www.gpf-europe.com

The European Geopolitical Forum

EGF Gazprom Monitor

Issue 1: November/December 2010

Key Developments in the External Relations of the Russian Gas Industry

Gazprom creates new daughter company in Belarus to operate gas transit

Half a year after the gas dispute with Belarus, Gazprom has created a new 'daughter' company in Minsk, Gazprom Transgas West, as a potential operator of the Belarusian stretch of the Yamal-Europe gas pipeline. The current operator of the section in question is Beltransgaz, in which Gazprom holds a 50% stake. However, the new 'daughter' company, which will exercise complete control over the Belarusian section of the pipeline, will be completely controlled by Gazprom. Although few experts predicted that another gas dispute in 2010 was likely, since the current contract between Gazprom and Beltransgaz does not expire until the end of 2011, establishment of Transgas West implies that Moscow has been taking steps to prepare for the likelihood of future dispute scenarios.

Gazprom and Naftogaz Ukraine paving the way for a joint venture....

Gazprom, Naftogaz Ukraine and the gas trader RosUkrEnergo have settled their long-running gas dispute. The arrangement will help pave the way for the creation of a Joint Venture (JV) between Naftogaz and Gazprom, which is planned to include Ukrainian gas-transport and gas-production assets, as well as Russian gas fields. Gazprom and Naftogaz announced the fact that they have reached a complete settlement of problems concerning the repayment of gas to RosUkrEnergo AG on 29 November.

According to the decision of the Arbitration Institute of the Stockholm Chamber of Commerce, Naftogaz will repay 12.1 billion cubic metres (bcm) to the gas trader RosUkrEnergo. The system of settlement is as follows: After Naftogaz returns the gas to RosUkrEnergo, the trader will sell the gas to Gazprom, who will then sell the gas to Europe. Gazprom will receive profit in the capacity of shareholder in RosUkrEnergo (Gazprom owns 50 percent of RosUkrEnergo). RosUkrEnergo will pay off its debts to Gazprom of $810million USD and pay back its $1.7bn USD debt to Naftogaz. The cost of a cubic metre of returned gas is $207 USD. In the event that RosUkrEnergo sells gas to Ukraine in the fourth quarter at a price of $250 USD per cubic metre, the trader will earn $515 million USD, which will be divided equally between the shareholders: Gazprom, Dmitri Firtash and Ivan Fursin.

....but obstacles in the way of a joint venture still remain

The clause stipulating that Naftogaz returns the gas (effectively to Gazprom) was one of the key conditions underlying the negotiations between the Russian and Ukrainian sides over the creation of a JV between Gazprom and Naftogaz. The two sides also agreed to include Gazprom's Astrakhan gas fields as part of the JV. The proposal of creating of a JV was first voiced by Russian Prime Minister, Vladimir Putin, at the end of April 2010. The completion of negotiations relating to the JV, including agreement over the legal form which the structure will take, is envisaged for 2011 according to unofficial sources. Kiev is still pushing for guarantees that Ukraine's gas transit system will continue to be utilised at volumes of no less than 100bcm, and wants to see the South Stream project terminated – with both points remaining a source of disagreement between the Russian and Ukrainian sides.

South Stream costs expected to inflate further

In accordance with the new estimates of expenditure on the construction of the South Stream gas pipeline, total cost of the project will equate to 15.5 billion Euros. Compared with estimates cited by Gazprom two years ago, the cost of the project has fallen by 25-55 percent, however, and is more in line with the EUdriven Nabucco project. In this case, the cost of laying one kilometre of pipeline on dry land is 2.4 million Euros.

Nonetheless, these figures do not reveal the entire story. The sum does not include the expenditure on modernisation and expansion of the network of gas pipelines on the territory of Russia, which is necessary for the realisation of the project. Expenditure is mentioned in Gazprom's business plan, but the company has not provided concrete figures. Nonetheless, in order to transport gas from northern gas fields to the South Stream pipeline system, it will be necessary to both conduct rehabilitation and establish pipeline networks totalling around 2500km in length. Ten further compressor stations will also have to be built. The capacity of the projected pipeline is 63bcm per year. South Stream is to be laid across the floor of the Black Sea to Bulgaria, and overland via Serbia, Hungary, Slovenia, Austria, and Northern Italy. According to the takeoff of the pipeline outlets, gas will be delivered to Croatia, Macedonia, Greece and Turkey. An option whereby one or two of the four strings of the underwater section will be rerouted to the Romanian coast has not yet been ruled out.

