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

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Gazprom and the EU

EU antitrust investigation: suspended but not finished

After several months in which the European Commission continued to 'formulate its statement of objections', sources are reporting mixed signals from the EU Competition Commissioner, Joaquin Almunia, whose term in office ends on the 31st of October. Mr Almunia has been quoted as stating, "Some work was done, but was suspended because of the Ukraine crisis, but this investigation will not stop."

While other sources report that Mr Almunia and his team are 'poised' to complete the statement of objections, Mr Almunia has not confirmed when he will send the document to Gazprom.

The 'statement of objections' is the list of grievances held by the EU regarding Gazprom's allegedly anti-competitive practices. Gazprom will have the opportunity to respond to these objections, and, if it chooses, to request a behind-closed-doors hearing of the case. If the case is heard in court and Gazprom is found guilty of anti-competitive behaviour in contravention of EU law, the company could face a fine of up to ten percent of its annual revenues (with the potential fine therefore estimated at €10-15bn).

Mr Almunia's nominated successor, Margrethe Vestager, will inherit the decision of whether to continue talks that will allow Gazprom to settle the case out of court, to press for a court hearing, or to drop the case altogether. The latter option is highly unlikely, while the choice between settlement and a court hearing will depend on Gazprom's answers to the statement of objections.

Lithuanian government continues with arbitration case against Gazprom

Gazprom acquired its 37.1 percent shareholding in Lithuania's gas utility, Lietuvos Dujos, in 2004. Gazprom has long been the sole supplier of natural gas to Lithuania. In 2012, the Lithuanian government initiated an arbitration case against Gazprom, claiming that Gazprom had abused its shareholder and monopoly supplier position by overcharging for gas supplies to Lietuvos Dujos between 2004 and 2012. Since then, Gazprom has sold its stake in Lietuvos Dujos, and Lietuvos Dujos itself has been 'unbundling' into several companies, in line with the liberalisation provisions of the Third Gas Directive.

The arbitration case still stands, and the Lithuanian government (as a shareholder in the successor companies to Lietuvos Dujos) is seeking 4.5bn Litas (approximately €1.3bn) in refunds from Gazprom. The Lithuanian Prime Minister, Algirdas Butkevicius, addressed the Lithuanian parliament on the 25th of September:

> The Stockholm case is proceeding according to the schedule set by the tribunal. Lithuania will present the final document in late November, while an oral hearing is planned for the next summer... the government's claim... that Gazprom had breached [the] privatisation deal and unilaterally raised gas prices still stands.

In a related development, the days of Gazprom's monopoly over Lithuania's gas imports appear to be numbered, with the start-up of Lithuania's floating LNG import terminal due on the 1st of January 2015. To this end, state-owned LitGas has signed a five-year contract with Statoil to import 540m cubic metres of natural gas per year, and is actively seeking further contracts in a bid to diversify the country's 3 bcm per year gas imports. Gazprom's own contract for supply of gas to Lithuania expires on the 31st of December, 2015.

Gazprom struggles to meet European gas demand beyond contracted levels as winter approaches

At a televised meeting on the 17th of September with the Russian President, Vladimir Putin, the CEO of Gazprom, Alexei Miller, reported that although Gazprom is continuing to supply contractually-agreed volumes to its European customers, Gazprom is not currently able to supply the additional volumes requested by those customers.

Mr Miller referred to forecasts from the Russian Hydrometcentre that Russia is set to experience a winter that will be 'colder than usual', and that Gazprom was stockpiling gas supplies accordingly, in order to secure domestic demand. This process will take another six weeks, at which point Gazprom will be able to resume extra deliveries to European customers.

President Putin pressed Mr Miller on the issues, asking, "There was information that Gazprom had stopped supplying gas to our European consumers. What is the real state of things?"

To which Mr Miller replied:

> Gazprom secures the reliability of daily gas supplies to European consumers. We fully meet our contractual obligations. The so-called additional volumes were meant. There is no doubt that as soon as the injection period, the period of active replenishment of our UGS facilities with the required volumes of gas ends, we will be able to meet the extra demand of our European consumers from then on.

President Putin asked for clarification:

> So, if I got you right, it means that within your contracts you have entirely fulfilled your obligations, but could not fully satisfy extra demands?

To which Mr Miller confirmed, "Yes, Mr. Putin, exactly."

European energy companies will undoubtedly follow the progress of Gazprom's stockpiling over the next six weeks, as they too prepare for winter by filling their underground gas storage facilities (UGSF).

