



# russian analytical digest

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## RUSSIAN ENERGY POLICY

- |   |    |
|---|----|
| ■ ANALYSIS  |    |
| Russia as a Neighborhood Energy Bully                       | 2  |
| By Stefan Hedlund, Uppsala                                  |    |
| ■ STATISTICS  |    |
| Production and Exports of Russian Oil and Natural Gas       | 5  |
| Gazprom Exports   | 6  |
| ■ ANALYSIS  |    |
| Conflict over Arctic Energy: States, Corporations, Politics | 7  |
| By Robert Orttung, Washington                               |    |
| ■ ANALYSIS  |    |
| Liberalisation Heralds Change in the Gas Market             | 10 |
| By Simon Pirani, Oxford                                     |    |

## ANALYSIS

## Russia as a Neighborhood Energy Bully

By Stefan Hedlund, Uppsala

### Abstract

This article examines whether Russia's extensive energy reserves can make up for the loss of its once formidable military might. Ultimately, interdependence between producers and consumers reduces the utility of energy as a weapon. Corruption and a willingness to pay large sums to achieve political goals, rather than superpower ambitions, define European–Russian energy relations. To the extent that both sides are willing to build expensive pipeline infrastructure for non-commercial purposes, they are both responsible for Russia's bullying behavior. However, the tactics Russia uses against a divided Europe are not likely to work in relation to the more unified and far-sighted China.

### Does Russia Possess an Energy Weapon?

Of all the various things that may be said about Vladimir Putin, one is beyond question: The man had impeccable timing. When he moved into the Kremlin, the Russian economy was only just emerging out of the hyper-depression of the Yeltsin era. When he opted to move out, the global financial crisis was just months away from sending markets into a tailspin. During the intervening two terms of his presidency, Russia underwent a radical reconfiguration.

Irrespective of who will be master of the Kremlin after the March 2012 presidential (s)election, Putin has left a mark that is bound to remain for quite some time to come. Out of the political turmoil and economic collapse that marked the 1990s, he pulled out a new Russia, a country not only self-assured that it is back as a global player but also complacent about its ability to forget about painful reform and to live instead off its hydrocarbon wealth.

Two oft-cited statements may serve to illustrate just how profound the transformation was. One was Putin's pronouncement to the Russian Federal Assembly in April 2005 that the "collapse of the Soviet Union was a major geopolitical disaster of the century". While it resonated well with Russian political elites, it was not equally well received by governments and populations in other newly independent former Soviet republics. The other was his distinctly hardline speech to foreign leaders in Munich in February 2007, which made it plain to all that the honeymoon with America, and with the West in general, was over.

As talk about the beginning of a new Cold War began to proliferate, it also became fashionable to refer to Russia as an emerging "energy superpower." Given the prominent role of Russian energy exports, both in turning the economy around and in fuelling a sense of self-assurance that has bordered on arrogance, it was somehow given that warnings about an emerging threat from Russia would focus on the alleged use by the Kremlin of a new-found "energy weapon," to support hegemonic ambitions.

But is this really a correct way of describing what is going on? Does Russia really possess an "energy weapon," and if so, may we assume that Moscow is both ready and able to wield it? The following will argue that matters are not quite as simple as that. Perhaps it is the case that accusations of Russia behaving like a neighborhood energy bully conveniently ignore how outside actors have been complicit in playing this game? And perhaps the real victim of the superpower ambition will turn out to be Russia herself? Let us begin by considering the notion of power as such, where Russia has clearly felt a distinct sense of loss.

### Power out of Barrels of Oil?

It used to be said that power comes out of the barrel of a gun. The envisioned transformation of Russia from its former undeniable status as a military superpower into a wannabe energy superpower somehow stands this statement on its head. Looking at the development both of Russia's armed forces and of its military-industrial potential over the past two decades, there can be little doubt that Moscow's prospects for re-emerging in its former role of military might have been seriously degraded, perhaps irretrievably so. May the possession of huge reserves of oil and gas really be construed as a substitute for this loss? Or, is the talk about an emerging Russian energy superpower little more than just that, namely, talk?

The answer will have to depart from the fact that commercial activity is fundamentally different from the projection of military might. Consider the track record of relations between OPEC and the big oil-consuming nations in Europe and North America. While the oil crisis in 1973 was traumatic as such, it was not only the consuming nations that suffered from the OPEC embargo. At stake for the oil producers themselves was the risk of a massive shift towards conservation and the promotion of renewable energy, which would leave OPEC with much oil and little money. The cartel has since rationally sought to maintain a price that provides

good revenue without triggering too much emphasis on a shift away from oil. Viewed from this perspective, may one not reasonably ask who has power over whom?

For all his ebullient rhetoric, Hugo Chavez has been similarly ineffectual in using Venezuela's oil wealth as a means for projecting power against the United States. If he should so desire, he could surely cease selling oil to Houston, and shoulder the extra cost of transporting his black gold elsewhere, but the impact of such a move on the government in Washington would not be impressive. The truth of the matter is that oil is a fungible resource. It is sold on spot markets across the world, and efforts to deny any specific customer access will be in vain.

Looking more specifically at the case of Russia, it is surely true that revenue from oil export has helped restore a sense of economic security and of political prestige, but does this really amount to having power, in any meaningful sense? If the notion is understood as being able to coerce others into doing things they would not otherwise have done, then it is not clear that oil alone will be very helpful.

The case of gas is somewhat different, mainly in the sense that here the supplier is typically linked with the consumer via a pipeline, and bound by long-term contracts (Liquefied natural gas (LNG) constitutes an exception, but not one that as yet is relevant to Russia). At a casual glance, this could be construed as a case of consumers being at the mercy of their suppliers, but even here it is debatable to what extent one may usefully speak of an "energy weapon." As in the case of the OPEC embargo, one must also consider who stands to lose the most should energy flow through the pipeline be shut down. On the latter count, the Kremlin has in recent years been forced to absorb some rather painful lessons.

### **A Neighborhood Energy Bully?**

Accusations against Russia for behaving like a neighborhood bully in the field of energy date back to the very early days of its post-Soviet existence, when shut-downs of energy deliveries became an integral component of relations between Moscow and capitals in the newly independent Baltic Republics. In those early days, it would have been hard indeed for Moscow to deny that there was a link between energy supply and strained political relations.

Subsequently, numerous incidents have followed where conflicts over the pricing of gas have caused supply disruptions. These cases have been less clear-cut. While Gazprom has projected lack of understanding, professing that its only ambition has been to follow Western admonitions to harmonize energy prices, those affected have pointed at a correlation between the nature of relations with the Kremlin and prices charged

by Gazprom. Although the pattern is not crystal clear, there has been a strong tendency for countries that are considered as friendly by the Kremlin to have enjoyed lower prices than others. Over time, however, the general trend towards harmonizing gas prices has eroded this argument.

