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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:

- *Gazprom hasn't given up on its attempts to break into South-East Asian gas markets. Its proposal for a potential trans-Korean pipeline has found support in both North and South Korea. However, North Korea's change in leadership casts a shadow of doubt over the situation*

- *Gazprom's purchase of the remaining 50 percent share in Beltransgaz brought a sigh of relief to European consumers, with transit disputes and Belarusian debts for Russian gas seemingly laid to rest. The purchase is one of several measures designed to bring Russia and Belarus closer together, and demonstrate to Ukraine the potential benefits of selling its gas transportation system to Gazprom*

- *Nord Stream was launched with great fanfare. The launch has a substantial impact on the current transit situation, with Ukraine looking like the loser of the piece as its transit volumes are increasingly likely to fall*

- *Gazprom intensified negotiations with Kiev over the possible sale of Ukraine's gas transit system. Given the sale of Beltransgaz to Gazprom and the announcement that South Stream will go ahead as planned, there is a fair chance that Kiev will give up shares in its gas transport system*

- *The Turkish national gas pipelines operator, Botaş has refused to renew its 26-year contract to purchase 6 billion cubic metres (bcm) of Russian gas annually, which expired on the 31st of December 2011. Gazprom's subsequent attempts to circumvent the national supplier have failed: The Turkish Ministry of Energy has refused applications by 26 companies for licences to import Russian gas*

- *PGNiG has filed an arbitration case against Gazprom for lower gas prices and greater spot-price element in contracts. Even if the Polish company ultimately succeeds in its aim, the process could drag on for months*

- *Gazprom plans to pay record dividends, estimated to be 200bn Roubles. However, shareholders should not expect such generosity from Gazprom next year: The size of Gazprom's declared investment programme precludes similar profits next year.*

[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

Exciting business prospects on the Korean Peninsula marred by political uncertainty

Following a meeting between the Presidents of Russia and South Korea in St Petersburg in November several details regarding the potential construction of a pipeline via North Korea were made public. The project would take five years, with the first gas scheduled for delivery in 2017. The planned capacity of the pipeline is 10bcm per year while the length of the pipeline will be 1100km. Gas for the pipeline will come from Sakhalin, via Khabarovsk to Vladivostok, where it will enter the gas transport system which connects Russia to South Korea. Chu Kang-soo, Executive Director of Korea Gas Corporation (KOGAS), announced that the project will cost around $100bn, of which £90bn will be used to pay for gas supplies over the course of the next 30 years, and $3bn for the laying of the pipeline.

If the project goes ahead, the gains for the Kremlin would be political and economic. Firstly, it could ensure closer cooperation between Pyongyang and Seoul, achieve greater interdependence between the two countries, and persuade North Korea to abandon its nuclear programme. Secondly, Gazprom could enter a profitable new market. In accordance with long-term contracts Seoul will pay up to $530 per 1000m³ for Russian gas. Gazprom currently supplies South Korea with 1.5 million tonnes of LNG per year from Sakhalin.

To increase the chances of the project being implemented, Gazprom has offered to sell its gas to Kogas on the border between North and South Korea, thus taking responsibility for transit via North Korea. In the middle of November it was announced that Gazprom has reached an agreement on transit fees with Pyongyang which, according to preliminary calculations, is $1.40 per 1000m³ per 100km. At this rate North Korea will earn $100 million a year in transit fees. However, the death of Kim Jong Il cast doubt over Gazprom's plans. Given the closed nature of North Korea, it is not yet known whether the agreements which have been reached will remain in force. South Korea is biding its time, while relations with its Northern neighbour are suspended. There is a strong chance of a new period of tension in the region, and therefore all joint economic projects have been postponed for the foreseeable future.

Gazprom relations with Belarus improving

At the end of November Gazprom took complete control of Beltransgaz, the owner of the Belarusian gas transmission system (GTS) and operator of the Gazprom-owned Yamal-Europe pipeline. Gazprom paid $2.5bn for a 50% stake in the Belarusian company. The remaining 50% stake was bought by Gazprom in 2007 (also for $2.5bn) as part of the resolution of a Russo-Belarusian energy dispute.

After the signing of the agreement Belarusian President Lukashenko announced that "the union of Russia and Belarus is not only economic, but also political and military". This announcement explains the preferential treatment Minsk has again received from Moscow. Aside from the $2.5bn, Belarus also received a 3-year contract with low gas prices. In 2012 the price per thousand cubic metres of gas will be $165.6 dollars – 40% less than Q3 2011. In 2013-14 the price for Belarus will fall further to reach parity with those charged by Gazprom in the Yamal-Nenets region of Russia (plus cost of transportation to the Russian border). Losses on the Russian side are estimated to be $6-7bn over three years.

