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

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In-Depth Report on Ukraine

Naftogaz, Gazprom, debts and prices: the saga continue

The issue of gas relations between Gazprom and Naftogaz remains the most prominent in all discussions of Gazprom's foreign commercial relations. At the beginning of April, the Gazprom CEO, Alexei Miller, met with the CEO of Naftogaz Ukrainy, Andrei Kobolev, in Moscow. Following that meeting, Gazprom issued a press release stating that Naftogaz owed Gazprom more than $2.2bn, including an unpaid bill for gas delivered in March.

In last month's Gazprom Monitor, we reported that the price that Gazprom now charges for gas deliveries to Naftogaz has risen from $268 per thousand cubic metres to approximately $385 per thousand cubic metres. This price increase was due to the cancellation of a discount, agreed upon in November, that formed part of Russia's package of financial aid to support deposed President Yanukovich. On the 3rd of April, it was announced that Gazprom had also cancelled the $100 per thousand cubic metres discount granted in April 2010 (as part of the Kharkhiv Accords, which also included the extension of Russia's lease on the Sevastopol naval base in Crimea). The price paid by Naftogaz from the 1st of April would now be $485 per thousand cubic metres.

In an interview with Ukrainian media outlet Mirror of the Week, on the 12th of April, Kobolev discussed the price paid by Naftogaz for Russian gas: "We see no reason for its revision, as proposed by the Russian side the price at the level close to $500; we consider it non-market, unreasonable and unacceptable. Accordingly, we suspended payments [during] the negotiations on the gas price". The announcement that Naftogaz was suspending payments to Gazprom was purely declaratory and had little practical effect, given that Naftogaz has already failed to pay for March deliveries and has continued to accumulate debts to Gazprom. Kobolev also stated that Naftogaz had yet to receive an answer to its proposal that the discounted price of $268 per thousand cubic metres be retained, and that "the issue of resolving the accumulated debt is directly connected to the issue of preserving the price of natural gas at the level of the first quarter of this year". In other words, Naftogaz will remain reluctant to pay off its debts unless it receives an acceptable price from Gazprom. What an acceptable price is remains unclear: just 48 hours after Kobolev's statements, the Head of the National Bank of Ukraine, Stepan Kubiv, claimed that Ukraine was ready to pay $385 per thousand cubic metres.

Kobolev's statements came just 24 hours after the Ukrainian Energy Minister, Yurii Prodan, announced that the Ukrainian government was preparing to file an arbitration case against Gazprom with the Arbitration Institute of the Stockholm Chamber of Commerce: "We invited international lawyers who have experience with companies that filed claims in court in Stockholm against Gazprom".

A fortnight later, Gazprom dealt a further blow to Naftogaz by announcing that it intended to utilise its contractual right to enforce financial penalties for Naftogaz's failure to take volumes stipulated by the 'take or pay' clause in their gas supply contract. The size of this financial penalty is reported to be approximately $11.4bn. The current Gazprom-Naftogaz supply contract stipulates delivery volumes of 52 bcm per year, with a take or pay clause of 80 percent. This means that

Naftogaz must pay for at least 41.6 bcm each year from Gazprom, whether or not they consume the fuel. In January 2013, Gazprom announced a fine of $7bn for failure to pay for contractual volumes in 2012, but did not enforce the fine. In 2013, Naftogaz imported just 12.9 bcm from Gazprom (31 percent of the contractually-agreed minimum), while other private Ukrainian energy companies imported an additional 12.9 bcm from Gazprom.

On the 30th of April, Gazprom spokesperson Sergei Kupriyanov announced that Naftogaz's gas debts to Gazprom (aside from the penalty noted above) had reached $3.492 billion. Russian sources report that the overall amount of gas to be imported by Ukraine in April was 2.7 bcm. Thus, with the price of $485 per 1,000 cubic metres, Ukraine's debt increased from 2.2 billion at the beginning of April by $ 1.3 billion, to reach $3.5 billion by the 1st of May.

Kupriyanov's announcement came just 48 hours before representatives from Russia, Ukraine, and the EU gathered in Warsaw to discuss the issues of Russian gas supplies to Ukraine and Russian gas deliveries to the EU via Ukraine. Following the meeting, Russian Energy Minister Alexander Novak stated that Gazprom will move to prepayment on the 16th of May, and may limit supplies if the June bill is not paid by the 31st of May.

At this point, it is worth noting that Naftogaz is currently obliged to pay for the gas supplies it receives by the 7th day of the month following the receipt of gas deliveries. Novak's suggestion that Gazprom could switch to prepayment means that Naftogaz would have to make payments before receiving shipments of gas.

