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The European Geopolitical Forum

EGF Gazprom Monitor

Issue 22: March 2013

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:

- *Lietuvos Dujos confirms its decision to spin off its gas transport business by the 31st of July 2013, with Gazprom and E.On expected to sell their stakes in the Lithuanian gas utility by October 2014; Gazprom agrees a deal with the Czech-based MND Group to construct a new underground gas storage facility in the Czech Republic by 2016; Gazprom signs a long-term gas supply contract with Serbia; Gazprom denies reports that it has offered to fund the restructuring of Cypriot banks in exchange for gas exploration rights in Cyprus' exclusive economic zone*
- *Gazprom is unlikely to offer significant gas price cuts to Ukraine, as the company dismisses Ukrainian plans to import more gas from other European sources; The European Commission supports the idea of a trilateral consortium including Naftogaz, Gazprom, and European energy companies to manage Ukraine's gas transport system*
- *Nord Stream has operated at just 27 percent of its capacity since the launch of the second string in October 2012*
- *Gazprom is reportedly considering constructing a spur of South Stream to Greece, but stands by its decision to remove the Greece-Italy connection from the project. The fate of South Stream's spur to Greece may well be decided by the outcome of the privatisation of Greece's national gas utility, DEPA, in which Gazprom is considering bidding for a stake*
- *Gazprom and the China National Petroleum Corporation (CNPC) sign a Memorandum of Understanding on gas supplies via the Eastern route, and hope to sign a gas supply contract by the end of 2013*
- *Russia's Energy Ministry supports proposals for the export of LNG by Novatek and Rosneft to the Asia-Pacific region, but insists that Gazprom retains its monopoly on gas exports to Europe; Gazprom to complete its purchase of Kyrgyzstan's national gas system by the end of March.*

Gazprom and the EU

Lietuvos Dujos confirms its decision to spin off its gas transport business by the 31st of July 2013, with Gazprom and E.On expected to sell their stakes in the Lithuanian gas utility by October 2014; Gazprom agrees a deal with the Czech-based MND Group to construct a new underground gas storage facility in the Czech Republic by 2016; Gazprom signs a long-term gas supply contract with Srbijagas of Serbia; Gazprom Marketing and Trading Ltd signs a 20-year deal to market LNG from Israel's offshore Tamar gas field; Gazprom denies reports that it has offered to restructure Cypriot banks in exchange for gas exploration rights in Cyprus' exclusive economic zone.

Lithuanian gas utility Lietuvos Dujos has confirmed its plans to spin off its gas transport business by the 31st July 2013. The new operator of Lithuania's gas grid, Amber Grid, will take 57.4 percent of Lietuvos Dujos' assets. Gazprom currently holds a 37 percent stake in Lietuvos Dujos, along with E.On (39 percent), and the Lithuanian state (18 percent), with the remaining 6 percent being held by minor shareholders. Under the terms of the Third Gas Directive, which prevents companies that produce gas or sell gas to final consumers from exercising majority control over gas transport infrastructure, Gazprom and E.On are expected to sell their stakes in Lietuvos Dujos by October 2014. Joachim Hockertz, Deputy Chief Executive of Lietuvos Dujos recently told journalists, "They must sell. Otherwise the main shareholders will lose all the management rights (in Lietuvos Dujos itself), and the minority shareholder, which is the government, will take all the rights. That, of course, is an unacceptable situation for the strategic shareholders, E.ON Ruhrgas and Gazprom, which together hold 76 percent and might have no say whatsoever".

In a bid to expand their gas storage capacity in Europe, and improve their flexibility in gas supplies to final consumers, Gazprom has agreed with MND Group to construct a new underground gas storage (UGS) facility in Damborice, in the Czech Republic. The facility is planned to have a capacity of 448 million cubic metres, with construction scheduled to begin in 2014 and the launch of the facility expected in 2016. The joint venture, to which each of the partners will contribute an equal investment, will cost $128m.

Gazprom CEO, Alexei Miller, has announced that Gazprom has signed a new long-term gas supply contract with Srbijagas of Serbia for the supply of 1.5 bcm per year until 2021, rising to 3.9 bcm per year following the planned launch of the first line of South Stream in 2016. South Stream supplies delivered via Bulgaria would represent a diversification of Serbia's gas imports, which are currently delivered only via a single route through Ukraine and Hungary. The new contract reportedly gives Serbia a 13 percent discount on its Russian gas imports in relation to the current import price, resulting in a new price of $370 per thousand cubic metres. Miller also suggested that Gazprom was willing to invest in gas-fired power plants in Serbia, with discounted gas supplies enabling those power plants to offer electricity supplies at competitive prices. Such investment would be beneficial from a Gazprom perspective, as it would ensure sustained demand for Russian gas in Serbia.

