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POLICY BRIEF

Gazprom: slow to adapt and unable to exert influence

Authors: Andrei V Belyi[1]

Highlights

- Changing market realities in natural gas engender significant challenges for Gazprom in both Europe and Russia alike. The trend consists in a growing number of suppliers domestically, with a boost of independent gas production, and internationally, with a more liquid gas and LNG trade.

- Transition towards a new market model in the EU affects existing pricing mechanisms and contracts. For the Russian gas export monopolist a separation between pipeline capacity and commodity markets also generates risks of capacity-supply mismatch and constitutes barriers to new pipeline projects.

- In Russia itself, Gazprom faces competition from fast-evolving gas producers such as Rosneft and Novatek. The two companies are striving for the gas export de-monopolisation, which already occurred for Russia's LNG.

- Current low price context reverts the situation in Gazprom's favour. In particular, Gazprom's production competitiveness improves, oil-indexation regains a rationale, while natural gas demand growth rates somewhat restarted, whereas domestic competitors experience severe difficulties.

- However, main political barriers, conflicts surrounding Ukraine and diversification strategies subsist. A more positive market context stems from exogenous factors rather than from Gazprom's own strategies.

- It may become essential to use the positive market context to demonstrate flexibility on contracts, pricing and hub-based exports. An ability to adapt does not deny a more vivid defense of the company's views especially regarding new projects and capacities. Nevertheless, pipeline over-capacity loses attractiveness.

- On a smaller scale, investments into small liquefaction capacities might be a starting point to depoliticize Gazprom's supplies to Europe.

- A transit agreement with Ukraine remains strategically important alternative to investments into new pipelines.

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1. Andrei V Belyi, Senior Researcher at the Centre for Energy, Environment and Climate Change Law, University of Eastern Finland. This commentary is based on the research project (276974) "Impact of Shale Gas in EU Energy Law and Policy" financed by the Academy of Finland, email: Balesene@gmail.com

Continued difficulties for Gazprom

Last year's working paper entitled 'Between a rock and a hard place: international market dynamics, domestic politics and Gazprom's strategy', published by the Florence School of Regulation, highlighted the major issues facing the Russian gas export monopoly. Among other issues, the paper pointed to the significant *pressure on Gazprom stemming from EU market liberalisation*. In particular, Gazprom faces considerable challenges as a result of various regulations relating to capacity anti-hoarding mechanisms. Consequently, South Stream, Gazprom's major export project, has been indefinitely postponed. In addition, Gazprom and its consortium partners face regulatory difficulties in relation to OPAL, the German onshore branch of Nord Stream. In this case, Gazprom may use only 50% of capacity for its long-term supplies, while the other 50% needs to be purchased annually from the capacity market. Russia's stated aim of bypassing EU regulations by backing a new Turkish Stream project did not come to fruition, on the face of it due to the aftermath of the Moscow-Ankara disputes over Syria. However, it should be noted that the Turkish Stream project was dogged by a structural problem: it did not address how to ship gas to delivery points in Central and Eastern Europe, to which Russian gas has to be shipped pursuant to long-term contracts. In the meantime, territorial and pricing conflicts with Ukraine increased the urgency of the need to find alternative transit routes.

In addition to regulatory complexities, *the newly evolving market context, characterised by LNG inflows and increasing liquidity in gas hubs*, led to a reconsideration of oil-indexed pricing. Thus, more flexible take-or-pay clauses and price discounts on traditional oil-indexation became the subject of disputes between Gazprom and European gas companies. Despite Gazprom's firm position backing oil-indexation and long- term take-or-pay contracts, European enterprises have succeeded in requiring it to adapt its contracts to the new situation.

On top of all of this, *the European Commission has launched an antitrust monitoring exercise* against the Russian supplier. Although Gazprom initially rebuffed the accusations made, it is now increasingly concerned with finding a compromise with Brussels. As oil-indexation is among the issues raised as representing anti-competitive behaviour, the European Commission has entered into a new policy area – that of gas prices. As a result, the European institutions have forged market norms based on hubs. Since these hubs are located in Europe, Gazprom has been excluded from the process of creating norms in respect of the gas markets.

In parallel, *Gazprom has been facing competition from other Russian enterprises* (Rosneft and Novatek) that wish to break into export markets. Paradoxically enough, Gazprom's competitors inside Russia have made similar demands: for access to networks and liquidity in gas trade. The changes that have taken place domestically include the creation of the SPB gas hub, from which gas can, hypothetically, be imported directly by Europeans via direct exchange trade. Russia's Federal Anti-Monopoly Service has often insisted on the transparent and non-discriminatory allocation of Gazprom's pipeline capacity. In a similar vein, it would like to see a proportion of gas exports being allocated to the SPB hub. Consequently, Gazprom's influence has diminished inside Russia and has been significantly challenged in Europe.

Finally, yet importantly, *the difficulties experienced by Gazprom in securing financial agreement with China* to implement the Power of Siberia pipeline project harmed its political position both within Russia and internationally. Gazprom's objective of demonstrating strong export diversification ability appears to be subject to certain constraints.

