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Gas business as usual? The new agreements between Gazprom and EU energy companies

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On 4 September 2015 at the Economic Forum in Vladivostok, Gazprom signed two agreements with Western companies: an agreement to extend the Nord Stream pipeline, and an agreement on exchanging assets with corporations from Germany (resuming the implementation of previously concluded agreements) and Austria (an initial agreement).

The agreement concerning Nord Stream-2 represents a success for Russia; it accomplishes the strategic goals of Russian gas policy in Europe (main - ceasing gas exports through Ukraine), despite the difficult political relations with the EU, the Western sanctions regime, and Brussels' declaration that it will diversify the EU's sources of supply and reduce its dependence on Russian gas. It indicates the consent of Berlin and other Western European capitals to reviving cooperation with Russia in the gas sector. Finally, it also testifies to the growing differences of interests within the EU concerning the shape of gas cooperation with Russia, and represents an attempt to reduce the role of the European Commission (EC) in shaping energy policy. The chance of constructing the new legs of Nord Stream seems good; however, the ultimate success of the project will depend on both financial (the access to external financing by the consortium) and legal factors (the compatibility of the use of Nord Stream-2's land infrastructure with EU law).

The shareholders' agreement concerning the construction of two new Nord Stream legs was signed by Gazprom and five major European companies: Germany's BASF, Austria's ÖMV, Germany's E.ON, the Dutch-British Shell and France's Engie (formerly GDF Suez). The draft envisages the construction of a gas pipeline with a total capacity of 55 bcm running from Russia to Germany (a memorandum to this effect was signed in June 2015 at the Economic Forum in St. Petersburg). The cost of construction is estimated at €9.9 billion, and the pipelines are to be completed by the end of 2019. The funding structure has not yet been determined, but according to Gazprom representatives it should be developed by January 2016. The project is to be undertaken by the New European Pipeline AG design company (registered in Zug, Switzerland), in which Gazprom will have a 51% stake, BASF/Wintershall, ÖMV, E.ON and Shell 10% each, and Engie 9%.

A Russian-German agreement was also signed, under which a subsidiary of BASF/Wintershall is expected to receive a 25-percent stake in two blocks on the Urengoy deposit in Western Siberia (production of which is expected to start in 2018, and is estimated to produce 8 bcm of gas annually). In return, Gazprom is to receive the other half of the shares in Wingas and Wintershall Erdgas Handelshaus Berlin (dealing with gas sales), companies previously controlled by BASF; as well as the gas reservoirs in Rehden and

Jemgum and their operator, the Astora company. In addition, Gazprom will receive a 50-percent stake in Wintershall Noordzee, which deals with gas extraction in the North Sea (off the coasts of Denmark, the Netherlands and the UK).

The Russian perspective

The agreement to construct the third and fourth legs of the Nord Stream gas pipeline is further confirmation that Russia is firmly committed to implementing its strategic political objective, namely building up infrastructure so it can cease using Ukraine as a transit country for Russian gas exports. Taking into account the current demand for Russian gas among its European customers (138.8 bcm in 2012; 161.5 bcm in 2013, 146.6 bcm in 2014), even with a possible increase in demand, the existing infrastructure is fully sufficient to meet Russia's export obligations: 55 bcm via the existing Nord Stream legs; around 33 bcm via the Yamal-Europe pipeline; theoretically 179 bcm along the Ukrainian route (around 142 bcm in real terms, due to the network's current technical state); and 16 bcm via Blue Stream. Although Moscow is aware that a complete shutdown of the Ukrainian transit route will not be possible before January 2020 (when the Russian-Ukrainian transit contract in force since 2009 expires), new strings of Nord Stream would allow Gazprom to significantly reduce the amount it now transmits via Ukraine. Assuming the maintenance of transit through Ukraine at the 2014 level (around 58.9 bcm), the new strings of Nord Stream (even if only half its capacity is used, due to constraints arising from the so-called Third Energy Package) would allow a reduction in transit through Ukraine to around 30 bcm of gas per year. The effect of this would be not only a reduction in Ukraine's transit income, but also and most importantly it would become unprofitable for Kiev to maintain the Ukrainian pipeline network (according to estimates, the lower limit of profitability is the transit of at least 35-37 bcm of gas annually). The new Nord Stream pipelines would strengthen Moscow's bargaining position in its talks with Kiev on a new, essential short-term transit contract, as well as other issues of both economic and political importance.

