POLITICS OR PROFITS? GAZPROM, THE KREMLIN, AND RUSSIAN ENERGY POLICY

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ABSTRACT

This paper adds to the ongoing discussion of Gazprom’s role in Russia by placing the debate around Gazprom within the broader contexts of both the increasing prevalence of national oil companies in the world and the changing natural gas landscape. It assesses how the interplay between politics and profits has affected the way Gazprom can adapt to a rapidly changing world natural gas environment and how both the Kremlin and Gazprom are adjusting—or failing to adjust—their strategies accordingly. It concludes that Gazprom and the Kremlin are both adjusting to changes in the world natural gas environment, but they are doing so in their own ways, but given the affects the actions of one has on the other, the pace of adaptation is slower than what we might see with an entirely independent firm.

The paper begins with a discussion of the tradeoffs inherent in Gazprom’s relationship with the Kremlin. It identifies various factors at work politically that prevent Gazprom from profiting in the domestic economy. Primary among these factors are entrenched rent-seeking interests and philosophies about natural resources, as well as geopolitical interests. The paper identifies the 2006 and 2009 gas disputes with Ukraine as evidence of Kremlin interference in Gazprom’s commercial activities and concrete examples of the boundaries between these two entities as well as the seeming blurring of these boundaries.
The paper then moves into a discussion of increased volatility and risk in Gazprom’s primary export market, Europe. The systemic context of a discussion of Gazprom today must include factors such as increased supply options for Europe that make natural gas a more fungible commodity than in the past and new legislation aimed at promoting energy independence via the development of a competitive natural gas market. This new context threatens Gazprom’s ability to mitigate price risk in its export market, which in turn makes providing for the domestic market through gas rents increasingly draining on the firm’s bottom line.

The paper concludes by asking how Gazprom and Russia are adapting to increased volatility in the European natural gas market and whether the new tactics reflect a change in the Kremlin’s relationship to Gazprom. It identifies three means of adaptation: Russia’s increasing diversification of supply in the domestic market; Gazprom’s increasing pipelines to Europe; and Russia’s pivot to the East. It determines that ultimately both the Kremlin and Gazprom are responding in ways that are reflexive and somewhat innovative, though their fundamental goals have not changed.
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INTRODUCTION

While fundamentally a commercial entity, Gazprom is pulled in both political and commercial directions, which at times adversely affects its ability to function as a profit-driven firm. Ultimately, what is best for Gazprom should also be best for the Kremlin, given that the goal for both is increased revenue. For the company, profits appease shareholders and provide for necessary capital expenditures, and therefore its decisions are primarily made to maximize profits. For the Kremlin, Gazprom’s profits can provide a source of rents that can be injected back into the economy in areas it deems strategically important. However, in Russia’s natural gas sector, these rents take the form of domestic price subsidies, which are paid for out of Gazprom’s bottom line, weakening its ability to accumulate capital for future projects. Gazprom has developed various strategies to survive in such a market, from striving for higher prices in Russia, to moving down the supply chain, to diversifying its assets, but today new sources of natural gas in Europe, its key export market, have caught the firm and Russia by surprise. This paper assesses how the interplay between politics and profits has affected the way Gazprom can adapt to a rapidly changing world natural gas environment and how both the Kremlin and Gazprom are adjusting—or failing to adjust—their strategies accordingly.

Developments in the hydrocarbon sector affect nations as well as firms, and as more firms appear that represent national interests, we will more often see the fates of states combined with those of state-level firms. According to a 2007 report from the Baker Institute at Rice University, by 2005 national oil companies (NOCs) had gained control of 77 percent of the world’s proven reserves, and of the top 20 oil producers, 14
were NOCs. As the Baker report notes, many of these companies “have close and interlocking relationships with their national governments [that] means that geopolitical and strategic aims” as well as “various important social and economic functions” are factored into foreign investment decisions.” Managing these various demands can easily make state natural resource companies susceptible to a unique set of problems, such as failing to keep track of runaway spending and waste and making poor investment decisions based on the commands of state agencies. Given the increased prevalence of NOCs that must confront the challenges of balancing political agendas with inherently commercial mandates, a case study of Russia’s natural gas sector and its largest firm, Gazprom, takes on broader significance.

This paper is split into three main parts and various chapters within each part. Taking the stance that Gazprom is inherently commercially motivated, it begins with a brief overview of Gazprom’s sales to the European market and factors that determine the company’s pricing considerations. While Gazprom seeks profits, it functions not in a vacuum, but as a Russian firm in a sector that has historically been integral to the wellbeing of the Russian economy. Thus, this first section discusses why and how the firm’s decision making has been affected by the Kremlin’s own geopolitical and domestic policy concerns. To demonstrate Kremlin interference in the firm’s activities and the consequences of such actions, the paper addresses briefly the 2006 and 2009 gas disputes with Ukraine, as these disputes bring the interplay between Gazprom and the Kremlin into relief. The ultimate goal of the first section is to demonstrate that, in addition to

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2 Ibid., 2.  
earning profits for itself and its shareholders, Gazprom simultaneously acts as both a public good, with rents from gas revenues distributed back into the domestic economy and, to some extent, as a lever for geopolitical power, and these demands at times threaten its ability to earn profits.

Having addressed broadly Gazprom’s incentives and its constraints as a Russian natural gas firm, the paper in its second section moves to new threats to Gazprom’s European market that are placing unprecedented stress on the firm and, by extension, the Russian state. While Gazprom has shifted its focus down the value chain to where it is most profitable, its European market, its security remains tenuous, as its revenue streams continue to be threatened by its non-commercial requirements. The sudden increase of unconventional natural gas around the world, led in large part by the United States’ “shale gas revolution” and its worldwide reverberations, along with new interconnector pipelines in Europe and gas market liberalization, are increasing price risk for Gazprom and threatening the already-fragile model by which the firm has functioned to this point. With diversification of supplies comes a threat to both prices and long-term contracts that Gazprom has not shown it can absorb without shedding its mandate to act as a public good for the Russian economy. This section attempts to demonstrate how this sudden threat came about and to illustrate the new challenges Gazprom is facing today and how Gazprom’s relationship with the Kremlin, as outlined in part one, affects the way it addresses these new developments.

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The third and final section incorporates the first two sections in a discussion of the ways Russia and Gazprom are responding to these new developments, arguing that thus far the historical relationship between the state and the natural gas sector continues to influence the adaptation strategies of each. Since Russia finds utility in cheap natural gas for the domestic economy, its fate is as entwined with the new developments in natural gas markets as is Gazprom’s. However, it has different ways of adapting. The Kremlin’s reactions thus far indicate that it continues to work within the confines of what it has historically found to be successful politically; Rosneft and Novatek, the two independent producers firms leading the way in “a new period of Russian gas,”\textsuperscript{6} may be little less dependent on the Kremlin than Gazprom. Gazprom similarly needs to adapt, and in many ways it has, through building pipelines to demonstrate its reliability as a supplier and integrating with firms all the way down its value chain. However, Gazprom still remains constrained by the Kremlin, and in this final section, the paper attempts to answer the initial question of how this interplay between politics affects Gazprom’s ability to adapt to a rapidly changing world natural gas environment.

\textsuperscript{6} Fiona Hill, “Energy Empire: Oil, Gas, and Russia’s Revival” (London: Foreign Policy Centre, 2004), 33.
PART 1: GAZPROM – A COMMERCIAL OR POLITICAL ENTITY?

While Gazprom is a commercial entity, it is a key strategic company for Russia, which accords it special attention from the Kremlin. To some extent, Gazprom welcomes this, for its position in the Russian market, where it has thus far maintained control of domestic pipelines and held a monopoly on natural gas exports, stems from its protected position as the Kremlin’s natural gas firm. At times it even receives state backing in international disputes, such as pricing disagreements with Ukraine and European Commission probes into the firm’s operations, as discussed below. Yet does this make the firm less commercially driven? Ultimately it does not, but it does affect the environment in which Gazprom conducts its commerce, at times at great cost to the firm.

While Gazprom may act commercially, it must pay political dividends at the expense of injecting profits back into operations. As of 2012, subsidized natural gas prices in Russia were set at 55 percent below European market levels, and over the past 10 years Gazprom has lost up to $49 billion on these subsidies. Naturally, with this much cash equivalent available to win over the electorate and key elites, the political will to move away from such subsidies has been slow to materialize, and Gazprom has continued to bear this burden.

The following four chapters attempt to outline the boundaries between firm and state in Gazprom’s business model, pointing to areas in which goals intersect and diverge. The first chapter discusses Gazprom’s commercial considerations, the basis for the firm’s decision making, asking to what extent Gazprom’s commercial decisions are driven, if at all, by Kremlin policies. The second chapter attempts to contextualize

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Gazprom today by pointing to historical geneses for the interplay between the Kremlin and the firm, looking at the Soviet natural gas industry and comparing and contrasting it to Gazprom after the dissolution of the Soviet Union. It determines that although there was a fundamental shift in Gazprom’s structure to become a more commercial company in the 1990s, Gazprom has never been able to act truly independently. The third chapter asks why to this day the Kremlin continues to interfere in Gazprom’s commercial dealings, questioning geopolitical leverage as a reason for interference and identifying the need for gas rents and the Russian philosophical approach to natural resources as the primary motivators. In the fourth and final chapter of this section, the paper briefly discusses the 2006 and 2009 Russia-Ukraine gas disputes as case studies demonstrating how this interplay between firm and state has manifested itself and what the negative consequences might be.

1. GAZPROM’S COMMERCIAL BASIS—PRICING

Price is a key element in the overall discussion of Gazprom and its various roles, as price can determine whether Gazprom keeps or loses access to certain markets amidst increasing competition. In this section, we briefly address some of the key determinants behind the price of Russian gas.

Gas is not the only hydrocarbon export upon which Russia depends, nor, arguably, the most important, but in many ways they are intertwined. Gas exports for Russia first gained popularity only once oil revenues began to decline in the 1970s. As long as oil sales remain high, gas continues to be of secondary importance to Russia’s state coffers. As Gustafson notes, while in terms of oil equivalent, Russia produces
roughly the same amount of oil as it does natural gas (approximately 10 million barrels per day), these industries are quite different politically and structurally, and the means by which they benefit Russia differ as well. Oil, three quarters of which is exported, “pays the bills abroad,” according to Gustafson, and gas, over half of which is consumed domestically, “pays the bills at home.”

Oil and gas are intrinsically linked for Gazprom, however, in the way the firm has historically priced its gas. Today, there are two different methods for pricing natural gas. In North America, natural gas prices are based on spot market prices at Henry Hub, Louisiana, a confluence of several pipelines. In Europe and Asia (with the exception of Great Britain), prices have been based on oil-indexation, whereby the price of gas changes to match the movements of various oil product prices. Historically, when gas was first introduced to the market, there was no mechanism for pricing, but since both gas and oil could be used for heating, power generation, and industrial processes, it was believed that these were essentially interchangeable fuels, and thus the price of gas became indexed to the price of oil.

Gazprom continues to demand in its contracts the “protection” of reduced price risk that comes from oil indexation, and Gazprom CEO Aleksei Miller argues that at

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least Ukraine, Gazprom’s key transit state, cannot handle spot prices in Europe.\textsuperscript{13}

Ultimately, Gazprom hopes its customers do not move to spot prices, for without oil indexation, natural gas prices would be too volatile and thus too risky for the firm, and Gazprom would lose its price stabilizer.

However, despite Gazprom’s insistence on oil-indexation,\textsuperscript{14} according to analysts at Oxford Institute of Energy Studies, the basic model upon which oil-linked prices originated is no longer applicable. Jonathan Stern and Howard Rogers argue that “there is no longer any market connection between [oil and gas] fuels.”\textsuperscript{15} These analysts contend that Gazprom’s continued insistence on oil indexation is tautological—the firm argues for continued oil indexation because there is a continuing link between oil-linked and hub-based prices, but this is the case in part because companies such as Gazprom continue to argue for this linkage in their contracts.\textsuperscript{16} Indeed, as greater diversification of supply comes into the European market, oil-indexation will be ever less applicable for Gazprom’s customers.

Pricing is a main concern for Gazprom not just in its export contracts, but within Russia as well. Tired of subsidizing the Russian market and the markets of certain CIS states, under the leadership of Alexei Miller, Gazprom has continually attempted to increase prices across the board—within Russia and in subsidized markets on Russia’s borders—to reach the same level as gas sold in Europe,\textsuperscript{17} or “netback parity.” However,


\textsuperscript{15}Stern and Rogers, 3.

\textsuperscript{16}Ibid., 4-5.

Gazprom does not have autonomous control over the pricing of gas in Russia; rather, gas prices are determined in part by the Kremlin, officially via the Federal Tariff Services.\textsuperscript{18} There has been some movement upwards in prices in Gazprom’s domestic markets, but not as much as it would like to see. According to Jonathan Stern, industrial prices in Russia have been at least non loss-making since 2004,\textsuperscript{19} but residential prices have taken longer to increase, given in part the political utility Vladimir Putin has found in promising to keep prices low.\textsuperscript{20} In this lies Gazprom’s challenge: with the Kremlin in part determining prices domestically and in the CIS, Gazprom has been unable to move quickly to reach netback parity, which in turn hinders its ability to adapt to the the volatility in the changing European market.

Gazprom has continuously been at odds with the Kremlin over pricing policy, but moving targets in pricing issues have kept netback parity from being reached. Indeed, seven years ago, on November 30, 2006, Vladimir Putin enacted a policy that put domestic gas prices on a path to reach parity with Europe’s prices over the course of five years, requiring over a doubling in prices.\textsuperscript{21} The goal, according to James Henderson, was to provide Gazprom with the funds needed for capital investments by making the domestic market profitable, ultimately to liberalize the gas market.\textsuperscript{22} For the Kremlin, increased gas prices will help modernize the economy, as inefficient industry is no longer

\textsuperscript{18} “Po kakim tsenam ‘Gazprom’ realiziruet gaz rossiiskim potrebiteliam? Kak ustanavlivaetsia eti tseny?” (Gazprom, 2013), \url{http://gazpromquestions.ru/?id=35#c251} (accessed April 27, 2013).
supported by subsidized prices. For Gazprom, increased prices are useful for two reasons: they increase the firm’s revenue domestically and encourage energy efficiency practices that free up gas for export. Gazprom argues that a history of subsidies to the domestic market for political gain has stunted its ability to make necessary capital expenditures, for which Gazprom, not the Kremlin, is now paying the price. As the firm trumpets on its website:

“[Low domestic] prices not only hindered the gas industry development but ultimately hampered the formation of an efficient structure of the Russian economy. In fact, the companies subsidized by Gazprom have no stimuli to cut operating expenses due to cheap energy supplies. Energy conservation technologies and new eco-friendly fuels lost the competition due to cheap gas….Moreover, long-term deliveries of cheap gas to Russian export-oriented producers can be viewed upon as unjustified export subsidies.”23

While the price of gas has slowly risen since the 2006 ruling, its growth has been stunted by a variety of factors from rising oil prices, slow progress on electricity reform, new independent producers offering up gas at lower costs, and the move to spot-market pricing in Europe.24 These factors have hindered Russia’s ability to set a target for netback parity pricing, halting the movement towards creating a liberalized natural gas market.

