Russia's Gas Power Play
Russia Tightens its Grip on Gas Infrastructure and Supply

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Proposed South Stream Pipeline
In June 2007 Gazprom (Russia) and ENI (Italy) announced a 50:50 agreement to construct (beginning 2009 and online by 2012) the "South Stream" gas pipeline (30 billion cubic meters of gas capacity / year - bcma) from Beregovaya on Russia's Black Sea coast some 900 km to the Bulgarian coast reaching water depths of more than 2,000 metres. Onward onshore sections, with routes yet to be finalized, would transport gas north to Austria (through Serbia or Romania and Hungary and south to Otranto in Italy through Greece.

The deal will enable ENI to add further value to its recent acquisitions of Russian assets of Arctic Gas and Urengoil (Eni bought the production companies at a YUKOS auction in April 2007, together with a 20% stake in Gazprom's oil subsidiary Gazprom Neft). However, it is Gazprom and Russia that accrue substantial strategic benefits from this line by providing it routes into Southern Europe that avoid the traditionally problematic transit countries of Eastern Europe and the ability to compete with any new pipeline not controlled by Russia that threatens to bring gas from Central Asia or Middle East into Europe via Turkey avoiding Russia.

Italy is Europe's third-largest gas market behind the UK and Germany and imports some 86% of its gas, mainly from Algeria and Russia. Gazprom is already supplying about 25 billion cubic meters of gas a year to Italy, making it Gazprom's second-largest country gas purchaser after Germany. However, ENI is Gazprom's largest single gas purchaser enabling ENI to have achieved the status of the largest gas company by sales in Europe, with some 18% of the total market. Just as the 55 bcma Nord Stream gas pipeline (agreed in 2006 by Gazprom, E.ON and BASF) to be online by 2010 across the Baltic Sea diminishes the leverage currently enjoyed by Ukraine, Poland and Belarus in transitting Russian gas to Germany, South Stream would isolate Gazprom's gas supplies to southern Europe from Turkey's influence. Its strategic significance should not therefore be under-estimated.

Stiff Political and Commercial Pressure for Proposed Nabucco Pipeline

Sanctioning of the South Stream pipeline is also likely to significantly dent the potential markets and economics of the Nabucco pipeline project, a 4.6 billion euro ($6.2 billion) plan, led by OMV of Austria. The Nabucco 3,300-km gas pipeline, with capacity potentially reaching 30bcma by 2020, is planned go through Turkey, Bulgaria, Romania, Hungary and Austria. It is scheduled for construction from 2008 to 2011, but few believe it will be ready to proceed at that pace. The European Union (EU) gave the project its backing in 2006 promoting any alternatives that lessen dependence on gas from Russia. Although the EU forecast that it will probably need an additional 200 to 300 bcma of gas supply over the next 25 years, suggesting that there is ultimately room for several new import pipelines of the scale of Nabucco, it is clear that South Stream and Nabucco will in the medium term compete head-to-head for customers. The announcement of South Stream appears to damage the commercial case for Nabucco to such an extent that financial commitments may now become difficult to secure.

