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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's Q1 profits rise due to increased sales revenues and reduced 'retroactive payments' to European energy; Gas price negotiations between Gazprom & Lithuania continue; Russia and EU agree terms of use for OPAL; Gazprom commissions underground gas storage facility in Kaliningrad and may build Baltic LNG import and export terminals; EU prepares to charge Gazprom with abusing its dominant market position in Central and Eastern Europe; Gazprom asset-swap with BASF to be confirmed by early 2014*
- *Ukraine faces delay in beginning of gas supplies from Europe via Slovakia; Gazprom and Ukraine reach a compromise over the amount of gas needed to be kept in storage to ensure stable transit of Russian gas via Ukraine in winter 2013-14*
- *The EU leaves South Stream off its list of Projects of Common Interest*
- *Gazprom and CNPC agree major T&Cs for gas supplies to China except for price, resulting in a delay to the start of construction of a new pipeline from Russia to China*
- *Gazprom predicts losses of $16bn from planned freeze of domestic gas price increases, responds with call to freeze proposed Mineral Extraction Tax increases*

Gazprom and the EU

Gazprom Q1 profits rise 4.6 percent as exports and prices increase and retroactive payments decrease

Gazprom has announced that its first-quarter profits increased by 4.6 percent versus the same period in 2012, from 371 billion Roubles to 388 billion Roubles. Net sales beyond the former Soviet Union (FSU) rose from 386 billion Roubles to 428 billion Roubles, reflecting a slight increase in sales volumes (from 42.7 bcm to 45.4 bcm) and a slight price increase (from 11526 Roubles to 11823 Roubles per thousand cubic metres). The company was also helped by a lower than expected expenditure on 'retoractive payments' (refunds to European energy companies based on the renegotiation of gas supply contracts): This enabled Gazprom to write back 73.4 billion Roubles from 'retroactive payments' into gas sales. According to Gazprom, "Retroactive gas price adjustments were recognized in the consolidated interim condensed financial information for the three months period ended March 31, 2013 as an increase of sales in the amount of RUB 73,430 million reflecting a decrease in previously accrued liability".[1] The trend established during Q1 was extended through 2013, with Gazprom's exports beyond the FSU between January and September increasing 15 percent year-on-year.

Gas price negotiations between Gazprom and the Republic of Lithuania continue

During September, Gazprom representatives met several times with representatives of the Lithuanian government and the Lithuanian energy company, Lietuvos Dujos. The Lithuanian company is responsible for importing gas (entirely from Russia) and managing Lithuania's domestic gas pipeline network. The company is partially owned by the Lithuanian state (17.7 percent), Gazprom (37.1 percent), the German energy utility, E.On (38.9 percent), and a number of smaller shareholders (6.3 percent). As part of the implementation of the provisions of the Third Energy Package in Lithuania, the government has reallocated the operation of Lithuania's gas pipeline system to a new company, Amber Grid, with the shareholders' stakes in Lietuvos Dujos being reallocated on a pro rata basis. Although Gazprom and E.On are technically allowed to retain their shares, they are not allowed any operational control over the company. Although this has been a contentious issue between Gazprom and the Lithuanian government, it appears that Gazprom is now willing to sell its shares in Amber Grid. However, disagreements over the price at which Gazprom sells gas to Lithuania remain ongoing. The Lithuanian side complains that it is being overcharged and that Gazprom is abusing its status as the monopoly supplier of gas to Lithuania. The Lithuanian government is demanding a 'fair, European' price for its Russian gas imports. For its part, Gazprom wants the Lithuanian government to drop its arbitration suit regarding Gazprom's past 'overcharging' and the investigation into the actions of Lietuvos Dujos' board of directors and management, which include representatives of Gazprom.

While Lithuanian government representatives are hopeful of a conclusion of discussions in October, both sides are also making alternative plans: Lithuania is pushing ahead with the lease of a floating LNG

[1] For more detailed information, see Gazprom's Q1 Financial Report at: http://www.gazprom.com/press/news/2013/september/article170308/

re-gasification (import) terminal, which could be operational by 2015. For its part, Gazprom has begun exploring the possibility of constructing an LNG regasification terminal in Kaliningrad, to end its dependence on gas transit via Lithuania. This would dovetail with Gazprom's proposals for an LNG export terminal on its Baltic coast at Ust-Luga, although that terminal would not be operational before 2018-19 at the earliest.

