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

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Key points:

- *Lithuania's competition authority fines Gazprom $48m for 'failing to comply with merger conditions' in relation to its shareholding in Lietuvos Dujos, thus stifling competition in Lithuania's gas market*
- *Gazprom sells its stakes in Lietuvos Dujos and Amber Grid*
- *European gas companies negotiated an average discount of 20 percent in 2013-14, according to Cedigaz*
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Gazprom and the EU

Lithuania's competition authority fines Gazprom $48m for 'failing to comply with merger conditions' in relation to its shareholding in Lietuvos Dujos, thus stifling competition in Lithuania's gas market

On the 10th of June, the Competition Council of the Republic of Lithuania fined Gazprom a record 123 million Litas ($48m, or €36m) for anti-competitive practices in the Lithuanian gas market. Gazprom has been a 37 percent shareholder in Lietuvos Dujos since 2004. According to an official press release from the Competition Council, Gazprom's acquisition of shares in Lietuvos Dujos was subject to the condition that Gazprom (as a gas supplier to, as well as shareholder in, Lietuvos Dujos) would not use its shareholder influence to prevent Lithuanian buyers from purchasing gas from other suppliers. In 2012, Lietuvos Energijos Gamyba sought a swap agreement, in order to buy gas from a Western European company between 2013 and 2015. The Competition Council ruled that Gazprom's refusal to negotiate such a swap agreement effectively prevented Lietuvos Energijos Gamyba from purchasing gas from alternative suppliers. Thus, Gazprom was deemed to have breached the condition of its shareholding in Lietuvos Dujos, and was subsequently issued with a fine for 'failing to comply with merger conditions'.

Gazprom sells its stakes in Lietuvos Dujos and Amber Grid

Just days later, it was announced that Gazprom would accept the offer of the Lithuanian state-owned holding company, Lietuvos Energija, to buy out Gazprom's 37.1 percent stakes in Lietuvos Dujos and Amber Grid, for a reported 417m Litas ($192m, or €121m). Last month, the Gazprom Monitor reported that state holding companies Lietuvos Energija and ESPO-G had agreed to buy E.On's shares in Lietuvos Dujos and Amber Grid, bringing the shareholding of Lietuvos Energija and EPSO-G in the two companies to 56.6 percent. Under Lithuanian law, Lietuvos Energija was then obliged to make an offer to buy out the remaining shareholders – in this case, Gazprom.

Lietuvos Dujos was Lithuania's vertically-integrated energy utility, responsible for the import of gas from wholesale suppliers (such as Gazprom), the management of Lithuania's gas transmission network, and the sale of gas to final consumers. Previously, Lietuvos Dujos was owned by E.On (38.9 percent), Gazprom (37.1 percent), and Lietuvos Energija (17.7 percent). In accordance with the EU Third Gas Directive, the Lithuanian government ordered the management of Lithuania's gas grid to be spun off to a new company, Amber Grid, whose shareholder structure previously matched that of Lietuvos Dujos. Following the spin-off and the buyout of E.On and Gazprom, Amber Grid is now owned by the state holding company, EPSO-G, separate from the ownership of Lietuvos Dujos by the state holding company, Lietuvos Energija.

European gas companies negotiated discounts of 10-20 percent in 2013-14, according to Cedigaz

According to a report just released by Cedigaz, European gas buyers that renegotiated their contracts with Gazprom over the past 14 months have received discounts of around 10 to 20 percent and a reduction of their 'take or pay' commitments. The volume of contracts renegotiated amounts to 60 bcm – around a third of Gazprom's annual gas exports to Europe. The gap between European spot prices and oil-linked prices is the highest since March 2009, with spot prices on Germany's main hub around 34 percent cheaper than oil-indexed gas prices. Such pricing dynamics give European gas buyers a strong motivation to press for renegotiations and discounts. Gazprom is not alone in facing pressure on the European gas market. Cedigaz noted, "Gazprom was not the sole provider to face tough renegotiations of its long-term contracts... All major European suppliers were either brought to the negotiating table or subjected to arbitration".

