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

By Jack Sharples, EGF Associate Researcher on the external dimensions of Russian gas

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Special Extended Report: Gazprom loses export monopoly as Novatek and Rosneft win the opportunity to export LNG

Non-Gazprom LNG exports to be limited to Rosneft and Novatek; Gazprom to retain monopoly on pipeline exports, with LNG directed to the Asia-Pacific market

On the 30th of October, the Russian government approved a landmark bill, which amended Russia's 'Law on Gas Exports' and 'Law on the Fundamentals of State Regulation of External Trade Activity' to allow for the liberalisation of Russia's liquefied natural gas (LNG) exports. In effect, the changes signal the end of Gazprom's monopoly on the export of Russian gas, which it has held since July 2006. The law will take effect in January 2014.

The changes do not represent a complete liberalisation of Russia's gas exports. Rather, LNG export licences will be granted to companies that fall into one of two categories: Firstly, companies that produce gas from fields of 'federal significance' (where the field resources are greater than 50 bcm) or companies that already held licences for the construction of an LNG terminal as of the 1st of January 2013. Secondly, state-owned companies in which the Russian state has a shareholding of greater than 50 percent, that are producers of gas from internal seas, territorial seas, or the continental shelf (with such offshore fields also designated as being of federal significance), and that produce LNG from gas extracted from these areas or from production-sharing agreements.

Therefore, in reality, these legal changes will allow the independent gas producer, Novatek (which already holds a licence to build an LNG plant) and the state-owned oil company, Rosneft (which also holds a licence to build an LNG plant and holds licences for offshore gas production at Sakhalin). Given that only state-owned companies may acquire licences for large or offshore fields of federal significance, it seems that smaller gas producers will be denied the opportunity to export LNG from Russia for the foreseeable future.

Russia currently has one LNG export outlet: The Sakhalin-II LNG export facility in Russia's Far East, launched in 2009. The project reached its 9.6 million tonnes per year LNG production capacity in 2010. Gazprom currently holds a 51 percent shareholding the project, along with Shell (27.5 percent), Mitsui (12.5 percent), and Mitsubishi (10 percent). Gazprom also intends to launch the first of three 5 million tonne trains at its planned LNG export terminal in Vladivostok in 2018. In a related development, in October 2013 Gazprom launched gas production at the Kirinskoye offshore gas field at Sakhalin and tested the links between the field and the Sakhalin-Khabarovsk-Vladivostok gas pipeline, with Kirinskoye a potential resource base for Gazprom's planned Vladivostok LNG project.

Novatek is currently constructing the Sabetta LNG export terminal on Russia's northern coast in partnership with Total (20 percent) and the China National Petroleum Corporation (20 percent) under the project name 'Yamal LNG'. The export terminal is planned to consist of three trains, each with a capacity of 5.5 million tonnes. The first train is expected to be launched in late 2016, with a further two trains to be launched in 2017 and 2018. On the 22nd of October it was announced that Novatek would export 3 million tonnes of LNG per year to China for the next 15 years at prices linked to the Japanese Crude Oil Cocktail. That announcement came just a month after CNPC acquired its 20 percent shareholding in Yamal LNG.

Rosneft is currently developing its own LNG export terminal on the island of Sakhalin, in Russia's Far East, in partnership with ExxonMobil. According to Rosneft, the terminal will have an export capacity of 5 million tonnes per year with the potential for further expansion, and is planned to be launched in 2018. The resource base for the terminal will be Rosneft's gas production on Sakhalin and its surrounding offshore areas.

According to an official announcement by Russia's Energy Ministry, the bill was prepared in accordance with requests from the President and Prime Minister. This suggests that the Russian government is somewhat disappointed with Gazprom's failure to expand its LNG exports and capture a larger share of the global LNG market – Russia currently accounts for 5 percent of global LNG production, having exported 203 bcm of pipeline gas and 1.92 bcm of LNG in 2012. In announcing the liberalisation, Russia's Energy Ministry expressed the hope that Russia could double its share of the global LNG market to 10 percent with the production of 35-40 million tonnes by 2020.

Finally, it should be noted that the limited liberalisation of Russia's LNG exports will not threaten Gazprom's monopoly on the export of Russian gas to Europe, which is conducted entirely via pipelines. Instead, Russia's LNG exports are expected to be delivered to the increasingly LNG-hungry Asia-Pacific market, where prices are higher than in Europe.