Novak's warning echoed that given by President Putin in a letter to European leaders, which was made public on the 10th of April. In that letter, Putin noted that given the current conditions of Naftogaz repeatedly failing to pay for gas delivered by Gazprom, "Gazprom is compelled to switch over to advance payment for gas delivery, and in the event of further violation of the conditions of payment, will completely or partially cease gas deliveries. In other words, only the volume of natural gas will be delivered to Ukraine as was paid for one month in advance of delivery. Undoubtedly, this is an extreme measure. We fully realize that this increases the risk of siphoning off natural gas passing through Ukraine's territory and heading to European consumers".

The fact that Putin's warning was itself a repetition of a similar warning given by Gazprom CEO Alexei Miller in early March, suggests that the Russian side remains unwilling to take the 'extreme measure' outlined in Putin's letter (the full text of which is available here). However, the likelihood of such measures being taken increases with every month that Naftogaz fails to pay its bills to Gazprom. Given that Naftogaz appears unwilling to settle its debts until it receives a new discount from Gazprom, and that Gazprom is currently insisting on a price significantly above the European average, one of two scenarios is likely to occur. In the positive scenario, Gazprom could offer to set the price at 'European netback' (approximately $360 per thousand cubic metres) in exchange for Naftogaz agreeing to settle its debts. Conversely, Gazprom could retain its demand of a price of $485 (the current non-discounted price) while Naftogaz could refuse to pay more than $268 (the heavily-discounted price of Q1 2014) and refuse to settle its (growing) debts. In the latter scenario, a disruption of Russian gas deliveries to Ukraine would become an increasingly possible outcome.

In a bid to limit its dependence on Russian gas, Naftogaz seeks alternative supplies from Europe

As its contractual wrangling with Gazprom continues, Naftogaz has been investigating the possibility of receiving gas supplies from Europe to lessen its dependence on supplies from Gazprom. On the 17th of April, this author reported that the German energy company RWE had resumed the 'reverse flow' of gas supplies to Ukraine – a process first undertaken in 2012, but subsequently suspended (the link to the original report is available here). Such 'reverse flows' essentially involve RWE buying gas on the European market (which may or may not be sourced from Gazprom), and physically delivering it back to Ukraine. The RWE contract stipulates deliveries of up to 10 bcm per year, if the physical infrastructure permits. Ukraine is predicted to import approximately 30 bcm total in 2014. Currently, the technical capacity exists for RWE to supply 5.5 bcm via Hungary and 1.5 bcm via Poland – enough to meet less than a quarter of Ukraine's predicted gas imports in 2014. The major point of discussion is the possibility of reversing one of the pipelines that delivers Russian gas to Europe via Slovakia. The current system is comprised of four large-capacity pipelines that deliver gas from east to west across the Slovak-Ukrainian border, plus a fifth, small capacity pipeline that has been mothballed and would require a $27.7m refurbishment before it could be brought back into use.

Unsurprisingly, given Slovakia's dependence on gas imports from Russia, the Slovak government has been anxious to ensure that Slovak pipeline operator Eustream would not be in breach of contract by facilitating reverse flows. On the 18th of April, Naftogaz CEO Andrei Kobolev issued a statement on the situation: "After lengthy negotiations, we were informally told that this area between the Ukrainian-Slovak border and gas metering stations on the Slovak side are virtually controlled by Gazprom Export and that Gazprom Export decides in which direction to pump gas: to Europe or to Ukraine".

On the 28th of April, Eustream and Naftogaz reached a compromise agreement to use the smaller pipeline to deliver up to 3.2 bcm per year from October 2014. Following refurbishment, the capacity of this pipeline could be raised to 10 bcm per year by spring 2015. By this time next year, Ukraine could source around half of its gas imports from Europe. However, this would mean paying European price (currently around $380 per thousand cubic metres). In the short term, Ukraine's dependence on gas supplies from Russia will remain undiminished.

__Gazprom and the EU__

EU continues formulating 'statement of objections' in antitrust probe as Gazprom and EU representatives confirm interest in retaining mutually beneficial energy relations

On the 2nd of April, Gazprom CEO Alexei Miller met with the EU Energy Commissioner, Gunther Oettinger, and the German Foreign Minister, Frank-Walter Steinmeier. Following the meeting, a Gazprom press release was issued, stating, “The parties affirmed their interest in preserving bilateral relations that have been built over several decades of fruitful cooperation to achieve mutual benefits”.

