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

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## Key points:

- *The calm before the storm: Gazprom fails to assuage EU concerns over pricing as EU continues preparing statement of objections in antitrust investigation*
- *Gazprom set to extend contract with Greece*
- *Gazprom agrees to withdraw from management of Amber Grid, and offers Lithuania lower gas price*
- *Russian loan to Ukraine strongly tied to Naftogaz's debt to Gazprom*
- *Nord Stream AG completes feasibility study for expansion, with UK as target market*
- *South Stream consortium signs pipe supply contract for offshore section as Gazprom presses ahead with the project, despite uncertainties*
- *Gazprom and Shell sign roadmap for third LNG train at Sakhalin-II*
- *Gazprom HQ could relocate from Moscow to St. Petersburg by 2015*

## *Gazprom and the EU*

*The calm before the storm: Gazprom fails to assuage EU concerns over pricing as EU continues preparing statement of objections in antitrust investigation*

Talks remain ongoing between the EU Competition Commissioner, Joaquin Almunia, the EU Energy Commissioner, Gunther Oettinger, and representatives of Gazprom. In early February, Almunia announced that progress had been made on Gazprom's use of destination clauses that prevent the re-export of imported Russian gas. Such clauses were dropped from Gazprom's contracts with Western European energy companies a decade ago, and it is likely that they will now be dropped from contracts with Central and Eastern European energy companies. Almunia also reported that progress had been made on Gazprom contract clauses that squeeze out competitors, which suggests negotiation over Gazprom's ownership of pipeline infrastructure and questions of Third Party Access to that infrastructure.

However, the issue of pricing remains a major concern. In a statement, Almunia explained, "We have received good comments on two of the three concerns that can give way to formal commitments but on prices we have not yet received what we need... So we continue drafting the statement of objections that can be adopted in coming months. If in the meantime, before the adoption ... we receive proposals that are good enough to eliminate our concerns then we can go to the commitment decision... I want to be clear that we are not stopped in the preparation of a statement of objections because we have not received what we want".

The investigation into the alleged illegality of Gazprom's pricing schemes in EU Member States of Central and Eastern Europe is based on Article 102 of the Treaty of the Functioning of the European Union (Part 3; Title VII; Chapter 1). Article 102 states that "Any abuse by one or more undertakings of a dominant position within the internal market or in a substantial part of it shall be prohibited as incompatible with the internal market in so far as it may affect trade between Member States. Such abuse may, in particular, consist in... directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions".

In September 2013, Almunia gave a speech at the Fordham's Institute of Competition Law Annual Conference where he asked the rhetorical question: when is a price 'unfair'? "The European Court of Justice offered guidance as far back as 1978. In the United Brands case, it ruled that one would need to establish firstly that the profit margin of the dominant firm is very high by considering the difference between its costs and prices, and secondly that this high margin is not the result of superior efficiency, by comparing it with the prices charged by competitors. Later on, the Court also considered other methods. A case that can illustrate this type of concern is our on-going investigation of the Russian energy giant Gazprom. One of the key issues in this case is that Gazprom may have imposed unfairly high prices on its customers in Central and Eastern Europe when compared to costs or to competitive benchmarks"[1].

To those following the investigation, it is vital to note that the European Commission does not object to the oil-indexation of gas prices. Such indexation has formed the core of the European gas market since the early 1960s. Rather, Almunia notes, "The problem is the use of these indexation mechanisms to set... abusive prices without connection to economic fundamentals". This can be interpreted as an argument that gas prices which

1 European Commission - Speech/13/758 (27/09/2013). Available at: http://europa.eu/rapid/press-release_SPEECH-13-758_en.htm

rise and fall in line with oil prices are not an issue, but oil-indexed gas prices that remain significantly above spot gas prices (generated by gas-to-gas competition) are problematic, especially when they generate a high profit margin that is not justified by superior efficiency.

Sources report that EU and Gazprom representatives have been holding regular meetings, and that Gazprom is keen to reach a settlement before the statement of objections is published and damages Gazprom's reputation. It has also been reported that Almunia and Oettinger would like to resolve the matter before the 31st of October 2014, when they will both step down from their current positions. With significant developments expected in the coming months, the current period of secretive, behind-closed-doors negotiations punctuated by press releases hinting at progress feels like the calm before the storm.

