RKK ICDS
RAHVUSVAHELINE KAITSEUURINGUTE KESKUS
INTERNATIONAL CENTRE FOR DEFENCE AND SECURITY
EESTI · ESTONIA

Analysis

Developments in the Russian Internal Gas Sector: Cosmetic Changes or Concrete Reforms?

June 2014 (revised March 2015)

By Mart Raamat* with Matthew Bryza

Edited by Emmet Tuohy

**Mart Raamat, advisor in the Environment Ministry*
The views presented here are his own

ISSN 2228-2076

Introduction

The Russian government has always regarded gas as a strategic resource that can be used to advance its political goals—both domestically and internationally. In particular, the Kremlin has used its national gas champion Gazprom—in which the state holds a blocking majority ownership share of 50.002%[1]–as the the main tool for supplying domestic consumers in remote areas. Indeed, until recently, the firm held the exclusive rights to export natural gas (in whatever form) to international markets.

However, in the last few years, substantial changes have taken place within the Russian gas sector, and as a result Gazprom has lost ground at home as well as abroad. Although the company's domestic market share has been in gradual decline for the last decade or so, the first clear sign of the change in paradigm within Russia's gas sector came in December 2013, when the government ended the monopoly to allow Gazprom's fiercest domestic rivals—Novatek and Rosneft—to export liquefied natural gas (LNG). The two companies had been strongly pushing for liberalization of Russian gas exports, a move that would harm Gazprom's positions as a sole exporter. The fact that the non-Gazprom gas companies (hereinafter NGPs – non-Gazprom producers) succeeded in their active lobbying campaign reveals one of two things: either Gazprom and the Russian government have differing views about the future of the company and of the Russian gas sector in general, or the emerging competitors have top-level political backing that supports the development of "independent" gas companies. Accordingly, this change has left the future of the Russian gas market unclear: should we anticipate a more liberalized domestic market as well as liberalized export policies of natural gas, or will Gazprom remain the dominant force both at home and abroad in the near- and medium-term future?

Declining market power of Gazprom

With proven reserves of 33 tcm (trillion cubic meters) which would last with current production ratio for next 56 years[2], Russia is currently the world's second biggest natural gas producer behind the US. Thanks to its vast resources, Russia uses a considerable amount of gas for power production, residential heating, and for its heavy industries; even though it is such a major exporter, some 70% of its production (437 billion cubic meters [bcm] annually),is consumed within the country.[3]

Pricing reforms for domestic consumers – netback parity goal

In oil- and gas-rich countries with relatively lower living standards, governments tend to regulate the prices of commodities to support industrial as well as residential consumers. This was the case in Russia until the first half of the 2000s. In 2006, President Vladimir Putin introduced a new target for domestic gas pricing, calling for a gradual move from fixed and regulated prices towards reaching export netback parity[4] with the prices Gazprom charged to its European export customers. Even though the government had already increased prices annually beginning in 2000, the domestic

1 http://www.gazprom.com/investors/stock/structure/
2 http://www.bp.com/content/dam/bp/pdf/statistical-review/statistical_review_of_world_energy_2013.pdf
3 http://www.eia.gov/countries/country-data.cfm?fips=rs*
4 Netback parity is when natural gas sales prices for domestic consumers equal the prices for exported gas, excluding transportation and other destination-associated associated costs.

price had only reached 42% of netback by 2005. The plan to expose Russian consumers to European price levels, which was supposed to be implemented by 2011, was initiated due to a number of reasons, most notably to support Gazprom's investments into developing new expensive gas fields and infrastructure. Additional reasons included encouraging energy efficiency, promoting gas market liberalization, and complying with the entry requirements of the WTO.[5]

Putin advocated this change in gas pricing policy at the beginning of a period of economic growth that saw a huge expansion of global demand for oil and gas products and a corresponding rise in commodity prices. Since most of its gas export contracts are indexed to the price of oil, gas export prices went up significantly—as reflected by Gazprom's stock price, which quadrupled between 2005 and 2008. The price reference for Russian pipeline gas exports to Europe – the German Border Price – saw an increase of 2.5 times during the same time span.[6] This meant that the set goal of reaching netback parity by 2011 was never realized; even though Russian government authorized domestic price increases by 15-27% annually,[7] the huge price spike on European markets made reaching the goal unthinkable. Currently, the domestic price is as far from the netback parity target as it was in 2006; the goal has been officially postponed until as long as 2020.

Since the regulated price increases in recent years were accompanied by economic growth, it was not a painful decision for government to raise the price of natural gas for residential and industrial consumers. The situation has changed remarkably since then – even before the effects of the sanctions that followed its annexation of Ukraine, Russia was already facing a second straight year with a sub-1% GDP growth rate and a generally poor economic outlook.

