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2020: A TURNING POINT FOR EASTERN EUROPEAN GAS MARKETS?

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With new infrastructure set to diversify regional natural gas supply and pro-market EU regulations coming into force, central and eastern Europe has the potential for rapid development in the coming years

BY AURA SABADUS AND DAVID SIMON OCTOBER 2018

In June, the first gas from Shah Deniz II, an Azeri project expanding the original offshore field, reached Turkey as the first leg of the Southern Gas Corridor was inaugurated.

This project will eventually connect fields in Azerbaijan to central Europe via Greece, bringing new volumes to an area traditionally reliant on Russian gas.

In Romania, large producers such as ExxonMobil and OMV are aiming to start production on Black Sea blocks, while Greece and Turkey have been expanding LNG import capacity. The Bulgaria-Romania-Hungary pipeline is set to transport some of those volumes by the end of the decade.

Ukraine is also set to ramp up production and may start exporting regionally. Much of the country's gas infrastructure may become idle if Russia diverts transit volumes destined for Europe through new upcoming pipelines, opening it up for other uses.

By the end of 2019 Russia's Gazprom will have completed the first string of the TurkStream pipeline, which will bring up to 15.75 billion cubic metres (bcm) of gas annually across the Black Sea into Turkey.

Gazprom is planning to commission a second string on the pipeline with a similar capacity for gas exports to eastern Europe.

Ukraine has depended on Russian gas for decades, but in recent years has switched to European markets where it has been an active buyer, following a pricing dispute.

This paper examines the key transit corridors coming online in the near future and their impact on market development beyond 2020.

Pipelines and interconnectors

The most important projects due to come online before the end of the decade include the Southern Gas Corridor, TurkStream and the Bulgaria-Hungary-Romania corridor.

These developments will include regional interconnectors that should improve and diversify supply in the area.

Apart from infrastructure being built from scratch, capacity on transit crossing Ukraine heading either to central Europe or south to Bulgaria, Turkey and Greece, is set to be opened up to the market.

Those pipelines were commissioned decades ago and were used exclusively by Russia. However, as transit contracts expire and new export routes from Russia are created, this infrastructure will become available for use by regional companies.

The Southern Gas Corridor

The countdown has started for the launch of the first leg of the 3,500km Southern Gas Corridor, which will bring 6bcm/year of gas to Turkey and another 10bcm/year to Greece and Italy.

This project is made up of two sections, with the first consisting of the Trans-Anatolian Pipeline (TANAP), stretching from Shah Deniz II in Azerbaijan to Eskisehir in northwest Turkey

The other leg is the Trans-Adriatic Pipeline (TAP), which will start at the Greek-Turkish border and move to the Italian coast.

Turkey became the first recipient of Azeri gas in June, when the first volumes arrived at Eskisehir and are set to reach 2bcm by the end of the year. Deliveries will ramp up to 6bcm/year from the beginning of the next decade.

Gas deliveries to Europe will start in 2020 at an initial rate of up to 6bcm/year for the first six months, before this rises to 10.5bcm/year in the plateau period.

In theory, the project should help recipient countries diversify away from Russian gas. In practice though it is unlikely to bring radical changes for several reasons.

First, in Turkey the Azeri gas will replace an existing 6.6bcm/year contract from the first phase of Shah Deniz, which will expire in 2021.

The price paid by Turkey for this is indexed to Russian gas import prices paid by state-owned supplier BOTAS. It is calculated at a 12% discount to the Russian import price.

The new supply will be delivered to BOTAS and there are no indications it will release volumes to private companies.

Second, TAP benefits from a third party access exemption, which means the pipeline can only be used by the companies off-taking the gas through 25-year agreements.

These include Italy's Hera (0.3bcm/year), Anglo-Dutch Shell (1bcm/year), German Uniper (1.6bcm/year), French ENGIE (2.6bcm/year), Bulgarian Bulgargaz (1bcm/year) and Greek DEPA (1bcm/year). Italy's Enel and Swiss Axpo also have contracts, but agreed volumes have not been disclosed.

Most of the contracts signed by Italian companies are reportedly indexed to prices at Italy's PSV hub, while the contract to Greece has an element of indexation to the Austrian VTP.

TurkStream

Initially mooted to bring 60bcm/year of natural gas to Turkey and European markets, the project has been downsized to 31.5bcm/year as regional demand did not justify such a large pipeline.

Of this, 15.75bcm/year will be earmarked for the Turkish market, replacing 14bcm/year that is currently exported via the Trans-Balkan Pipeline.

This means Turkey will gain 1.75bcm/year, although it is not known whether the same supply structure will remain in place.

Currently 10bcm of the gas exported via the Trans-Balkan Pipeline is contracted by seven independent importers, the remaining 4bcm is taken by BOTAS.

Some of these contracts are set to expire by 2021 and, given difficulties linked to market regulation in Turkey, it is possible they will not be renewed.

This would mean independent importers might have to return their contracts to BOTAS, effectively ending Turkey's private gas sector.

The second TurkStream string will reach the Bulgarian border and that country's grid operator Bulgartransgaz recently conducted an open season for capacity.

It received market interest for 54.6 million cubic metres (mcm)/day at an entry node close to the existing Strandja-Malkoclar point on the Trans-Balkan pipeline.

The commissioning date for the new entry point is set for 1 October 2019, which coincides with the second string of TurkStream coming online.

The gas imported via Bulgaria could be further exported, either to Serbia or to central Europe via Romania and Hungary.

According to Bulgartransgaz, Russian gas could be transited to the Serbian border and exported at the Provadia-Zaychar point. A maximum of 34.4mcm/day could be delivered via this link.