Gazprom and Ukraine

Gazprom implements prepayment in Ukraine, meaning that Naftogaz will only receive gas for which it has already paid. Given that Naftogaz failed to pay up front for its June gas supplies, the practical result was the suspension of Gazprom deliveries to Naftogaz

Last month's Gazprom Monitor reported that the Gazprom CEO, Alexei Miller, the Russian Prime Minister, Dmitrii Medvedev, and the Russian Energy Minister, Aleksandr Novak, had agreed that Gazprom would switch to pre-payment in its gas supplies to Naftogaz. This agreement stipulated that, from the beginning of June, Gazprom would only supply Naftogaz with gas for which Naftogaz has paid in advance. This is in contrast to the previous arrangement, whereby Gazprom invoiced Naftogaz for gas that had already been delivered. Gazprom and the Russian government have cited Naftogaz's outstanding debts as the reason for the shift to pre-payment.

By the 7th of June, Naftogaz had failed to pay in advance for its June gas supplies. The Russian government offered a revised deadline, giving Naftogaz an extra week to settle its debts and pay in advance for June gas supplies. At 10am (Moscow time) on the 16th of June, Gazprom announced that from then on, Naftogaz would only receive gas for which Naftogaz had already paid. Given the failure of Naftogaz to pre-pay for its June supplies, the practical result was the suspension of Gazprom deliveries to Naftogaz.

On the 2nd of June, Gazprom reported that Naftogaz had paid its outstanding debts from Q1 2014 ($786m). According to Gazprom, this leaves a total outstanding debt of $4.45bn. Of this debt, $1.45bn was accumulated in November and December 2013, and $3bn was accumulated in April and May 2014. The debt for November-December is largely accepted by both sides. However, from the 1st of April, the cancellation of the gas price discounts meant that the price paid by Naftogaz rose from $268 to $485 per thousand cubic metres. Naftogaz refuses to accept this price increase, and therefore does not accept the debt of $3bn accumulated during April and May under the new pricing regime as legitimate.

In bids to unlock the dispute, both sides have launched arbitration proceedings in the Arbitration Institute of the Stockholm Chamber of Commerce. Gazprom is seeking to recover the outstanding debt of $4.5bn for gas that has already been delivered, and is seeking compensation for Naftogaz's failure to adhere to the 'take or pay' terms of its gas supply contract for the last two years. Russian sources report that the penalty for the latter could be as high as $18bn, given that Naftogaz has imported volumes far below the 42 bcm stipulated by the existing contract. For its part, Naftogaz is claiming that it has overpaid for gas in recent years, and is seeking compensation and a lower gas price. Naftogaz representatives have called for a return to the discounted price of $268 per thousand cubic metres. Gazprom countered with an offer of $385. Naftogaz rejected this offer, and proposed an interim price of $326 until a new pricing formula is agreed. This finalNaftogaz offer was rejected by Gazprom shortly before the switch to prepayment. Gazprom is refusing to countenance any further offers until Naftogaz pays off at least $1.95bn – just over 40 percent of its outstanding debt to Gazprom.

Finally, given that Naftogaz refuses to accept the current pricing structure, it is unlikely that it will pre-pay for gas supplies at the current price, unless the situation becomes more desperate. The key questions are, therefore: how much gas will Naftogaz be able to import from alternative sources, and how long will Naftogaz's reserves in the company's underground gas storage facilities last? Reports suggest that, although Naftogaz has begun small-scale deliveries from Europe, these are not sufficient to meet Ukrainian gas demand. Likewise, sources suggest that Ukraine has 14 bcm in gas storage – sufficient for the next few months. However, by autumn Naftogaz will need to start building up its stockpiles for the winter. While this dispute is unlikely to be resolved any time soon, the shift from summer to autumn and the preparations for the winter heating season provide a potential natural deadline for some kind of resolution. Failure to reach such a resolution by the beginning of autumn could mark the beginning of a more serious stage in this long-running dispute.

