new pipelines through Estonian territorial waters.

Estonian Prime Minister, Andrus Ansip, appears sceptical about the proposal. Speaking at a press conference he referred to the request as a 'pre-application' about which a decision could not yet be made, although he also stated: "I cannot currently predict a different standpoint from that made by the previous government", referring to the rejection of a similar proposal by the Estonian Government in 2007, before going on to add, "But there is no reason for me to rush ahead of events and speculate on the government's decision on an application that has not been submitted". It seems that Ansip's scepticism is shared by Ansip's coalition partners, the Union Pro Patria and Res Publica (IRL), whose Chairman, Urmas Reinsalu, referred to the conduct of Russian research in Estonian territorial waters as "unthinkable". Nord Stream AG's request comes just weeks after the company published a report on the environmental impact of Nord Stream. According to Nord Stream AG "The report shows that the construction of Line 2 in German waters had no unanticipated impacts on the environment", with no detectable disturbances to local wildlife.

South Stream

South Stream could be re-routed via Croatia, bypassing Hungary

According to Russian sources, the South Stream pipeline could be re-routed via Croatia, thus bypassing Hungary. Sources in Croatia report that Gazprom has reached agreement with Plinacro, the Croatian gas transmission system operator. Plinacro spokesperson, Neda Erdeljac, reportedly stated that the company has the finance and technology to take on the project, but emphasised that "the final decision on the direction of the South Stream pipeline will be up to Gazprom." However, the Hungarian Economy Ministry has dismissed these reports, claiming that it is "unlikely" that South Stream would bypass Hungary, given Hungary's existing gas pipeline and gas storage infrastructure, and the proposed final destination of South Stream being Vienna. Gazprom has reportedly confirmed the negotiations with Croatia, but refused to comments on the possible bypassing of Hungary.

The reports of changes to the South Stream route are reminiscent of previous uncertainty over whether the offshore section would reach landfall in Romania or Bulgaria, and serve as a reminder that, until the final investment decision is taken (scheduled for November), nothing about the South Stream project can be guaranteed.

Russia-Ukraine

Putin and Yanukovych meet in Sochi, with Ukraine planning to reduce its Russian gas imports and hoping for an (unlikely) gas price discount

At the beginning of August, Ukrainian Prime Minister, Mykola Azarov, again criticised the gas deal with Russia signed by Yulia Tymoshenko in January 2009, stating that "The contract for gas supplies Ukraine and Russia signed in 2009 is one of those rare cases when one side gets everything it wanted, while the other side – Ukraine – loses everything it could lose in the agreement". However, Azarov went on to claim that he does not expect Gazprom to impose penalties on Ukraine for unilaterally reducing its purchases of Russian gas. In 2011 Ukraine bought 40 bcm of gas from Russia. The contracted volume for 2012 is 52 bcm, yet the Ukrainian Government proposes reducing that volume to 27 bcm.

Speaking at his meeting with Russian President Putin on the 25th of August, Ukrainian President, Viktor Yanukovych, suggested that Ukraine could soften its stance in negotiations with Russia over gas imports: "The issue (of gas supplies from Russia) will never be excluded from our relations and will always remain sensitive," he said. "We would like to slightly alter our positions in our relations with Russia".

The Bank of Finland Institute for Economies in Transition (BOFIT) reported at the beginning of August that Russia is offering reduced gas prices in exchange for allowing Gazprom to buy Naftogaz, the operator of Ukraine's gas pipeline network, or for Ukraine's joining of the Russian-led Customs Union (with Belarus and Kazakhstan). At the beginning of August the Ambassador Extraordinary and Plenipotentiary Ambassador of Ukraine, Oleksandr Chalyi, confirmed that "Ukraine must remain the sole owner of the Ukrainian GTS", but suggested that the management of the system could be passed over to an international consortium which included representatives of Ukraine, Russia, and the EU. Likewise, Ukrainian PM Azarov proposed a 3+1 formula for Ukraine to cooperate with the Customs Union, which was rejected, but stopped short of promoting Ukrainian membership of the Customs Union. However, on the 30th of July the Ukrainian parliament did ratify Ukraine's accession to a Free Trade Agreement (FTA) with Russia, Belarus, Kazakhstan, Kyrgyzstan, Tajikistan, Moldova and Armenia. The Ukrainian steel firm, Interpipe, has since been allowed to export 150000 tonnes of steel pipes to Russian without paying the 19.4-37.8 percent customs duties, according to Ukrainian sources.

