Analysis

Will Russia Create a Gas Cartel?

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Summary

The media has hyped the idea of a new gas OPEC which could menace the European Union with the specter of even higher prices for natural gas. This speculation has little to do with reality however. Numerous obstacles will prevent the formation of such a global cartel. Nevertheless, other types of producer alliances may be possible and these deserve careful attention.

Rhetoric Currently Exceeds Reality

"Europe, the U.S., and Asia should be doing everything possible to prepare for the possible future of a natural gas cartel. Gazprom is already actively engaged in anti-competitive policies to pre-empt, disaggregate, and coordinate the energy market." This warning from Robert Amsterdam, a former legal counsel to Yukos, is an example of a recent trend in the Western media portraying the threat of a gas cartel led by Russia as the next step in Russia's attempt to control energy flows to Europe. This interpretation is exaggerated.

To be sure, the rhetoric of the Russian leadership with regard to the possibility of a gas cartel has not helped to ease Europe's fears. At the end of 2006, Vladimir Putin responded publicly to Iranian President Mahmoud Ahmadinejad's proposal that a gas OPEC was "an interesting idea and we will think about it." In January 2007, a deal between Algeria (the second largest supplier of natural gas to Europe) and Russia to boost energy cooperation seemed to confirm to the already suspicious Europeans that Russia was up to something that meant bad news. During his visit to Qatar in February 2007, Putin reiterated that "we do not reject the idea of creating a gas cartel." Moreover, the Kremlin leader announced that Russia will send a high-level delegation to the Gas Exporting Countries' Forum (GECF) meeting in Doha on April 9, 2007, where the issue of creating a gas cartel has been formally put on the agenda.

All these developments feed into the Western view of an increasingly aggressive Russia trying to use energy as a weapon against Europe by creating a gas-OPEC. The reality, however, is more complex. Several senior Russian officials described the idea of a cartel as ludicrous. A Kremlin spokesman said there was "no substance at all" to this claim, and that Russia's main approach to energy policy remained "interdependence of producers and consumers." Minister of Energy Viktor Khristenko commented that there were no objective grounds to create a gas cartel. Indeed, the consensus among energy experts is that such a cartel is simply not feasible for a variety of reasons related to the structure of the gas market and the irreconcilable interests of some of the major players. Of course, from the point of view of Europe, the net result of these conflicting signals is a big question mark about what the Russians are up to. In this context, the talks at the GECF meeting in Doha will be watched carefully.

Obstacles to a Gas Cartel

The GECF was created in 2001 in Teheran and it has been described as a potential institutional framework that will slowly evolve into some kind of producers' cartel. However, in its six years of existence, the GECF has not been able to produce any significant agenda. It has functioned essentially as an informal discussion platform, and its organization has been frequently chaotic, as illustrated by the collapse of the Venezuelan presidency in 2006.

The heterogeneous membership of the organization has played a large role in the lack of clarity about the objectives and the functioning of the organization. It brings together LNG exporters focused on the Atlantic Basin (Algeria, Nigeria, Libya, and Egypt) and the Pacific Basin (Indonesia, Malaysia, and Brunei), as well as large pipeline exporters such as Russia. Other major pipeline players, like Canada, are not part of the forum, while Norway only has observer status. Iran, one of its most active members, is not yet an exporter of any significance, despite its future potential.

Another important reason why experts doubt the success of a gas OPEC is related to the structure of the world gas market, which is actually not a single market like the one for oil, but a series of regional markets.

Those who argue that establishing a cartel is indeed a possibility generally point to the high concentration of gas reserves in a small set of countries. Taken together, the top five countries by size of reserves (Russia, Iran, Qatar, Saudi Arabia and the UAE) control 62 percent of the world's total reserves. Additionally, the seven largest exporters account for 80 percent of world gas trade, a very high level of concentration. But these figures also mean that a cartel excluding one of these countries, such as Russia (which accounts for 30 percent of world exports), would not wield extensive market control. This fact is important since many analysts agree that at least in the medium-run, Russia's interests diverge from those of other major exporters, particularly Qatar's.