By far the most high-profile case of accusations that Russia is an unreliable source of energy supply has been that of the repeated "gas wars" between Russia and Ukraine. Up until the end of 2005, Gazprom had successfully nurtured an image of itself as an impeccable and highly preferable supplier of gas to Europe. It was, however, hostage to the fact that such exports must transit via Ukraine. A temporary stoppage during the first days of 2006, provoked by a pricing dispute, caused the image of reliability to crack. When the very same was repeated at the outset of 2009, leaving some of the new member states in the European Union freezing in the dead of a very cold winter, it was a public relations disaster.

Exactly who was to be rightly blamed has been impossible to ascertain. The fact, however, that both Moscow and Kyiv seemed quite happy to allow the conflict to drag out for two weeks, while European customers were freezing, would seem to indicate that there were forces at play behind the scenes. If it is indeed the case that much of the blame lies with conflicts relating to the role of shady intermediaries in Russo-Ukrainian gas trade, then the Europeans have not been the victims of Russian superpower ambitions. They have been suffering collateral damage from energy corruption, which is not quite the same thing.

In addition to supply disruptions, Russia has also been accused of building pipelines whose commercial rationality is weak but whose function as bypass options seems all the more obvious. This was the case with the Blue Stream pipeline that was built across the Black Sea in 2005, facilitating exports to Turkey without transiting via Ukraine and Moldova. And, it was the case with the Nord Stream pipeline through the Baltic, which links Vyborg in Russia with Greifswald in Germany, cutting out both the three Baltic Republics and Poland.

Ambitions to build new pipeline capacity for oil have similarly been aimed at securing bypass options. The traditional export route for Russian oil to Europe has been the Druzhba ("Friendship") pipeline that was commissioned in 1964. Ports in Latvia (Ventspils) and in Lithuania (Butinge) have also been used. In 2001, it was decided to create a Baltic Pipeline System that links Western Siberia directly with a Russian port at Primorsk, outside St. Petersburg. A second stage of the same is planned to divert oil from Druzhba from a point at the

Belarusian border to a Russian port at Ust-Luga, again outside St. Petersburg.

It is easy enough to ascribe sinister Russian ambitions to these latter projects. Poland in particular has been vociferous in arguing that whenever Berlin and Moscow join hands it tends to be bad news for Poland. Yet, it should be recognized that the European Union itself has long been scheming to build its own bypass option, Nabucco, which would transport gas from Central Asia to Europe without transiting Russia.

The true core of the problem lies not in Russian superpower ambitions *per se*, but in the fact that both sides are so determined to assume substantial extra costs in order to build pipelines whose main motivation is political rather than commercial. This can surely only be ascribed to a fundamental flaw in the relationship as such, for which both sides will have to accept their respective shares of the blame.

### It Takes Two to Tango

Looking back at developments in Russian energy policy over the past couple of decades, two major lessons emerge. The first is that it takes two to tango. It is certainly true that much of what the Kremlin has been up to in the energy field over the past decade in particular has been hard indeed to explain as in any sense commercially rational. To the extent that this is true, we must conclude that the Kremlin has been willing to pay a price for reaching its non-commercial goals. But just how large has this price been?

It has often been claimed that in relations to the European Union, Russia will not dare to push its hand, for the simple reason that this would cause negative counter-reactions. But is this really true? Is it not rather the case that far too many European politicians have been far too eager to show to their friends and partners in the Kremlin that no matter what there will be no serious consequences?

Consider the long-standing talk about a common EU energy policy, which would be aimed at promoting competition and at “unbundling” pipeline assets from production assets. Noting that actual action taken stands in no correspondence whatsoever to the amount of talk that has surrounded this laudable ambition, one may ask if it is not the absence of European cohesion, much more so than the presence of sinister Russian ambitions, that is at fault. While implementation of a common European energy policy would surely be in the best interest both of European customers and of the Russian economy at large, improving its deplorable energy efficiency, political circles on both sides would stand to lose. Can Russia alone be held responsible for this?

Something similar may be said for those foreign investors that of late have been subjected to some heavy-handed treatment by the Kremlin, mainly but not exclusively in the energy field. Having derived much benefit from opportunities in the early 1990s, when Russia was weak, as the tide turned and as the Kremlin began to play hardball, the foreigners could have adopted a common policy of protesting against the most egregious forms of rights violations. They chose instead to bow their heads and to shut their mouths, hoping for lucrative new deals for themselves. Again one may ask if the outcome been caused by Russian superpower ambitions, or perhaps by foreigners tempting Russians into playing fast and loose with investor rights and with the rule of law more generally.

The second and for Russia more fundamental lesson to be drawn concerns the fact that creating a truly authoritarian system is just as hard as creating one that rests on working democratic institutions. For all his brash posturing, Putin has fallen far short of reintroducing a true “vertical of power.” Borders remain open. Capital flight remains an attractive option. The blogosphere is brimming with harsh critique. Corruption is worse than ever, and the ubiquitous bureaucracy remains able to simply ignore directives that it does not like.

Accepting that the combined outcome of Putin’s much-vaunted “authoritarian restoration” has been to allow a host of predatory elites to engage in gross self-enrichment, and to sink the regime into a sense of fear of a hostile takeover of its power, one is wont to ask if this really can be construed as the foundation of a superpower in any sense of the word. Is it not rather the case that the biggest loser has been Russia herself? If and when the price of hydrocarbons should take another nosedive, it would be revealed just what a house of cards it is that Putin has built. Simply pretending to be a superpower will not impress adversaries who are ready to play hardball.

The true litmus test of whether there is any serious content in the sinister talk about a Russian energy superpower will rest not in relations between Russia and Europe, but in the mounting needs to deal with China. Here the Kremlin will be faced with a system that is truly authoritarian. It will have to deal with a regime whose thinking is truly long term, and it will have to bargain with a counterpart that has a \$2 trillion war chest. Facing up to this challenge, it will no longer be possible to play a game of divide and conquer, and any thought of recruiting Chinese politicians to promote Russian interests may be dismissed out of hand. Beijing will, quite simply, prove to be very different from Brussels.

Viewed against this background, one may reasonably wonder if and why Putin would really want to remain

in power. Irrespective of what one chooses to believe about future movements in the price of oil, when push

really comes to shove the wannabe energy superpower will surely come up short.

