

GAZPROM AND THE KREMLIN | RUSSIA'S DOUBLE APPROACH TO EUROPE'S ENERGY MARKETS?



Up to now, no one has really doubted that the Russian State and Gazprom have overlapping interests on European energy markets. The State gas company's projects fit within the State's policies towards Europe. There is a coincidence of positions between both players, Gazprom relaying and implementing Russia's State strategy to the European Union (EU). Hence, a largely-shared analysis among European policy-makers that Gazprom is the energy armed wing of the Russian government, its tool, one of its levers for action. That Thomas More Institute Tribune strongly questions this too easy approach. By highlighting Gazprom's corporate and economic strategies in Europe, it presents a more nuanced picture of Russian energy positions within and towards our markets.

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2012, Gazprom has lost shares on European gas market. For the first time since long, Norway has become the first gas supplier to the EU, reaching 1/3 of EU imports, whereas Gazprom's share, due to a lack of flexibility to adjust gas prices, has fallen to a bit less than 1/3 of EU imports. The other third is divided between additional minor suppliers (Algeria, Nigeria, Qatar...). Last year indeed, following the US shale gas revolution and in a world depressing economic context, gas price starts to fall down, including in Europe. European buyers then tried to renegotiate their contract with Gazprom with much difficulty. Consequently, they fulfilled their obligations from the Russian supplier at minima and bought the remaining needed volumes on the spot market or from Norway at cheaper price, reducing so Gazprom's market shares¹.

Russia's position on the energy chapter within the Partnership and Cooperation Agreement may hinder the gas company to react. Negotiations between the two parties are frozen, the EU advocating an inclusive approach whereas Russia is demanding a separate agreement on energy infrastructures with many legal exemptions from the European law and particularly from the Third Energy Package². Gazprom of course could have interest into these exemptions but needs also more urgently to regain its shares or at least to maintain them. Gazprom cannot only be a political tool. It must balance accounts, make and increase profits as much as possible to ensure productive investments while limiting and rationalizing spending. There is clearly, in addition to any political functions, an economic rational in Gazprom's strategy. Both, Gazprom and the Russian State obviously do not have the same timing.

The present research paper, hosted by the Thomas More Institute, argues that Gazprom seeks to become and to act as a normal economic European actor. This commitment leads the Russian gas company hold at 50,002% by the Russian State, to look for more flexibility and compromise, opposing on some specific matters its main shareholder's more rigid political stance. Gazprom and Russia's respective rational simply start diverging. They do in Europe but in Russia as well. Gazprom seemingly tends to look for its own strategic path. Relying on first-hand sources from the European Institutions (General Secretariat of the Council, DG Energy, Desk Russia at the European External Action Service) and from Russian official representations, notably Valery Yazev, head of the Russian Gas Society and Duma's deputy chairman, that report presents a balanced picture of what are today Russia's complex interests in Europe.

1 | Gazprom's Corporate Strategies in Europe

From a purely corporate perspective, Gazprom in Europe is playing by the rule of the game. The company's myriad of subsidiaries, partners and allies, in 24 EU countries (Croatia included) and Turkey makes Gazprom a deeply rooted European company. All of them are structured and abide by the local laws of each country. Valery Yazev even points out that "Gazprom's dominant position in Eastern Europe, in Slovakia and in the Baltic States particularly, is an historical fact but that does not prevent yet the European Union from developing its gas market, diversifying its supplies, building LNG terminals or exploring and exploiting shale gas"³.

| Gazprom' scheme brief overview

Gazprom Germania appears as the main operational centre for Gazprom in Europe. It manages, in Gazprom's name, relations and projects with German gas companies and beyond. It has for instance organized the assets swaps with BASF allowing Gazprom to take full control of the trading and supply gas company, Wingas. Gazprom's objective in that case is clearly to distribute gas directly to final private consumers, as Gazprom Marketing and Trading is already doing in UK. Significantly, Gazprom Marketing and Trading, located in London with offices in Manchester, Berlin, Paris and Switzerland, as well as in Singapore and Houston, is fully controlled by Gazprom Germania. It is examined however to upgrade the latter to

¹ Interview, European Commission, DG Energy, Brussels, March 2013.

² Interview European Commission, Desk Russia, European External Action Service, March 2013.

