Analysis

Gazprom's Perspective on International Markets

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Abstract

Gazprom's strategy towards markets abroad has stirred debate in the Western press about Russia's foreign policy intentions. This article rebuts conventional Western views about Gazprom and Russian foreign policy in general. It argues that Gazprom's strategy of expansion is not based on political considerations, but largely follows an economic logic. Since about 2002, the company's declared aim is to transform itself from a natural monopoly into one of the world's leading global energy companies.

Role of Gazprom in International Markets

Gazprom is today not only Russia's biggest state-owned company, but also the largest gas company in the world. According to British Petroleum estimates, Gazprom possesses about 16.5 percent of the world's gas reserves and produces over 19.4 percent of the total world output. Gazprom is responsible for more than 84 percent of gas production in the Russian Federation. Moreover, it owns all export and major trunk pipelines and has the sole right to ship gas to international markets.

At present Gazprom supplies natural gas to many European countries (including the largest buyers of Russian gas: Germany, Italy, Turkey and France) and is also a key supplier of gas to Eastern European and CIS states (see Diagram 1 on p. 13). No other company exports more gas than Gazprom: According to Gazprom figures, 2006 sales to Europe reached 161.5 billion cubic meters (bcm), and sales to the CIS and Baltic States amounted to 101.0 bcm. The rest (316 bcm or about 54.6 percent) was consumed on the Russian domestic market.

Gazprom's New Strategy: From Big Pipe to Big Business

With the appearance of new markets in the Asian-Pacific region, the sharp increase of oil prices and the shaping of a new regulatory framework in Europe, the environment for Russian gas sales changed considerably during the past years. These changes have demanded a change in Gazprom's approach from a policy of "big pipeline" to a policy of "big business."

Gazprom overcame the slump in gas production experienced shortly after the collapse of the Soviet Union and, by the end of the 1990s, successfully made the transition from a Soviet ministry designed to fulfill "gross plans" into a heavyweight on the world market. Once it was clear that there would be no restructuring or even break up of Gazprom, the Gazprom management was confident enough to start developing a new foreign strategy in line with the changes on the international markets. These changes meant in the first place adapting a new sales market structure, which included a much more active expansion strategy into downstream markets. Gazprom's new strategy also included the expansion of its production base. Given that all its major fields were mature and declining, it was necessary to develop and commission new greenfield projects in remote areas of Russia.

Establishing new centers of production in inhospitable territory demanded massive investment and new technology, meaning that Gazprom had to develop a totally new approach – namely, to make the leap from being a state natural monopoly into a global company, based on the same operating principles as Exxon, BP, Chevron or Shell. The key changes included: broadening and diversifying the company's businesses (to include not only gas, but to expand into oil, coal and power), implementing internal structural reforms, beginning to make asset swaps with foreign partners, and selling shares on the open market. The latter action attracted considerable attention and led to a dramatic increase in capitalization, though by law the government owns a majority of the stock so it is impossible to radically change the ownership structure.

As regards Gazprom's strategy towards foreign markets, the most important elements defining the move from the old export strategy of "big pipeline" to the new "big business" model can be summarized as follows:

- While the old strategy focused on one external market (Europe), the new strategy aimed at diversifying exports, particularly to the Asia-Pacific region.
- While the old strategy was geared towards maximizing gas volumes, the new strategy aimed at maximizing profits.
- While the old strategy relied only on indigenous resources, the new strategy aimed at increasing Central Asian gas imports and transit and also grad-

ually expanding into production beyond the former Soviet Union.

- While the old strategy was characterized by the two principles "no foreigners in production" and "sales on the border," the new strategy envisages the upstream and downstream integration of Russian companies in the international gas business, and in particular the participation in gas production activities in Central Asia and other regions.

In the following sections, we provide an overview of how Gazprom is implementing this new strategy in the individual regional markets.