As the Kremlin is unable to find a target towards which to increase Russian gas prices, Gazprom continues to look for ways to mitigate the risks inherent in selling at low prices domestically while facing increasingly variable prices abroad. Domestically, it is undertaking strategies such as encouraging energy efficiency and buying up electricity generators to increase its lobbying power for electricity reforms so that electricity-

23 “Po kakim tsenam” (Gazprom)
generating companies will be able to purchase more expensive gas. While improving energy efficiency has long been a stated goal of the Kremlin and appeared to be about to take hold when then President Dmitry Medvedev signed an energy efficiency bill in 2009, it has thus far failed to make serious headway, and this in turn has forced Gazprom to continue supporting inefficient industry. This case demonstrates how, on the domestic market, Gazprom and the Kremlin have similar end goals, but the means and pace of achieving them diverge. The Kremlin has some incentive to keeping prices low for the time being, but this is not beneficial to Gazprom, which ultimately adopted for itself the goal of acting as the Kremlin’s proxy in energy efficiency when political will was lacking.

Part of the problem is the history of Russian politicians’ providing Russia and the CIS with inexpensive gas. While providing subsidized gas within Russia and to the CIS was politically useful for keeping a weak country together, the policy encouraged long-term inefficient use of the resource. While Russia recognizes the benefits that improved energy efficiency would have, especially given Russia’s reliance on hydrocarbons, policies thus far have been “inadequate,” and it has fallen to Gazprom to take the lead to help maximize its own profit-making potential.

Abroad, Gazprom continues to invest downstream while pursuing “take-or-pay” contracts. In gas sales, the seller assumes the price risk and the buyer the volume risk. Since storing gas is expensive, producers like Gazprom (the “sellers”) require contractually-obligated consumers before it makes financial sense for them to extract

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25 Ibid., 25.
discovered gas. Even at that point, the risk of pouring billions into infrastructure projects—including pipelines that span thousands of miles—is always high for both the producer and the consumer, and thus there must be a mutually assured sense of reliability for both sides. The consumer must assure the producer that the gas will be paid for per the terms stipulated in the contract (ensuring the project’s economic viability for the producer), and the producer must promise to supply the gas to the customer at the stipulated volumes for the contracted period of time (assuring reliability of supply for the consumer, who could lose billions if the gas were shut off or, worse yet, literally freeze to death).

To mitigate price risk, Gazprom relies on these “take-or-pay” clauses, or sections inserted into long-term contracts with large EU import companies that require a certain amount of money to be transferred to Gazprom regardless of changes in demand, protecting the firm from both price and volume risk.\(^{28}\) This transferring of some of the risk of production to the consumer is necessary for the producer to make capital investments in upstream projects.\(^{29}\)

Gazprom’s European customers in the past were not opposed to these contracts. As long as Gazprom was the primary gas supplier on the market, long-term contracts were equally important for the firm’s customers. Abdelal and Mitrova note that Gazprom has long built up strong relationships with downstream companies, and these companies in return have long relied on the firm as a source of steady supply.\(^{30}\) It is in Russia’s best interest to maintain a stable flow of gas to Europe to emphasize the country’s, and

\(^{28}\) Locatelli, 247.
\(^{29}\) Ibid., 251.
Gazprom’s, reliability as a partner in the natural gas sector.

Thus far, some of Gazprom’s partners continue to see the firm as a reliable supplier and even appear willing to support increased import routes for Russian gas.\textsuperscript{31} However, as LNG becomes more plentiful in Europe and has potential to undercut Russian natural gas prices in some markets,\textsuperscript{32} and as new interconnecting gas pipelines are built to transfer the gas across a wider swathe of Gazprom’s export market, Gazprom must argue not only that it is a reliable supplier of gas, but that the prices it states in its contracts are competitive against LNG and, moreover, reflect “market prices.” However, as Gazprom prefers oil-indexed prices, it cannot argue that its gas is based on a market price for natural gas, but only, rather, that its gas is priced at better and more reliable prices than spot market gas.

Despite its arguments for oil-indexed prices and long-term contracts, the relationships between European firms and Gazprom have weakened, and Gazprom’s contracts have come under closer scrutiny from the firms themselves and from the European Commission. Russian gas has historically been very dependent on the European market, however, and possibly losing its hold there due to increased supplies and greater price risk, matched with an inability to raise its domestic prices, will be a serious blow to Gazprom’s model.

2. CONTEXTUALIZING GAZPROM TODAY

Before discussing how European firms and the EU are responding to new

\textsuperscript{31} Ibid.
changes, it is useful to understand the context of Gazprom’s relationship with this market and the historical basis for Russia’s reliance on it. While natural gas played a role in overall modernization efforts in the Soviet Union after World War II, it did not occupy a place of prominence vis-à-vis oil or coal due to the complexity of its requisite infrastructure and the more widespread use of oil in petrochemicals and transportation.  

Relatively small amounts of gas were exported to Poland beginning in the 1940s, through the Soviet Union’s gas production arm, gazovaia promyshlennost’, whence the name “Gazprom” is derived. High-volume exports began in 1967, when gas was sent via an export pipeline to Czechoslovakia. Sales first expanded beyond the Soviet Union’s sphere of influence in 1968, when Austria’s OMV became the first Western country to sign a long-term contract with the Former Soviet Union. Contracts were later signed with Italy’s Eni and then with West Germany in the mid-1970s.

It was at this time, in the late 1960s and early 1970s, that the gas industry in the Soviet Union gained traction. By the 1970s, coal and oil production began to decline, and Soviet General Secretary Leonid Brezhnev responded in part by pushing for greater output of natural gas. Unexpectedly, gas was the “only energy source whose output in

37 The original contract was for 6 BMCA for 20 years. See “40 let postavok rossiiskogo gaza v Itliiu,” O “Gazprom” (Gazprom, 2013), http://www.gazprom.ru/about/history/events/italy40/ (accessed February 27, 2013).
1980 actually reached the target set for it\textsuperscript{39} and thus became of increased interest to central planners. In addition, not only did gas become important domestically as a way to offset losses in meeting energy quotas, but gas exports at this time also became more valuable. Increasing prices and reduced volumes of oil on the world market due to the global oil shock of 1973 provided an opportunity for the Soviet gas to exploit a niche in the market.\textsuperscript{40}

The pricing schemes for exported Soviet gas differed between the Comecon states in Eastern Europe—which received discounted “friendship” prices—and Western Europe, which was charged higher prices to make up the difference and supply the Soviet economy with much-needed hard currency.\textsuperscript{41} While the goal was to retain influence among members of the Comecon, this strategy ultimately did not increase the Soviet Union’s political leverage over the Comecon countries, yet it nonetheless forced the Soviet Union’s gas industry to incur significant economic losses.\textsuperscript{42} However, this is the policy that became entrenched. These countries depended primarily on lignite, and thus gas never a fundamental necessity, which weakened its role as a geopolitical tool. Despite the seeming futility of subsidizing countries with cheap gas to ensure their political support, however, Gazprom continued to be the vessel for such schemes much longer, and the legacy of these policies has shaped the way Gazprom and Russia are seen by their customers today.

When the Soviet Union fell, Russia was left with a domestic economy riddled with chronic nonpayment of taxes and wages, and neighboring states were seeking

\textsuperscript{40} Bahgat, 166.
\textsuperscript{41} \textit{Ibid.}
\textsuperscript{42} Closson, 347.
increased autonomy. Subsidized gas prices became a tool to hold both the Russian state and the former Soviet alliances within the CIS together, though gas was subsidized at the expense of Gazprom’s bottom line.

To meet these demands, Gazprom had to maximize revenue from its most profitable source at the time—the European export market. As if to underscore the paradox of such a policy, Gazprom’s revenue increased thanks to the faltering of the domestic economy, which caused Russia’s domestic gas consumption to decrease at a faster rate than production, freeing up additional volumes for export.

The importance of Gazprom to the state in the aftermath of the Soviet Union’s collapse was exemplified by the failure of Russian leaders to privatize the gas industry. As long as Gazprom remained important to the Russian state, the European gas market would remain important to Russia. In the early 1990s, Russia, with the support and guidance of the IMF and Western experts, simultaneously undertook a massive move towards privatization and market liberalization. The energy strategy promoted in the 1990s by leaders such as Yegor Gaidar and Anatoly Chubais under President Boris Yeltsin similarly focused on privatization and demonopolization. Gazprom was transformed into a commercial entity by Presidential decree on November 5, 1992, and following this, the firm’s shares were split between the Russian Federal government, American depository receipts, and the Russian people, with the Russian government holding approximately 40 percent of the shares.

The means by which Gazprom was “privatized” initially, however, led to

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43 Poussenkova, “Rethinking Russia.”
44 Bahgat, 166.
consequences for the firm later. As Treisman retells is, the company was already prepped for privatization in the final years of the Soviet Union, when Viktor Chernomyrdin, the last Soviet gas minister, “packed together the plants, refineries, and pipelines of the Soviet gas industry into a monopolistic concern, Gazprom,” before personally overseeing the company’s privatization.46 According to Treisman, most of the company’s shares remained in the company, spread amongst managers and employees, and Rem Vyakhirev, who took over for CEO of Gazprom after Chernomyrdin moved to his role as Prime Minister, developed a scheme whereby he could only be removed from the company by, essentially, his own vote.47 With these entrenched interests “privatizing” Gazprom only amongst themselves and to their own benefit, Gazprom never underwent full-scale privatization and “the liberal model never took hold in the gas industry.”48

According to Nemtsov and Milov, under Boris Yeltsin Gazprom was used “to solve political problems,” such as helping the state pay out pensions at one point, and under both Yeltsin and Vladimir Putin Gazprom has been a “wallet” for Kremlin elite.49 Whether or not this is the case, it does appear that under Putin the possibility of greater autonomy for Gazprom was no closer to realization. However, the firm was able to bring in new leadership and become something more akin to a profit-driven company.

In 1999, when Putin took over as acting President, Russia’s central government remained enfeebled, its leaders seemingly unable to make decisions without the assistance of powerful “oligarchs.” The Kremlin under Putin took on the task of recapturing the power of the state and regaining a sense of Russian pride that he believed

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47 Ibid., 225.
48 Åslund, “Russia Energy,” 2.
had been damaged by the humiliation of the failures of the 1990s. Part of this meant ridding key industries of their old Soviet-era managers. In 2001, Putin removed Rem Vyakhirev and replaced him with Aleksei Miller as CEO of Gazprom, and since then the company has been continually focused on increasing prices and, by extension, revenue for the firm.⁵⁰

However, by determining Gazprom’s leadership through the Kremlin and not through privatization, Putin strengthened Gazprom’s relationship with the Kremlin and reemphasized its task of sustaining domestic industry though subsidized natural gas, which, for Gazprom as a commercial entity, was “a schizophrenic assignment,” according to Abdelal.⁵¹ With Gazprom’s subsidizing the inefficient post-Soviet economy with cheap gas, Putin was able to help rebuild the Russian state and garner his own political support, but Gazprom benefited least. Not only did Gazprom fail to make money on the Russian market at this time, but there were also periods when the firm’s cost of production was greater than the Russian market price.⁵²

In Putin’s second term the Kremlin reasserted its control over the company. Seeing the benefits of increased political power through hydrocarbon exploitation, by 2005 Vladimir Putin was committed to pursuing a reversal of Yeltsin’s privatization plan for the so-called “strategic sectors.”⁵³ State capitalism’s reintroduction into the oil industry culminated with the takeover of YUKOS and the imprisonment of Mikhail Khodorkovsky in 2004, and for the gas industry, it reached its apogee in the same year.

₅₀ Åslund, “Russia Energy,” 3.
₅² Ibid., 10.
₅³ Åslund, “Russia Energy.”
with the state’s acquiring a majority stake in Gazprom.\textsuperscript{54} Since then, the central government has held 50.002 percent of Gazprom’s shares.\textsuperscript{55}

3. WHY CONTINUED KREMLIN INTERFERENCE?

But why was reasserting control over the already only partially privatized Gazprom important for the Kremlin? While oil and gas as a portion of Russian budget revenue make up around 56.2 percent,\textsuperscript{56} natural gas actually contributes less to the Russian budget relative to oil. According to analysts at Rice’s Baker Institute, as of 2009, for every dollar of revenue Russia received from oil exports to Europe, it earns 86 cents for the equivalent volume of gas.\textsuperscript{57} Moreover, Gazprom is not the only natural gas company in Russia, and by many accounts, such as that of Russia’s Federal Antimonopoly Service Igor’ Art’emov, it is a “highly inefficient company.”\textsuperscript{58} If this is the case, what is it that has inspired the Kremlin to support Gazprom abroad, as opposed to pushing it aside and allowing the new producers to take its place?

If Gazprom were a useful geopolitical tool, this would help explain why the Kremlin has continued to take active interest in Gazprom’s disputes in Europe. However, Gazprom’s effectiveness as a geopolitical lever today may not be as strong as widely perceived, and certainly weaker than it once was. If Gazprom’s ability to carry out its geopolitical mandate were weak, then what would provide the incentive for continued

\textsuperscript{54} Yang et al., 144.
\textsuperscript{57} Fang, Jaffe, and Temzelides, 17.
Kremlin interference in its activities abroad? This section argues that in there are two additional factors, as deeply ingrained in Gazprom’s model as geopolitics once was, that serve as this basis for support: Gazprom serves as a source of rent in Russia’s “virtual economy” and as a manifestation of Vladimir Putin’s and Russia’s philosophical views on natural resources. While geopolitics, rents, and philosophical views of natural resources might all influence Gazprom’s decision-making, it is the latter two especially that can help explain why the Kremlin might interfere in Gazprom’s decision to the point of detriment to the firm itself.

