

THE EUROPEAN GEOPOLITICAL FORUM

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Gazprom Monitor Annual Review Analysing the External Dimensions of Russian Gas Summer 2014 - Summer 2015

Report Extracts

Authored by Dr Jack Sharples
EGF Associate Research



Director's Foreword

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Given the complexities and present-day dynamics of Eurasian gas markets, we at the European Geopolitical Forum feel it necessary to provide, in addition to the monthly Gazprom Monitor reports, a high-level yearly summary. We feel the additional perspective and analysis made possible through this extended format will be invaluable for policymakers, business leaders, and other interested stakeholders. As with our monthly Gazprom Monitor, this Annual Review will focus on Gazprom's external activities, with particular reference to the EU gas market, the Nord Stream and South Stream (now Turkish Stream) export pipelines, Gazprom's relations with Naftogaz Ukraine in the context of Russia-Ukraine relations, and the competition Gazprom faces regarding Russia's LNG exports. We also provide analysis on the 'eastern dimension' of Gazprom's business.

The report briefly summarises developments prior to mid-2014 as background information and then provides more detail on developments taking place during the last 12 months. In doing so, this Annual Review assumes no prior knowledge on behalf of the reader. For further background information, please refer back to the previous year's Annual Review. While this voluminous work can be read in its entirety, the report is also structured in a manner where the reader may choose to delve into the individual sub-sections of the report on their own, as highlighted in the table of contents on the following page. Finally, it should be added that the information and analysis provided in this report is predominantly the work of the author, and does not necessarily reflect the opinions of the European Geopolitical Forum as an organisation.



Dr Marat Terterov

Founder and Principal Director of the European Geopolitical Forum

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Gazprom and the EU gas market: Contracts, discounts, and investments

In 2014, Gazprom reported exports of 127.3 bcm to the EU, down 16.5 percent year-on-year from 148.3 bcm in 2013.

Gazprom is adapting to the changes on the European markets, to a certain extent. Since 2013, it has grudgingly begun to add spot-price elements to its pricing mechanisms where forced to do so by arbitration or by negotiations with customers in competitive markets.

In Lithuania, we have seen the launch of LNG imports and the possibility of re-exporting some of those supplies to neighbouring Baltic states.

Poland is due to begin its own LNG imports and is working on a cross-border connection with Lithuania. In the Czech Republic and Slovakia, the development of West-East gas flows has enabled Czech gas importers to abandon Gazprom in favour of purchases on the European spot market, while Slovakia now provides 'reverse flow' supplies to Ukraine and itself has the option of purchasing gas on the European spot market, via its western Czech neighbour.

In the Baltic region and Central Europe, where it was once utterly dominant, Gazprom must now adapt to increasingly competitive market conditions.

The EU antitrust investigation into Gazprom

In last year's Annual Review, it was noted that the EU Directive on Antitrust Damages Actions could have a significant impact on consequences of the antimonopoly investigation for Gazprom. The Directive was agreed between the European Parliament and the Council on the 17th of April 2014, and was then passed to the EU Council of Ministers for final approval. This was the 'state of play' at the time of the publication of last year's Annual Review. Since then, the text was approved by the European Council on the 10th of November 2014, and signed into EU law on the 26th of November.

The greatest test for Gazprom in 2015-16 will undoubtedly be the outcome of the EU antimonopoly investigation. As discussed in the following section, the European Commission is highly unlikely to rule against oil-indexation as a means of gas pricing *per se*. However, if it does rule that Gazprom has used oil-indexation to charge prices significantly above those prevailing on the broader market, and that this constitutes an abuse of its monopoly position, we can expect a raft of new arbitration cases and private damages actions facilitated by the EU Directive on Antitrust Damages Actions. This could leave Gazprom in a situation where it not only has to grant refunds and rebates on a dramatic scale, but is also obliged to undertake a fundamental shift away from its traditional model of long-term contracts with oil-indexed pricing mechanisms.

