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

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Key points:

- *European Commission further postpones ruling on use of OPAL pipeline*
- *Gazprom and Wintershall finalise asset-swap, as Gazprom gains control of Europe's largest underground gas storage facility (UGSF)*
- *Lithuania breaks free of Gazprom monopoly with first LNG delivery*
- *Gazprom and Naftogaz agree on short-term 'winter package' until March 2015 to ensure gas supplies and transit during the upcoming winter*
- *Nord Stream: Nord Stream AG deny reports that plans to extend Nord Stream to the UK will be shelved amid tensions between Russia and the EU*
- *South Stream: Hungarian MVM shows its support for Gazprom with gas storage deal; MVM also pledges to complete the Hungarian section of South Stream by 2017*
- *Gazprom CEO holds talks, discusses funding from Chinese banks and gas supply via the 'Western Route'*
- *Gazprom refills Serbian gas storage facility to capacity in preparation for winter*

Gazprom and the EU

European Commission further postpones ruling on use of OPAL pipeline

The 36 bcm per year capacity OPAL pipeline connects Nord Stream's landfall site at Greifswald with Olbernhau on the German-Czech border. OPAL is 80 percent owned by OPALGasTransport, a wholly-owned subsidiary of W&G. W&G is a parity joint venture between Wintershall and Gazprom. According to the principle of third party access, OPALGasTransport must reserve up to 50 percent of the capacity of OPAL for purchase through auction by 'third party' companies. In 2009, the German energy regulator, BundesNetzAgentur (BNetzA), granted a 22-year exemption from third party access to the OPAL project. In March 2012, this was challenged by the European Commission, which planned to offer a ruling on the matter.

In December 2013, the European Commission promised a ruling in early 2014. In February 2014, BNetzA proposed a compromise solution: OPALGas-Transport could keep 50% of the capacity for its own use, and has to offer the other 50% to the market using the PRISMA platform. The first auction was proposed for July 2014.

On the 10th of March 2014, the European Commission announced that it would delay its decision on granting OPAL an exemption from third party access provisions, citing the need for technical clarifications.

In July 2014, the proposed OPAL capacity auction was cancelled. A proposed deadline for a ruling in mid-September then passed, and now it seems that the revised deadline of the 31st of October will also pass without a ruling on OPAL.

The Russian Energy Minister, Alexander Novak, spoke to the press on the 24th of October, stating:

> I believe this is not the last delay… It seems to be [the EU's] principal decision not to consider this issue yet, although all the necessary agreements with the German regulator were reached in late 2013.

Reports suggest that a ruling is unlikely until the Russia-Ukraine gas dispute is resolved and tensions in the EU-Russia relationship are eased. However, it has also been suggested that the failure to grant a ruling on OPAL could make it more difficult to utilise the full capacity of Nord Stream in the event of a disruption in gas supplies via Ukraine this winter.

Gazprom and Wintershall finalise asset-swap as Gazprom gains control of Europe's largest UGSF

In early October, the European media widely reported that Gazprom had just 'bought Europe's largest underground gas storage facility' (UGSF). This was actually the completion of a deal that was agreed to back in November 2012, and approved by EU regulators in December 2013.

According to the agreement, Gazprom exchanged 25 percent shares in two blocks of the Achimov deposits of its Urengoi gas field (West Siberia) for increasing its shareholdings from 50 percent to 100 percent in the Gazprom-BASF Wintershall joint venture gas trading and storage companies Wingas, WIEH, and WIEE. Gazprom also received a 50 percent share in BASF Wintershall subsidiary WINZ, which carries out exploration and gas production in the North Sea.

The Wingas subsidiary, Astora, operates the largest gas storage facility in Western Europe, at Rehden in Germany, and holds a 30 percent stake in the second-largest gas storage facility in Central Europe, at Haidach in Austria.