Russia historically has relied on long-term contracts to deliver gas via pipeline to European markets. Gazprom has often indicated that long-term contracts are its preferred option in order to sustain the massive infrastructure investments needed to bring Russian reserves to market. Russian policy-makers continue to stress the importance of security of demand and deem a continued reliance on pipelines and long term contracts as the most effective way to achieve this goal. Qatar is in a distinctly different position, being the world's largest LNG exporter. The Qataris made significant investments in developing LNG technologies and know-how, and they have little incentive to enter into a formal alliance with Russia, which is almost exclusively oriented towards a continental pipeline market. Like Qatar, Algeria has relatively well-developed LNG production, but also has significant pipeline exports to Europe. However, Algerian reserves, albeit significant, do not match those of Qatar, and, in the long run, the Algerians may have an interest in gaining access to the Russian fields.

Most experts agree that a potential gas cartel would only be possible if a truly global market for natural gas developed. Such a development can only take place if LNG plays a much larger role relative to pipeline delivery. Otherwise, prices will continue to be based on the specific features of each market, preventing any possibility for agreement. Currently, LNG trade accounts for less than 10 percent of global gas trade. Given the costs involved in developing the infrastructure to support a global LNG market, the possibility that a real world market based on LNG will emerge is a distant prospect at best. Moreover, if Russia – which is years behind countries like Qatar and Algeria in terms of LNG technology – resists the trend because of its continued focus on pipelines and long-term contracts, the market might well remain fragmented for a long time.

The size of investments in gas projects is also likely to be an important consideration in setting up capacity control mechanisms in a potential cartel. Indeed, a key condition in effectively controlling world prices is the ability to regulate capacity expansion and enforce quotas. Maintaining such oversight is likely to prove extremely challenging because the costs of gas development projects are enormous, and it will be very difficult for any producer artificially to slow down capacity expansion and restrain production given the massive opportunity costs involved. In the oil market, Saudi Arabia traditionally plays the role of swing producer by maintaining spare capacity, but it is unclear how this could be achieved with gas. Russia, which given the size of its reserves has often been described as a good candidate for the role of swing producer, is unlikely to have any real incentive to play this role. Unlike Saudi Arabia, Russia has a very large population and rising domestic gas demand. It would be politically damaging for any leader to maintain costly spare capacity under such conditions. Gas storage is very expensive and creates an additional obstacle to establishing spare capacity.

A further obstacle to creating an effective cartel is that unlike oil, gas has to compete against other types of resources. While petroleum cannot – at the moment – be replaced with other sources of energy in the transportation sector, gas in electricity and heating has to compete with alternative sources, such as oil, coal, hydro, and nuclear. As a result, producers have to be more careful about the risk of losing their market if price setting mechanisms seem unreliable to the consumer.

Other forms of producer's agreements

If a real "gas-OPEC" is unlikely, one has to accept that other types of producers' agreements short of a formal alliance might emerge, at least with regard to certain regional markets. For example, LNG-exporters might have a real interest in working out production control agreements. LNG is traded separately on different regional markets, and prices are set in relation to different competing energy sources. Exporters in the Atlantic Basin in particular, may find it easier to establish common rules to cartelize this specific market, where spot-trading is expanding more rapidly than on other markets and where cooperation among the main players may be easier to achieve because of convergent interests.

Another idea proposed by Vladimir Putin is more straightforward bilateral coordination on energy projects. In this respect, Russia's current deal with Algeria might have a particular significance. The agreement provides for a swap of upstream assets between Sonatrach and Gazprom, as well as possibilities for Gazprom to play a role in the distribution and marketing of Algerian gas to Europe. The source of potential worry for Europe, which views Algeria as an important component of its diversification strategy in gas imports, is not so much the creation of a full-fledged gas cartel. It is, rather, the fact that Algeria has a large outstanding debt to Russia related to recent large weapons purchases, which may weaken its ability to push ahead with projects that are not in Russia's interest. Indeed, Algeria's bilateral agreements in the economic and military spheres taken together put Russia in a position where it might be able to exert significant influence in order to prevent projects that compete with its own plans. Russia has a history of such practices: one example is the agreement between Russia and Turkmenistan, which allows Russia to purchase virtually all Turkmen gas until 2028 at a comparatively high price, in effect preventing the construction of any infrastructure projects linking Turkmenistan more closely to China. Such practices are common commercial behavior, but they may not always be in Europe's interest if competing projects were designed to build a more diversified supply.

