
Gazprom's evolving strategy in a new commercial and political context: how should the EU react?

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After years of unchallenged commercial domination of a sizeable portion of the EU's gas market, Gazprom is confronted with a statement of objections issued on 22 April by the EU Commission for abusing its dominant market position. The company was already prevented from going ahead with its South Stream project aimed at consolidating Gazprom's grip on Southeast Europe's markets by bypassing Ukraine – due to alleged non-compliance of intergovernmental agreements with the EU regulatory framework. Furthermore, it walked away from negotiations that could have allowed it to access more than 50% of the OPAL pipeline – an onshore branch of the offshore Russian German Nord Stream pipeline –, whilst its attempts to go downstream through the acquisition of European distribution and transmission operators, such as Wingas and DESFA, failed due to current political tensions and the risk of a negative Commission ruling on the operation.

Does this mean that the Russian gas behemoth – so often portrayed as the energy arm of the Kremlin – is not so powerful after all? This Policy Brief aims to frame the erosion of Gazprom's power in a wider perspective, analysing its peculiar position at a time of transition, with the global gas business going from a sellers' to a buyers' market, and providing recommendations on how Europe should deal with it. It will be argued that Gazprom – despite still being affected by the Kremlin's political priorities – is moving towards more commercially sound behavior. The EU should profit from this evolution without being tempted by mercantilist options, and rather use the political momentum provided by the energy union to remove barriers to solidarity and to increase competition on the trading platforms.

BACKGROUND

The old strategy

Basing its strategy on the assumption that gas is a scarce, regionally fragmented and increasingly expensive commodity with a rigid infrastructure, Gazprom has been pursuing a policy of vertical integration in Europe, regional infrastructure control, and preference for oil-linked long-term supply contracts for a long time.

Focus on the EU market. For many years, Gazprom has been framing its energy relations with Europe in strategic terms. And for good reasons, considering the EU's advantages as a client: a sizeable demand, combined with regulatory and infrastructural fragmentation and political divisions. Gazprom has been responding to the waves of liberalisation in EU gas markets by following a strategy of downstream expansion and trying to sell gas directly to European customers through a policy of asset swaps, eased by preferential political relations, instead of competing on the trading platform. The strong focus on the EU market also pushed Gazprom to take measures aimed at preventing EU efforts to diversify supplies, keeping the resources of former Soviet countries' – notably located in Azerbaijan and Turkmenistan – out of Europe's reach through multiple means. First, by using the 63 bcm South Stream project to deprive the EU-sponsored Nabucco pipeline of commercial rationale; second, by contributing to Turkmenistan's isolation from Western outlets by delaying a legal settlement of the Caspian waters; third, by offering Turkmenistan an alternative outlet in Russia accounting for approximately 40 bcm until 2009, and reluctantly allowing it to export the exceeding production (24.4 bcm/y in 2013) to China.

Reluctance to feed China. Until 2014 Gazprom gave no particular attention to Asian markets, beyond the LNG production sharing agreements in Sakhalin, aimed at feeding Korea and Japan. The Kremlin's priorities prevented Gazprom from pursuing an arbitrage policy between East and West, signalling political reluctance to open Siberian and other eastern resources to China. For a long time this allowed Russia to maintain an excessively strong bargaining position *vis-à-vis* Chinese counterparts, leading to a permanent stalemate on any serious attempt to diversify Gazprom's client base.

Infrastructural control in the former Soviet space. With mixed results, Russia has tried to remain the main gas export outlet for Central Asian countries through the exploitation of the Central Asia-Centre (CAC) infrastructural system. The control of a sizeable part of the post-Soviet infrastructural panorama by Gazprom has been instrumental to the Russian will of keeping these countries export or import-dependent on Russia, and therefore also subjected to Moscow's political grip. Turkmen gas was sent to Ukraine at discounted prices until 2006, allowing Moscow to provide under-priced gas in exchange for political influence. In other cases, the Russian grip was maintained in Armenia, whilst Georgia and Azerbaijan successfully managed to become energy-independent from Gazprom.

Preference for long-term, oil-indexed take-or-pay contracts. Gazprom has consistently promoted long-term contracts, as they served the double purpose of ensuring demand security and allowing for close bilateral relations with national energy companies, a linchpin of Gazprom's divide and rule practice on EU markets. With this type of contract the seller bears the price risk – as he is not in control of oil price dynamics – whilst the buyer bears the volume risk, as he commits to pay the whole contracted volume regardless of demand dynamics, without having the possibility to sell any excessive amount due to destination clauses.

STATE OF PLAY

A new strategy in the making?