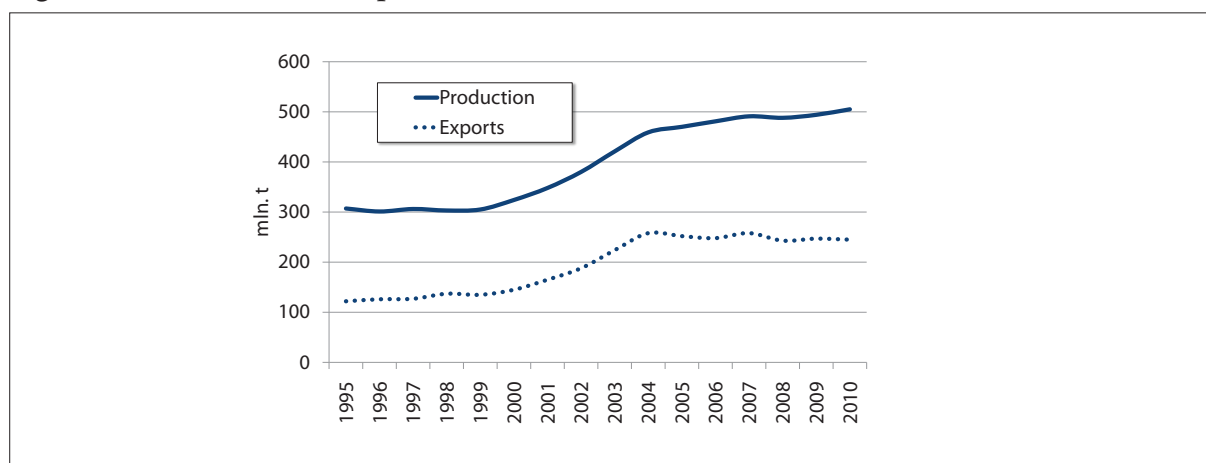
#### *About the Author*

Stefan Hedlund is Professor of Soviet and East European Studies at Uppsala University in Sweden. The present text draws on his forthcoming book *Russia as an Energy Superpower: Empty Threat or Serious Problem?* (Lynne Rienner Publishers, 2012).

## STATISTICS

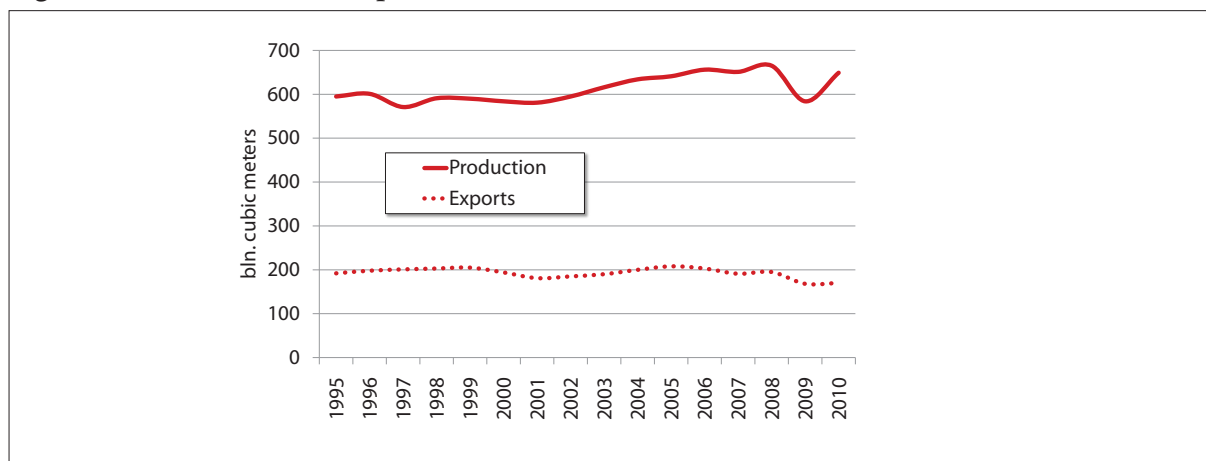
### Production and Exports of Russian Oil and Natural Gas

Figure 1: Production and Exports of Russian Oil 1995–2010 (mln. t)



Source: Rosstat

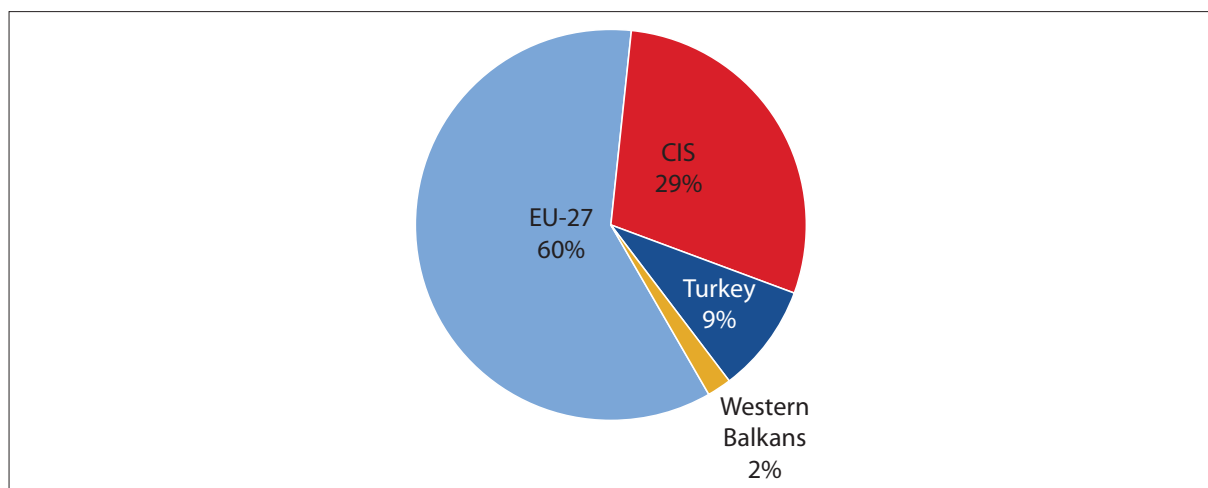
Figure 2: Production and Exports of Russian Natural Gas 1995–2010 (bln. cubic meters)