Russia also hopes that the alliance between Gazprom and influential European energy companies to build new Nord Stream branches will result in an increase in Russia's lobbying capabilities within the EU, particularly Germany. Strengthening Russian-German gas cooperation, even at the cost of economic concessions by Russia (the heavier burden of the project's costs will be borne by the Russian side, and possibly more favourable price conditions from the supply of Russian gas will be offered to Germany) would give Russia the chance of gaining a significant political advantage. It would then be likely that interest in trilateral cooperation between Russia, Ukraine and the EU would decrease. It is also possible that intensified Russian-German gas cooperation would increase Moscow's lobbying possibilities in EU institutions (for example, in the context of demands for exemption from the so-called Third Energy Package for both existing and new Russian infrastructure projects).

On the other hand, implementing the agreement to exchange assets between BASF/Wintershall and Gazprom will lead to Russia obtaining control over the German gas storage facilities, which constitute a quarter of the estimated 24 bcm gas storage capacity in Germany. The underground gas storages which Gazprom will acquire can meet 5.5% of Germany's annual demand for gas, which will increase Gazprom's room for manoeuvre on the European market (which will be especially important when it stops storing gas in Ukraine), depending on changes in prices and demand.

Both the agreement on the new strings of Nord Stream and the return to implementing the agreement on the asset swap between Gazprom and BASF/Wintershall provide further confirmation that – regardless of its stated 'return to the East' – Gazprom still sees Europe as a key market in its external gas strategy.

The German perspective

The share of gas in the German economy after 2009 fell by 5%, despite fairly high economic growth in Germany. This was the result of high gas prices, the rapid development of strongly-subsidised renewable energy, and significant investment in the thermal insulation of buildings. Despite these negative market trends, in 2013-2014 the share of gas imported from Russia rose to 38% from 33% in previous years.

In analysing the consequences of these new agreements for Germany, we may expect an increase in the importance of Russia in German imports, although the expansion of Nord Stream will not lead to any dramatic increase in the share of Russian gas consumed in Germany. Berlin favours leaving the gas agreements in the hands of the corporations, but is likely to oppose any radical increase in its degree of dependence on gas from Moscow. It is also unlikely that Russia will be able to offer such attractive prices that it can push imports from the Netherlands and Norway out of its market completely, especially as these countries will not readily give up their extremely lucrative German markets. Nevertheless, Russia's share could gradually grow together with an increase in gas consumption in Germany. One opportunity to raise the amount of gas sold from Russia to Germany is offered by the slow decline of gas production in Germany, which covers 10% of the country's demand and is gradually falling (in 2007-2013 the amount of gas extracted dropped by 40%), as well as the slow fall in the Netherlands' resources.

However, the German energy companies and the federal government will definitely want Germany to obtain a position as a major gas hub. German companies in the energy sector, such as E.ON and RWE, are experiencing significant problems in adapting to the rapid expansion of renewables on the German energy market, and in recent years their financial results have been worsening noticeably. BASF, in turn, has its own financial problems related to the drop in oil and gas prices on the global market.

A significant consequence of the agreements between the German energy companies and Gazprom may be a limit to Germany's support for EC action aimed at diversifying gas supplies to the EU. No major German politician has commented on reports of the conclusion of these agreements, which proves that the government has no objections to the expansion of Nord Stream. Chancellor Angela Merkel has not initiated any projects to diversify gas supplies to Europe in recent years, despite having repeatedly declared her support for such initiatives. There is a risk that Berlin will be willing to give more robust support to German companies in implementing new energy projects with Russia, irrespective of the European Commission's plans to diversify gas supplies to Europe, as well as the interests of Central and Eastern Europe. This could therefore undermine the principles of the Third Energy Package.