In early 2014, the Russian government not only abandoned plans to continue price increases, but actually enacted a price decrease of 3% for Gazprom's industrial consumers[8]. The main reason behind this move was believed to be the grim perspective of industrial output and slow economic growth[9]. Adding to the arguments against pursuing the netback parity goal are the internal factors of Russian gas market: domestic demand for natural gas is weakening, while production capacity was set to undergo substantial growth in coming years. Accordingly, political support for abandoning the market pricing model grew. As early as June 2013, Prime Minister Dmitry Medvedev voiced his support for regulated lower domestic prices, arguing that "we should have some competitive advantages because we are Russia, because we are the largest supplier of energy resources"[10]. So it seems that long-anticipated move to "market prices" may be put on hold—and the biggest loser in this decision is Gazprom.

Gazprom is losing domestic market share to competitors

Just over a decade ago, there was no significant competition for Gazprom on domestic market, as low prices made it unattractive for NGPs. However, when the government

5 http://www.oxfordenergy.org/wpcms/wp-content/uploads/2011/11/NG_57.pdf
6 http://carnegieendowment.org/files/gas_pricing_europe.pdf
7 http://www.oxfordenergy.org/wpcms/wp-content/uploads/2011/11/NG_57.pdf
8 http://www.reuters.com/article/2013/02/25/gazprom-tariffs-idUSL6N0BP8Z820130225
9 http://www.oilandgaseurasia.com/en/news/russian-minister-revises-domestic-gas-tariff-increases-citing-slow-economic-growth
10 http://www.4-traders.com/GAZPROM-OAO-6491735/news/Russia-PM-Need-To-Consider-Whether-Gas-Netback-Parity-Needed-Reports-17050767/

started to execute a program for annually raising gas prices, the market almost immediately became appealing to competing producers. The market share of independent gas companiesstarted growing exponentially Within 15 years, it has increased by a factor of 3.5: from 6% in 1999 [11] to the current figure of 27%--with further growth potential in the future.[12] Although one of the main reasons behind the change in domestic gas pricing was to make Gazprom's domestic activities more financially sustainable, its effect for the national gas champion was just the opposite.

Decreasing domestic market share itself is not a problem for Gazprom – the popular assessment deems domestic market activities unprofitable for Gazprom. The company goes as far as claiming that it loses around $50 (€46) per thousand cubic meters supplied to domestic consumers[13]. Looking at the data from 2012, when Gazprom supplied 265 bcm to the domestic market[14], the company's total reported subsidies to Russian consumers was $13.25 billion (€12.1 billion). The losses that Gazprom suffers on domestic market are even more striking when compared to financial earnings figures from 2012 – the company reported a net profit of $38 billion (€35 billion).[15] This means that up to third of its annual profits is covering its losses on domestic market. Therefore, it is not in the company's best interests to retain its overwhelming market leader position—it would be much more profitable to concentrate only on the export market.

While Gazprom is claiming that it is operating with a non-existent profit margin on domestic market despite the recent price increases, its competitors had found rising domestic prices attractive for expanding their share on the market. The two-tier pricing system is also supporting the emergence of competition: the independent gas company Novatek and the oil giants LUKoil and Rosneft. Since they are not subject to regulated price restrictions, these biggest rivals to Gazprom can charge its customers on the basis of free market prices.[16]

The system also favors these competitors, because they can choose their customers, while Gazprom is required to ensure supply of gas to remote regions that are much less profitable than the high-yield areas near the main production centers. Gazprom is partnering with federal government to carry out expensive regional gasification programs, which are intended to connect Russian regions with the national gas network. Most of these projects—which require huge investments—have very distant break-even points. From the government's perspective, this program makes a lot of sense – it supplies regions with domestic, cheap, and relatively clean energy. From Gazprom's side, however, these projects are rather less attractive. In addition to the huge initial investments, maintenance costs will also rise as more remote regions join the grid; moreover, according to current market predictions, the earnings from supplying these regions are questionable.

---

11 http://www.cne.es/cgi-bin/BRSCGI.exe?CMD=VEROBJ&MLKOB=244087914138

12 http://www.platts.com/latest-news/natural-gas/moscow/gazprom-expects-to-keep-domestic-gas-market-share-26972184

13 http://www.euractiv.com/energy/russias-natural-gas-dilemma-analysis-512092

14 http://www.ukrinform.ua/eng/news/gazprom_earns_more_from_gas_sales_to_europe_domestic_customers_in_2012_302743

15 http://www.bloomberg.com/news/2012-12-12/world-s-largest-profit-at-gazprom-pays-for-putin-s-pipes-energy.html

16 http://www.oxfordenergy.org/wpcms/wp-content/uploads/2011/11/NG_57.pdf

At the same time, Gazprom is finding more and more difficult to retain its market share in mature and high-yield market regions, as the NGPs enjoy a comparative advantage. Most importantly, the independent gas companies can offer flexible pricing to their consumers and are required to pay fewer taxes (as well as zero maintenance costs).[17] An additional problem for Gazprom derives from the fact that production from its old fields (i.e., those that were first developed during the Soviet era) is starting to decline; to fulfill its supply commitments it has to start producing from distant fields with higher marginal cost[18].

