www.gpf-europe.com

The European Geopolitical Forum

EGF Gazprom Monitor

Issue 9: October 2011

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

Key points:

- *In a somewhat surprising development for Gazprom, Turkish state-owned gas pipeline operator, Botaş, has declined to extend its contract for 6 billion cubic metres (bcm) of gas per year. The move is seen by some as an attempt by Ankara to obtain gas price discounts.*
- *The Polish state-owned energy company, PGNiG, has joined its European counterparts in pressing for lower gas prices from Gazprom. Warsaw wants to change the gas price formula and tie it to spot gas market prices.*
- *Another recent, unpleasant surprise for Gazprom was the launch of an investigation into its European partners carried out by the European Commission (EC). Officially, the EC investigation concerns the potential violation of antimonopoly legislation, although some commentators see the investigation as an attempt to strengthen the position of European consumers in their negotiations with the Russian gas giant.*
- *Belarus has agreed terms with Gazprom for the sale of the remaining 50 percent stake in Beltransgaz. In return, Belarus President, Alexander Lukashenko, is demanding guarantees of transit through the Belarusian pipeline network and a reduction in gas import prices to the level of internal Russian prices.*
- *Ukraine President, Viktor Yanukovich's attempt to destroy his political rival, Yulia Timoshenko, is playing into Gazprom's hands. As Brussels toughens its stance towards Kiev, Ukraine is forced to be more amenable in its negotiations with Russia, especially those over the future of Ukraine's Gas Transit System (GTS)*
- *Prime Minister Vladimir Putin's visit to China failed to produce a breakthrough in negotiations over the Altai gas pipeline and potential Russian gas deliveries to China. The price of gas exports via the Altai pipeline remains the main stumbling block, as Gazprom is currently seeking other ways of exporting gas to China, namely via the Sakhalin-Khabarovsk-Vladivostok pipeline.*

[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

Gazprom samples Turkish Delight

The month of September ended with the unexpected announcement that the Turkish state-owned gas pipeline concern, Botaş, would not be renewing its 6bcm per annum contract with Gazprom, citing a rapid increase in gas prices and a refusal by Gazprom to grant discounts to the Turkish side.

The news is a major blow to Gazprom, considering that Turkey is one of Gazprom's largest customers, with contracted delivery volumes of around 30bcm per annum. Ankara is also one of Gazprom's oldest clients, with the Botaş contract dating back to 1986. It is this contract which expires in 2012, and its non-renewal could mean a drop of 6bcm in Turkish purchases of Russian gas. In reality, Turkish purchases of Russian gas have long been below contracted volumes, amounting to 18bcm in 2010, including approximately 8bcm via the Blue Stream pipeline and 10bcm via the Trans-Balkan pipeline.

The Turkish Minister for Energy and Natural Resources, Taner Yildiz, estimates that over the last 30 months Gazprom has raised its gas prices by 39 percent. Mr Yildiz also announced that only a reduction in gas prices could persuade Botaş to renew its contract. The announcement follows the precedents set last year, when Gazprom granted discounts to a number of its European customers.

However, Turkey is in no position to completely abandon gas supplies from Russia, given that Gazprom supplies over 40 percent of the country's gas needs. It has been suggested that supplies from Azerbaijan and Iran could compensate for the reduction in Russian supplies, but all Azeri production from the Shah Deniz field are contracted for the next ten years, and supplies from Iran are considered unstable.

Gazprom has already begun its search for a way out of the situation, by opening negotiations with a number of independent players on the Turkish market, including its own subsidiaries. Potential buyers include Shell Energy AS, Bosphorus Gas AS, Enerco Enerji AS, and Avrasya Gaz AS. However, the final result will depend on the prices offered by Gazprom.

It has been suggested that Ankara's decision to reduce its purchases of Russian gas is actually designed to put pressure on Moscow, as Turkey joins the pan-European quest for Russian gas price discounts. Turkey has a greater chance of achieving these discounts than its European counterparts, given Turkey's relatively stronger bargaining position: Russia needs Turkish permission for the laying of the South Stream and Samsun-Ceyhan gas and oil pipelines and for the construction of the Akkuyu nuclear power plant, the tender which was won by the Russian nuclear energy concern, ROSATOM.

Europe demands gas price discounts

The queue of those hoping for gas discounts from Gazprom continues to grow: Following in the footsteps of Italy, Germany, Lithuania and Turkey, Poland has now come forward with demands for discounts from Gazprom.