The decade-long strategy described in the previous section was politically driven. The company's core business – onshore transit – was sacrificed in order to cultivate ambitions in unfamiliar environments, such as downstream distribution and LNG. Indeed, Gazprom's close relationship with the Kremlin brought no significant advantages to the firm in these areas. It rather damaged the firm's reputation on every occasion Russian foreign policy became unpredictable or aggressive, compromising ambitions that required the involvement of foreign partners.

Its geopolitical ambitions will not come to an end, but it will have to adopt a new strategy due to the following events: first, the EU's enforcement of the Third Energy Package adopted in 2009 has raised the costs of controlling downstream infrastructures; second, the shale gas revolution in the US along with the expansion of LNG is disrupting longstanding arrangements, such as oil-linked contracts and the separation between North American, European and Asian markets; and third, sanctions placed on Russia as a consequence of the crisis in Ukraine have compromised access to foreign capital and know-how. How is the company reacting?

Gas at the borders. Gazprom is abandoning the intention to enter distribution in the EU due to the increasingly stringent enforcement of competition rules. The EU's Third Energy Package includes a third country clause that does not allow a foreign supplier to own majority stakes in the EU transport infrastructure or to be a transmission system operator (TSO), preventing vertical integration strategies by suppliers. The South Stream quarrel – where the EU Commission called into question the legal compliance of several intergovernmental agreements between EU countries and Russia – stemmed from the enforcement of this regulatory evolution. Gazprom's reaction – which also anticipates the results of the Commission investigation on anti-competitive conduct by the Russian company – seems to comprise the abandonment of vertical integration plans down the EU market chain, in favour of selling gas at the borders. This is consistent with multiple objectives: first, no longer being subjected to the EU's regulatory discipline, which then would also apply to the buyers of Russian gas at the EU borders. Second, potentially letting European buyers bear the transit risk through unstable territories – notably Ukraine – thereby inducing European politicians to favour routes circumventing Ukraine.

Export diversification. Another fundamental aspect of Gazprom's re-orientation lies in its attempts to expand its client base eastwards. EU demand can no longer be taken for granted, not least because of renewables-friendly legislation and feeble growth. At the same time, due to the continued development of new resources in Russia's Yamal peninsula to offset declining production of other Western Siberian fields, and the continued erosion of the domestic market share by alternative producers, Gazprom now struggles to find outlets to allocate its estimated

(end 2014) 100 bcm/y overcapacity. These factors pushed Russia to strike a \$400 bn deal with China in 2014, signing an agreement to open a route towards a major new market for the first time since the fall of the Soviet Union. The combination of the Altai and Power of Siberia routes aims to deliver 68 bcm/y of gas to the fastest growing gas-consuming province in the world, bringing disruptive potential to the Asian regional market, characterised so far by expensive LNG imports. Russia intends to signal the ability to conduct arbitrage between Europe and Asia in a moment of harsh political confrontation with the West over Ukraine. For this reason, it ended up accepting a particularly onerous deal with China in terms of prices (presumably lower than the range of \$12-13/mmBtu estimated against \$90-\$100 Brent)¹, not to mention the possibility that – due to difficulties in funding the project with internal sources – Russia will probably have to let China enter its upstream. In the past, with Russia in a stronger bargaining position, this condition was always rejected. The same applies to the deal with Turkey over the construction of Turkish Stream. The 63 bcm project replaces the abandoned South Stream in an attempt to recover the cost borne so far by Russia in building this corridor. The cancellation of South Stream placed Turkey – which cultivated the ambition of becoming a gas trading hub for a long time – in a strong bargaining position, allowing Ankara to ask for discounts in the range of 6%-10%.

From control to market competition with former Soviet Union countries. With Turkish Stream, Russia will enter into direct competition with Azerbaijan on the Turkish market. The planned four-string size of the pipeline, along with Russia's spare production capacity, would allow Gazprom to price out high-cost extraction gas from the Caspian. Similarly, Russia will enter in direct competition with Turkmenistan on the Chinese markets, with the advantage of taking gas directly to the energy-hungry Chinese coastal provinces, rather than crossing increasingly unstable eastern Turkestan provinces and other Central Asian countries. As such, an expensive and politically-driven policy of infrastructural control of the past is changing in favour of a competition-based approach, adapting to an increasingly global and buyer-driven environment.

Contractual evolution. The preference for long-term gas relations remains, but oil indexation will be increasingly abandoned in favour of a partial spot indexation and a series of selective rebates and discounts. New disruptive technologies (US shale gas and technological developments allowing for LNG expansion) have had an impact on European markets; with US demand disappearing from the Atlantic basin, unsustainable East-West pricing differentials have emerged in the EU. As hub pricing now accounts for more than 50% of the EU gas imports, these differentials impose an excessive burden on continental European midstream companies, modifying their preferences and creating momentum for an evolution of a traditionally comfortable relationship between them and Gazprom.