With the extension of Russia's lease of the Sevastopol naval base secured in exchange for a gas price discount in April 2010, and taking into account that Ukraine currently lacks an alternative source of natural gas imports, Russia has little incentive to grant further gas price discounts to Ukraine – unless Ukraine accedes to Russia's demands. Further, it is known that in the second quarter of 2012 Ukraine paid around $425 per thousand cubic metres for its Russian gas imports, one of the highest prices in Europe.

Ukraine is currently pursuing several related policies aimed at reducing the country's dependence on Russian gas imports. On the 8th of August Ukrainian Energy and Coal Industry Minister, Yuriy Boyko, announced that the Ukrainian Government had approved a feasibility study for the construction of an LNG terminal in the Odessa region. If the results of the study are positive, construction could begin in 2013. According to the Ukrainian State Agency for Investment and National Projects, the Spanish company, *Socoin Ingenieria Y Construccion Industrial* SLU, has completed a feasibility study for the 10 bcm per year capacity project, with construction scheduled for commencement in 2013 and completion in 2016.

In mid-August it was announced that the consortium led by Exxon Mobil and Royal Dutch Shell, in partnership with Romanian OMV Petrom and the Ukrainian state-owned firm, Nadra, has been awarded the contract to develop the (reportedly) 250 bcm Skifska (Scythian) offshore gas field in the Black Sea. The Western-backed consortium was chosen in preference to Russia's LUKOIL. Commercial production at Scythian could begin in 6-8 years, with anticipated production volumes of 3-4 bcm per year. The announcement comes three months after Shell and Chevron were awarded the right to develop Ukrainian shale gas fields at Yuzovka and Oleske, with Ukraine reportedly holding Europe's fourth largest shale gas reserves. On the 21st of August Ukrainian Ecology and Natural Resources Minister, Eduard Stavytsky, stated publicly that Chevron and Shell had submitted draft Production Sharing Agreements, and that the signing of those agreements was expected in September. The two fields are expected to produce 13 bcm per year.

Also during August, the Ukrainian Government announced that it is interested in using Chinese coal gasification technology as a substitute for gas imports. Ukrainian PM Azarov released an official statement, confirming that: "The issue of substitution of expensive imported gas with coal is a strategic issue for us. We are interested in China's coal gasification technologies in the hydrocarbon fuel". For its part, China is willing to offer Ukraine a loan of $3.6bn to pay for the project. Ukraine currently imports two-thirds of its gas consumption. In the long term, Ukraine hopes to increase its gas production from 20 bcm in 2011 to 44 bcm in 2030.

Finally, Ukraine has become the third country (after Russia and Belarus) to ratify a free trade agreement with CIS countries. Ukrainian PM Azarov recently stated that the agreement was extremely important and could allow Ukraine to import gas from Central Asian countries with free transit via Russia: "In particular, we are interested in the access to pipeline transportation within the CIS countries. As soon as the treaty enters into force, our negotiators will address these issues". Currently, Russia does not transit gas. Instead, Gazprom buys Central Asian gas and re-exports it, thus giving Russia significant control over Central Asian gas exports to Europe.

Whilst these measures could indeed help to reduce Ukrainian dependence on Russian gas imports, the development of offshore and shale gas production remain long-term strategies, while the shorter-term plan LNG imports could still be years away from fruition and concerns relatively small import volumes. With Ukraine's parliamentary elections just two months away and Gazprom threatening to take a final investment decision on South Stream in November, the Ukrainian Government remains under pressure to deliver progress in its gas negotiations with Russia, but the results of those efforts remain far from certain.

Russia-Belarus

Gazprom CEO, Alexei Miller, held recent meetings in Belarus, discussed investments in the gas transmission system of Beltransgaz and the expansion of natural gas as a motor fuel in Belarus

According to Gazprom, the integration of Beltransgaz into the Gazprom Group remains an important factor in ensuring the reliability of gas transit via Belarus. The meeting in Belarus resulted in the decision to prepare an action plan for the development of the Beltransgaz gas transmission system, with Miller stating that "as a strategic investor, Gazprom targets on widespread and exhaustive development of the Belarusian gas transmission system".