By increasing its shareholding in Wingas to 100 percent, Gazprom has therefore gained complete control over the Rehden UGSF. The Rehden facility has a storage capacity of 4.2 bcm and a send-out capacity of 48 million cubic metres per day. This send-out capacity is equal to approximately half the daily capacity throughput of the Yamal-Europe pipeline connection on the Polish-German border.

Lithuania breaks free of Gazprom monopoly with first LNG delivery

In previous editions of the Gazprom Monitor, we have followed the development of Lithuania's plans to free itself from complete dependence on Gazprom for its imported gas supplies. Those plans were realised in late October, when Lithuania took its first delivery of LNG.

Such deliveries are possible because the state-owned Lithuanian gas terminal operator, Klaipedos Nafta, is renting a floating storage and regasification unit (FSRU) from Norwegian company Hoegh LNG. That unit will have a storage capacity of 170,000 cubic metres. The total import capacity of the terminal is estimated at 2-3 bcm per year, while regasification capacity is estimated at 4 million cubic metres per day and the send-out capacity of the FSRU is estimated at up to 11 million cubic metres per day. The Norwegian gas exporter, Statoil, has a contract to deliver LNG to the terminal for its first five years of operation. LNG will be delivered to the terminal by a specially-built LNG tanker named 'Independence'.

Over the past decade, Lithuania's gas imports have ranged from 2.7 bcm to 3.7 bcm. More recent statistics show that Lithuania imported 3.3 bcm in 2012 and 2.7 bcm in 2013, all from Russia. Therefore, the new terminal could meet the overwhelming majority of Lithuania's gas imports.

However, Lithuania may not need to diversify its gas imports entirely away from Russia. In May 2014, Lietuvos Dujos negotiated a 20 percent discount on the price it pays for gas imported from Gazprom, bringing the price down to \$372 per thousand cubic metres. The discounted price is slightly lower than the price of Russian gas on the German border in Q3 2014 (\$10.1 per MMBtu, or \$374 per 1000 m^3). If Gazprom is prepared to continue the discount, then Lietuvos Dujos may continue importing gas from Gazprom. Lietuvos Dujos' current long-term contract with Gazprom expires at the end of 2015.

Media sources have suggested that the new Lithuanian LNG import terminal could help Lithuania's Baltic neighbours reduce their dependence on Russian gas imports. Lithuania currently has a cross-border pipeline connection with Latvia with a capacity of 5.8 million cubic metres per day (just over 2.1 bcm per year). Between them, Latvia and Estonia imported 1.8 - 2.4 bcm of natural gas from Russia in 2013. Therefore, the new Lithuanian terminal could help all three states diversify their gas imports, but it will not be sufficient to replace regional imports of Russian natural gas completely.

Gazprom and Ukraine

Gazprom and Naftogaz agree on short-term 'winter package' until March 2015 to ensure gas supplies and transit during the upcoming winter

On the 30th of October, EU-mediated talks between Gazprom and Naftogaz Ukraine finally yielded tangible results. Gazprom will restart gas deliveries to Ukraine, with deliveries estimated at 2 bcm in November and 2 bcm in December, to help Ukraine get through the winter heating season.

To make this restart possible, the two sides agreed that Ukraine would repay $3.1bn of its debts in two tranches: $1.45bn is to be repaid 'immediately' and the remaining $1.65bn by the end of 2014. The two sides also agreed on temporary discounts for gas supplied between November and March: in November and December, Gazprom's deliveries to Ukraine will be priced at $378 per thousand cubic metres. In Q1 2015, the price will fall further to $365. Taken together, these measures have been referred to as the 'winter package', to emphasise their temporary, seasonal, nature.

The current Russia-Ukraine gas dispute has been simmering for almost a year. Gazprom accuses Naftogaz of failing to pay its gas bills since November 2013, and claims at least $4.5bn in unpaid debts. Naftogaz accuses Gazprom of overcharging since the signing of a 10-year gas supply contract with oil-linked prices in January 2009, and is seeking a refund of around $6bn. Both sides have lodged claims with the Stockholm Commercial Court Arbitration Institute.

