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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]

INTERNATIONAL MARKETS

Will European consumers pay more for Russian gas ?

On April 25 of this year Gazprom head, Alexei Miller, predicted that the price of gas sold to European gas consumers would increase to $500 per 1,000 cubic metres by the end of 2011. This suggests a price hike of almost 40 percent as currently the average European gas price is $350 per 1,000 cubic metres. While Gazprom officials do make public references to limitations to increases in the gas price, most such comments tend to refer to Russian domestic gas prices.

The gas price formula used by Gazprom in negotiating supply contracts is predominantly linked to the price of oil, although price formulas in Gazprom's supply agreements with its gas clients are highly complicated affairs, which include not only indices to oil product prices, but also adjustments for interest rates and inflation. According to this formula, the price of 1,000 cubic metres of gas is approximately four times the price of a barrel of oil (on the Brent Crude measure), with a time lag of two or three financial quarters (or six to nine months). Considering that a barrel of Brent Crude cost $126 on April 30, it is quite likely that by the end of the year the price of 1,000 cubic metres of gas could reach the predicted $500 mark.

At the same time, an increase in gas prices could lead to a drop in sales in Europe, as happened after the Financial Crisis of 2008-09, when Gazprom lost part of its market share to LNG suppliers. In fact, the high price of Russian gas could again be a cause of concern for Gazprom's customers. Until now there has been a surplus of gas on the spot market, the price for delivery of which in May 2011 is $340 per 1,000 cubic metres. Furthermore, according to data provided by the investment bank, Societe General, in March of this year global LNG production reached a historic high of 21.8 million tonnes, and Gazprom's main European clients – E.ON, RWE, GDF Suez – repeatedly demanded discounts and the revision of contracts. Therefore, the question looking forward to 2012 remains as to whether Gazprom's pricing policy will take into account the oversupply on the LNG market.

Lithuania-Gazprom negotiations remain challenging

We described in some detail the challenging nature of the negotiations between Gazprom and the Lithuanian government in the previous issue of the EGF Gazprom Monitor. Given the comparatively high price which Lithuania pays for Russian gas, it is worth mentioning that in the course of Vilnius' efforts-negotiations aiming to persuade Gazprom to reduce the price of gas supplied to Lithuania, Gazprom offered Lithuania a compromise – it would be prepared to reduce gas prices in exchange for fixing the volumes of deliveries. Currently, Vilnius is only taking 3.5 billion cubic metres (bcm) of gas per year out of the contracted volume of 5 bcm per year of contracted volumes. This means that deliveries are of uneven volume throughout the year. A switch-over to regular deliveries throughout the year would make it possible to reduce the cost of servicing the gas transport system, which would in turn make it possible to lower the price of gas for Lithuania.

It is far more advantageous for Gazprom not to hold back volumes of gas, as it does currently, but rather to fix volumes of deliveries and use any surplus for sales on the domestic market. The current agreement on gas deliveries to Lithuania was signed in 2008, before the adoption of the Third Energy Package was accepted by Vilnius. Gazprom management is confident that if it is forced to engage in legal proceedings with Lithuania in the Stockholm Court of Arbitration, its chances of obtaining a favourable ruling will be reasonable. At the time of writing, amidst rumours that the price which Vilnius will pay for 1,000 cubic metres of gas will rise to $404-410 (up $25 from last March), Gazprom representatives are heralding the position that the company continues to engage in 'friendly negotiations with Lithuania.'

[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

Yet Gazprom and Germany's E.ON-Ruhrgas come to terms

While the ongoing gas price-supply negotiations between Gazprom and the Lithuanian government have yet to reach a breakthrough, negotiations on a similar topic appeared to reach a successful crescendo between Gazprom and the German energy giant, E.ON-Ruhrgas. This outcome followed a recent meeting between E.ON's Chairman of the Supervisory Board and Chief Executive Officer, Dr Johannes Teysson, Chairman of E.ON, and Gazprom head, Alexei Miller, which was convened to discuss the price of gas supplied by Gazprom. In 2010, after a decline in the spot market gas price, several European energy companies which purchase Russian gas (including E.ON-Ruhrgas) demanded an increase in the spot-price component in long-term contracts.

However, while an agreement was reached, neither Gazprom nor E.ON-Ruhrgas representatives have revealed the new delivery conditions agreed to by the two companies. It is known only that the share of spot-price gas in the contract between E.ON Ruhrgas and Gazprom is 16 percent. Judging by the fact that E.ON Ruhrgas representatives were content with the results of the negotiations, it seems that they achieved their aim of increasing the spot-price component.

