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EGF Gazprom Monitor
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A Snapshot of Key Developments in the External Relations of the Russian Gas Sector [1]

Key points:

- *According to Gazprom's estimates, in 2011 revenues from gas exports to Europe of 158 billion cubic metres (bcm) will reach about $60 bn.*
- *Within the framework of the launch of the giant Shtokman field, Gazprom may soon sign LNG export contracts with Indian companies. The total amount of natural gas to be purchased as per these contracts is about 7.5 million tonnes per year.*
- *Independent Russian natural gas producer, Novatek, is planning to build a 15 million tonnes/year LNG plant on the Yamal Peninsula by 2016.*
- *Gazprom failed to close a deal to purchase a 30 percent share in the Central European Gas Hub Gmbh (CEGH). The conditions on which the deal could have been concluded were unacceptable to the Russian gas holding. However, this asset remains very attractive for Gazprom and we may therefore witness another such attempt by the Russian gas giant in the future.*
- *The Economic Parliamentary Committee of Lithuania has postponed its decision on the re-organisation of Lietuvos Dujos until July 1, 2013. This decision seems to be favorable for Gazprom and its German partner, E.ON Ruhrgas, as it leads to preserving the dependence of Lithuania on Russian gas imports.*
- *Gazprom's refusal to review gas prices is compelling Kiev to search for alternative sources of gas. Naftogaz Ukraine is planning to conclude a deal with Norway's Statoil and concentrate on increasing gas production in Ukraine.*
- *Moscow and Beijing failed to sign a contract for the export of Russian gas to China via the Altai gas pipeline during Chinese President Hu Jintao's recent visit to Russia.*
- *The Russian Ministry of Finance has decided on an"almost final" formula to increase taxation on mineral resource production in the country, which will primarily affect Gazprom. In 2012, the tax on the production of 1,000 cubic metres of gas will be RUR 480[2], in 2013 it will be RUR 600 and in 2014 RUR 635.*

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[1] The EGF Gazprom Monitor is completely based on Russian sources and is translated into English by Jack Sharples, PhD candidate at the University of Glasgow, Scotland, and EGF Researcher on Russian external energy policy

[2] 1 EURO = 41.5 RUR (Russian Roubles). $US1 = 29 RUR (Russian Roubles)

Gazprom raises estimates for 2011 export revenues

This year, Gazprom is likely to report an income of about $60 billion from the export of 158 bcm of gas to Europe, according to expert estimates. This represents a 12 percent growth in income compared to the previous year and, according to Alexander Medvedev, Deputy Chairman of Gazprom's Board of Executive Directors, the company's profits will be close to the record-breaking levels of 2008, when its income from exports reached $65 bn.

It is expected that Gazprom's most profitable periods of the year will be the first and the fourth quarters. During the first five months of 2011, Gazprom reported $36.6 billion in revenue. The average price for exported gas is presently $400 per thousand cubic metres, but Alexey Miller, Deputy Chairman of the Board of Directors and Chairman of the Management Committee of Gazprom, estimates that by the end of the year, the price will rise to $500 per thousand cubic metres. In that case, the total revenue of the company during 2011 could be substantially higher.

The basis for this estimate takes into account the increase in the oil price, as well as the current increase in spot prices for gas in Europe. Before March 2011, the market was over-supplied, which is explained mostly by the increase of gas production in the US. The levelling out of gas prices between long-term agreements and spot contracts was expected not earlier than in 2015. Due to a number of factors, however, including the Japanese earthquake, civil war in Libya, and interruptions in gas supplies from Nigeria and Algeria, it may still be some time before prices begin to level out. Experts suggest that if leveling out of prices for gas in the long-term period and spot contracts does take place, Gazprom may return to the position it had on the market before the 2008 crisis.

These developments have helped Gazprom to maintain a strong position in negotiations with gas consumers on the possibility of reconsideration of the rates in the contracts, provision of discounts and the linking of gas prices with spot contracts. In 2009 alone, Gazprom received $3.4 billion for so-called "make-up gas" on the basis of "take-or-pay" contracts. Virtual export to Europe in 2009 reached 4.1 bcm and the company earned $1.2 billion, while in 2010 the amount of "make-up gas" was 7.2 bcm.