After the completion of the deal it became clear that Gazprom intends to continue investing in Beltransgaz, with promises to triple the wages of Beltransgaz workers and invest $1.5-2bn in the modernisation of the enterprise. Given that the Belarusian company employs 6500 people, and the average wage in 2010 was equal to 16000 Roubles, the cost of increased wages will come to $100m a year for Gazprom.

In related developments, Russia agreed to a 15-year $10bn loan to Belarus for the construction of a nuclear power plant in Belarus, and the Russian-led Anti-Crisis Fund of the Eurasian Economic Community (EurAsEC) released the delayed $440m second tranche of its $3bn bailout package for Belarus. Taken together, these developments clearly represent an attempt by Russia to convince Ukraine of the benefits it could receive in exchange for selling its gas transit system and agreeing to enter the Customs Union.

Nord Stream now a fact of life

On the 10th of November an event, momentous in the history of Gazprom, took place. In the presence of the Presidents of Germany and Russia the first line of the Nord Stream gas pipeline was launched. According to Gazprom, the cost of the construction of the pipeline was $8.8bn. The first line of Nord Stream will deliver 27.5bcm per year of Russian gas to Gazprom's key customers: Germany, the UK, the Netherlands, France, and Denmark. Deliveries will also reach the Czech Republic and Slovakia. The second line, which will bring Nord Stream's total capacity to 55bcm per year, is scheduled for launch in late 2012. Many critics continue to refer to Nord Stream as primarily a political project, with the main benefits for Gazprom being increased security of deliveries to Western Europe, and a strengthened bargaining position relative to its western neighbours, Ukraine and Belarus. To a lesser degree, Poland and the Baltic states have also seen their relative bargaining power vis a vis the Russian gas giant decline.

The stakes are high, given that the value of Russian gas deliveries to the EU has now reached EUR20bn per year. The launch of Nord Stream not only offers Gazprom added security of sales to Europe, but will improve Russia's reputation as a reliable supplier to Europe. However, such benefits come at a price. The main financial burden of Nord Steam lies on Gazprom, following the company's pledge to pay transit fees for 100% of capacity, despite the significant risk of under-utilisation of the new pipeline. Following the commissioning of the second line of Nord Stream in 2012 the total capacity of Russian gas exports to Europe will be 225bcm per year, whilst to date contracts have been signed for just 158bcm per year, leaving 67bcm of spare capacity.

It is this potential spare capacity which disturbs Ukraine and Belarus. In the event of a short-term dispute with either country, Gazprom could easily redirect at least some its gas deliveries through Nord Stream, without significant impact on the West European states which Gazprom regards as its key clients. In the long term, both Ukraine and Belarus fear the loss of valuable transit revenues from the delivery of Russian gas to Europe. It is this fear which prompted the Belarusian Government to agree to the sale of Beltransgaz to Gazprom.

Given that Gazprom is unlikely to reduce transit via Belarus following the purchase of Beltransgaz, the threat of transit reduction hangs directly over Ukraine. If South Stream (with its projected 63bcm per year capacity) is built as promised, and the volume of Russian gas exports to Europe remains unchanged, Ukraine could lose its transit status entirely. It seems that Ukraine can preserve its Russian gas transit revenues only by agreeing to sell shares in its GTS to Gazprom, in the hope that the Russian company chooses the option of refurbishing Ukraine's GTS rather than constructing South Stream. It is in this context that Russo-Ukrainian energy negotiations have entered a new phase.

Gazprom now better placed to extract concessions from Ukraine's Naftagaz

Ukraine is continuing its attempts to lower the price it pays for Russian gas, which was established following the 'gas war' of January 2009. Kiev considers $224 per 1000m³ an acceptable price, which would see Gazprom lose $5-6bn on its current contracts with Ukraine. Naturally, Gazprom won't agree to such a price unless the Ukrainian side offers substantial concessions. Such concessions could include giving Gazprom control over Ukraine's GTS, or accepting Gazprom's proposal to establish a joint enterprise on the basis of Ukraine's internal and transit gas transmission networks.

The sale of Ukraine's gas infrastructure has become a more realistic proposition since the launch of Nord Stream. Yet in Kiev opinion remains divided on whether to accept Gazprom's proposals. Vice-Premier Sergei Tigipko believes that 25% of national operator Naftogaz should be sold to Russia, 25% to the EU, and 50% retained by Ukraine. Valery Muntian, Plenipotentiary of Ukraine's Cabinet of Ministers for cooperation with Russia, CIS, and EurAsEc (Eurasian Economic Union), supports the continued search for a way of integration without giving Gazprom control over Ukraine's GTS. But, as a Vadim Chupun, Deputy Chairman of the Naftogaz Management Board put it neatly, "without Russian gas it is impossible to preserve and support our GTS. Otherwise it will just be an empty pipe".

