Analysis

Gazprom's Expansion Strategy in Europe and the Liberalization of EU Energy Markets

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Abstract

Gazprom has focused its expansion strategy on Europe, its main consumer market. Driven by a desire to open up and secure markets as well as to acquire strategic assets in these markets, the company has intensified its internationalization efforts in the last couple of years. The European Union (EU) gas market liberalization has also propelled Gazprom's expansion; the company has striven to increase its share in the European downstream market. However, Gazprom's expansion in Europe is running into increasing opposition fuelled by fears of over-reliance on Russian gas and growing Russian influence on distribution networks in Europe.

Gazprom's Expansion Strategy

Russia's quasi-gas-monopoly Gazprom is trying to re-establish its networking and extraction-supply chain on the territory of the former Soviet Union and expand its traditional consumer markets in Western and Central Europe. To this end, it is venturing into new markets and market segments, such as power generation. Additionally, the company is expanding into new global markets in the Middle, Near, and Far East, South America, and Africa.

Gazprom has developed plans to expand natural gas exports in all possible directions. Since 2005, its export share has sharply increased, from a formerly fairly stable level of around one-third of its production to nearly half of its overall production in 2006 (see Table 1). In Western and Central Europe especially, Gazprom is trying to diversify the structure of its consumer base and to increase its participation in deliveries to end-users. Gazprom has established overseas sale subsidiaries in nearly all countries to which its natural gas is exported. Moreover, the company has made overtures to gain direct access to large industrial and gas-fired power generation markets in Western and Central Europe.

These actions represent attempts at market-seeking (participation in the EU downstream market) as well as strategic asset- or capability-seeking – mainly in Central Europe and the former Soviet Union – in order to maintain influence and secure control over transit routes. To prevent its partners from engaging in opportunistic behavior, Gazprom is endeavoring to maintain control through majority ownership rather than acting as a mere profit-seeking investor (see Table 2). The company certainly wanted to take the opportunity to enter the liberalized EU gas market.

EU Gas Market Liberalization as a Pull Factor

The first formal step in the liberalization process of the European gas market was the first EU Gas Directive (98/30/EC). Adopted in June 1998, the Directive laid down the common rules for an EU internal gas market in which eventually all users were to have a choice of supplier. It came into force in August 2000.

In June 2003, the European Commission (EC) issued the second Gas Directive (2003/55/EC), which stipulated a new set of common rules for the internal gas market and thus replaced the first Directive. In so doing, the EC wanted to reduce the power of energy companies by obligating them to split up or "unbundle" the ownership of generation and distribution networks. The Directive granted all non-household gas customers the right to choose their supplier freely as of 1 July 2004 at the latest, with all customers to have this right by 1 July 2007.

Gazprom has profited from the EU's gas market liberalization initiatives by gaining access to the downstream business in Europe. To participate in the profitable downstream market, it has established joint venture marketing companies in nearly all of its consumer countries (see Table 2). Gazprom has also invested in non-core business equity outside the Russian Federation, like gas equipment manufacturing, petrochemicals, media and financial services.

Gazprom's Joint Ventures in Europe

It is difficult to establish a full picture of Gazprom's activities abroad. The company puts enormous effort into covering its tracks by using subsidiaries such as Gazprom Germania (Germany), Gazprombank (Russia), Gazprom Media (Russia), or shell companies to invest overseas. One can only guess at the reasons:

to avoid resistance to its investment in the host countries and/or to avoid taxation and/or for asset stripping purposes. As of 2005, the company's strategy for the upcoming decade was not only to become a gas giant (which it already was), but "to become the largest energy company in the world" (Alexander Medvedev). Therefore, the company's joint ventures listed in Table 2 only represent the tip of the iceberg.

Gazprom's investment activities frequently encounter opposition. The problems and political protests Gazprom met in its attempts to acquire the Hungarian Borsodchem in 2000 and the British Centrica in 2006 highlight the fact that the Russian gas company is not always welcome in Europe. Gazprom used an Ireland-based sham firm for a hostile take-over of Hungary's Borsodchem chemical manufacturer in 2000, a move that was opposed by the Hungarian government and led to numerous political protests. Nevertheless, Gazprom was able to acquire a 25 percent stake in the company.

In 2006, Gazprom planned to acquire Centrica, which owns the largest distribution network in Great Britain. However, the British government signaled discontent and undertook measures to make the acquisition more complicated. As a result, Gazprom backed down from the deal but issued a sharp warning to Europe not to interfere in its efforts to expand on the continent, calling the practice discriminatory.