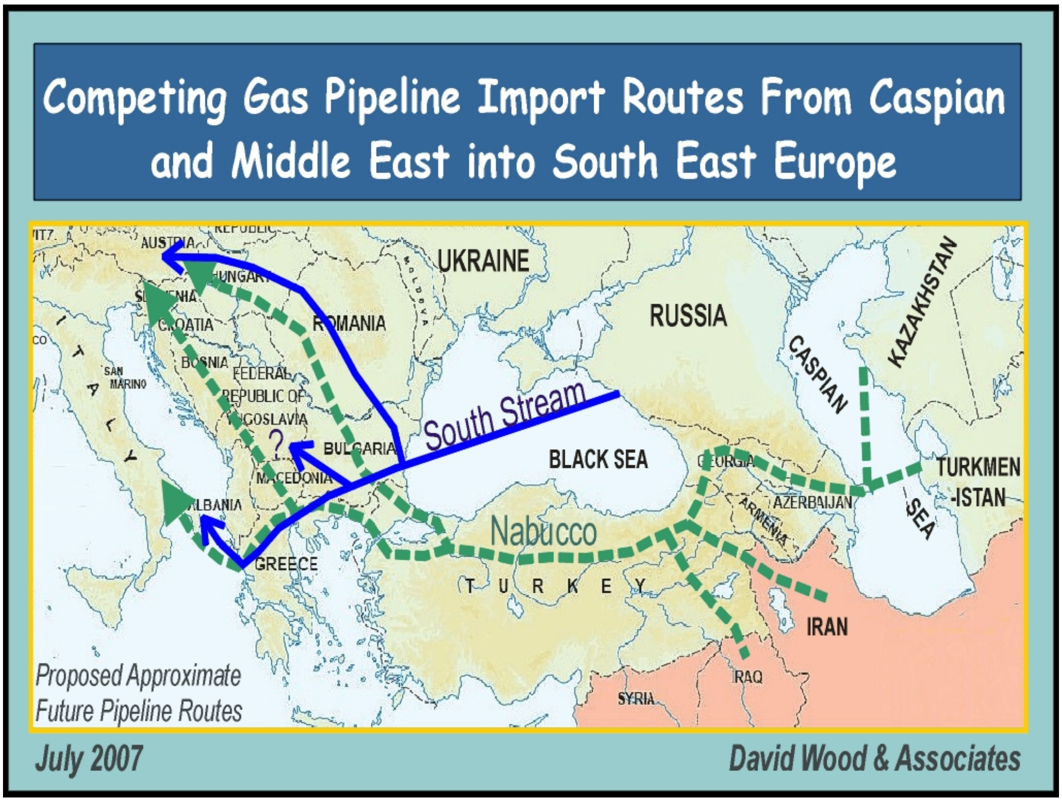

Figure 1. Cross-Lines? **Proposed pipelines to be constructed in the next few years compete to bring additional gas supplies into Europe. Russian-backed South Stream Line may undermine the EU-favoured Nabucco line that could bring gas outside Russian control.**

Gazprom Moves in on Baumgarten

It was probably not coincidental that President Putin, Alexy Miller (Gazprom) visited Austria and met with Wolfgang Ruttenstorfer (CEO of OMV) in May 2007 to agree on further cooperation in the gas business, particularly in the expansion (through Gazprom taking an equity interest) of its Central European Gas Hub at Baumgarten (Austria), making it a major European gas entry point, transit and distribution hub. OMV, it seems, is keener in the short term on the development of Baumgarten as a hub than its throughput gas being sourced outwit Russia's control. OMV has been importing gas from Russia since 1968 and in September 2006 extended its gas supply agreements with Russia to 2027 by contracting some 150 bcm of natural gas for Austria. Linking South Stream into Baumgarten with Gazprom an Equity holder in the hub further limits Nabucco's independence.

Russia has been extraordinarily successful in 2006 and 2007 in picking off the major gas distribution companies in individual EU member countries (e.g. Germany, Italy and Austria so far) counter to the strategic intensions of the EU collectively to diversify gas supply and avoid Russia achieving enough dominance to control or manipulate prices.

Caspian Gas to be Routed through Russia

Gazprom has taken steps to contractually tie up a significant portion of the Central Asian nation's gas reserves under long term contracts following through its strategy to continue to control gas and oil resources, infrastructure and export routes from Kazakhstan, Turkmenistan and Uzbekistan. In the short term selling on this Caspian gas may also enable Gazprom to delay investment in some of the expensive pipeline and field developments required in northern and central Russia (e.g. Shtokman and Kovykta).

The Central Asian States undoubtedly realise they are being manipulated and also held to ransom by Russia, but know the consequences for them by not cooperating with Moscow. Turkmenistan had held out in negotiations with Gazprom for gas prices of $100 per 1,000 cubic meters (mcm) for 2007 shipments compared to $65/bcm in 2006, but with no access to alternative export infrastructure their negotiating power is limited. Russia bought some 42 bcm of Turkmen in 2006 at the $100 /mcm price, which remains low in comparison to the some $250 / mcm Gazprom charges its Western European customers.

However, in May 2007 Turkmenistan and Kazakhstan agreed to expand shipments though a new-build 20 bcma pipeline out of Central Asia via Russia in a blow to concerted Western European efforts to build alternative pipelines for Central Asian and Middle Eastern gas bypassing Russia. Building the new pipeline and modernizing the old ones would allow Russia to purchase up to 80 billion cubic meters of gas from Turkmenistan, which is believed to hold some 2tcm of proved gas reserves. The $1 billion plus new pipeline project is planned to commence in mid-2008 with deliveries reaching 20 bcma by 2012 and potentially building to 30 bcma. Once upgraded, the whole Caspian pipeline export system through Russia is anticipated to be capable of carrying some 90 bcm of gas. This agreement is a blow to China as well as the EU, both of whom were hoping to secure access to substantial Caspian gas without Russia's involvement.