European gas prices continue to fall – Gazprom could face revenue shortage

According to the Russian Ministry of Economic Development, the price of Russia's gas exports could fall by more than 25 percent in the next three years. Russian gas export volumes are forecasted to remain stable, thus leading to a decline in gas export revenues. The Ministry predicts that the average price for Russia's gas exports will decline to $349 per thousand cubic meters by the end of 2014, and could eventually fall to $302 per thousand cubic meters by 2017.

Data from the IMF confirms the current trend of declining gas prices in Europe: the price of Russian gas at the German border fell from $447 per thousand cubic metres ($11.98 MMBtu) in 2012 to $417 ($11.19 per MMBtu) in 2013, and has since fallen even further to $392 per thousand cubic metres ($10.51 per MMBtu) for 2014 year to date. In Q3 2014, the price of Russian gas at the German border fell to $375 per thousand cubic metres ($10.06 per MMBtu), down from $409 ($10.97 per MMBtu) in Q3 2013.

Gazprom and Ukraine

New round of trilateral gas talks imminent as winter approaches

It is official. The winter heating season has begun. Here in St Petersburg, the district heating systems have sprung into life, delivering supplies of hot water to the radiators and heating systems of homes and businesses across the city. Russian colleagues assure me that the system is initiated following three consecutive days of temperatures below 7 degrees Celsius. Yet despite falling temperatures and related gas demand increases across Europe, the Gazprom-Naftogaz dispute remains far from resolved. As I write (the 8th of October), reports suggest that a new round of trilateral talks between Russia, Ukraine, and the EU will take place in the next few days.

The background to this dispute has been well covered in previous issues of the Gazprom Monitor. To briefly recap the situation, Gazprom currently claims that Naftogaz Ukraine owes approximately $5.3bn in unpaid gas bills. Naftogaz (and the Ukrainian government) dispute the bill, claiming that Gazprom has been abusing its almost total monopoly over Ukrainian gas imports by overcharging for gas supplies since the signing of the contract that brought the January 2009 gas dispute to a close.

In June 2014, Gazprom switched to a 'pre-payment' scheme with Naftogaz. Naftogaz now only receives gas for which it pays in advance. Since Naftogaz refuses to accept the gas price proposed by Gazprom, the practical result has been several months of suspension of Gazprom gas sales to Naftogaz. Since then, Naftogaz has relied on a mixture of low summer gas demand, its own reserves, and some 'reverse flow' imports from Europe.

But winter is now approaching, and experts are warning that Naftogaz may not have enough gas in storage to last the winter without cutting off domestic supplies or interrupting the Ukrainian transit of Russian gas supplies to Europe. In mid-September, the CEO of Naftogaz, Andriy Kobolev, announced that Naftogaz had 16 bcm in storage. On the 8th of October, the Ukrainian Prime Minister, Yatsenyuk, confirmed that Ukraine had 16.7 bcm in storage and required another 5 bcm to make it through the winter heating season. On the same day, the Ukrainian Fuel and Energy Minister, Yuri Prodan, revealed that the Ukrainian government and Naftogaz had sent proposals to the European Commission regarding the resumption of gas supplies and the settlement of Naftogaz's debts:

> We've sent not only our proposals on the gas schedule, but also all our proposals linked to settling the situation with Gazprom... We're sending them to the European Commission, and it is likely that the European Commission will agree on them with Russia.

Current proposals suggest that Ukraine could repay a portion of its debts (approximately $3.1bn) by the end of 2014, and pay in advance for the delivery of 5 bcm of supplies from Gazprom at a discounted price of $385 per thousand cubic metres. However, Kyiv rejects the use of a 'discounted' price, in favour of fundamentally renegotiating the 'base price' in the Gazprom-Naftogaz contract. This is most likely driven by concerns that discounts are not permanent, and may be withdrawn when circumstances change, as happened between November 2013 and April 2014.

Gazprom reduces gas supplies to Poland, Slovakia, and Austria – a warning against 'reverse flow'?

On the 12th of September, the Polish state-owned gas importer, PGNiG, reported that gas deliveries from Gazprom on the 8th and 9th of September were 20 percent and 24 percent, respectively, below contracted amounts. On the 10th of September, deliveries were 45 percent below the contracted amount. PGNiG reassured its customers that this did not necessitate the withdrawal of gas from underground storage facilities, which were full (2.6 bcm) ahead of the winter season. PGNiG also confirmed that it had only requested volumes in accordance with its contract with Gazprom, and that the shortfall did not refer to a request for additional volumes:

> Under the Yamal Contract, PGNiG may order gas supplies up to a maximum daily amount specified in the Contract. The volumes of gas ordered by PGNiG were lower than the maximum volumes, and therefore compliant with the provisions of the Contract.