One potentially effective tool for Gazprom for curbing domestic competition is its pipeline grid – following a state decree, Gazprom is the sole owner and operator of Russia's vast high-pressure gas pipeline network UGSS (United Gas Supply System). This includes export infrastructure as well as less financially lucrative domestic pipeline grid. A clause in the Federal Law of Gas Supply prohibits the unbundling or breakup of UGSS to be disintegrated.[19] By nature, a pipeline network is a natural monopoly and creating a competitive market involves allowing all market participants to access the grid. The legislation regulating third party access has been in place since 1997. It requires the owner of the grid to allow other producers to access the grid on a non-discriminatory basis; producers that supply natural gas for daily living and governmental needs are supposed to have priority access to the grid.[20] In practice, the system has not worked effectively and access to network has been subject to the goodwill of Gazprom.

Being the owner of pipeline system, it has the complete information about the capacities as well as technical situation of the grid. While the grid may remain nominally under state control, the owner of the grid can still use its insider information to enhance its position on the market and make it difficult for competitors to access the transmission system. The fact that there is no requirement for unbundling the vertically integrated transmission system owner and operator creates a business conflict of interest for Gazprom – it is obliged to grant access to UGSS for competitors when there is vacant capacity on the grid. Since it would eventually harm Gazprom's own business interests, the company has felt reluctant to allow its domestic competitors access to the grid. Starting from 2009, the Federal Antimonopoly Service has started fighting against the market-disrupting practices of Gazprom and brought latter before the courts on several occasions.[21] The fact that Mr. Putin himself ordered the investigation into Gazprom's activities implies that Gazprom is losing its political edge[22]. Comments and opinions of the top officials of Russian government have ever since been supportive for the development of non-Gazprom gas production, further suggesting the change in perception in official rhetoric.

Moreover, official strategic plans have supported a more liberal market structure. The ***Energy Strategy of Russia to 2030*** document, released in November 2010, establishes the main goals of the gas market as the improvement of the competitiveness of gas

17 http://www.gazprom.com/press/news/2014/april/article189315/
18 http://www.oxfordenergy.org/wpcms/wp-content/uploads/2012/03/Is-a-Russian-Domestic-Gas-Bubble-Emerging.pdf
19 http://www.yklaw.ru/datadocs/doc_2314ho.pdf
20 http://iurisprudentia.ru/files/Gas09Russia.pdf
21 http://hal.archives-ouvertes.fr/docs/00/85/37/76/PDF/CL_CR2bis-2013-EDDEN_Post-communist-economies.pdf
22 http://www.oxfordenergy.org/wpcms/wp-content/uploads/2013/01/NG_73.pdf

sector in the long-term perspective, with the gradual and controlled liberalization of gas markets as well as the creation of a non-discriminatory access regime to infrastructure for all business entities also a key objective.[23]

As we can observe, the last decade has been difficult for Gazprom domestically. A pricing reform intended to enhance the position and prospects for future growth of the national gas champion has instead evoked domestic competition and resulted in a loss of market share. What is most painful for the company is the fact that it has given away market share in the most profitable regions and market niches. When comparing domestic gas sales, only 6% of Gazprom's sales were to high-margin and 36% to low-margin markets, whereas Novatek's figures are 71% and 6% respectively.[24] With growing importance on Russian market, the NGPs have executed an efficient lobbying campaign to undermine Gazprom's positions on natural gas export policies.[25] This emerging competition begs the question about the origin of these major NGPs and their ties with the Kremlin's inner circle.

Emergence of "independent" gas companies

Legally, competition in the gas market was never been prohibited after the dissolution of Soviet Union, but until early 2000s, there was little visible competition for state-run Gazprom on the domestic market due to low regulated prices that made "independent" gas companies unable to compete with Gazprom. Only after the government initiated annual price increases for regulated gas were competitors were able to sell their gas with reasonable profit margins. The main players on the market have been major oil companies, which seek to market natural gas produced as a byproduct of oil drilling, and a few gas companies. The current market picture is still quite consolidated – apart from Gazprom, only the oil companies LUKoil and Rosneft and the gas firm Novatek produce significant amounts of natural gas. While the two latter companies market their product independently – i.e. they negotiate contracts with consumers and only use the Gazprom-owned transmission network to supply the gas to end consumers, LUKoil simply sells its gas to Gazprom. The firm cites problems with accessing the pipeline network as the main reason behind this decision. [26] LUKoil and its top managers have not actively been fighting against Gazprom's position on the gas market; the two companies have even started working together to develop East Siberian fields[27]. As it seems, LUKoil does not want to penetrate a domestic market in which it has formed close ties with Gazprom, but instead to develop gas projects abroad (i.e. its deposits in Uzbekistan).

The two true rivals on domestic market for Gazprom – Rosneft and Novatek – have been the main advocates of challenging Gazprom's dominance. Although these two NGPs essentially share the same agenda and view of market reforms, the two companies have some inherent differences that merit attention.