**Gazprom as Foreign Policy Tool**

Historically, there is little doubt that gas was a tool for Soviet domestic policy, as it subsidized industry in the territories of modern-day Russia, Ukraine, Belarus’, and the Baltics. After the dissolution of the Soviet Union, a gas glut allowed this practice to continue, and what was Soviet domestic policy became Russian foreign policy, though the difference was primarily in name. However, Russia has steadily lost its ability to influence geopolitics through natural gas exports, and as Goldthau argues, Russian energy strategy today may “not [be] primarily about geopolitics,” but rather, “gas disputes” between neighbors are undertaken foremost out of profit maximization.59

While Russia has interfered in Gazprom’s business dealings with its European customers, we have not seen that politicizing gas disputes helps resolve them. Goldthau60 and Abdelal61 both argue that a natural gas policy based on acquiring geopolitical influence is unnecessary for Russia, for it is in Russia’s interest to foster, not break, ties

60 Ibid., 56.
61 Abdelal and Mitrova, “U.S-Russia Relations and the Hydrocarbon Markets of Eurasia.”
with its European partners. In this vein, Gazprom has supported long-term contracts and built pipelines not because doing so subjugates transit countries or end consumers to Russia, but because long-term contracts and gas transit infrastructure create a stability that decreases risks to the market, for both the producer and consumer. According to this line of thinking, building a pipeline demonstrates the producer’s commitment to a long-term relationship with the consumer, for it is literally not worth it to break relations once the “high upfront costs” have already been made.62

Some pundits, such as Dmitry Mikheev, formerly of the Hudson Institute, believe Russia’s goal is to make its neighbors “addicted” to Russian oil and gas before suddenly shutting off the pipes,63 as if natural resource exports were fundamentally punitive tools. Not only do such views fail to consider Russia’s reliance on these exports for its own survival, but they also fail to consider the good relations Gazprom has formed with its European customers, who have continued to sign contracts for Russian gas. Even in 2004, at the height of Putin’s heavy-handed recentralization of the energy sector, Fiona Hill noted that (speaking in terms of oil), “even with these problems” Russia was a more reliable supplier than was the Middle East.64

Today, in terms of gas, Gazprom has alienated many by shutting off flows to Ukraine, but it has nonetheless demonstrated relative reliability as a supplier. Unlike in the Eastern Mediterranean, for example, where pipelines are at threat from terrorist groups as well as governments, and where the Arab-Israeli gas pipeline was permanently closed in 2010 after numerous terrorist attacks, leaving Israel suddenly without a supply

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62 Goldthau: 56.
64 Hill, 31.
of natural gas, Gazprom not only continues to ship gas through its existing pipelines, but it has also proven willing to build even more pipelines to reach the same consumers when transit states are unreliable. Moreover, as Patrick Armstrong points out, despite warnings from the West that it would do so, Russia has not seized pipelines, conquered Georgia or Azerbaijan, or shut off gas in any situation that cannot be explained through an inherently commercial logic.  

Given these considerations, while Gazprom’s actions may have geopolitical impact, the firm itself does not appear to act primarily for Russia’s geopolitical interests outside of the context of profit maximization. If this is the case, there are likely additional factors at play that cause the Kremlin to continue to take active interest in Gazprom’s business dealings, especially at the expense of long-term profit maximization. Two of these possible factors may be Russia’s dependence on a rent-based economy and Russian leaders’ approach to the natural resource sector.

**Gazprom and Russia’s Virtual Economy**

According to Gaddy and Ickes, one cannot understand Gazprom without assessing the role of rents in the Russian economy. Since 1992, the authors contend, natural gas has been a steadily growing source of rents in the Russian economy, totaling about one-third of the total rents from 1991-2005. The authors attribute much of this to Vladimir Putin, who increased “formal” (or transparent) rents from the oil sector through increased taxation while continuing to transfer gas rents to the domestic economy through other

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65 Voice of Russia, “Is Washington’s Concern over the ‘Russian Menace’ in the EU Energy Market Justified?”  
67 Ibid., 562.  
68 Ibid., 564-565.
means, chiefly lower prices, totaling over ten billion dollars per year in savings for Russian industry over the past ten years, as noted above.

The other part of the increase, however, has come from what Gaddy and Ickes call “informal rents,” or rents determined by the payee in order to secure political protection. In the hydrocarbon sector, these rents can take many forms, from cash, to social spending, to subsidized prices. Whatever the form, these are paid to provide political protection for the rent payers.69 In the natural gas sector, these rents have primarily taken the form of subsidized prices for the domestic economy. In return for providing these rents, Gazprom has been allowed (until recently, as discussed in part three) to maintain its monopoly control over gas exports and pipeline access.

The culture of rents is not new to Russia, but rather a holdover from the Soviet system. Gaddy and Ickes demonstrate the continued correlation between GDP and oil and gas rents in the Soviet and Russian economy from 1970-2005, arguing that rents were not only a product of the natural resource-based economy, but its very foundation. According to the authors, the erroneous belief amongst some in Soviet policymaking circles that Russia’s resource base was inexhaustible led to poor use of the resources and to the creation of a manufacturing base that depended on unlimited, cheap natural resources.70 In this sense, the subsidized prices of natural resources formed the very economy that continued to exist after the dissolution of the Soviet Union, and Russia continues to struggle with this dependence on natural resource rents today.

This system failed to account for the depletion of natural resources, and when oil production began to decline and gas partially took its place, it was the widespread system

\[69\] Ibid., 565.
\[70\] Ibid., 569.
of natural gas rents that sustained the domestic economy through the mid 1990s until the price of oil recovered in 1999 and export revenues returned.\textsuperscript{71} The downside to natural gas’ saving the economy, however, was that there was no period during which Russia was able to move away from a rent-based system, which has allowed a culture of rent seeking from natural gas to remain entrenched to this day.

Moreover, distribution of rents is a politically useful tool in a top-down system, and Gaddy and Ickes believe this is necessary in Russia, where lack of developed institutions requires allies and friends, who can be purchased through rent sharing.\textsuperscript{72} While Putin removed some of the main rent-sharing oligarchs of the 1990s with his rise to power, he allowed the rent-sharing system to remain, but centralized and controlled it so that those wishing to gain from the state would have to contribute to it through informal rents. To consolidate Kremlin control over the gas industry, Vladimir Putin has installed his allies in leadership positions in Gazprom, switching leaders between public service and top Gazprom positions. By using this tactic, argues Vladimir Milov, former Deputy Minister of Industry and Energy of the Russian Federation, Putin has not only increased control over the natural gas sector, but has subjugated a wide range of sectors to the state, including television—the primary source of news in Russia—via Gazprom, which owns major shares in state-owned companies across various sectors.\textsuperscript{73} This tactic benefits the Kremlin, for with loyalists in positions of power in Gazprom, the firm is more easily molded into a vehicle for rents and a proxy for the government within the gas industry. The state can then use the firm’s export revenue to finance “social, budgetary,

\textsuperscript{71} Ibid., 570.
\textsuperscript{72} Ibid.
and private…special projects,” as opposed to placing the revenue back into the company or dividing it amongst shareholders.

Placing such individuals in positions of power in the hydrocarbon sector to secure state firms as vehicles of rents is a proverbial double-edged sword. As more influential individuals become connected with Gazprom, their fates become more intertwined with that of the company. Subsequently, the lobbying power of the gas industry becomes ever greater, as these individuals desire to see its power increase. Notably, though, since the elites in power desire foremost a vehicle for rents, the lobbying power supports continued inflow of rents, not efficiency. Gazprom may continue to act commercially, for rents are derived from its profits, but in paying rents the revenue flows not back into the company but into the pockets of the rent seekers.

To maintain their steady flow of revenue, Russia’s hydrocarbon firms must be able to carry out the Kremlin’s populist agenda, but they must also make money to provide the funding for these populist policies. In this sense, the firms both supply the rents and, in some instances, apply the rents. Given their interest in carrying out the Kremlin’s programs, which in turn ensures their own survival, these elites have developed a symbiotic relationship with Vladimir Putin. Bukkvoll traces the rise of Russia’s oil and gas elite within Putin’s “winning coalition”—or the group that helps Putin remain in power and in return can influence policy—to 2001. Until that point, argues Bukkvoll, the gas lobby had seen a rise in influence from 1993-98 under Prime Minister Viktor Chernomyrdin, former Gazprom Chairman, followed by a fall from 1998-2001,

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74 Ibid., vi.
75 Bukkvoll, 225.
when Prime Minister Yevgenii Primakov had hoped “to use the income from the export of oil and gas to subsidize the revival of other groups of the Russian economy.”\textsuperscript{76}

These elites, according to Milov, have created a firm that “leaks value” while serving private interests as expenses rise faster than profits.\textsuperscript{77} Despite the inefficiencies such a system creates, however, the utility of a vehicle for the rent-based economy remains as important to Russia’s domestic political leadership as does the natural gas sector’s ability to create revenue. In this sense, understanding the strength of the rentier economy in Russia helps shed light on why Gazprom in particular continues to garner such strong political support from the Kremlin, even if this very group of supporters contributes to the firm’s inefficiencies.

\textbf{Gazprom and the Russian approach to Natural Resources}

The culture of rents in Russia and in Gazprom manifests itself in the firm’s glaring inefficiencies, perpetuated by an allegedly widespread culture of corruption that encourages expenditures to maximize kickbacks instead of long-term capital investment.\textsuperscript{78} These issues would not be necessarily widespread were the company forced to compete amongst other gas producers to succeed, but thus far the monopolistic control over Russia’s natural gas exports and transit hinders any attempts to reform through competition. State control encourages firm managers to reinforce their monopoly power through regulation rather than through responding to competition.

We have seen thus far many explanations for this monopoly, from an historical legacy, to the possible use of gas as a foreign policy lever, to the role of gas revenue as an integral part of a rent-based economy. One final, additional basis for the ambiguity

\textsuperscript{76} Ibid., 233.
\textsuperscript{77} Milov, [Introduction] to Kevin Rosner, vii.
\textsuperscript{78} Åslund, “Russia Energy.”
between state and firm that should not be overlooked lies in Russia’s philosophical approach to the extractive industry itself. As Wright and Czelusta note, “Minerals themselves are not to blame for problems of rent-seeking and corruption. Instead, it is largely the manner in which policymakers and businesses view minerals that determines the outcome.”

To better understand why certain policies are undertaken, it is therefore important to pay attention to the way Russians and particularly their key policymaker, Vladimir Putin, view their natural gas abundance.

Russians historically approach land rights from the belief that “the Motherland is created sacred and ought not to be bought or sold.” Such a notion is contrary to individual property rights, and it was ingrained in Russian history through a long history of collectivism and nationalization under communism. This history has thus far influenced the way policymakers think of the land and the resources it contains. Indeed, as Balzer outlines in his analysis of Vladimir Putin’s doctoral dissertation and accompanying 1999 article, Putin argued in 1999 that, “Regardless of whose property the natural resources and in particular the mineral resources might be, the state has the right to regulate the process of their development and use.” In these statements we see both the importance of natural resources to Putin from an early stage and the importance of these resources in providing for the wellbeing of the Russian state. Thus, despite moves towards liberalization, there is an underlying belief amongst Russia’s top leadership that natural resources belong not to firms, but to the people, to be controlled by the

representative of the people—the state. While this might not be a unique notion for many states around the world, in Russia it has helped influence the development of and, moreover, the struggles inherent in, the natural gas sector.

The way of thinking about natural resources in Russia is important for the natural gas sector as Russia has by far the largest proven natural gas reserves in world, with 21.4 percent of the world’s total. Russia is the world’s second largest gas producer after the United States, producing roughly 670 billion cubic meters in 2011, according to U.S. Energy Information Administration statistics. Yet for Putin, these resources are simultaneously a tool to be exploited if need be to hold the country together, at times at the expense of the firm.

Cheap oil and gas have in particular been important for Russia’s manufacturing base, which has historically been focused on energy-intensive intermediate goods and dependent on Russia’s hydrocarbons for success. In Garanina’s 2008 analysis, the manufactured goods for which Russia is most advantaged all rely on the hydrocarbon sector—goods such as fertilizers, organic chemicals, iron and steel, and power generating machinery. Russia’s central government has been historically averse to assuming the costs of these subsidies itself, and the burden has fallen to actors such as Gazprom, which was expected after the collapse of the Soviet Union to support inefficient industry

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in return for its monopoly on the export of Russian natural gas and access to domestic gas transit infrastructure.

Since the 1990s, the Kremlin, at Gazprom’s urging, has sought across the board increases in its domestic gas prices. However, reform in the residential sector, which makes up 19 percent of Gazprom’s market today, according to Gazprom, has been particularly slow in coming, and prices remain at low, regulated prices.

As Simon Pirani notes, providing cheap gas to households has a long history in Russia. In the early 1990s, the Kremlin was unwilling to increase these prices given the difficult economic climate and the expectation among citizens that basic social goods would remain paid for. In addition, having witnessed the largest street protests Putin had seen to that point in 2004 when it monetized benefits, as chronicled by gazeta.ru, the Kremlin was hesitant to increase prices in the gas sector because of the social policy component of natural gas subsidies for residential use. When the decision was made in 2007 to liberalize gas prices, the Kremlin excluded the residential and municipal sectors from the price reform.

The belief in Russia that natural gas is a public good, and the history of providing this good to the people at subsidized rates thus lessened the political will to liberalize gas prices until 2007, and even then not all gas prices were included in the liberalization measure. Then, after 2007 the world entered economic crisis in 2008-09, followed by contentious Duma elections in Russia in 2010 and an even more fraught announcement

that Vladimir Putin would return to the Kremlin in 2012, and there has been no moment yet that the Kremlin has found opportune to increase domestic gas prices for the housing sector. Indeed, in the run-up to the 2012 presidential election, for example, candidate and then Prime-Minister Putin announced he would be putting off increases on natural gas tariffs until the summer, or after the election. While partially this may have been a weather-related decision, keeping prices lower when gas is more crucial for heating one’s home, the announcement also meets political ends, as it appeals to the electorate, albeit at the expense of Gazprom’s profits. Due to such practices, Gazprom’s attempts to liberalize prices within Russia remain hindered not only by commercial factors such as moving targets for netback parity, but also by the Kremlin’s inertia.

Though it has pushed for higher prices, Gazprom continues to provide cheap gas to the Russian market in return for its protected position in natural gas exports. The Kremlin will provide Gazprom an export on gas abroad in return for the latter’s providing subsidized gas domestically, which the Russian people have come to expect, and which Putin appears to agree Gazprom should supply. Today Gazprom faces increased competition on the European market, and with its export market under threat, providing for the domestic economy is increasingly unattractive. However, while the Russian public continues to expect cheap residential gas prices, and given the philosophy behind public versus private resources that leads the Kremlin to believe Gazprom should provide this gas, increasing gas prices in this sector appears yet out of reach.

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4. POLITICS AND COMMERCE INTERMINGLED—THE UKRAINIAN GAS DISPUTES

While Gazprom is a commercial firm, the Kremlin continues to have geopolitical interests, and while the Kremlin controls tariffs on gas exports, it has the ability to interfere into Gazprom’s business dealings for its own ends. Politicizing gas disputes may not be effective in the long run, but this has not stopped the Kremlin from stepping in to Gazprom’s high-profile disputes with its neighbors. In doing this, the Kremlin has fostered a negative perception of the Gazprom within the public opinions in Gazprom’s export markets. Whether Gazprom has acted more commercially or more politically in Europe becomes a moot question once European governments begin to perceive the firm as a geopolitical tool. Gazprom does not argue that it is a commercial entity out of concern for semantics, but rather because there are concrete commercial consequences to being perceived as proxy of the Kremlin in its export markets. Thus far, the need for Russian gas and a history of reliable supply has led the bulk of Europe to continue to rely on Gazprom. However, Russia’s general geopolitical posturing, at times seen through the lens of natural gas disputes, has fostered a sense amongst EU policymakers that the firm is to a large extent politically-driven and thus, a geopolitical threat. Until recently, market conditions had not given rise to a need to change policy, but today, amidst the changes in the European gas market, such views are able to gain traction and have lent support for a strategy of increased diversification of energy imports.