Gazprom executives continue to emphasise the fact that South Stream will circumvent Ukraine as evident in the following comment: "The only thing, that one may say, is that they (the routes of the underwater section) will not infringe upon the exclusive economic zone of Ukraine" (Leonid Chugunov, Gazprom Head of Department for Project Management). Further to the fact that Gazprom's current transit capacity enables deliveries of around 200bcm of gas to Europe per year, and that both Nord Steam and South Stream combined will add a further volume of 118bcm, Gazprom is increasingly making the case that South Stream is not a geopolitical project. Gazprom analysts predict that after 2020 demand for gas in Europe will exceed 600bcm, and that its own production of gas will fall by half – net imports of gas into the EU may grow from 240bcm to 450bcm per year.

Moscow-Sophia agreement on South Stream ruled invalid by the European Commission

A further risk factor facing South Stream is the future implementation of the Third Energy Package, which was adopted in April 2009 and foresees full liberalisation of the gas and electricity markets of the EU. As viewed by Gazprom, the Third Package threatens the company's monopoly over the transportation of gas to EU markets. A practical example of a dispute arising out of this situation becomes evident when the European Commission adjudicated that intergovernmental agreements regarding South Stream were not compliant with the Third Package. In the middle of November of this year, the Commission singled out the intergovernmental agreement between Russia and Bulgaria from 18 January 2008 regarding South Stream. It ruled that under this agreement, energy infrastructure must be open to all EU member states, and not only participants in the project.

Moscow's "sour grapes" with the European Commission over the Third Package evident

These issues are currently being resolved on several levels: On 2 November, in a meeting with the European Commissioner for Energy, Günter Oettinger, Russian deputy-Prime Minister responsible for Energy, Igor Sechin, suggested to the EU that it should award the South Stream pipeline the status of a Trans European Network (TEN), analogous to the Nabucco project. Sechin argued that the project "improves both the energy and ecological security of the EU". TEN status also allows participants in the project to qualify for 30 percent of the cost of the project to be financed by EU-related funding sources and, most importantly, to circumvent the guidelines of the Third Energy Package.

During a recent visit to Germany, Vladimir Putin further raised the stakes with the Commission when he lambasted the Third Energy Package, implying that it would have nefarious consequences for the Russian gas export business. According to Putin, Gazprom is being obliged to "sell Nord Stream", which Gazprom is building with its German partners BASF and E.ON Ruhrgas. Putin also mentioned the case of Lithuanian Lietuvos Dujos, where EU internal energy market reforms would deprive Gazprom and E.ON Ruhrgas, as shareholders in Lietuvos Dujos, of control over the main gas trunk pipelines in Lithuania. Putin argued that the final price paid for gas by European consumers would only increase when "three, four or five companies will sit between producers of gas and consumers. Every one of these wants to make a profit". Angela Merkel, the German Chancellor, sided with the Russian partners concerning the gas pipeline and noted that Berlin has always spoken out against a ban on ownership of infrastructure from the point of view of the supplier.

Third Energy Package poses questions to ongoing Russia-Poland gas supply agreements

The implementation of the provisions of the Third Energy Package also affects the stretch of the Yamal-Europe pipeline which passes across the territory of Poland. Russia and Poland recently came to agreement over deliveries of additional volumes of Russian gas for the period 2010-2022. Warsaw, for its part, has undertaken commitment for security of Russian gas transit through the Yamal-Europe pipeline until 2019. This effectively ended a two-year long-dispute between Moscow and Warsaw over the Polish section of the Yamal-Europe pipeline. That being said, new disputes may arise between Gazprom and the new Polish pipeline operator in connection with the implementation of the provisions of the Third Energy Package

The recent agreements between Moscow and Warsaw resulted in the establishment of a new operating company for the section of the Yamal-Europe pipeline running through Poland, in order to make the agreement (ie, the operations of the pipeline) compliant with EU third party access legislation. The new operating company, Gaz-System, went about immediately publishing information about the establishment of a code of unified rules (ie, a network code) for non-discriminatory access to the pipeline. Jan Chadam, General Director of this new pipeline operator, Gaz-System, declared that the code will appear on the company website in two months time. The implementation of the code is to be developed jointly with the Polish energy regulator, URE.

