Analysis

Gazprom – A Reliable Partner for Europe's Energy Supply?

By Andreas Heinrich, KICES, Koszalin

Summary

The conflict with Ukraine over natural gas in January 2006 that also caused delivery shortfalls in Central and Western Europe gave rise to concerns in the EU, including in Germany, as to the reliability of Russia – and thus of Gazprom – as an energy supplier. On the one hand, Gazprom is striving for greater integration in the world market, while on the other hand, it seeks to maintain its dominant monopoly position in the opaque markets of the Commonwealth of Independent States (CIS). The company keeps a tight rein on competition in the post-Soviet natural gas market and acts as sole supplier of natural gas from Russia and Central Asia on the foreign markets. The strategy pursued by Gazprom within the CIS is fundamentally incompatible with the basic tenets of the EU's energy policy in terms of competition and non-discrimination. Despite these contradictions, Gazprom has proven to be a reliable supplier of natural gas to the EU.

Introduction

The conflict with Ukraine over natural gas in January 2006 that also caused delivery shortfalls in Central and Western Europe gave rise to concerns in the EU, including in Germany, as to the reliability of Russia – and thus of Gazprom – as an energy supplier. This article will therefore analyze the motives, plans, and rationale of Gazprom's actions in order to determine whether Gazprom acts as an independent actor or as an extension of the Russian government, and to find out who directs the company's policy. It is important to distinguish between the CIS, which Russia regards as its own sphere of influence, and the "far" abroad as seen from Russia.

Within the CIS, the Russian gas monopolist tries to limit competition and to preserve market structures that lack transparency, and thus to act as sole supplier of natural gas from Russia and Central Asia to the foreign markets. Therefore, Gazprom is in favor of preserving state-regulated markets (though it advocates raising the natural gas prices that are determined by the state) and is trying, in accord with Russian foreign policy, to reestablish its predominance in the energy markets on the territory of the former Soviet Union.

As a result, Gazprom's behavior in Russia and within the CIS is very different from its conduct on the international markets. It is therefore important to distinguish between the level of the CIS – or in Russian parlance, the "near abroad" – and the international stage that lies beyond. This approach reflects the enduring discrepancies in the institutional structures of the markets that Gazprom operates in, but equally takes into account the Russian government's notion of zones of influence, according to which the CIS is still regarded as part of the Russian hegemonial sphere.

Gazprom and the CIS

The company, in close cooperation with the Russian state, has been trying since the 1990s to reinstall a consolidated energy sector in the "near abroad" and thus to expand the regulated markets. The strategy to achieve this goal involves the creation of transnational companies under Russian leadership as well as shared development and production projects. Energy deliveries negotiated by state officials, and Russian credits to finance them, also serve to integrate the natural gas industries of the CIS countries. The debts of the buyer states, which are further accelerated by this form of financing, are leveraged for the acquisition of company shares in the respective country's energy sector.

At the level of the "near abroad", mutual manipulation and instrumentalization between Gazprom and the Russian government is commonplace. However, despite the fundamental correspondence of interests, the two parties have not always interacted in a spirit of cooperation. Measures undertaken by one side have repeatedly obstructed or even prevented the other from realizing its goals. This can be demonstrated using transit states and gas-exporting countries as an example.

Weakening the Central Asian competition

Gazprom is using all its influence to keep in check its Central Asian competitors, who are seeking access to the world markets. To date, all pipelines exporting natural gas from Central Asia pass through Russian territory. Gazprom and the Russian government are exerting massive pressure to thwart any planning or implementation of alternative routes that would circumvent Russia.

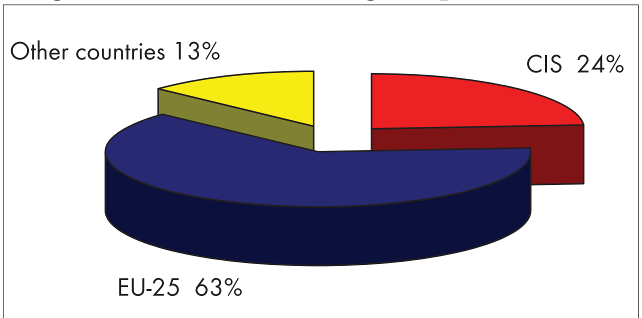
The most important Central Asian gas-producing country by far is Turkmenistan. Until 1994, Gazprom had granted Turkmenistan a transit quota of 11 per cent of the pipeline network's total capacity. Subsequently, Gazprom denied the country that quota and instead tried to sell its own natural gas to Turkmenistan's clients. Gazprom even vigorously obstructed Turkmenistan's access to customers in the financially weak CIS states.

