EXPANDING RUSSIAN GAS EXPORTS TO THE EU GAS MARKET UNDERGOING LIBERALIZATION

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ABSTRACT

Gazprom is one of the leading exporters of natural gas in the world supplying 1/4 of the world gas exports and covering 25% of European gas needs. Russian natural gas is exported to 21 countries in Central and Western Europe for the most part under long-term contracts that have been signed in most cases under intergovernmental agreements. The priority of the company’s export strategy is the commitment to actual long-term contracts, some of which are in the process of supply expansion. Gazprom is the most important element of European energy security which is demonstrated by almost 40 years of gas supply to the European market.

Trying to expand its presence in the European market Gazprom enhances application of new forms and methods of trade. We are striving to get closer to end customers in many European countries.

Though new forms and methods of trade will be developed further we are definitely sure that spot and short-term contacts will have an auxiliary role in liberalized market, while the long-term agreements will remain the backbone of gas trade in Europe ensuring stability and security of supply. Only long-term contracts are able to cope with a high rate of demand for gas import in European countries. Energy security of the region requires the long-term contracts to be the foundation of the European gas market allowing fair risk distribution and adequate contribution from both sides.

The creation of adequate transportation infrastructure is the key performance driver of long-term contracts as the most important factor of energy security is. Gazprom main focus is on diversification of export infrastructure. Gazprom priority project is North-European Gas Pipeline which is going to be brought on line in cooperation with other European companies. The pipeline will deliver Russian gas to Western Europe without crossing territories of transit countries.

The growing role of LNG has been taken into account while planning gas exports. We plan to export Shtokman field produced LNG to North America and Europe.

Russian gas accounts for the most part of consumption in some European countries. Being denominator of a profound confidence in Russian gas this in its turn makes the Company feel responsible for European gas security.
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1. EXPANDING RUSSIAN NATURAL GAS EXPORTS TO THE EU GAS MARKET UNDERGOING LIBERALIZATION

1.1. Introduction

The Russian Federation holds the first place in the world in natural gas production and exports. Gazprom is the largest Russian company and leading world gas producer. The Company takes the leading position in gas exports rating covering one forth of the world exports (including supplies to CIS and Baltic States). Foreign trade transactions with Russian natural gas are executed by LLC Gazexport (100% ownership of JSC Gazprom).

The resource base of our exports consists of unique fields-giants in West Siberia (Medvezhye, Urengoyskoye, Yamburgskoye, Zapolyarnoye) being developed by JSC Gazprom. The results of 2004 showed that the Company had reached a peak production in the last five years - 545 bcm of gas. The Company is planning to raise production up to 560 bcm by 2010, up to 580-590 bcm - by 2020, 610 - 630 bcm - by 2030.

Having operated for decades in a foreign market Gazprom has gained the reputation of a reliable gas supplier. Even though the European political map has changed dramatically over the last 15 years Russian gas exports were on a continuous rise irrespective of the contract signing date. Gazprom is always scrupulously committed to its contracts.

1.2. Gas Exports of JSC Gazprom

In 2004 natural gas exports of Gazprom to Central and Western Europe were increased by 5.7 percent (in comparison with 2003) in spite of the fact that offer exceeded demand and reached its peak in the whole history of Russian foreign trade – 140.5 bcm. Export earnings rose by 10.9 percent reaching a record-breaking level of $18.3 billion. The Company sold 8.2 bcm of Central Asian gas. 4/5 of gas exports volume is supplied to EU member countries. In 2004 Russian gas share in the European market amounted to 25.4 percent.
In 2005 the Company will supply Western and Central Europe with 145 bcm of natural gas, in 2006 – 151 bcm.

Gazprom export strategy is based on a single export channel and a system of long-term gas contracts, some of them are in a period of boosting supplies. Russian natural gas is exported to 21 countries of Central and Western Europe for the most part under long-term (for 25 years) contracts that have been signed in most cases under intergovernmental agreements.