To more fully understand the current anti-Gazprom sentiment and actions undertaken in the EU, it is useful to look briefly to the high-profile gas disputes between Russia and Ukraine in 2006 and 2009, respectively. The Ukraine-Russia disputes are key
because they contain all of the elements that have contributed to these anti-Gazprom biases—Kremlin interference in an otherwise commercial dispute, historical subsidies, and Soviet legacy.

When the Soviet Union fell, the Soviet gas infrastructure, which spanned numerous republics, was divided among the newly independent states, and ownership of assets was transferred to the nations on whose territory they lay. Ukraine inherited a 1,100 km pipeline system for natural gas transportation through which 97 percent of Russian gas was transported until the Yamal-Europe pipeline reached full capacity in the 2000s, decreasing the share of Russian gas through Ukraine to 80 percent (110-120 bcma).91

With such a large percentage of natural gas transiting Ukraine, Gazprom was dependent on Ukraine, and Ukraine, with its own reserves having entered into decline in 1970s, was dependent on Gazprom’s west Siberian gas.92 According to Pirani et al., this mutual dependence strengthened from 1991-97 as both Ukraine and Russia were weakened by economic decline after the collapse of the Soviet Union.93 Ukraine, with an industrial base dependent on natural gas and lacking alternative sources of energy, was unable to find a replacement for Russian gas. At the same time, Russia, as we have seen, was in need of keeping its fragile domestic economy together with subsidized gas prices that it offset through exports to Europe, thus creating a mutual dependence.

Although they needed each other, the relationship between Gazprom and Ukraine was tense throughout the 1990s, with Ukraine’s inability to pay for gas, alleged stealing

93 Ibid.
of gas intended for Europe, and inability to agree on alternative means to pay for the gas, all contributing to increased animosity. Despite the tension, Ukraine ultimately had more bargaining power, and with a gas glut following the dissolution of the Soviet Union, Gazprom was not in a position to block transit through Ukraine. As a result, Ukraine was able to negotiate favorable gas prices in return for the transit of Gazprom gas to Europe.

Recognizing the losses it was making on the market but still needing to transit Ukraine, Gazprom attempted to diversify supply in Ukraine, encouraging, for example, Turkmenistan to sell gas to Ukraine to lessen its burden in that market. It also set up intermediaries such as Itera, Eural Trans Gas, and RosUkrEnergo to transport the gas, thus creating a buffer between Ukraine and Gazprom. These latter moves were met with criticism in Europe and Ukraine, as they were seen as opaque, and the excessive salaries paid to their CEOs lent a sense that Gazprom was charging unnecessarily high prices for its gas.

This arrangement was fraught with tensions that culminated in 2005, when Gazprom and Ukraine failed to agree on a contract for gas transit prices. Until that year, Russia’s pricing and subsidies for CIS states were determined on an *ad hoc* basis and differed between countries and by year. In 2005, however, following three years of steadily increasing oil prices in Europe and, consequently, natural gas prices, the price differential between European gas and CIS gas was great enough that Gazprom changed its policy, calling for increased prices within the CIS countries to meet netback “market

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96 Closson, 350.
prices,” which meant “Germany’s gas prices minus transportation costs plus an X factor of profit for Gazprom.” In 2006, the Russian government first decided to attempt to reach netback parity, a goal it has failed to reach but nonetheless strives for to this day. Since most of Russia’s gas transited via Ukraine, it was key that Ukraine adopt these new prices.

While Russia argued at the time that the impetus to move to market-based pricing at this time was commercial, the way it was implemented evidenced some underlying political motives; the timetables for countries more closely aligned with Moscow politically (Belarus and Armenia) were longer than those for countries seeming to stray from Russia’s orbit (Ukraine and Georgia). While it appears that both commercial and political factors played a role in these cases, the ultimate result of their aligning was a backlash against both Gazprom and Russia that has increased the tenuousness of Gazprom’s position in the European market.

As Abdelal retells it, Ukraine was the first to propose moving to market-based tariffs and prices. According to a statement made by Alexei Miller on March 28, 2005 that Abdelal cites as the basis for his position, Ukraine proposed “transparency and market-based mechanisms of interactions between firms,” and Gazprom supported “increasing the gas transmission tariff rate to the level adopted in Europe.” At the same time, in 2005, as Western analysts and policymakers were quick to pick up on, Russia decided to punish Ukraine for its failure to elect Russian-backed presidential

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99 Ibid.
100 Pirani et al., 7.
candidate Viktor Yanukovich in the so-called “Orange Revolution” of 2004, perceived by
the Kremlin as a Western-backed regime change.

Negotiations on increasing the price stalled, with Ukraine amenable neither to a
higher price for 2006 nor an agreement whereby prices would be kept low in return for a
transfer of a stake in Ukraine’s gas transport system to Gazprom. On January 1, 2006,
the existing contract expired without a new contract being signed, and for three days gas
to Ukraine was shut off\(^\text{102}\) until deals could be struck on prices and on the role of the new
intermediaries in Russian-Ukrainian gas trade.

Following 2006, oil prices again rose, and again European gas prices rose with
them. However, Ukraine had demonstrated in 2006 that to some extent it has the upper
hand in gas disputes with Russia, as it could block shipments to Europe. To some extent
this made Russia less willing to shut off volumes to Ukraine, but at the same time, Yulia
Tymoshenko came to power in Ukraine as Prime Minister and set out to push
RosUkrEnergo out of the market, placing business and politics at odds\(^\text{103}\) and providing
the necessary impetus for Gazprom’s actions.

Russia reduced the shipment of volumes meant for the Ukrainian market in
January 2006, though it continued shipping volumes pre-paid for by European customers.
However, pressure in the pipeline exiting Ukraine dropped, indicating that gas was taken
out unpaid for in Ukraine. On January 1, European customers received from 25 to 40
percent less gas than they had paid for.\(^\text{104}\) Europeans blamed the Russians for failing to

\(^{103}\) Pirani et al., 10.
supply the gas, and Russia blamed Ukraine for “stealing”\textsuperscript{105} the European-bound volumes.

There are numerous instances in which Russia has cut off oil and gas supplies to the newly independent states, typically due to these states’ inability to pay, according to Gazprom,\textsuperscript{106} and gas had been first shut off to Ukraine in 1992. In 2006, however, these disputes gained international attention,\textsuperscript{107} largely because they were so highly politicized. As a result, Gazprom’s image as a commercially-minded company gave way to the perception that Gazprom is a vehicle for Russian geopolitical maneuvering.

While the 2006 gas dispute was temporarily resolved, this did not finally settle the long-term dispute with Ukraine over pricing. The 2006 dispute ended with Ukraine still only paying half of the European price, though the price for its gas would nonetheless increase twofold. While it agreed to this deal, Ukraine was unable to pay for the gas at these new rates, and by 2009 it was $2.4 billion in debt to Gazprom and again accused by Aleksei Miller of stealing Russian gas.\textsuperscript{108} It is unclear why Gazprom let the debt increase to these levels. Pirani et al. consider that perhaps Gazprom had waited because it did not want to halt supplies of gas until a new contract could be concluded, but then in 2009, settling supplies, prices, and tariffs made commercial sense because oil prices were falling and quickly reducing Gazprom’s revenue, so Gazprom had to collect these past dues from Ukraine, especially as RosUkrEnergo had failed to monitor the situation and collect the money.\textsuperscript{109} As a result, again on January 1, 2009, Gazprom cut the volume of

\begin{footnotes}
\item[106] Closson, 352.
\item[107] \textit{Ibid.}
\item[109] Pirani et al., 18.
\end{footnotes}
gas entering Ukraine by 110 million cubic meters. This was, according to Abdelal, the exact amount that had been allotted for Ukraine’s domestic consumption, while volumes pre-paid by European customers continued to be compressed and transmitted and, according to Putin, the dispute was again entirely commercial, though Ukraine was trying to drag Russia into its own domestic problems. Ultimately negotiations remained unresolved, and on January 7, Gazprom completely halted supplies to Ukraine until a new agreement could be reached, which occurred on January 19.

In the case of the Russian-Ukrainian gas disputes, the line between Gazprom’s priorities as a firm and Russia’s political priorities is vague. It is unjust to claim in this case that the dispute was primarily political or primarily commercial, for both politics and profits determined the way these originated and played out.

In these disputes, however, popular opinion that was formed arguably had more lasting impact than did the commercial aspects of the dispute. In Western media, there were reports of people freezing to death, and while Gazprom shut off the gas, the perception of Gazprom as a political tool was already widespread, and the deaths were attributed to “Russia’s cutoff,” not Gazprom’s. Ultimately, it was this narrative that portrayed Ukraine as the victim to the bully Russia—a view strengthened by the belief that Russia was punishing Ukraine for its “Orange Revolution” and then Westward-leaning Viktor Yushchenko’s rise to power—that became popular in the West.

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Moreover, Vladimir Putin’s weighing in further politicized the dispute, when the President claimed that “Russia would not subsidize energy prices for ‘Orange forces.’”

While the gas disputes between Russia and Ukraine have a long history, the 2006 and 2009 disputes occurred at a time when the European market was poised to unexpectedly benefit from a gas glut following the United States’ newfound abundance. For Gazprom, the disputes sped up the necessity of avoiding Ukraine as a transit route. Moreover, though, it increased tensions between Gazprom and the Kremlin, as the commercial disputes became too entangled in politics for Gazprom’s comfort. Thus following the disputes, Gazprom attempted to extricate itself from political dealings with Ukraine as evidenced by its renewed emphasis on supply routes such as Nord and South streams that bypass Ukraine, though the Russian state continued to have interests in Ukraine, primary among them the Black Sea naval base, located in Sevastopol’, in the Crimea. In 2010, the naval base’s lease was up and then-Russian President Dmitry Medvedev negotiated deal with Ukraine’s President Viktor Yanukovich, whereby Russia would pay cash in addition to discounted gas for the continued lease of the Black Sea base. However, the discount came not through a decrease in the price of gas, but through a reduction in Gazprom’s duties for export to Ukraine.

In other words, Gazprom, which saw Ukraine as a liability, was not to pick up the bill for meeting political ends in Ukraine; rather, these would be paid for by the Russian state, signaling a break in the symbiosis of Gazprom’s relationship with the Kremlin and an unwillingness to continue such a relationship unchecked.

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114 Closson, 352.
116 Ibid.
However, by 2009, this distinction may have come too late; the belief that Gazprom pursued the Kremlin’s political agenda was cemented into policymakers’ minds in the West. The consensus was that, while Putin had announced upon taking office that he would be raising prices of natural gas to match “market” prices, the speed with which this process was to take place depended in part on countries’ being amenable to Russia’s political ambitions.

Tension and mutual distrust persist in gas price negotiations between Russia and Ukraine to this day, and the countries continue to disagree on price, despite changes in leadership. Ukraine continues to argue for discounted gas, but Gazprom CEO Alexei Miller meanwhile claims he sees “no reason to review the price” with Ukraine, and Gazprom has billed Kiev for $7 billion to account for the gas it did not transit in 2012 as stipulated in its take-or-pay clause.¹¹⁷ This is the very strategy that some policymakers in Europe and the United States view as a political tactic—increasing prices until transit states or consuming states are forced to give up their autonomy to Russia through the sale of energy infrastructure. Thus far refusing to accede to Gazprom’s offer, Ukraine has undertaken a strategy of diversification, seeking gas supplies from sources outside of Russia (chiefly Russian gas resold via Poland), attempting to improve energy efficiency, increasing coal imports, and pursuing domestic gas production. Ukraine’s Naftogaz has signed deals to explore possible shale gas deposits and has held talks with hopes to build its own LNG terminal, and in December 2012 signed a deal with China’s CNPC to help

finance the projects. As a result of these tactics, Ukraine’s gas imports from Russia in H2 2012 fell by nearly half the amount from the same time the previous year.

Gazprom, in turn, is resorting to a strategy of Ukraine-avoidance, expending billions on new pipelines that circumvent Ukraine, as detailed below. This is a move Gazprom has been pursuing since the mid-1990s, but which has taken on renewed force after the 2006 and 2009 gas disputes. Avoiding Ukraine is useful as Russia and Gazprom must maintain their reliability as suppliers of natural gas as much as possible. While ultimately the underlying issue is one of price, a legacy of subsidies and favored position as an ally of Russia has led Ukraine to believe that it should receive a lower price than other countries. This, compounded with inefficiencies and corruption in its own energy market, makes Ukraine unwilling to pay for gas at prices pre-negotiated with Gazprom. However, the historical legacy of Soviet natural gas remains in place today, most visibly in the form of gas pipelines across Ukraine. While Gazprom has been building pipelines to avoid Ukraine since the 1990s, the process is slow and costly. Instead, working within this context and drawing on a legacy of barter, Gazprom has allowed Ukraine to pay for its gas in-kind, selling its energy infrastructure to Gazprom in exchange for forgiveness of its debt.

For Ukraine, increased prices and the sale of its gas infrastructure signal both a loss in revenue and a lessening in political influence. Moreover, Russia has proposed alternatives to the sale of infrastructure that have little to do with natural gas, further contributing to the belief that the Kremlin, not Gazprom, dictates natural gas export

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policy. On October 9, 2012, Ukrainian Prime Minister Mykola Azarov claimed that Russia “offered Kiev the opportunity to join the Customs Union, and in return receive Russian gas for $160 per thousand cubic meters (Tcm), an offer that falls outside of what might be justifiable for Gazprom, indicating instead the Kremlin’s attempt to lure Ukraine back into Russia’s sphere of influence. Ukraine has chosen to emphasize the political element of the gas negotiations, portraying Russia as a bully, which it is more easily able to do because of the history it has with Russia that based on the geopolitical realities of the Soviet Union, tensions spanning back into Medieval Russian history, and because the Kremlin decided to step into the dispute, clearly politicizing it.