23 http://www.energystrategy.ru/projects/docs/ES-2030_(Eng).pdf
24 Interfax vaata screen clipp
25 Zarubashneft story
26 http://en.ria.ru/russia/20140123/186804805/LUKoil-Gazprom-to-Continue-Gas-Cooperation--Report-.html
27 http://en.ria.ru/business/20140527/190161802/Russias-Lukoil-To-Enter-Gas-Business-Collaborate-With-Gazprom--.html

Novatek

Currently the second-largest gas producer in Russia, Novatek has evolved throughout its two decades of existence from a relatively minor oil-and-gas production company into a firm poised to become a gamechanger in the Russian gas business. Its main fields in Yamal-Nenets region are the base of its production and though the company's reserves that are located within a fairly limited area, its proven reserves still rank in the global top ten. Novatek is operating efficiently and sustainably – through smart acquisitions and active exploration, the company reported a 32% increase in its reserve portfolio in 2012, which now amount to 1088 bcm[28]. The company has also aggressively been increasing its gas production, which stood around 60 bcm in 2013[29]--double its output in 2008[30]--and its quarterly profit margins exceeded 30% in 2014. Unlike Rosneft, Novatek has not been facing serious problems with accessing the gas transmission system either. Its main production fields use the same pipeline branch as the declining Nadym-Pur-Taz fields owned by Gazprom, leaving the physical available capacity for Novatek to access the UGSS in the future.

The gas and oil sector in Russia does not function according to a normal liberal business model – a considerable amount (if not all) of decisions are made behind closed doors, which is why the sector has remained largely open only to the Kremlin inner circle. Though the success of Novatek has been remarkable, it also can be argued that much of this can be attributed to its main shareholders. Before the initial public offering for the shares of Novatek in 2005, a controlling share was owned by its management. Leonid Mikhelson, who has served as the CEO of the company for over 10 years, personally owned 35% of the company. Following a number of different deals that included Gazprom buying a stake in company[31], two controlling shareholders have emerged. The former owner of oil-trading giant Gunvor, Gennadi Timchenko acquired a 23% share of the company. Together with Mihkelson, the two have a controlling share of 51% of the company, making it impossible to restructure it without the consent of both Timchenko and Mihkelson.

Although Timchenko came under US sanctions after the Russian invasion of Crimea, the company claims that it does not harm the international projects of Novatek. Observers have noted that Timchenko is a long-time personal friend of Vladimir Putin and not surprisingly, it is also argued that the company started emerging as a serious competitor for Gazprom only after Timchenko came on board. In 2009, Novatek completed a blockbuster 6-year 64 bcm supply deal with Inter RAO, Russia's biggest power producer. This serves as a huge setback for Gazprom, who had previously been the sole supplier of the lucrative power generation sector. The following years also saw a remarkable amount of new supply contracts signed by Novatek. The independent gas company is offering its customers much needed flexibility in pricing as well as capacity contracts and its supply price is increasingly competitive with regulated gas.

The average premium charged by Novatek has fallen drastically – in 2007, there was a price difference of 15% between Novatek's and Gazprom's contracted gas prices, but already in 2010, Novatek sold gas with only a 0.3% price margin over Gazprom

---

28 http://www.ey.com/Publication/vwLUAssets/EY_-_Global_oil_and_gas_reserves_study_2013/$FILE/EY-Global-oil-and-gas-reserves-study-2013.pdf
29 http://www.reuters.com/article/2014/05/21/us-novatek-yamal-idUSBREA4K09K20140521
30 http://www.oxfordenergy.org/wpcms/wp-content/uploads/2013/01/NG_73.pdf
31 Currently Gazprom owns around 10% of the company

regulated price.[32] The narrowing of the gap was not because Novatek lowered its supply price, but rather because of the annual price rises for regulated Gazprom gas.

One concrete example for the Kremlin's appraisal of Novatek is illustrated by the tax breaks that government offered to the gas production from Gydan peninsula basins. The exemption in legislation was personally ordered by Putin and only applies for natural gas that is destined to Yamal LNG plant.[33] Not surprisingly, Novatek holds significant licenses for exploration and production on the peninsula and most of it (if not all) is for supplying the LNG plant. Tax breaks in Russian gas sector are not extremely rare – major export pipeline projects for Gazprom has also received tax incentives to support the commercial viability of the project. Still, it is argued that Novatek is enjoying remarkably lower tax rates on its gas-associated activities than Gazprom – the average tax rate for Novatek is estimated to be as much as 35% lower. [34] Even though some groups within Kremlin are pushing for higher taxes on energy companies as a means of obtaining much-needed additional finances for the state budget, Novatek has still managed to gain substantial tax exemptions highly favoring its domestic as well as international activities.

