



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:

- *Negotiations between Russia and Lithuania over their gas relationship and the unbundling over Lietuvos Dujos continue; Polish Treasury Minister and PGNiG Chief Executive are sacked as a result of a EuRoPolGaz-Gazprom agreement to investigate the possible expansion of the Yamal-Europe gas pipeline*
 - *Gazprom boycotts a high-level roundtable held by Ukrainian and EU representatives on the future management and development of Ukraine's gas transport system, and warns European energy companies against reselling Russian gas back to Ukraine, as Ukraine continues to seek alternatives to Russian gas imports*
 - *Gazprom and Gasunie agree to investigate the possibility of expanding the Nord Stream gas pipeline, with Gazprom eyeing an increase in gas exports to the British market, despite the current under-utilisation of the existing Nord Stream pipeline*
 - *Gazprom announces that the spatial planning and Environmental Impact Assessment (EIA) reports for South Stream in Slovenia are almost complete and that construction could begin next year; Bulgarian government announces a review of South Stream, but pledges to continue with the project; Construction of the Serbian section of South Stream could start by the end of 2013, rather than in 2014 as planned*
 - *Gazprom announces its 2012 financial results; Rosneft continues to challenge Gazprom in the sphere of gas exports by announcing talks with ExxonMobil over the construction of an LNG export terminal in Russia's Far East; Beltransgaz to be renamed Gazprom Transgaz Belarus to reflect Gazprom's takeover*
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Gazprom and the EU

Negotiations between Russia and Lithuania over their gas relationship and the unbundling over Lietuvos Dujos continue; Polish Treasury Minister and PGNiG Chief Executive are sacked as a result of a EuRoPolGaz-Gazprom agreement to investigate the possible expansion of the Yamal-Europe gas pipeline

Negotiations between the Russian and Lithuanian governments over their energy relationship remain ongoing. The vertically-integrated energy utility, Lietuvos Dujos, currently accounts for all of Lithuania's gas imports (from Gazprom), manages the gas transportation system in Lithuania, and sells gas to final consumers. As well as supplying gas to Lietuvos Dujos, Gazprom currently holds a 37 percent stake in the company. The other major shareholders are the German energy company, E.On (39 percent), and the Lithuanian state (18 percent). As reported in last month's Gazprom Monitor, the Lithuanian government has announced its intention to implement the most radical variant of reforms proposed by the EU Third Energy Package, which stipulates the full ownership unbundling of Lietuvos Dujos. Under these plans, the ownership and operation of Lithuania's gas transport system will be transferred to a new, state-owned, company – Amber Grid - in July 2013, while Gazprom and E.On will be obliged to sell their shares in the new company by October 2014.

The announcement by the Lithuanian government last month followed almost three years of discussion and negotiation, during which Gazprom claimed that it was coerced into accepting the reforms. It was on this basis that Gazprom appealed for arbitration from the UN Commission on International Trade Law in March 2012, although the results of that arbitration have yet to be revealed. Conversely, in October 2012 the Lithuanian government launched a suit with the Arbitration Institute of the Stockholm Chamber of Commerce, claiming that Gazprom abused its monopoly position and overcharged for gas supplies

to Lithuania between 2004 and 2012 (see Gazprom Monitor Issue № 15). The two lawsuits give Gazprom and the Lithuanian government sticks with which to beat each other, or bargaining chips that may be conceded in return for progress in the negotiations, depending on your perspective. Additional factors in these negotiations are Lithuania's plans to construct a new LNG import terminal at Klaipeda by the end of 2014 to reduce Lithuania's dependence on Russian gas, and the fact that Lithuania will assume the 6-month rotating EU Presidency in July 2013, while the current European Commission antimonopoly investigation into Gazprom also undermines Gazprom's opposition to Lithuanian plans to implement ownership unbundling in its gas sector.

The situation became even more complex in mid April, when Lithuanian sources began to report a draft memorandum between the Lithuanian and Russian governments. The memorandum proposed that Gazprom would reduce its gas prices for Lithuania by 20 percent if the Lithuanian government agreed to push back the timescales for its implementation of the Third Energy Package to 2015 and freeze all current litigation against Gazprom. Having initially claimed ignorance of the memorandum, the Lithuanian Prime Minister, Algirdas Butkevicius, acknowledged the offer but claimed that the proposal would not be implemented. Instead, the negotiations were handed over to 'expert groups', including representatives from the Lithuanian Energy Ministry and Gazprom, who held their first meeting in Vilnius on the 3rd of May. Although Gazprom CEO, Alexei Miller, stated that the issue would be settled by July, the Lithuanian Energy Minister, Jaroslav Neverovic, has suggested that "Obviously the process won't be simple or fast". Given the complexity of the situation, Neverovic is more likely to be proved right in his assessment.