However, despite these backlashes, Gazprom has not abandoned its desire to diversify into Europe's gas transportation, distribution and power generation industries to gain added value and build upon its traditional business of supplying wholesale gas supplies to regional monopolies. In its latest move, Gazprom is negotiating to acquire storage facilities and distribution hubs across the EU; the company is eager to have direct access to the distribution networks as well as venture into power generation. The new strategy involves establishing joint ventures to build large natural gas storage depots in Hungary, Germany, Belgium, Serbia, and Romania. The storage facilities are designed to cope with unusually high demand during cold snaps and would help to ensure continued supplies to Western markets in case of new disputes involving the pipeline transit countries.

Additionally, Soteg SA, a Luxemburg company, and Gazprom struck a deal in April 2007 to build an 800 megawatt electricity-generating facility in Eisenhüttenstadt, Germany. The facility plans to sell most of its electricity across several EU states via long-term industry contracts.

More Liberalization, but with Safeguards

In September 2007, the EC published its "third liberalization package" of EU energy legislation focusing on anti-competitiveness within European energy markets. It presented EU governments with the option of full ownership unbundling or introducing an Independent System Operator (ISO) for the gas sectors. Originally, the EC wanted only to propose full ownership unbundling, but after significant pressure from Germany and France, the EC ended up offering both options. (Germany and France argue that unbundling would weaken their bargaining position against energy suppliers like Russia.) Ownership unbundling would involve selling the transmission business or dividing the network operations from production and supply. Alternatively, the network could be run by an ISO approved by the EC. This would allow integrated energy companies to continue to own networks, but at the price of relinquishing day-to-day control of these networks to independent operators.

The EC legislation also bans any non-EU company from controlling European gas networks. The unbundling proposals would also extend to gas storage providers, which also supply gas. In EU states choosing ownership unbundling, networks would be off limits to any energy supplier regardless of nationality; in states opting for ISOs, any energy supplier could invest in, but not control or operate, an EU network.

If enacted, the EC legislative proposals would both seriously jeopardize Gazprom's expansion plans and also undermine the position the company has already achieved in EU markets. The proposals would not only prevent Gazprom from buying parts of the EU's transmission network, but would also force the company to sell its assets in EU transport, distribution, and storage infrastructures or spin them off into separate companies managed by independent operators. This would undo the strategy that the company has been pursuing for the last few years, which is to dominate all segments of the EU gas market (production, transport, storage, and distribution). However, Gazprom could still acquire generation, production, and retail assets.

Russian politicians have criticized the EC's liberalization proposals. Russian officials consider many of these to be unfair business practices and demand non-discriminatory access to downstream assets in Europe. In October 2007, Gazprom hinted that it was prepared to take retaliatory measures if the EU decided to limit its expansion.

Most experts believe that the EC's draft is unlikely to come into force in its present form. The legislative initiative must be approved by the European Parliament and the Council, and may have to undergo major adjustments. There is already opposition to the legislation inside the EU; the proposal has already been criticized by German and French government officials and

EU companies that are monopolies in their respective markets.

European Concerns about Over-Dependence on Russian Gas

EU countries are concerned about over-reliance on Russian gas. The EU is therefore aiming to open up energy markets to competition and secure energy supplies through the diversification of sources by geographical regions, goals which may adversely affect Russian gas exports to the EU in the medium and long runs. This position has been explicitly formulated by the European Commission. Even though there are officially no restrictions on amounts, it is recommended that not more than 30 percent of EU members' energy needs come from any one source.

The Eastern European EU members are highly dependent on Russian 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 gas in the EU, has managed to keep the Russian share in its overall gas consumption fairly stable at approximately one-third since the 1970s.

The EU is also striving to further geographically diversify its energy supplies as an instrument of energy security (for the current EU-27 supply structure, see Table 4). 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 (LNG). The Nabucco project, which has been delayed by internal problems, is countered by Russia's South Stream pipeline project, which it announced in June 2007 and which would transport Russian gas to Italy and Austria. The 900km South Stream pipeline is to cross the Black Sea directly into Bulgaria. From there, two onshore branches, one going to Austria and the other to Greece and then to Italy will be considered. The pipeline will have a capacity of 30bcm per year and will take three years to build. Gazprom expects the work to start in 2008 or 2009.