Western Europe is still our target foreign market for natural gas supplies. This region gets 3/4 of our gas exports – 101.9 bcm in 2004. The main customers are the Federal Republic of Germany (36.1 bcm) and Italy (21.6 bcm). They are followed by Turkey (14.5 bcm) and France (13.3 bcm). These four countries get more than 70 percent of our exports to Western Europe. In 2004 Belgium became the 21st European country receiving natural gas under direct contracts with Gazexport.
The Central European market plays a vital role in Gazprom’s export policy due to its geographical proximity to Russia and dominating role of Russian gas. In 2004 this market got more than 1/4 of our exports (38.6 bcm) and accounted for 90 percent of total gas imports of Central European countries. Hungary was the most active gas purchaser among Gazprom clients (9.25 bcm). Then followed the Czech Republic (6.8 bcm), Poland (6.3 bcm) and Slovakia (5.9 bcm). These four countries got almost 3/4 of our gas exports to Central Europe.

We continue to build up our relations with loyal purchasers of Russian natural gas. In late 2004 Gazexport and German WIEH and Wingas have signed agreements on prolongation of existing long-term contracts up to the end of 2030. In January 2005 Gazexport and Gasum (Finland) signed an agreement stipulating extension of gas supplies up to 2025. The Company also signed contracts with CONEF (Romania) on natural gas supplies to Romania in 2005-2009 time frame. A contract with INA (Croatia) was also signed to export gas to Croatia during the period 2005-2010. In September 2005 a contract with E.ON Ruhrgas was extended up to 2020 with annual export volume about 8 bcm. At the moment negotiations on prolongation of gas exports to Italy are being held.
1.3. European Gas Market Undergoing Liberalization: Today and in Perspective

In recent years gas consumption in Europe and in the world has risen sweepingly. According to international gas association CEDIGAZ, in 2004 global gas consumption has increased by 3.2 percent compared to the previous year and has reached 2,777 bcm. In Europe gas consumption has increased by 4.3 percent up to 554 bcm. High increment rate can be explained by improvement of general economic situation and upturn in gas demand because of gas environmental benefits especially for power generation. By CEDIGAZ estimates, in 2004 natural gas imports by Europe have boosted by 7.2 percent and reached 384.4 bcm.

The current gas supply in the world as well as in the European market is larger than demand (as was the case before). That is why competition continues to aggravate between suppliers in liberalized market. It is estimated that the situation will be the same for several years.

In 2004 the process of European Union gas market liberalization (the target market for Russian gas) became more active. The new Gas Directive of EU (enacted by European Parliament and European Council) came into force in July 2004 and replaced the previous one of August 10, 1998.

This new Directive has essentially accelerated the opening of new national gas markets for competition. Beginning from July 01, 2004 all customers (excluding the domestic sector) had the right to choose a supplier. From July 01, 2007 all customers without exception may use this right. These are minimum requirements for the market opening; however, the country-members of EU can open their markets much earlier.

In contrast to Gas Directive of 1998, which provided for both regulated and negotiated third party access to gas transmission and gas distribution systems and to LNG terminals, the new EU Directive allows only regulated access. This means that third party access to gas transmission and gas distribution systems and also to LNG terminals should be provided on the basis of unified tariffs which come into force after their publication.

It should be mentioned that at the moment EU does not officially have any objections to gas trading on long-term contracts which are the basis of our export sales as well as of the cross border trading system in Europe. Moreover, new Gas Directive states that long-term contracts will preserve their importance as a major part of gas supply for the member countries of the organization (Preamble, item 25).
It must be emphasized that Gazprom is one of the few major gas suppliers that has foreseen the structural changes in the market. We have created a vast technical and organizational infrastructure in Europe (pipelines, UGS facilities, joint ventures).

The future is expected to see the same outstripping growth rate of the world demand for gas. According to the US Department of Energy, the average annual growth rate of natural gas consumption in the world in 2002 - 2025 will be at 2.3 percent, whereas oil consumption – 1.9 percent, coal consumption – 2.0 percent. As a result the share of natural gas in the world’s energy consumption structure will raise from 23 percent in 2002 to 25 percent in 2025. This is promoted by technological advantages of gas as a fuel, and its high ecological characteristics that are especially important in view of adoption of Kyoto Protocol on the limitation of atmosphere pollution after ratification by the State Duma in 2005.

It should be noted that one of the most important factors of gas demand growth is the fast expansion of its consumption by the power industry. By 2025 about a half of gas demand growth might be pushed by the power industry.