The new rules on gas supply contracts currently being developed by the European Union (EU), according to which wholesale companies sign contracts with their clients for one-to-two year periods, may also yet work out as a development favourable to Gazprom. The EU contracts will be based on the same "take-or-pay" principle which is used by Gazprom as the basis for its contracts at the moment. At the peak of the economic crisis, buyers drastically reduced the amounts which they purchased from wholesale traders, meaning that traders had to sell the excess gas at low prices, which in turn caused a collapse of spot gas prices. As a result, traders contracted lower amounts of gas in subsequent contracts. Simultaneously, spot prices went up and that led to an increase in Gazprom's overall exports. During the first five months of 2011, therefore, the company's exports have gone up by 17 percent.

Natural gas from Shtokman may be sold to India

Gazprom has prepared contracts for trading LNG with Indian companies in the framework of the Shtokman field launch. Petronet LNG, the main importer of LNG to India, recently announced its plan to purchase 2.5 million tonnes of LNG yearly for the next 25 years. Similar statements were subsequently made by two other Indian companies, GSPC and GAIL, expressing interest in purchasing the same amount of LNG yearly. Experts estimate that the total amount of LNG to be purchased in the Indian market may thus reach 7.5 million tonnes yearly. If current prices are anything to go by, it could be suggested that Gazprom could earn $100 billion in revenue over the next 25 years. Furthermore, these developments would enable 100 percent utilization of the production capacity of the LNG plant at the Shtokman field.

An agreement on prices and conditions governing deliveries is expected to take place during the coming months – developments which we will be monitoring closely. Deliveries may begin as early as 2016-2018, following the launch of enhanced production capacity from the Yamal LNG plant and the increase of production capacity from Sakhalin-II on Russia's Pacific coast.

Russian sources report that Gazprom began exporting small volumes of LNG to India in 2005, with noticeable volumes (of 2.5 million tonnes) of LNG supplied during 2005-09 on the basis of spot contracts. The resource base for these deliveries has been the Yamal LNG plant, with its 7.5 million tonnes (of LNG) per year production capacity. These factors will bear influence on the implementation of the Shtokman project, which has previously suffered from chronic delays.

Another factor bearing on the commencement of the Shtokman project might lie in the progress made by Novatek, the independent Russian natural gas producer, in constructing a 15 million tonnes/year LNG plant on the Yamal Peninsula. The project is planned to be launched in

2016. Novatek controls 51 percent of the planned project, while the rest of the shares are owned by Gennady Timchenko and Petr Kolbin, two entrepreneurs who have the option of purchasing Novatek shares. India's ONGC, Petronet and GAIL have all likewise expressed interest in purchasing a 15 percent stake in order to participate in the project.

Gazprom fails to conclude deal with OMV

Gazprom has failed to conclude a deal to purchase a 30 percent stake in the Central European Gas Hub GmbH (CEGH). Negotiations were held with Austrian energy company OMV, which owned 100 percent of CEGH at that time. According to the terms of the proposed deal, OMV was to retain a 30 percent stake, 30 percent would have gone to Gazprom, and two 20 percent stakes would have been sold to the gas traders Centrex (controlled by Gazprom) and Wiener Boerse, respectively.

Gazprom had been planning to make the CEGH the biggest gas trading hub in Central Europe. However, it seems that the European Commission was concerned that the hub might lead to the monopolisation of gas supply channels to Europe and dictate prices to consumers. The purchase would have also given Gazprom the chance to enter the gas market in Western Europe and to control the storage of gas in Austria's Baumgarten facility. In the end, Gazprom was offered conditions to which it could not agree and the deal was cancelled.

Russian gas currently accounts for at least 30 percent of the gas traded at the CEGH, although the actual figures are difficult to estimate given that Russian gas is also re-sold by other independent traders. One of Gazprom's aims was to eliminate such independent traders and trade gas directly at the platform, linking the exchange trading with actual gas sales.

The potential increase in the trade volumes of the Russian gas and the rise in Gazprom's supplies to Europe (therefore raising the level of European consumer dependence on Gazprom) proved to be sufficient reasons for the European Commission to block the deal, although this was not officially confirmed in Brussels.

However, the CEGH remains a very important potential asset for Gazprom, and it is most likely that the gas holding will renew its efforts to persuade the European Commission to change its mind. Gazprom might be able to count on support from its Austrian partners, who are also interested in the creation of such a large natural gas trading platform.