Algeria is being eyed by EU officials as a primary source for the diversification of gas supplies in order to decrease dependence on Russian gas. Meanwhile, Gazprom is pursuing closer cooperation with the Algerian government and local gas operators, reportedly in an attempt to establish an international cartel to control the majority of the European market's gas supplies. The two sides plan to work together on production, extraction, and transportation of local gas to the world market. However, due to divergent interests between the potential partners (that would supposedly also include Iran, Qatar etc.) of this "gas OPEC," its creation seems rather unlikely.

Taking into account the events of the Russian-Ukrainian gas crisis in January 2006, the question arises whether Gazprom is a reliable energy supplier. 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. In 2006, around 54 percent of Gazprom's natural gas exports were delivered to the EU-27, while a further 9.3 percent went to other European countries (including Turkey).

However, as the crisis over oil supplies with Belarus in January 2007 showed, Russia is a slow learner.

Nevertheless, 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 its members, they would nevertheless be well advised to continue their current diversification efforts, since technical difficulties, for instance, can never be excluded. An intensification of energy ties with Russia, such as Germany is pursuing with the Nord Stream gas pipeline project, is not advisable. Germany should not be tempted by this deal to significantly increase the share of Russian gas in its overall energy supply.

However, EU concerns have so far failed to translate into a united energy policy towards Russia. Many EU members still favor national champions in the energy sector, whose strong position domestically and internationally is valued more than a common EU energy policy. These companies seek to develop privileged relations with Gazprom. Each EU country has its own bilateral relationship and special deals with Russia over energy. Countries that enjoy close energy cooperation with Russia (like Germany and Italy) have a stronger inclination to engage with Gazprom than other EU members. Additionally, the range of Russian gas on EU members' energy balances differs strongly (see Table 3).

Conclusion

Gazprom has focused its expansion strategy on Europe, its main consumer market. It has intensified its internationalization efforts since the EU introduced its gas market liberalization policy. The EU has put pressure on energy companies to dismantle the links between production, transportation, and distribution to open the sector to greater competition and price transparency; meanwhile, Gazprom's strategy in Europe entails establishing a large distribution and trading network throughout the EU.

However, Gazprom's expansion in Europe has not been smooth sailing. Fuelled by concerns of overdependence on Russian gas and of Russian control over distribution networks in Europe, member states are searching for alternative supplies.

Even though Gazprom has had a reliable track record as a supplier, its western clients should continue their current diversification efforts. However, Gazprom is doing everything in its power to undermine these efforts: for example, the company is blocking the Nabucco pipeline project by supplying the markets with Russian gas via the South Stream pipeline. Gas hubs and storage facilities within the EU will be filled with Russian gas and thus blunt demand for gas from other sources.

A common energy policy is needed to make diversification work. One way to increase the EU's energy security would be to liberalize its own market and unbundle its national utilities. This would cut profit margins in gas distribution, and thereby reduce Gazprom's appetite for these assets. It would also weaken "special relationships" between Russia and single member states and thus strengthen a common EU energy policy. The weakened bargaining position of individual EU energy companies against energy suppliers would be offset by a common EU position presented by the EU energy commissioner.

Europe is also talking of building more LNG terminals that can be supplied by other suppliers; unlike the pipeline projects, these facilities would be beyond the reach of the Russian gas behemoth.

About the author
Andreas Heinrich is a senior researcher at the Koszalin Institute of Comparative European Studies (KICES) in Poland.

Recommended reading

- Andreas Heinrich, "Internationalisation of Russia's Gazprom," *Journal for East European Management Studies* 8, No. 1 (2003): 46-66.
- Andreas Heinrich, "Between a Rock and a Hard Place: The Energy Sector in Central and Eastern Europe," in Kari Liuhto and Zsuzsanna Vincze, eds., *Wider Europe*, (Tampere: Esa Print, 2005), pp. 457-490.
- UNCTAD, *World Investment Report 2007: Transnational Corporations, Extractive Industries and Development* (New York: United Nations, 2007), http://www.unctad.org/.
- Peeter Vahtra and Kari Liuhto, *Expansion or Exodus? Foreign Operations of Russia's Largest Corporations* (Turku: Pan-European Institute, 2004).

Tables

Gazprom Joint Ventures, EU Gas Imports

Table 1: Share of Exports in Gazprom's Total Natural Gas Production (in bn cm)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Production	533.8	553.7	545.6	523.2	511.9	521.9	540.2	545.1	555.0	556.0
Exports	188.9	173.0	174.0	173.7	166.5	168.9	175.5	192.0	232.7	262.5
Export ratio	35.4	31.2	31.8	33.2	32.5	32.4	32.5	35.2	41.9	47.2

Sources: Company information; own calculations.