Gazprom and the EU

Pride before the fall? Gazprom's exports to Europe in October jump 17% y-o-y and year-to-date exports increase 16% y-o-y while the European Commission prepares to charge Gazprom as part of its antimonopoly investigation into the company

Gazprom's exports to Europe reached 12.6 bcm in October 2013, an increase of 17 percent versus October 2012. This result was part of an ongoing trend, with Gazprom's January-to-October gas exports to Europe reaching 131 bcm – a 16 percent increase in Gazprom's European exports of 113 bcm during the same period last year.

According to Sergei Komlev, the Head of the Contract Structuring and Price Formation Directorate of Gazprom Export, the increase has been caused by a combination of three developments: The redirection of global LNG supplies away from Europe to Asia, where prices are higher, an unexpected decrease in Norwegian production at its Troll gas field due to technical problems, and disruptions in Libyan natural gas production caused by the ongoing political instability in the country.

Another reason for Gazprom's autumn gas export surge is that European energy companies have left it later than usual to buy gas for their winter storage. Reports suggest that the injection of gas into storage facilities for use during winter was delayed by four weeks in 2013 compared to last year, and that by mid-October European gas storage levels were approximately 15 bcm lower than averages for previous years. While European energy companies leaving it late to replenish their gas storage is a short-term phenomenon, the longer-term question for Gazprom is whether the trends of LNG being attracted to Asia rather than Europe, and the production disruptions in Norway and Libya will continue through 2014, thus opening up the possibility for another good year for Gazprom's European gas exports.

However, even if the picture does look promising for Gazprom's European exports over the next year, there remains the not insignificant matter of the European Commission antimonopoly investigation into Gazprom's practices in Central Europe. As reported in the last issue of the Gazprom Monitor (№ 28 – September 2013), the European Commission antimonopoly investigators are concluding their investigation and preparing the charges against Gazprom, known as the Statement of Objections. Although EU Competition Commissioner, Joaquin Almunia refused to be drawn on a timetable, sources suggest that action could be taken by the end of the year. If found to be in breach of EU Antitrust regulations, Gazprom could face a fine of up to 10 percent of its annual turnover, which could result in a fine of €11bn.

Ukraine

Gazprom demands that Naftogaz pay overdue $900m gas bill for August gas supplies a month ahead of the Ukrainian government's planned signing of a Free Trade and Association Agreement with the European Union

During a televised meeting with Russian Prime Minister, Dmitry Medvedev, on the 29th of October the Gazprom CEO, Alexei Miller, claimed that Naftogaz had failed to a bill of $882m for its August gas imports from Gazprom. Miller added that not only Gazprom extended the payment deadline to the 1st of October, but also that Gazprom had previously paid $1bn up front to Naftogaz as payment for gas transit. Therefore, Gazprom claims that there can be no financial reason for Naftogaz to fail to pay its August gas bill. Although Medvedev referred to the situation as 'critical', just 48 hours later he gave another interview in which he stated that there would be no reduction of gas supplies to Ukraine, nor any interruption in Russian gas exports to Europe this winter.

While Naftogaz has yet to comment publicly on the issue, the Ukrainian Prime Minister, Mykola Azarov, emphasised the commercial nature of the issue: "This primarily is a question concerning two companies and they have to sort things out". Meanwhile, Ukraine's Energy and Coal Industry Minister, Eduard Stavytsky, appeared confident that an agreement will be reached between the two parties, telling reporters, "We always come to an agreement, we'll come to an agreement now as well".

However, European importers of Russian gas are becoming increasingly nervous following the development of the dispute. The current contract between Gazprom and Naftogaz states that, should Naftogaz fail to make a payment on time for gas supplies already consumed, then it would automatically switch to pre-payment for gas supplies. Given that this switch could, theoretically, take place as soon as December, there could arise a situation whereby Gazprom cuts off supplies to Naftogaz and fails to reinstate them until Naftogaz has paid up front for supplies. As reported in last month's Gazprom Monitor, the two sides recently reached an agreement on the amount of gas that ought to be stored in Ukraine to facilitate winter transit of Russian gas to Europe, while the most recent reports suggest that Ukraine has 17 bcm in storage.

Ukraine has long complained that it is overpaying for Russian gas supplies, and has taken steps to reduce its reliance on Russian gas imports. Between January and September 2013 Ukraine's total imports of Russian gas amounted to 19.7 bcm, a 20 percent reduction compared to the 24.6 bcm imported from Russia during the same period last year. This marked the continuation of an ongoing trend: In 2012, Ukraine's gas imports of 33 bcm were 26.5 percent lower than in 2011, while the transit of Russian gas via Ukraine fell 19 percent vs. 2011 to 84 bcm.