European Market

Western Europe is the major external market for Russian gas. Gazprom supplies around one-third of Western Europe's aggregate gas imports (see Diagram 2 on p. 14), typically under long-term contracts. In 2006 and 2007, a number of Gazprom's key European partners, including Gaz de France, E.ON Ruhrgas, Wintershall, ENI, and others, renewed their contracts for up to 20 or even 25 years.

Unlike in the past, gas is not only supplied "up to the border," but is directly supplied to European costumers. European gas trading houses, established in importer countries through joint ventures with Gazprom, serve as traders. Through these joint ventures, Gazprom has over the past ten years successfully expanded its presence in Europe's gas consumer market.

The key market and hub for Gazprom's sales to Europe was, and remains, Germany. As far back as 1990, Gazprom established a joint venture with Wintershall (which is a subsidiary of BASF AG for the energy market) and through the establishment of the joint companies Wingas, which is a pipeline transportation company, and the WIEH trading house, it gradually managed to enter other European markets. As a result of these joint projects, Gazprom began selling gas directly to consumers in Germany and obtained much larger profits than under the previous system, when gas was sold at the border. Moreover, through the Wingas gas transportation system, which is now over 2,000 km long, Gazprom is able to supply natural gas not only locally within Germany, but also to Germany's neighbors (see Map 1).

Gazprom has also established itself firmly in Austria. Already in 1991, thanks to the establishment of the Gas- und Warenhandelsgesellshaft mbH (GWH) company on a parity basis with OMV AG, Gazprom's share in the local market reached 78 percent. The GWH also provides for transit of one quarter of Gazprom's European supply. Gazprom intends to expand its presence in Austria and to create a transport hub there for gas trading operations.

Gazprom has also strengthened its position in Italy, where – since April 2007 – the company is allowed to make direct deliveries of Russian gas to the Italian market through joint ventures with Italian companies. Already in November 2005, Gazprom obtained official authorization to sell gas to end consumers in France. Despite the strong objection of the British government, Gazprom has now also successfully entered the UK gas market, which is the largest gas market in Europe, and the most competitive one. Over the past years, Gazprom has also significantly enhanced its presence in Finland, Greece, Hungary, Bulgaria, Serbia, and several other European countries.

Gazprom views the liberalization of the European gas market as a way to expand the company's direct access to end-consumers. However, there is intense competition in this sector, and a number of countries try to counter-act Gazprom's expansion. The decision of the EU Commission in summer 2007 on strategic foreign investments is illustrative; according to the EC proposal, companies from third countries cannot acquire control over a community transmission system or transmission system operator unless this is permitted by a special agreement between the EU and the third country.

Gazprom has traditionally exported its gas under long-term contracts. However, the EU market liberalization leads to the wider use of mid- and short-term contracts, as well as spot deals. Although Gazprom is one of the most active proponents of long-term contracts (it even managed to make the European Commission revise its position and proved that such a mechanism is needed for large new projects), it is eager to use spot and short-term deals (and uses them more and more often), as well as exchange transactions (especially when selling gas to the UK).

CIS and Baltic Markets

In 2006 gas sales to the CIS and Baltic States grew by one-third to reach 101 bcm. The key customers were Ukraine, Belarus, Kazakhstan and Azerbaijan (see Figure 3 on p. 14). In 2004, Gazprom started to raise its gas prices to CIS costumers to market prices. The price changes, which Gazprom has instigated with a range of former Soviet countries, represent a paradigm shift in Russia–CIS energy relations. The conflict in Russian–Ukrainian relations coincided with a period when oil and gas prices were rising to new heights. By late 2005, the $54 per thousand cubic meters of gas which Ukraine was paying for Russian gas contrasted sharply with European border prices 3–4 times that level. The difference was too great. After 15 years of supplying Ukraine with cheap Russian gas, Gazprom and the Russian government decided that they would no longer be prepared to provide gas at subsidized prices to former allies.

As a result, gas prices for the CIS region have grown two- to threefold and are gradually reaching European levels (minus transportation costs). An important result of these difficult negotiations was that finally a clear differentiation between contracts for gas supply to Ukraine and Belarus and contracts for gas transit via their territory to Europe was achieved. The market principles of relationships are fixed in a five-year gas supply and transit contract signed with Belarus.