The situation only improved in 2000, when Gazprom was no longer able to meet all its delivery obligations through its own production. Gazprom then conceded part of the financially weak, low-price end of the CIS market to Turkmenistan in order to be able to fulfill its supply contracts with Western and Central European customers. Since then, Turkmenistan has played an important role in the company's strategy, as exemplified by the temporary resolution of the natural gas conflict with Ukraine in January 2006. It is envisaged that Turkmenistan will advance to become the main supplier to Ukraine, and that its cheap deliveries will set off the high prices charged by Gazprom. So while Gazprom charges US$230 per thousand cubic meters for its gas, Ukraine only pays an average price of US$95. This price difference comes at the expense of Turkmenistan.

The refusal of Gazprom to transfer Turkmen natural gas to more solvent customers in Western Europe forced Turkmenistan to seek export options southwards that would skirt Russian territory. However, all such projects have failed, and Turkmenistan will remain dependent on Russian export pipelines for the time being. Turkmenistan, therefore, has only partially managed to translate its importance for Gazprom's supply strategy into a stronger negotiating position. The price increases for Turkmen natural gas are far below the price rises that Gazprom has been able to enforce vis-à-vis its non-Russian customers.

Since Gazprom continues to be the sole operator of the gas pipelines from Central Asia that pass through Russian territory, it can exclude the contractors from that region from the direct export business.

Diagram 1: Russian natural gas exports



Competition within the CIS market is thus largely avoided. The liberalization of the Russian gas sector, which would imply a division of extraction, transport, and sales services among independent companies, has been ruled out by the Russian government for the time being. The Russian side even refuses to offer guarantees on transit deliveries as stipulated by the European Energy Charter.

Gazprom and the transit countries

Within the CIS, Gazprom is trying to assert control over the natural-gas infrastructure, and especially over the export pipelines. Ukraine and Belarus have a key role here, since approximately 85 per cent of Russia's natural gas exports pass through these two countries. Both of these transit states are also consumers of Russian natural gas. Gazprom could theoretically use the many years' worth of accumulated arrears in payment for gas deliveries as a way of enforcing its own interests. The company has therefore been trying for years to acquire ownership of transport pipelines or the companies that run them, as a way of offsetting debts. However, it has only rarely managed to do so. Ukraine, though, has been particularly successful in exploiting its strong position as a transit country to compensate for its weak position as a customer and debtor of Gazprom.

The relationship with Ukraine has long been determined by disagreements over debts for Russian natural gas, transit fees, and Gazprom's charges that Ukraine was illegally siphoning off gas for its own use from the transit pipelines. The Russian government supported Gazprom's attempts to resolve these disagreements and to persuade Ukraine to pay off its debts. Gazprom and the Kremlin attempted to apply joint pressure on their Ukrainian negotiating partners.

These enduring disputes with Ukraine prompted Gazprom to consider alternative transport routes. This move was intended to smash the Ukrainian transport monopoly and to generally reduce transit through the former member states of the Soviet Union as far as possible. One of these alternatives is the Yamal-Europe pipeline, inaugurated in 1999, which passes from Western Siberia through Belarus and Poland to Germany. While this route avoids Ukrainian territory, it has not ended the disputes with the transit countries.

The importance of Belarus as a transit country has increased since the construction of the Yamal-Europe pipeline. Gazprom was therefore obliged to make concessions concerning the country's natural gas debt. Additionally, the Russian government had a hand in shaping prices and determining the method of payment – mainly in order to prevent Gazprom's business policies from endangering the political and economic union of the two countries.

Despite Gazprom's compromises, disagreements with Belarus increased, leading to the interruption of deliveries via the Yamal-Europe pipeline in early 2004. In this way, Gazprom hoped to exert pressure on the Belarusian government in order to be able to enforce its price demands and take over complete control of the Yamal-Europe pipeline. The Russian government supported the company in this endeavor. However, Gazprom's attempt was largely unsuccessful and was aborted after a couple of days. It was not until December 2005 that the company was able to acquire control over the Yamal-Europe pipeline. In return, Gazprom delivers natural gas to Belarus at a fraction of the average price paid in Europe. Table 1 offers an overview of Gazprom's pricing policies.