***Gazprom set to extend contract with Greece***

According to Greek sources, the Greek national gas utility, DEPA, is close to signing a new gas supply contract with Gazprom. The current contract expires in 2016. The new contract is expected to run until 2026, and will be backdated to June 2013. While the current contract stipulates a price of $470 per thousand cubic metres, Gazprom is willing to offer a discounted price below $400 in exchange for securing contractual volumes of 2.5-3 bcm per year for the next decade. The new contract will not displace DEPA's plans to import 1 bcm from the Shah Deniz consortium via the planned Trans-Adriatic Pipeline (TAP), with those deliveries planned to commence in late 2018. However, the new deal will ensure that Gazprom remains the dominant gas supplier of Greece for the next decade.

***Gazprom agrees to withdraw from management of Amber Grid, and offers Lithuania lower gas price***

Following informal talks during the Sochi Olympics between Gazprom CEO Alexei Miller and Lithuanian PM Algirdas Butkevicius, it has been confirmed that Gazprom has submitted written proposals to the Lithuanian government regarding the terms and conditions of Russian gas supplies to Lithuania. The major issue of pricing has not been confirmed, but reports suggest that Lithuania could receive a discount of 20 percent, taking the price down from $470-480 to $376-384. For comparison, sources suggest that Lithuania currently pays 13 percent more for its Russian gas supplies than neighbouring Estonia, and 20 percent more than Latvia. Gazprom's proposals also include withdrawing from the management of Amber Grid, the new company created to manage Lithuania's gas pipeline network following the unbundling of Lietuvos Dujos in August 2013. However, it is not yet clear whether Gazprom is prepared to sell its 37 percent stakes in Lietuvos Dujos and Amber Grid. The written proposal also reportedly includes consideration of the transit of Russian gas across Lithuania to the Russian enclave of Kaliningrad, although no details have been announced.

Gazprom's offer comes just weeks after Lietuvos Dujos shareholders voted to initiate arbitration proceedings against Gazprom, citing the failure of ongoing negotiations to bring lower gas prices. Lietuvos Dujos is also currently pursuing arbitration against Gazprom in a bid to gain a refund of $2bn for Gazprom's alleged overcharging of Lietuvos Dujos between 2004 and 2012. It is not clear whether Lietuvos Dujos will drop its latest arbitration case against Gazprom, should it decide to accept the new proposals. Just a week before the Gazprom offer, the Lithuanian President attended a ceremony at a shipyard in Ulsan, South Korea, where a new LNG-terminal vessel destined for Lithuania was christened 'Independence'. The vessel is expected to arrive in Lithuania by the end of 2014. Lietuvos Dujos's current contract with Gazprom expires in 2015.

Gazprom's latest offer to Lietuvos Dujos is a sign that the Russian company is keen to retain Lithuania as a gas export market in the face of planned LNG-based competition.

***Ukraine***

*Russian loan to Ukraine strongly tied to Naftogaz's debt to Gazprom*

In December 2013 the Russian government agreed a loan of $15bn to Ukraine, whilst Gazprom agreed to reduce gas prices for Ukraine by a third, from around $400 to $268. The first tranche of the loan – around $3bn – was delivered to Ukraine. At the beginning of February, it was reported that Naftogaz owed Gazprom $2.6 billion for 2013 deliveries and $658m for January 2014 deliveries. At the time, the Russian Finance Minister, Anton Siluanov, announced that the provision of further tranches of the loan would depend on Naftogaz paying its debts to Gazprom. Since then, sources report that Naftogaz has paid around half of this debt: $1.28bn of the 2013 debt and $191m of the debt accumulated during January 2014. On the 17th of February, Siluanov announced that the Russian government was prepared to transfer the second tranche of the loan to Ukraine by buying $2bn of Ukrainian Eurobonds.

Clearly, the situation remains fragile. The latest tranche of the Russian loan to Ukraine will be just about sufficient to enable state-owned Naftogaz to pay off its remaining debts of $1.79bn to Gazprom. However, with massive non-payment for gas supplies by Ukrainian consumers depriving Naftogaz of revenue, the company will depend on another tranche of Russian loans to pay for February's gas supplies. The scale of this non-payment by Ukrainian industrial consumers was illustrated in early February, when Naftogaz released a statement claiming that industrial consumers owed Naftogaz $3.1bn, with 37 percent of this debt ($1.2bn) having been accumulated in the three months from November to January. For Gazprom, the difficulty lies in recovering these debts without pushing Naftogaz into the desperate measures of defaulting or starting to siphon off volumes destined for Europe.