Source: Rosstat

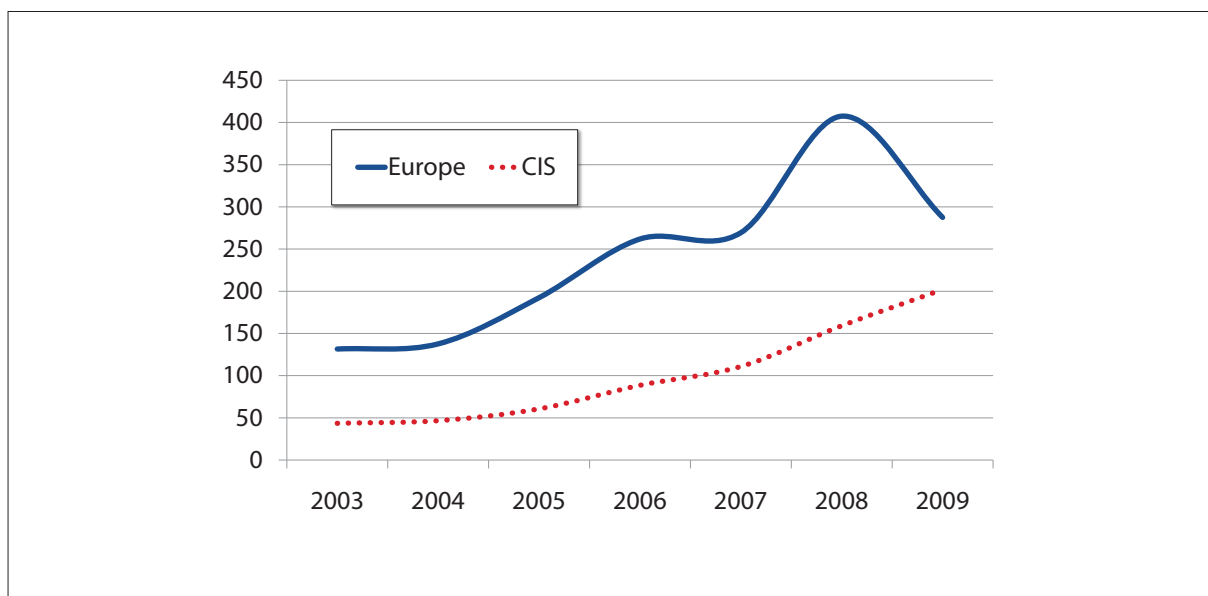
## Gazprom Exports

Figure 3: Gazprom's Exports According to Regions (2009)



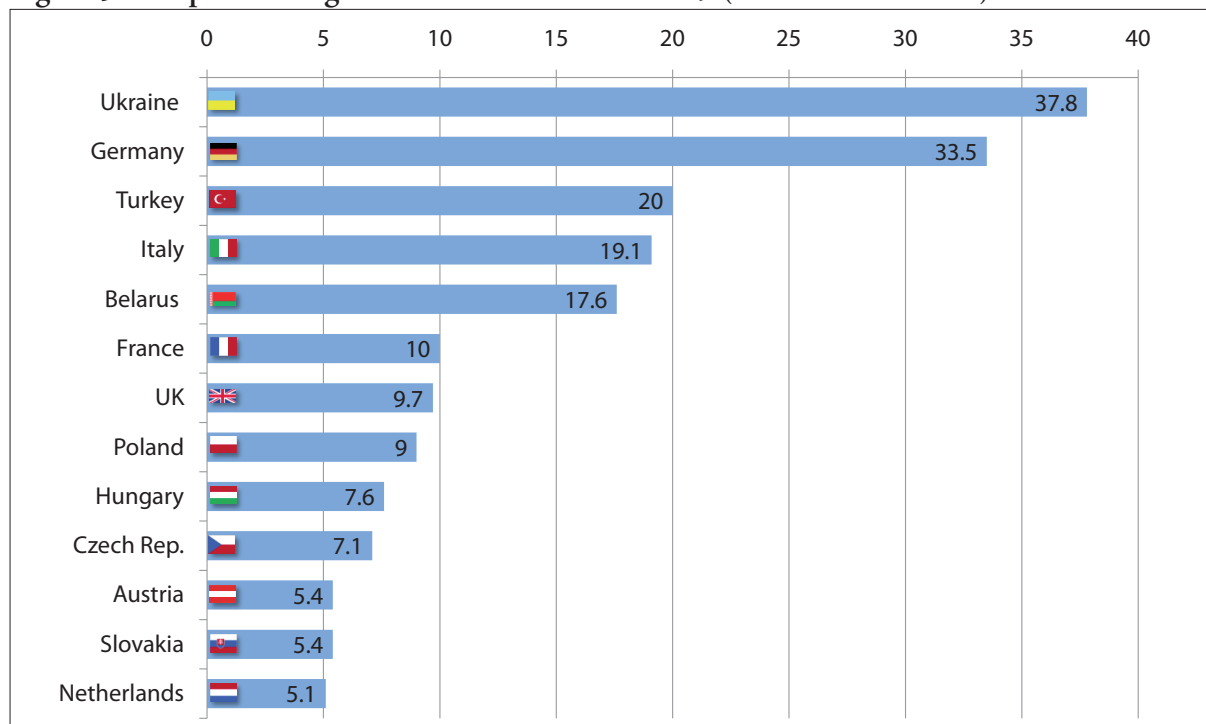
Source: calculations of the Research Centre for East European Studies based on company data:  
[http://www.gazprom.com/f/posts/55/477129/gazprom\\_databook-en\\_1h\\_2010\\_1.xls](http://www.gazprom.com/f/posts/55/477129/gazprom_databook-en_1h_2010_1.xls)

Figure 4: Gazprom's Average Retail Prices  
(without taxes and customs duties, in mln. US dollars for one mln. cubic meters)



Source: Gazprom company data, [http://www.gazprom.com/f/posts/55/477129/gazprom\\_databook-en\\_1h\\_2010\\_1.xls](http://www.gazprom.com/f/posts/55/477129/gazprom_databook-en_1h_2010_1.xls)

Figure 5: Gazprom's Largest Customer Countries 2009 (in bln. cubic meters)



Source: Gazprom company data, [http://www.gazprom.com/f/posts/55/477129/gazprom\\_databook-en\\_1h\\_2010\\_1.xls](http://www.gazprom.com/f/posts/55/477129/gazprom_databook-en_1h_2010_1.xls)

## ANALYSIS

### Conflict over Arctic Energy: States, Corporations, Politics

By Robert Orttung, Washington

#### Abstract

Most of the Arctic's oil and gas resources are located in Russian territory. While violent inter-state conflict is unlikely in the area, Arctic resources will be subject to business and domestic political disputes. Russia's unstable political system and thorny investment environment will make it difficult to conduct a far-sighted policy for developing Arctic resources.

#### State to State Conflict Unlikely

The extent of the resources available in the Arctic is unknown due to a lack of sufficient data, but the United States Geological Survey has concluded, based on a probabilistic model, that the Arctic contains 30 percent of the world's undiscovered gas and 13 percent of its undiscovered oil, mostly offshore in less than 500 meters of water (Gautier, 2009). Despite this treasure, conflict over Arctic resources is unlikely to involve violent state-to-state confrontation, though there are many unresolved issues among the various Arctic states that

are current subjects of dispute. Therefore, the region is not likely to be a focus of security concerns. Rather, the main forms of conflict are expected to be among business partners and within countries' domestic politics. These disputes are probably going to be acrimonious, but largely non-violent.