Nord Stream

The Nord Stream gas pipeline consists of two lines, each running under the Baltic Sea from Vyborg (Russia) to Greifswald, on Germany's northern coast near the border with Poland.

Gazprom's indecision over the expansion of Nord Stream, coupled with the cancellation of South Stream, the proposal for Turkish Stream, and mixed messages regarding the possibility of gas transit via Ukraine after 2019 (discussed later), all suggest that Gazprom is keeping its options open, and playing its partners off against each other by prioritising different projects at different times. Until construction actually begins, Nord Stream II should be treated as a purely theoretical possibility.

Turkish Stream

On the 1st of December 2014, the Russian President, Vladimir Putin, announced in a press conference that the South Stream project had been cancelled, and would be replaced with a new project: Turkish Stream. According to Gazprom, Turkish Stream is a successor to South Stream. Gazprom proposes using the same pipeline infrastructure that it was preparing for South Stream, and using most of the planned offshore route. Gazprom's plans suggest that Turkish Stream will follow the first 660km of the planned South Stream route, before breaking away towards Turkey with a final 250km section, instead of continuing onwards to Bulgaria.

To avoid the regulatory difficulties it faced with South Stream, Gazprom has proposed that Turkish Stream will make landfall in Western Turkey and proceed only as far as the Turkish-Greek border. In this way, Gazprom will avoid building pipelines on EU territory.

Looking further into the future, the expansion of Turkish Stream beyond a single line depends on Gazprom's ability to deliver that gas westwards from the Turkish-Greek border. That would require new cross-border transmission capacity to deliver gas either northwards from Greece to Hungary via the Former Yugoslav Republic of Macedonia and Serbia, or westwards under the Adriatic Sea to Italy. Until that happens, Turkish Stream will find itself constrained by a Greek bottle-neck.

Gazprom and Ukraine

For the much of the past decade, the Russian state-owned gas exporter, Gazprom, has been locked in dispute with the Ukrainian state-owned gas importer, Naftogaz. The history of these disputes, including the shut-offs in January 2006 and January 2009, was discussed in detail as background information in last year's Annual Review.

For much of 2014-15, the CEO of Gazprom, Alexei Miller, was resolute in his claims that Russian gas transit via Ukraine will cease when the current gas transit contract expires in 2019. However, as spring turned to summer Miller's claims that Gazprom will 'never' sign a new transit contract with Naftogaz softened to an assertion that "We will never sign a contract *on unacceptable terms*" (author's emphasis). Indeed, Miller has stated:

We still have 4.5 years; we will hold corresponding negotiations with our Ukrainian partners before the contract expires.

Miller's apparent change of heart may be part of a broader negotiating strategy: in promoting first South Stream and

then Turkish Stream and the expansion of Nord Stream, the assertion that Gazprom will not, under any circumstances, extend its gas transit contract beyond 2019 was a clear attempt to put pressure on Naftogaz. However, with South Stream cancelled and Turkish Stream now stuttering, never mind the on-off-on approach to Nord Stream II, Miller was able to put pressure on Turkey by re-visiting the possibility of extending gas transit via Ukraine. There are a number of reasons for Gazprom to leave the door opened for further gas transit via Ukraine after the year 2019 that are discussed in detail in this report.

Gazprom in the Asia-Pacific region

Gazprom has long planned to diversify its gas exports away from Europe, by increasing the volume of its exports to the Asia-Pacific region.

In May 2014, Gazprom took what appeared to be a significant step towards expanding its Asian exports, when it signed a sale and purchase contract with the China National Petroleum Corporation (CNPC). The significance of the deal was analysed in both the May 2014 edition of the Gazprom Monitor (№ 36) and the 2014 edition of the Gazprom Monitor Annual Review.

Pipeline named 'Power of Siberia' as well as details of Western and Eastern routes of delivery; construction specifics, timing and probable pricing are discussed in this section of the Report.