In response, Gazprom issued a statement on the 10th of September: "Gas volumes currently delivered to Poland remain the same – 23 million cubic meters per day".

The immediate impact of the shortfall was that PGNiG temporarily halted its re-export of gas to Ukraine under the 'reverse flow' scheme. The scheme is labelled as such, because it describes the movement of gas from West to East – the opposite of the usual flow of gas deliveries in Central and Eastern Europe, where Russia is the dominant supplier. Gazprom has criticised the re-export of Russian gas to Ukraine, arguing that it breaches Gazprom's gas supply contracts with European energy companies. Reverse flow supports Naftogaz Ukraine in its current battle of wills with Gazprom over debts and gas prices.

During September, reports suggested that the Slovakian energy company, SPP, also suffered 10 percent shortfalls in its deliveries from Gazprom on the 11th and 21st of September, while Austria also reported short-term reductions of 10-15 percent. Like Poland, Slovakia has facilitated the reverse flow of gas supplies from Europe to Ukraine.

Hungary sides with Gazprom against Ukraine

On the 26th of September, the Hungarian Prime Minister, Viktor Orban, announced that the Hungarian gas pipeline system operator, FGSZ, had 'indefinitely' suspended the export of gas to Ukraine. Mr Orban's announcement came just days after the Gazprom CEO, Alexei Miller, visited Budapest and agreed to increase gas deliveries to Hungary in order to facilitate the stockpiling of gas for the winter season. In his announcement, Mr Orban said:

> Hungary cannot get into a situation in which, due to the Russian-Ukrainian conflict, it cannot access its required supply of energy.

In response, European Commission spokesperson Helen Kearns stated:

> The message from the Commission is very clear: we expect all member states to

> facilitate reverse flows as agreed by the European Council... There is nothing preventing EU companies to dispose freely of gas they have purchased from Gazprom and this includes selling this gas to customers both within the EU as well as to third countries such as Ukraine.

When interviewed, the Russian Energy minister, Alexander Novak, criticized reverse flow schemes as violating the terms of Gazprom's gas supply contracts with European energy companies:

> We hope that our European partners will stick to the agreements... That is the only way to ensure there are no interruptions in gas deliveries to European consumers.

Clearly, the ongoing Gazprom-Naftogaz gas dispute is spilling over and affecting European energy companies, and will be watched closely as winter draws in and temperatures fall across Europe. The reductions in gas supplies to several EU member states clearly coincide with their stances on re-exporting gas to Ukraine. However, despite the short-term reductions in supplies, the greater worry for European energy companies remains the reliability of Russian gas transit across Ukraine.

Nord Stream

European Commission delays decision on OPAL pipeline until 31st of October

The Russian Energy Ministry has announced that the European Commission has communicated its intention to delay its decision on the OPAL pipeline until the 31st of October, citing the more pressing concern of moderating Russia-Ukraine gas negotiations.

The OPAL pipeline connects Nord Stream's landfall site (at Greifswald on Germany's Baltic coast) with Olbernhau on the German-Czech border, some 470km south of Greifswald. OPAL is one of two pipelines designed to connect Nord Stream with the German gas pipeline network. The other is the NEL pipeline, which connects Greifswald with the Rehden underground gas storage facility in north-western Germany.

OPAL has a capacity of 35 bcm per year, and NEL has a capacity of 20 bcm per year. Together, their capacity exactly matches that of the offshore Nord Stream pipeline (55 bcm per year). Gazprom holds 40 percent and 25.5 percent shares in OPAL and NEL, respectively, through its 50 percent shareholding in W&G, a joint venture with BASF Wintershall.

As they are located on EU territory, OPAL and NEL are subject to EU gas market legislation – in particular, the provision for third party access to pipelines. Reports suggest that approximately one third of the capacity of OPAL (as a cross-border pipeline to the Czech Republic) and half the capacity of NEL (as an 'internal' pipeline within Germany) must be reserved for use by 'third party' companies that do not hold shares in the pipelines. This could leave Gazprom with access to 33.1 bcm of capacity in OPAL and NEL.

Gazprom and its European partners have previously applied for an exemption from EU third party access provisions for OPAL and NEL, arguing that only Gazprom could possibly wish to pump gas into OPAL and NEL, because Gazprom is the sole company pumping gas into Nord Stream, and Nord Stream is the sole source of gas for OPAL and NEL.