To many in the West, it seemed that Russia was trying to force Ukraine into accepting a gas price increase as some sort of political punishment for "moving west" after the Orange Revolution. Yet when Gazprom raised the price, it in fact eliminated the political element from its energy relations with Ukraine and put the relationship on a firm business footing. The main problem was that Gazprom failed to explain in time to its European and CIS partners its position and eventually lost the public relations battle with Ukraine, which was able to present itself as the "victim" of Russian imperial politics.

Unfortunately, the company still has to deal with the long-term adverse effect of the Russian–Ukrainian gas conflict of January 2006. The actions of the Russian side, particularly, the demonstrative closing of the valve for 24 hours, created a very negative image of Gazprom in the West. Currently, the Europeans are more determined than ever to seek alternatives to Russian gas supplies.

Russia, for its part, is building new pipelines in order to provide alternative routes for gas shipped through Ukraine, thus assuring the Europeans of its intentions to be a reliable partner. Even when these pipelines are built, however, the bulk of Russian gas will still cross Ukraine. Its existing gas transportation capacities are three times larger than any other routes being built or designed; moreover, the Ukrainian route is the shortest way to the most attractive markets. The North European gas pipeline under the Baltic Sea (the Nord Stream Pipeline), which will connect Russia and Germany directly, will be used for the additional gas volumes that Europe will need during the next decade. Meanwhile, the Ukrainian pipelines need a general upgrade, since they were built during the Soviet era. The need to update the infrastructure partly explains why Gazprom proposed the idea of creating a Russian-Ukrainian-German consortium to manage Ukraine's gas transportation system. As of today, however, Ukraine has rejected any such proposal.

Gas Imports from Central Asia

Central Asia has substantial oil and gas reserves. Yet, the obstacles to the development of the region include its remote geographical position, with no direct access to sea routes, and a lack of large gas export pipelines other than those through Russia. At the same time, foreign investments (currently concentrated mostly in Kazakhstan) may turn this region into an important center of hydrocarbon production. The Central Asian countries, in turn, will try to obtain direct access to consuming countries in Europe, for example, via a pipeline under the Caspian Sea – a project which Russia opposes vehemently.

Should the Central Asians manage to establish direct outlets for their gas and should Gazprom lose control over these energy flows, the Central Asian export resources may be sent not only to the European markets, but also to China, India and Pakistan. These resources will compete with Russian gas in each of these markets.

Central Asian gas is important for Gazprom's domestic gas balance. Controlling the flow of Central Asian gas is also important as it ensures Gazprom's continuous control over overall flows of Eurasian gas to Europe, thus ensuring that Gazprom is able to maintain its share in the lucrative European market.

Gazprom already buys almost the entire volume of gas exported from Turkmenistan, Kazakhstan and Uzbekistan (57 bcm in 2006) and has been authorized to operate the "Central Asia – Center" gas-pipeline system designed to export gas from the region to Russia. Gazprom is ready to expand purchases of Central Asian gas and upgrade the existing pipeline system. The problem is, however, that since 2003, when a fundamental agreement on energy cooperation was signed with Turkmenistan, which is the main gas producer and exporter in the region, the production volumes in this country have stagnated.

Production in the Other Countries

Due to the fairly rich resource base of the domestic gas industry, Gazprom has never been seriously interested in production projects outside the post-Soviet space. Yet the natural depletion of low-cost resources in West Siberia and the Urals has made it urgent for Gazprom to redirect some capital to prospective projects in other parts of the world. While Gazprom has shown interest in hydrocarbon production in foreign countries, the scope of these projects are so far limited.

Gazprom began this activity in 2000, when the company was involved in production projects in Vietnam and India. In December 2005, the Indian state gas distribution company GAIL together with Gazprom began exploration drilling in oil-and-gas fields located in the Bay of Bengal. Gazprom invests capital in the development of the British field in the North Sea. In October 2005 Gazprom won the bid for geological exploration and hydrocarbon field development in Venezuela. The appropriate licenses are granted for 30 years.