Gazprom Marketing and Trading Ltd has signed a 20-year deal with Levant LNG Marketing Group to market liquefied natural gas produced at Israel's offshore Tamar gas field. The Tamar gas field reportedly contains 238 bcm of natural gas reserves, while the Tamar LNG project, which would involve the world's third floating LNG terminal, is expected to be commissioned in 2017.

Gazprom representatives have denied reports by Cyprus' Sigma TV that the company has offered to fund the restructuring of the country's banks in exchange for gas exploration rights in Cyprus' exclusive economic zone.

Ukraine

Gazprom is unlikely to offer significant gas price cuts to Ukraine, as the company dismisses Ukrainian plans to import more gas from other European sources; The European Commission supports the idea of a trilateral consortium including Naftogaz, Gazprom, and European energy companies to manage Ukraine's gas transport system.

Despite the ongoing disagreement between Gazprom and Naftogaz over the price of Russian gas supplies to Ukraine, reports suggest that Gazprom is unlikely to offer Naftogaz a price discount in the near future. This is due to the high spot prices for gas in Europe, which are being caused by the unseasonably cold weather. According to Gazprom CEO, Alexei Miller, "The price for Russian gas, which is being supplied to Ukraine, is significantly lower than the spot price, which has settled in continental Europe". However, spot prices in Europe are currently extremely volatile. For example, spot prices in the UK reached $630 per thousand cubic metres) on Friday 22nd of March, but had fallen to around $420 by Monday 25th of March. For comparison, Gazprom currently sells gas to Naftogaz at a price of $406. Therefore, Miller's claim that "Ukraine will not be able to bear spot prices" is based on the peaks of currently volatile prices, rather than the current quarterly or yearly average.

According to the international ratings agency, Fitch, the price of Gazprom's exports to Ukraine, which are index-lined to international oil prices, are set to rise to $426 in Q2 2013, while Naftogaz wants to reduce that price to $250-280 – a 35 percent discount on current prices. The issue remains an important one for Gazprom, as Naftogaz is one of Gazprom's largest export customers, having purchased 25 bcm of gas in 2012 with plans to reduce this to 20 bcm in 2013. The Ukrainian government is desperate to achieve a discount on its Russian gas supplies, with the Ukrainian President, Viktor Yanukovych, recently claiming that "it (the contract) is killing us". However, Naftogaz's negotiating position remains weakened by the lack of alternative gas supplies, with the company currently negotiating for the import of 7-8 bcm of gas from Germany via Hungary and Slovakia – a volume equal to just one third of its current imports from Russia.

On the related issue of the management of Ukraine's gas transport system (GTS), the European Commission has announced that it would support the formation of a trilateral consortium consisting of Naftogaz (the current operator), Russia (Gazprom), and European energy companies. In an interview with Kommersant-Ukraine published on the 4th of March, the EU Energy Commissioner, Gunther Oettinger, noted; "It's your government's right to decide who should own the gas transportation system and who will run it. If Kiev decides Gazprom should have that right, why not? Gazprom is involved in other pipeline projects, some of them in EU territory".

While a significant renegotiation of the price paid by Ukraine for its Russian gas imports and the management of Ukraine's GTS should not be expected in the near future, any future gas price discount is likely to be connected to Russia's desire for Ukraine to join its Customs Union with Belarus and Kazakhstan. Ukraine's accession to the Customs Union has, thus far, been rejected by the Ukrainian government in favour of proposed integration with the EU. Meanwhile, the $7bn fine issued to Naftogaz by Gazprom for failing to import the volumes of gas stipulated by the 'take or pay' clauses in the current Naftogaz-Gazprom contract could yet act as a stimulant to a new round of negotiations between Gazprom and Naftogaz or, in the worst case scenario, a renewed gas dispute between the two parties.

Nord Stream

Nord Stream has operated at just 27 percent of its total capacity since the launch of the second string of the pipeline in October 2012.

According to recently-released data, the Nord Stream gas pipeline has operated at just 27 percent of its 55 bcm per year capacity since the launch of the second string of the pipeline in October 2012, meaning that just 6.25 bcm has been delivered via Nord Stream in the past five months.

One reason for the under-utilisation of Nord Stream is the delay in the NEL pipeline, which connects Nord Stream to north-western Europe, reaching its full capacity. NEL should have been fully operational by October 2011, but is currently operating at 20 percent capacity (4 bcm per year) and is not expected to be fully operational until the second half of 2013. However, the main reasons for the under-utilisation of Nord Stream appear to be the failure to redirect gas flows for long-term contract supplies from Ukraine to Nord Stream, and a lack of demand for additional supplies of Russian gas on the European spot market, despite Gazprom's predictions that Nord Stream would provide new and additional gas supplies to that market over and above current long-term contract-based supplies.

South Stream

Gazprom is reportedly considering constructing a spur of South Stream to Greece, but stands by its decision to remove the Greece-Italy connection from the project.