Rosneft

The emergence of second big rival for Gazprom, Russia's national oil champion Rosneft as a competitor in gas sector, is somewhat different. Being a state-owned and operated company, it has always had an access to vast resource basins, but until recently, Rosneft was only looking at the oil production. With series of acquisitions, Rosneft has aggressively been expanding into gas business and have increased its gas reserves to over 3 trillion cubic meters.[35] Rosneft holds significant licenses for drilling in the Arctic region; it also is increasingly looking to market its vast gas reserves in Eastern Siberia and gas from its Rospan gas project in Yamalo-Nenets region, with an estimated one trillion cubic meters of natural gas reserves[36]. Rosneft's most notable deal included purchasing the Russian-British independent oil company TNK-BP in 2013. The oil company was known for its vast gas resources and had already agreed on a number of gas supply deals with regional power companies. Also, in 2013 Rosneft finalized the takeover of Russia's third-largest gas company Itera, to consolidate yet further its growing importance in the gas market. Before these major acquisition, Rosneft's gas output was significantly lagging behind Novatek – the former company was not willing to invest into producing from its own gas reserves from Kharampur field due to questions about the commercial viability of the gas. Thanks to extremely aggressive business and political tactics, Rosneft was able to increase its gas production with record-setting two-fold rise up to 38.2 bcm in 2013[37]. Its strategy sees a rapid production increase that should amount to 100 bcm by 2020.

32 Domestic gas prices
33 http://www3.energyintel.com/WebUploads/gei-moscow/media-files/iod-story-24-10.html
34 http://www.bloomberg.com/news/2013-05-22/russia-gas-tax-shift-to-help-producers-from-gazprom-to-novatek.html
35 The estimation derives from the company's own assessment. It should be noted that the reserve figures of Novatek only included proven reserves, than Rosneft figures include both proven and probable reserves. Hence the higher figure. http://www.rosneft.com/Upstream/GasStrategy/
36 http://fief.ru/img/files/V.Rusakova_Rosneft.pdf
37 http://en.itar-tass.com/economy/730087

Rosneft is controlled by the state via state holding company Rosneftegaz, who holds 69% of total shares. Through selling its share in TNK-BP to Rosneft, BP acquired a 20% stake – making it the only other entity to possess more than 1% of Rosneft's shares. The highly capable management of Rosneft is y behind its latest success in effectively penetrating gas sector. The top manager of Rosneft is Putin's long-time ally and personal aide Igor Sechin. During his long tenure in public service, Sechin has served in influential positions both inside the government and in the presidential administration. When Putin served as a prime minister, Sechin occupied the post of Deputy Prime Minister in charge of energy policy. In 2012, he was appointed as a secretary of energy commission under President Putin. It can definitely be argued that Sechin has the personal as well as official capability to heavily influence the outcome of Russian energy policy.

Shared and contradicting business interests on domestic market for independent gas producers

With the emergence of competition on the Russian domestic gas market, the views and interests of market players have also transformed in time. The "independent" gas companies shared a similar interest of curbing Gazprom's market power and making the domestic market more competition-friendly. The cooperation between Novatek and Rosneft, the two biggest rivals for Gazprom on domestic market, is vital for both companies for making the domestic market more competitive. As Novatek CEO Mikhelson pointed out during a shareholders meeting in 2013, "[w]e are partnering with Rosneft to find solutions to urgent and important questions in regarding the development of domestic and external market policies for independent gas companies."[38] The number of antimonopoly investigations prompted by Putin himself are a good indication that the Kremlin has reversed its previously pro-Gazprom position and begun to favor the development of competition on the domestic market. The key problem for natural gas producers still revolves around the access to pipeline network – if they want to fulfill their respective goals and increase market share domestically, the operator UGSS should ensure enough capacity for NGPs.

The independent gas companies have been extensively getting more vociferous in their opinions and aspirations. While there has been a push against Gazprom's monopoly on domestic market for a number of years now, the growing confidence of Gazprom's competitors has started to reshape the current discourse. In the beginning of 2014, Rosneft drafted a proposal for the government to de-monopolize the network system and create an independent system operator.[39] This move would create regime, where all market participants have equal access to the grid. Much like the provisions in the EU's Third Energy Package for European markets, this would mean that Gazprom would be divided into two companies, one of which would be a strictly regulated system operator. This move would be a major step toward liberalizing Russian gas market. There are many issues regarding the regulation and financing huge investments into grid infrastructure that need to be worked out, if the plan will ever

---

38 http://www.vedomosti.ru/companies/news/11590861/mihelson_nashel_soyuznika#ixzz2RZ4wDxN7

39 http://www.osw.waw.pl/en/publikacje/analyses/2014-06-11/creeping-de-gazpromisation-russian-exports

be realized. But with the growing importance of Novatek and Rosneft, some kind of amendments favoring growing domestic competition are definitely anticipated.

The independent gas producers have been able to break into the domestic market thanks to a number of factors. Most notably, as stated above, the Gazprom regulated price has created a situation in which NGPs can match the price in Gazprom's contracts. Additionally, they can offer more flexible contracts and supply volumes and are thus a reasonable option for many consumers. The second biggest contributor to growing domestic market share of "independent" gas producers has been the pressure from the Federal Antimonopoly Service, which has begun extensive investigations into the alleged anti-competitive actions of Gazprom in blocking access to the gas transmission grid for other market participants. The fact that government has started to put some effort into fighting the Gazprom's market-curbing activities has given the independent producers much needed confidence that if they invest into developing new production facilities, their gas can be delivered to end consumers via the UGGS. Novatek and Rosneft have concluded agreements with consumers whose high profile and economic importance make it difficult for Gazprom to use its "nuclear option" of blocking access to the grid. These consumers include huge domestic utility companies, such as InterRAO and Mosenergo as well as their international competitors on Russian market – E.ON Russia and Fortum.