Naftogaz was able to accrue debts because it was only obliged to pay for gas after delivery, not before. In June 2014, Gazprom switched to a 'prepayment' regime – Naftogaz would only receive gas that had been paid for in advance. The practical result was the suspension of Russian gas deliveries to Ukraine.

With winter approaching, Naftogaz has approximately 17 bcm in storage. Reports suggest that Ukraine faces a shortfall of 3-5 bcm between now and March, depending on the weather. In a bid to restart Russian gas deliveries to Ukraine, the EU agreed to mediate talks between the two sides. Throughout October, it seemed increasingly likely that no agreement would be reached before the current EU Energy Commissioner, Gunther Oettinger, steps down on the 1st of November.

Between the 29th and 31st of October, the two sides met for another round of talks. The Naftogaz CEO, Andriy Kobolyev, claimed that Naftogaz is willing and able to pay off $3.1bn before the end of 2014:

> That money is already there, in a special escrow account. $3.1 billion has already been set aside for paying Gazprom.

However, the size of the remaining payment (beyond the initial $3.1bn) will depend on the arbitration case in Stockholm. The current contractual price is estimated at $485 per thousand cubic metres. By comparison, the IMF reports the price of Russian gas at the German border as being $10.4 per million British Thermal Units (MMBtu), or approximately $367 per thousand cubic metres, in Q3 2014. Gazprom initially offered a $100 discount to bring the price down to $385. Naftogaz refused to countenance temporary 'discounts' and sought a permanent, fundamental revision of the contractual formula, along with the recalculation of Naftogaz's debt based on a price of $268 (rather than the contractual price of $485). While the volumes imported by Naftogaz are not disputed, the lowering of the calculation price would significantly reduce Naftogaz's financial debts to Gazprom.

The breakthrough was achieved through Gazprom's willingness to grant the discount, Naftogaz's willingness to pay off a portion of its debts before the results of the arbitration cases are known, and the willingness of the EU to put together a package of loans to Ukraine that will enable Naftogaz to pay in advance for its winter gas supplies from Gazprom.

While European gas importers dependent on the delivery of Russian gas via Ukraine may breathe a sigh of relief, the Russian Energy Minister, Aleksandr Novak, issued a warning to his Ukrainian counterparts regarding the payment of the second tranche of debt by the end of 2014:

> If Kiev fails to pay off $1.65 billion, we will stop the supplies in January. It is stipulated in the agreement... There are no risks for the Russian side and for Gazprom. If the debt is paid off – then there will be deliveries.

Furthermore, it should be emphasised that the 'winter package' is only a temporary measure. Both Mr Novak and Gazprom CEO Alexei Miller have affirmed that the existing contract remains in force, and that the price of Russia's gas deliveries to Ukraine will revert to contractually-stipulated levels at the end of March 2015. While the results of the two Stockholm arbitration cases will be eagerly awaited, there will undoubtedly be further negotiations during Q1 2015, as Naftogaz will surely try to avoid a dramatic increase in prices. In this regard, they may be helped by current trends in international oil prices (to which Ukraine's gas import prices are linked). Weekly spot prices for Brent crude have fallen from $110 a barrel in early July to $100 in early September. Prices fell further to $85 a barrel in late October. The slide in oil prices has been caused by a combination of weak demand, increased production in the US, and the current policy of Saudi Aramco (the world's 'swing' producer) to defend market share rather than price by refusing to curtail its own production. Unless these factors change, lower oil prices could be sustained.

For Naftogaz, the price of its gas imports from Gazprom are revised quarterly, and index-linked to monthly averages of Mediterranean gasoil (0.1% sulphur) and fuel oil (1% sulphur) products over the previous 9 months. It is reasonable to predict that the slide in oil prices in H2 2014 will be reflected in oil products, and, therefore, in Naftogaz's gas import prices from the end of Q1 2015. This could make the transition from 'winter package' back to 'contractual pricing' easier to bear.