The development of Beltransgaz infrastructure is part of a broader plan to increase gas transit via Belarus, in contrast to the falling levels of gas transit via Ukraine. Belarusian transit is set to increase by 4 percent to 44.5bcm in 2012, against a total transit capacity of 47bcm per year. "We already see good potential for development, and are convinced that the potential of Belarus for transit is not exhausted," Miller said. "We see the possibility here to increase gas transit in the future."

Following Miller's trip to Belarus, Russian sources reported that Gazprom and the Belarusian Government have signed statement of intent to broaden their cooperation in the use of natural gas as a motor fuel. Belarus currently has around 5000 gas-fuelled vehicles, while Beltransgaz operates a network of 26 gas stations offering natural gas as a motor fuel, which sold 16.6 million cubic metres of gas as a motor fuel in 2011.

Russian Arctic

Statoil withdraws from Shtokman project, ceding its 24 percent stake to Gazprom

According to reports originating in Russia, the existing Gazprom-Total-Statoil shareholder agreement expired on the 1st of July, and has not been renewed, while Statoil has withdrawn its executives from the Shtokman Development AG Board of Directors and written off its reported $355m of investments in the project.

The prize for developing Shtokman remains a rich one (3.9tcm of gas and 53 million tonnes of gas condensate), but, for now, at least, a mix of geography, geology, conflicting standards of corporate governance (reported in the last edition of Gazprom Monitor), and the combination of the global slump in gas demand and the US shale gas boom of recent years (which between them deprived Shtokman of its intended markets) appear to have brought the project to a standstill.

With Shtokman located 600km from Murmansk, north of the Arctic Circle, the investment necessary to produce gas in such conditions was always going to be considerable. But with Shtokman Development AG having already spent a reported $1.5bn since its formation in 2008, and Phase 1 costs being revised upwards from $20bn to $30bn, it seems that Statoil has decided that enough is enough. "We have made it quite clear that we need to see considerable improvement in fiscal terms and conditions in order to move forward on Shtokman" said Statoil's executive vice president for global exploration, Tim Dodson.

The question remains as to whether Gazprom will find another foreign partner to replace Statoil, or whether Total will decide, like its Norwegian former partner, that no matter how cold the waters of the Barents Sea, now is the time to jump ship.

In other developments...

Novatek announces a breakthrough deal to supply gas to German utility company EnBW, as E.On Russia confirms that it will buy gas for its power stations from Novatek, not Gazprom, from 2013

On the 14th of August Novatek announced a breakthrough deal to supply 2 bcm a year to the German utility EnBW, starting in the fourth quarter of 2012, and confirmed that Gazprom will not act as its agent in the deal. Novatek's Chief Financial Officer, Mark Gyetvay, reportedly referred to the deal as a "trading operation" between Novatek's Swiss-based gas trading arm, Novatek Gas&Power, and the German utility company, although he declined to offer any further details of the agreement.

Meanwhile, it was also reported in Moscow that E.On Russia is set to become "the first wholesale power company to buy all its gas from independent producers when it drops Gazprom for Novatek next year". Under the terms of the agreement, Novatek will supply gas to four of E.On Russia's power stations from 2013 to 2027. Gazprom representatives have been quick to play down the shift, stating that "In 2011, Gazprom's delivery volume amounted to around 1.5 billion cubic metres of gas, which is not more than 10% of the total volume of gas supplied to these enterprises". By mid-2012 Novatek provided approximately 33 percent E.On Russia's fuel supplies, with Surgutneftegaz the largest supplier, with a share of 36 percent.

The announcement caps a successful first half of 2012 for Novatek, whose revenues rose 16.4 percent and profits from operations rose 3.3 percent in that period, compared to the first half of 2011.

EGF Gazprom Monitor
Published by European Geopolitical Forum SPRL

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

Avenue Du Manoir D'Anjou 8
Brussels 1150 Belgium
Tel/Fax: +322 770 1001
info@gpf-europe.com
www.gpf-europe.com
www.gpf-europe.ru