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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:

- *Gazprom is under pressure from all sides. European energy companies request further gas price discounts, export volumes fell in 2012 and are expected to remain weak in 2013, PM Medvedev suggests that Gazprom's export monopoly could be revoked, and Gazprom faces criticism from Europe and the United States over its bid for Greece's state-owned gas utility, DEPA.*

- *Gazprom slaps Naftogaz with a $7bn bill for failing to purchase sufficient amounts of gas in 2012.*

- *The Czech section of Nord Steam, Gazelle, is launched as Gazprom CEO, Alexei Miller, declares an expansion of Nord Stream to be 'feasible' despite the pipeline operating at well below capacity since its launch*

- *Gazprom and the Croatian State-owned energy company, Plinacro, to set up a joint venture in mid-2013 for the construction of a spur from South Stream into Croatia, while Serbia is set to grant South Stream 'national status'*

- *Gazprom signs an agreement with Novatek to produce LNG on the Yamal Peninsula, with Asia the predicted export destination*

- *Gazprom lobbies the Russian government for Shtokman tax breaks as the Russian government considers revoking the Gazprom-Rosneft monopoly on offshore gas and oil production in Russia*

Gazprom and the EU

Gazprom is under pressure from all sides, as European energy companies request further gas price discounts, export volumes fell in 2012 and are expected to remain weak in 2013, PM Medvedev suggests that Gazprom's export monopoly could be revoked, and Gazprom's bid for the Greece's state-owned gas utility, DEPA provokes criticism from Washington and Brussels.

In 2012 Gazprom granted significant gas price discounts to several European gas importers including Wingas and E.On Ruhrgas (Germany), Eni (Italy), and SPP (Slovakia) in a bid to retain market share by lowering its prices to match those of the European spot market. Gazprom also granted 133bn Roubles ($4.4bn) in 'retroactive payments' (refunds) between January and September 2012, in a tacit admission that its prices were too high. The pressure on Gazprom has continued into 2013, as Wingas, Econgas (Austria) and Gaz de France have requested a review of long-term contract gas prices. Gazprom's current long-term contract prices are index-linked to international oil prices with a time delay of around 9 months, a formula that has long been standard for gas exports. However, gas is increasingly being traded on the spot market, where the relative surplus of supply in relation to demand is causing spot prices to fall significantly below Gazprom's long-term contract prices, which remain high in light of sustained high oil prices.

Gazprom also faces continued weak demand for its gas exports. Initial reports from Russia suggest that Gazprom's exports to Europe and Turkey declined to 138 bcm, versus 150 bcm in 2011. For comparison, Gazprom's European exports of 138.5 bcm in 2010 were its lowest since 2003. Conversely, Gazprom's main competitor on the European market, Statoil (Norway), saw its European exports rise by 13 bcm to a record 107 bcm in 2012. The fact that Statoil has increased its exports at Gazprom's expense has been attributed partly to increased Norwegian gas production, and partly to Statoil's willingness to include a greater spot price element in its export contracts, while Gazprom continues to insist on oil-indexed prices with temporary discounts.

At the World Economic Forum in Davos, the Russian Prime Minister, Dmitrii Medvedev, suggested that Gazprom could lose its export monopoly, as long as a plurality of Russian gas exports did not result in competition driving down the export price for Russian gas: "Potentially it is possible because currently we have other independent gas supplies, but we should not lose money, and that is the most important thing". While Mr Medvedev did not refer to any particular independent Russian gas producers, it is believed that Novatek would be the main beneficiary of the revocation of Gazprom's export monopoly – Novatek is currently undertaking a joint project with Total (France) to produce gas in Russia's Yamal region, and wishes to export that gas in the form of LNG.

Finally, Gazprom has reportedly made a €900m bid for the Greek state's share (65 percent) in the country's gas utility company, DEPA, but faces competition from the private Russian oil and gas company, Sintez, which has reportedly bid €1.9bn for DEPA and its subsidiary gas transmission system operator, DEFSA. The Sintez bid is believed to be more than twice that of the other three non-Russian bidders: SOCAR (the Azerbaijani state-owned gas company), M2M (a partnership of two Greek energy companies, Mytilineos and MotorOil), and GEK Terna (a Greek energy company that is bidding only for DEFSA). While the US Ambassador to Azerbaijan, Richard Morningstar, has reportedly warned the Greek government not to let DEPA and DEFSA fall into Russian hands, the European Commission has cautioned Greece that whoever buys DEPA must abide by EU legislation. A Senior Greek official responded by reminding critics of the pressure on Greece from the European Commission, EU Central Bank, and IMF to raise as much money as possible from privatisation of state assets: "It begs the question – what if the Russians make us an offer we can't refuse?"