Nord Stream

Nord Stream AG deny reports that plans to extend Nord Stream to the UK will be shelved amid tensions between Russia and the EU

The consortium that owns and operates the Nord Stream gas pipeline (Nord Stream AG) has denied reports that plans to extend the pipeline to the UK and Netherlands are to be scrapped due to the current tensions in international relations between Russia and the EU.

Gazprom is the majority (51 percent) shareholder in Nord Stream AG consortium, in partnership with Wintershall (15.5 percent), E.On (15.5 percent), Nederlandse Gasunie (9 percent), and GDF Suez (9 percent).

Reports, including those issued by *The Times* newspaper in the UK, suggested that the consortium's British partners (thought to be BP) had gone cold on the project, due to the deterioration in relations between Russia and the EU. Several of those reports quoted John Lough, an Associate Fellow in the Russia and Eurasia Program at the Chatham House think tank in the UK:

> Given the current tensions in the relations between Russia and the Western countries, I see no possibilities for the project to go further than the drawing board… This is hardly a favourable time for Gazprom to continue its expansion into the European market.

Russian sources also quoted an unnamed Nord Stream AG spokesperson:

> Nord Stream does not have a mandate to proceed with the extension project and therefore we have to focus on our primary needs and objectives of an efficient gas pipeline transport operator.

Later that same day, different Russian sources reported another unnamed Nord Stream AG spokesperson offering a robust response to the claims that the project had been scrapped:

> The basis of the project remains and the technical and economic review that Nord Stream completed has given a strong base for the development of the project in the future whenever the decision is made. The Times' intent to tie the lack of progress [of the project] of expanding the pipeline with the events in Ukraine and existing sanctions have nothing to do with it in regard to terms, reasons, and consequences.

These claims and counter-claims fail to address the point that, despite Gazprom's conduct of a feasibility study in late 2012 to determine the commercial prospects of extending Nord Stream and reports that Gasunie confirmed its interest in extending the pipeline in mid-2013, no further progress has since been made on adding third or fourth lines to the pipeline, whatever their direction. Furthermore, these reports were based on the opinion of an expert independent researcher, who simply offered his take on the matter – none of Nord Stream AG, BP, or Gasunie have made official statements or published press releases on the matter, beyond the anonymous quotes attributed to Nord Stream AG spokespeople. Perhaps a better headline reporting the issue would be: 'Rumours suggest that seemingly-stalled project is now actually halted'.

South Stream

Hungarian MVM shows its support for Gazprom with gas storage deal

In the weeks since the Gazprom CEO, Alexei Miller, met with the Hungarian Prime Minister, Viktor Orban, in Budapest, the Hungarian government has increasingly shown its support for Gazprom.

In late September, immediately following the Miller-Orban meeting, the Hungarian government announced the 'indefinite' suspension of gas exports from Hungary to Ukraine and an increase in gas imports from Russia, in order to fill Hungary's gas storage facilities for the upcoming winter.

Prior to that announcement, the flow of gas from Hungary to Ukraine averaged 147 million cubic metres (mcm) per month in Q3 2014 – the equivalent of 1.76 bcm per year. For comparison, the flow of gas from Poland to Ukraine in Q3 2014 averaged 117 mcm per month. The ‘reverse flow’ of gas from Slovakia to Ukraine began in August 2014, at a rate of 144 mcm per month.

On the 10th of October, it was announced that Hungarian state-owned energy company MVM would store 700 mcm of natural gas on behalf of Gazprom, in preparation for the winter season, of which 135 mcm had already been injected into MVM’s underground gas storage facilities.

The agreement resulted in increases in Hungary’s daily gas imports via Ukraine and daily injections into gas storage, as noted by the energy information provider, ICIS:

> Storage injections have ramped up to a rate of 17mcm/day between 26 September and 26 October, after shipper nominations to flow Russian gas through Ukraine into Hungary increased to 24mcm/day. Previous storage injections in September had averaged 11mcm/day, while deliveries to Hungary via Ukraine stood at 15mcm/day.