In contrast to the South China Sea, where tension has been rising over control of natural resource deposits between China, on one side, and Vietnam and the Philippines on the other, developments in the Arctic are moving in a peaceful direction. In May, the Arctic



Council signed its first legally binding treaty coordinating search and rescue activities in the polar area. Even though the Arctic plays a central role in the way that Norwegians and Russians conceptualize their national identities, on June 7, 2011, they culminated a 40-year process by signing and ratifying a maritime delimitation treaty. The deal included dividing up a large area of sea that is rich in fisheries and likely oil and gas deposits. In making the agreement, Russia had to overcome significant internal opposition, since it came around to a position that the Norwegian side had considered in the 1970s (Moe, Fjaertoft, & Overland, 2011). Some nationalist bloggers claimed that the deal gave Russian territory to Norway and warned darkly that President Dmitry Medvedev was next planning to make territorial concessions to Japan. Russian fishermen also complained about losing some of their prime fishing grounds (though they sell most of their catch to Norway anyway to avoid Russian customs). By drawing a firm line between them, both countries opened the door to exploration for hydrocarbons, which had been banned in the area earlier. The deal will make it easier for Russia to work with Norwegian energy companies who have the technology Russia lacks for off-shore development. Additionally, the visa-free travel for borderland inhabitants is Russia's first such arrangement with a Schengen country and may serve as a useful precedent.

But actual development of the resources is some time off. Given the harsh climate conditions, ice, water, and darkness in the Arctic, extracting hydrocarbons there is difficult and oil prices would have to be well north of \$100/barrel for production to be profitable. A more sensible strategy for Russia would be to develop resources that are more easily available and cheaper to produce in other areas.

The successful treaty signing is a dramatic change in mood from three years ago. On 1 August 1 2007, Russia planted a titanium flag on the Arctic seabed in order to bolster its territorial claims. Subsequently Canada increased its military presence in the high north and other states expressed displeasure with Russia's move. Russia did not follow up this bold act with further provocations and instead worked more cooperatively with the other Arctic states. On 28 May 2008, Canada, Denmark, Norway, Russia, and the US signed the Ilulissat Declaration, stressing that they were satisfied with the existing international agreements covering the Arctic. These agreements provide mechanisms for resolving territorial disputes, though some charge that they do not do enough to protect the Arctic environment (Casper, 2009).

Despite the apparent agreement, the potential for conflict remains. In 2012 Russia plans to resubmit its claim to the UN for the Lomonosov and Mendeleev ridges and the shelf area's presumed extensive mineral

resources, perhaps reviving the tensions that have been dormant since 2007. In July, the Commander of the Russian Northern Fleet Adm. Vladimir Vysotsky warned that NATO and Asian nation activities in the Arctic threatened Russia's economic interests and Russian Defense Minister Anatoly Serdyukov said that Russia was planning to deploy more troops in the north. Canada is planning its annual Nanook military exercise in the Arctic for August this year, again provoking Russian concern. The amount of ice in the region is shrinking, opening up greater possibilities for hydrocarbon development. It remains unclear if the methods of cooperation in the Arctic Council will be flexible enough to accommodate the quickly changing conditions in the Arctic, particularly as non-Arctic countries like China take a growing interest in resource and shipping potentials available there. In several cases, the Arctic border countries have a variety of overlapping claims that have yet to be resolved.

The United Nations Convention on the Law of the Sea (UNCLOS) remains the main instrument regulating international behavior in the area even though the United States Senate has so far failed to ratify this agreement. Both the Bush and Obama administrations have recommended that it do so, with little luck. Nevertheless, UNCLOS is effectively operating and most of the resources are located within the exclusive zones of the Arctic littoral states, limiting potential sources of dispute (Dolatat-Kreutzkamp, 2011).

### Corporate Conflict

The real battles over resources in the Arctic today are among corporations. Since many of the resources potentially available in the Arctic are in Russian territory, international oil companies have sought out Russian partners. By Russian law, the only companies that can work on the Arctic's continental shelf are the state-owned and controlled Gazprom and Rosneft (Baev, 2010). However, these Russian firms lack the technology and financial resources to develop the shelf on their own and must find Western partners to work with them.

The most spectacular conflict so far pitted key Russian players in the energy sector against each other. On 14 January 2011 Rosneft and BP announced that they had signed an agreement to jointly develop offshore deposits in the Kara Sea in a \$16 billion share swap: 5 percent of BP for 9.5 percent of Rosneft. The BP press release described the deal as "the first major equity-linked partnership between a national and international oil company." The agreement looked like a big break for BP, which was still trying to recover from the damage to its reputation caused by its giant oil spill in the Gulf of Mexico during 2010.



Working with the state-owned Rosneft seemed like a good solution to the problems that BP had previously had in Russia. TNK-BP, BP's joint venture with AAR (Alfa, Access, and Renova, controlled in turn by Mikhail Fridman, Viktor Vekselberg, and Leonid Blavatnik) lost its license to develop the massive Kovykta gas field in East Siberia after coming into conflict with Gazprom. Since Rosneft's board chairman was Deputy Prime Minister Igor Sechin, a close ally of Prime Minister Vladimir Putin, this BP deal seemed to be protected from the kinds of conflicts that had derailed its earlier effort.

However, the would-be partners failed to consummate their deal when Fridman and his allies blocked BP from going ahead with its agreement with Rosneft. A Stockholm arbitration court on 6 May supported the oligarchs' argument that according to the deal between AAR and BP in setting up TNK-BP, BP could not form other joint ventures in Russia without working through TNK-BP. In blocking the deal, BP's oligarch partners gave up a chance to sell their interest in TNK-BP for \$32 billion, a move that they thought was not in their interest since the company pays several billion in dividends a year (*Kommersant*, June 23, 2011). In the wake of the conflict, the future of TNK-BP remains in doubt. Rosneft is currently negotiating with Shell, Chevron, ExxonMobil, Petrobras, Petronas, and others to be its main partner for future work in the Arctic.

So far all the sides say that they want to continue talks. At the same time, everyone seems to have lost from the conflict. BP has yet again seen its plans collapse in Russia, though it still benefits from its on-going lucrative venture in TNK-BP. Sechin looks weak since he was not able to bring the deal that he supported to fruition. TNK-BP and AAR have made powerful enemies in Sechin and Rosneft. Rosneft would have benefitted from BP's vast off-shore experience and its strong desire to sign a deal with Rosneft as it sought out new opportunities after the fiasco in the Gulf of Mexico (*Kommersant Oil and Gas*, June 16, 2011).