Russia and EU agree on terms for use of OPAL pipeline

The Russian Energy Ministry has announced that a political deal has been reached on Gazprom's use of the OPAL pipeline in Germany, which had been restricted by the implementation of EU gas market legislation. According to a spokesperson from the Russian Energy ministry, "A compromise has been reached, and we expect the companies and the regulator to sign a binding deal by the end of October".

The restriction stemmed from the application of the provision of Third Party Access. In accordance with this provision, large-scale, long-distance gas pipeline operators must reserve a certain percentage of the capacity of the pipeline for 'third party' companies that are not connected to the operators of the pipeline.

The OPAL pipeline is operated by OPAL Gastransport, a subsidiary of W & G Beteiligungs-GmbH & Co. KG, which itself is a joint venture of Gazprom and BASF Wintershall. In accordance with existing provisions, OPAL Gastransport must reserve 50 percent of the capacity of OPAL for third parties. However, it seems that an exemption to these provisions has been granted on the basis that Gazprom (via Nord Stream) is the only supplier of gas to the OPAL pipeline. This is good news for Gazprom, which has seen the capacity of Nord Stream limited by the restrictions on its use of OPAL.

The 36 bcm per year capacity OPAL pipeline runs parallel to the German-Polish border from Griefswald on Germany's northern coast (where Nord Stream makes landfall) to Olbernhau on the German-Czech border. Olbernhau is one of two points (the other being Waidhaus) where Russian gas enters Germany having been delivered via Ukraine and Slovakia. OPAL is one of two pipelines (the other being the 20 bcm capacity NEL pipeline) that connect Nord Stream to Germany's natural gas pipeline network. Given that the current capacity of Nord Stream is 55 bcm, and the combined capacity of OPAL and NEL is 56 bcm, the restriction of Gazprom's use of OPAL clearly prevented the use of Nord Stream at full capacity.

Gazprom commissions underground gas storage facility in Kaliningrad, and proposes new import and export terminals in the region

Gazprom has commissioned an underground gas storage facility (UGSF) in its Baltic enclave of Kaliningrad in a bid to ensure the region's energy security. In 2012, Gazprom supplied 2.17 bcm of gas to Kaliningrad (an average of 5.95 million cubic metres per day), delivered via Lithuania. The new UGSF has two tanks with a total working capacity of 52 mcm and the ability to deliver 4.8 mcm per day. Another five tanks will be added, bringing the working capacity to 261 mcm and the daily withdrawal capacity to 12 mcm. Once completed, the system could theoretically support all of Kaliningrad's gas consumption for several weeks in the event of a supply disruption.

Gazprom's Chief Executive, Alexei Miller, also met with Kaliningrad's Regional Governor, Nikolai Tsukanov, to discuss proposals for an LNG import terminal in Kaliningrad, which could be used to deliver imported LNG to Kaliningrad and the surrounding region. The investment rationale for the project is scheduled for completion in 2014.

During September, Gazprom also announced that it was giving further consideration to the possibility of constructing an LNG export terminal on Russia's Baltic coast, at Ust-Luga. It has been reported that Gazprom is considering at 10 million tonne per year capacity for its new Baltic LNG export terminal, with a launch date of 2018-19. Sources also suggest that Gazprom would be willing to allow foreign partners up to 49 percent shareholding in the project, which is estimated to cost around $12bn.

The EU prepares to charge Gazprom with abusing its dominant market position in Central and Eastern Europe

During a visit to Vilnius, the EU Energy Commissioner, Gunther Oettinger announced that European Union would conclude its investigation into Gazprom's pricing and contract policies by spring 2014. Oettinger added, "I can't say which month or which day. But it's not a never-ending story... Our Russian partners have to understand and to accept that we have European Union rules. (It) means we are market-based, market-oriented". If found guilty of a breach of EU anti-competition rules, Gazprom could face a fine of up to 10 percent of its annual turnover, which could equate to 10 billion Euros ($15bn). The investigation covers the three Baltic states (Latvia, Lithuania, and Estonia), four Central European states (Poland, Hungary, Czech Republic and Slovakia), and Bulgaria.

At the beginning of October, the EU Competition Commissioner, Joaquin Almunia, revealed that EU antitrust investigators are preparing to charge Gazprom with abusing its dominant market position in Central and Eastern Europe by hindering the free flow of gas across Europe and charging unfairly high prices. Almunia added, "It would be premature to anticipate when the next steps would be taken in this investigation, but we have now moved to the phase of preparing a statement of objections".