***Nord Stream***

*Nord Stream AG completes pipeline expansion feasibility study, with UK as target market*

Gazprom has completed a feasibility study for the possible expansion of Nord Stream, concluding, "the construction of one or two additional gas pipeline strings is economically viable and possible both from the technical and environmental points of view, as well as for the purposes of attracting necessary financing in the banking market". However, in a subsequent statement, Gazprom added that it needs to be confident of the stability of regulations on the EU market and to have guarantees of demand before it implements the pipeline expansion. If the expansion of Nord Stream does proceed, it has been suggested that the UK will be the target market.

***South Stream***

*South Stream consortium signs pipe supply contract as Gazprom presses ahead with the project, despite uncertainties*

The South Stream consortium, South Stream Transport B.V., signed a $1bn contract with three pipe suppliers for 75 thousand 12-metre pipes. Half of the pipe will be provided by a German company, EUROPIPE, while the other half will be provided by Russian companies United Metallurgical Company and Severstal. Together, the pipe will cover a distance of 900km, just short of the 931km length of South Stream's offshore route. The deal follows an agreement with three sea ports in Bulgaria (Burgas, Varna-East, and Varna-West), where pipes will be stored prior to construction.

Despite the lack of clarity around the implications of EU gas market legislation (Third Party Access in particular), Gazprom appears determined to press ahead with the project. With offshore pipeline construction scheduled to begin in autumn 2014, and first deliveries scheduled for December 2015, Russia's Ambassador to the EU Vladimir Chizhov confirmed that the first line of South Stream could begin pumping gas within the next two years.

***Asia***

*Gazprom and Shell sign roadmap for third LNG train at Sakhalin-II*

Gazprom and Shell have signed a roadmap agreement for the expansion of the Sakhalin-II LNG export terminal. The terminal currently consists of two trains, and exported 10.8 million tonnes of LNG (approximately 15 bcm) in 2013. The addition of a third train would raise the export capacity of Sakhalin-II to approximately 15 million tonnes (22.5 bcm) per year. Gazprom is the majority shareholder in Sakhalin-II (50 percent plus one share), while Shell holds 27.5 percent minus one share. The other Sakhalin-II shareholders are the Japanese companies Mitsui (12.5 percent) and Mitsubishi (10 percent). At the signing ceremony Gazprom CEO Alexei Miller noted, "The global LNG market is booming – primarily in Asian countries". The CEO of Shell, Ben van Beurden, added, "The third train will help confirm the status of the Sakhalin II project as a reliable energy supplier to the Asia-Pacific region".

The expansion of Sakhalin-II is a more straightforward way of expanding Gazprom's capacity for LNG exports to the Asia-Pacific compared to related plans to construct an entirely new export terminal in Vladivostok. The latter project proposes three LNG trains, each of 5 million tonnes, with the first train planned for launch in 2018.

However, Gazprom will face competition from fellow Russian energy companies in the coming years. Novatek is developing its Yamal LNG project with the participation of Total (France) and CNPC (China). Rosneft has signed an agreement with ExxonMobil (USA) to develop a new LNG export terminal on Sakhalin Island. The Rosneft-ExxonMobil terminal has a projected capacity of 5 million tonnes of LNG per year, and a proposed launch date of 2018. While Gazprom is taking delivery of LNG tankers from South Korea (as reported in last month's Gazprom Monitor), Rosneft is formulating ambitious plans to build two new shipyards for the construction of offshore terminals and LNG tankers. One will be located in a new complex at Rosliakovo, near Murmansk. The second will be an expansion of the Zvezda ('Star') shipyard in Russia's Far Eastern Primorsky region. Novatek and Rosneft's ambitions received a boost in late 2013 when the Russian government liberalised regulation of gas exports, allowing the two to export their own LNG production rather than be compelled to use Gazprom as a shipping agent (see previous issues of the Gazprom Monitor for October and November).

***And in other developments…***

*Gazprom HQ could relocate from Moscow to St. Petersburg by 2015*

Gazprom is currently building a new headquarters in St. Petersburg - the Lakhta Centre – that is scheduled for completion in 2018. However, Gazprom's move to Russia's northern capital may take place sooner. Several of Gazprom's departments and subsidiaries have already made the move to St. Petersburg, and more are actively searching for office space in the city. The construction of the 463m tall Lakhta Centre has not been without controversy. The tower was originally planned for St. Petersburg's city centre, on the right bank of the Neva. However, after protests from locals that such a tower would greatly exceed the existing 43m height limit for buildings in the city centre – a UNESCO World Heritage Site – it was decided to relocate Gazprom's new headquarters to the Gulf of Finland, on the outskirts of St. Petersburg.



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