In the long run, there is a good reason to believe that in European countries gas demand will rise because of its ecological advantages. However, the key driver will be political decisions (tax rate, the rejection of less clean fuel, etc.)

The growth of European gas demand in view of the drop in production because of exhaustion of explored local resources will lead to Europe’ increasing dependency on gas imports. As expected, import share of third countries in EU 15 gas consumption will rise from 51 percent (2004) to 70 percent (2020).

In this situation, by the end of the decade the oversupply of gas might convert into a gas deficit that will set the stage for reinforcement of the Company’s standing in the European market.

The increase of import share in the European gas consumption stipulates establishing stable market conditions. On the other hand, the gas market liberalization washes out the risk sharing system and moves practically all the gas supply risks over producers and exporters.
1.4. Development of Export Infrastructure for Russian Natural Gas

The long-term export gas supply contracts as the most important factor of security of gas supply and customers’ energy safety require the creation of appropriate infrastructure. Gazprom is working hard in this direction placing the highest emphasis on diversification of gas transmission infrastructure. This is one of the key elements of the Company’s export strategy.

1.4.1. Gas Export Pipelines

The gas pipeline Yamal-Europe has a particular importance. Beginning from July 01, 2005 at the Polish section of pipe in addition to two existing compressor stations (Kondratki and Wloclawek), another two projects were brought online (Szamotuly and Ciechanow). Shamotuli and Chehanuv have increased the pipeline capacity up to 28 bcm per year. In 2004 the overall volume of gas supply via compressor station Kondratki was 23.6 bcm. With the fifth compressor station put in operation in Poland (Zambrow) at the end of 2005 the Polish section of the Yamal-Europe gas mains reached the full project capacity.

In autumn–winter period of 2005/2006 Gazprom is planning to boost the capacity of the Byelorussian pipe section of the Yamal-Europe gas pipeline up to 33 bcm per year. To do that in addition to existing Byelorussian Nesvizhskaya and recently put in operation Krupskaya and Slonimskaya compressor stations, another two units – Minskaya and Orshanskaya should be brought on line.

The deliveries through the Blue Stream Black Sea gas pipeline launched in 2003 continue to be successful. In 2004 this pipeline supplied 3.3 bcm, in 2005 – about 4.5 bcm. In perspective Russian gas via Blue Stream might be delivered to the Southern Europe.
The North European Gas Pipeline (NEGP) is fundamentally a new stage of cooperation with European gas consumers. For the first time NEGP will channel Russian natural gas to Western Europe directly without crossing transit country borders. That will help to avoid political and economic risks associated with transit deliveries via third countries. The project outlines the possibility of constructing a spur line for gas delivery to Sweden.

The new pipeline will enhance the reliability of our gas export to the Western Europe due to route diversification. It will facilitate boosting our gas export volumes and will also increase gas deliveries to customers in North-West part of Russia. This project receives support from Russia and European Union, where it got the status of a Trans-European Network.

In September 2005 Gazprom signed a framework agreement with BASF and E.ON concerning the NEGP construction. Under this agreement there are plans to build the offshore pipeline section by a joint venture (Gazprom will have 51 percent, BASF and E.ON 24.5 percent each). By April 2006 Gazprom will choose a third foreign partner in the joint venture where the Company’s share will remain unchanged.
Participation of German partners in the NEGP project is considered to be a part of mutual cooperation in energy partnership. This cooperation involves a number of assets swaps forming a balanced portfolio. Besides we are discussing the terms of access to partners’ gas transmission networks (existing and prospective) for possible gas transmission via NEGP through the territory of the German Federal Republic to other target markets.

The design capacity of twin pipe line is 55 bcm per year. The offshore section of the pipeline from Vyborg to Germany’s coast is about 1.2 thousand km and the onshore section of it (from Torzhok to Vyborg) is about 917 km. In December 2005 the first joint of NEGP was welded in Russia.

With its first line to be launched in 2010 NEGP will be brought to its design capacity in 2013.

**1.4.2. Underground Gas Storage Facilities**

Important element of Gazprom export strategy is to expand UGS system in European countries. Nowadays UGS acquires specific importance due to the ongoing European gas market liberalization. While implementing this aspect of export strategy the Company plays an active role in expanding USG network in European countries. We have signed a contract with Wingas to store our gas in their Rehden UGS facility - the largest one in Europe with the capacity of 4 bcm. The Company also rents capacities in UGS facilities of Austrian OMV, German VNG and Vitol.