South Stream

Bulgaria halts construction of South Stream, pending EU concerns over the tender process for its construction on Bulgarian territory

At the beginning of June, the European Commission demanded that Bulgaria halt work on the South Stream pipeline. On the 3rd of June, the European Commission wrote to the Bulgarian authorities, asking for information on how the construction contracts had been awarded. According to Chantal Hughes, a spokesperson for EU Internal Market Commissioner Michel Barnier, the European Commission has "grounds to believe" that EU internal market rules, "in particular those related to the award of public contracts are being breached... Until there is full compliance with EU law, we have also asked the Bulgarian authorities to suspend the project". In particular, the European Commission is concerned that South Stream Bulgaria (the 50-50 joint venture between Gazprom and Bulgarian Energy Holding) awarded the construction contract without a competitive tender. Reports claim that eleven groups, including those from Austria, Belgium, Germany, India, Italy, Japan, Russia, and Sweden, bid for the project. The contract was awarded to a group led by Russian company Stroytransgaz, whose major shareholder, Gennady Timchenko, currently faces US sanctions.

The following day, the President of the European Commission, Jose Manuel Barroso, gave a speech ahead of the G7 Summit, in which he noted, "The Commission will also ensure that all energy infrastructure and projects in the European Union such as South Stream comply 100% with European rules on energy competition public procurements and so on. We have just launched an infringement procedure against Bulgaria which shows that we mean business".

There also remain concerns regarding the principle of Third Party Access to South Stream's onshore sections. This principle aims to ensure that energy companies that do not hold ownership stakes in the pipeline can still gain access to it, and is a key component in the EU Third Gas Directive, which aims to increase the competitiveness of the EU gas market. Furthermore, there are concerns that Gazprom's 50 percent-minus one shareholdings in each of the pipeline's onshore sections are too close to infringing on the principle of 'unbundling', which stipulates that gas producers (such as Gazprom) cannot hold majority shareholdings in gas pipeline infrastructure on EU territory.

On the 8th of June, the Bulgarian Prime Minister, Plamen Oresharski, announced that the construction of South Stream in Bulgaria would be suspended until EU concerns were satisfied: "I have ordered all work to be stopped. We will decide on further developments following consultations with Brussels". However, Gazprom CEO Alexei Miller remained optimistic about the prospects for South Stream in Bulgaria; "The EU cannot stop the construction. No one can stop us building it. Our answer is very simple. In December 2015 the first gas along the marine section under the Black Sea will arrive in Bulgaria and the European Union".

Gazprom and OMV confirm Austria's entry into the South Stream project

In an apparent boost to the project, Gazprom signed an agreement with Austrian energy company OMV on the construction of a spur of South Stream from the Austria-Hungary border to the Baumgarten gas hub in Austria. Gazprom and OMV will each hold 50 percent stakes in the joint venture company managing the project. The pipeline itself is planned to have a capacity of 32 bcm per year. Construction is expected to begin in 2015, first deliveries are scheduled for 2017, and full capacity could be reached in early 2018. In recognition of the concerns currently being raised over the Bulgarian section of South Stream, the CEO of OMV, Gerhard Roiss, stated, "This project - investment in European energy security - will fully comply with EU legislation".

The deal represents the next step following the Memorandum of Intent signed between the two parties on the 29th of April, and reported in the April edition of the Gazprom Monitor. At the time we noted that, while Austria's promotion of South Stream highlighted a divisive issue in EU energy politics, it also reflected the current levels of concern over the stability and reliability of Russian gas deliveries via Ukraine to the EU.