Once Gazprom has received the statement of objections, it can request an oral hearing. Once the hearing has taken place, EU regulators will decide if there is sufficient evidence of breach of regulations to impose a fine. However, Gazprom could avoid taking the matter this far by reaching a settlement with the affected parties.

Gazprom and Wintershall to finalise asset-swap by end of 2013 or early 2014

In November 2012 Gazprom and Wintershall signed a binding Basic Agreement on an asset-swap: Wintershall would receive 25 percent stakes in the 4A and 5A blocks of the Yuzhno-Russkoe oil, gas, and condensate field in Russia (with the option to increase this shareholding to 50 percent). In return, Gazprom would increase its shares from 50 percent to 100 percent in the current Wintershall-Gazprom joint venture W & G Beteiligungs-GmbH & Co. KG, and its wholly-owned subsidiaries, Wingas (gas trading) and Astora GmbH & Co. (gas storage), and also receive a 50 percent stake in WINZ, which conducts oil and gas production in the

North Sea. Both Gazprom and Wintershall representatives have suggested that the deal will be signed before the end of 2013 and finalised in 2014, while Wintershall Chief Executive, Rainer Steele, noted that Gazprom officials would apply to EU antitrust regulators for approval this month, and that the subsequent timescale would depend on the response of those regulators.

Ukraine

Ukraine faces delay in beginning of gas supplies from Europe via Slovakia

The joint plan of the Ukrainian government and Ukraine's state-owned gas company, Naftogaz Ukraine, to diversify its sources of gas imports by importing gas from the European market via Slovakia has hit a delay. The EU Ambassador to Ukraine, Jan Tombinski, sought to explain the delay in terms of Slovakia's own contracts with Gazprom for gas supplies and for contracting the capacity of Slovakia's gas transit pipelines, which are currently used to delivery Russian gas from East to West, and at least one of which would have to be reversed to bring gas from the European market to Ukraine: "Slovakia won't have full clarity and the possibility of opening reverse flows to Ukraine without reaching an agreement with Gazprom, which supplies this gas".

That message was reiterated by Ukraine's Deputy Minister of Energy and Coal Industry, Andriy Bondarenko, who told a Cabinet Ministers meeting that, "Like us, the Slovak operator has a contract with Gazprom. It is still difficult to talk about the implementation of the Slovak direction without Gazprom's consent, though it is one of the most promising areas of diversification of supplies". If approved, imports via Slovakia could reach 10 bcm per year, in addition to up to 5 bcm from Poland and Hungary (an increase on the 2-2.5 bcm currently being imported from these two countries). In addition, Naftogaz has announced that it will not import more than 18 bcm from Russia next year.

Gazprom and Ukraine reach compromise on the amount of gas storage needed to ensure the reliable transit of Russian gas via Ukraine in winter 2013-14

Over the past months, Gazprom and its Ukrainian counterpart, Naftogaz, have been negotiating how much gas should be placed in Ukraine's gas storage facilities to cope with increased Ukrainian winter demand, and therefore ensure the reliable transit of Russian gas via Ukraine in winter 2013-14. Gazprom suggested 19 bcm, while Naftogaz was only prepared to stockpile 14 bcm, citing the high price it currently pays for gas imports from Russia. However, the two sides have now reached a compromise thanks to the participation of Ukraine's second-largest gas importer, Ostchem, run by Dmytro Firtash. Ostchem agreed to purchase 5 bcm of gas from Gazprom and place it into underground storage, to ensure reliable gas transit during the winter season. In an interesting development, a Gazprom spokesperson, Sergey Kuprianov, then revealed that Gazprom had sold the gas to Ostchem at a substantial discount - $260 per thousand cubic metres, in contrast to the $380-390 currently paid by Naftogaz. This discount was then confirmed by the Russian President, Vladimir Putin.

In a sense, everybody wins: Naftogaz doesn't have to buy extra gas for storage, Gazprom doesn't have to put its own gas into Ukrainian storage (and thus pay the costs of that storage), Ostchem will make a healthy profit selling the discounted gas from Gazprom after the winter heating season even after it has paid the storage fees. Furthermore, by personally associating himself with the discount, President Putin can claim that Russia is doing all it can to avoid any disruptions in the transit of Russian gas to Europe during the forthcoming winter, thus burnishing Russia's reputation as a reliable supplier of gas to Europe.