However, the European Commission has yet to make a final ruling on the case. A decision was expected in mid-September, but that has now been pushed back to the end of October. Until then, Nord Stream continues to operate below full capacity. In 2013, Nord Stream operated at 43 percent of its design capacity, delivering 23.7 bcm. For 2014, IEA statistics show Nord Stream delivering an average of 67 million cubic metres per day from January to July 2014 (inclusive). This is the equivalent of 24.46 bcm per year – less than half the capacity of Nord Stream. Significantly, this is also below the capacity that would be allowed to Gazprom if third party access provisions were applied to OPAL and NEL.

During the coming winter it is expected that Gazprom will seek to maximise its deliveries via Nord Stream and reduce its deliveries via Ukraine. Crucially, if there is any interruption in Russian deliveries to Europe via Ukraine, Gazprom will have a case for allowing a short-term exemption from third party access provisions and the use of Nord Stream (and OPAL and NEL) at full capacity.

South Stream

EU cannot halt South Stream construction, but threatens action upon completion of the pipeline

It is well known that the European Commission has concerns over the extent to which the South Stream pipeline is compatible with EU gas market legislation. This is particularly the case with regard to the provisions of unbundling and third party access. The term 'unbundling' refers to the provision that gas producers – such as Gazprom – cannot hold majority shares in subsidiaries that own or operate pipeline infrastructure. The term 'third party access' refers to the provision that owner-operators of gas pipelines on EU territory must reserve a share of the pipeline capacity for 'third party' companies that do not hold shares in the pipeline. On the 17th of September, Marlene Holzner (a spokesperson for European Energy Commissioner Gunther Oettinger) stated that while the European Commission cannot prevent the construction of South Stream, it could take action once the pipeline enters into use, if the use of the pipeline contravenes EU gas market legislation.

If Gazprom believes this to be an idle threat, and that the European Commission will acquiesce to the operation of South Stream once it is built, they should bear in mind the current situation regarding Nord Stream and its onshore sections (the OPAL and NEL pipelines) in Germany.

EU puts pressure on Serbia to halt South Stream construction

In its annual enlargement report, the European Commission has reminded Serbia that the continued construction of South Stream on Serbian territory could have a negative impact on Serbia's EU accession prospects. In particular, the report clearly states:

> The Intergovernmental Agreement (IGA) signed by Serbia and Russia to build the South Stream pipeline is not compatible with the *acquis.* Serbia should not commence work on constructing South Stream until the IGA is aligned with the *acquis*.

In essence, Gazprom's 51 percent shareholding in the joint venture that will own and operate the Serbian section of South Stream ('South Stream Serbia') contravenes EU gas market legislative provisions on unbundling, which would require Gazprom's shareholding to be limited to 50 percent. Furthermore, the European Commission believes that the lack of a planned provision for third party access to South Stream will also contravene EU gas market legislation when the pipeline becomes operational.

However, Serbia's Foreign Minister, Ivica Dacic, sought to reassure Serbia's Russian partners on the 7th of October, by issuing the statement:

> Everything is fine with the South Stream. We are ready to build it. All preparatory works are running as planned. All other matters will be settled between Russia and Brussels.

The Serbian government is currently walking a fine line between keeping close relations with Russia and not wishing to jeopardise Serbia's accession to the EU. We expect that, especially with regard to South Stream, the Serbian government will continue to walk this tightrope in the coming months, and that the fate of the South Stream project could hinge on the stances of Serbia and Bulgaria (two states that are highly dependent on Russian gas supplies and suffered significantly during the suspension of gas transit via Ukraine in January 2009), as they try to balance their commitments to South Stream in the interests of their own energy security with their desire to maintain good relations with the European Commission.

Gazprom in Asia

Gazprom could sign second contract for gas deliveries to China, this time via the 'Western Route'

During his televised meeting with President Putin on the 17th of September, the Gazprom CEO, Alexei Miller, reassured the President that work on the 'Power of Siberia' pipeline, designed to deliver Russian gas to China, was proceeding according to schedule. He also suggested that Gazprom was preparing to sign a second contract for further gas deliveries, this time via the 'Western Route'.

When Gazprom signed its landmark contract with the China National Petroleum Corporation (CNPC) in May 2014, it was agreed that Gazprom would deliver the gas via the 'Eastern Route'. Gas produced in Eastern Siberia would be delivered further east across Russia via the yet-to-be-built 'Power of Siberia' pipeline, which is planned to continue to Vladivostok, with a spur crossing the Russia-China border in North-East China. That deal stipulates the delivery of 38 bcm per year from 2018.