Ukraine

Gazprom hits Naftogaz with a $7bn bill for failing to purchase sufficient amounts of gas in 2012.

Throughout 2012, the Ukrainian government repeated its intention to reduce the volumes of Russian gas imported by Ukraine, as part of a wider effort to lessen Ukraine's dependence on Russian gas supplies. Although the current contract, signed in

2009, stipulates that Naftogaz must purchase at least 33 bcm per year from Gazprom, the wholesale Ukrainian gas importer, Naftogaz, actually imported just 24.5 bcm in 2012. From the Ukrainian side, the need to reduce imports of Russian gas is based on the 'unacceptably' high price of those imports – Ukrainian officials have long complained that Ukraine is paying a higher price than other Gazprom customers further West, despite the April 2010 agreement to grant Ukraine a $100 per thousand cubic metres discount in exchange for extending Russia's lease on the Sevastopol navy base in Crimea.

The tacit accusation from Ukraine, when it protests about Russian gas prices, is that the 2009 contract was signed under duress from Russia, at the height to the January 2009 Russian-Ukrainian gas dispute, which saw gas supplies to Ukraine cut off for two weeks. Former Ukrainian Prime Minister, Yulia Timoshenko, is currently in prison, charged with abuse of office for signing the January 2009 contract, although Ukraine has faced criticism from the EU over the allegedly political motivation of those charges.

Gazprom has consistently refused to renegotiate its contract with Naftogaz, which runs until 2019, yet remained silent on the issue of Naftogaz failing to purchase the stipulated volumes. By letting Naftogaz build up its shortfall and allowing Naftogaz to believe that it would face no penalty for doing so, on the grounds that it informed Gazprom in advance of its intentions to buy less gas and paid in full and on time for gas that was purchased, Gazprom now has a $7bn leverage over Naftogaz in its (so far unsuccessful) attempts to gain control of Ukraine's gas transportation system. While Gazprom have so far declined to comment on the issue, Naftogaz have released a statement claiming: "We feel that we met all obligations, paying all bills for gas imported from Gazprom in 2012, in full and in a timely fashion". If Naftogaz refuses to pay the bill, the dispute could result in international arbitration between Gazprom and Naftogaz at best, or an escalation into a more serious political and economic dispute between Russia and Ukraine at worst.

Nord Stream

The Czech section of Nord Steam, Gazelle, is launched as Gazprom CEO, Alexei Miller, declares an expansion of Nord Stream to be 'feasible' despite the pipeline operating at far below capacity since its launch

The Gazelle pipeline, which connects the Czech Republic to Nord Stream via the OPAL pipeline in Germany, was launched on the 14th of January of this year. The 30 bcm capacity pipeline also connects to the German MEDAL pipeline, which carries Russian gas westward across southern Germany to France. As a connection to Nord Stream, Gazelle therefore represents an alternative to the Ukraine-Slovakia-Czech Republic route for the delivery of Russian gas to southern Germany and France. However, unlike Nord Stream's offshore section, and onshore German sections, Gazelle has no element of Russian ownership. Instead it is owned and operated by Net4Gas, a subsidiary of the German RWE.

Meanwhile, Gazprom CEO, Alexei Miller, recently told journalists that an expansion of Nord Stream through third and fourth lines would be 'economically feasible', but added that the expansion may not be undertaken by the joint venture that built the first two lines (ie, Nord Stream AG) but rather by another company. In this context, parallel talk has emerged that Britain's BP may have an interest in extending Nord Stream to the UK. However, such pronouncements are tempered by the fact that, since its launch, Nord Stream has operated at approximately 30-40 percent capacity. This is partly due to weak demand for Russian gas in Europe, and partly due to negotiations over third party access to Nord Stream's onshore sections in Germany, the OPAL and NEL pipelines.