A week later, Commissioner Oettinger chaired a joint meeting of the Gas Coordination Group and roundtable on security of supply in the gas industry. In a press release issued following the meeting, it was noted that the European Commission had “committed to conduct an in-depth study of EU energy security and to present by June 2014 a comprehensive plan for the reduction of EU energy dependence”. Although Russia was not specifically named as a target of these measures, the general political climate in Europe and uncertainties over gas transit via Ukraine suggest that a reduction of dependence on Russian gas imports remains a concern of the European Commission and several EU Member States. It is in this context that the European Commission continues to prepare its ‘statement of objections’ against Gazprom and conduct meetings with Gazprom representatives, although no specific developments have been announced by either side in the past month.

Russian government seeks talks with EU over energy legislation in possible first step towards WTO arbitration

On the 30th of April, the Russian government contacted the World Trade Organisation (WTO) Secretariat, requesting talks with EU officials over EU energy legislation in a possible first step towards WTO arbitration proceedings. Under WTO procedural rules, Gazprom and the EU have 60 days to settle their dispute, possibly with the assistance of a WTO mediator. If that fails, a dispute settlement panel will be appointed within 45 days. That panel will then have 6 months to prepare its report and recommendations.

A WTO press release states that Russia’s complaint relates to specific aspects of the Third Energy Package regarding the “production, supply and transmission of natural gas or electricity, the alleged discriminatory certification requirements in relation to third countries in this sector and the requirement in respect of granting access to natural gas and electricity network capacity by transmission service operators. According to the Russian Federation, these measures are inconsistent with a number of obligations and specific commitments of the European Union and constitute an infringement of these obligations and commitments”.

The request by the Russian government has particular relevance to the South Stream project. The European Commission claims that current EU gas market legislation stipulates that a percentage of the capacity of the pipeline must be reserved for third party access. Gazprom and the Russian government contest this claim.

South Stream

South Stream divides EU as OMV (Austria) breaks ranks to sign deal

On the 29th of April, it was announced that the Austrian energy company, OMV, had signed a Memorandum of Intent with Gazprom to bring a spur of the South Stream pipeline to the Baumgarten gas hub in Austria. According to a Gazprom press release, the deal was signed on the basis of an intergovernmental agreement between Russia and Austria that had been signed in April 2010. The Austrian section of South Stream is planned to have a capacity of 32 bcm per year. If South Stream is constructed at its full design capacity of 63 bcm per year, this suggests that the Slovenian-Italian parallel spur will have a capacity of approximately 31 bcm per year. Gazprom and OMV plan to obtain construction permits before the end of 2015, with first supplies to be delivered in 2017 and full capacity to be reached in 2018. The Austrian Minister for Economy, Reinhold Mitterlehner, expressed his support for the project: "The international development shows once again that in the long term, we not only have to diversify our energy sources, but also our supply routes".

Austria's decision to pursue a deepening bilateral gas relationship with Russia contradicts the current calls from the European Commission and several European politicians for European countries to reduce their dependency on Russian gas imports. However, it could be argued that Austria's enthusiasm for South Stream represents a growing concern over the long-term stability of gas deliveries via Ukraine, upon which Austria is currently dependent.

Asia

Gazprom claims progress in talks with CNPC, expects contract to be signed in May

Gazprom CEO Alexei Miller visited Beijing on the 9th of April for a meeting with his counterpart, Zhou Jiping, from the China National Petroleum Corporation (CNPC). Three weeks later, Mr Zhou made the return trip to Moscow for another round of talks. Both sides claimed progress, with Gazprom issuing a press release, stating, "Gazprom and CNPC are getting ready to sign the contract in May as was initially planned". Such sentiments were echoed by the Russian Deputy Prime Minister, Arkady Dvorkovich, who stated, "We really hope that the contract will be signed in May".

At the G20 Summit in St Petersburg, in September 2013, the two sides agreed on the major terms of the deal. A new pipeline system (named 'Power of Siberia') will be built to connect the gas fields of Eastern Siberia (primarily Kovyktinskoe and Chayandinskoe) with Vladivostok, where Gazprom plans to build an LNG export terminal. At two points along the Russian-Chinese border (Blagoveshchensk and Dalnerechensk), pipeline spurs will deliver gas across the border. This system is referred to by Gazprom as the 'Eastern Route', in contrast from the prior proposals to deliver gas via Russia's Altai region to north-west China (the 'Western Route'). Gazprom plans to begin gas production at Chayandinskoe in 2017, and to begin pipeline deliveries to China in 2018.

