

Gazprom's EU Partners Anxious for Price Cuts

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ANAPA, Russia (AP) — Russian energy giant Gazprom is spending billions to expand its already massive footprint in Europe. But it will have to tread carefully at a time when global natural gas supplies are surging and prices are falling, giving European utilities and businesses more leverage in negotiating supply contracts.

At a lavish ceremony in December to mark the start of construction of a new pipeline to Europe, Gazprom put on a show of its industrial might to match the project's €1 billion (\$20.92 billion) price tag. On the Black Sea coast, 600 miles south of Moscow, the company built a eight massive steel-framed marquees to house Russia's President Vladimir Putin, Gazprom's executives and various European partners — all for a two-hour ceremony in which two short sections of the new South Stream pipeline were welded together.

In spite of all the public praise heaped on Gazprom at the event, there was recognition behind the scenes that the company is losing some of the clout it holds over Europe. While the region will remain heavily dependent on natural gas piped from Russia for decades to come, its ability to demand better prices is improving. That's because Gazprom is facing competitive pressures around the globe as gas production grows in the U.S., Australia, the Middle East and Africa. In other words, it needs Europe more than ever before.

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Published on Chem.Info (<http://www.chem.info>)

Born out of the Soviet gas ministry in the rush of Russian privatizations in the late 1980s and '90s, Gazprom is effectively the country's gas industry, accounting for about 80 percent of the country's natural gas output. The company, which posted some \$5 billion in net profit in the second quarter of 2012, holds a monopoly on Russia's gas export market and has first choice of which fields to operate. Gazprom exported some 238 billion cubic meters of natural gas around the world last year.

The vast majority of those exports arrive in Europe. The company supplies a quarter of the 27-country European Union's gas needs, some 124 billion cubic meters, according to Eurostat, the EU's official data service. Europe still tethers itself to Gazprom because, at the moment, it is almost impossible to find enough gas from other sources to replace the sheer amount the company exports.

The South Stream pipeline — jointly funded by Gazprom, Italy's Eni, France's EdF and Germany's Wintershall — was conceived in 2007. South Stream is due to start operating in 2015 and will bring up to 63 billion cubic meters of Russian gas a year to the Balkans, Austria and Italy.

However, the market for natural gas has changed dramatically since South Stream was first thought of. Natural gas reserves and export facilities are springing up around the world. European energy groups have already started importing gas from Qatar and will have more and more suppliers to choose from as more facilities come online.

Over the past few years, Gazprom has been locked in disputes with its European clients over its pricing policies. The big European energy companies — such as Germany's E.ON, France's GdF Suez or Poland's PGNiG — are unhappy with what they believe are rigid contract terms: High tariffs linked to oil prices and the take-or-pay clause which leaves energy firms locked with the volumes they may not need.

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In 2012, Gazprom exported gas to Europe at an average price of \$381 per 1,000 cubic meters — or \$10.88 per 1,000 cubic feet. That is higher than the two most important European benchmarks for gas prices, the U.K. and Amsterdam, which had average prices for gas of \$9.47 per 1,000 cubic feet and \$9.42 per 1,000 cubic feet respectively, according to Platts, a global energy information provider.

In the first half of 2012, Gazprom has paid some 133 billion rubles (\$4.3 billion) in "retroactive discounts" to settle these contract disputes with its clients, according to its earnings report. And the Europeans are hungry for more.

Paolo Scaroni, chief executive of Italy's Eni which owns 20 percent in South Stream, said his company would not need as much gas from Gazprom this year as it is bound to buy under the take-or-pay obligations because of weak market conditions.

Eni managed to get a lower price from Gazprom last year, and Scaroni told the AP that he does not see "any reasons why they should not be changing the prices in the future and adapt them to market conditions."

"Russian gas should be extremely cheap to produce, so it's going to be competitive with any gas in the world," he said.

One of the biggest long-term threats to Gazprom comes from the U.S., where the country's natural gas industry has grown rapidly thanks to recently perfected drilling techniques known as "fracking" — that have allowed drillers to extract from underground shale deposits.

U.S. natural gas production rose to a record 1.78 billion cubic meters (63 billion

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cubic feet) per day on average in 2012, according to the U.S. Energy Information Administration. That's up 24 percent since 2007, when drillers were first beginning to tap enormous reserves of gas trapped in shale formations under several U.S. states. The U.S., once thought to be in need of additional natural gas imports, is now expected to become an exporter within a few years.

That's a big turnaround from five years ago when Gazprom was working on supplying liquefied natural gas to the U.S. market. The International Energy Agency expects U.S. gas production to rise to overtake Russia in 2017.

"The shale gas boom in North America and the U.S. in particular has a double-sided impact for Gazprom," said Andrew Neff, a senior energy analyst at IHS Energy. Not only does the company lose a customer, it also has to find somewhere to sell the gas it had set aside the U.S.

On top of this, Neff warns that "North American LNG exports could potentially compete with Russian gas."

Gazprom's South Stream pipeline is being built to secure Russia's gas supply to Europe following a series of clashes with Ukraine, to whom Gazprom currently pays about \$2 billion a year in transit fees. In 2006, Russia cut off its supplies to the Ukraine after the two countries clashed over the price of gas and the transit fees. Russia kept shipping gas to the EU through Ukraine. However, to cope with a spell of severe cold weather, Ukrainians siphoned off some of that supply. European customers started reporting a drop-off in supplies as a result.

The dispute escalated in the winter of 2009 when Gazprom again cut off supplies to Ukraine after talks over a new gas contract failed. Again, Europe started experiencing a fall in supplies. In spite of Ukraine denying this time that it had siphoned off Russian gas, tens of millions of Europeans were left without gas for three weeks in the depths of winter.

Going through the Balkans, Austria and Italy, South Stream will avoid Ukraine, which will still get its supplies from the existing pipeline but won't get the extra transit fees.

However, analysts are concerned that Gazprom could be overreaching with its pipelines. On top of the South Stream project, the company in October opened Nord Stream, a new pipeline under the Baltic Sea, directly linking Germany with Siberia's vast natural gas reserves with the capacity of 55 billion cubic meters. The construction of South Stream and expansion of Nord Stream will mean Gazprom's capacity will exceed expected demand by between 50 billion to 100 billion cubic meters, according to analyst estimates.

Alexei Kokin, an oil and gas analyst at Moscow-based UralSib investment bank, is skeptical of the reasoning behind the South Stream, adding that for Gazprom and the other investors, the project "is pretty much a waste" of capital expenditure.

"The timing of South Stream looks bad for Gazprom," said IHS Energy's Neff.

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Gazprom officials, however, defend the Balkans-bound pipeline despite its estimated cost of €16 billion (\$20.6 billion).

"If that wasn't profitable for our partners, we would not go ahead with this project," Gazprom's CEO Alexei Miller said in December.

Miller explained that Gazprom would be saving a lot of money by not having to pay the \$2 billion in transit fees to Ukraine: "With South Stream, we will be paying these transit fees to ourselves," he said jokingly.

As well as battling to maintain its clout in Europe, Gazprom is also fighting on the political front in the region. European officials have warned Gazprom that it would have to allow third-party gas producers to use South Stream to comply with European laws that ban suppliers from owning transit facilities such as pipelines. Gazprom and its European partners in the project are lobbying for South Stream to be exempted from the law.

The company is also facing an EU probe to determine whether it violated competition rules by linking gas prices with prices for oil.

Putin strongly criticized the EU energy regulations as he sat down for talks with European leaders in Brussels last December. "It creates confusion and undermines confidence in our mutual work," he said.

Source URL (retrieved on 12/29/2014 - 1:48am):

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