Gas Storage Europe also provide data evidencing Hungary’s stockpiling of gas for the winter: natural gas stored in Hungary rose from 3,817 mcm on the 26th of September to 4,121 mcm on the 10th of October, and further to 4,429 mcm on the 28th of October. Therefore, by the 28th of October, MVM had stockpiled 443 mcm of the 700 mcm promised to Gazprom. At current injection rates, it will take MVM 2-3 weeks to meet its target.

The Hungarian gas grid operator, FGSZ, cites the increase of gas imports coming via Ukraine as the reason for the interruption in Hungary’s ‘reverse-flow’ gas exports to Ukraine. However, given Hungary’s increased support for Gazprom, it appears unlikely that ‘reverse-flow’ exports to Ukraine will resume even when Hungary reaches its target for gas storage.

Hungary’s gas storage facilities are now 70 percent full, with 4.4 bcm of Hungary’s 6.3 bcm storage capacity being utilised. According to MVM, the volumes stored are now sufficient to meet two-thirds of Hungary’s winter gas demand.

Hungarian MVM pledges to complete the Hungarian section of South Stream by 2017

MVM, Gazprom’s 50-50 JV partner in South Stream Hungary, has pledged to complete the Hungarian sections of South Stream by 2017, in defiance of calls from the European Commission to suspend the project. On the 27th of October, the CEP of MVM, Csaba Baji, announced:

> We could put shovel to dirt as soon as six months from now but we would like to complete the Hungarian stretch by 2017.

Hungarian sources report that the Hungarian government is also actively supporting the project. Antal Rogán, the head of the ruling Fidesz party’s parliamentary group, proposed amending a bill put forward by Fidesz MP Roland Mengyi. The amendment proposes that any gas company – not only the Transmission System Operator (TSO) – could build a pipeline. The motivation behind the amendment is that a pipeline built by a non-TSO would fall outside the remit of EU regulators, and be responsible only to the Hungarian Energy Ministry.

This is another unrealistic, hastily contrived proposal put forward by those who believe that they can side step the ‘letter of the law’ regarding EU gas market regulation. In that sense, it is similar to the proposal put forward at the beginning of September for South

Stream in Bulgaria to be re-classified as a 'field pipe' in order to exempt it from third party access provisions (reported in Issue 39 of the Gazprom Monitor in August 2014).

As we reported last month, the European Commission cannot prevent any member state government or its energy companies from constructing South Stream on EU territory. However, the European Commission will be able to take action once the pipeline enters into operation, if it is deemed to be in breach of EU gas market regulation. With respect to South Stream, such breaches are most likely to be found regarding Gazprom's shareholding in the pipeline ('unbundling') and provisions for third party access.

From the perspective of European gas consumers, the South Stream project would bring increased energy security by reducing dependency on gas transit via Ukraine. If gas flows are re-directed from Ukraine to South Stream, there will be no net increase in dependence on Russian gas imports. However, in order to maintain (and even increase) the competitiveness of the EU gas market, South Stream must comply with EU gas market regulations.

Gazprom in Asia

Gazprom CEO holds talks, discusses funding from Chinese banks and gas supply via the 'Western Route'

On the 10th of October, Gazprom CEO Alexei Miller visited Beijing for a meeting with Zhang Gaoli, First Vice-Premier of China's State Council. Gazprom report that:

> The parties discussed the Intergovernmental Agreement for Russian pipeline gas supply to China via the eastern route. It was pointed out that the document was at its final stage and could be signed in the near future. The meeting discussed the next specific steps for preparing a project for gas supply via the western route. Three main documents will be inked: an intergovernmental agreement, a commercial contract and a technical agreement.

Several days later, on the 13th of October, Miller and the Vice-President of the China National Petroleum Corporation, Wang Dongjin, met in Moscow to sign the technical agreement. That document states the basic parameters of the design, construction, and operation of the 'Power of Siberia' pipeline, which will be used to deliver gas via the Eastern Route. The Russia-China Intergovernmental Agreement was also signed by the Prime Minister of Russia, Dmitrii Medvedev, and the Premier of China's State Council, Li Keqiang. Following the meeting, Miller noted:

> As of today, all the necessary documents on gas supplies to China have been signed, including the Intergovernmental Agreement. The construction of Power of Siberia is in full swing. We have a particular plan and specific deadlines to be met without fail.