Ukraine’s insistence that the dispute is political has also lent more credence to the geopolitical undertones of Russia’s tactics with its other neighbors vis-à-vis natural gas. As Åslund notes, Gazprom’s pipeline shutoff scenarios outside of the Ukraine example are hard to justify from the perspective of profits. Rather, these strong-arm tactics have led to losses for Gazprom. In 2009, Gazprom shut off its pipeline from Central Asia, following a long history of price disputes, causing it to explode in Turkmenistan. As a result, a new pipeline was built transiting Turkmen gas to China, taking customers away from Russia’s planned Altai route to ship gas to China. In addition, not only is Turkmen gas now flowing to China, but it also has prospects of competing with Gazprom’s gas in the Turkish market. As Michael Fredholm notes in his analysis of gas shutoffs during

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120 Lilit Gevgorgyan, “Ukrainian PM Confirms Russia's "Gas for Economic Integration" Offer,” IHS Global Insight, October 10, 2012.
the Yeltsin years, Gazprom has never found success from such energy tactics, which have always hurt the company in the end.\textsuperscript{123}

In this sense, it is tempting to view these shutoffs of gas, including that to Ukraine, as political moves made by the Kremlin, rather than Gazprom decisions made in response to price disputes. Given Alexei Miller’s statements and Gazprom’s need to ensure reliable supply to Europe while simultaneously moving away from price subsidies, most likely these decisions included both political and commercial elements. However, it was the politics that resonated more with European audiences, and the Kremlin interference in these disputes solidified preexisting beliefs that Russia attempts to influence its neighboring countries through natural resources and non-competitive pricing, as did the Soviet Union. As a result of this perception, the European Commission has responded with probes into Gazprom’s pricing mechanisms and presence in Europe, with consequences both for Gazprom and for Russia.

PART 2: GAZPROM AND THE CURRENT WORLD NATURAL GAS ENVIRONMENT

Thus far, Gazprom’s existence has been predicated on access to a stable European market that it can rely on to absorb price risk, made all the more necessary as Gazprom continued to provide for the Russian economy in return for its domestic control over exports and domestic pipelines. What Gazprom did not account for, however, is that the permanence of pipelines or a history of sales does not necessarily equate to the permanence of a loyal customer base. Gazprom’s long-term goal since the 1990s has been to expand both upstream and downstream to maximize revenues, but it continued to be held back by its need to serve the domestic market. While it has been moving towards export netback, the process has been slow. Though Gazprom is creative in its ways of adapting domestically, moving down the value chain in gas-heavy sectors, such as electricity generation, it has been impeded by lack of across the board modernization in Russia and lack of the political will necessary to make the investments in both the economy and the firm that would make it competitive against increased competition.

Unfortunately, new developments in the world natural gas market appear to have caught Gazprom by surprise, and the model by which it has historically existed has now steered it towards possible crisis. Rallying behind an increase in gas import options and perceptions that Gazprom in part carries out the Kremlin’s mandate, as discussed below, policymakers in the European Union have begun to push for market liberalization in ways that threaten Gazprom’s business model.

While the previous section outlined the way Gazprom’s requirements in the domestic market have hindered its ability to maximize profits, this section discusses new external threats to Gazprom’s European market. Chapter five lays out the genesis of new
supply in Europe and the threat this poses to Gazprom, while chapter six discusses anti-monopoly policies in Europe also threatening Gazprom’s operational model.

5. THE IMPACT OF THE “SHALE REVOLUTION” AND CHANGING EU ENERGY TRENDS

Exxon Mobil predicts that natural gas will overtake coal as the second most popular energy source in the world after crude oil by 2025, with demand growing by 65 percent through 2040.124 This could be good news for Russia, since Gazprom is the largest gas producer in the world, accounting for 78 percent of Russian and 15 percent of global gas output, according to its own statistics.125

After the dissolution of the Soviet Union, Gazprom continued to grow in importance. Its pipelines spread like webs across the territory of the Former Soviet Union and into Europe. However, as we have seen, Gazprom’s export market is not diversified. While Gazprom maintains monopoly control of Russia’s domestic pipeline network and oversees the world’s largest gas transmission system,126 its pipelines pump gas westward, and it has historically lacked a significant market to the East.127 Thus far, Gazprom and the European Union have had a mutual dependence; Europe has had few other options outside of Russian gas, providing Russia a sense of comfort with its

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Eurocentric export model. The increased popularity and availability of natural gas is changing this, however.

In the last decade the European Union has seen increased liquefied natural gas (LNG) imports, displacing Russian natural gas to some extent. In 2010-2011, the European Union (EU) imported approximately 33 percent of its gas from Gazprom, down slightly from 2009 levels, though some forecasts have Russian gas decreasing as a percentage of EU gas from 2009 onward. Eastern European countries not linked to regasification terminals or eastward-flowing pipelines remain much more dependent on Gazprom. Part of this dependence is the result of simple geology; apart from Norway and the Netherlands, the European Union has few of its own significant extractable natural gas deposits, and Eastern Europe’s proximity to Russia has made it an ideal market for Russian gas. This systemic environment has created a relationship of mutual interdependence between Gazprom and the EU, and this relationship has been as key to Gazprom as it has been for its European customers.

Today, Gazprom’s exports continue to act as a stabilizing force for Russia as they finance the domestic contributions of natural gas to the economy in the form of subsidies, and exports to Europe make up the bulk of Gazprom’s sales abroad. By Gazprom’s own calculations, 29.9 percent of the firm’s total sales and 66.15 percent of

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131 Ibid., 144.
total exports went to Europe in 2011. Ukraine was the largest export market by volume, importing 40 billion cubic meters of gas (bcm), followed by Germany, the leading importer until 2013, with 34 bcm, Turkey (26 bcm), and Italy (17.1 bcm).

Thus far, this export model has been effective for Gazprom, which has been able to finance its operations through its export revenues. However, the European natural gas market is changing drastically, and Gazprom’s grip on this market—so important to both the firm and to Russia—is loosening.

In 2008, the European natural gas market experienced a decline in demand due to the economic crisis of that year. While this decreased natural gas imports from Russia, it more importantly coincided with what has come to be known as the U.S. shale gas “revolution.” Investments in gas extraction technologies undertaken in the 1970s in the United States—primarily in hydraulic fracturing—led, four decades later, to a boom in commercially extractable natural gas. While in 2005 the world was preparing to ship LNG to the United States as the latter’s brownfield production waned, by 2011, the U.S. had found enough recoverable gas that the Energy Information Administration (EIA) estimated it held 100 years’ available supply, assuming demand steady at 2010 levels.

With this increase in U.S. self-supply, LNG exporters from Middle East, North

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Africa, and Nigeria, who originally intended for their gas to supply the U.S., began to seek other markets. These exporters, led by Qatar, began to ship their gas to Continental Europe. This, in turn, helped to cause spot prices at Europe’s major gas hubs—NetConnect Germany (NCG) and the UK National Balancing Point (NBP)—to tumble, and LNG imports displaced Russian gas volumes shipped via pipelines.

The abundance of plentiful (and, consequently, cheap) natural gas in the U.S. also began to displace coal in U.S. power generation, and U.S. coal, which, while more expensive than U.S. natural gas was still cheaper than European coal, began to ship to Europe to make up for losses in electricity-generating capacity after Germany’s decision to move away from nuclear power following Japan’s Fukushima crisis. Between 2010-12 Europe saw a 72 percent increase in imports of U.S. coal, and in 2012, coal overtook gas as Britain’s primary fuel source for electricity generation. In this sense increased coal imports act as an additional means by which the U.S. shale gas boom has decreased the demand for Russian natural gas in Europe.

As Europe’s economy declined and natural gas prices fell, Russia’s European exports shrank. While Gazprom’s initial export plan was for 150 bcm to Europe in 2012, the final year-end tally rested at only 138.8 bcm, and once Europe’s economy

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137 Ibid.
138 “Russian Gazprom sees 2013 gas exports to Europe rising on year—report,” Platts, February 8, 2013,
picks up again, predictions indicate that imports of Russian natural gas may remain lower than initial estimates. In July 2012, Harvard University’s Belfer Center and Rice University’s Baker Institute published a report that laid out several different possible scenarios for the world by 2030, and in each case Europe’s dependence on imported natural gas decreased, and the balance of power tilted away from Russia. As the world enters a “golden era of natural gas,” led at the moment by the United States but which Australia, Indonesia, Argentina and others will join in the near future, buyers, not sellers, will increasingly influence markets. Gazprom appears to be one of the first casualties in this new era, as it loses its ability to secure long-term sales on its own terms.

Gazprom has not “dominated” the European gas market, but more accurately has been dependent on it, and because of the repercussions of the shale revolution in the U.S., Gazprom’s ability to create secure long-term contracts is now under threat.

CHAPTER 2: A REINVIGORATED ANTI-GAZPROM SENTIMENT AND THE “THIRD ENERGY PACKAGE”

In 2009, in the aftermath of the Ukraine-Russia gas disputes, the European Commission (EC) resolved to question EU import dependency on Russia, viewing its

146 Boussena and Locatelli, 35.
dependence on Gazprom as a security risk. Such a move is important for our discussion because it emphasizes the inherently political nature of natural gas trade, or, more aptly, the inextricability of natural gas trade from politics. Technically, disputes between a gas producer and the consumers could be addressed between energy supply companies and their customers. The European natural gas market, however, concerns investments so large that government backing is necessary, and the historically-based perception that Russia may have ulterior motives in its export policy (i.e. subjugation of its neighbors through strong-arm pricing tactics) elevates the disputes to the political level.

The antitrust interest in Gazprom is not focused primarily at Russia, but with its high-profile disputes with Ukraine, Gazprom opened itself up much more to scrutiny by the Directorate General (DG) of Competition in the European Commission (EC). The EC has been pursuing a policy of liberalization of electricity and gas markets since the 1990s, with the first liberalization directive adopted in 1998 for gas and the second in 2000. These directives have been accompanied by additional inquiries into specific issues, such as June 2005 inquiry into anti-competitive activity across electricity and gas markets. The third liberalization directive, or “third energy package,” was negotiated in 2009 with plans to be implemented in 2013. Already over a dozen major European energy companies, including EDF, E.ON, and RWE have been prosecuted. According to Alan Riley, the commission began investigating states beginning with those who had been EU members longer, and slowly it has made its way East, where Gazprom is more involved

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151 Ibid.
in internal gas dealings. In this sense, Gazprom is not the target of these disputes, but part of a much larger investigation.

The Third Energy Package calls for the “unbundling” of energy supply from distribution and is aimed specifically at breaking downstream integrations that Gazprom and other natural gas companies have used thus far to insulate themselves from changes to the market.\footnote{Locatelli, 248.} Such a policy would weaken Gazprom’s ability to dictate prices within the European market as well as open its pricing mechanisms to greater transparency.

The EC has simultaneously voiced concern at a lack of transparency in Gazprom’s contracts and has opened an antitrust probe into the firm, predicated on the suspicion that Gazprom obstructs competition in the gas markets in Central and Eastern Europe. Investigations under the auspices of this antitrust case began on September 27, 2011, with searches of the offices of Gazprom’s European customers. This investigation was initiated by the complaints of natural gas consumers—led primarily by Lithuania and followed by Poland—who argue that the cost of Russian natural gas has not always been determined fairly. Lithuania’s Energy Minister Arvydas Sekmokas has appealed to the EU to pressure Gazprom into cutting the prices in Lithuania, believed to be unfairly high, and Poland’s PGNiG renegotiated its contracts with Gazprom\footnote{Howard Amos, “Gazprom Strikes Back at EU Panel,” The Moscow Times, September 5, 2012, http://www.themoscowtimes.com/business/article/gazprom-strikes-back-at-eu-panel/467709.html (accessed March 14, 2013).} after discovering shale gas deposits within Poland, even though these have not proven commercially extractable.

Specifically, the EU Commission is assessing to what extent Gazprom hindered the free flow of gas across EU member states, prevented countries from diversifying their supplies, and imposed unfair prices on its customers by insisting on oil-indexed prices.
contracts. While part of the problem is the lack of clearly-definable “market prices,” given the history of subsidies, the possibility for in-kind payments, and the lack of alternatives to Russian gas, former Russian Deputy Energy Minister Sergei Kudryashov admitted in a March 2012 report that, “There has been a considerable price dispersion in the long-term export contracts that has not always been determined by the objective market situation.” This implies that non-commercial considerations have indeed influenced pricing consideration for Gazprom’s gas, and today these decisions are culminating in probes that have the potential to threaten Gazprom’s tactics in the European market.

Today, opposition to such schemes and aversion to perceived political backing from Gazprom, combined with downward pressure on prices in the European natural gas market thanks to new gas sources and economic recession, has caused European importers to “push for change” in long-term, oil-indexed contracts for Russian gas. This is a trend that has now taken on its own momentum outside of the EC’s investigation in to Gazprom. While long-term contracts contain reopener clauses that allow prices to be reevaluated, the trend of taking Gazprom to open arbitration is new and threatens Gazprom’s ability to manage risk in the European market. Gazprom could face hefty fines if it is found to have priced gas unfairly. Raiffeisenbank analyst Andrei

Polishchuk estimates Gazprom’s share of the European market at 25-27 percent, and an annual export to Europe that amounts to 60 billion US dollars. If the EC rules against, it faces a fine of 10 percent of its annual sales, or $6 billion. Yet, a finding against the firm would suggest that Gazprom has been pricing its gas unfairly, which would put further pressure on the firm to decouple its transmission, distribution, and transit, thus threatening its entire business model to this point.

Given Gazprom’s commitment to the European market, upon which it continues to rely in large part because export netback negotiations remain stalled, both Gazprom and Russia are fighting the EU claims, but they do not have a unified strategy. Rather, their views represent their respective positions; Gazprom argues there is no economic rationale for the reforms, while the Russian state argues they are politically-motivated.

Gazprom’s argument centers on a defense of its pricing model in Europe and criticism of the EC, which it believes is turning Gazprom’s commercial dispute with Ukraine into a political dispute with commercial consequences. Sergei Komlev, head of Contract Structuring and Price Formation Directorate in Gazprom’s trading arm, Gazprom Export, contends that European demands are unrealistic, for granting firms the ability to renegotiate at any time would unequally distribute the risk, placing the entirety of it on the producer, causing exports to Europe to fall outside of acceptable risk-reward ratios for Gazprom.

The Kremlin, on the other hand, has moved to consolidate its control over Gazprom to provide the firm with political protection from what it views as politically-

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motivated inquiries. Vladimir Putin signed a presidential decree, “Measures to Protect the Interests of the Russian Federation in Foreign Economic Activities Conducted by Russian Legal Entities,” that requires any concession made to the European Union by a strategic-sector company, such as disclosure of information regarding Gazprom’s policies or revisions of contracts to be approved by the Russian state. This, however, further calls into question Gazprom’s decision-making autonomy as a profit-driven firm. Russia argues that Gazprom “is an institution set up outside the jurisdiction of the EC… that under Russian law has public functions and the status of a strategic organization, controlled by the state.”

The level of convergence between Gazprom and the Russian state is proportional to the amount of political opposition to Gazprom in Europe. According to Andrew Neff, Gazprom initially responded “to the announcement of the probe with a more measured tone, citing its long-established practice of setting gas prices according to an oil-indexed formula and expressing confidence in its legal standing.” As the debate continued, however, Gazprom’s positions changed to reflect the same line of the Russian Government—that the probe was politically motivated and “an attempt to undercut the Russian gas giant and force it to share in the burden of subsidizing Europe's weaker economies with cheap gas.” Indeed in 2012, as in 2009, it was not Gazprom’s board of Directors that took the position of speaking for the company on the issue, but Vladimir Putin. Putin’s taking the helm and attempting to block the EC probe into Gazprom has

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159 Andrew Neff, “Russia Tightens Control over Gazprom, Prepares Gas Giant for Political Fight over EC Probe,” IHS Global Insight, September 12, 2012.
161 Neff, “Russia Tightens Control.”
162 Ibid.
provided justification for the EC position Russia is “making the investigation political.”