Over the last two years, Gazprom has shown interest in diversifying its production through an expanded presence in North Africa, the Middle East and the North Sea shelf. Gazprom is negotiating a role in oil-and-gas field development in Egypt and Algeria, as well as participation in gas projects in Libya and Nigeria. Additionally, it works with energy companies from various countries of Latin America, which were the first to enter in Gazprom's area of interest. A key aim is to enter the US gas market.

Asian Market

The EU's declaration that it wants to reduce its dependence on Russian gas (as reflected, for instance, in the EU's Green Paper) is understandable. Similarly, Gazprom is making efforts to diversify gas sales markets. If EU countries diversify away from Russia then it is only natural that Gazprom looks for ways to diversify away from the EU in order to maximize profits and to minimize investment risks related to new gas projects. Therefore, Gazprom is looking to expand its presence in Asia.

Gazprom considers the development of the eastern markets a priority. The company has signed strategic cooperation agreements with the largest Chinese and Indian oil and gas companies. In 2007, Russia adapted a program for the comprehensive development of hydrocarbon fields in Eastern Siberia and the Far East with the aim of creating a gas supply system for Russia's eastern regions and a channel for gas exports to Asia. According to this document, the top-priority steps for Gazprom in this region are the development projects for Sakhalin offshore fields, which are already being implemented or are in a state of "high readiness."

Some European experts claim that in the context of Gazprom plans to organize gas supplies to China, Gazprom will not have enough gas to provide gas to all potential markets, thus threatening the reliability of Europe's gas supply. Yet these experts fail to understand that gas supplies to China will originate in yet-to-be developed frontier gas fields in East Siberia and the Far East (Europe receives its gas from fields in West Siberia and the Urals). Deliveries from the East Siberian fields to Europe would be economically inefficient. Actually, Russia has sufficient reserves and investment potential to become a "gas bridge," supplying both the eastern and western parts of Eurasia.

Yet it is unlikely that Russian gas will enter the Asian market in the near future. The main uncertainty for Gazprom is related with volumes of future demand. China's economic growth does not look sustainable to Russia, and Beijing's energy policy priorities in the gas sector are not very clear. Moreover, the two sides have not yet agreed on a price that is mutually acceptable. There is yet another reason why Russia is reluctant to build a pipeline directly connecting Russia and China. As Russia learned from its experience with the "Blue Stream" pipeline connecting Russia with Turkey, a single buyer is in a relatively strong bargaining position to demand lower prices once the pipeline is built or else it refuses to buy the gas.

Challenges for Gazprom in Europe

Europe is and will remain Gazprom's key market. Yet there are also a number of serious challenges which Gazprom is facing implementing its new strategy of expansion. These challenges can be grouped around two issues: on the one hand, Gazprom might face serious regulatory barriers in those European countries where it currently operates; on the other, Gazprom might face serious market risks due to growing competition and unpredictable price and volume movements.

Gazprom is currently very concerned about the possibility that existing long-term contracts will be revised. Long-term agreements, which form the basis of Gazprom's business in Europe, typically contain a "take or pay" provision and assure steady gas supply and a reliable market. Long-term deals serve as a guarantee to the supplier that its multibillion dollar investments in major gas export projects will be amortized. Conversely, they ensure the steady and uninterrupted flow of gas to the consumer. In this regard, the EC's proposal of summer 2007 to separate production from transportation activities might, if implemented, also affect the stimulus for Gazprom to invest in the export pipelines.

As mentioned earlier, Gazprom has been expanding into spot market trading and plans to develop its LNG capabilities in order to react flexibly to market changes. However, if there is a radical change in the system of long-term contracts, there is a real threat that the incentives for producers to invest in new projects will be sharply reduced. Short-term contracts cannot give a guarantee that large capital-intensive projects, comparable in scale with the development of Yamal or Stockman, will see a long-term financial return.