South Stream

Gazprom and the Croatian energy concern, Plinacro, to set up a joint venture for the construction of a spur from South Stream into Croatia in the second half of 2013, while Serbia is set to grant 'national status' to the pipeline project

On the 17th of January Gazprom CEO, Alexei Miller, visited Croatia and met with the Croatian President, Ivo Josipovic, and First Deputy Prime Minister and Foreign Minister, Vesna Pusic, to discuss Croatia's participation in the South Stream project. During the visit, Miller signed an agreement with Mladen Antunovic, Head of the state-owned Croatian energy company, Plinacro, for the creation of a Gazprom-Plinacro joint venture in mid 2013 to construct South Stream in Croatia between 2013 and 2016. Although Gazprom has not confirmed the details of the agreement, Antunovic told the press that the Croatian section of South Stream will cost €60m and have a capacity of 2.7 bcm. According to the latest plans released by Gazprom, the Croatian section will be a spur from the main pipeline from Serbia. Croatia therefore will not become a transit country for South Stream. As part of the agreement, the Director-General of Gazprom Export, Alexander Medvedev, announced that Gazprom will secure continued demand for Russian gas in Croatia by constructing a 500 Megawatt gas-fired power station, most likely in Osijek, Eastern Croatia.

On the 25th of January the Serbian government adopted a bill to give South Stream 'national status' in Serbia. According to Serbian Mining Minister, Milan Bacevic, the bill will accelerate land expropriation for the pipeline and simplify the procedure for obtaining construction permits. The bill was presented to the Serbian parliament on the 26th of January, and was due to be passed by the end of January. Construction work on the 410km Serbian section is planned to begin in Q1 2013 at a cost of €1.7bn. Bacevic added that the Serbian share of South Stream is worth around €900m, and will generate €500-600m per year in transit fees.

Asia

Gazprom signs an agreement with Novatek to produce LNG on the Yamal Peninsula, with Asia the predicted export destination

On the 10th of January Gazprom announced that it had signed an agreement with Russia's leading independent gas producer, Novatek, to create a joint venture for the production of LNG in Russia's Yamal region. Neither Gazprom nor Novatek have confirmed details of the agreement, but reports suggest that Gazprom will take a majority 75 percent stake leaving Novatek with the remaining 25 percent. Novatek is already developing its own LNG project in cooperation with Total of France, with the construction of the 16.5m tonne per year Sabetta LNG plant, which is due to be launched in 2016. The capacity of the Gazprom-Novatek plant is likely to be similar, given that Gazprom CEO, Alexei Miller, announced that the new joint venture could lead to a doubling of LNG production on Yamal.

The target market for both Yamal LNG projects is likely to be Asia, in light of increasing gas demand in Asia, competition on the European gas market, and the dramatic decline in US gas imports in recent years due to increased shale gas production. The possibility of delivering LNG to Asia via the 'northern route' was demonstrated in November-December 2012, when Gazprom chartered its 'River Ob' LNG tanker from the Norwegian port of Hammerfest to the Japanese port of Tobata – the first time LNG had been delivered from Europe to Asia via the northern route in winter.

And in other developments…

Gazprom lobbies the Russian government for Shtokman tax breaks as the Kremlin considers revoking the Gazprom-Rosneft monopoly on offshore gas and oil production in Russia

According to Russia's Deputy Finance Minister, Sergei Shatalov, Gazprom has requested that Shtokman be included in the list of offshore Arctic gas projects eligible for tax breaks, in a bid to resurrect the project. The Russian government is currently considering a system of tax breaks for offshore oil and gas production, with four categories of tax breaks ranging from 5 to 30 percent, based on the difficulty of the project.

Gazprom and Rosneft currently hold a monopoly on offshore Arctic oil and gas production in Russia, which is limited to state-owned companies with at least five year's experience of offshore oil or gas production. Earlier this month Russia's Ministry of Natural Resources proposed that any offshore oil or gas fields that are not wanted by Rosneft or Gazprom be developed by private Russian companies. Deputy Prime Minister, Arkady Dvorkovich, reiterated that "Foreign companies will keep acting as technical partners but not as actual license holders". However, a resolution to the issue is not expected any time soon. According to Natural Resources Minister, Sergei Donskoi, "If all the requests [by the companies for new blocks] are granted, state-run companies will receive up to 80% of the oil and gas blocks. This would mean that all those blocks -- half of which are as big as medium-sized European countries -- would be booked by the companies for 10 years”.

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