The last few years have seen the two domestic rivals of Gazprom entering into a new phase of their development – competition against each other. This rivalry between the companies is even more fuelled by personal relationships of the top managers of the two firms. It has been reported by business insiders, that there is definite antipathy between Gennadi Timchenko and Igor Sechin. The two companies had a major collision of interests in 2012, when Rosneft signed a major $80 billion (€73 billion) deal with Inter RAO, replacing Novatek as the supplier of natural gas for the power producer.[40] The deal, which is a clear blow to Novatek, marks a major starting point in competition between the two "independent" gas companies. The main architect behind this is Sechin, who was (and remains) chairman of the board of Inter RAO.

Changing export policies for Russian gas

With growing power on domestic market, the independent gas companies are becoming more vociferous about their export prospects in the future. The first major win against the former export monopoly Gazprom was scored in the end of 2013, when a long lobbying campaign was successful and Novatek and Rosneft were granted a right to export gas in a form of LNG. Although a landmark in Russian gas policies, the move should still only be viewed as a partial liberalization – the *de facto* beneficiaries are only the two aforementioned companies. All other projects in the future and those currently in the planning stages require another amendment to the law; the export license was only given to a predetermined list of projects which only included those belonging to Novatek and Rosneft.

The main argument against export liberalization was based on the rationale that Russian companies should not compete with each other on export markets in order to maintain high export prices. Accordingly, the first suggestions for the export

40 http://bryantkirk2801.typepad.com/blog/2012/11/rosneft-pips-novatek-for-huge-gas-deal-with-inter-rao.html

liberalization saw granting the export license only to projects that were designated to serve Asian markets (i.e. not competing with Gazprom's pipeline gas in Europe). However, the idea did not take into account the fact that LNG would soon become competitive with natural gas in Europe—and that LNG can be shipped globally.

The difference between Rosneft and Novatek in their strategies as well as perceptions about the future of Russian gas industry derives from their different resource pools. While the latter has resource basins on a concentrated area in West Siberia, the former has reserves in various parts of Russia. Novatek's Yamal LNG has already passed its final investment review; most of the initial reported output of 5.5 million tonnes of LNG, which is reported to be coming online in 2017,[41] has already been contracted under long-term agreements. Meanwhile, by contrast Rosneft is in talks with ExxonMobil to build a LNG plant on Sakhalin Island in the Pacific, while also adding its own LNG plant on the Yamal Peninsula to market gas from its Arctic offshore fields.

Additionally, Rosneft is looking for the opportunity to market its vast gas resources from eastern Siberia fields. With large domestic consumption centers distant, and with a low domestic price less attractive than export options, Rosneft and its influential CEO Sechin have even begun to challenge the sacred cow of Russian energy policy: Gazprom's pipeline export monopoly. Export via pipelines is currently only possible for Gazprom and for its trading arm Gazprom Export. If NGPs want to sell their gas to international markets, they first have to sell it to Gazprom Export, which handles all market activities for Russian gas on international markets. Rosneft wants access to Gazprom's *Сила Сибири* (Power of Siberia) pipeline that is designated to carry 38 bcm of Russian gas to China[42]. On June 4 of last year, Sechin again proposed a plan to de-monopolize Russian pipeline gas exports. While Putin had harshly criticized the idea in the past, this time he did not display any open opposition to Sechin's proposal[43].

Novatek remains largely skeptical about the possibilities to market its gas via pipelines. Due to the the geographic position of its main fields, the only logical market for pipeline-sourced Novatek gas would be Europe, but right now Gazprom and Russian government seem to be reluctant to give up the "energy weapon." Some commentators have argued that this could be option on the table for Russian government and Gazprom to escape from the ongoing antimonopoly investigations of the European Commission and to overcome legal and regulatory hurdles. However, the Russian government is not currently pursuing the path of normalizing energy relations with its biggest customer, the EU.

Given the recent events and developments in the Russian energy sector, liberalizing pipeline exports would definitely be the next logical step in the development of Russian gas sector—at least as far as the NGPs are concerned. As Sechin has become increasingly influential and he has succeeded in plans to expand the activities of Rosneft, allowing pipeline exports only for "exclusive projects" (e.g. the soon-to-be-

---

41 With full operational capacity, the LNG plant is reported to be producing 16.5 million tonnes annually. Considering the fuel conversion factors, the Yamal LNG project would need an annual input of 7.6 bcm initially and 22.8 bcm of natural gas in the final phase of the project.

42 http://uk.mobile.reuters.com/article/energySector/idUKL6N0M412120140307

43 http://www.osw.waw.pl/en/publikacje/analyses/2014-06-11/creeping-de-gazpromisation-russian-exports

completed pipeline to China) could be an option to allow Rosneft to expand while still letting Gazprom retain its influence in Europe.