### Domestic Politics

Plans to develop Russia's Arctic hydrocarbon resources put the region at the center of Russia's political system.

#### *About the Author*

Robert Orttung is assistant director of the Institute for European, Russian, and Eurasian Studies at The George Washington University's Elliott School of International Affairs, and a visiting fellow at the Center for Security Studies of the Swiss Federal Institute of Technology Zurich.

#### *Further Reading*

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(continued overleaf)

Russia's political economy is based largely on exploiting oil and natural gas resources and some of the key conflicts that take place in Russian politics pivot around determining who controls these resources.

A central player in such battles is Sechin, the informal leader of the siloviki. His rise in Russian politics is closely associated with that of Vladimir Putin's and they have been close since their days working together in Leningrad. Sechin played a key role in the decision to prosecute Mikhail Khodorkovsky in the Yukos case and then managed the transfer of Yukos's most valuable assets to Rosneft. Sechin's continuing influence over Russian politics makes it unlikely that Russia will be able to modernize its political and economic systems (Sakwa, 2011).

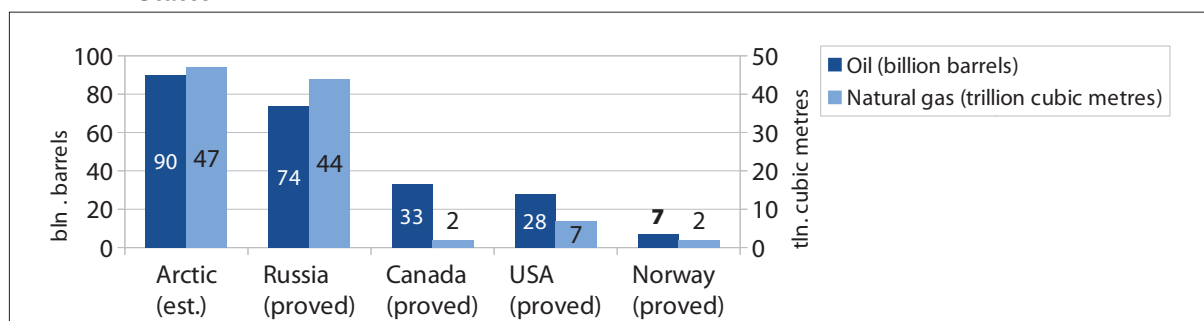
Sechin uses the opaque connections between the state and business to maximize his control. On 30 March 2011, Medvedev seemed to strike a blow against this system when he announced that he wanted all government ministers to give up their seats on corporate boards. This move forced Sechin formally to step down as the chairman of Rosneft, apparently reducing his control over Russia's energy assets. But, as usual with Medvedev's initiatives, the content did not live up to the form. Even as Sechin quickly resigned from Rosneft, his associates made it clear that he would still exercise control over the company through informal means. Accordingly, the factions inside the Russian government supporting and opposing reform will continue to do battle.

### Conclusion

The unstable nature of the Russian political system, which is characterized by clan conflict rather than far-sighted planning, means that the country is unlikely to develop a coherent strategy to develop its Arctic resources. While violent inter-state conflict over the use of Russia's Arctic resources is unlikely, the increasingly intense struggles among the advocates of maintaining Russia's status quo political and economic system and those who want to pursue a path of reform means that the politics and corporate struggles surrounding Arctic policy will remain unsettled.

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**Figure 1: Undiscovered Oil and Gas Resources of the Arctic and Proved Reserves of the Littoral States**



Source: United States Geological Survey, July 2008, <http://pubs.usgs.gov/fs/2008/3049/fs2008-3049.pdf> (undiscovered resources of the Arctic); BP Statistical Review of World Energy June 2010 <http://www.bp.com/statisticalreview> (proved reserves of littoral states)

## ANALYSIS

### Liberalisation Heralds Change in the Gas Market

By Simon Pirani, Oxford

#### Abstract

The Russian government's efforts to liberalise the domestic gas market, and specifically to raise gas prices to levels comparable to those in Europe, will be a decisive factor in the country's energy sector over the next 5–10 years. Already, Ukrainian prices are close to "European netback" (i.e. European border prices minus export duties and transport costs)—and although Russian prices lag behind, sales across the former Soviet Union have become much more important to Gazprom, Russia's dominant, state-controlled gas company, than they were during the oil boom of 2002–08. In the domestic market, Novatek (Russia's no. 2 gas company after Gazprom) and the oil producers now account for one quarter of sales, and are giving weighty political support to liberalisation.

#### The European Netback Principle

The Russian government finally decided on gradual gas market liberalisation in 2006, as a corollary of liberalisation of power and heat markets (which account for more than half of domestic gas consumption). The key decree, no. 333 of May 2007, provides for domestic gas prices to move up in stages according to the principle of

"equal profitability of gas supply to domestic and foreign markets" (i.e. European netback), and for other steps to end Gazprom's quasi-monopoly of domestic sales and control of the pipeline network through which gas is transported to customers.

In ruble terms, Russian consumers pay roughly nine times more for gas than they did in the late 1990s. But

prices remain regulated at levels around, or less than, half of European netback. In 2007, ministers spoke of reaching European netback pricing by 2011—but as oil prices shot up to unprecedented highs that year, pulled back from these original targets. The world financial crisis, and the ruble devaluation that followed, further complicated things. Nevertheless, actual prices in dollar terms rose in 2009 and 2010.

The state regulatory body, the Federal Tariff Service (FTS), calculated nominal European netback levels in 2010 (averaged across Russian regions) at 5534 rubles/thousand cubic metres (r./mcm) (first quarter), 4190 r./mcm (second quarter), 4257 r./mcm (third quarter) and 4736 r./mcm (fourth quarter). Wholesale prices, which are regulated by the FTS, were (averaged across regions for the year) at about 40% of that level for households (1903 r./mcm), and just over half of it (2478 r./mcm) for other customers (including power companies, industry etc).

When the government reviewed progress last year, it decided that regulated wholesale gas tariffs would move up by 15% per year, for both industrial and residential sectors, with a view to reaching European netback by 2015. But raising tariffs remains extremely sensitive for governments that fear social protest—and Russia is no exception.<sup>1</sup> In April 2011, both prime minister Vladimir Putin and finance minister Aleksei Kudrin suggested that increases in all regulated tariffs—i.e. those for electricity, water, heat and rail freight as well as gas—should be slowed down to around the level of inflation. The economic development ministry drew up an alternative schedule, under which tariffs would rise “no faster than the expected level of inflation”, i.e. 5–6% a year. Putin told officials to look at the two schedules and come back with proposals.