Gaz-System is thus already preparing to make the pipeline accessible to third parties for the second quarter of 2011. Gazprom reaction to these developments was hardly benign, with some analysts suggesting that some level of confusion became apparent. This was due to the fact that all spare capacity available via the pipeline for 2011 has already been contracted out (by Gazprom) with no further capacity available for new market entrants. Furthermore, the decision of the operator about the implementation of the provisions of the Third Energy Package were deemed as a merely a formality, or were possibly viewed as early means of preparing for the launch of Nord Stream. After Nord Stream would come into operation, part of the existing capacity may be freed up, as Yamal-Europe and Nord Stream enter neighbouring German *Länder* (federal states).

Russia and China yet to agree on gas prices and volumes of deliveries

Russia's negotiations on deliveries of gas to China, which have already lasted four years, are continuing at present, with the two sides seeking to reach an agreement on price and gas volumes. The construction of the 'Altai' gas pipeline will commence after agreement on prices, which remains a stumbling block between the two sides, will be reached. Another potential stumbling block is that China may be prepared to take substantially smaller amounts of the contracted gas than required. There have been suggestions at the governmental level that deliveries should be 30bcm for the 'Altai' gas pipeline and 38bcm for the eastern gas pipeline.

The Chinese National Petroleum Company (CNPC) is concerned that such volumes will be too difficult for the market to absorb, and therefore the Chinese side is prepared to take only 41 percent of the contracted quantity. At the same time Gazprom is not prepared to create a precedent to which European clients will be able to refer, namely that the company will take upon itself all market risks regarding the construction of pipelines and be prepared to take on the role of reserve supplier. In its supply arrangements with European consumers, which are based on the principle of 'take-or-pay', Gazprom stipulates the volume of withdrawal at 80-85 percent.

Furthermore, disagreements remain in relation to the price of purchased gas. Gu Jun, Deputy Director-General of the International Department of China's National Energy Administration, recently announced that at the present moment the difference in price of Russian gas between the negotiating parties was $100 USD per 1000 cubic metres. According to current information, announced earlier by Gazprom's Alexander Medvedev, the two parties have further reduced this differential (to around $60 USD per 1000 cubic meters), and the signing of a contract will be possible in mid-2011. Deliveries are planned to begin at the end of 2015.

Given the high cost of gas production in Eastern Siberia, the minimum acceptable price for Gazprom to make its business with China feasible is $180 USD per 1000 cubic metres. China is pushing for $165 UDS per 1000 cubic metres, which is the deal it agreed with Turkmenistan for 10bcm of gas. It should also not be ruled out that no kind of arrangement will be reached by the parties. China is steadily increasing its gas imports from Central Asia, and is also increasing its own domestic production. Deciding factors in the final outcome may be either Russian government decisions about whether to grant licenses to Chinese companies to invest in Russian upstream exploration projects, or similar efforts to attract credit lines from Chinese banks.

Gazprom bullish on potential gas export business with Israeli partners

After the opening up of large gas fields in Israeli territorial waters earlier this year, Israel went from being the most probable consumer of gas via 'Blue Stream 2' to becoming its potential exporter. Recent upstream exploration activity has revealed that the gas fields in the Israeli continental shelf may be as large as 3.4 trillion cubic metres (tcm). Israel has announced that the beginning of gas production from these fields will not only allow it to cease its gas imports, but also to begin the export of gas to the countries of Southern Europe, which have traditionally sourced Russian gas. Thus Gazprom is planning to create a JV with Israel for the production and export of Israeli gas to Southern Europe, envisaging a 50 percent share and a cost of around $100-150 million USD. Exploratory drilling is expected to begin in 2011.

Gazprom's stake in the JV will most likely centre around the Ratio Yam deposit, for which Gazprom already holds a license. Noble Energy of the US is also part of Gazprom's existing Ratio Yam license, with the US concern already having stakes in other large Israeli fields including Tamar, Dalit and Leviathan. There will be little logic in further pursuit of the 'Blue Stream 2' project if these developments materialise. It should also be noted that in line with Israeli legislation, companies which are planning to undertake the development of mineral resources must receive permission for prospecting for one and a half years, then a licence for three years with the possibility of extension for another four years, then a 30-year lease with extension for another 20 years. Gazprom has already passed the first stage, having received a prospecting licence.