The problems connected with attracting investments are aggravated by one additional factor – the dramatic growth of price volatility. As a result of liberalization, the uncertainty of price forecasting will increase in comparison with the traditional system of long-term contracts because significant fluctuations on spot markets will be added to the fluctuations of oil prices. Even a relatively small increase in gas supplies to the spot market may lead to price decreases, while seasonal deficits may sharply raise them. The popular belief holds that the main threat of European gas market liberalization for Russia is a decrease in gas prices as a result of stronger competition. However, the real danger for Russian exports is connected not so much with the level of prices, but mainly with growing price instability.

Europe will remain the key market for Gazprom for the foreseeable future, especially taking into account the system of export gas pipelines already built and under construction, but there are also serious risks involved in this market which Gazprom needs to take into consideration when deciding on upstream investments. Europe's demand for gas is forecasted to grow dramatically, but there are many factors that might limit this growth, namely if Europe experiences an economic recession or if energy efficiency programs are pursued more vigorously. The difficulty to predict demand rates is the more problematic for Gazprom since the company might also face much tougher competition for its sales in the future: Over the next 10–15 years the European market will see new gas suppliers from North Africa (Algeria, Libya, Egypt), Central Asia (Turkmenistan and Kazakhstan) and the Middle East (Iran), which are able to sell their gas at a relatively low price. A further problem is the development of LNG, which will slowly turn the gas market into a global market once it becomes less expensive in the future to produce LNG. All these developments would further enhance competition for Russian gas.

Gazprom's Strategy: Business Prevails over Politics

Many Western experts consider Gazprom not just a commercial corporation, but a vehicle for promoting Russia's political interests abroad. By the same token, Gazprom is often referred to as a state company of Russia, and hence, its economic initiatives are often viewed as being the political business of the state. But Gazprom, although it is 51-precent state-owned, is indeed a commercial organization and must justify its strategy and activities to its main shareholders, which consist of both state and non-state actors.

Actually, in recent years there was only one political decision about Gazprom – to make it a "national champion" of Russia. The creation of a "champion" means that it has to respect international rules and, more importantly, it has to be profitable, efficient and commercially oriented – otherwise it would never prevail in international competition. Unfortunately, the media frequently tries to find political roots in economic decisions (as happened with the Russia–Ukrainian crises). The process of transforming the former Ministry of Gas Industry (which Gazprom was less than 20 years ago) into a quasi-ministry in the 1990s, and then into one of the leaders of the international energy business (according to current plans) is necessarily evolutionary and takes time. There is a lot of work to do with the companies` management, transparency and mentality. But even now the progress is obvious.

One important implication that gives optimism is that to be successful in the global market, Gazprom will have to "play by the rules of the game" in this market. Gazprom will thus have to adapt to the same standards as other private international energy companies when operating in a globalized environment. The Western press has often criticized Gazprom for diminishing the status of foreign partners in its upstream projects in Russia to minority share-holders. Yet one also needs to take note of the fact that all of Gazprom's new export projects will be developed in cooperation with foreign companies. These joint projects include the Gazprom-ENI cooperation in Astrakhan as well as the Blue Stream and South Stream parity projects, the Gazprom-Wintershall joint venture at Urengoi, the Gazprom-Total-StatoilHydro plans for Shtokman, the Gazprom-Shell cooperation in Sakhalin-2, and the Gazprom-E. ON-BASF and Gasunie cooperation at the NEGP and South Russian fields.

This market-based mutual penetration of capitals will have a strong influence on the behavior of Gazprom. Gazprom's global activities are the best stimulus for the company to change and develop. Generally, Gazprom's presence abroad and interaction with foreign companies will force it to be more efficient and reform in order to survive and win in the international competition. As of now, however, the problem is that Gazprom's partners abroad, especially in the CIS and partly also in Europe, have a negative view of Gazprom and perceive it as an organization with a largely political agenda. It will take some years, maybe even decades, for this image to transform.

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