In October 2010 Polish state-owned PGNiG signed an agreement with Gazprom to increase Polish gas purchases from 9.7bcm in 2010 to 10.5bcm in 2011, and 11bcm per annum from 2012 to 2022. However, following the fall in spot-market prices and the granting of discounts to regional neighbours Estonia and Latvia, in March 2011 the Polish side began to press for a 10 percent gas price discount. If Gazprom agrees to this discount, the Polish side could save $300million per annum.

The Gazprom-PGNiG contract provides for arbitration in Stockholm if a price dispute is not resolved within 6 months, and the Polish side has threatened to activate this clause if the dispute was not resolved by the end of October. That deadline has now passed, and we now await an announcement on the beginning of proceedings. As a precursor, on the 3rd November the Warsaw Business Journal claimed that Poland has begun to buy Russian gas from Germany, at a price 15% lower than deliveries direct from Russia.

Poland relies on Russia for approximately two-thirds of its gas consumption, but aims to reduce this dependency by developing domestic shale gas production. In late September Poland began technical production of shale gas at the Lubocino-1 well at the Wejherowo gas field. The preparations for drilling and hydraulic fracturing are expected to take approximately a year, and commercial production of shale gas could begin sometime between late 2013 and early 2014.

European Commission adopts Russian-style heavy handedness

Another surprise for Gazprom at the end of September came in the form of searches (raids) of the offices of its European partners by the European Commission antitrust investigators. These actions were followed by large-scale seizure of documents.

In all, twenty of Gazprom's European partners were searched in ten central and eastern European countries. Gazprom CEO, Alexei Miller, called the raids "completely unexpected".

The official reason for the investigation was the suspicion of violations of EU anti-monopoly legislation, and concerns over consumer protection. However, some experts consider the investigation to be motivated by European consumers' desires to consolidate their positions vis a vis the Russian gas giant by gaining access to internal company documents as a means of improving their bargaining positions in ongoing negotiations with Gazprom over issues such as the renegotiation of long-term contracts, the attempted abolition of 'take-or-pay' clauses in those contracts, and the quest for political concessions from Moscow including permission to build the Trans-Caspian pipeline. The latter intends to link Turkmenistan with Europe via Azerbaijan.

The impact on Gazprom's image and reputation (already far from the best in Europe) may have also played a motivating role in precipitating the raids. With the company's relationship with European energy companies under investigation, it will be easier to unite those dissatisfied with Gazprom's European policies whilst at the same time convincing others to be more cautious in their relations with Gazprom.

If found guilty, both Gazprom and its European partners could face fines of 10 percent of their annual revenues (applicable to business generated in the countries in which the raids took place). Gazprom's earnings in the ten central and eastern European countries under investigation were approximately $13.5bn in 2010. Accordingly Gazprom could face a fine of up to $1.35bn if found guilty of violating antimonopoly legislation. However, such investigations are lengthy and often end with a combination of recommendations and negotiated settlements, without bringing the matter to court.

Belarus Set to Receive Further Discounts from Gazprom

On the 19th of October, having just attended a meeting of the Customs Union and EurAsEC, Russian PM Vladimir Putin announced that the price of Russian gas for Belarus in 2012 would be "lower than equally-profitable prices in the customs area".

According to analysts' estimates the price will range from $200 to $250 per thousand cubic metres. The price for Belarus in the fourth quarter of 2011 was $304.

In a related development, Belarusian representatives have confirmed that Gazprom has accepted the terms proposed by Minsk for the sale of the remaining 50 percent stake in Beltransgaz, and that the transaction could take place in November 2011. This would give Gazprom 100 percent ownership of Beltransgaz, which owns and operates the Belarusian gas pipeline network, and operates the Gazprom-owned Belarusian section of the Yamal-Europe pipeline.

Furthermore, the Belarus President, Alexander Lukashenko, has demanded guarantees for continued transit of Russian gas to Europe via Belarus in order to protect future Belarusian tax revenues, and has also demanded equally-profitable prices between Belarus and Russia. The gas price for neighbouring Smolensk region is around $100 per thousand cubic metres.

Belarusian gas prices change every quarter and are tied to oil prices. The period 2008 to 2011 has been referred to as a 'transitional period' during which time Belarus was supposed to shift from low, heavily-subsidised prices to higher market prices. This is reflected in the gradually-decreasing discounts of 33 percent in 2008, 30 percent in 2009, and 10 percent in 2010, leading to a new agreement in 2011.