Gazprom continues to make assurances that South Stream will be built according to schedule regardless of how much it costs. This could ultimately deprive Ukraine of transit revenues and snuff out any dreams Ukraine had of receiving any kind of gas price discount. The current Russo-Ukrainian gas contract is valid until 2019, and it will be difficult to alter without handing over a slice of Ukraine's energy system.

Neighbouring Belarus offers a pertinent example to Ukraine. The final price paid by Gazprom for its 100% control over Beltransgaz was $5bn, which is exactly the discount sought by Kiev. It is likely that Gazprom's recent announcements, promising higher social payments to Beltransgaz workers and substantial investment in the modernisation of the company itself, are aimed directly at Ukrainian officials.

As it stands, it seems increasingly likely that Ukrainian representatives will negotiate some kind of deal with Gazprom. The fact that Gazprom's construction of South Stream has not yet begun should offer some room for negotiation. Quite how much Ukraine is prepared to concede, and what Gazprom is willing to accept remains to be seen.

Turkey preventing sale of Russian gas to independent customers

As we wrote in the last issue of the Gazprom Monitor, Gazprom turned to independent gas companies as potential customers following Turkish state-owned company Botaş' refusal to extend its 25-year contract for the purchase of 6bcm per year. However, Gazprom's efforts have proved to be in vain. In the middle of December the Turkish Ministry of Energy refused applications by 26 private companies for licences to import Russian gas. Among these companies were the Gazprom subsidiary 'Bosphorus Gas Group', and the independent Turkish Akfel Group.

The official reason for the refusal was that not one of the companies gave the Ministry a signed agreement for the purchase of gas from Gazprom. One can only speculate as to the real reason for Ankara's refusal. Turkey currently buys 24bcm on Russian gas annually. The 6bcm refused by Ankara was declared to be an excess volume, which was contracted for 'just in case'. If future Turkish gas demand exceeds current import volumes, there is nothing to prevent Botaş buying the necessary volumes from Gazprom on a 'one-off' basis, or even renewing their contract on different terms.

Poland's PGNiG pressures Gazprom through new arbitration round

For Gazprom 2011 was rich in arbitration cases, the initiators being European energy companies. The latest of these is PGNiG, which has appealed to Swedish arbitration with demands for gas price discounts and a greater spot-market element in gas contracts. The Polish state-owned company filed its claim against Gazprom at the beginning of November. Although the details of the claim have not been released, it is known that PGNiG bases its claim on the fact that Gazprom granted 15% discounts to its Estonian and Latvian clients, and agreed adjustments to its gas-price calculation formulas for E.On Ruhrgas, GDF Suez, and Eni.

The demands of the Polish side are somewhat more modest – Warsaw hopes to receive a 10% discount and a change in the contract formula which includes a greater spot component. PGNiG currently pays around $500 per 1000m³. This is $65 more than the price paid by German customers, even though the principle of equal profitability implies that gas exported to Warsaw should be, as a minimum, cheaper than Russian gas exports to Berlin, given the lower transportation costs.

PGNiG has a fair chance of success. Gazprom has previously been prepared to make concessions rather than take the matter to court. Nevertheless, resolving the issue will take time. The conditions of arbitrage mean that the case will be examined in Stockholm within a year, but the two sides may reach an agreement between themselves up to six months from the date on which the claim was filed. There are precedents: In 2010 Gazprom settled a claim by Italy's Edison SPA, which saved the Italian company EUR200 million, thanks to the introduction of additional factors into the price-calculation formula and a reduction in 'take-or-pay' obligations.

Good news for Gazprom shareholders?

On the 20th of December 2011 the Gazprom Board of Directors examined the issue of dividends for 2011. The result is that Gazprom plans to pay out dividends of 8.39 Roubles per share – double the amount paid out the previous year. The definitive size of shareholder profits will be confirmed at the beginning of 2012.

If the decision is approved by the council of shareholders, the sum paid out for 2011 will be approximately 200bn Roubles. This means that the payout will be around 25% of net profit, as calculated by Russian Accounting Standards. In comparison, the record dividends of 2010 were around 17.5% of net profits.

Despite the good news, shareholders should not expect such generosity to be repeated in the future. Given the size of Gazprom's investment programme, the company will not have the means to pay such dividends next year. The 2012 budget expects the company's total earnings to be around 4.9 trillion Roubles, while the company's obligations, expenditures and investment will total 5.1 trillion Roubles. Such predicted outgoings include the planned modernisation of the Belarusian GTS and the possible purchase of shares in the Ukrainian GTS.

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