Poland's Treasury Minister, Mikolaj Budzanowski, was dismissed from his role on the 22nd of April for failing to inform the Polish Prime Minister, Donald Tusk, of the signing of a memorandum of understanding between EuRoPolGaz and Gazprom to expand the

Yamal-Europe gas pipeline through Poland. Is it not entirely surprising that Budzanowski failed to inform Tusk of the deal, as Budzanowski himself was unaware of it. It seems the deal was constructed bilaterally between EuRoPolGaz and Gazprom, without permission from PGNiG or the Polish authorities. In relieving Budzanowski of his duties, Tusk rather diplomatically stated that, "Despite my respect for Budzanowski's qualifications, he failed to adequately supervise strategic companies in charge of energy security". Grazyna Piotrowska-Oliwa, Deputy Chairman of the EuRoPolGaz supervisory board and Chief Executive of PGNiG, was quick to play down the memorandum, claiming "This is just a document regarding a feasibility study and does not mean that the gas link will be built". Such contrition was not enough to save Piotrowska-Oliwa though, and she was relieved of her position at PGNiG at the beginning of May.

State-owned PGNiG and Gazprom each own a 48 percent stake in EuRoPolGaz, which owns and operates the Polish section of the Yamal-Europe gas pipeline, which delivers 33 bcm per year of Russian gas to Germany via Belarus and Poland. The proposed expansion would involve the construction of a new 15 bcm per year capacity pipeline from Russia to Hungary, via Belarus, Poland, and Slovakia, to be named Yamal-Europe 2. Gazprom CEO, Alexei Miller, has announced that the project would cost \$5bn and would be completed by 2019, after the completion of South Stream.

The proposed project was met with limited enthusiasm in Poland. Prime Minister Tusk claimed that Poland is not interested in increasing its gas imports from Russia and is instead pursuing a diversification of its gas supplies. Before his sacking, Budzanowski suggested that the experience of Yamal-Europe showed that mixed ownership is 'not effective' and that future decisions on new gas pipelines in Poland will be made by the Polish government and Polish pipeline operator. Therefore, the future of the project remains uncertain at best.

Ukraine

Gazprom boycotts a high-level roundtable held by Ukrainian and EU representatives on the future management and development of Ukraine's gas transport system, and warns European energy companies against reselling Russian gas back to Ukraine, as Ukraine continues to seek alternatives to Russian gas imports

In an interview with the German media, Ukrainian Prime Minister, Mykola Azarov, has again criticised the inequity of the current Gazprom-Naftogaz gas supply contract. In responding to a question on former Prime Minister, Yulia Tymoshenko, Azarov claimed that the gas deal she authorised in January 2009 has since cost Ukraine an extra 15bn Euros in payments for Russian gas. With Gazprom refusing to renegotiate prices for its 10-year gas supply contract, Naftogaz has adopted the strategy of minimising its Russian gas imports. This strategy is being facilitated by a sharp drop in Ukrainian gas consumption, and the modest beginnings of gas imports from central Europe: Naftogaz hopes to receive 7-8 bcm in 2013 from Germany, Hungary, Poland, Slovakia, and Romania – a volume equal to one third of its current (significantly reduced) imports from Gazprom. Unless new cross-border infrastructure is built, the vast majority of such imports could only be facilitated by a 'virtual reverse'. In this case, European energy companies would purchase gas from Gazprom and resell it to Naftogaz, while the physical gas would be delivered directly to Ukraine from Russia – the movement of gas from Russia to Central Europe and then back to Ukraine would thus be 'virtual'.

Gazprom spokesman, Sergei Kupriyanov, has criticised the scheme, stating that "physically reversing the direction of gas flow from Europe is impossible. There is no separate gas pipeline. Therefore, these can only be some kind of 'paper,' opaque operations, whose legality needs to be investigated: if the 'virtual reverse' uses our transit gas, that is a direct violation for which there must be an accounting," he said. "We

are confident that no serious European companies would participate in dubious gas deals with Ukraine that rely on Gazprom gas that doesn't belong to Naftogaz”.

Gazprom's strategy of keeping the pressure on Ukraine was also evident in the company's decision to boycott a high-level roundtable meeting on the future management and development of Ukraine's gas transportation system (GTS) at the beginning of May. The meeting was attended by EU officials, Ukrainian officials, Ministers from EU Member States, and representatives of European gas companies and financial institutions. Gazprom's absence was a stark reminder that, without Russian gas, Ukraine's GTS is deprived of its *raison d'être*. This point was not lost on EU Energy Commissioner, Günter Oettinger, who told a press conference that “At the end of this process, it must be a win-win-win effect because Russia was, is, and will be the most relevant gas exporter to the European market”.

