The Implications of Gazprom’s Demise

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Roger W. Robinson, Jr.

It is now no secret that the Russian natural gas behemoth, Gazprom, is in a state of gradual, and likely inexorable, decline. Perhaps needless to say, this is no ordinary energy major. Besides being the world’s leading natural gas producer, it has a long tradition of serving as the leading political “slush fund” or “piggy bank” of Vladimir Putin’s rise to power and his ability to remain there. Indeed, the entire Russian system of “crony capitalism,” as it exists today, is more lubricated by Gazprom revenues than any other single source. Accordingly, the phrase, “Where goes Gazprom, goes Russia” may only be a partial exaggeration.

A sustained slump of Gazprom profits, which were some $44 billion last year, could also seriously complicate Putin’s expensive purchases of loyalty in the military, the police and the security services as well as the national pride and patriotism (as defined by support for him) he hopes to evoke from a modernized, sophisticated and highly lethal military machine and a Russia standing astride the world stage. Already, the signs of a more arrogant and aggressive Russian posture regarding Syria, Iran and other global “flash points” are unmistakable, not to mention the swipe recently taken at the U.S. with the closure of the State Department’s Moscow office of the Agency for International Development. The faltering of Gazprom under this new market and political scrutiny could prove a very sobering event for Russian leadership and its wealthy cadre of supporters. Accordingly, this analysis has potentially important foreign, security and energy policy implications for Japan, the United States, Eastern, Central and Western Europe, gas-producing Central Asian states and parts of the Middle East.

The “multi-tasking” of Gazprom by Russian authorities has, no doubt, contributed to the company’s seeming lethargy and inattentiveness to clear and ominous global energy developments with respect to the firm’s traditional business plan, and the urgent need for infrastructure investment and modernization. The advent of a spot market in gas, the shale gas revolution in the United States, official raids against the offices of Gazprom affiliates last year and increasing disconnect between oil and gas prices, all conspired with Russian rigidity on the terms of its “take or pay” gas contracts with Eastern, Central and Western Europe, to undermine fundamentally the position of Gazprom in the markets, perhaps irreversibly. Certainly, it threatens the present configuration of the gas giant, which engages in both production and transmission activities. The company is also being compelled to shelve “flagship” projects, like the Shtokman gas field in the
Arctic (i.e., Barents Sea) due to now-prohibitively high costs and the evaporation of the export opportunity to the U.S.

In the coming retrospective, one of the defining moments in the decline of Gazprom will likely be the European Commission’s announcement of an anti-trust investigation of Gazprom practices in Central and Eastern Europe. Specifically, the Commission will be examining Gazprom monopolistic activities in Poland, Bulgaria, the Czech Republic, Estonia, Latvia, Hungary, Lithuania and Slovakia.

The alleged abuses reportedly include: 1) limiting freedom of movement of gas among EU member states; 2) preventing attempts to diversify gas supplies to EU customers; and 3) imposing unfair prices on contractors. Some twenty EU gas companies affiliated with Gazprom (both subsidiaries and joint ventures) as well as the company’s contractors and transmission operators, have been targeted by this inquiry. The rough timetable associated with this investigation allows four months for Gazprom to respond to the charges, followed by 6 to 12 months of internal administrative procedures at the EC. Should their be a negative ruling against Gazprom, the company can appeal the decision to the EU Court of Justice, a circumstance that could take up to 2 years to resolve definitively. Accordingly, worst case, this entire process could take over 3 years.

Several of the plaintiff countries, however, have no intention of waiting for this EC initiative to play out. Lithuania has, for example, already filed suit against Gazprom with a $1.9 billion claim that the country overpaid for gas deliveries since 2004, the year Gazprom acquired a major stake in Lithuania’s largest gas importing company. German and Polish companies have also sued Gazprom over similar complaints.

A negative EC ruling would involve a fine being levied on Gazprom equivalent to 10% of its previous year’s sales turnover, or about $15 billion. Already this year, the company has had to return some $4 billion in retroactive discounts to key West European customers, which threatened to move to alternative sources of supply due to Gazprom overcharging (with prices as high as $490 per 1,000 cubic meters when the market price is somewhere between $405 to $415). To gain a better sense of what has happened to gas prices since the explosion of shale gas development in the U.S., current European gas prices hover at about $10 per unit versus an estimated $3 per unit in America. A “guilty” verdict by the EC could likewise place additional pressure on Gazprom to comply with the EU’s so-called “Third Energy Package,” which calls for the separation of gas production and transmission businesses and third-party access to infrastructure.

This EC announcement on September 4 set off a firestorm of reaction in Moscow that was as revealing as it was intemperate and ill-considered. Even Vladimir Putin entered the fray, declaring Gazprom a “strategic company” that has no obligation to disclose any of its internal workings or documentation to EC investigators. He went on to dismiss shale gas as little more than an environmentally-hazardous fad. Indeed, Moscow is widely suspected of having helped fund activist environmental groups to generate fierce opposition to shale gas “fracking” in Europe to reduce the threat it poses to the competitiveness of Russian gas supplies. (France and Bulgaria, for example, have
already banned fracking). Not coincidentally, Gazprom itself owns media companies throughout Russia and Europe that have been running high-profile stories on the environmental risk of fracking. Putin also stated publicly that Gazprom had every intention of continuing its price discrimination against Central and Eastern Europe, despite having agreed to steep price discounts for select West European customers. The Russian President also unwisely reaffirmed the firm linkage of gas prices to the price of oil.