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Alternatively, Bulgaria could also export Russian gas via the existing Giurgiu-Ruse interconnector with Romania. The link was EU funded and commissioned in January 2017 to help Bulgaria, which currently depends entirely on Russian gas, to import Romanian volumes and diversify supply.

Since its launch, the interconnector has only been used for exports of Russian-sourced gas from Bulgaria to Romania.

It is also possible that some of the Russian gas exported via the second string of TurkStream will be transported to Greece via an existing interconnector with a 4.6mcm/day capacity.

Although no details have been discussed regarding the contractual terms for the export of Russian gas via TurkStream, the odds are that the contracts may be somewhat different from those in place now.

This means that unlike the legacy contracts signed in the 1980s, the new agreements may be shorter, similar to deals signed by Gazprom with western European customers.

Following the settlement of an EU antitrust case against Gazprom last month, the Russian producer may no longer ban importing EU countries from reselling volumes, although this is unlikely to apply to Turkey.

The Bulgaria-Romania-Hungary corridor

An EU-backed gas corridor designed to help eastern and central Europe diversify supply, the Bulgaria-Hungary-Romania-Austria pipeline, is unlikely to materialise in its initially conceived form.

Last year, Hungarian and Romanian grid operators decided it was no longer viable to include Austria, moving the end point of the corridor to Hungary.

The decision came as a blow to companies such as ExxonMobil and OMV, which are expecting to start gas production in the Romanian Black Sea and want to export these volumes to Austria and onwards to western Europe.

As Romanian commitments to open up borders have stalled, there are questions whether Black Sea gas will actually reach neighbouring markets.

The country held an open season on the Hungarian border in December 2017 and interest for capacity on the existing bidirectional pipeline was high.

Three companies are thought to have expressed interest, with grid operators FGSZ and Transgaz allocating 4.16bcm/year of capacity into Hungary and 2.82bcm/year into Romania.

Romania's previous behaviour, which has brought it under the spotlight of an EU investigation, shows the country has been an uncooperative regional player, seeking to block cross-border trading with Hungary, Bulgaria and Ukraine.

More recently, the government has been looking to expand gas demand for electricity generation or for fertiliser production, to absorb volumes set to be produced in the Black Sea.

According to a recent study by Deloitte, recoverable Black Sea resources could amount to 135bcm, more than 13 times Romania's current annual demand.

However, Romania's barriers to export are raising concerns the Bulgaria-Romania-Hungary corridor may largely transport Russian gas imported via TurkStream.

Future of pricing

Despite EU efforts to liberalise the gas sector in eastern Europe and Turkey, these countries are still a long way off transparent wholesale markets.

The question is whether new sources of gas will help to fast-track the liberalisation process.

On closer inspection, neither TANAP nor TurkStream are likely to boost liquidity and support the formation of a reference price.

As mentioned, Turkey will be importing Azeri gas via TANAP at a price indexed to the Russian imports and volumes will only be delivered to BOTAS.

Since Turkish imports are oil-indexed, BOTAS has no flexibility in setting a market price, being entirely exposed to fluctuations in crude futures.

It is not known how Russian gas exported via TurkStream will be priced, but considering the region traditionally buys at oil-indexed prices and that there are no liquid hubs in proximity, it is possible Gazprom will continue the practice in countries such as Bulgaria.

Romania, which is not dependent on Russian gas due to its own resources, may start developing its own reference price, although if it continues to block cross-border trading, the benchmark would not have much regional significance.

Thanks to its active cross-border buying, Ukraine could start a border price that may act as a benchmark for the region.

If Ukraine succeeds in ramping up production and reforms its domestic sector, which represents more than 60% of demand, its chances to launch a reference price would increase. However, the development of a Ukrainian reference price would depend on its commitment to continuing the reform process.

Hungary, on the other hand, is one of the more promising central European countries in terms of establishing a market, looking to boost its regional connections and encourage competitive trading.

The extra sources of gas that would be brought to the market, as well as the opening up of numerous bidirectional interconnections, are likely to contribute towards that.

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Cross-border trading

In theory, the pipelines and interconnectors being built should help to boost cross-border trading and create an integrated regional market.

In practice, that goal could be scuppered by nationalist instincts, or obstruction raised by Russia's Gazprom, which is unlikely to relinquish its historic control over the region.

Romania is currently under investigation by the European Commission for allegedly blocking the export of gas to neighbouring countries. The result of the investigation and potential penalties could force it to open up its borders.

In previous cases where Gazprom's legacy transit contracts expired and third party access should have been implemented at border points, some countries did not facilitate cross-border trading, citing threatening Gazprom behaviour.

An EU investigation showed Gazprom was blocking the integration of markets in eastern Europe by preventing buyers from reselling gas bought from the Russian supplier. Under the latest settlement, Gazprom is expected to lift the re-sale condition.

There are fears Gazprom would use measures to disrupt access to border points, for example by insisting the Russian gas day is used for capacity sales, which differs from the EU standard by three hours.

The emergence of cross-border trading will also depend on whether non-EU countries such as Turkey are willing to open borders and allow flows with neighbouring Bulgaria and Greece.

At present there is little clarity on how the export of Russian gas via TurkStream to Bulgaria will happen, with details such as whether EU norms will be applied to be confirmed in the coming months.

Application of network codes

The application of network codes is compulsory at cross-border interconnection points between EU members.

As more projects such as the Southern Gas Corridor and TurkStream will link Turkey to member states it is questionable whether EU rules would apply on the Turkish side.

According to existing arrangements, it is up to the regulator of the non-EU member state to decide whether it would apply third party access rules and organise capacity auctions.

In the case of the Southern Gas Corridor, TAP will benefit from a third party access exemption throughout the period of the first supply contract.

For TurkStream it is unclear whether the transfer point between Turkey and Bulgaria will be subject to EU regulation.

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