

South Stream and the political battleground

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With the expansion of US sanctions against Russia, the regulatory dispute between the EU and Russia, and the resignation of Bulgaria's government, the ongoing feasibility of Gazprom's \$50 billion South Stream project is being questioned.

While Gazprom is not listed under the US sanctions, announced by the Obama administration on 16 July 2014, its financial arm, Gazprombank and the state-owned bank Vnesheconombank (VEB) both are, along with Russia's biggest oil producer, Rosneft, and Russia's largest private gas producer, Novatek.

The sanctions severely reduce the two banks' access to capital markets by closing the medium and long-term US dollar lending window, allowing them only to deal in debt of less than 90 days maturity.

Gazprom responded to the sanctions on 20 July by stating that it can settle all of its payments in both Russian and foreign currencies, but as South Stream is being funded 70% through long-term debt, the funding requirement still seems significant.

The EU is due to announce an expansion of its sanctions blacklist, following the crash of Malaysia Airlines Flight MH17, by the end of July. It is expected to impose further financial restrictions on Russian businesses and individuals close to Russian president Vladimir Putin.

The EU has instructed the European Investment Bank to suspend new loans to Russia and the European Bank for Reconstruction and Development has also announced it will not be making any new investments in Russia in response to the sanctions. In spite of this, Bulgaria and Serbia are expecting to receive loans worth hundreds of millions of euros from Gazprom to help finance the construction of their sections of the South Stream pipeline.

South Stream structure

The 2,380km South Stream pipeline will be built across the Black Sea from Russia to South and Central European countries, bypassing the traditional transit route of Ukraine. The onshore sections required Gazprom to sign agreements with Bulgaria, Serbia, Hungary, Greece, Slovenia, Croatia, and Austria.

The project has been split up into sections, with each country the pipeline passes through containing its own special purpose vehicle (SPV), which will incorporate the various participating state utilities. The offshore section's SPV, called South Stream Transport, consists of Gazprom (50%), Eni (20%), EDF (15%) and Wintershall (15%).

Observers expect each SPV to be able to raise capital, once the project gains EU approval, relatively quickly due to Gazprom's experience in building pipelines and a ready market for the gas. Analysts have suggested that if commercial

lenders are reluctant to lend, Russia would pay for the pipeline from its own treasury.

Russian president Vladimir Putin's trip to Vienna signalled the final shareholders agreement (in this instance with OMV) to be signed with counterparties, guaranteeing equity investment into the project.

Crédit Agricole Bank (France), ING Bank London Branch, and RPFB Project Finance Ltd (Russia) are joint financial advisors for the entire financing process. The financing package will likely involve similar international banks and financial institutions across each SPV, with domestic lenders involved in each section.

The third energy package

Although financing may not prove a stumbling block, regulations may be more of a hinderance. The EU's third energy package's unbundling rules are crucial to the future of the South Stream project and are being closely watched by investors. The legislation is intended to prevent a monopolistic supply chain and requires that energy suppliers and owners of transmission networks be different parties.

The EU claims that the intergovernmental agreements with each of the member states for South Stream are in breach of European law, as contracts have not followed EU rules such as competition and public procurement. The project also goes against the EU's energy security policy which seeks to diversify supply, as South Stream only diversifies the route.

A statement from the European Commission said: "South Stream is not - and has never been - a priority project for the Commission."

In May, Russia challenged the legislation in front of the World Trade Organisation, arguing that Gazprom's agreements were in place before the energy package, but market observers say a compromise with the EU will be necessary to get the deal completed.

Russia had hoped to use the change in leadership at the European Commission as a chance to lobby for South Stream, welcoming Italian's foreign minister, Federica Mogherini, who is being discussed as a candidate for the role of High Representative of the Union for Foreign Affairs and Security Policy and Vice President of the European Commission, to the Kremlin on 9 July 2014.

The visit was heavily criticised however and, together with ongoing discussions over further sanctions, is one of the reasons the EU postponed the announcement of a nomination for the post until 30 August.

The Bulgarian controversy

The Bulgarian government's resignation on 24 July has added further confusion to the future of the project, with elections scheduled for October. The government's decision was in part a result of pressure from the European Commission over its continued support for South Stream.

Construction on the pipeline in Bulgaria was supposedly halted in early June following demands from European officials and a US delegation of senators which expressed concerns over the project and the influence it gave to Russia. Under particular scrutiny was the award of a contract to build the pipeline in Bulgaria and Macedonia to Stroytransgaz Holdings, a company belonging to Gennady Timchenko, a major shareholder of Novatek and sanctioned by the US in March following the annexation of Crimea.

However, local news reports earlier this week implied work on the pipeline was continuing contrary to the announcement it had been temporarily suspended last month. A key task for the caretaker government is likely to involve forging a closer link with the EU over its views over the pipeline.

While South Stream has become a battleground between EU-US leaders and Russia, the project continues to push forward and many in the market remain confident that the deal will reach financial close.

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