³ Interview, Valery Yazev, Brussels, May 2013.

become a 100% subsidiary of Gazprom Export. Gazprom Germania and Gazprom Marketing & Trading would thus be on the same level, as the two main Gazprom's companies in Europe⁴.

Beyond Germany, Switzerland appears to play also a major role as a main financial basis, managing transactions related to trading, distribution and production of gas and other fuels, all activities that are operationally driven either in Austria⁵ by Centrex Europe Energy & Gas AG or in Germany. In addition, Netherlands-based Gazprom's companies seem more especially focused on pipelines management. Amsterdam shelters headquarters for Blue Stream and South Stream. Significantly, around 50 new employers are currently being recruited by the South Stream company in the Netherlands⁶. This structure supervises the more operational ones in Bulgaria, Slovenia, Hungary, Austria, Greece and Croatia.

Lastly, in Turkey, Gazprom, through the Bosphorus Gas Corporation, is increasing its stance, trying to benefit from gradual privatisation of BOTAS, Turkish main actor, former monopoly, for import, distribution, sales and pricing of natural gas. It also positions itself in Istanbul's distribution gas company, Isgas, announced to be next in line for privatisation. Gazprom has applied to the tender, whose results are not yet disclosed⁷.

| Impact of the EU anti-trust probe

In September 2012, the European Commission has opened formal proceedings to investigate whether Gazprom might be hindering competition in Central and Eastern European gas markets. The Commission singles out three particular practices, i.e to hinder the free flow of gas across Member States; to prevent the diversification of gas supplies; to impose unfair prices by linking the price of gas to oil prices⁸.

In the Russian State's understanding, the judicial campaign against Gazprom appears to be thus both politically and industrially motivated. A Russian official from the Russian Embassy in Brussels (who asked to remain anonymous) notice that the DG Competition at the European Commission was already following for a while (several years) Gazprom's commitment and presence on European markets but has only and suddenly decided last year to launch the anti-trust procedure⁹. It is said unofficially that the investigation into anti-competitive practices by Gazprom might result from an intense and successful lobbying by some unnamed EU member states as well as by some (also unnamed) European energy companies which would be quite happy to see Gazprom's positions weakened on European markets.

In Russia's perspective consequently, it cannot be other answer or responding strategy to that probe than political ones. It is assumed so that negotiations about the Energy chapter of the next Partnership and Cooperation Agreement (PCA) must continue and intensify, mainly with the European member states. As soon as a diplomatic compromise is in sight with the capitals, the issue at the European Commission level will go forward towards a new cooperative bilateral framework. It will be then far easier to bury the anti-trust probe or at least to find a convenient arrangement. For now so, Gazprom is excluded from the negotiations process and gets dependent on a purely diplomatic and political confrontation.

| Impact of the EU 3rd Energy Package

The Third Energy Package appears to be a far more challenging issue, as it impacts the future of Gazprom's positions in Europe. The Russian representatives in Brussels made it clear on that point that Gazprom must not break its monopoly as a supplier and on some transit networks which it has built and which it controls¹⁰. Moscow's authorities argue of the extra-territoriality of the Russian law for Gazprom. As a specific Russian company, it is bound by the national law which continues to apply outside the territory. Gazprom adds that

⁴ Interview, correspondent Itar-Tass, Brussels, April 2013.

⁵ Owned totally by Gazprombank, Centrex Europe Energy & Gas AG, Austria appears to be as one of the main Gazprom's channel for its activities into Central Europe. Centrex website, <http://www.centrex.at/en/organismedetail2.asp?d=4>, visited on April 10, 2013.

⁶ Interview, European Commission, Desk Russia, European External Action Service, March 2013.

⁷ Interview, Necdet Pamir, Turkish expert on energy, Istanbul, March 2013.

⁸ European Commission, Press release, Brussels, 4 September 2012.

⁹ Interview, Russia's Representation to the EU, Brussels, March 2013.

¹⁰ *Ibid.*

its status as an important, even strategic supplier of the European countries gives it right to some exemptions¹¹.

Actually neither Russian authorities nor Gazprom do really insist on those two arguments. The Third Energy Package does not lie, as such by principle, at the heart of the discussions between the European Commission (DG Energy) and the Russian representatives in Brussels. They tend rather to focus on some concrete issues, where Russia is seeking to obtain exemptions for Gazprom and then set up a precedent in favour of Russian interests¹². It is implicitly acknowledged that on the basis of this precedent, it will reinforce Russia's position in the PCA negotiation process. This set-up precedent will also facilitate Gazprom's attempts to avoid a complete implementation of the third energy package.