Following a visit by a Gazprom delegation to Athens this month, Gazprom CEO, Alexei Miller, announced that Gazprom still intends to construct a southern spur of South Stream to Greece. The President of Gazprom Marketing and Trading in France, Iouri Virobian, commented at the Athens Energy Forum 2013 that "The main pipeline is going to (northern) Italy and from this pipeline we can take a branch - like we will do for Bosnia-Herzegovina and Croatia - to build a branch to Greece in order to deliver the necessary volumes. But it is under consideration. It will depend on the development of Greece's market".

One particular aspect of the Greek gas market that will significantly influence any decision on extending South Stream to Greece is the privatisation of Greece's national gas utility (DEPA) and grid operator (DEFSA), with Gazprom strongly interested in acquiring a stake in DEPA. The deadline for the submission of final bidding offers is the 29th of April. If Gazprom were to acquire a significant shareholding in DEPA, this would act as an incentive for Gazprom to extend South Stream to Greece.

Asia

Gazprom and the China National Petroleum Corporation (CNPC) sign a Memorandum of Understanding on gas supplies via the Eastern route and hope to sign a gas supply contract by the end of 2013

Following the second meeting between representatives of Gazprom and the China National Petroleum Corporation (CNPC) in the space of two weeks (the first in Beijing and the second in Moscow), Gazprom representatives announced that the company has signed a Memorandum of Understanding with the CNPC on the delivery of gas supplies to China via the 'Eastern Route' from Russia's Far East to Eastern China. According to the Gazprom CEO, Alexei Miller, "The signed document is of long-term strategic nature. It determines the parameters of Russian natural gas supplies to China via the eastern route and establishes the framework for a 30-year contract for gas supplies from Russia to China". The partners also announced their intention to sign a gas supply contract before the end of 2013. However, given that the price at which Gazprom will sell gas to the CNPC has been the main stumbling block in the long-running negotiations between the two parties, the signing of a contract before the end of the year cannot be guaranteed.

The decision to push forward with the Eastern Route reflects Gazprom's decision to press ahead with new gas production in Eastern Siberia and to link that gas production with Russia's Far East for LNG export from Vladivostok and potential pipeline export to China via the proposed 'Power of Siberia' gas pipeline. From the Chinese perspective, the eastern route is preferable on the grounds that the north-east of China is a more industrially-developed region with greater gas demand than western China, which could have been the destination of Russian gas exports to China via Russia's Altai region – the so-called 'Western Route'.

If Gazprom does conclude an agreement with the CNPC to export pipeline gas via the Eastern Route, this, along with the proposed LNG exports from Vladivostok, will cement the separation of Russia's gas production and export into two distinct centres: Gas production in the Yamal region for pipeline export to Europe via Nord Stream, South Stream, Ukraine, and Belarus, and gas production in Eastern Siberia for export by pipeline and LNG tankers to the Asia-Pacific region.

And in other developments…

Russia's Energy Ministry announces its support for the export of LNG by Novatek and Rosneft to the Asia-Pacific region, but insists that Gazprom retains its monopoly on gas exports to Europe; Gazprom to complete its purchase of Kyrgyzstan's national gas system by the end of March.

In a significant announcement, Russia's Energy Minister, Alexander Novak, has offered his support to proposals that state-owned oil company, Rosneft, and independent gas producer, Novatek, will be allowed to export LNG from Russia. However, these exports will not be directed to Europe, where Gazprom is expected to retain its export monopoly. The announcement comes two months after Prime Minister, Dmitrii Medvedev, suggested at the World Economic Forum that Gazprom's export monopoly was under review. According to Novak, a formal government decision on the status of Russia's LNG exports could be made by 'the middle of this year'.

Novatek is currently constructing an LNG export terminal, Sabetta, in north-western Russia as part of its Yamal LNG project, in which the French Total holds a 20 percent stake. The launch of the Sabetta plant, scheduled for 2016, will boost Russia's LNG exports from 11 million tonnes to 27.5 million tonnes.

While Gazprom holds a 10 percent stake in Novatek, and agreed to cooperate with Novatek in LNG production in Russia's Arctic region in January 2013, the potential entry of Rosneft into LNG exports illustrates the increasing challenge posed by Rosneft to Gazprom's dominant position in Russia's gas industry. Russian sources report that the support from government ministers for proposals to allow Novatek and Rosneft to export LNG represents a change in attitude by the Russian government: while the announcement does not amount to the encouragement of competition in Russia's gas sector, the decision not to prevent the development of competition reflects a distinct shift in Russian state policy and a challenge to Gazprom's gas export monopoly, which has been in place since 2006.

According to an announcement by Kyrgyzstan's Prime Minister, Gazprom is set to complete its purchase of Kyrgyzgaz, Kyrgyzstan's national gas utility, by the end of March, thus cementing Gazprom's presence in Central Asia – a region of increasing Chinese influence

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EGF Gazprom Monitor
Published by European Geopolitical Forum SPRL

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