Decision on Lithuanian gas pipelines postponed until 2013

We have already discussed in some detail Gazprom's potential loss of influence over the Lithuanian gas pipeline network in previous issues of Gazprom Monitor. With respect to our current issue, mention should be made of the fact that the Economic Parliamentary Committee of Lithuania has proposed to postpone the re-organisation of Lietuvos Dujos, the country's pipeline operator, until June 2013.

The political decision to restructure Lithuania's pipelines is strongly linked to the diversification of sources of imported gas coming into the country. The emerging legislation in the European Commission's Third Energy Package, to which Vilnius referred during the dispute with Gazprom, does not make exceptions for countries which receive gas from a single source. Vilnius will be able to begin diversifying supplies only from 2014, at the earliest. The Lithuanian side plans to construct a 3 bcm LNG terminal by 2014 and start purchasing gas from American Cheniere Energy, Inc., with which Vilnius has signed a Memorandum of Understanding. While it is understandable that Vilnius seeks greater energy independence from Moscow, experts doubt as to whether a large scale LNG terminal could be constructed in the 3 years suggested above, bringing into question the timeframe proposed for the project.

In the middle of June, Gazprom, acting upon earlier suggestions, filed a case in the Stockholm Tribunal with a request to forbid Lithuanian courts from examining the cases concerning an investigation into the activities of Lietuvos Dujos. These tactics yielded results, and after two weeks, the Economic Parliamentary Committee of Lithuania postponed the final decision on reorganization of Lietuvos Dujos until July 1, 2013.

This decision might be interpreted as being favourable to Gazprom and E.ON Ruhrgas. Over the next two-three years, Lithuania will continue to remain highly dependent on Russian gas. Moreover, the proposed LNG terminal construction has yet to begin, while the development of nuclear energy projects seems doubtful in light of the latest events in Japan (Fukushima) and subsequent reactions of European countries.

Gazprom's refusal to review gas prices compelling Ukraine to diversify energy policy

At the beginning of June, Gazprom's Alexey Miller gave the company's final response to the issue of changing the *pricing formula for gas sold to Ukraine: The price will remain linked to the oil price and will not be linked to that of coal, as proposed by Kiev.*

Earlier, at the beginning of May, the Ukrainian government had sent a proposal to Gazprom to change the pricing formula, suggesting that gas prices should be linked to the price of coal rather than to that of oil. The proposal also suggested fixing the discounts connected with purchase volumes and seasons. Currently, Ukraine buys gas from the Russian gas holding for an average of $295 per thousand cubic metres. If the formula is changed and linked with coal, the price would drop to around $200 per thousand cubic metres.

According to Miller's forecasts (referred to earlier in this text), the long-term contract price for gas sold to Ukraine could reach $500 per thousand cubic metres by the end of the year. The price dynamics for the gas sold by Gazprom to Ukraine during 2011 are as follows: Q1:$265 per thousand cubic metres; Q2:$295; Q3:$365 and Q4:$420-$500. Such forecasts are obviously a cause for concern for the Ukrainian government.

Kiev has subsequently announced a number of steps alluding towards its intention of reducing its dependence on Gazprom. To begin with, Naftogaz plans to conclude an agreement with Norway's Statoil and to double the amount of gas production in Ukraine in order to satisfy up to three-quarters of its own gas demand.

Ukraine currently produces around 18 bcm/year of gas domestically and purchases 35-40 bcm from Gazprom each year. Domestic consumption in 2010 was 55 bcm (75 bcm in 2007 by comparison.) Exports to Ukraine account for around 17 percent of Gazprom's export volumes. Should Ukraine double its own production, Gazprom would lose a market equivalent to about 10 percent of its export volumes.

However, there is next to no information about the Ukrainian natural gas fields which would be used for production in cooperation with Statoil, nor is there any information concerning the amount of planned investments in these projects.

Nord Stream and South Stream pipelines heap pressure on Ukraine

Another matter of concern for Kiev is the commissioning of the South Stream pipeline. Marcel Kramer, CEO of South Stream, recently announced that nearly two thirds of the pipeline's capacity would be accounted for by gas that is currently delivered via Ukraine (equating to around 40 bcm of natural gas). The relevant parties are currently re-signing contracts, whereby a part of deliveries will be transferred from the Ukrainian gas transit system to South Stream. Over the next seven years, Ukraine stands to lose almost half of the transit income it receives from Gazprom.

