

## Analysis

# The Northern Dimension of the Russian Gas Strategy

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## Abstract

The gas conflict between Russia and Ukraine that broke out in January 2009 underscored again the vulnerability of Russia's main gas customers in Europe. In a situation when 70 percent of Russian gas exported to European customers has to be shipped through the territory of Ukraine, which has its own unsettled energy scores with Russia, any sharpening of the conflict between those two countries has dire consequences for security of supply of Russia's main gas customers further west and south. The EU, Russia and Ukraine are aware of the situation and each of these three actors has adopted a different strategy to cope with this difficult challenge. In order to understand what has been the Russian long-term strategic response to that challenge this article examines what could be termed the Northern dimension of the Russian gas strategy.

## The Northern Dimension of Russia's Natural Gas Strategy

Due to the adoption of a more comprehensive approach to the energy sector, the Russian political and energy authorities have realized the importance of the northern areas in the realization of the country's energy strategy. The need to address the problem of the possible gas crunch in Russia and possible problems with meeting the country's international gas commitments dictated decisions on the development of the Shtokman offshore gas field and Yamal deposits. The invitation to Western companies (Total and StatoilHydro) to join Gazprom in developing the Shtokman field probably reflects Russia's recognition of the need to share technological and financial risks and Gazprom's lack of offshore expertise, which prevents it from realizing the project on its own. Russia's focus on energy-related issues in the north is also linked to the wish to diversify transport routes, circumvent geographical bottlenecks and, not least, avoid problems with Ukraine in general.

Russia's renewed focus on the north also has much to do with the expectation that this area contains extensive discovered and undiscovered energy resources which may become more easily accessible due to global warming. Control over those areas and development of resources there is to secure Russia's position as an important global energy player for many decades. Those are the reasons why in September 2008, Russian president Dmitri Medvedev and his Security Council discussed Russian interests and policies in the Arctic. Russia has also taken practical steps and in March 2009 announced that it would reform its power structures to better protect the country's interests in the Arctic region.

Implementing Russia's comprehensive energy strategy would not be possible without consolidating the state's role in the energy sector. This goal was achieved

by taking back some assets from private owners, such as Yukos in 2003, and by limiting the role of foreign owners in the Russian energy sector. Russian oligarchs who still control parts of the country's energy sector were intimidated and those who were not cooperative enough – like the former owner of Russneft, M. Gutseriev – were forced to hand over their assets to those who – like Oleg Deripaska – had more understanding for the state's interests. The result was that by 2007 the Russian state controlled approximately 30 percent of oil and 87 percent of natural gas production in the country. As strengthening the state's role in the country's energy sector has been an important policy goal of Putin's team, it is highly probable that in the northern context the state is not going to be willing to relax its grip on strategic assets. The fact that Gazprom decided to develop Shtokman on its own in October 2006 and that Gazprom has retained the majority of the shares in the company that is going to develop Shtokman jointly with Total and StatoilHydro shows that that state control of the strategic assets is still a preferred option. The country's recently adopted law on subsoil resources, with its focus on strategic fields, is also an important instrument strengthening the state's role in that sector.

Strengthening the link between the country's political and economic elites facilitated greater state control of the energy sector. While Yeltsin appointed many Russian tycoons to various positions in the Russian government, during Putin's tenure, state officials took over key positions in strategically-important Russian enterprises. Putin delegated his close aides and allies to manage the most important jobs in the Russian energy sector, sending Alexei Miller and Dmitrii Medvedev to Gazprom, Igor Sechin and Sergei Naryshkin to Rosneft, and Sergei Vainshtokh and Viktor Khristenko to Transneft. At the same time, he effectively curbed the political and eco-

conomic power of the oligarchs and gave the state the upper hand in relations with this group of influential players. Under Putin it was the Russian state – or, more precisely, his team – that dictated the rules of the game and Russian oligarchs could survive only if they played by these rules. Putin effectively strengthened the connection between the political and economic elite of the country and made sure that his allies were the ones to take strategic decisions on the development of the energy sector.

On the international stage, he adopted a similar strategy of co-opting political players and placing them in key positions in the Russian energy sector. The most innovative use of this technique in the northern context was the invitation to former German Chancellor Gerhard Schröder to front the company realizing one of the strategic energy projects – the construction of the Nord Stream pipeline linking Russia with Germany and circumventing some of the trouble-making transit countries. Also, the recent appointment of former Finnish prime minister Paavo Lipponen as consultant to the Nord Stream project and the role played by, Matthias Warnig, a German banker who is now managing director of Nord Stream, are good illustrations of this policy of blurring the line between economic and political elites in the Russian energy sector.

The election of Dmitri Medvedev, the former head of the Gazprom's Board of Directors, as Russia's new president and the appointment of Putin as the country's prime minister have secured the continuation of Putin's energy strategy. This outcome will likely have far-reaching consequences for the realization of Russia's strategic gas projects in the north as Nord Stream and Shtokman seem to be the pet projects of those two leaders.