Putin's idea that Qatar and Russia should cooperate more closely to ensure they will not be competing for markets seems rather unlikely to be realized. Qatar is planning to increase LNG exports not only to the US, but also to Europe in the near future. These intentions play well into Europe's strategy of import diversification, and the Europeans will be willing to pay high prices to achieve this objective. Furthermore, any agreement between Russia and Qatar would undermine the two sides' ability to compete for the best and most advantageous prices in this lucrative market. In this case, competition seems inevitable.

Both Russia and Iran have raised the possibility of collaboration, but the political obstacles are significant. As long as the nuclear issue is not resolved, Russia will not engage in serious collaboration in the energy sector because doing so would provoke a major dispute with Europe, its main consumer, and because emboldening Iran is not necessarily in Russia's interest either. In the medium run, it is not clear that the two countries would really have an interest in cooperation since they are likely to compete for the same markets. It seems unlikely that a country like Iran, which has an enormous potential for future exports to Europe that are not reflected in current sales, would want to agree on market shares at this point. On the Russian side, there are no incentives to help a competitor emerge from its current state of isolation.

Russia's Risky Strategy

While several Russian Duma members claim that a gas alliance would boost Russian interests, a closer look at Putin's declarations reveals a much more prudent approach. His cautious language demonstrates a clear realization that it is not in the interest of Russia to create an organization that will push its customers to diversify away from natural gas. Indeed, as noted above, natural gas competes against other sources of energy for most of its end-uses. The emergence of an organization like OPEC for gas could well tip the balance in favor of other sources for many consumers.

In this light, one may wonder why the Kremlin has frayed European nerves by repeatedly discussing the possibility of a gas OPEC only to contradict itself in subsequent statements? The answer might well be that it is a purely tactical move. One hypothesis is that by convincing many Europeans that a gas OPEC is a realistic threat, Putin can gain a valuable bargaining chip. Even if he realizes a gas OPEC is never going to happen, maybe Europeans, blinded by fear, do not. The next step is to ask for something in return for dropping the idea of a gas cartel. The Europeans may allow Gazprom to make controversial acquisitions in the European distribution markets for instance, if in return they receive assurances from Putin that a gas cartel will not be formed. Or they may be much more careful when it comes to placing U.S. missiles close to Russia's borders. The irony being of course, that experts (and maybe Russian officials too) have long understood that a gas cartel was not something that really made any sense.

Russia has embarked on a risky strategy, and it may well backfire. In March, the Europeans agreed for the first time on common targets for bio-fuels, renewable energy technologies and carbon emission reductions, objectives that will decrease Russian and European interdependence and reduce Russia's ability to achieve demand security. This new consensus among the Europeans certainly is a consequence of the recent threatening discourse Russia has adopted.

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Suggested Reading:

- Jonathan Stern, *The New Security Environment for European Gas: Worsening Geopolitics and Increasing Global Competition for LNG* (Oxford Institute for Energy Studies, October 2006), http://www.oxfordenergy.org/pdfs/NG15.pdf
- *Putting a Price on Energy: International Pricing Mechanisms for Oil and Gas* (Energy charter Secretariat, 2007), http://www.encharter.org/fileadmin/user_upload/document/Oil_and_Gas_Pricing_2007_ENG.pdf
- Ronald Soligo and Amy Myers Jaffe, "Market Structure in the New Gas Economy: Is Cartelization Possible", *Geopolitics of Gas Working Paper Series*, (Program on Energy and Sustainable Development at Stanford University/ James A. Baker III Institute for Public Policy of Rice University, May 2004), http://iis-db.stanford.edu/pubs/20705/Gas_OPEC_final.pdf