The ultimate result of making the situation overtly political is that it further strains Gazprom’s relations with the EU and reduces the possibility for discussion on purely economic terms. If the consequences of Putin’s politicization of the Gazprom dispute in Europe may be detrimental to Gazprom’s ability to make money, we should question why the Kremlin deems it in its best interest to interfere in Gazprom’s business dealings abroad. On one hand, Putin’s intervention in the process is likely motivated by a fear that probe into Gazprom and opening up the market to competition will cut Gazprom’s export revenues. On the other hand, by politicizing the situation, Putin increases the perception that Gazprom is not acting for purely commercial reasons, even though doing so may intensify pressure on Gazprom.

The previous section demonstrated several reasons for the Kremlin’s active interest in Gazprom’s export dealings, from a history of expected subsidies, to the need to provide rents to both the economy and certain interests, to fear of possible losses of power in the CIS, an area of historical strategic importance and today key to Gazprom’s ability to transit gas. Given the new developments within Gazprom’s export markets, however, the previous way of operating is now in greater threat than ever before, and the Kremlin, still unable to move away from certain subsidies, has not demonstrated it is ready to adapt. However, several fundamental changes are taking place in Russia’s natural gas sector, though to what extent they alter the status quo is the question addressed in the following section.

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163 Ibid.
PART 3: IS CHANGE ON THE HORIZON?

Gazprom’s current *modus operandi* has allowed it to survive through the dissolution of the Soviet Union and through various Russian leaders. However, given the sudden changes to its export markets, the old model of relying on long-term contracts with European customers while simultaneously acting to appease the Kremlin in certain areas makes Gazprom less able to adapt and in turn threatens its ability to earn revenue. It also threatens the Kremlin’s ability to profit from Gazprom’s successes.

Thus far, the logistics of the European gas market have allowed Gazprom and Russia to move slowly towards addressing these tensions, for as long as there was demand for Russian gas in Europe, pipelines to supply it, and long-term contracts to guarantee a return on capital, Gazprom’s market position was safe. As we now see, though, the repercussions of the U.S. shale gas boom on the European market have allowed latent political reservations about Gazprom to manifest themselves, and various countries and their major energy firms are using this momentum to renegotiate contracts, build new interconnecting pipelines or LNG terminals, and threaten Gazprom’s dominant position in the European market.

The question moving forward is, given these various factors that have caused Russia to support Gazprom thus far, to what extent is adaptation possible in this system of “interlocking political and economic institutions (both formal and informal)”\(^\text{164}\) now that Gazprom’s shortcomings have come to light? To assess this question, this final section looks at ways Russia has thus far hedged its bets, and it asks whether Russia, with

its demonstrated history of protection and influence in the natural gas sector, and Gazprom, are prepared for the already-changed natural gas market. It also asks to what extent these are actual changes, or merely superficial adaptations.

Chapter seven addresses increased liberalization of the Russian domestic natural gas market and the rise of “independent” producers, questioning whether these firms are truly more independent from Kremlin interference than Gazprom. The eighth chapter looks at Gazprom’s own strategies, which appear primarily to center around strengthening its hold on its existing European markets. The ninth chapter discusses the entirely new diversification of Russia’s export market through a pivot in focus from Europe to Asia, where there may be more genuine ambiguity between commercial and policy motives.

7. THE RISE OF INDEPENDENT GAS PRODUCERS

Samuel Green argues that, since the dissolution of the Soviet Union, a “system of rent-seeking and arbitration,” which he refers to as “networked authoritarianism,” has developed across various levels in Russia that “supports the status quo and militates powerfully against significant reform.” According to Greene, a “closed but internally competitive elite,” discussed above as Putin’s “winning coalition,” influences Russian politics up to the level of the “nominally elected” president, whose power is drawn both formally and informally from a wide range of sources. Greene also maintains that “economics is dominated by rent-seeking behavior” that reinforces—and indeed, demands—a system of state control over industry, from which economic actors can

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165 Ibid.
derive their rents. This system is inherently anti-reform and self-reinforcing, as actors seek short-term benefits at the expense of long-term costs to society.

Juliet Johnson seconds Greene’s thesis, arguing that recent threats to the existing Russian model—namely the global financial crisis—did not lead Russia to challenge state intervention in economics, but rather it “reinforced [the system’s] central characteristics, in the process rendering it even more resistant to modernization efforts.”

However, we do see loosening of the gas sector as new players (over 70 of them, according to Henderson, though two, Novatek and Rosneft, of primary importance thus far, as discussed below) have come to prominence, cutting into Gazprom’s traditional market. The rise of non-Gazprom firms in Russia’s natural gas sector is unprecedented, and they are playing key roles as Gazprom’s export markets come under fire. To some extent, Gazprom’s itself helped give rise to these producers’ current successes through its decision to increase prices, but the more interesting question is why the Kremlin is supporting them, given its reliance on Gazprom as a source of rents.

Through these new producers, the Kremlin appears to be hedging its bets. While these new producers are challenging Gazprom today, it is uncertain whether they are threatening the Kremlin’s goals, such as the need to collect rents and act as possible geopolitical lever, and the Kremlin appears to be supporting these producers even to a minor extent at the expense of Gazprom’s control of exports. If this is the case, we must ask to what extent this liberalization is a change in the Kremlin’s goals, for this may...
indicate why the Kremlin appears to be supporting these new developments, and what this means for Gazprom.

Thus far, Gazprom’s monopoly on transportation in Russia has allowed it to choose from where it will source its production (from its own production, from third party Russian producers, or from Central Asia) and for how long (usually reviewing its plans based on anticipated demand for one to three years), thus making other producers’ existence dependent on Gazprom. This “Gas Balance” negotiating process still exists, but since 2007, with new Russian gas sold at unregulated prices, Gazprom’s monopoly has weakened. Commercially for the firm, despite the weakening of its dominant position, this change overall has been beneficial; thanks to the deregulation of prices, the firm made its first profits from domestic sales in 2009.

As these changes have taken place and previously-unknown companies sell directly to end consumers in Russia instead of to the Gazprom monopoly, they weaken the latter’s monopoly position in Russia. But if Gazprom loses its market share, does it not also lose its ability to act as a vessel for rents, and possibly, its protected position? And do the Kremlin and its rent seekers not lose their tool?

Indeed, these companies are a threat to Gazprom. They have not only begun selling directly to end-consumers, but they have even breached Gazprom’s export monopoly, indicating that the State may be prepared to change its relationship with Gazprom. Indeed, the Kremlin is promoting more viable alternatives domestically to Gazprom, and Vladimir Putin has even called for a gradual end to Gazprom’s monopoly

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on exports through new LNG exports to non-Gazprom firms.\textsuperscript{171}

However, the two companies that stand to challenge Gazprom’s monopoly do not significantly differ from Gazprom in their connections to the Kremlin or in their ability to act as conduits for the political priorities of the state. Given this paper’s assessment that Gazprom’s existence has depended on its ability to address its competing political and commercial priorities, the rise in prominence of these two companies—Novatek and Rosneft—supports the notion that the ability to manage competing mandates is a prerequisite for a successful Russian natural gas firm.

The relationship between states and firms is a complex one, and, according to Abdelal, a larger stake in a firm held by the state does not necessarily equate to increased influence of the state in the decision-making processes of the firm; rather, domestic business-government relations and the interaction of firms with policy-makers determines these strategies.\textsuperscript{172} Given the close business-government relationship between the state and these two firms discussed below, they are arguably independent only in name. Novatek is owned by alleged Putin confidante Gennady Timchenko, while Rosneft is headed by Igor’ Sechin, Putin’s long-time “oil tsar.” A brief look at each of these companies will help us understand how their market position is improving and why they may be acceptable to the Russian state as alternatives—or at least complements—to Gazprom.

**Rosneft**

Rosneft, Russia’s largest oil producer, is not an independent gas company.


\textsuperscript{172} Abdelal, “The Profits of Power: Commerce and Realpolitik in Eurasia”: 6.
Whether it acts independently or under state authority, a question asked by the EU in February 2013, remains unanswered.\textsuperscript{173} However, approximately 75 percent of Rosneft’s shares are held by OJSC Rosneftegaz, which in turn is fully owned by the Russian government. An additional nine percent stake is held tangentially through Sberbank, also owned by the government.\textsuperscript{174} Rosneft has recently been the target of liberalization by former President Dmitry Medvedev and Deputy Prime Minister in charge of oil and gas Arkady Dvorkovich, but Putin loyalist Igor’ Sechin has strongly opposed privatization,\textsuperscript{175} and with Putin’s third term came a greater consolidation of hydrocarbon companies under the behemoth Rosneftegaz, headed by Sechin.

Sechin, former Deputy Prime Minister in Vladimir Putin’s cabinet, has no official government capacity today \textit{per se}, but he is nonetheless believed to control the energy sector as CEO of Rosneft, board member of Rosneftegaz, the state’s holding company and privatization vehicle for energy assets, and as secretary of the presidential energy commission.\textsuperscript{176} Sechin’s personal and professional relationship to Putin, moreover, allegedly goes back to at least 1990, when the two met on a joint trip to Brazil for a city delegation when Putin was working in Saint Petersburg under then mayor Anatoly Sobchak. Following the trip, Sechin joined Putin in Sobchak’s administration, and their


paths have kept them together since.\footnote{177}{Vladimir Pribylovskii, “Sechin, Igor’ Ivanovich,” \textit{Antikompromat.ru}, http://www.antikompromat.org/sechin/sechbio.html (accessed April 28, 2013).}

Moreover, though Sechin has moved out of the Cabinet, he has historically led the consolidation of the energy industry under state control, as demonstrated most clearly by his overseeing the takeover of YUKOS in the mid 2000s.\footnote{178}{Neil Buckley, “Russian Evolution – Reshaping Putin’s Oil Industry,” \textit{The Financial Times}, August 9, 2012, http://www.ft.com/cms/s/0/9e293f12-fed3-11db-aff2-00b65df10621.html#axzz2NHvSmMsG (accessed April 15, 2013).} Today, though officially Arkady Dvorkovich chairs the government commission on the energy sector, analysts posit that Dvorkovich’s power is limited, as energy policy in Russia tends “to be made by a small group of individuals, usually associates of Putin who have direct access to him,” including “top managers of leading companies,”\footnote{179}{John Lough, “Why Dvorkovich and Sechin’s Turf War is Public,” \textit{The Moscow Times}, July 24, 2012, http://www.themoscowtimes.com/opinion/article/why-dvorkovich-and-sechins-turf-war-is-public/462509.html (accessed February 8, 2013).} led foremost by Igor’ Sechin, versus commissions set up within the administration itself.

While the Kremlin does not claim to be recentralizing the hydrocarbon sectors under Sechin, the vocal criticism from other Russian elites, from Dvorkovich to Alexander Novak, Russia’s Minister of Energy, Vladimir Strzhalkovsky, CEO of Norilsk Nickel, and Interros’ Vladimir Potanin, indicate that this consolidation appears to be taking place and that the state is more strongly reasserting itself into the hydrocarbon sector.\footnote{180}{Dmitry Zhdannikov, “Kremlin Oil Control Drive Could Backfire,” \textit{Reuters}, September 27, 2012, http://www.reuters.com/article/2012/09/27/us-russia-summit-oil-idUSBRE88Q1EA20120927 (accessed April 18, 2013).}

Concomitant with Sechin’s increased influence over the hydrocarbon sector, Rosneft’s role appears to be increasing and, notably, expanding into Gazprom’s traditional realm. In November 2012, Rosneft signed a 25-year $80 billion contract with
state-owned electricity provider Inter RAO UES for 35 billion cubic meters per annum (bcm). This deal supersedes that of Novatek, Russia’s largest natural gas producer (discussed below), which fought in 2009 to secure the deal from Gazprom. At the time, this contract made up between 20 and 30 percent of Novatek’s revenue, and thus losing it shows the increasing power of Rosneft vis-à-vis Russia’s largest independent producer.\footnote{Ol’ga Samozhalova, “Sopernik dla Gazproma: Rosneft’ ozvuchala masshtabnye plany po dobyche gaza,” \textit{Vzglyad}, April 23, 2013, \url{http://vz.ru/economy/2013/4/23/630022.html} (accessed April 23, 2013).}

These moves make commercial sense for Rosneft. The firm as of 2010 had 791 bcm of proven natural gas reserves,\footnote{“Zapasy i resursy,” \textit{Razvedka i dobycha} (Rosneft, 2013), \url{http://www.rosneft.ru/Upstream/Reserves/} (accessed April 28, 2013).} a mere fraction of Gazprom’s almost 19,000 bcm of proven reserves.\footnote{“Audit zapasov,” \textit{Zapasy gaza i nefta} (Gazprom, 2003-2013), \url{http://www.gazprom.ru/about/production/reserves/} (accessed April 28, 2013).} However, Rosneft is also looking to market its associated gas from its oil projects, which it claims as one of its strategic priorities.\footnote{“Gazovaia strategia,” \textit{Razvedka i dobycha} (Rosneft, 2013), \url{http://www.rosneft.ru/Upstream/Reserves/} (accessed April 28, 2013).} If Rosneft were to effectively bring this associated gas to market, this would simultaneously promote the Kremlin’s goal of increasing energy efficiency in the country’s hydrocarbon sector and reducing gas flaring in its oil sector,\footnote{“Zasedanie Komissii po modernizatsii i tekhnologicheskomu razvitiu ekonomiki Rossii,” \textit{kremlin.ru} (Gorki: June 27, 2011), \url{http://kremlin.ru/news/11755} (accessed April 28, 2013).} which may possibly help explain the Kremlin’s support of Rosneft’s move into the natural gas realm.

Rosneft does not have the historical connection to Russian gas sales that Gazprom does, but it is nonetheless large enough and well enough connected to Russia’s elites and top policymakers that, should it be asked to, it could be in the same strategic position as Gazprom to carry out domestic or foreign policy priorities for the state in addition to meeting its commercial goals. As Gustafson discusses in his survey of Russia’s oil sector, Rosneft’s original involvement in the gas sector stemmed initially from its desire
to become a key oil producer. The firm became interested in natural gas in 2001, where in order to economically exploit that oil reserves in west Siberia’s Kharampur’s fields, it would first need to find someone to accept the gas capping the field, for which Rosneft, via its subsidiary Purneftegaz, recruited Gazprom.\textsuperscript{186} This instance marked the introduction of tensions between Gazprom and Rosneft that continue to this day, as Rosneft first began to hint that it might have its own interest in exporting natural gas.\textsuperscript{187} In this sense, the introduction of Rosneft into the natural gas market is not a threat to the Kremlin, even though Gazprom certainly perceives it as one.