Positive market context

Still, the situation does not seem to have been altogether negative for Gazprom. Moreover, the company appears to have reinforced its position over the past year. Its good fortune in this respect may largely be explained by reference to market trends which can be summarised along four main lines:

Regaining the oil indexation rationale. Perhaps paradoxically, the fall in hydrocarbon prices has in fact benefitted Gazprom. At first glance, oil-indexation seems to have undergone a gradual process of depoliticisation. The decline in the oil price drove the price down to USD 6 per MBTU for 2015, and this figure will decline still further when the oil price hits bottom. Consequently, European companies have not been making many complaints regarding Gazprom's pricing mechanisms. The low price may even prove to be a significant barrier preventing new supply sources from breaking into European markets.

Decline in production costs. Gazprom's production costs have declined mostly due to a fall in service costs and the exchange rate between the Russian rouble and the US dollar. This favourable exchange rate has been a factor in Gazprom's wellhead price. At the end of 2015 and in early 2016, conversion rates brought about a reduction in costs in dollars of at least 30%. Russian gas production costs averaged USD 30 per tcm mostly as a result of this. Hence, Gazprom now also has the possibility of reducing the gas price and thus imposing itself as the most competitive supplier to Europe.

Domestic competitors' export projects have lost momentum. Initial ambitions by Rosneft and Novatek to export LNG appear to have become more difficult to implement. Both major LNG projects – Yamal LNG promoted by Novatek and Sakhalin-1 invested in by Rosneft – fixed elevated price benchmarks between USD 11 and 13 per MBTU, on the basis that the Asian markets would then be natural buyers for the new liquefaction projects. However, the gas price has since halved and both projects seem to have been postponed. In this context, Gazprom has reinstated itself as the main exporter of Russian gas via existing supply chains. Furthermore, it has fought off the process of export demonopolisation called for by its competitors.

Rising export volumes via long-term contracts. The SPB gas hub has traded way below initial hopes, with the price not differing much from that achieved under Gazprom's long-term contracts. Furthermore, while Gazprom opened export trade in September 2015 it did not attract any strong interest from European consumers. By contrast, in 2015, its exports to Germany increased by 14%, to Italy by 12%, and to France by more than 30%. Furthermore, the first quarter of 2016 marked growth in the volumes exported by Russia of 36% compared to the previous year.

It remains to be seen whether market reinforcement will become a structural trend or remain a result of the decline in the price. One can argue that a price decline usually tends to stabilise existing supply chains, while diversification is usually stimulated by a higher price.

The way forward?

The paradox of Gazprom's situation lies in the fact that even its growing competitiveness does not decrease the level of politicisation of Russian gas supplies. The main barrier for Gazprom's business remains at the level of political considerations concerning security, either perceived or real. For instance, some LNG import projects in the Baltic region have continued despite the new price context. In a similar vein, Gazprom faces opposition to Nord Stream-2, its new pipeline project, again mostly because of the latter's political dimension. Hence, Gazprom faces a situation where any major involvement in a large-scale trade and investment project may be met with reluctance. Even from a business perspective, the continuous over-investment in new pipeline projects seems outdated in the context of the decline in gas demand in Europe combined with the growing volume of LNG trade. In the meantime, Gazprom's own liquefaction projects may face sanctions on access to technologies. Still, a cooperation on small LNG plants has been growing. Among the newest ones, Gazprom supplies gas for a small liquefaction plant in Finland owned by Skangas. It remains to be seen if involvement into LNG business attenuates a vivid politicization of the sector.

Ukraine remains the core difficulty, as it intends to implement the EU energy market rules following its recent accession to the Energy Community Treaty. The implementation of these rules will mean that Gazprom will face new regulatory realities in Ukraine, especially with regard to capacity allocation and the transformation from a transit to an entry-exit system. Kiev's unwillingness to continue importing Russian gas adds a new element to this concern. The company has accordingly been driven to consider alternative pipeline options, all of which are subject to constraints either for political or for regulatory reasons. As of now, Ukraine may become more vital for Gazprom than vice versa. However, instability in Ukraine itself combined with Kiev's difficulties in reforming the gas sector, rather leaves Ukraine outside the full implementation of the Energy Community Treaty. Hence, Gazprom would be interested in a specific transit agreement, exceptional in the Energy Community rules. Most probably such an agreement will be mediated by Brussels.

Gazprom increasingly appears incapable of quickly adapting to the new realities or of turning the situation to its own advantage. Even low prices and competitive costs do not decisively reduce the political barriers it faces. Maybe common assumptions that Gazprom is a strong political tool are simply overestimated. Instead, its impact and power to influence is declining despite a rather positive business context. Any market leverage gained still stems from exogenous factors (the market price and exchange rates), which do not come from Gazprom's own strategy.

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Florence School of Regulation
Robert Schuman Centre
for Advanced Studies

European University Institute
Via delle Fontanelle 19
I-50014 San Domenico di Fiesole (FI)
Italy

FSR Research Coordinator:
Ilaria.Conti@EUI.eu

The Florence School of Regulation

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