Despite the optimism surrounding the signing of the key documents, the meeting was somewhat overshadowed by a disclosure from the Deputy Head of the Chayanda Office of Gazprom Dobycha Noyabrsk (a Gazprom production subsidiary), Viktor Selin, some 10 days earlier, that the launch of the Power of Siberia pipeline would be delayed from 2018 to 2020. The delay had been reported in the Russian press back in March 2014, but the apparent confirmation of the delay by a senior Gazprom manager was significant. So significant that it reportedly cost Selin his job.

With regard to gas supplies via the Western Route, using the yet-to-be-built 'Altai' pipeline, Gazprom reports that a contract for deliveries of 30 bcm per year is currently being prepared, with ambitious plans for potential second and third lines to bring delivery volumes up to 100 bcm per year.

Plans published by Gazprom show the 'Altai pipeline' connecting Gazprom's current gas production 'heartland' of Novyi Urengoi (in the Yamal-Nenets Autonomous Region of North-West Siberia) with the Russia-China border.

If such plans are actually realised, it is most likely that gas from Gazprom's longstanding fields around Novyi Urengoi would be diverted from Europe to China, while gas production on the Yamal Peninsula would be ramped up to supply European customers.

Gazprom launched gas production at the Bovanenkovo field on the Yamal Peninsula in 2012, but production remains well below capacity due to a lack of demand. Gazprom has already built the first line of a pipeline connecting the Yamal Peninsula to European Russia, and plans to complete the remaining lines by 2016. This could coincide with the construction of the Altai pipeline for gas exports to China, if Gazprom is able to secure a contract with a Chinese gas buyer and generate the investment capital. The implementation of the 'Western Route' project would bring Gazprom's gas exports to China up to 68 bcm – the amount envisaged in the framework documents of the Gazprom – CNPC agreement.

Interestingly, Miller also cast doubt on Gazprom's proposed LNG export terminal, which Gazprom plans to be built in Vladivostok for the export of Eastern Siberian gas to the Asia-Pacific market. Miller noted:

> Gazprom is ready to consider the possibility of pipeline gas export to China as an alternative to the Vladivostok LNG project.

Several days later, on the 14th of October, Gazprom hosted a visit from the state-owned Industrial and Commercial Bank of China (ICBC), one of the world's largest. Although the contents of the meeting were not disclosed, it is highly likely that the meeting was connected to Gazprom's search for financing for the Power of Siberia pipeline and (potentially) the Altai pipeline. Although Gazprom itself is not under sanction by the US and EU, it is finding it more difficult to obtain credit and financing on international markets, meaning that ICBC could offer Gazprom some much-needed support in getting its China-oriented projects off the ground.

And in other developments…

Gazprom refills Serbian gas storage facility to capacity in preparation for winter

During the St Petersburg International Gas Forum, a working meeting took place between the Gazprom CEO, Alexei Miller, and the Director General of the Serbian state-owned Srbijagas, Dusan Bajatovic. Following that meeting, Gazprom announced that it had "almost fully replenished" gas stocks in the Gazprom-owned Banatski Dvor underground gas storage facility (UGSF) in Serbia.

The capacity of Banatski Dvor is 450 million cubic metres (mcm). In 2013, Serbia imported 2 bcm of Russian gas, all of which was sourced from Russia and delivered via Ukraine. In the same year, Srbijagas signed a new long-term contract with Gazprom for the supply of 1.5 bcm per year. Serbia's gas consumption is approximately 2.5 bcm per year. In winter 2013-14, Serbia's gas imports averaged 226 mcm per month between October and January. Given that Serbia usually draws on its gas stocks during winter, the gas stored at Banatski Dvor would be sufficient to replace Russian gas imports via Ukraine for little more than a month.

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