In December 2004 Gazexport, Austrian RAG and Wingas have signed Basic Terms of Agreement on Heidach UGS project. Haidach UGS is situated in the North-West of Austria. In May 2005 the Company signed a contract to design and operate the Heidach field as UGS facility with the capacity of 2.4 bcm, of which 1/3rd belongs to Gazexport.
In July 2005 we have signed a five year contract with Vitol for leasing half of UGS Humbly Grove capacity (143 mcm) which is located in the South of Great Britain and is scheduled to become operational by the end of 2005.

We are going to be engaged in contract negotiations concerning purchase or lease of UGS facilities in some other countries of Western Europe, such as Germany and Belgium.

All this, undoubtedly, will raise the reliability and flexibility of Russian natural gas exports to European consumers and will foster security of European gas supply.

Investment in gas infrastructure – especially in gas transmission - are the long-lead assets, capital intensive and of high risk for investors. A few companies which are able to accomplish that sort of investment and subject themselves to such risks need clear, economically feasible and long-lasting framework arrangements in the energy policy. This is the only way to attract new major investments and business operations focused on the future.

1.5. Prospects of Russian Natural Gas Export Development

On the one hand, the European gas market liberalization and the world market globalization lead to the market uncertainty and competition growth but, on the other hand, provide the market players with new opportunities for running an efficient business.

1.5.1. New Forms and Methods of Natural Gas Trade

The Company does not ignore the essential changes taking place in the European market under the influence of active liberalization processes, including the development of forms and methods of international gas trade. Gazprom is continuously applying new business strategies (“spot” and short-term deals, gas hubs) in order to enhance its participation in the European market. We also endeavor to get to the end consumers in some of the European countries.

Gazprom is a player in short term deals since 1999, mostly through Gazprom subsidiary in Great Britain Gazprom Marketing and Trading. This company has all the necessary licenses for trading activity in NBP system, in Zeebrugge gas hub and Dutch gas exchange TTF. In November 2004 Gazprom Marketing and Trading got the license for gas supplies to French end customers.
Currently Gazprom significantly increases its gas deliveries to the British market. In 2003 Great Britain got more than 2.1 bcm of gas (including spot contracts), in 2004 there were about 4 bcm (part of this volume was supplied via Wingas). In 2005 gas sales by spot contracts in Great Britain, Belgium and the Netherlands will total more than 4 bcm, and in 2006 we plan to sell in spot markets of these countries more than 5 bcm. In 2010 natural gas supplies to the Great Britain will reach about 10 bcm (excluding gas deliveries via NEGP).

When economically feasible we sell natural gas on a short-term basis to other markets, for instance to Italy.

Undoubtedly, in future new forms and methods of trade on the liberalized market will be developed further. However, we are sure that the spot and short-term deals will have an auxiliary role, while the long-term agreements will stay as the basis of international gas trade in Europe, because long-term contracts guarantee the stability and security of supply. They are the only way of meeting a rapidly growing demand for gas imports in European countries where the gas production volume is constantly reducing. Only long term contracts guarantee a total payback on capital intensive export projects to a producer and an exporter and an importer is guaranteed of secure and continuous gas supply for a long period of time.

An increasing number of analysts are coming to the conclusion of an auxiliary role of spot transactions. In our view major European gas buyers are the first and foremost parties interested in security of supply and in long-term agreements with producers.

Providing energy security for the region requires preserving long-term contracts as the backbone of European gas market that gives the parties an opportunity to share risks fairly and make adequate contributions.

Gazprom is actively reviewing options of diversification of natural gas supply. With this in mind different ways of entering markets of North America and Asian-Pacific region are being investigated.

China is regarded as a very promising market for Russian pipeline gas. At the moment in the context of Russian-Chinese inter-governmental agreement the question of Russian natural gas supply to China is being examined. The agreement on strategic cooperation with CNNC is being successfully implemented. Under this agreement pipeline gas supplies to China after 2010 are being studied.
Another very attractive market for Russian gas from East Siberia and the Far East is the Republic of Korea where both pipeline gas and LNG could be delivered to. Besides that Japan, Taiwan and US Pacific coast are the challenging markets for Russian LNG deliveries.