The Russian-Chinese intergovernmental framework agreement provides for deliveries of up to 68 bcm per year, although the initial contracted amount will be 38 bcm per year for 30 years. The take-or-pay level has reportedly been agreed upon, but not made public. All that remains is for the two sides to agree on a price. Recent reports suggest that Gazprom is hoping for a price of $10-11 per million British thermal units (MMBtu), equivalent to $372.46-409.71 per thousand cubic metres – similar to the price of $377 per thousand cubic metres that it received for its European exports in 2013. China is reportedly paying $9 per MMBtu ($335.21 per thousand cubic metres) for its supplies from Turkmenistan, while Indonesian LNG supplies to Japan averaged $17.8 per MMBtu ($662.98) in Q1 2014. Maxim Nechaev, Head of Consulting at IHS in Moscow, was quoted in January as stating that a Japanese LNG price of $16-17, minus the costs of transportation and liquefication, would give a price of $10-11 per MMBtu. Therefore, we should expect that the deal will be concluded in this price range.

At this stage in the negotiations, it should be noted that a difference of $1 per MMBtu is equivalent to $37.25 per thousand cubic metres ($37.25m per bcm). Over the course of just one year of a 38 bcm contract, this difference would be worth $1.4155bn. Over the lifetime of the 30-year contract, a price difference of $1 per MMBtu would amount to $42.465bn, in comparison to the projected $22bn cost of the Russian-China gas pipeline system. Little wonder, then, that the Gazprom-CNPC price negotiations have been so hard-fought.

However, the scheduled visit of President Putin to China on the 20-21st of May could bring the negotiations to a successful conclusion, even if it means Gazprom making one final price concession to get the deal over the line (such as accepting a price of $9.5-10 per MMBtu). The signing of the contract with CNPC would be a boost for Gazprom, whose future in Europe currently appears to be less than promising, as European energy companies are being urged to reduce their dependence on Russian gas supplies. The deal would make CNPC the single largest importer of Russian gas in the world, and would be a welcome diversification of exports for Gazprom. Gazprom and CNPC are at the altar, but will they take the vows?

And in other developments…

Gazprom reports 2013 financial results in accordance with international financial reporting standards (IFRS)

At the end of April, Gazprom reported its 2013 financial results. The report stated that Gazprom earned 5.25 trillion Roubles ($138bn) in sales and incurred 3.6 trillion Roubles ($94.7bn) in operating expenses. Gazprom's pre-tax profits were 1.49 trillion Roubles ($39.2bn), a 4.6 percent decrease on 2012. Post-tax profits were 1.17 trillion Roubles ($30.7bn), down 6.9 percent on 2012. Total sales volumes fell 1.1 percent to 477 bcm, but net total sales revenues rose 11.8 percent to $78.2bn.

In Russia, Gazprom's sales volumes fell 8.3 percent to 243.3 bcm, but revenues rose 4.4 percent to 794.3bn Roubles ($20.9bn). In the former Soviet Union, sales volumes fell 10.1 percent, while sales revenues fell 20.6 percent to 420.3bn Roubles ($11.1bn). Beyond the former Soviet Union, sales volumes rose 15.4 percent to 174.3 bcm, while sales revenues rose 14.5 percent to 1.7 trillion Roubles ($44.3bn).

In brief, these results were expected. Gazprom's declining exports to Ukraine (the largest importer of Russian gas in the former Soviet Union) were well-publicised. Conversely, exports to Europe were buoyed by the redirection of competing LNG supplies from Europe to the Asia-Pacific market (where prices are significantly higher), limitations on Norwegian gas production caused by technical difficulties at the Troll gas field, and political unrest that adversely affected gas exports to Europe from Libya, Egypt, and Algeria.

Gazprom and Turkey consider expansion of Blue Stream from 16 bcm to 19 bcm

The Director of Gazprom Export, Alexander Medvedev, attended a meeting in Ankara with the Turkish Minister of Energy and Natural Resources, Taner Yildiz, on the 21st of April. During the meeting, the two sides discussed the possibility of expanding the capacity of the Blue Stream pipeline (which runs under the Black Sea directly from Russia to Turkey) from 16 bcm per year to 19 bcm per year. A Gazprom press release following the meeting noted, "The increase in capacity would not require laying additional strings of Blue Stream". This suggests that the increase in throughput capacity could be achieved by upgrading Blue Stream's compressor stations. In 2013, Gazprom supplied Turkey with 26.7 bcm of natural gas. The portion of those supplies that is not delivered via Blue Stream is delivered via Ukraine (the 'Western Line').

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