With the political establishment preparing for the presidential election in March 2012, this proposal to put the brakes on tariff increases was no great surprise. In the electricity market, it has caused friction with companies that bought power generation assets at privatisation in 2006–07, who complained that it cuts into expected revenues on which they had based investment plans. In gas, it will not only have significant implications for Gazprom’s investment programme, but will also make it unlikely that European netback will be reached even by 2015—although that of course depends partly on how prices move in the European market.

For all Russian gas producers—Gazprom, Novatek and the oil companies—even the long-term prospect

that domestic gas sales will be anywhere near as profitable as European sales is a game changer. Gazprom, almost continuously since being formed in 1990, has subsidised its domestic sales—which in turn have subsidised industry and the population—from revenues earned on European sales. Because European gas prices are linked to oil prices, those revenues soared during the oil boom of 2002–08 and remain high. But if the differential between the export and domestic market closes, the rationale for focusing on export disappears. In fact the sheer scale of the FSU markets could make them potentially more attractive.

Consider the numbers. Roughly, 650 billion cubic metres (bcm) of gas is consumed annually by the FSU, compared to 550 bcm by OECD Europe; Russia consumes roughly three times as much gas (450 bcm) as it exports to Europe (150 bcm). Between 2000 and 2010, when Gazprom’s average sales price in Europe almost trebled from \$103.20/mcm to \$301.80/mcm, its average Russian sales price rose from 12% to 25% of the European price and its average sales price in other FSU countries (mainly Ukraine) rose from 52% to 77% of the European price. Those gaps will take time to narrow further, but, as they do, companies’ strategies will be transformed.

### Decree No. 1205

Decree no. 333 on market liberalisation was supplemented by decree no. 1205 “On improvement of state regulation of gas prices”, issued by Putin on 31 December 2010, which set out the regulatory steps required. It directs officials to draw up proposals “on the transition, starting from January 1, 2015, from state regulation of wholesale gas prices to state regulation of transport services on high-pressure pipelines on the territory of the Russian federation”. If and when this were implemented, it would amount to non-discriminatory third-party access with all parties, Gazprom subsidiaries included, paying regulated transport tariffs while selling gas at free market prices.

Decree no. 1205 also introduces the idea that regulated prices should be set taking into account not only the European netback levels but also “the cost of alternative fuels”. It is not clear how these costs would be calculated, but it has long been an objective of Russian government policy to raise gas prices relative to coal prices.

This wording could also be an acknowledgement of the biggest uncertainty hanging over the price reform process—that the average sale price of Russian gas in Europe, which forms the basis of the FTS calculation of netback levels, is subject to powerful changes in the European market. The trend away from oil-linked prices on one hand and long-term contract sales on the other,

1 A recent survey of this issue in Russia is: Indra Overland and Hilde Kutschera, “Pricing Pain: Social Discontent and Political Willpower in Russia’s Gas Sector”, *Europe-Asia Studies* (2011) 63:2, pp. 311–331.

towards a bigger role for spot prices, will inevitably influence these calculations.

### **Ukraine Nearer to European Price Levels Than Russia**

Ukrainian domestic prices are approaching European netback much more rapidly than those in Russia (see Table 1). Import prices of Russian gas, to which industrial consumer prices are tied, rose to a nominal European netback level under contract (about 10% higher than actual European netback) from January 1, 2010, and were \$305/mcm in the first quarter and \$336/mcm in the second quarter. Thereafter a \$100 discount was applied under the agreement concluded with Russia in April last year. With the discount applied, this year's import prices were \$264/mcm in the first quarter and \$297/mcm in the second quarter.

Accelerated price increases for residential gas customers were scheduled as part of a programme of revenue-raising measures agreed with the International Monetary Fund (IMF) under a loan programme launched in October 2008—but, like Russia, Ukraine has found it difficult to implement changes at the pace initially envisaged. And the reasons are the same: apprehension about popular protest prior to elections (in Ukraine's case, parliamentary, in 2012). Regulated tariffs for residential consumers were raised by 50% in August 2010, in accordance with the government's commitments to the IMF. A further 50% increase was scheduled for April this year, but is now being implemented in stages: 10% in April, 20% in June and the remainder later in the year.

### **Russian and FSU Sales Have Cushioned Crisis Effect**

As a consequence of the economic crisis of 2008–09, and the resulting zig-zag of oil prices and oversupply of the European gas market, Gazprom's Russian and FSU sales became significantly more important to it in 2010 (see Table 2). In 2009, demand for gas in both Europe and the FSU fell sharply due to the economic recession. In Europe, Gazprom found itself struggling to retain its market shares against other importers.

Gas prices in the long-term sales contracts that are used for most imports, which are tied to those of oil, dipped briefly but then returned to high levels, while gas sold on liberalised “spot” markets in Europe was much cheaper—half the price, at one point in 2009. Some importers, e.g. Norway, offered more substantial discounts on their contract prices than Russia was prepared to. Gazprom decided to lose volumes rather than cut its prices, and by 2010, with oil prices still high but the economy recovering and the gas market better bal-

anced, it found its European market share had fallen (roughly, from 29% to 24%).

What saved Gazprom from a substantial fall in revenue were the sharp increases in prices for gas exported to Ukraine, and modest increases for Russian industrial customers. This meant that revenues from Russian sales have risen steadily for the last two years, and revenues from FSU sales—despite a sharp fall in Ukrainian import volumes—dipped negligibly in 2009 and rose sharply in 2010. In round numbers, Russia and the FSU contributed 40% of Gazprom's gas sales revenues in 2008, and 50% in 2010. That proportion may well keep rising.

### **Market Reform, Continued**

There are two other key aspects to Russian market reform: (i) the development of an unregulated market, dominated by non-Gazprom gas producers, and (ii) the erratic progress towards pipeline access for those producers that is a precondition for a completely liberalised market. Gazprom stated recently that the unregulated market now accounts for up to 25% of total domestic gas sales—i.e. more than 100 bcm/year. The main sellers are Novatek and the Russian oil companies; the main buyers are large power and industrial sector customers. Prices are rarely disclosed, but usually hover at, or just above, the regulated prices at which Gazprom sells to industry.

A further aspect of market reform was the establishment in 2007–08 of the gas exchange, operated by Mezhhregiongaz, Gazprom's domestic sales arm, on which 5 bcm of Gazprom gas and 5 bcm from non-Gazprom producers was to be sold. Operations were suspended in 2009 as prices fell sharply during the recession. President Dmitry Medvedev in April instructed officials to draw up plans to reopen the exchange, and industry sources expect this could happen at some point in 2012.

While the 2007 decree set out a framework for the unregulated market to grow, it left unresolved the issue of third-party access to the pipeline system, which is owned and maintained by Gazprom. According to current rules, spare capacity must be made available to any non-Gazprom producer that requests it. But until 2009, even the largest non-Gazprom producers complained that Gazprom granted or withheld capacity on the basis of its own commercial interests.

