



In the end, it always comes down to the Gas

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There are at least three major problems keeping EU–Russia relations focused on natural gas: (1) the pricing mechanism in long-term gas supply contracts, (2) the impact of the EU third energy package on the Russian-owned gas assets, and (3) the future (status) of the South Stream project.

Current developments in the oversupplied gas market are being affected by four interlinked factors: (1) lower demand, (2) the sharp rise in unconventional gas production, (3) the surge in LNG production and (4) globalizing gas markets. Due to the convergence of these factors, the pricing issue is now at the centre of attention.

Due to oversupply and oil price level movements, prices in the gas hubs have been set far below oil product-indexed prices in long-term gas supply contracts, putting great pressure to move to a system of hub-based gas prices. Insisting on the old system, Gazprom has made temporary adjustments. But E.ON's request for 100 per cent spot indexation was categorically refused in February 2011 (*Bloomberg*, February 16, 2011). Meanwhile oil prices have surged. However, as illustrated by oil forecasts in 2008, it is better to treat such forecasts with caution.

As argued by analysts at the Bank of America Merrill Lynch (BoA–ML), high oil-indexed contract prices have been curbing demand (*Bloomberg*, October 11, 2010). Gazprom's current loss of market share is mainly due to this artificial price mechanism, which does not reflect supply and demand. Based on data from Gazprom's quarterly financial reports, according to our calculations exports to Italy, the third largest importer of the Russian gas after Germany and Turkey, were seriously impacted in 2010.¹ Nevertheless, the

situation in Libya recently forced Italy to boost imports from Gazprom. BoA–ML claims that Gazprom received 1 billion USD in penalty payments in 2009 from European gas consumers because they actually imported less gas than provided for in take-or-pay contracts. According to ICIS Heren, Gazprom's take-or-pay minimum volume is reportedly set at 85–90 per cent and unused take-or-pay minimum gas is charged at 75 per cent of the full price of the gas.

In this situation Günther Oettinger said in July 2010 that Russia's share in EU gas consumption may grow to 30–35 per cent [from the current 23 per cent] in the medium-term perspective (*Kommersant*, July 30, 2010). But careful attention should be paid to what the EU Energy Commissioner means by the "medium-term perspective". In the 2000s, Russia's share in EU hard coal and crude oil imports increased significantly, but the role of Russian gas declined.

The year 2009 brought a turning point in Russia's gas balance. The nightmare of gas deficits was replaced by oversupply. In the 1990s, Russia also faced oversupply problems and declining demand. Russia's gas production "nearly" recovered in 2010 (from 584 billion cubic meters (bcm) in 2009 to 649 bcm in 2010) after declining to the level of 2000. Gazprom thought in February 2011 that its gas production will exceed pre-crisis levels in 2013 from a historical low in 2009. (The respective numbers are 549.7 bcm in 2008, 461.5 bcm in 2009, 508.6 bcm in 2010, 505.6 bcm in 2011, 531.4 bcm in 2012, and 558.3 bcm in 2013.) Gazprom is the world's largest gas

nt. (Different analyses of Mikhail Korchemkin of East European Gas Analysis draw attention to these. A recent paper 'The Transition to Hub-Based Gas Pricing in Continental Europe' by Jonathan Stern and Howard Rogers of Oxford Institute for Energy Studies published in March 2011 also addresses this topic.)

¹ In 2010 Turkey also significantly reduced gas purchases from Russia, but to a much lesser extent.

producer. And Gazprom has increased its share of gas reserves in Russia it has met with persistent declines in domestic and international production shares.

Gazprom Export, a 100 per cent owned subsidiary of Gazprom, exported 140.65 bcm of Gazprom's gas outside the former Soviet Union in 2009, 11.4 per cent less than the 158.8 bcm exported in 2008. 2010 brought a slight further decline to 139 bcm. But the projected volume for 2011 is 152 bcm.² For Gazprom, as a piped-gas exporter locked into the European market, long-term take-or-pay contracts are essential for investments in production and pipeline capacity. With Sakhalin-2, a production-sharing agreement with participation from Gazprom and others, LNG production and export was initiated in 2009 and achieved the specified design capacity of 9.6 mmtpa in 2010.

Uncertain demand and increased production costs in Russia make Gazprom cautious with investments. There appear to be two different views about when the gas glut will end. The International Energy Agency (IEA) and E.ON Ruhrgas AG, Germany's leading gas buyer and Gazprom's largest customer, see gas oversupply as a longer-term story. In November 2010 Fatih Birol said that the gas glut would be with us for 10 more years, while Klaus Schafer, despite saying in August 2010 that "we are likely to see [the end of Europe's gas glut] in three to five years" (*Reuters*, August 25, 2010), also declared it would remain for the next decade (*Reuters*, November 9, 2010). Others think gas oversupply will disappear before 2015. Experts from the Oxford Institute for Energy Studies—suggesting the IEA may be confusing a glut of gas transportation capacity with a glut of gas³—concluded that the gas glut will end sometime during 2012–

14 (see the work of Jonathan Stern, Anouk Honoré and Howard Rogers, published during 2010–11). In 2010, the French utility GDF Suez, the largest buyer of natural gas in Europe, Total, one of the 'supermajors', and the oil minister of Qatar, the world's leading supplier of LNG, believed oversupply would be absorbed by 2013 (*Gas Connections*, July 15, 2010; *Bloomberg*, November 11, 2010; *Reuters*, November 1, 2010). The latter projections are close to Gazprom's October 2010 predictions that oversupply in Europe could disappear as early as 2012 (*Bloomberg*, October 14, 2010).