Kiev seeks to consolidate Ukraine's security of transit

At a meeting held recently, Russian Prime Minister Vladimir Putin and his Ukrainian counterpart, Mykola Azarov, discussed the subject of trade as well as Ukraine's possible entry into a customs union with Russia, Belarus and Kazakhstan. During the meeting, the Ukrainian side raised the question as to how such talks may in fact be concluded, given that a customs union with Russia would provide for the transit of guaranteed volumes of gas channelled across Ukrainian territory.

Gas transit across Ukraine remains a crucial issue for Kiev, since it earns around $3bn a year in transit fees from Europe-bound Russian gas supplies. At the same time, in accordance with the 'take-or-pay' agreement signed with Gazprom, Ukraine is obliged to buy 41.1bcm of natural gas per year. Conversely, Gazprom does not have an obligation to continue using Ukraine for the transit of gas to Europe. Therefore, the Ukrainian side feels that the signing of an agreement on transit of guaranteed volumes would be highly appropriate as this would oblige Gazprom to continue relying on the Ukrainian grid for Europe-bound gas and ensure the Kiev retains income from transit royalties. Furthermore, Ukraine fears that transit volumes of gas may fall sharply after the Nord Stream gas pipeline comes on stream, given that this project could redirect substantial volumes of Russian gas around Ukraine.

On April 20, Prime Minister Putin stated that the laying of the Nord Stream gas pipeline on the bed of the North Sea will be completed by June 2011, and gas supplies to European consumers will commence by October. The capacity of the first string of Nord Stream is 23.5bcm per year, with full capacity of 55bcm per year to be reached by 2014. Analysts contend that transit volumes will fall from 95bcm in 2010 to 70bcm once Nord Stream has reached full capacity.

Ties between Gazprom and Ukrainian gas tycoons remain strong

On April 20, the Ukrainian gas tycoon, Dmytro Firtash, announced that Ukrainian national gas pipelines operator, Naftogaz Ukraine, had fully repaid 12.1bcm of natural gas to his gas trading entity, RosUkrEnergo (RUE). In 2009, after the conclusion of an 11-year-long gas supply contract between Gazprom and Kiev, RUE was virtually left without business since the agreement had the aim of eliminating intermediary gas trading entities and facilitating direct supply contracts between Gazprom and Naftogaz. RUE faced the risk of being shut down altogether, although it had yet to collect the debts which had become incurred to it by Naftogaz.

Facing the gauntlet, however, Ukraine's most infamous gas industry personality, Dmytro Firtash, found a new means of retaining his significance in the Ukrainian gas market. His company, Osthem Holding, was able to conclude an agreement on deliveries of Turkmen gas to Ukrainian chemical enterprises – namely manufacturers of nitric fertilisers. The holding company buys gas, transports it to the Ukrainian border, and sells it to local enterprises (most of which are believed to be controlled by the Ukrainian gas tycoon himself). Thus Firtash recently announced that Ukraine began to receive gas from Central Asia as of April 1 of this year.

In theory this means that, as is the case with RUE, Gazprom has been removed from the list of suppliers (of gas to Ukraine) and that Osthem Holding is now a competitor to Gazprom on the Ukrainian gas market. At the same time, the delivery of Central Asian gas to the Ukrainian border is impossible without Gazprom's consent – the only gas pipelines which connect the Central Asian gas fields with Ukraine traverse Russian territory. Therefore, such deliveries require Gazprom's permission and most likely

reflect private arrangements between Firtash and Gazprom.

With a view to the new arrangements and the role of Osthem Holding, it is likely that Gazprom gave permission for the transit of gas across Russian territory only after imposing heavy tariffs. Thus, Gazprom will retain a share of the revenues from the delivery and sale of gas to Ukraine according to the same system as existed until 2009, although the delivery volumes at present are notably smaller.

How Gazprom lost an Elephant in Libya

Negotiations over Gazprom's entry into Libyan oil and natural gas projects owned or controlled by Italy's ENI have been temporarily suspended. Civil war in Libya disrupted the negotiation process, and Gazprom's potential purchase of a 50 percent stake in the Elephant (also known as Al Feel) oil field project has been postponed indefinitely.