Negotiations went round in circles: the energy ministry insisted that Gazprom would itself only be allowed to sell gas at deregulated prices only when pipeline access was granted in a more transparent and predictable manner; Gazprom insisted that fuller price deregulation would have to precede third-party access. It also complained that regulated transport tariffs were far short of

the levels needed to maintain and upgrade the world's largest gas transport system, while also fulfilling investment commitments insisted on by the government, Gazprom's majority shareholder.

In practice, pipeline access was always granted by means of opaque negotiations between Gazprom and other producers. In 2009, as the oil lobby grew stronger in government and the powerful oil trader Gennady Timchenko became the largest shareholder in Novatek, Gazprom was forced to make substantial concessions on pipeline access. Novatek signed contracts with OGK-1, the state-controlled power company, to supply nearly 10 bcm/year of gas at the regulated price, but on more favourable contract terms than Gazprom. This bomb-shell deal, which presumably involved OGK-1 breaching the terms of its previous purchase contracts with Gazprom, suggested that political pressure was being put on Gazprom to grant pipeline access to its powerful competitors without further delay.

The Novatek-OGK-1 deal marked something of a turning-point. At the same time, Rosneft, Russia's largest oil company, took monopolies commission proceedings against Gazprom over pipeline access: the case was halted by a last-minute deal between the companies. The Russian press subsequently reported major supply deals between Novatek and power, chemicals and metals companies; oil companies Rospan (TNK-BP) and Lukoil also reported higher sales of gas in the unregulated market. New third-party access rules have yet to be agreed, but in practice things are changing.

Changes in the taxation of gas production, proposed in April, sparked speculation that the rules of the game could be further tilted against Gazprom and in favour of its powerful competitors. The mineral resources extraction tax, which was 147 rubles/mcm in 2006–2010, rose to 237 r./mcm this year, and in March the finance min-

istry reportedly urged sharp hikes to 529 r./mcm in 2012 and 558 r./mcm in 2013. Last month several government sources hinted that a significant tax break could be introduced for "wet" gas—gas from relatively deep layers with high liquids content—which accounts for about three-quarters of Novatek's output, but less than a quarter of Gazprom's.

## Conclusions

While European netback pricing is not the same as market liberalisation, in the Russian context it is a precondition for it. The government remains committed to achieving European netback prices, but its concerns about inflation mean that this target, already postponed to 2015, could be delayed still further. In Russian policy circles, the discussion on gas pricing is also linked to the progress of electricity market liberalisation, and Central Bank policy (i.e. whether to shift from exchange rate targeting to inflation targeting). In order to determine the future pace of change in gas prices, all these elements need to be considered. The significant changes in the European market, which itself appears to be shifting away from oil-linked pricing, could further affect Russian price reform.

The government and the Russian gas industry see European netback pricing as part of a broader liberalisation project and the oil industry's progress on pipeline access have put that issue on the political agenda, although it remains a subject of disagreement between different industrial lobbying groups. When European netback pricing finally arrives, it will imply (i) a transformation of Gazprom, away from its strategy of maximising revenue from exports to cross-subsidise domestic sales, and (ii) an ever-greater diversification of supply, with the non-Gazprom producers playing an increasing role.

### *About the Author*

Simon Pirani is a senior research fellow at the Oxford Institute for Energy Studies (OIES).

### *Further Reading*

Publications of the OIES Natural Gas Research Programme ([www.oxfordenergy.org](http://www.oxfordenergy.org))

### *Forthcoming (July 2011):*

Simon Pirani, *Elusive Potential: Natural Gas Demand in the CIS and the Quest for Efficiency*.

### *Published working papers:*

- Jonathan Stern and Howard Rogers, *The Transition to Hub-Based Gas Pricing in Continental Europe* (March 2011)
- Simon Pirani, Jonathan Stern and Katja Yafimava, *The April 2010 Russo–Ukrainian gas agreement and its implications for Europe* (June 2010)
- Simon Pirani, *The Impact of the Economic Crisis on Russian and CIS Gas Markets* (November 2009)

### *Books:*

- Simon Pirani (ed.), *Russian and CIS Gas Markets and Their Impact on Europe* (OUP, 2009)
- James Henderson, *Non-Gazprom Gas Producers in Russia* (OUP, 2010)



**Table 1: Russian and Ukrainian Gas Prices Compared**

\$/mcm	2005	2006	2007	2008	2009	2010	2011 (proj)
Russian industry, wholesale	35.51	40.58	52.81	67.87	64.80	82.60	85.58
Russian households, wholesale	25.61	31.72	40.27	51.85	49.47	63.43	75.28
Ukraine import prices	77	95	130	179.50	236.10	255.20	264 (q1)
Ukraine industry, net of VAT	69.11	107.30	142.60	192.50	251.50	258.90	287.03 (q1)
Ukraine households, net of VAT	30.5	67.16	57.40	52.35	56.54	70.25	83.98 (q1)
European border price	213.70	285.20	294.10	418.90	307.80	323.70	n/a

Source: Federal Tariff Service (Russia), national electricity regulatory commission (Ukraine), OIES estimates and currency conversion

**Table 2: Gazprom Sales of Natural Gas, 2008–2010**

			2008	2009	2010
Europe	Net sales (Billion ru)		1260.6	1105.5	1099.2
	Volumes (billion cubic metres)		167.6	148.3	148.1
	Gross average gas price, per thousand cubic metres	\$	407.4	296.7	301.8
		rubles	10125.4	9413.5	9166.6
FSU	Net sales (Billion ru)		356.5	309.9	450.1
	Volumes (billion cubic metres)		96.5	56.7	70.2
	Gross average gas price, per thousand cubic metres	\$	159.2	202.1	231.7
		rubles	3956.9	6411.1	7039.0
Russia	Net sales (Billion ru)		479.4	503.1	636.8
	Volumes (billion cubic metres)		292.2	273.5	277.3
	Gross average gas price, per thousand cubic metres	\$ (estimate)	66.15	58.03	76.56
		rubles	1640.6	1839.5	2296.8
Total	Net sales (Billion ru)		2096.5	1918.5	2186.2
	Volumes (billion cubic metres)		556.3	478.5	495.6
Exchange rate, rubles/\$			24.8	31.7	30

Source: Gazprom Management Reports 2009 pp. 26–27; 2010, p. 30



## ABOUT THE RUSSIAN ANALYTICAL DIGEST

Editors: Stephen Aris, Matthias Neumann, Robert Orttung, Jeronim Perović, Heiko Pleines, Hans-Henning Schröder, Aglaya Snetkov

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