Given the Beltransgaz deal, it is likely that Belarus will receive another lenient deal from Gazprom, although President Lukashenko will insist on transit guarantees to the bitter end. If Gazprom grants such guarantees, then Ukraine will suffer first and foremost. With the first line of Nord Stream due to be inaugurated by Russian President Dmitri Medvedev and German Chancellor Angela Merkel on the 8th of November, Ukraine will most likely see a reduction of transit across its territory, which will lead to a reduction in transit revenues and perhaps even a reduction in the value if Ukraine's Gas Transit System (GTS).

A friend in need is a friend indeed: Timoshenko continues to help Gazprom

Since the beginning of 2011 Ukraine has been calling for a review of the gas-price formula used for its Russian gas imports, which was agreed by Yulia Timoshenko at the height of the Russo-Ukrainian 'gas crisis' in January 2009.

Kiev has threatened to terminate the contract using judicial procedures, and has offered instead to tie the gas price to the price of coal, which would result in a reduction from the current $350-400 to $200 per thousand cubic metres. Gazprom is not prepared to offer such concessions, and the only possible solution seems to be Gazprom's willingness to forego implementing the financial penalties provided for in the current contract, and to remove conditions regarding the minimum off-take of gas by the Ukrainian side. As a result the two parties must, in fact, conclude a new agreement which will not include the 'take-or-pay' principle.

If such an agreement is concluded, Ukraine will probably yield to Gazprom over the latter's desire to establish a consortium to manage Ukraine's Gas Transit System (GTS). It was originally envisaged that Ukraine would hold a 40 percent stake in the consortium, whilst Gazprom and the EU would get 30 percent each. According to the latest reports, this proposed structure has changed: Ukraine is now set to receive 40 percent plus one share, Gazprom will receive 40 percent minus one share, and the two European energy companies Gaz de France and Ruhrgas will receive 10 percent each.

There has been no official confirmation of this proposal, but Ukraine's increased compliance seems entirely plausible, given the cooling of Kiev's relations with Brussels: In mid-October EU officials cancelled President Yanukovich's meeting with the EU leadership, a week after Timoshenko was sentenced to seven years for abuse of office as Prime Minister, in relation to the gas deal signed with Russia in January 2009.

Indeed, Ukraine seems to be caught between a rock and a hard place: Brussels is taking a tougher stance towards Kiev as a result of the Timoshenko case, while Moscow continues to promote its own projects: The acquisition of the Ukrainian GTS and subsequent entry into Ukraine's internal gas market, and Ukraine's possible entry into the Customs Union against a background of Ukraine's deteriorating relationship with the EU.

Time appears to be on Moscow's side, however, with the first string of Nord Stream due to be launched on the 8th of November and the second string due for completion in late 2012, while the South Stream project continues to take shape. At the end of September Gazprom signed agreements with two European energy companies, EdF and BASF, in order for them to join the South Stream project, which now appears to be more than just a bluff designed to intimidate Kiev in order to pave the way for Moscow to assert control over Ukraine's GTS. Meanwhile, time is running out for Kiev if it wishes to turn the situation to its advantage, or at least profitably dispose of assets such as its GTS, whose value is steadfastly decreasing.

No breakthrough in sight on the Eastern Front

PM Vladimir Putin's recent visit to China failed to produce a breakthrough in negotiations over the construction of the proposed 'Altai' gas pipeline from Russia to North-Western China, which foresees a potential 30bcm per annum of gas deliveries over the next 30 years.

The final stage of negotiations has once again been postponed indefinitely, with the price of gas delivered via the Altai pipeline the main stumbling block. Beijing still seems to be of the opinion that gas prices in the East should be substantially lower than those for Europe.

It seems that the idea of launching the Altai project has finally exhausted itself, and that the Russian side has lost all confidence in gaining a positive result from the negotiations. It therefore appears much more likely that the eastern Sakhalin-Khabarovsk-Vladivostok gas pipeline will be used for the delivery of Russian gas to China. In late October Gazprom proposed discussions with its Chinese partners on how China might participate in the project, and the potential price of gas delivered to China via this route.

Given the fact that Beijing has recently unveiled plans to increase its own shale gas production to 80bcm per annum, while Kazakhstan has confirmed the possibility of increasing its own gas exports to China via the Central Asia-China pipeline, negotiations on the eastern route promise to be no less intense than those over Gazprom's Altai epic.

EGF Gazprom Monitor
Published by European Geopolitical Forum SPRL

Director and Founder: Dr Marat Terterov
Email: Marat.Terterov@gpf-europe.com

Avenue Du Manoir D'Anjou 8
Brussels 1150 Belgium
Tel/Fax: +322 770 1001
info@gpf-europe.com
www.gpf-europe.com
www.gpf-europe.ru