While on this matter we consider the unified export policy on the basis of a single gas exporter and with due respect to existing production sharing agreements, execution of export contracts and setting effective gas export prices for a long-term period to be of priority consideration.

1.5.2. Prospects of Russian LNG Export

One of the most important tendencies of the world gas market development is outstripping growth rate of LNG trade. Due to LNG ecological benefits and world economies globalization gas demand leads to LNG trading activation. In addition, growth of demand for LNG in the USA and in Europe is driven by decline of indigenous production and the objective to diversify foreign gas supply sources.
During gas export planning we take into consideration the increasing role of LNG in the European market which is a key market for Gazprom. The company adjusts its strategy adding a new incentive to enter the world LNG market. The Company strategy with regards to the world LNG market is a step-by-step one, with very challenging North American market being the first.

In the short run, Gazprom evaluates different options of LNG deliveries to the American market. Specifically, a variety of variants of swap operations and spot LNG purchases is being studied. In September 2005 Gazprom delivered the first LNG cargo, in December 2005 a swap operation with this commodity was executed. In 2006 we plan to increase spot supplies to the American market. Today we are in a process of negotiating contracts with the leading LNG market players which will allow us to cooperate more closely in the field of LNG trade.

In the midterm, Gazprom strategy to enter LNG market provides for increasing trade activity by purchase of the goods in countries of the Atlantic zone under short and medium term contracts for the consequent sales of LNG in the American market. In the USA as well as in European countries we seek to reach the end customer and get involved in every piece of value chain. Currently we negotiate our equities in regasification facilities in the USA and Canada.

After completion of assets swap with Shell in Sakhalin-II and Zapolyarnoye-Neocom projects we will be in a position to enter LNG markets of Japan, Republic of Korea and US Pacific coast.

Asia-Pacific consumers will receive Russian LNG in 2008 when Sakhalin liquefaction train is put into operation in Russia. The target markets for Sakhalin LNG will be Japan, Republic of Korea, China and the USA. Sakhalin Energy company has signed contracts to deliver LNG to Japan and Mexico, and also won the competition to provide LNG supplies for Republic of Korea.

In the long run we plan to export LNG produced by our own liquefaction trains. Currently we are in a process of designing a liquefaction plant at the Baltic coast which will be fed from the Unified Gas Transportation System. It is assumed that this project will help to facilitate early deliveries of Gazprom indigenous production LNG to Atlantic basin markets in 2009. This will provide us with necessary experience for the ultimately efficient large-scale LNG supplies from Shtokman field which are planned to be launched in 2010.

Recently Gazprom has announced a short list of potential partners in the Shtokman project which includes 5 major international companies: Statoil, Hydro, Total, ConocoPhillips and ChevronTexaco. The final decision on partners of this consortium will be taken in the 1st half of 2006.
Shtokman LNG may be delivered to the USA, as well as to the markets of Great Britain, Spain and other European countries. Decision on these contracts will be taken in accordance with strategic goals and with due respect to the economic efficiency of such deliveries, bearing in mind pipeline gas supply to Europe. Examination of optimum LNG transport routes and negotiations with future gas consumers in European markets are an integral part of Gazprom export strategy.

1.6. Conclusion

While defining its marketing policy plans Gazprom is governed only by principles of economic expediency and minimization of market risks. Russian gas accounts for considerable share in gas consumption of many European countries. Being the sign of a high degree of credibility in Russian gas it makes the company feel responsible for the gas security in Europe. Our actions are not motivated by political reasons and they are aimed against nobody. Gazprom is the key element of energy security in Europe and that is proved by a 40 years of European gas supply experience.

We intend to be players in new markets of natural gas in other parts of the world while preserving our share in the European market and endeavoring to form full cycle production & sales chains in order to actively take part in the international division of labor with an export commodity which is new to us – LNG. The further advancement of Russian natural gas exports will provide for LNG maintaining a major role in the Russian foreign trade framework being the most important source of export earnings.

As a result of steadfast implementation of its export strategy Gazprom is resolved to become one of the leading global vertically integrated energy companies.
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