Until recently, Gazprom management tried to reassure their Ukrainian colleagues that the commissioning of the Nord Stream and South Stream pipelines would not lead to a considerable reduction in gas delivered through Ukraine. However, Gazprom's Alexey Miller declared in May that Nord Stream will operate at full capacity shortly and that approximately 20 bcm of gas would be transferred from the Ukrainian route, meaning that from 2012, Kiev will lose approximately 20 percent of its transit volumes. The commissioning of the second line of Nord Stream will result in an additional reduction, and in 2013, Kiev could suffer further losses of transit revenues equating to $1 bn. South Stream CEO Kramer recently added that in the period 2015-18, when South Stream comes on-stream and reaches its full capacity, the transit of gas through Ukraine could be halved in volume.

China: no breakthrough in the East

In the course of his visit to Russia in June 2011, the President of China, Hu Jintao, met with Russian President Dmitry Medvedev in the Kremlin. However, Moscow and Beijing failed to sign a contract for gas supply to China via the Altai gas pipeline.

Negotiations over the construction of the Altai gas pipeline (with a proposed capacity of 30 bcm annually) and the Eastern gas pipeline (with the designed capacity of 38 bcm annually) were described in the memorandum signed by Gazprom and Chinese National Petroleum Corporation (CNPC) in March 2006. In September last year, Gazprom and CNPC signed an agreement during the visit of President Medvedev to Beijing. The document called for an expanded gas delivery via the Altai pipeline. The agreement also stated that a contract would be signed in the middle of 2011.

Due to a disagreement over gas prices, however, negotiations came to a standstill. Gazprom believes that the price of gas exported to China should be equal to the price paid by its European customers – a minimum of $352 per thousand cubic metres. At the same time, China wants to fix the price at $200 – the price at which Beijing is reportedly buying gas from Central Asia.

However, experts suggest that Gazprom is unlikely to sell gas at what may amount to be below the cost of production, and it certainly does not wish to set a precedent which could lead to European customers demanding similar prices. Suffice it to mention that in the past few months some European energy companies -- Italian ENI, the German E.ON and the French GdF -- have directed such inquiries to Gazprom.

China, for its part, does not see any benefit in buying overpriced Russian gas when it has access to the natural resources of Central Asia. The day before the Moscow negotiations, Kairgeldy Kabyldin, the president of Rfzmunaigaz, announced that Hu Jintao had agreed to the construction of a third Kazakh line of the Turkmenistan-Uzbekistan-Kazakhstan-China pipeline, whilst the Chinese president was on a visit to Kazakhstan. The additional capacity would be 25 bcm annually, and construction of the pipeline would be completed by 2013. Furthermore, gas from Russia can be used only in the north-eastern regions of China, where the local gas price is around $230 for one thousand cubic meters. Prices are higher in the more economically developed south of the country, but for Russian gas to reach these regions more pipelines would have to be built across China – a project which would not make economic sense under current price regimes.

This means that a price of $200 per thousand cubic metres is also critical for China. It will accept Gazprom's proposals if gas demand passes a critical level, and natural gas from Central Asia is not sufficient to satisfy this demand.

Rise in mineral production taxes will affect Gazprom

The Russian Ministry of Finance seems to have reached an "almost final" formula for mineral production taxes which will apply primarily to Gazprom. Thus in 2012 the tax rate on a thousand cubic metres of gas will be RUR 480, in 2013 it will be RUR 600, and in 2014 RUR 635.

The tax rate increases in 2012 will not be as high as some expected and the total sum of tax funds that the Ministry of Finance will collect is expected to remain the same – RUR 505 billion in three years. While there may yet be a decrease in the planned tax rate for 2012, the tax increase on mineral production in 2013-2014 will be even more than previously supposed. According to this formula, the additional tax payments by Gazprom will amount to RUR 150 billion in 2012, RUR 170 billion in 2013, and RUR 185billion in 2014.

However, the government is currently discussing a reduction in the tax rate payable by sectoral monopolies, such as Gazprom, in 2012, which will take into account the rate of inflation. Gazprom might benefit along with other state monopolies. This may provide the company with better prospects for financing its projected investment program.

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