ENI and Gazprom signed a strategic partnership agreement in 2006 to invest in gas exploration and production projects in the emerging economies of developing countries. Later, a supplementary agreement was signed, according to which Gazprom obtained the possibility of purchasing ENI's foreign assets.

In February 2011, ENI signed a new agreement with Gazprom, according to which the former ceded a 16.5 percent stake in the Elephant project. The Libyan National Oil Corporation (NOC) is also a stakeholder in the project.

While this contract was valued at $163 million, the money was not transferred to the Italian company. When the Libyan disturbances aggravated into civil war, Gazprom decided to postpone the deal for an indefinite period, while the fate of the Libyan regime remained uncertain.

Meanwhile, according to the former-Energy Minister of Libya, Omar Fati Ben Shatvan, Russia and China have lessened their chances of participating in the development of oil and gas fields in Libya due to the position they have taken on the Libyan crisis. According to Ben Shatvan, Russia will lose out on contracts because it refused to support the opposition, while Italy and France, which have recognised the Transitional National Council, will obtain access to deposits on the most favourable conditions.

Growing scope for Gazprom's LNG business in Asia-Pacific

At the end of April of this year, the Deputy Chairman of Gazprom's Management Committee, Alexander Ananenkov, and the General Director of the Japan Far East Gas Company Ltd, Yoshio Matsukawa, signed an agreement for a joint feasibility study on the building of a liquefied natural gas (LNG) plant and a gas-chemical complex in the Vladivostok Region of Russia. The study is to be completed by the end of the year.

The supposed capacity of the LNG plant will be 10 million tonnes of LNG per year and it is expected that raw materials will be delivered to the plant by the Sakhalin–Khabarovsk–Vladivostok gas pipeline system, although Gazprom representatives do not exclude the possibility that gas from Yakutia could be used for the project. The capacity of the plant will be sufficient to produce 13.8bcm of natural gas per year. Furthermore, the Vladivostok venue benefits from an ice-free port, meaning that transportation of the gas to consumers in the Asia-Pacific Region, particularly Japan, will be made easier. This could, in future, allow Gazprom to provide regional gas consumers with a serious alternative to LNG volumes supplied from Qatar.

Gazprom seeks to assert market dominance in Sakhalin gas projects

The Russian Prime Minister has instructed the Ministry of Energy to speed up the resolution of the so called Sakhalin-1 "gas question". Russian companies, in the form of Rosneft affiliates RN-Astra and Sakhalinmorneftegas-Shelf, control a 20 percent stake in the Sakhalin-1 project, with the remaining 80 percent controlled by Exxon Neftegas (a subsidiary of ExxonMobil), the Japanese SODECO consortium, and the Indian state-owned oil company ONGC. Gas from Chayvo 1 offshore field of the Sakhalin-1 project is currently processed at the Chayvo onshore processing facility, and then delivered to the Russian domestic market.

For several years now Rosneft and Exxon have been trying to convince Gazprom that Sakhalin-1 gas should be processed for export at the Sakhalin-2 LNG plant. Gazprom has rejected these proposals, claiming that gas produced from the Sakhalin-2 project (in which Gazprom controls a 50 percent plus one share) is sufficient to meet its LNG export commitments. However, given that demand is rising on the Asia-Pacific gas market and that Sakhalin-2 LNG trains are already operating at full capacity, a decision must be made by the end of the year on the construction of an additional, third train for the production of LNG.

DOMESTIC MARKETS

Gazprom position on dividends lacks full transparency

Gazprom has decided to pay around 63.9 billion Roubles (EURO 1.6 billion), or 17.5 percent of net profits as dividend to shareholders, on the basis of the 2010 operating results and taking into account Russian Accounting Standards. The company's management recommended a dividend of 2.7 Roubles per share, although the market had expected more, due to signals given to that effect by Gazprom Deputy Chairman, Andrei Kruglov, during public comments in 2010**.**

The dividend of 63.9bn Roubles was calculated without taking into account of losses related to the decrease in value of shares in the oil company 'Gazprom Neft', a Gazprom daughter company and there appears to be a debate between market analysts as to whether Gazprom management could have (or should have) paid out higher dividends. Analysts forecast that discussion on a dividend hike is not likely before the commissioning of the capital-intensive Bovanenkovo gas exploration project, planned for 2012. Instead, Gazprom will devote a large part of its resources to the implementation of its own investment programme.

End of the EGF document

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