Gazprom's boycott of the meeting also reflected the current priorities of the company – the development of new gas export pipelines that bypass Ukraine and reduce Gazprom's dependence on gas transit via Ukraine. In 2011 (the latest year for which figures are available), Gazprom exported 150 bcm to Europe (EU-27 plus Turkey and the Balkans), of which 100 bcm was delivered via Ukraine. The reported transit capacity of Ukraine's GTS for Russian gas deliveries to Europe is 142 bcm, whilst the transit capacity of Belarus is estimated at 48 bcm (33 bcm through the Yamal-Europe pipeline and the remaining 15 bcm through Soviet-era infrastructure), and the Blue Stream pipeline from Russia to Turkey has a capacity of 16 bcm. Therefore, the total capacity of infrastructure for the export of Russian gas to Europe was 206 bcm. The two-stage launch of the 55 bcm-capacity Nord Stream pipeline in 2011-12 increased the 'excess capacity' to 111 bcm. If constructed as planned South Stream would add a further 63 bcm per year to Gazprom's export capacity. This would give Gazprom a total export capacity of 324 bcm, of

which 182 bcm circumvents Ukraine. In short, gas transit via Ukraine could be eliminated entirely.

The irony for Gazprom is that, by pressuring Ukraine so strongly on gas prices, the revenue gains from higher prices paid by Ukraine have been offset by a dramatic decline in Ukrainian gas imports and consumption. Even though Ukraine was Gazprom's largest gas export market between 2005 and 2011, Gazprom appears willing to sacrifice export volumes for higher prices – a strategy the company is also pursuing in Europe by clinging to oil-indexed gas prices while its competitors are switching to spot pricing.

Nord Stream

Gazprom and Gasunie agree to investigate the possibility of expanding the Nord Stream gas pipeline, with Gazprom eyeing an increase in gas exports to the British market, despite the current under-utilisation of the existing Nord Stream pipeline

At the beginning of April, Gazprom CEO, Alexei Miller, met with the Chairman and President of Gasunie, Paul Van Gelder, in Amsterdam to discuss future cooperation, and signed an agreement to explore the possibility of expanding the Nord Stream gas pipeline. BP signed a similar agreement with Gazprom in October 2012. The proposals suggest the construction of two new strings for the Nord Stream pipeline, each with a capacity of 27.5 bcm per year – the same as the existing two strings. If implemented, the project would therefore double the capacity of Nord Stream.

Gazprom's focus is primarily on increasing its supplies to the British market, from a current 8 bcm per year up to a potential 40 bcm per year. The UK has been a net gas importer since 2006, and domestic production continues to decline, increasing the need for imports. Gasunie already owns a 9 percent share in the Nord Stream gas pipeline consortium, and perhaps has one eye on the future: Gas production in the Netherlands

is declining, and the country could be a net importer by 2020-2025.

However, the final configuration of shareholders in the Nord Stream expansion project and the route of the new strings have not been decided. Given that Nord Stream is currently operating at less than one third of its total capacity, the need for an expansion of the pipeline will be closely linked to the outcome of current negotiations on Russian gas transit via Ukraine, and the willingness of British energy companies to dramatically increase their imports of pipeline gas supplies from Russia, rather than pursue further increases in LNG imports, as has been the strategy over the last five years.

South Stream

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On the 26th of April, Gazprom CEO, Alexei Miller, met with the Slovenian Prime Minister, Alenka Bratusek and several other Slovenian Ministers to discuss the progress of the Slovenian section of South Stream. Following the meeting, Miller announced that the spatial planning and Environmental Impact Assessment (EIA) reports were almost complete, and that construction would begin by next year. Gazprom currently supplies Slovenia with 500 million cubic metres of natural gas every year.

On the 10th of April Bulgaria's Prime Minister, Marin Raykov, called for a review of Bulgaria's participation in the South Stream project, to ensure that it was compatible with EU gas market legislation: "This topic is important in order to be sure to what extent this

investment decision is compatible with the third energy package of EU. Our European partners also have to make such a verification". Raykov added that the review would be routine, and in no way suggested that Bulgaria would back out of the project. Bulgaria's Economy and Energy Minister, Assen Vassilev, explained that the review was "an insurance policy for Bulgaria that we will not be sanctioned by Brussels".

A major talking point is EU legislation on Third Party Access (TPA), which requires 33-50 percent of the capacity of pipelines on EU territory to be reserved for 'third parties' that do not hold ownership stakes in the pipeline and wish to utilise the pipeline, in return for payment to the pipeline owner or operator. If the principle of TPA is applied to South Stream's onshore sections on EU territory, the pipeline will most likely operate below its operational capacity, as Gazprom would be the only company pumping gas into the pipeline. At the EU-Russia Summit in December 2012 the Russian Energy Minister, Alexander Novak, proposed that pipelines designated as 'projects of national significance' by the governments across whose territory they pass should be exempt from TPA regulations. The European Commission has yet to formulate a response to that proposal. Until the question of TPA is resolved, the South Stream project will face an uncertain future.