The negotiation process goes mainly between the two public entities, as regulators enforcing the rules of the game. Gazprom is of course represented at the table but does not hold the main say in the process. The company intervenes as a subsidiary of the Russian official State negotiators. Gazprom agrees of course with the strategy of getting a precedent on exemptions. Its position however may slightly differ from its main shareholder's one.

2 | Gazprom's Economic and more Flexible Approach

Along the interviews and conversations, it leaks out a kind of slight divergence within the Russian front. Gazprom's approach to the anti-trust probe for instance tends to confirm that impression. The Russian company indeed has largely delegated the case to its lawyers and does not seem to pay real attention to the process. Gazprom's stance on the Third Energy Package gives another nod of flexibility, as it focuses on concrete projects that need to be continued or implemented without worrying on the general philosophy or the political background of the European directive.

| Extension of North Stream

Gazprom is currently already negotiating a 3rd and even a 4th line with investors in North Stream, tackling purely economic and financial matters. Much of the decision will naturally depend on European forecasts for gas consumption¹³. Despite the talks being still supervised by both the European Commission and by the Russian Embassy¹⁴, North Stream is now mainly a commercial project. The third line is certainly agreed and should reach the UK. Regarding the 4th which is also thought to connect the UK, there is no formal guarantee yet. The capacity of the two new lines remains also to be determined but will not probably be as high as the current ones transporting 27.5 billion cubic meters (bcm).

Gas volumes, made available to feed those two lines, seem to be already earmarked. They will likely come from the Yamal Peninsula, particularly the Ob-Taz and Shtokmanovskove fields, close to the Yuzhno-Ruszkove field contributing by now the bulk of gas supplied. Apparently only the Ukraine-transiting gas amount will be adversely impacted, if it is to consider for instance Valery Yazev's assertion that transit through Belarus is thought to increase in the near future. He also confirmed Russian interest in building a parallel line to Yamal Europe – Yamal Europe 2 – crossing Belarus and reaching Poland. He even specified that Poland then could become a large European gas hub, capitalising on its efficient infrastructure networks, if the Polish state implements its development plans¹⁵.

| OPAL's bottleneck problem

¹¹ Interview, General Secretariat of the Council, Brussels, March 2013.

¹² Interview, European Commission, DG Energy, Brussels, March 2013.

¹³ Interview Valery Yazev, Brussels, May 2013.

¹⁴ Interview, Russia's Representation to the EU, Brussels, March 2013 & Interview, European Commission, DG Energy, Brussels, March 2013.

¹⁵ Interview Valery Yazev, Brussels, May 2013.

The OPAL pipeline is set to connect North Stream I and its 25 bcm to the middle and western European pipeline grid. The unbundling rule in the Third Energy Package, giving 2/3 access to third parties, would then mean that OPAL should have a capacity of 75 bcm. It would then prove too expensive to build. If Gazprom consequently has to reduce its supplied volumes by the North Stream, then the sub-sea pipeline itself gets non profitable. For that reason, the Russian State reckons that Gazprom is entitled to be granted some exemptions on European markets regarding pipelines' sharing¹⁶.

Apparently, current negotiations between the European Commission and the Russia Embassy are said to go quite successfully. Discussions exclusively tackle now technical issues and Wingas (a Gazprom subsidiary at 50% less on share who has built the pipeline) as well as Gazprom seem to be deeply involved into the process. To some extent, Gazprom here benefits from the more pragmatic turn that the negotiations have taken. A quick solution is naturally and economically in its short-term interest, whereas politically the Russian State had no real emergency. None of the parties, particularly the economics actors, doubt that a solution will be found pretty soon¹⁷.

| Gazprom in hurry on South Stream

In the Russian State's perspective, the South Stream pipeline project tends to be more and more guided by a long-term view¹⁸. There is no hurry on their side. The situation on European markets regarding gas needs could improve on the medium term, considering the uncertainty of German energy supplies after the abandon of nuclear power. Russians clearly are not betting on a decrease of EU gas demand by 2030. But the delay is mainly political, as if the Russian side had not yet finish gathering all the political benefits from this apparent commercial project. It is quite telling to hear Valery Yazev listing the risks of Ukraine's gas transit, specifically the lack of modernization of the networks and the much needed reforms that the Ukrainian domestic gas market has to undertake. His elusive answer on the dominant political rational of South Stream is another implicit indication¹⁹.