Although Russia has opened some projects to foreign companies, the overall trend seems to be that the state wants to limit the role of Western companies in the Russian energy sector. In recent years, several foreign companies – such as Shell, Mitsui, Mitsubishi and BP – have faced problems in Russia and there are relatively few examples of the Russian state opening the Russian energy sector to Western companies. In the northern gas context, the cooperation between E.ON and BASF, on the one hand, and Gazprom, on the other, in the development of the Yuzhnorusskoye gas field is going to be a good litmus test of Russia's long-term intentions towards cooperation with strategic Western partners. Also the final decision on whether to go ahead with the joint development of the Shtokman field by Gazprom, StatoilHydro and Total that is to be taken in the first quarter of 2010 will show whether the Russian

state is interested in giving Western companies a greater role and on which conditions.

Although the Russian state may be willing, or forced, to give Western – or other foreign – companies a more prominent role in the country's energy sector in order to satisfy a need for capital and technology, it is highly unlikely that the state will ease its control over the pipeline system. The fate of the oil pipeline that was to be built by private companies in order to transport oil to Murmansk for shipping to global markets is a good example of the state's unwillingness to relax its monopoly in favor of privately-owned and operated pipelines in Russia. As far as gas is concerned, the state has also retained de facto complete control over export routes by giving Gazprom a monopoly on the export of gas and focusing more on implementing a strategy of avoiding transit countries. Especially this last element – avoiding transit countries – will shape Russian gas policy on the northern flank. Already today effects of this strategy are evident – the cancellation of the Yamal II pipeline that was to be built parallel to Yamal I through the territory of Belarus and Poland, and the decision to build Nord Stream.

The development of the Shtokman gas field is also partly driven by the strategy of avoiding transit countries as the gas from that field is to be shipped directly to Russia's gas customers either through a pipeline going via Russia and then through Nord Stream or as LNG from the LNG plant that is to be built at Teriberka, just east of Murmansk.

As Norway is the sole viable alternative source of gas in the northern part of the European gas market, Russia may be willing to implement measures that will raise the political and economic stakes for Norwegian involvement in the regional energy game in case Norwegian actions could be seen as detrimental to Russian gas interests. One of the projects that may suffer as a result of Nord Stream is the planned Skanled pipeline that is to supply relatively small volumes of Norwegian gas to the Polish market.

In recent years, as the Russian economy rebounded, Russia has been showing growing interest in downstream investments in the energy sector. However, as Gazprom and Russian energy policy have become not only politicized but also securitized in many European countries, the company's interest in downstream investments is seen as being politically and not necessarily economically motivated and as a challenge rather than as an opportunity.

Europe's reluctance to engage in closer energy cooperation with Russia and to accept Gazprom's down-

stream investments is partly due to the fact that Russia frequently has used its energy resources for political purposes. The two gas conflicts with Ukraine, gas and oil arguments with Belarus, problems with the supply of oil to the refinery in Mazeikiu in Lithuania, Russia's use of preferential gas tariffs and the use of gas prices as a political incentive have given many Europeans second thoughts about Russia's reliability as a strategic energy partner.

### **The Economic Crisis and the Future of Russia's Northern Gas Strategy**

After more than 8 years of relatively strong and rapid economic growth, driven partly by high oil and gas prices, the global economic crisis has hit Russia hard. In July 2008, the price of the Urals blend of oil reached almost USD 130 per barrel, Russia's European gas customers paid almost USD 500 per 1000 m<sup>3</sup> of Russian gas and Gazprom's capitalization reached almost USD 300 billion and was to reach USD 1000 by 2011. The Russian state budget in 2009 was to have a surplus and the country's economic future seemed bright. Also Gazprom's future in Europe was promising. In an article published in 2008, Alexander Medvedev, the head of Gazprom Export, outlined the history and future of his company's gas cooperation with Europe. According to Medvedev's calculations, Gazprom provided 26 percent of gas consumed in Europe and 85 percent of its export income was from sales on that market. Russia was to increase its export of gas to Europe to 180 billion bcm in the next few years, and then to 250 billion bcm by 2020. Gazprom's share in the overall volume of gas consumed in Europe was to jump from the current level of 26 percent today to 33 percent.

The European direction in the Russian gas strategy was indeed the most important one, not least due to the fact that Russia exports 63 percent of all exported gas to the EU, covers 45 percent of the EU's gas import needs and 19 percent of its total consumption of gas. By 2020, the enlarged EU is to increase its gas consumption by 50 percent and according to some Russian estimates, Russia could cover as much as 70 percent of the EU's gas import needs by 2020. In more general terms, it is expected that the EU25 production of gas is to decline by 59 percent by 2030 and its import dependence is to increase from 50 percent in 2000 to 70 percent. This situation could provide Gazprom and Russia with some new opportunities, but the increasing gas dependence on Russia is seen as a strategic challenge by a growing number of actors in Europe.

Until recently one of the main topics in the European debate on gas dependence on Russia was Russia's reliabil-

ity as a supplier, a reliability that could be undermined by the lack of investment in the Russian gas sector. This was a typical energy security debate focusing on security of supply conducted from the perspective of European gas customers who were afraid either of Russia's market power and its political and geopolitical consequences or of Russia's inability to provide the volumes of gas to cover their short-, mid- and long-term gas needs.