South Stream

South Stream omitted from list of EU Projects of Common Interest

The European Commission has revealed its list of Projects of Common Interest (PCI) that will reportedly "benefit from accelerated licensing procedures and could have access to the €5,85 billion budget allocated for the period 2014-2020". While Poland's LNG import terminal at Swinoujscie, the Trans-Adriatic Pipeline (TAP), the Nabucco West pipeline (a scaled-down successor to the Nabucco project), and a proposed LNG import terminal in the Baltic region were all on the list, South Stream was not.

In confirming South Stream's omission, EU Energy Commissioner, Gunther Oettinger, stated: "South Stream is an addition, but it does not give us access to any new sources of energy and it does not increase the competitiveness of the energy market in European Union.... South Stream is an idea that comes from our eastern partners. We have no problems with South Stream, but we don't think it's a particular EU priority".

The announcement has not deterred Gazprom or its partners. At a meeting of the South Stream Transport consortium Board of Directors in Paris, a detailed construction schedule was signed, reiterating the intention to commission the first offshore line of South Stream before the end of 2015.

Asia

Gazprom and CNPC agree major T&Cs for gas supplies to China except for price, resulting in a delay to the start of construction of a new pipeline from Russia to China

Amid great fanfare at the G20 summit in St Petersburg, in the presence of Russian President, Vladimir Putin, and Chinese President, Xi Jinping, the Gazprom CEO, Alexei Miller, and the Chairman of the Board of the China National Petroleum Corporation, Zhou Jiping, signed a legally binding agreement on the terms and conditions for the export of Russian gas to China. The document stipulated that gas would be delivered via a new pipeline along the 'Eastern Route' (from gas fields in Eastern Siberia to Skovorodina on the Russian-Chinese border, and then parallel to that border to Vladivostok, with multiple entry points into North-Eastern China). According to Gazprom, the agreement also stipulated "the export volume [thought to be 38 bcm] and starting date [reported to be 2018], the take-or-pay level, the period of supply buildup, the level of guaranteed payments, the gas delivery point on the border as well as other basic conditions of gas offtake. The price conditions will not be linked to the Henry Hub index".

The single most important detail not stipulated by the document was the detail that has been an obstacle to the Russian-Chinese gas trade for several years: The price at which Gazprom will sell gas to the CNPC. Whilst the exclusion of Henry Hub pricing is a step forward, China is in no hurry to commit to high gas prices, when it is expanding cooperation with Central Asian gas exporters, developing ties with Gazprom's competitor, Novatek, for the import of LNG, and examining the possibility of LNG imports from other suppliers on the global market. For Gazprom, the prize is significant: The 38 bcm contract would make China the single largest importer of Russian gas, ahead of Germany (34.0 bcm in 2012), Ukraine (32.9 bcm), Turkey (27.0 bcm in 2012), and Belarus (19.7 bcm). In total, Gazprom exported 203.2 bcm in 2012.

Following the signing of the agreement, Alexei Miller noted that "The fact that the major terms and conditions were signed during the G20 summit indicates the parties' aspiration to successfully end the negotiations and sign the contract before the end of 2013". However, the failure to conclude a definitive agreement has led Gazprom to announce a delay in the start of construction of its East Siberia – Skovorodina – Vladivostok pipeline, named 'Power of Siberia', from November 2013 to Q1 2014, in anticipation of wrapping up a contract with CNPC before the end of the year. Yet given the history of gas price wrangling between the two sides, even the promise of concluding a contract by the end of 2013 cannot be guaranteed.

And in other developments…

Gazprom predicts losses of $16bn from planned freeze of domestic gas price increases, responds with call to freeze proposed Mineral Extraction Tax increases

Russian sources report that the Russian government is considering freezing tariffs set by state monopolies in 2014, and allowing only increases in line with inflation in 2015 and 2016. For Gazprom, this essentially means freezing domestic regulated gas prices, which had been increasing on average by 15 percent per year. In response, Gazprom claimed that it stood to lose up to $16bn over the next three years, which would result in Gazprom's investment programme to be scaled back by $12.6bn over the three year period. Gazprom also claimed that it would respond to tariff freezes with a call to revoke the planned increases in Mineral Extraction Tax (MET) on natural gas production. MET on gas production is currently 582 Roubles per thousand cubic metres, and is set to rise to 622 Roubles in 2014, and to 788 Roubles in 2015.

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