Sakhalin-II expansion

During the St Petersburg Economic Forum, in June 2015, the Gazprom CEO, Alexei Miller, and his counterpart from Shell, Ben van Beurden, signed a Memorandum on adding a third train to the Sakhalin-II LNG export terminal. According to Gazprom's press release, supplies for the third train will be provided by Gazprom from its Sakhalin-III project. But not all is so simple and different scenario of the project development is considered.

Brief conclusion

Overall, 2014-15 was a challenging year for Gazprom, with highs and lows. While South Stream was abandoned, agreement was finally reached on exports to China. While the difficulties with Ukraine continued, Gazprom enjoyed a peaceful year of gas supplies to, and gas transit via, Belarus. While the Vladivostok LNG terminal project was abandoned, Gazprom reached agreement with Shell to expand the Sakhalin-II LNG export terminal. And whilst Gazprom's European exports were lower than in the record-breaking year of 2013, they compared favourably with its European exports in the 'post-crisis' period of 2010-12.

The year 2015-16 promises to be a highly significant one for Gazprom, and a highly interesting one for experts and observers with an interest in Gazprom and its activities. We hope you will join us in following all of these developments through the monthly issues of the Gazprom Monitor, just as we hope you have enjoyed reading this Annual Review.

Dear Reader,

The full version of the Gazprom Monitor Annual Review, together with last year's review, are now available for purchase from the newly opened Web Shop of the European Geopolitical Forum <http://shop.gpf-europe.com>

About EGF

The European Geopolitical Forum (EGF) was established in early 2010 by several independently minded practitioners of European geopolitics, who saw a certain vacuum in the information flow leading into the European geopolitical discussion. EGF is dedicated, therefore, towards the promotion of an objective pan-European geopolitical debate incorporating the views of wider-European opinion shapers rather than simply those from the mainstream European Union (EU) member states. EGF seeks to elaborate upon European decision makers' and other relevant stakeholders' appreciation of European geopolitics by encouraging and effectively expanding the information flow from east to west, from south to north. In order to achieve these objectives, the European Geopolitical Forum was established as an independent internet-based resource, a web-portal which aims to serve as a knowledge hub on pan-European geopolitics. EGF's strength is in its unique ability to gather a wide range of affiliated experts, the majority of whom originate from the countries in the EU's external neighbourhood, to examine and debate core issues in the wider-European geopolitical context. Exchange of positions and interactivity between east and west, south and north, is at the heart of the EGF project. Please visit our website for further information at www.gpf-europe.com.

About the Author

Dr Jack Sharples is a Lecturer in Energy Politics and Energy Law at the European University of St Petersburg, where he also teaches EU Politics in the Department of Political Science and Sociology, and is a researcher in the newly-opened International Energy Centre. He has been the author of EGF's monthly Gazprom Monitor reports since May 2012. Dr Sharples received his PhD from the University of Glasgow, UK, having written his thesis on the political economy of state-business relations in the Russian gas sector. His doctoral thesis analysed the relationship between Gazprom and the Russian state on the domestic Russian gas market, in transit/supply relations with Ukraine and Belarus, and in the sphere of Russian gas exports to the EU market. He also holds the qualifications of MSc (2007) and MRes (2008) in Russian and East European Studies from the University of Glasgow, and BA in Politics from the University of York, UK (2005). Dr Sharples has published articles on Russian approaches to energy security and climate change (in the journal *Environmental Politics*), and the role of Russia in European energy security (in the journal *Political Perspectives*). He was previously a Visiting Researcher at the European University of St Petersburg (2009-10), the Brussels School of International Studies (2010), and the Institute of Europe (Russian Academy of Sciences), Moscow (2011). Dr Sharples' current research interests include: EU-Russia energy relations; Russian foreign and domestic energy policy; Energy security; The relationship between energy security and climate change; EU Politics.



He can be reached at jack.sharples@gpf-europe.com / jsharples@eu.spb.ru

His personal website is available at: <https://eu-spb.academia.edu/JackSharples>



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