Back to old businesses. Gazprom will scale back its LNG plans, basing its diversification strategy on onshore pipelines. Over the past decade, Gazprom tried to expand its presence in LNG markets in order to diversify its customer base, looking especially to North America. The North American shale revolution deprived this plan of economic rationale, leading to the indefinite suspension of the development of the offshore Shtokman field. From 2012 onwards, the reversal of Gazprom's LNG ambitions became more and more evident. As the development of offshore fields needs foreign expertise and technology, the worsening political climate adds to the current difficulties. With eroding revenues due to lower hydrocarbons prices, tax-free LNG exports also became less attractive from a government perspective, not to mention the fact that, contrary to pipeline exports, LNG exports are subject to the growing competition of independent Russian producers.

PROSPECTS

Politics still affect Gazprom's choices – notably in the intention of circumventing Ukraine and putting pressure on Europe by diversifying exports –, but these are becoming more realistic in commercial terms. However, uncertainties loom large on the horizon of this strategic re-orientation, as the combination of Turkish Stream, Altai and Power of Siberia is financially very challenging. Rising competition on the domestic market and declining demand in Europe and the former Soviet Union make the firm's financial outlook grim.

Assuming that Gazprom's plans will be realised, potential risks emerge for the EU. How should the Union and its members adapt to the new reality?

The risks of Gazprom's diversification. Fears are mounting over the possibility that Gazprom's export diversification implies a loss of monopsony power for Europe. But in terms of volumes, there is such an abundance of gas in Yamal/West Siberia that Gazprom will be able to supply both markets. Also, if the overall European objective is to reduce dependency on Russia, it would be unrealistic to expect Russia not to look for alternative markets. This is not a development the EU should try to prevent.

The risk of cartelisation. In a globalised and flexible market, with prices driven by demand and supply instead of oil, gas producers might be tempted by cartelisation, with Russia playing the role of a swing producer.² However, coordinated behaviour among exporters would only be a risk under tight supply/demand conditions. The potential for North American gas to reach global markets will add to the current difficulties for gas producers to establish cartels.

The risk of dumping. As cartelisation remains difficult to enforce in the short run, the risk posed by the 'new' Gazprom is probably the opposite; profiting from multiple routes and overcapacity to price out competitors – in particular LNG suppliers and the high-cost Caspian producers. Instead of reflecting on mercantilist options such as purchasing cartels, the EU should maintain the objective of injecting more competition on the trading platform, as this is the place where Gazprom accepted (or was forced) to play in the future.

Internally, this will be possible if remaining barriers to integration will be removed to spread the benefits of an open, globalised market all across the continent and provide alternatives for EU countries in terms of supply security. This will contribute to fostering intra-EU solidarity, along with commercial maturity, and reducing the level of political paranoia in EU-Russia gas relations, which will remain relevant anyway, even though they will be based on different conditions. Beyond the diplomatic efforts to reduce barriers between member states, the regulatory framework review expected in 2015-2016 will be of paramount importance to address market imperfections leading to a sub-optimal use of cross-border capacity. This will have to be expanded beyond the stated targets as well, in case its utilisation approaches full use, indicating an un-matched need for investment.

Externally, the market place at the Turkish-Greek border can remain contestable on the condition that an overwhelming capacity differential between the Turkish Stream and the Trans-Anatolian Pipeline (TANAP, aimed at gathering additional Caspian Gas from Shah Deniz to Turkey and Europe) can be avoided. TANAP's initial capacity of 16 bcm can be easily displaced by a four-string 63 bcm Turkish Stream. Diplomatic efforts should be dedicated to push Turkey towards signing for a two-string maximum Turkish Stream, leveraging on its interest to ensure a hub for Azeri and potentially Turkmen exports to Europe. Preserving contestability is essential in order not to discourage additional future supply from Iran or Northern Iraq once the political conditions are mature.

Gazprom's shifting strategy should be seen as an opportunity to normalise the EU-Russia energy relations, for the benefit of everyone. The energy union should focus on the right priorities in order not to miss it, as political drive will be needed both domestically and externally.

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- 1 Henderson, James (2014), "The Commercial and Political Logic for the Altai Pipeline", *Oxford Energy Comment*, available at: <http://www.oxfordenergy.org/2014/12/commercial-political-logic-altai-pipeline/>
 - 2 Finon, Dominique and Locatelli, Catherine (2008), "Russian and European Gas Interdependence: Could Contractual Trade Channel Geopolitics?", *Energy Policy*, nr. 38.

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