The EU's perspective

The agreement on Nord Stream-2, the renewal of the agreement on the Gazprom/BASF exchange of assets, and the talks about a similar agreement with ÖMV, all fit into the intensification of the cooperation (which has been apparent for several months) between some major Western European gas companies (BASF, E.ON, Engie, Shell, ÖMV) and Gazprom. This indicates – despite Russia's abandonment of the South Stream pipeline, the problems connected to the Turkish Stream project and the plans to build gas pipelines to China, and regardless of whether the new lines of Nord Stream are ever actually constructed – that a large part of European gas business, mainly in Northwest Europe, wants to strengthen its strategic cooperation with Gazprom and boost the role of gas on the European market. These agreements also serve the interests of Germany, France, Austria and the Netherlands linked to the shape of the European gas market, and – despite the lack of any official confirmation – they must have been consulted with the governments of these countries. However, the construction of Nord Stream-2 goes against the interests of most countries in Central Europe, because by increasing the availability of Russian gas from the West, it will reduce the profitability of gas imports from alternative sources and of the new projects of diversification.

The contracts signed by the European companies and Gazprom also go against the aims of the EU's policy over the last year on diversifying gas supplies, increasing energy security in Central and South-Eastern Europe, and gas cooperation with Ukraine, including the provisions of the European Commission's strategic documents, such as a document about the Energy Union and the European Strategy for Energy Security (one of goals of this last document was to reduce dependence on Russian gas). The binding agreement for Nord Stream-2 is thus a sign of the European companies' distrust of current EU policy (both its line and its effectiveness), and represents an attempt to co-shape that policy in a way which suits them. At the same time, it points to the wide variety of opinions and interests within the EU related to the shape of gas cooperation with Russia. The lack of a uniform response from the European Commission itself to the signed agreement is symptomatic of this. While Maroš Šefčovič, the Vice-President of the European Commission and Energy Commissioner, adopted a critical stance, pointing to the problems that the construction of Nord Stream-2 would create for the EU's gas policy, Miguel A. Cañete, the Commissioner for Energy and Climate, stated that the draft would not give rise to any problems as long as it is compatible with EU law.

An 'old' project in a new context: assessing its feasibility

The Nord Stream-2 project, although very similar to the already constructed Nord Stream-1, will be implemented in a fundamentally different market context. Since 2008, the European market has shown decreasing demand for gas; last year it fell by 12% to levels not seen since the mid-90s (BP data). Thus, the forecast is for lower increases in gas imports to the EU than previously expected. There is also a greater availability of gas on global markets; this is a result of the shale gas revolution in North America, as well as changes on the global LNG market. Finally, one should note an increasing degree of liberalisation on the EU market; more and more gas is being sold on gas exchanges, and the traditional suppliers (including Gazprom) are progressively adjusting their contracts to the changing realities (showing greater flexibility with respect to the use of take-or-pay clauses, taking market prices into account in contractual pricing formulas, et al.). The position of Gazprom itself is also weakening, due to its continuing financial problems (caused by both the declining current demand for gas in the EU, and the low oil prices, which reduce the price of Russian gas when sold for export), as well as challenges on the domestic (growing competition from the so-called independent gas producers) and the EU markets (including the ongoing antitrust proceedings and the implementation of the so-called Third Energy Package). All this shows that if the Nord Stream-2 project does become reality, the gas it transmits can be sold to customers in the EU on different principles than before (not necessarily only through long-term contracts, but also to a greater extent on gas exchanges), and Gazprom's partners will play an important role in the gas trade.

The agreement to construct new pipelines via the Baltic Sea is so far the only concrete agreement Gazprom has concluded with European partners since withdrawing from the South Stream project. The European energy companies' consent to sign such a serious agreement – despite the sectoral anti-Russian sanctions introduced by the EU, and in a context of serious political tensions in relations between the EU and Russia – suggests that the chances for the project appear to be considerable. Thus, the Nord Stream-2 pipeline is now becoming the most promising of all the European infrastructure projects which Russia has announced in recent years.

However, its implementation will depend on two main factors. Firstly, there are currently no established sources of funding for the project: neither the exact shares of the capital contributions by the partners nor the expected external financing. In the light of the current political climate in Russia's relations with the West, it is difficult to assess how likely international financial institutions or the EU banks will be to grant the loans. Gazprom, due to its own difficult financial situation, will not be able to cover all the project's costs itself. Secondly, although the Commission does not have any formal powers to block the construction of an undersea section of the new Nord Stream strings if the consortium does obtain the necessary permits from the coastal states (as in the case of the first and second strings of Nord Stream), problems may appear in the case of the land infrastructure. Implementing the project will require the expansion of connections on German territory, which will be evaluated for their compliance with EU energy law regulations (in particular, restrictions on the possibility of using the full capacity of the expanded infrastructure, based on the principle of third-party access).