Conclusion: political consequences and implications for the future of Russian gas sector

Energy business and politics in today's Russia are so intertwined on a personal and state level that any changes in either of the two are poised to have serious implications for them both. It is acknowledged by Kremlin observers that the two major clans in Russian politics are very tightly connected with two powerhouses in Russian energy business: the more liberal-minded group, headed by the "gray cardinal of Kremlin" Vladislav Surkov—which backs Gazprom—and Sechin and the powerful *siloviki*, who are firmly behind Rosneft. The latest developments in the Russian gas policies suggest that we can see Gazprom losing even more importance – as the political fight between the two clans is not settled, the heated rivalry between two state-owned energy giants is set to continue.

Sechin and his group of former FSB officials have succeeded in promoting Rosneft as serious contender for Gazprom in gas business. The interests of two giants are colliding in the oil market as well, because the former is also trying to get into the playing field of Rosneft. With the two companies pitted against each other, the managers of the two companies are constantly trying to get the approval of the Kremlin. Not surprisingly, the two CEOs have a mutual distrust and dislike of each other. While Gazprom CEO Alexey Miller is also reported to be close to Putin, Sechin is clearly a far more close and longstanding ally of the president. The two oil and gas heavyweights' business interests are clashing in the Arctic region, where both are hoarding exploration licenses at the expense of the other. To speed up its activities and to bring on board much needed know-how of deep water drilling, Rosneft has formed a powerful alliance with ExxonMobil, which is partnering with Rosneft in all of the major projects of the Russian national oil champion– drilling in the Arctic and building gas liquefaction plants in Russia and Alaska. Considering all of the factors, Rosneft is poised to become a major powerhouse in the gas business as well. The most important question mark remains the possibility of further sanctions for Russia for its actions in Ukraine. The next round of sanctions from the US may target the energy industry—thus far largely exempt—and Rosneft's cooperation with Exxon could be put to an end, causing considerable damage to the Russian oil firm's expansion plans.

Rosneft also has a trump card regarding the future pipeline exports to China. While Gazprom has contracted to supply 38 bcm annually, the pipeline's capacity is significantly bigger. It is reported that with full operational capacity, it could ship 61 bcm of natural gas to China. As pointed out above, Sechin has already started lobbying for access to the export pipeline. Sechin has already suggested a framework for how Rosneft would finance (albeit on a smaller scale than Gazprom) the construction of the necessary infrastructure. If the company is granted access to the pipeline, the oil champion would be free to negotiate its own supply price—and it is unlikely that Rosneft would not be able to secure a better deal than Gazprom.

The power struggle between Gazprom and Rosneft leaves Novatek in a somewhat peculiar position – the company is largely regarded less political than its two rivals and does not seem to have direct confrontation with either of the two state companies, therefore giving the independent gas company a much broader playing field. While Rosneft and Gazprom may view Novatek as a potential tool to use in their mutual battle for the upper hand within the Kremlin, Novatek skillfully uses its position to realize its own goals. It backed Rosneft on the LNG export liberalization issue because of its own interests. However, its comments on further liberalization of pipeline exports have been quite moderate—thus indirectly supporting Gazprom. The reason for the latter is because there is not much upside for Novatek in such liberalization: the company is strongly developing its Yamal LNG project and though no decision about the further expansion has been made yet, some comments from company's officials have indicated a possible two- or three-fold increase in output of the LNG plant.

Novatek's principal owner, Gennadi Timchenko, was appointed last year as head of the Russia-China Business Council – a position that would surely mean that if the plans to expand the Yamal LNG output are fulfilled, it would be easier to conclude LNG supply agreements with energy-hungry China. Keeping in mind its strong presence in domestic market and the fact that Novatek has not been facing such difficulties accessing UGSS system as have Rosneft or LUKoil, the bulk of its projected further natural gas production output has already been booked. Therefore, the company's wariness about Sechin's proposed plan to strip Gazprom of its exclusive rights to export natural gas via pipelines makes sense. The growing closer relationship between Gazprom and Novatek is illustrated by the recent deal that saw the latter contracting to sell 3 million tonnes of LNG annually to Gazprom on a long-term basis[44]

Contrary to its emerging competitors, Gazprom seems to be on a downward trajectory. Though it is argued that the company has been poorly managed,[45] the roots of its problems derive from the fact that Gazprom has always had to serve "two masters" and Kremlin has not allowed the company to operate under normal market principles. Rather it has had to serve Kremlin's foreign and domestic policy goals. In a changed international environment, what is good for Russia is no longer good for Gazprom. Indeed, Gazprom has failed to adapt to changes in the functioning logic of global gas markets. Building underwater pipelines to Europe only to avoid crossing transit countries with existing pipelines is not an economically reasonable decision for a normal company. The latest blockbuster deal effectively tying Gazprom to a long-term supply contract with China is also an indication of how politics trumps economics. Gazprom had been negotiating for a satisfactory price for up to 10 years—but it was only when the relations between Russia and the EU were at their lowest point that Gazprom and its Chinese partners were able to strike a deal..