When discussing the 'Western Route', Mr Miller was referring to the potential to drive a new pipeline from Western Siberia, through Russia's Altai region, to North-Western China. This was initially Gazprom's preferred option for delivering gas to China, as the pipeline route is shorter and could be supplied from gas fields in Western Siberia that are already developed. The Eastern Route will require both a longer (and therefore more expensive) pipeline, and the development of new gas production in Eastern Siberia.

During the meeting, Mr Miller noted:

> We are going to sign a contract to supply 30 billion cubic meters of gas for 30 years, and various volumes within new contracts for the western route have been announced at the talks. A possibility of supplying 60 to 100 billion cubic meters of gas to China is being considered... the western route has its own advantages. Firstly, the existing gas

> transmission system in Western Siberia will be involved. Secondly, there is no need to create gas chemical or processing capacities for the Western Siberian gas, therefore, the investments required for the western route will surely be smaller than for the eastern route. On the other hand, the potential is huge. It is even greater than in Eastern Siberia and, by all means, we can rapidly boost the volumes of gas supply via the western route to respond to growing demand in the Chinese market.

Russia's Energy Minister, Alexander Novak, confirmed Mr Miller's views in a statement on the 4th of October:

> We do not have hard deadlines, the talks between Gazprom and CNPC are underway, and as soon as the agreement is reached regarding the price, the terms of the construction of the gas pipeline, and the gas supply, we will be able to say something more specific. Under favourable circumstances, we expect that this could be done until the end of the year, if the companies reach an agreement.

The optimism of Mr Novak was matched by that of the Chinese Deputy Foreign Minister, Cheng Guoping:

> Chinese and Russian energy departments are busy with negotiations on the construction of the West Route gas pipeline. We believe there will be progress this year.

Given the current challenges faced by Gazprom as it seeks to find the capital to develop new gas production on the Yamal Peninsula and on the Arctic shelf, whilst simultaneously attempting to construct South Stream and implement plans to develop new gas production in East Siberia and deliver that gas to China via a brand new, as yet unbuilt pipeline, it is difficult to see how Gazprom will be able to successfully build yet another pipeline in the short term. Therefore, if a new agreement is signed with CNPC before the end of 2014, it will most likely be a framework agreement to be implemented in several years' time.

The surest means of ensuring the successful implementation of the proposed 'Western Route' pipeline project would be to involve China more heavily in its funding and construction, just as CNOC was the driving force behind the implementation of the Central Asia-China pipeline. The third line of that pipeline is set to be completed by the end of 2015, while the construction of a fourth line is scheduled to begin before the end of 2014.

The two existing lines of the Central Asia-China pipeline have a combined capacity of 30 bcm per year. With the addition of two further lines, the overall capacity of the Central Asia-China pipeline could rise to 80 bcm per year by 2020.

Gazprom's exports via the eastern and western routes will therefore not only compete with China's growing LNG imports, but also with significant import volumes from Central Asia. Therefore, the commercial success of Gazprom's two pipelines to China will depend greatly upon the supply and demand dynamics of the Chinese gas market over the coming decade and beyond.

And in other developments…

Gazprom agrees to expand the capacity of Blue Stream pipeline from 16 bcm to 19 bcm per year

Following a meeting between the Gazprom CEO, Alexei Miller, and the Turkish Energy minister, Taner Yildiz, Gazprom has announced that it intends to expand the capacity of the Blue Stream pipeline, which deliveries gas from southern Russia to Turkey under the Black Sea. The capacity of the pipeline will be raised from 16 bcm per year to 19 bcm per year by modernising the Beregovaya compressor station on Russia's Black Sea coast and the Durusu reception terminal in the Carsamba district of Turkey, 60km from Samsun.

Gazprom currently supplies gas to the Turkish state-owned energy company, Botas, through Blue Stream. Mr Yildiz is reported to favour private companies purchasing the additional 3 bcm per year, as part of the Turkish government's drive to liberalise the Turkish gas sector. Gazprom began deliveries of 6-10 bcm per year to private energy companies on the 1st of January 2013, under a 30 year long term contract.

In 2013, Gazprom shipped 26.7 bcm to Turkey, of which 13.7 bcm was delivered via Blue Stream. Daily flows via Blue Stream reached full capacity several times in the past year, when Turkey experienced minor gas supply shortages. For the year 2014 as a whole, Gazprom hopes to boost gas exports to Turkey to the contractual maximum of 30 bcm.

However, Gazprom will face increased competition on the Turkish market when the TANAP pipeline comes online, bringing gas from the Shah Deniz 2 field in Azerbaijan to the Turkish market. Given that the first gas production from Shah Deniz 2 is expected in 2018, Gazprom faces a race against time to upgrade Blue Stream and secure new contracts with Turkish energy companies.

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