The flare-up of the dispute between Gazprom and Naftogaz comes just a month before the Ukrainian government is due to sign Association and Free Trade Agreement with the EU at a forthcoming summit in Vilnius. The Russian government, which is trying to entice Ukraine into a Customs Union with Russia, Belarus, and Kazakhstan, has warned Ukraine that it cannot be party to two free trade agreements. During a discussion forum in Yalta, one of President Putin's personal advisers commented that, "Russia is Ukraine's major creditor. Only with the Customs Union with Russia can Ukraine balance its trade". However, Putin's press spokesman, Dmitry Peskov, was quick to assert that it was a coincidence that the gas dispute with Ukraine flared up just before the summit in Vilnius.

South Stream

South Stream construction begins in Bulgaria with aim of December 2015 launch

On the 31st of October, Gazprom began the construction of the Bulgarian section of the South Stream gas pipeline with a symbolic welding at the Rasovo compressor station. Watching the event via video link were Alexei Miller, Chairman of the Gazprom Management Committee, Plamen Oresharski, Prime Minister of the Republic of Bulgaria, Dragomir Stoynev, Bulgarian Minister of Economy and Energy and Alexander Novak, Russian Minister of Energy. Following the event, Miller announced that, “This project is a key element of energy security of the whole European continent. Gas will be supplied directly from Russia to Bulgaria, from Russia to the European Union, bypassing transit countries, thus providing for the most reliable and uninterrupted supplies. South Stream will eliminate transit risks forever”. Miller then added that Bulgarian customers would receive the first South Stream deliveries in December 2015.

South Stream will deliver Russian gas across the Black Sea from Russia to Bulgaria, and then on to Northern Italy via Serbia, Hungary, and Slovenia. Gazprom also plans to construct spurs to Bosnia-Herzegovina and Croatia.

Asia

Gazprom and CNPC to finalise deal by year end: Russian Energy Minister

Following another bilateral meeting between Russia and China at which the pair failed to finalise their long-awaited gas supply contract, Russia’s Energy Minister, Alexander Novak, announced that Gazprom and the China National Petroleum Corporation (CNPC) will finalise their bilateral gas supply contract by the end of the year.

In last month’s Gazprom Monitor we reported that during the G20 Summit in St Petersburg the two sides had “signed a legally binding agreement on the terms and conditions for the export of Russian gas to China”, including delivery volumes of 38 bcm, a start-date of 2018, the route (from Eastern Russia to North-East China) and other non-publicly-announced details such as the contract length and take-or-pay levels. In principle, everything was agreed except the price. And despite another high-level meeting, it seems that the two sides will continue their negotiations until the end of the year. Given the scale of the undertaking, which would make China the single largest importer of Russian gas in the world, and the pace at which global LNG trade and shale gas production is developing, it is hardly surprising that both sides are taking a cautious approach to the negotiations, being unwilling to make too many concessions.

In 2012, China imported 42.5 bcm of natural gas, of which 20 bcm was imported from Turkmenistan. That represented a 30 percent increase versus gas imports in 2011 and a ten-fold increase versus 2007, while gas demand grew an additional 13.5 percent during the first nine months of 2013. Although Turkmenistan has promised to triple its deliveries to China to 65 bcm per year by 2020 this will not be enough to meet Chinese import demand. Reports suggest that Chinese gas demand will more than triple between 2010 and 2040, and that Russian gas will have a major role to play in China’s increased gas demand, along with domestic gas production, pipeline imports from Central Asia and LNG imports from the Asia-Pacific market.

And in other developments…

Gazprom launches its first solo offshore gas production project

And finally, in other developments, Gazprom has launched its first solo offshore gas production project. The Kirinskoye gas field is located 28 kilometres off the coast of Sakhalin Island, in Russia's Far East, where the sea is 90 metres deep. The field has 162.5 bcm of C1 category reserves, and full production capacity at the field will be 5.5 bcm per year – approximately that of the first LNG train of Gazprom's planned Vladivostok LNG terminal. Once the gas is extracted from beneath the seabed, it is transferred to an onshore production facility for treatment, and then fed into the Sakhalin-Khabarovsk-Vladivostok gas pipeline. The achievement is notable because it is the first time that Gazprom has ever successfully implemented an offshore sub-sea gas production project by itself. Although Gazprom has experience of offshore gas production thanks to the Sakhalin-II project, that project was originally based on a Production Sharing Agreement with foreign energy companies. Gazprom only acquired its shareholding in the project in 2006.

However, this does not suggest that Gazprom will exclude foreign energy companies from its future projects. For example, Gazprom representatives have already announced that the company is willing to cede up to 49 percent of the shareholding in the planned Vladivostok LNG terminal to foreign investors. Rather, the achievement at Kirinskoye illustrates Gazprom's commitment to expanding production volumes at export-oriented projects.

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