In early 2009, the tone in the European energy security debate changed. Gazprom has announced that the company will reduce its production by 10 percent due to the falling demand both on the domestic and international markets. Consequently, the focus is shifting from security of supply to security of demand. This situation will force Gazprom to reduce production from 550 bcm in 2008 to 510 bcm in 2009. What is even worse is that exports are to fall from 179 bcm in 2008 to 165/170 bcm in 2009 and that the average price will fall from USD 410 per 1000 m<sup>3</sup> on average in 2008 (USD 460–500 in the fourth quarter) to USD 280 in 2009. This will also have a very negative impact on sales revenues in Europe that could fall from USD 73 billion (USD 66 according to other sources) in 2008 to USD 42–44, or in the best case, 48 billion in 2009.

In April 2009, the leadership of Gazprom confirmed that the fall in production could be even greater and will have a more chronic character – Gazprom was to produce on average 10 percent less gas per year than in the peak year of 2008. According to revised estimates for 2009, production was to fall to 492 bcm (11.5 percent lower than in 2008 and lower than overall output in 1987) and it was not ruled out that in years to come the production could be as low as 460–470 bcm per year. This could mean a substantial drop in incomes in the coming years (USD 62–91 billion) causing huge problems for the realization of long-term plans.

This dramatic drop in expected sales revenues, combined with the lower capitalization of the company and problems with liquidity, may have a negative impact on the company's ambitious investments program, according to which the company is to spend USD 29 billion in 2009 alone. According to recently released plans, Gazprom plans to increase its export capacity to 304 bcm per year by 2020, while its planned exports in that year are to reach the level of 220 bcm. In order to achieve those goals, the company has to realize several highly complex and expensive projects in the north and south – the development of the new fields with infrastructure on the Yamal Peninsula (Bovanenkovo and the connection to Ukhta), the Shtokman gas field in the Barents Sea, the Nord Stream pipeline in the Baltic Sea

region and South Stream in the Black Sea region. Each of these projects involves serious economic, technological and political challenges. The fact that three of those four major projects are to be realized on the northern gas flank underlines the importance of that direction of the Russian energy and gas strategy. One can therefore say that much of the game for the future of Gazprom and Russia as reliable energy partners is going to be played in the north. The outcome of that game is, however, not given, not least due to the current economic crisis

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and lack of predictability in the area of energy pricing. According to various estimates, in order for Shtokman to be a profitable undertaking, the oil price should be as high as USD 80 per barrel, although also a lower price – USD 50 to USD 60 – is mentioned as guaranteeing the economic feasibility of that project. However, the oil price rollercoaster the markets have experienced over the last couple of years makes any predictions and planning a rather challenging task.

## Analysis

### Gazprom and Russia's Great Eastern Pipe-Dreams

By Nina Poussenkova, Moscow

#### Abstract

Gazprom maintains monopoly control of Russia's domestic pipeline and is the only company allowed to export Russian gas. Gazprom has long talked about expanding its capacity to produce gas in East Siberia and the Far East, but has made little progress toward these goals. Efforts to send gas to China have been stymied by the two sides' inability to agree on a price for gas and Russian concerns about China's growing power. Territorial disputes prevent deals with Japan. In contrast, Russia has moved ahead with plans to send gas to South Korea, which is not affected by the problems associated with China and Japan.

#### Gas Pipelines and Geopolitics

Controlling gas pipelines means wielding power over those dependent on the pipeline for access or gas consumption. Laying a pipeline from a gas-producing country to a consuming country means establishing a physical bond and long-term dependency between two parties. Disrupting this connection leaves the consumer without energy as there are often no alternatives available to quickly switch to other sources and suppliers. Thus, pipelines provide the producer with powerful leverage over the consumer – hence the geopolitical significance of gas pipelines, which is nowhere more significant than in the case of Russia, where the country's gas export pipelines, all controlled by Gazprom, connect Russia's huge gas reserves with dozens of European and CIS costumers.

Gazprom is Russia's single most powerful company and the world's biggest holder of gas reserves. It controls some 60 percent of Russia's gas reserves which equals 17 percent of the entire known global reserves of gas.

Gazprom produces around 85 percent of Russian gas and some 20 percent of the world's gas. What makes Gazprom dominant in the Russian gas market is also the fact that the company owns Russia's entire gas supply system, the so-called Unified System of Gas Supplies (USGS). This system comprises 155,000 km of trunk pipelines and their branches, 268 compressor stations, six gas and condensate processing plants and 24 underground storage facilities. Ultimately, every single gas producer in Russia is dependent on Gazprom for gas transmission.

Also, only Gazprom has the right to export gas abroad. So far, Gazprom has managed to resist any attempts from international organizations or Russian reformers to restructure the company by dividing its monopolistic control over gas transportation from the more competitive production sector, where several independent producers compete with Gazprom in bringing small amounts of gas out of the ground. A final important feature of Gazprom is that it is owned and protect-