Rumoured resignation of Gazprom head of company unlikely

Rumours within the Russian gas sector surfaced in November in relation to the resignation of the head of Gazprom, Alexei Miller. Such rumours are not a particularly new phenomenon, and follow similar news taking place last summer, purporting the resignation of senior Gazprom executives such as Alexander Medvedev and Stanislav Tsigankov. Ill health was suggested as a possible reason perpetuating the current round of resignation rumours, which were unequivocally put to rest in the middle of the month by Sergey Kuprianov, Gazprom's chief public spokesman. Kuprianov refuted suggestions of Miller's resignation as "nonsense".

Gazprom to downsize investments in 2011

On 23 November Gazprom announced that it would be reducing investments for 2011 on its earlier mentioned investment program by 10%, to 816.4bn Roubles. Nonetheless, this is 50bn Roubles more than the company invested in 2009. Long-term financial investment during next year will be cut by almost half, to 86.5bn Roubles, while capital investment will remain at practically the current level – 729.9bn Roubles as compared to 751.8bn Roubles in 2010.

The reduction of investment into the Shtokman gas deposit is particularly indicative – in 2011 Gazprom plans to invest only half the amount invested into the project this year. Planned reductions will mean that only 5.5bn Roubles will be invested into this 'mega-project' of the Russian gas industry during 2011. Gazprom, together with its key international partners engaged in the development of the project, Total of France and Statoil of Norway, have therefore once again delayed the start date for upstream exploration with reference to Shtockman from 2014 to 2016. Given that the project was reportedly oriented for the export of natural gas to the US market, contraction in the volumes of projected investments for next year comes as the result of the decreased likelihood of realising such objectives in the current demand environment for global gas supplies. The US, with its boom in shale gas production during the past 18-24 months, has gone from being an importer of natural gas to planning its own gas exports. This relates in particular to the market for Liquefied Natural Gas (LNG), which it intends to begin exporting in 2012. A symbolic delivery has already been made – in the middle of November the USA sent its first shipment of LNG to the UK.

Outlook for Gazprom's European gas exports appears uncertain

Also in November Gazprom management announced that it would not compel European countries to take full gas amounts stipulated under contracted volumes for the period 2010 to 2012. Gazprom's forecast for its gas exports for the period 2020 to 2025 was subsequently lowered by 10bcm, which is likely to result in short-term losses totalling $4.5bn USD, which the company will have to sustain. However, these concessions for European companies were made on the understanding that there will be an increase in gas procurement under contracted volumes at a later date.

Consequently, Gazprom's European earnings for 2010 total $47.5bn USD, which is still 10 percent more than the analogous indicators for 2009. Furthermore, the penalty for failing to comply with the gas volumes stipulated under full contracted volumes is $2.5bn USD rather than $4bn USD, which Gazprom could have levied on European consumers. The declining share of profitability stemming from its European business as a percentage of Gazprom's overall revenues may be gradually compensated by future profits from the Russian domestic gas market. Gazprom has recently announced a strategy where an equally profitable price for gas sales in Russia will be achieved by 1 January 2014.

Gazprom pushing for export diversification through new agreement with Shell

Most close followers of the major developments in the Russian energy markets will recall that in late 2006 Gazprom muscled its way into Shell's Production Sharing Agreement (PSA) signed with the Russian government back in the 1990s, which aimed to develop natural gas off the Russian Pacific continental shelf. Four years after Shell was effectively obliged to yield half of its controlling stake in the Sakhalin-2 project to Gazprom, Alexei Miller, Gazprom Chairman of the Board, and Peter Voser, Shell's Chief Executive Director, signed a protocol on global strategic cooperation.

The agreement foresees the further strengthening of mutual cooperation in the sphere of exploration and production of hydrocarbons in Western Siberia and the Russian Far East; as well as the development of joint activity in the sphere of processing and distribution of hydrocarbons in Russia and Europe. Furthermore, the agreement also foresees Gazprom participating in Shell's oil and gas upstream exploration projects in third countries. Experts believe that such an agreement is an important step in Gazprom's efforts to diversify its own gas exports. Cooperation of this nature with Shell may enable Gazprom to develop LNG production projects and enter Asian markets. The Russian gas holding seeks to gain greater access to new hydrocarbons deposits. In this context Shell and Gazprom are currently discussing the possibility of expanding the Sakhalin-2 project in order to further increase the export of LNG.

EGF Gazprom Monitor
Published by European Geopolitical Forum SPRL

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

Suite 1/Level 3, Avenue Du Manoir D'Anjou 34
Brussels 1150 Belgium
Tel/Fax: +322 770 1001
info@gpf-europe.com
www.gpf-europe.com
www.gpf-europe.ru