Belarus Gas Network Now in Gazprom's Hands

In May 2007 Belarus signed an agreement to hand over a 50% stake in its gas pipeline network, Beltransgaz, to Gazprom, a key part of the settlement to the January 2007 dispute between Minsk and Moscow that lead to oil and gas supply disruptions into Western Europe. The Beltransgaz deal further increases Gazprom's control over gas networks into Western Europe. The Gazprom deal will be worth some $2.5 billion to Belarus eventually but in staged payments: an immediate $625 million paid for a 12.5% stake in Beltransgaz with the remaining 37.5% to be transferred to Gazprom control between 2008 and 2010.

Russia Shows IOCs Who is in Control

Russia is gradually retaking control of the few production-sharing agreements (PSA) ratified in Russia with international oil companies (IOCs) in the 1990s. After months of bullying tactics by the government, in December 2006 Shell and partners agreed to cede control of the Sakhalin-2 (massive oil, gas and LNG) project to Gazprom in exchange for $7.45 billion. The deal completed in February 2007, left Shell and Japan's Mitsui and Mitsubishi holding 27.5%, 12.5% and 10% in the $22 billion project, respectively. In addition to this state-imposed dilution at a knock-down price, Shell, as former operator, still has the outstanding threat of court proceedings against it for alleged environmental damage to the value of some $5 billion. Following the deal the European Bank for Reconstruction and Development (EBRD) declined to approve a second tranche of a loan it had earmarked for the project.

In June 2007, after some four years of pressure and threats from Russia's Natural Resources Ministry, TNK- BP agreed to sell its interest in the giant East Siberian Kovykta gas field to Gazprom for a payment of between $600 million and $900 million. The assets include a 62.9% stake in the Kovykta operating company, Rusia Petroleum, and a 50% stake in a smaller company, which is constructing a regional gasification project. The Kovykta gas field is about 450 kilometres (280 miles) from the city of Irkutsk with resource estimates of some 2.0 trillion cubic metres of gas. TNK-BP had failed to meet its original license obligations in terms of production targets, because Gazprom had blocked TNK-BP’s plans to build a gas pipeline to China. This was the leverage used by Russia to re-gain state control over the asset.

In spring 2007 it seemed that TNK-BP might simply be stripped of its interest in Kovykta, including the loss of the $450 million the joint venture had already invested. Analysts have valued TNK-BP’s former interests in Kovykta at between $2.0 billion to $3.6 billion, based on the field's gas being sold on local markets and much more if exported to China. The sale price to be finalised by September 2007 will be a fraction of that although BP tried to put a gloss on that by announcing by a new agreement with TNK-BP and Gazprom to work to develop major projects in Russia and overseas. If this venture bears fruit TNK would be able to exercise an option to buy a 25 % plus one share stake in Kovykta at an independently assessed market price. The deal also recognises investments already made by TNK-BP in the Kovykta project. The new venture with Gazprom could see BP swap interests in assets in places like Libya, where in May 2007 BP signed a $900 million gas exploration deal, for access to big Russian fields such as Shtokman. The balance of power in this alliance has however now moved very much in Gazprom’s favour.

Russia’s Ruthless Gas Strategies Continuing to Pay Off

Flushed with the success from the tactics used to extract control of PSA assets from Shell and BP, Russia turned its attention to ExxonMobil’s Sakhalin-1 asset in June 2007. Gazprom asked the Russian government to cancel an agreement to pipe large quantities of gas to China from the Sakhalin-1 project on the basis that the gas was required by Gazprom to supply Russia’s domestic regions. Rosneft - the Russian state-controlled oil firm – is already a shareholder in the project, together with Japan's Sadeco and India's Videsh. Whether this will help or hinder the foreign companies in retaining control of this asset remains to be seen.

Collectively all of these recent events demonstrate the carefully orchestrated but ruthless being pursued by Russia and Gazprom to achieve its objectives to expand both gas supply volumes and to secure long-term control of strategic assets and infrastructure to inhibit competition.

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