Gazprom is following the slower trend set by the Russian authorities but would have liked to speed up a bit the process. Gazprom is thus pushing for a final investment decision to be taken soon, at least. It would help a lot the Russian gas company to secure deeper relations with its partners, i.e. Hungary, Bulgaria, Croatia and Slovenia. As for the competition with Nabucco, it is not anymore considered as a risk, since the reframed Nabucco shape into Nabucco West, now involves far less gas volumes. The two routes are not seen by Gazprom as opposed anymore. Still, it remains difficult to assert that South Stream will be implemented or will be cancelled. Both options are as likely. That uncertainty may last during the coming years, with Gazprom willing to galvanize and the Russian State managing the inertia. If the project should not be done, it is very unlikely that a decision will be made in that sense. South Stream would rather wane away gradually.

| Gazprom's minor scandal with Lithuania

The dispute over governance of Lietuvos Dujos in which Gazprom owns 37.1% stake and the Lithuanian government a 17.7% is the only one to be noticed so far regarding Gazprom corporate presence in Europe. It is related to the EU Third Energy Package, stipulating the unbundling of supply, transit and distribution activities. Gazprom considers that it had to accept that decision by Lietuvos Dujos' shareholders under constraints and duress. The Russians argue that they have been simply deprived of their rights. They talk of "expropriation" by the Lithuanian government. The case has been reviewed by the Stockholm's arbitration court but did not appease the different²⁰.

¹⁶ Interview, Russia's Representation to the EU, Brussels, March 2013.

¹⁷ Interview, European Commission, DG Energy, Brussels, March 2013.

¹⁸ Interview, General Secretariat of the Council, Brussels, March 2013.

¹⁹ Interview Valery Yazev, Brussels, May 2013.

²⁰ Platts, Lithuania, Gazprom at odds over arbitration ruling on Lietuvos Dujos, 1 August 2012, <http://www.platts.com/RSSFeedDetailedNews/RSSFeed/NaturalGas/8583537>.

That dispute however, involving indirectly the European Union, is unlikely to harm further and seriously Gazprom-EU relations. Firstly the gas volumes are marginal relatively to the total of Gazprom supplies and distribution to Europe²¹. The Lithuanian market is not significant. Secondly, Gazprom had earlier already left its second Lithuanian property, i.e the Kaunas Heat and Power Plant, selling 99.5 % of its stakes to another shareholder. Finally, at the European Commission level, it is recognized that the Lithuanian government has acted too quickly and too harshly. A compromised solution then appears likely reachable soon²².

| Gazprom's disinterest of shale gas

Gazprom has willingly decided not to invest on shale gas developments in Europe and in Russia, for three reasons at least, all non-political²³. The ecological sensitiveness in Europe firstly is too high and will hamper a normal and necessary business building. Secondly, resources are not as numerous and easily reachable as thought previously. Thirdly, laws of soil, water and land use are not as favourable to the owners as they are in the US, deterring thus Europeans to let someone else dig on their property.

3 | Gazprom's Challenged Position in Russia

Due to WTO's liberalization constraints, Gazprom is facing the rise of other Russian gas producers, i.e. the already known independent (Itera and Novatek), as well as a newcomer (Rosneft). Theoretically and constitutionally, Gazprom is bound to share access with them to its own transportation system and to leave them procuring final consumers with gas at least on domestic gas market²⁴. Yazev, additionally, recognizes and encourages Novatek's growing shares. Interestingly however, regarding exports liberalization he remains vague, explaining only that measures have been taken to prevent the domination of Gazprom domestically.

Nothing is said on access to foreign markets for Russian gas newcomers. Obviously Russia and Gazprom are still far from those liberal perspectives but Rosneft, Novatek and Itera are pushing hard in that direction. Those issues are currently being discussed at the highest political level in Russia and negotiations will probably end with a reduced Gazprom's position, whatever liberalization scheme is agreed.

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²¹ Interview, European Commission, DG Energy, Brussels, March 2013.

²² *Ibid.*

²³ Interview Valery Yazev, Brussels, May 2013

²⁴ *Ibid.*