In order to increase the independence of its exports and to circumvent the existing problems with Belarus and Poland, Gazprom in 2004 began planning a pipeline through the Baltic Sea to Germany (the North European gas pipeline; NEGP) that – like the Blue Stream pipeline, which runs through the Black Sea to Turkey and has been in operation since 2002 – avoids transit countries altogether. But even if the Baltic Sea pipeline is completed as planned in 2010, it will at best reduce Gazprom's dependency. In the year 2005, 73 per cent of Russian natural gas was piped to Central and Western Europe (excluding Finland) through Ukraine. Even after the Baltic pipeline's completion, Ukraine will still be in a position to control approximately 66 per cent of Russia's export capacity to Central and Western Europe (see Table 2).

Since Gazprom will continue to be highly dependent on Ukraine as a transit country, more conflicts like the January 2006 gas dispute seem inevitable. While the international public has largely forgotten the last interruption of natural gas supplies to Ukraine in the early 1990s, the events of January 2006 have created sustained international interest and triggered a discussion on energy security in Europe. Primarily, this appears to be the case because this time, influential gas consumers such as Germany also noticed a pressure drop in their pipelines. At the beginning of 2004, when only Poland and the Baltic states were affected by a disruption of supplies from the Yamal-

Table 1: Gazprom's prices for natural gas produced by the company itself (US$ per 1000m^3)

	2005	2006
CIS		
Ukraine	50	230
Belarus	47	47
Georgia	68	110
Azerbaijan	60	110
Armenia	56	110
Estonia, Latvia, Lithuania	85–95	120–125
Moldova	80	160
Russia		
Average domestic price	38	46
Europe		
Average price for Western Europe	174	250
Germany	200	n. a.
Poland	120	n. a.
Turkey	75	n. a.

Source: Roland Götz, SWP Aktuell No.3, www.swp-berlin.org

Table 2: Gazprom's export routes (in bn. m^3)

Pipeline	Route	Capacity 2005	Capacity 2010
"Brotherhood"/"Union" (Soviet pipeline network)	Russia – Ukraine – Central Europe	130	130
"Northern Light" (Soviet pipeline network)	Russia – Belarus – Ukraine – Central Europe	25	25
Trans-Balkans (Soviet pipeline network)	Russia – Ukraine – Balkan countries	20	20
Finland Connector (Soviet pipeline network, expanded in 1999)	Russia – Finland	20	20
Yamal-Europe (in operation since 1999)	Russia – Belarus – Poland – Western Europe	28	28
"Blue Stream" (in operation since 2002)	Russia – Black Sea – Turkey	16	16
Baltic Sea pipeline (operation planned for 2010)	Russia – Baltic see – Germany	—	28
Total capacity		**239**	**267**

Europe pipeline, the international reaction was negligible.

Gazprom is and remains dependent on transit states, especially Ukraine. The relationship between the company and the transit states is, however, characterized by recurrent conflicts. The fear in Europe is that these conflicts could threaten Europe's supply of natural gas.

Gazprom and international gas consumers

At the international level beyond the CIS, there is no discernible mutual influence between Gazprom's strategy and Russian foreign policy. In this area, Gazprom pursues an independent policy that is in line with the market, and seeks cooperation with transit and customer states in Western Europe. The company's activities are increasingly geared towards international business practices and do not differ significantly from those of other energy companies operating on the international markets. The Russian government's support for the company in this sector is limited to creating favorable framework conditions, as is customary in Western countries as well.

Especially during the early 1990s, on the other hand, Gazprom's company policy in the Central and Eastern European states of the former Council for Mutual Economic Assistance (COMECON) was highly ambivalent. The company's modus operandi vacillated between the methods used in dealings with former Soviet states on the one hand, and recognition of customary international norms in dealings with Western business partners on the other. Gazprom's conduct towards most of these countries has been largely in line with international standards since the beginning of their EU membership negotiations, or at the latest since the date of their EU accession. One distinctive legacy of the previous era is the harsher tone that prevails in negotiations between Gazprom and the new EU members due to the suspicions harbored against Gazprom in these states, especially in Poland (see Table 3).

Taking into account the events in Ukraine in January 2006, the question arises whether such suspicions may also be appropriate in other consumer countries. "Although the natural gas affair damaged the Kremlin's image, Gazprom's actions – when regarded dispassionately – gave no reason to question the company's reliability as a gas supplier. The very fact that the authorities were obliged to reverse their decision to cut off gas supplies to Ukraine clearly shows that fiddling with the gas tap is not a real policy option for Russia. The Russian side cannot seriously blackmail either the transit states or the end customers in Europe, because it is fundamentally dependent on both." (Roland Götz cited from Ukraine-Analyse no. 2/2006).