The tense discussions over the compatibility of the South Stream structure and EU gas market legislation, particularly regarding Gazprom's 50 percent ownership of each of the sections and the issue of granting third party access to South Stream for alternative gas suppliers, ought to be considered in the context of current developments. The European Commission has effectively prevented Nord Stream from operating at full capacity by enforcing the principle of third party access to Nord Stream's onshore sections, OPAL and NEL, while joint EU and US pressure on Bulgaria appears to have halted the construction of the Bulgarian section of South Stream. Even these developments are overshadowed by the European Commission antitrust investigation into Gazprom, and the current crisis in EU-Russia relations over Ukraine. If Gazprom is going to not only construct South Stream, but also operate it at full capacity, there will need to be compromises on both sides and a considerable warming of EU-Russia relations. In the current environment, that is far from guaranteed.

Gazprom in Asia

Gazprom expects $25bn pre-payment in China gas deal, but terms yet to be finalised

The Deputy Head of Gazprom (and Head of Gazprom Export), Alexander Medvedev, has announced that China will pay Russia $25bn in pre-arranged advance payments. Those payments will be used to fund the construction of the Power of Siberia pipeline, which will deliver gas from the Russian Far East to North-Eastern China. However, Medvedev refused to divulge further details, citing a number of conditions that cannot be disclosed; "You won't get the price from me, or the (price) formula".

And in other developments…

Rosneft claims that a Gazprom monopoly on domestic pipelines in the Russian Far East would be illegal, and promises legal action to secure its right to supply Russian consumers in the region

In a statement on its company website, Rosneft has claimed that a Gazprom monopoly on gas pipelines in the Far East of Russia would be illegal, and that Rosneft would be prepared to pursue legal action to secure its right to supply Russian consumers in the region. According to the Rosneft statement,

> The head of Gazprom, Alexei Miller, has announced that 'Power of Siberia pipeline and export supplies to China were planned only for Gazprom resource base'. This position is completely different from the target of developing Siberia and Far East regions and openly contradicts the current legal system... Gazprom, being an infrastructure monopoly, is obliged to guarantee independent producers access to the transport system. And in this case 40 bcm of gas, produced by Rosneft subsidiaries in East Siberia and at least as much produced by other manufacturers will become a part of region's economy, will provide light, heat and energy for their development. We will protect the rights of our citizens by means of negotiations within the framework of corporate procedures, discussions with regulators and if necessary court proceedings.

Results of Gazprom's Annual General Meeting of Shareholders

On the threshold of Gazprom's Annual General Meeting of shareholders, it was announced that, in terms of EBITDA (Earnings Before Interest, Tax, Depreciation, and Amortisation), Gazprom was ranked first in global public companies, and third in terms of net profit. In 2013, Gazprom's EBITDA was over 2 trillion Roubles ($63bn) and net profit was 1.139 trillion Roubles ($36bn).

At the meeting itself, on the 27th of June, Gazprom's CEO, Alexei Miller, and Chairman of the Board of Directors, Viktor Zubkov, were re-elected to their posts. The participants in the meeting also approved Gazprom's Annual Report for 2013. In addition to the statistics regarding Gazprom's sales volumes and revenues (reported in the April edition of the Gazprom Monitor), it was noted that overall sales revenues grew by 4.9 percent versus 2012 and net profit grew by 8.8 percent. Gazprom also added 646.9 bcm to its natural gas reserves, giving a total of 35.669 trillion cubic metres, which equate to 17 percent of global natural gas reserves and 72 percent of Russian natural gas reserves. Total production in 2013 was 487.4 bcm, of which 22.8 bcm was produced at the Bovanenkovskoye gas field as part of the Yamal Megaproject. At the beginning of the winter 2013 heating season, Gazprom's underground gas storage capacity in Europe stood at 4.1 bcm, with a dailysend-out capacity of 51 million cubic metres – the equivalent of one-third of the capacity of the Nord Stream pipeline, or approximately 18 bcm per year.

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