On April 11, 2011, Alexey Miller, recently re-elected Chairman of Gazprom's Management Committee, emphasized that while in the first quarter of 2010 the average price under Gazprom's export contracts (at USD 293 per mcm) was 50 per cent higher than European gas spot prices, in the first quarter of 2011 the gap between the average contract and spot prices had narrowed to 8 per cent (USD 346 and 320 per mcm, respectively) (*Gazprom news*, April 11, 2011). In early April 2011, Valery Golubev, Deputy Chairman of Gazprom, claimed that "[t]he European trend is such that European clients want less and less to include a spot price in their contracts" (*Reuters*, April 7, 2011). But as Stern and Rogers stress in their March 2011 paper, "the assertion that, when the gas supply/demand balance tightens, gas prices will "recouple" with oil prices, reflects a fundamental confusion between price level and price formation".

Already in 2007 it was clear that the third energy package, adopted by the European Parliament and the Council in July 2009, would become a serious source of conflict with Russia. The concept of preventing takeover attempts was not new to Europe. But the legislative package also concerns existing assets with Russian ownership. Moreover, Pierre Noël of the University of Cambridge stated in a working paper in June 2009 that "[t]here is a clear, if not perfect, match between the EU countries' foreign policy position towards Russia and their position during the European debate about 'ownership unbundling' of transmission networks".

Lithuania was happy to take the opportunity to implement the ownership unbundling of Lietuvos Dujos by March 2012. The Lithuanian government targeted Lietuvos Dujos, 37.1 per cent owned by Gazprom, not only because of very high gas prices, but also because Lietuvos Dujos "would neither ensure free access to the grid

² For 2008 and 2009, the numbers presented at Gazprom's annual press conferences every June are used. Presentation shown at 'Gazprom Investor Day' in February 2011 gave 160 bcm for 2008 and 141 bcm for 2009. Export numbers for 2010 and 2011 have also been obtained from the 'Gazprom Investor Day' presentation.

³ This is a very important statement from Stern and Rogers (2011) as the IEA measured the gas glut by the difference between the volumes actually traded and total capacity of inter-regional pipelines and LNG export plants. The IEA estimated that the glut amounted to about 130 bcm in 2009 and expected it to peak at over 200 bcm in 2011 (IEA WEO 2010, p. 52). The catastrophe in Japan affects the market.

nor build new interconnections and a link to a proposed LNG terminal” (*Gazprom news*, June 11, 2010). In the Baltic States, where the Russian (and German) ownership presence is strong, no diversification has taken place. However, the situation is a “bit” more complex. Renationalizing ownership of the transmission system will not be cheap and ultimately someone will have to pay for it (*ICIS Heren*, June 30, 2010). In Estonia, which was granted a derogation, the ownership unbundling of Eesti Gaas by January 2013 was proposed in 2010 (*Bloomberg*, October 22, 2010).⁴ Gazprom has a 37 per cent stake in Eesti Gaas. At the end of 2010 it was announced that gas prices for Latvia and Estonia would be lowered if they take up at least as much gas as in 2007, but would not change for Lithuania in 2011 (*Interfax, RIA Novosti*, December 24, 2010). In the following months the dispute was intense. But according to Gazprom the meeting of representatives from the Lithuanian Energy Ministry and Gazprom held on April 13, 2011 was constructive (*Gazprom news*, April 14, 2011, *Reuters*, April 14, 2011).

Another conflict of interest occurred in Poland where EuRoPol GAZ, the owner of the Polish section of the Yamal-Europe (Yamal-1) gas pipeline, handed over operation and the Polish state-owned Gaz-System became the independent system operator (ISO) in 2010. Gazprom and the Polish PGNiG SA are the principal shareholders of EuRoPol GAZ. According to Gazprom Export, 30.32 bcm of Russian natural gas were transported to Western Europe via the Russia–Belarus–Poland–Germany pipeline in 2009.

Gazprom has recognized that beyond the pipeline acquisitions, the consortium option, and its operator role there is a more secure (although expensive) solution, with which it can change the current vulnerable transit situation: the building of pipelines by avoiding (unreliable) transit states. An important factor is that it is possible to separate transit gas from gas for domestic consumption only in Belarus and only *partially*, by using the Yamal-Europe pipeline. Among the post-Soviet transit states, in Ukraine and Geor-

gia,⁵ Gazprom has not participated in the ownership of transmission pipelines.

Despite strong opposition (and pessimism) regarding the Nord Stream pipeline, the laying of the offshore pipeline linking Russia to Germany, finally started last year and is expected to start deliveries in late 2011. Though the start of the Arctic Shtokman gas field has also experienced delays, work on line 2 is scheduled to begin in May 2011.