President Putin has also been using the argument that some 60% of the cost associated with Russian gas imports emanates from European taxes, not overpricing. He also stated that if Europe continues to pursue these allegations that Moscow will increasingly divert its gas deliveries to Asian customers. Perhaps in preparation for revelations that will likely stem from the EC investigation, Putin has, for the first time, acknowledged the possibility of corruption at Gazprom. He stated on October 2, “we hear claims more and more frequently about how the company’s business is developing and how there’s corruption there. There probably is.” Such statements could give him some “wiggle room” concerning the company’s misdeeds down the road.

It is useful to note the leverage that Gazprom continues to enjoy over the countries of Eastern and Central Europe, accounting for: 100% of the gas supplied to Bulgaria, the Baltic States and Slovenia; 80% of that supplied to Poland and Hungary; and 70% to the Czech Republic. European efforts to address this energy security concern have not been very successful to date. For example, the EU has not yet achieved the segregation of supplies and deliveries or the construction of new pipelines for the purpose of diversification. Accordingly, it is now concentrating on the subject of unfair competition. In some ways, it is this present challenge to Gazprom that offers the best prospect for results. As Fiona Hall of the Brookings Institution recently put it “[Gazprom’s] days of dominating the European gas markets are gone.”

Even prior to this anti-trust investigation, the EC had become more activist in taking on Gazprom’s thuggish behavior in the European markets, recently informing the Poles that they would be well-advised to alter their new supply contract with Russia to eliminate Moscow’s right to divert gas from Poland should domestic requirements call for such action and other disadvantageous provisions of the Russian draft. The European Commissioner for Energy, Gunther Oettinger, also recently accused Russia of engaging in “pure blackmail” with regard to Gazprom’s behavior toward Moldova, which he deemed “unacceptable.” This is a far cry from the Western Europe of the early 1980s that fiercely resisted President Reagan’s ultimately successful efforts to place a 30% ceiling on Soviet natural gas deliveries to the Continent as a percent of overall natural gas supplies and to kill the second strand of the huge Siberian gas pipeline project. At that time, there had, as yet, been no precedent of heavy-handed Soviet politicization of gas deliveries (or actual cut-offs) to its European customers, a semi-regular occurrence since.
During this earlier period, the Europeans, and many in Japan, held the view that a naïve and ideological Ronald Reagan was simply “overreacting” to a possible extortion scenario which had a near-zero probability of eventuating. Not so now. Even the South Stream pipeline, designed by Moscow to undermine the viability and competitiveness of the Western-sponsored Nabucco pipeline, may be in jeopardy. Indeed, many in the industry believe that gas-producing Central Asian states, like Turkmenistan, must continue to sell their gas to Russia, if Gazprom is to fulfill its contractual obligations to West European customers.

**IMPLICATIONS FOR THE CZECH REPUBLIC AND CENTRAL EUROPE**

The gradual demise of Gazprom, and the selection by President Putin of favored replacements (e.g., Rosneft), is one of the largest seismic shifts on the Russian economic and political scene since the fall of the Soviet Union. Energy-related exports are still responsible for roughly two-thirds of Russia’s total annual hard currency income (similar to the early 1980s). Gazprom has produced Russian leaders from the time of Prime Minister Viktor Chernomyrdin in 1992 right up to Dmitri Medvedev in 2008. At some level, Gazprom is a vast, state-sponsored enterprise riddled with corruption, which was lulled into complacency by seemingly unlimited political patronage as the global energy architecture was transformed around it.

President Putin will likely feel increasingly on the defensive at home and abroad and may well exhibit greater hostility toward the U.S., the Czech Republic, Poland and other NATO allies. Problems at Gazprom could also prompt more sophisticated, front-line weapons sales to Iran, Syria and other potential adversaries to augment Russian revenues, while strengthening its own offensive military capabilities aligned against NATO countries.

These Gazprom customers viewed as siding with the EC investigators will likely be subject to an increase in Russian “active measures” (e.g., the funding of more vocal and militant environmental groups) and other disruptive activities, including in the energy sector. Symptoms of this more menacing attitude toward regional gas customers is presently on display concerning Moldova, which Moscow is trying to have “renounce [its] protocol on entering the Europe Energy Community agreement,” according to Russian Energy Minister Alexander Novak. One thing is clear, Gazprom and its political benefactors will not go quietly into the twilight of being a less powerful and competitive player on the global energy stage. Nor will it voluntarily comply with the kind of comprehensive corporate restructuring necessitated by the EU’s “Third Energy Package” or the disclosure requirements involved with the EC anti-trust inquiry. In short, a wounded Gazprom will likely manifest itself in an angrier and more belligerent Russia.