\textit{Novatek}

Not surprisingly, the other main competitor to Gazprom’s dominant position, Novatek, shares many of these key characteristics. Though it is an independent producer, there is reason to believe that it would be as able to carry out the Kremlin’s political mandates through natural gas sales as Gazprom has been.

After Gazprom, Novatek produces the most gas in Russia, and since 2009 it has been steadily taking away Gazprom’s clients.\textsuperscript{188} While Gazprom’s production has been stagnant for a long time, finally dropping by 15 percent year-on-year in 2012, Novatek’s production increased in the same period by 19 percent.\textsuperscript{189} In the domestic market, in August 2012, E.ON Russia, controlled by Germany’s utility E.ON, chose not to continue its contracts with Gazprom but to buy gas for its power plants from Novatek until 2027, a

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\footnote{Thane Gustafson, \textit{Wheel of Fortune}, 337.} \\
\footnote{Ibid.} \\
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$22.04 billion deal.\textsuperscript{190} In addition, having already taken the gas supply contract for Russia’s major electrical utility, OGK-1, from Gazprom in 2009, it later followed up with a contract to supply OGK-3\textsuperscript{191} and, more recently, in December 2012, it secured a large contract with Mosenergo. These moves demonstrate that not only will Novatek sell directly to end consumers, but that it also is indeed taking market share directly from Gazprom, as the latter had fought to acquire electrical generation customers in Russia to secure a future guaranteed supply for its gas. At the same time, in foreign markets, Novatek signed a deal to supply gas to a Russia-based power plant owned by Finnish utility Fortum for 15 years, and such deals have contributed to sharp increases in Novatek’s annual output.\textsuperscript{192}

Novatek is controlled by Putin-ally and Gunvor trading house co-owner Gennady Timchenko and its Chief Executive Officer Leonid Mikhelson. The company was founded in 1994, and it has gained significance through its work in the Yamal-Nenets Autonomous Region on the Yamal Development (Yamal Razvitie) projects. Through these licenses, Novatek ranks among the leaders, apart from Gazprom, in controlling Russia’s proven reserves, holding in 2012 1,758 bcm of proven reserves.\textsuperscript{193}

The company’s largest shareholder, Gennady Timchenko\textsuperscript{194} (who controls his


\textsuperscript{192}Novatek said it will deliver natural gas to the Smolenskaya power plant, the Surgutskaya GRES-2, the Shaturskaya GRES and the Yayvinskaya GRES power stations of E.ON, as well as to the Nyaganskaya GRES and power stations of Fortum in Chelyabinsk.


share in the company via the Volga Resources Fund),\(^{195}\) is an alleged long-time ally of Vladimir Putin and Kremlin insider, though the details of their relationship remain in the shadows.\(^{196}\) In the 1970s Timchenko graduated from *Voentekh*, or the Leningrad Mechanical Institute that several elites attended, including Vladimir Yakunin (Russian Railways President) and Sergei Naryshkin (Board member of Rosneft, Sovkomflot, Channel 1, Russian Government Chief of Staff, and Chairman of the State Duma).\(^{197}\)

While Timchenko publicly denies ties to Putin, there are reasons to believe the two do indeed have a relationship.

Timchenko and Putin likely first crossed paths in several key instances in early 1990s Saint Petersburg, when Putin was working in the political administration under Anatoly Sobchak and Timchenko was making his initial forays into the business world through the project Golden Gates.\(^{198}\) Since the 1990s, they are said to have developed a friendship, and Stanislav Belkovsky has claimed (though perhaps falsely)\(^{199}\) that Putin stores his personal wealth in stakes in Timchenko’s Gunvor.\(^{200}\) Similarly, in their report “Putin. Results.”\(^{201}\) opposition leaders and Kremlin critics Boris Nemtsov\(^{202}\) and


\(^{196}\) Gustafson, *Wheel*, 245.

\(^{197}\) *Ibid*.


\(^{202}\) *Ibid*.
Vladimir Milov claim that Timchenko’s success stems directly from his personal relationship with Putin.\(^{203}\)

In addition to murky allegations of a special personal relationship between Timchenko and Putin, the two do share an interest in perpetuating Russia’s hydrocarbon successes. Moreover, Timchenko’s company has proven able to support the Russian economy through its own investments, and this integration into the economy broadly demonstrated a commitment to Russia’s domestic economy struggling to keep investors. Timchenko, for example, purchased a 25 percent share\(^ {204}\) of the Russian petrochemical company SIBUR from Gazprom through Novatek in 2010, and by October 2011 he had increased his shares to 95%,\(^ {205}\) demonstrating his commitment to the Russian gas market.

Via Volga Resources, he also owns one hundred percent of Clearlake Shipping, which rents tankers (including from Sovcomflot) for transport in the Baltics and South-East Asia. It also controls one hundred percent of the Cyprus-based company Capefar Ltd, which finances various projects in Russia.\(^ {206}\) Gunvor maintains a controlling share of Transoil, Russia’s largest rail-transit company for oil, and it controls to various degrees numerous oil terminals throughout the world.\(^ {207}\) Timchenko also owns majority shares in the Saint Petersburg-based insurance companies of Regiongarant and Al’ma.\(^ {208}\)

Like Gazprom’s leaders, Novatek’s Timchenko prefers vertical integration. In


\(^{207}\) *Ibid.*

\(^{208}\) *Ibid.*
addition to owning Gunvor, Timchenko controls Stroitransgaz, one of the country’s leading contractors for construction of gas infrastructure.\textsuperscript{209} He has large stakes in two of the largest gas fields: Southern Tambeisk (Yamal) and Angero-Lensk.\textsuperscript{210}

These investments and holdings deeply integrate Timchenko into the Russian politico-business world, and this integration is complemented by the relationships Timchenko has fostered through Gunvor. Gunvor’s work requires its leaders to maintain ties with other Russian elites in companies such as Transneft, which controls the pipelines, Russian Railways (RZD), which determines if the oil tankers will reach the ports on times, and with Sovkomflot, the largest fleet of tankers in the country. Indeed, Timchenko’s ties to these businesses are peculiarly deep. Viktor Yakunin, son of RZD’s head Vladimir Yakunin, worked at Gunvor for some time as the director of legal questions,\textsuperscript{211} and the Director General of Sovkomflot, Sergey Frank, is tied to Timchenko through his son, Gleb, who married Timchenko’s daughter Kseniia in 2008.\textsuperscript{212}

These ties to the Kremlin and this proven dedication to investment in Russia—requirements that Gazprom has also managed—may have provided the political will necessary in a tightly-regulated gas market for Novatek to bite into Gazprom’s market. Thus far, it appears Novatek’s efforts are successful. Novatek was the first company to break Gazprom’s monopoly on natural gas exports when, in August 2012, it signed a 10-year, $732 million contract with Germany’s Energie Baden-Württemberg AG (EnBW) to

supply about 2 bcma. While the deal may not require Novatek to export the gas itself, the company’s working directly with foreign consumers may signal a change in the way of thinking about Gazprom’s monopoly.

As the only non-state company benefiting from LNG exports, Novatek’s rise has marked a significant change in the way the gas sector has been run in Russia. If we ask what it is about Novatek that has allowed it to benefit from these changes, we find that the company has a proven track record of operating successfully both commercially and politically. Timchenko’s companies are clearly run by competent managers, but moreover the Kremlin’s relationship with Timchenko has benefited both the country and the company, in many ways similar to Gazprom’s relationship with the state. While clearly Novatek and Timchenko stand to benefit from such moves, there is a symbiotic relationship between the administration’s goals and Novatek’s.

**What these New Producers Mean for Gazprom**

Opening up the domestic market to competition has always been in Gazprom’s best interest, giving it greater flexibility in export pricing in the markets where it makes its money. However, opening the market allows other companies to prove themselves and their abilities, which might increase their own lobbying power to gain access to the export market, as we have seen with Novatek. For the Kremlin, this is a way of hedging its bets, as Novatek and Rosneft are relatively safe choices, given their leaders’ relationships with Putin and key industry figures. Ultimately, opening up to these new producers could be a positive move for everyone, though as it stands now, the risk of opening the market is on Gazprom alone, for its protected position over exports is

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214 Locatelli: 247.
now under threat.

While competition in the domestic market will benefit Gazprom, losing portions of its monopoly is still relatively new for Gazprom. For the Kremlin, however, the change appears to be win-win. Novatek and Rosneft are not entirely independent actors, thus likely to carry out the Kremlin’s political mandates. By increasing the number of producers, the Kremlin can introduce competition into both the domestic and export markets, allowing its new firms the flexibility Gazprom lacks.

8. GAZPROM’S “ADAPTATION” STRATEGIES

As Gazprom’s protected position weakens, proving itself to be a reliable supplier for its customers takes on renewed importance, for if it can hold onto its customers in Europe, it can remain competitive.

Gazprom has attempted to prove its reliability in two ways: it continues to work to secure its position in the market and increase its leverage through integrations with European customers, and it is investing in multi-billion dollar capital projects that both serve to bypass troublesome transit states like Ukraine.

Vertical and horizontal integration has become a key part of Russia’s strategy for securing demand in its export markets, and between 2006 and 2007, in the aftermath of the first Ukraine energy dispute, Gazprom doubled the number of its joint ventures.215 This strategy—meant to guarantee that companies throughout the supply chain will continue rely on Gazprom’s exports—has been a cornerstone of Gazprom’s export scheme since 1980, when the firm began buying shares in various transmission and distribution companies as well as in its end consumers themselves, such as major

electrical utilities. In today’s market, such tactics are all the more meaningful for Gazprom.

However, Gazprom’s strategy of buying assets across down the value chain has raised hackles amongst Europe’s antitrust commissions, and the Third Energy Package is aimed specifically at unbundling these types of integrations and at preventing Gazprom from insulating itself from competition in the market and from combining volumes and capacity under the same owner. To counter this, Russia, as we have seen, has shown signs that it might be willing to open up its exports to new gas suppliers, but Gazprom has continued to focus on the EU markets through increasing its number of supply routes into Europe in an attempt to gain direct access to as many countries as possible and prove itself a reliable source of supply, as strategy it has had since the mid-1990s.

While this policy may seem risky given the increases in available gas supply in Europe, predictions vary for future gas demand in Europe, and some analysts predict that Russia will continue to supply one quarter of Europe’s gas for the foreseeable future despite increased LNG imports. In order to assure its customers of its reliability, Gazprom must demonstrate as well its commitment to bringing new reserves online. It has done this most clearly in the development of the Yamal Peninsula and its related offshore areas, production from which began in 2011 and which Gazprom expects to see up to 360 bcm of gas by 2030.

Moreover, Gazprom’s abundance of gas can allow it to dictate the rules to some extent, for it can dump gas onto the market to undercut prices, increasing price risk for

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216 Locatelli: 248.
217 Ibid.
LNG suppliers in a way similar to how they are increasing risk for Gazprom.\textsuperscript{219} Gazprom is often criticized for its history of investing externally rather than internally,\textsuperscript{220} but if the firm projects continued demand for its gas, these capital expenditures make commercial sense.

Russia’s gas is currently exported though the Yamal Pipeline (32.9 bcm capacity), the Ukrainian Corridor (50 bcm capacity), Nord Stream (55 bcm capacity), Blue Stream (16 bcm capacity), and a proposed South Stream pipeline (63 bcm capacity). The new Nord Stream project and the proposed South Stream project are emblematic of this policy of supplying the European market from as many angles as possible. The Nord Stream pipeline reaches Germany without transiting a third country, and the proposed South Stream will reach Bulgaria before branching out into other parts of Southeastern Europe. The exact route is yet to be concluded, but the proposed pipeline would transit to Italy’s distribution network by transiting through the Black Sea in Turkish waters to Bulgaria, then to Serbia, Hungary, Slovenia, and Austria.\textsuperscript{221} Alexei Miller has indicated that Gazprom may consider building additional pipelines into Europe, including one directly to the U.K.\textsuperscript{222}

One major assumption about South Stream is that it is meant to eschew transit through states such as Ukraine, perhaps even as a means of punishing Ukraine. Paradoxically, though, South Stream will increase the number of states though which the

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\textsuperscript{220} Closson: 353.
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gas will actually transit. Russia has already signed intergovernmental agreements with Bulgaria (January 18, 2008), Serbia (January 25, 2008), Hungary (February 28, 2008), Greece (April 29, 2008), Slovenia (November 14, 2009), Austria (April 24, 2010) and Croatia (March 2, 2010). Such agreements lay the groundwork for preparing feasibility studies as well as setting up joint ventures between Gazprom and national energy companies authorized to implement the project. Given this, it seems unlikely that Gazprom’s primary motivation for building South Stream would be to bypass Ukraine.

Rather, this project, like so much else about Gazprom, can be understood by looking not only at recent challenges, but also at the structure of the Russian natural gas market and Gazprom’s historic existential relationship with its European customers. Gazprom’s challenges with Ukraine likely influenced its decision to create routes bypassing the troublesome transit state, and perhaps they are even meant to bring Ukraine back into Russia’s orbit through Nord Stream and South Stream pressure. However, this is unlikely the sole motivation for the pipeline. Rather, given Gazprom’s historic dependence on its European gas customers, these pipelines also serve to both demonstrate and assure a reliable supply of Russian gas and to physically connect that gas with as many customers as possible.

Moreover, from a commercial standpoint, Gazprom appears to firmly believe that the benefits of “reliable” (read pipeline) gas are greater in the long-term than the immediate costs of building the pipelines to provide this gas. This is understandable given that, for Gazprom, reliability of price and a guarantee of purchase are necessary for the company to make its long-term capital investments. This philosophy appears to guide its reasoning in its negotiations with its European customers. Gazprom maintains that
though the estimated 60 bcma of natural gas that will flow through South Stream “will be more expensive than hub-traded gas,” the pipeline will nonetheless “win customers by ensuring them a more secure and flexible supply,” thus justifying the pipeline’s creation. In June, Gazprom Export’s head of contract structuring and price formation Sergei Komlev reiterated this belief, noting that gas sold via pipelines and long-term contracts will “provide more security and supply flexibility than spot gas through a hub.”

For Russia’s policymakers and the Kremlin’s geopolitical interests, pursuing these pipelines will hopefully increase Russia’s geopolitical clout in Europe through diversification of its supplies and pressures Ukraine back into gas trade with Russia, which we know Russia can leverage for political gain (the Sevastopol’ flotilla, as we have seen). Gazprom’s policy of integration with European firms works much in the same way—it attempts to guarantee customers within Europe, though it does so from the consumer side, rather than from the producer’s.

To maintain the benefits they each respectively derive from natural gas sales, Russia and Gazprom are both searching for ways to adapt. Russia both continues to support Gazprom while diversifying suppliers, while Gazprom frantically attempts to increase its dominance of the European gas markets through diversification of supply routes. Since these tactics are able to satisfy both mandates, they continue to receive support from within Russia and continue to be promoted as viable options.