Considering the high investment costs needed to develop new fields, pipeline network and additional necessary infrastructure, an estimated supply price of $350 (€319) per thousand cubic meters, which is a significant downgrade from earlier negotiations,[46] does not offer enough revenue for Gazprom to even cover all the costs. These expensive export infrastructure projects have exhausted the financial capabilities of

44 http://barentsobserver.com/en/energy/2014/05/gas-giants-yamal-deal-27-05
45 The heads of the company have been blamed about downplaying the importance of „shale revolution" in the US. Gazprom's major LNG development in the Arctic Region, Shtokman LNG was supposed to ship LNG to the US, the market that is now flooded with cheap shale gas. The project have been put on halt and now decision about its further status has been made.
46 During the 10-year negotiating period, the price ranged from 380-570 per thousand cubic metres. http://www.chathamhouse.org/expert/comment/14633

Gazprom—the Power of Siberia pipeline as well as the proposed South Stream pipeline to Turkey would require an investment of over $80 billion (€73 billion)[47], a considerable fraction of Gazprom's market capitalization. An economically wise business decision would be to follow the global trends and to invest into LNG producing facilities instead of committing to a market with uncertain demand outlook (Europe) or to an unattractive supply price (China). Even a company as big as Gazprom has problems finding financing for all the expensive infrastructure projects – a massive LNG project and new pipeline infrastructure would together need an unreasonably large investment capital portfolio. Gazprom, under considerable pressure from the Russian government, has decided to put the main emphasis on investments into pipeline infrastructure.

The problem with high capital expenditure costs is even more aggravated with Gazprom's domestic activities. Russian government is relying on Gazprom to carry on and bankroll its extensive gasification programs. Building and maintaining long transmission networks to connect regions further and further from main production centers, requires huge investments. Gazprom does charge transmission fees from companies using the UGSS; however, its own policies of restricting competitive gas in the grid, combined with its competitors' strategy of targeting high-yield customers, have minimized its profits from transmission activities. Gazprom is also losing money on domestic sales, since the government does not have a solid pricing policy intact. The government is instead trails socioeconomic trends in adapting Gazprom's regulated prices to economic reality. This is illustrated by the opinions of top officials and the recent decisions on decreasing regulated price for industrial and residential customers alike.

Some commentators have been calling for splitting the national gas champion in order to make the company as well as Russian energy system more efficient. This would echo the views of top government officials, who have voiced support for creating a more competitive domestic gas market. The plans would foresee stripping Gazprom of its transmission assets and establishing an independent system operator, effectively granting all market participants equal right to access the network. Though it may free Gazprom from the huge investments to pursuit the extensive gasification programs of the government, it would also mean that it could lose even more market share in the high-yield domestic regions, since it would not be able to block competitors for accessing network. Gazprom cannot compete with independent gas producers on a free market since the latter offer much better terms. The independents are not interested in supplying remote regions that need significant price subsidies – which Gazprom is required to serve. Moreover, the government believes it cannot afford to let gas prices to float freely due to the possible social unrest that policy changes and significant price hikes would evoke. Accordingly, it continues to cap Gazprom's price, costing the company billions every year.

---

47 CAPEX of the proposed South Stream project was estimated 45% up in December of 2013 than according to earlier estimations. Building the underwater pipeline in the bottom of Black Sea is now expected to cost $22.5 bln dollars. http://www.platts.com/latest-news/natural-gas/moscow/russias-gazprom-hikes-southern-corridor-gas-line-26534458. Gazprom estimates total costs for developing all necessary infrastructure to start exporting to China to be $55 bln. Experts believe that the costs are extremely undervalued and that a in a good scenario for Gazprom, the total cost of the project is around $100 bln. http://www.chathamhouse.org/expert/comment/14633.

Curiously enough, the internal changes in Russian gas sector seem to have only a minor influence on EU-Russia gas relations. Even if Kremlin decides finally to allow other companies to use Gazprom's export pipelines, it is highly questionable whether Novatek or Rosneft would be interested in penetrating European markets given the high degree of uncertainty regarding demand and prices as well as the difficult regulatory framework. Both NGPs are instead pursuing their respective LNG projects, which will be supplied by gas fields located in Arctic region and Western Siberia. Accordingly, there is little or no spare gas production capacity left in the region for the possible gas exports to Europe via pipelines.

For the time being, it seems that the Russian energy sector really has changed. While Igor Sechin has succeeded in reshaping the policy of the Kremlin, and while Novatek has managed to carve out an independent space for itself, Gazprom is left to respond to policies created by others. As the political choices keep getting worse for Russia, Gazprom will continue to suffer, while the NGPs will likely enjoy the fruits of their political connections and business interests respectively.

International Centre for Defence and Security
Toom-Rüütli 12-6, 10130 Tallinn, Estonia
info@icds.ee, www.icds.ee
Tel.: +372 6949 340