Table 3: Natural gas imports from Russia 2004

	Imports from Russia (bn. m^3)	Percentage of total imports
EU-25		
Estonia	0.9	100%
Finland	4.3	100%
Latvia	1.5	94%
Lithuania	2.9	94%
Hungary	9.3	85%
Greece	2.2	80%
Slovakia	5.8	80%
Austria	6.0	77%
Czech Republic	6.8	69%
Poland	6.3	69%
Germany	37.3	41%
Italy	21.6	35%
France	13.3	30%
CIS		
Moldova	2.7	100%
Azerbaijan	4.9	89%
Belarus*	10.2	52%
Ukraine*	34.3	50%
Other countries		
Serbia	2.3	100%
Bulgaria	3.1	100%
Romania	4.1	70%
Turkey	14.5	65%

** Not included are imports from Central Asia through Russia.*
Source: Roland Götz, SWP Aktuell No.3,
www.swp-berlin.org

The CIS states and the Eastern European EU members, especially, are highly dependent numerically on Russian natural gas (see Table 3). The Western European states' reliance on Russia is fairly low by comparison, especially when European domestic energy extraction is taken into account. Even Germany, by far the largest consumer of Russian natural gas in Western Europe, has managed to keep the Russian share in its overall gas consumption fairly stable at approximately one-third since the 1970s.

Nonetheless, further geographic diversification of energy supplies should not be neglected as an instrument of energy security. This is the purpose of a number of current projects, such as pipelines from North Africa, the "Nabucco" pipeline running from the eastern border of Turkey to southern Europe, and the construction of further terminals for liquefied natural gas.

Conclusion

On the one hand, Gazprom aims for increasing integration into the world markets, while on the other it seeks to consolidate its dominant monopoly position in the opaque markets of the CIS. The company limits competition on the post-Soviet gas market and acts as sole purveyor of natural gas from Russia and Central Asia on the world markets. By buying comparatively cheap natural gas in Central Asia, the company can make substantial profits from selling Russian gas at significantly higher prices in Europe. This is also the ulterior aim of attempts to regain export pipelines that were inherited by the successor states of the Soviet Union. This strategy, which is entirely sensible from the company's point of view, enjoys the support of the Kremlin.

Within the CIS, the goals of official Russian foreign policy and Gazprom's company interest largely coincide. As a rule, therefore, Gazprom's activities meet with no resistance from state authorities. However, the Russian government is usually not able to offer direct support for company policy; nor is such cooperation pursued at the international level, beyond the former Soviet Union, by either of the two parties. Therefore, Russian foreign policy is only instrumentalized by Gazprom to a very limited degree, and there are only isolated instances of Gazprom serving as a tool of Russian foreign policy.

Gazprom's strategy within the CIS is fundamentally incompatible with the EU's energy policies in terms of competition and non-discrimination. Consequently, Russia has not yet ratified the EU Energy Charter, which is based on these ideas. However, applying the Energy Charter to the territory of the CIS would offer an opportunity to resolve conflicts, such as the January 2006 Russian-Ukrainian gas dispute, long before they escalate to a stage with far-reaching consequences. This, however, would imply that Russia would surrender its dominance in energy politics.

Despite these contradictions, Gazprom has proven to be a reliable supplier of natural gas to the EU. But even if Gazprom does not per se constitute a risk factor for the energy security of the EU and Germany, they would nevertheless be well advised to continue their current diversification efforts, since technical difficulties, for example, can never be excluded. An intensification of energy ties with Russia, as pursued by Germany with its Baltic Sea gas pipeline project, is not advisable for the EU. And Germany should not be tempted by this deal to increase the share of Russian gas in its overall energy supply to significantly more that one-third.

Translation from the German: Christopher Findlay

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Suggested Reading:

- Andreas Heinrich: Between a Rock and a Hard Place: The Energy Sector in Central and Eastern Europe. In: Kari Liuhto/ Zsuzsanna Vincze (eds.): Wider Europe. Tampere: Esa Print 2005, S. 457–490.
- Jonathan Stern: The Russian-Ukrainian gas crisis of January 2006. Oxford: Oxford Institute for Energy Studies 2006.