Although the South Stream requires huge investments and has an uncertain future in light of current demand conditions and recent changes in Ukrainian–Russian relations after the Ukrainian presidential elections of 2010, it is not a phantom project and will proceed. However, LNG options have recently emerged (discussed for the first time on March 9, 2011).

The consolidated feasibility study of South Stream is expected to be completed in May–June 2011 (RBK-Ukraine, April 8, 2011).⁶ Russia would like to see South Stream given “European top-priority project status [i.e., ‘project of European interest’] pursuant to the Trans-European Energy Networks (TEN-E)” (*south-stream.info*). At least in Russian intergovernmental agreements with the Bulgarians and Serbians it is stipulated that they will try to acquire TEN-E status. Among others, Nord Stream, Nabucco, the Interconnector Turkey–Greece–Italy (ITGI) and Yamal-2 are considered ‘priority projects of European interest’, while among others Trans Adriatic Pipeline (TAP, Greece–Albania–Italy), White Stream (Georgia–Romania and Georgia–Ukraine) and Amber (Russia–Latvia–Lithuania–Poland–Germany) are labelled ‘projects of common interest’. In July and November 2010, the spokesperson for the EU Energy Commissioner tried to dispel expectations of South Stream TEN-E status, emphasizing that the “Commission is obliged to stick to the existing TEN-E Guidelines of 6 September 2006” (*Sofia News Agency*, July 30, 2010; *Euinside*, November 18, 2010).

The Communication “Energy infrastructure priorities for 2020 and beyond,” adopted by the

⁴ The system operator AS EG Võrguteenus is legally unbundled (a 100 per cent owned subsidiary of Eesti Gaas).

⁵ Of course, Georgia does not transit gas from Russia to Europe outside the former Soviet Union and nowadays Georgia does not buy gas from Gazprom. Gas from Russia is only received as a transit fee for the Armenian transit.

⁶ Other sources say that the results will be released sometime in May or June.

European Commission on November 17, 2010, identifies the Southern (fourth) Corridor as a priority corridor intended to further diversify sources. But the Southern Corridor does not include South Stream. The Communication will be followed in 2011 by a legislative proposal for a new European Energy Security and Infrastructure Instrument to replace existing TEN-E guidelines and TEN financial regulation. Marcel Kramer, CEO of South Stream summarized the situation as follows: "If you are designated a project of European interest, you get benefits. You get your stamps more quickly, better financing" (*European Energy Review*, February 14, 2011).

„[T]here is no requirement that a proposed project must not be in competition with an existing TEN-E recognised project, although [...] the Commission does not believe that any competition exists," Andris Piebalgs then EU Energy Commissioner noted in June in response to an April 2008 Parliamentary question. For a while, the Commission appeared to have changed its mind about the competition issue between Nabucco and South Stream when Günther Oettinger declared in November 2010 that "South Stream can, in the long term, be considered a rival to the Nabucco project" (*Sofia News Agency*, November 22, 2010). But in March 2011, when urging Russia not to pressure Azerbaijan and Turkmenistan, Oettinger said the two projects were not direct competitors (*Sofia News Agency*, *EurActiv.de*, March 28, 2011). Moreover, unlike the previous US administration, the current one is not opposed to the South Stream project. (Responding to remarks by US ambassador to Italy, Eni CEO Paolo Scaroni declared in January 2011 that South Stream and Nabucco cannot converge. In March 2010, Scaroni proposed to merge the two pipelines for part of the route, but this was rejected by Russia [*Bloomberg*, March 10, 2010 and January 11, 2011]. The Italian company is Gazprom's partner in both the Blue Stream pipeline and the South Stream project.)

A range of criticisms have been made of the intergovernmental agreements signed by various countries in early 2008, partly because the agreements state that the Russian party has the right to use all the capacity in the pipeline. But Article 32 of Directive 2009/73/EC (which replaced Article 18 of the Directive 2003/55/EC) must be applied. However, pursuant to Article 36 of the same Directive (which replaced Article 22

of Directive 2003/55/EC), South Stream may apply for an exemption from normal third party access (TPA) rules if it falls within the definition of an interconnector and if the conditions of that Article are met (Answer to a Parliamentary question by Günther Oettinger, August 13, 2010). The 50 per cent exemption the EU granted its own Nabucco pipeline project would not be acceptable for Gazprom. But the EU is unlikely to give South Stream more than a 50 per cent exemption (*ICIS Heren*, February 1, 2011). In early 2008, a spokesman for Energy Commissioner Andris Piebalgs stated there was "no way" South Stream would get the same derogation (*business new europe*, February 27, 2008). Bulgarian Economy and Energy Minister Traicho Traikov said in November 2010 that the Commission would be asked to reserve 50, 60 or 70 per cent of the pipeline capacity for its shareholders (*Eubusiness*, November 16, 2010).

The main issues raised above were addressed at the meeting between the Commission and Russia's government held in Brussels on February 24, 2011. This most recent meeting demonstrated that, in the end, it always comes down to the gas.

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