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224 Ibid.
9. RUSSIA’S PIVOT TO THE EAST

The third option for adaptation to the new natural gas environment is entirely
different and cannot be explained as easily as can Gazprom’s attempts to strengthen its
hold on the European market.

As Mareš and Laryš describe, Russia began to discuss penetrating the East Asia
oil and gas market in 2005 and 2006, riding the coattails of high energy prices before the
2008 financial crisis, and this decision must by understood “both economically and
politically.”

Currently, there are no export pipelines for natural gas to Asia, but
Russia’s Energy Strategy to 2030 envisages up to 19-20 percent of the country’s natural
gas flowing via pipeline to Asia by 2030. East Asian natural gas trade promises to
offer both profits and political rewards, and thus the option of shipping gas to the East
has gained in popularity.

Historically, the Kremlin and Gazprom both have been averse to looking towards
Asian markets for new sales. Part of this is due to a mutual distrust and frustration
between Russia and China based in large part on geopolitical concerns, even though
deepening these ties would help stabilize the world gas market. As Fyodor Lyukyanov
notes, “It’s the old Soviet thinking. We still live in the Brezhnev era, actually. Brezhnev
laid the gas pipelines, and they define geopolitics today.”

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226 Miroslav Mareš and Martin Laryš, “Oil and Natural Gas in Russia’s Eastern Energy Strategy: Dream or
227 “Prilozhenie 3,” Energeticheskaia strategia Rossii na period do 2030 goda (November 13, 2009)
228 Andrew Kuchins, “Russia Looks East: Energy Markets and Geopolitics in Northeast Asia,” CSIS, (July
229 Oliver Carroll et, al., “Talking Point: the Logic of Russian Foreign Policy,” Open Democracy Russia,
(December 2012), http://www.opendemocracy.net/od-russia/oliver-carroll-fyodor-lukyanov-marie-
standpoint, East Asian gas trade has not come to fruition due to the difficulty of developing the resource base in Eastern Russia.\textsuperscript{230} While an overt alliance between Russia and China might remain out of sight due to this distrust and individual “geoeconomic interests,”\textsuperscript{231} Gazprom’s struggles in its traditional European markets may now provide the impetus for diversifying exports eastward, where it can take advantage of a growing Chinese market.

With oil’s already having moved to eastwardly diversification through the ESPO pipeline, gas may be prepping to follow. Gazprom Marketing and Trading opened an office in Singapore in 2010, its first in Asia, with a stated goal of helping Gazprom “develop a significant and sustainable carbon business across the region.”\textsuperscript{232}

This shift to Asia will promote new fields in underdeveloped areas of Russia. Gas production in eastern Siberia and the Far East is expected to increase tenfold by 2030, primarily through development of the Kovykta field in Irkutsk, the Chayandand field in the Sakha Republic, and the Yurubchens-Takhoms field in Krasnoyarsk—\textsuperscript{233} fields that will complement the existing volumes produced through the Sakhalin fields, currently the cornerstone of Russia’s eastern gas production.

This diversification towards Asia, were it able to attract the necessary capital, would provide an opportunity for Russia to develop its territory in East Siberia, which it has so far been unable to do. Russia may now have the political will for such a project, however, as Vladimir Putin looks to keep his country appeased through large New-Deal type projects, and the need for such stimulus is clearer each year as Russia continues to

\textsuperscript{230} Kuchins, v
\textsuperscript{231} Goldthau and Hoxtell: 62.
\textsuperscript{232} “Singapore,” \textit{What We Do}, Gazprom Marketing and Trading (2010), \texttt{http://www.gazprom-mt.com/WhatWeDo/Pages/default.aspx} (accessed April 28, 2013)
\textsuperscript{233} Kuchins, 11, 13.
lose its population East of the Urals. According to figures from Russia’s state statistical services, the Far East and Eastern Siberia lost approximately 2.5 million people from 1990-2008, while China’s population along the Russian border has grown yearly.\textsuperscript{234} As we have seen above, with both political and economic benefits to be derived from a move eastward, the possibility of such a move is more likely.

As the Fall 2012 APEC meeting in Vladivostok showed, there is no lack of political will for this shift. Vladimir Putin has stated that Russia’s future depends on Asia, and strengthening these ties is key to developing Russia’s Siberia and the Far East.\textsuperscript{235} As a symbol of the importance Russia is placing on renewed ties with East Asia, Russia spent $20 billion on the conference to emphasize the port’s becoming a transit point from Europe to the Asia Pacific.\textsuperscript{236}

Russia’s Far Eastern gas is based to date in the Sakhalin Islands, where gas produced is transited to Vladivostok, where it is either used in domestic consumption or exported to Japan, South Korea, and North America as LNG.\textsuperscript{237} Sakhalin II, the LNG-processing facility, is Russia’s only LNG facility, and from this facility Russia has been exporting LNG to East Asia. The 2007 program calls for the development of a nationwide gas transit system, new gas production centers in Krasnoyarsk, Irkutsk, the Sakha Republic, Sakhalin and Kamchatka, and various gas processing facilities throughout Eastern Russia. A proposed pipeline would export 20-50 bcma to Korea and China by 2020, and an additional 21 bcma of LNG by the same period, with export targets

\textsuperscript{234} Ibid., 39.
\textsuperscript{236} Ibid.
increasing from that point on.\textsuperscript{238}

This program will be to Gazprom’s benefit, but, according to the firm, the Eastern Gas Program is not a Gazprom program, but rather a state-run initiative that Gazprom is simply carrying out.\textsuperscript{239} Thus the Kremlin must bear the burden of the capital costs, not Gazprom. This is a line Gazprom is drawing similar to that which it drew during the Ukraine gas disputes, indicating that even when Gazprom may benefit from a project, it nonetheless emphasizes its independence from the Kremlin. With Kremlin support of a shift to the East, Gazprom can benefit from Moscow’s financial assistance in these projects. However, the costs of the proposed Yakutia-Khabarovsk-Vladivostok trunkline are at an estimated $24.4 billion, due to harsh climate conditions and lack of basic infrastructure in Russia East.\textsuperscript{240} The Kremlin, however, suffering from a poor investment climate due in part to its inability to extricate itself from commercial decision-making, continues to struggle to raise this capital.

The solution for the Kremlin thus far has been to transfer the costs of the infrastructure projects onto the consumer, increasing electricity prices for domestic consumers and limiting domestic consumption, while it fosters ties with China with cheaper gas.\textsuperscript{241} According to Viktor Ishayev, Minister for the Development of the Russian Far East, Russia charges 3-4 rubles per kilowatt-hour domestically, varying per region, while it exports power to China at 1.5 rubles.

\textsuperscript{238}Kuchins, 28.
While the Kremlin arguably has a proven track record of transferring the costs of modernization onto Russia’s regions and its citizens,242 in the natural gas sector it has historically been Gazprom, not Russian citizens, that has born the costs of politically-backed projects. This shift thus signifies that the relationship between Gazprom and the state may be changing concomitantly with the diversification of Russia’s natural gas policy.

Gazprom does own 50 percent of the Sakhalin-2 project, the current source of Eastward-bound exports. Currently, all of Sakhalin’s gas is exported to Japan and locked in via long-term contracts. The new developments, however, focus on increased trade specifically with China. To date, China and Russia have been unable to agree on the price of gas sales, which has stymied greenfield development in the Far East.243 Developing more eastern fields would be a massive development project for Russia’s Far East and Eastern Siberia, and the gas could provide Gazprom with a new revenue stream in East Asia as its western markets are threatened.

Gazprom, however, is finding its historical tactics are hindering its ability to secure access to the Chinese market. According to Andrew Barnes, the only “correct” price for gas between Russia and China is a price they can both agree on, given the uncertainty of natural gas prices amidst renegotiations happening across gas markets.244 However, China, unsure of the direction the world is headed regarding natural gas pricing, has resisted settling on an oil-indexed price with Russia as long as prices remain

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242 For more on this, see Remington, 2011.
243 Locatelli: 254.
volatile and new import sources are possible.\textsuperscript{245} Moreover, unlike Gazprom’s European customers, China has alternative supply options, and Gazprom’s dallying has been at its own expense, as China has signed agreements with Myanmar, Kazakhstan, Uzbekistan, and Turkmenistan.\textsuperscript{246} The pipeline from Turkmenistan began exports in 2009, and in 2012 China signed another agreement to increase volumes to 60 bcm.\textsuperscript{247} Thanks to these imports and increased LNG, China is successfully diversifying its natural gas imports and increasing its energy independence.

Gazprom, however, successfully signed a memorandum of understanding with China’s CNPC in Moscow in March 2013, setting out the terms for a thirty-year supply of gas.\textsuperscript{248} While this is the result of nine years of negotiations, it nonetheless signals Gazprom’s commitment to pursuing a pipeline option to China, which is more important today than in the past given the new threats to Gazprom’s markets in Europe.

These developments in Gazprom and Russia’s negotiations with East Asia are important because they are the first real test of Gazprom’s ability to adapt to the new natural gas market in an innovative manner. It also signifies what the Kremlin is willing to do vis-à-vis Gazprom, and what it is not willing to do. While Gazprom states that the pipeline from the Chayandan field is the Kremlin’s project, there is no sign as of yet on who is going to pay for the pipeline, or where the funds will come from. This calls into question whether, despite all of the talk of a pivot to the East, there actually is one.

Nonetheless, the Kremlin has a stake in developing Russia east of the Urals, and

\textsuperscript{245} Barnes, 3.
\textsuperscript{246} Kuchins, 34-36.
now, given the changes in the European gas market, Gazprom does as well. With this symbiosis of commercial and political goals, a memorandum of understanding was finally signed, and though no steel has been laid yet, the confluence of interests between Gazprom and the Kremlin appears to be speeding up the process.

The new gas developments focusing on East Asia signal adaptation on several levels. First, as success on the European market becomes less assured for the future, Gazprom is now looking for new markets and new customers willing to sign long-term contracts for pipeline gas. Second, the relationship between the Kremlin and Gazprom appears to be changing within the contexts of pipelines to China. The Kremlin may be willing to take on some of the costs for projects that it find politically useful, and Gazprom may be willing to carry out these projects because it will earn profits from the move. In this sense, there is a symbiosis in this relationship perhaps not seen in the European market, where the greater the Kremlin interest, the more problems it has caused for Gazprom.
CONCLUSION

So what does the discussion above tell us about Gazprom’s relationship with the Kremlin and where it stands today, and what does this mean? There is no clear answer to the question of whether Gazprom is a political or a commercial entity, for its role and its relationship to the Kremlin has changed over time. While today Gazprom appears to make decisions primarily for the motives of increasing its profits, it nonetheless acts in an environment formed in part by the Kremlin’s policies. There is an ongoing dialogue between firm and state, for the two entities both attempt to hold onto power and secure their own futures; Gazprom does this by demonstrating its reliability as a gas supplier and working to guarantee a future for its gas in the market, while the Kremlin derives power by balancing the various interests of the Russian Federation and appeasing the electorate through the tools at its disposal, one of which is natural gas.

This paper demonstrates that Gazprom has been and remains of great import for Russia, and being a vessel for carrying out policy comes with both great risk and great reward. Subsidizing the CIS and the domestic economy in the Soviet Union and after its fall made the European market inordinately important for Gazprom, and providing rents to hold together the political elite and domestic economy has made Gazprom a less efficient commercial entity. However, the natural gas industry increased in political importance at times when no other sectors could provide as sweeping of benefits as it could. This conferred on it a special status as a company whose goal was not only to make profits, but also provide for the success of a nation. Because it was key to the Russian state’s wellbeing, Gazprom was never privatized, though the positive upshot of
this for the firm is that it has been able to control access to pipelines in Russia and keep the profits of gas exports within its own company, as it denied exports to other producers.

Today, increased volatility through new supply choices in Europe threaten both Gazprom and, by extension, Russia. The relationship between Gazprom and the Kremlin makes adaptation challenging for both. Putin continues to support the firm vocally and politically, as he has always done, though the Kremlin is simultaneously promoting the new producers, for it is rents from the natural gas sector, not Gazprom, that the Kremlin seeks to control. To this end, however, the promotion of Novatek and Rosneft does not necessarily represent a fundamental loss of the Kremlin’s vessel for rents. Rather, Moscow is hedging its bets within its comfort zone, promoting two firms that have a history of working closely with the Russian state and, in particular, with Putin. Thus far these producers’ resources have not been diverted to meet political ends to the detriment of their commercial goals, but they have not yet taken on the importance that Gazprom has. If Gazprom’s history is an indicator, these firms will continue to be favored by the Kremlin as long as they can manage to balance these mandates.

As for Gazprom, it is neither in the firm’s nor the Russian state’s best interest to allow it to collapse. Both, ultimately, need continued revenue, but they have differing ways of attaining this, and on some level they are mutually exclusive, for with the rise of new producers, Gazprom loses its market share. Though the Russian state is allowing new producers into the market now that Gazprom is facing criticism and increased competition, it is not letting Gazprom die. The gas projects in Eastern Russia are allegedly Kremlin projects that have been contracted out to Gazprom, and the latter stands to benefit greatly if it is able to build a new pipeline to Asia and diversify the
sources of its profits away from Europe. The Kremlin, however, prefers at all costs to eschew the taking upon the costs of reform itself, and it has thus far done a poor job of attracting foreign capital for new projects. We have yet to see if how this will affect these new developments, but taking note of the political priorities of the Kremlin will be key to understanding the ways in which this new strategy develops.

Ultimately, Russia’s energy policy is driven by both economic and geopolitical constraints,\(^\text{249}\) and which might be the more influential of the two has changed through history. Recognizing the challenges inherent to both the firm and the state in the case of Gazprom may help serve as a basis of comparison for case studies that will likely arise are more national oil companies arise across the globe. The specifics of a Gazprom case study may not be universally applicable, for the challenges in Russia’s natural gas sector are unique to Russia. The legacy of the Soviet Union created a particular relationship between early managers and the firm, between the state and the firm, and between the firm and its customers. This particular set of factors gave rise to some of the challenges Gazprom has faced, and the very playing field in which it operates has been shaped in part by the domestic and geopolitical policy agendas for the Russian state.

Gazprom and the Kremlin are both adjusting to changes in the world natural gas environment, but they are doing so in their own ways, but given the affects the actions of one has on the other, the pace of adaptation is slower than what we might see with an entirely independent firm. Understanding the challenges inherent in such a relationship is important today as NOCs become more prevalent. While the details may differ from company to company and from state to state, the fundamental challenge is one that any firm so crucially important to the wellbeing of a nation may face—that of balancing

\(^{249}\) Gawdat Bahgat, “Russia’s Oil and Gas Policy,” OPEC Energy Review (September, 2010): 163.
commercial interests in a politicized sector. Recognizing and managing the difficulties of this relationship may provide benefit both sides and help both the state at the firm meet their goals.
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