Following a meeting between Gazprom CEO, Alexei Miller, and the Serbian Minister for Natural Resources, Milan Bacevic, in Moscow on the 15th of April, it was announced that the construction of South Stream in Serbia could begin by the end of 2013, rather than in 2014, as planned. The Serbian section will be paid for by Gazprom, which has provided a 1.7bn Euro loan to Serbia, to be paid back using transit taxes once the pipeline is operational. Gazprom holds a 51 percent stake in South Stream Serbia, with Srbijagas holding a 49 percent stake. In March 2010, Srbijagas signed a 10-year, 1.5 bcm per year gas supply contract with Gazprom.

Asia

Japanese energy companies may participate in the construction of Gazprom's Vladivostok LNG export terminal, with Japan the target export market

Following the April visits by Gazprom representatives to Japan, and by the Japanese Prime Minister, Shinzo Abe, to Moscow, it has been announced that Gazprom is considering inviting Japanese energy companies to participate in its Vladivostok LNG project. The project is planned to have a 15 million tonne per year capacity, while the first stage (5m tonne capacity) is scheduled for launch in 2018. For its part, Japan is the world's largest LNG importer, with LNG demand rising dramatically since the Fukushima nuclear disaster and the decommissioning of Japan's nuclear reactors. Japan currently imports approximately 100 bcm of LNG per year, of which Russia currently supplies about 10 percent. Japan is therefore regarded as a key target market for LNG exports from Vladivostok.

Itochu and JGC are the foremost contenders for participation in the Vladivostok LNG project, while Mitsui and Mitsubishi (both shareholders in the Gazprom-led Sakhalin-2 project) and the Japan Far East Gas Consortium (consisting of Itochu, Japex, Marubeni, Inpex, and Ciceo) are also reportedly interested in participating in the project.

And in other developments...

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On the 30th of April Gazprom officially announced its operating results for 2012. According to those results, production fell from 513 bcm in 2011 to 487 bcm in 2012. Sales on the domestic Russian market fell from 281 bcm to 265 bcm. Sales to the former Soviet Union

fell from 82 bcm to 66 bcm. Sales beyond the FSU fell from 157 bcm to 151 bcm. Therefore, total sales fell from 519 bcm to 482 bcm. However, prices rose on all three markets: From 2632 Roubles per million cubic metres (mcm) (65 Euros) to R2871 (71 Euros) on the domestic Russian market, from R8509 (209 Euros) to R9490 (233 Euros) in the FSU, and from 11259 Roubles (277 Euros) to R11970 (294 Euros) beyond the FSU. Net revenue from sales to the domestic Russian market rose slightly from R738.6bn (18.1bn Euros) to R76.1bn (18.7bn Euros). Net revenue from sales to the FSU fell from R637.2bn (15.6bn Euros) to R529.5bn (13bn Euros). Net revenue from sales beyond the FSU rose slightly from R1.44tn (35.3bn Euros) to R1.47tn (36.1bn Euros). Therefore, net sales revenues from all three markets fell from 2.82 trillion Roubles (69.2bn Euros) to 2.66 trillion Roubles (65.3bn Euros).

On the 11th of April Rosneft announced that it was in talks with ExxonMobil over the construction of a \$15bn LNG export terminal either on Sakhalin island or on the Pacific coast of Russia's Khabarovsk region, in Russia's Far East. Rosneft President, Igor Sechin, explained that the partnership could use gas from the Sakhalin-1 project, where Rosneft already cooperates with ExxonMobil. According to Glenn Walder, President of ExxonMobil Russia, the study for the project could be ready by June. If the project does go ahead, reports suggest that it could begin exports by 2018. Given that this would place Rosneft and Gazprom in direct competition, President Putin has warned that the two companies should consult each other and work according to a 'unified plan'. The announcement comes a month after Rosneft's takeover of TNK-BP, and follows a number of landmark deals between Rosneft and ExxonMobil, Statoil, and Eni on the production of oil and gas in Russia's Arctic regions. This has lead President Putin to warn Rosneft not to abuse its dominant market position in Russia's Far East, telling Sechin: "You really occupy practically a monopoly position".



At the beginning of April Gazprom announced that it has renamed Beltransgaz, which it purchased in several stages between 2007 and 2011, Gazprom

Transgaz Belarus. On the 4th of April the President of the Republic of Belarus, Alexander Lukashenko, signed a Decree allowing the company to use the new name.

Disclaimer

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