Gazprom and Europe's gas problem

21 Sept 2012

Summary

- The launch of the European Commission's expected market abuse investigation against Russia's Gazprom has raised temperatures between Brussels and Moscow. We might ask: is the case a sign of European bullishness in the face of Gazprom's mounting commercial and strategic challenges and diminishing domestic patronage? Or is it an expression of frustration at Gazprom's continued capacity to be a spanner in the works of Brussels long term plans for European gas markets? Or both?

- The launch of the case was the latest in a growing list of problems faced by Gazprom. The US shale gas boom and expanding international LNG capacity has caused increasing volumes of gas to flow to Europe and put Gazprom under increasing pressure in its major export market. At the same time it is struggling to maintain its domestic influence and commercial dominance.

- Those who are hope to see Gazprom's place in the European market seriously undermined will probably be disappointed. Neither Europe's strength nor Gazprom's weakness should be overstated. Most likely will be an outcome in which Gazprom pays a politically negotiated price, and Europe agrees not to bite the hand that – for the foreseeable future – fuels it.

The announcement last week that the European Commission has launched a formal market abuse investigation against Gazprom, the state-owned Russian gas company, had been expected following raids on company offices last year. The investigation focuses on Bulgaria, the Czech Republic, Slovakia, Poland, Hungary and the Baltic state. The accusation is that Gazprom has prevented the free flow of gas, hindered diversity and inflated prices by insisting on oil price linked contracts.

This is the latest twist in the difficult relationship between the EU and Gazprom and Russia. As the supplier of a quarter of the gas, European politicians and policy-making officials see the company as an obstacle to the improved working of European gas markets, worry about the company's closeness to the Kremlin and, with the experience of Ukraine in mind, question its reliability as a supplier. And while Russia's gas reserves are the world's largest, some questions hang over the ability of Gazprom to finance their development and extract the gas efficiently.

Despite the European Commission's coy suggestion that the case was a legal issue rather than a political one, the reality is that everything that passes between Brussels and Gazprom is political. As if to make the point, Moscow announced a day later that it would shield Gazprom from the EU investigation and Vladimir Putin signed a decree forbidding 'strategic' Russian companies from disclosing information to foreign regulators. Gazprom itself presented the case as simply a tactic in price negotiations.

How is the Commission's move to be interpreted? Has the Commission been emboldened by Gazprom's weakening grip on European gas markets? Or is it an expression of frustration at the EU's progress on its own energy reform agenda? It is probably a mix of both. To understand the context of this investigation you need to understand the extent to which EU energy policy on gas in particular has delivered on

Brussels' hopes, and the new global gas market in which Gazprom itself is operating. This Global Counsel Insight explains these issues.

Diversify or bust

The EU's third energy market reform package, which was implemented in March 2011, aims to establish a more liberalised, integrated European gas market by boosting cross border supply within the Union. Gazprom's overwhelming dominance of Europe's Eastern and Central gas markets has long been a concern for reasons of security of supply and the economic consequences of single company dominance. In Brussels there is also a strong view that Gazprom's continuing insistence on oil-linked pricing and restrictive contracts is a major obstacle to the policy goal of liberalising and integrating the EU's gas market.

Launching the case, the Commission said it was particularly concerned that Gazprom was using its dominant position in central and Eastern Europe to manipulate prices, an allegation that presumably rests on evidence turned up in last year's raids. Included in this is Gazprom's practice of indexing supply prices to the oil price in long term contracts which has pushed up prices in a way that smaller buyers in central and Eastern Europe have little leverage to resist.

Whilst pricing gas with reference to oil made sense when the two fuels were alternatives, the Commission argues that this is no longer relevant and is unfairly punishing certain gas consumers. Gazprom has offered some concessions to the larger European utilities such as E.ON, but has lagged behind Norway's Statoil in offering integrated spot prices into its contracts.

The Commission's second target is allegations that Gazprom restricts the ability of buyers in Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland and Slovakia to sell gas on from their own market through 'destination' clauses. A major pillar of the Commission's measures in the 2009 reform package – the unbundling of holdings in both distribution and supply – is fairly transparently targeted at Gazprom.

Vilnius, a major agitator for launch of the Commission's case, has insisted that Gazprom sell its stake in Lietuvos Dujos, the main Lithuanian distributor. Gazprom also has a network of subsidiaries throughout Eastern Europe that are implicated in divestment requirements. Its pipelines are in principle subject to European requirements that such transit lines be made available to competitors on commercial terms, something Gazprom has assertively resisted.

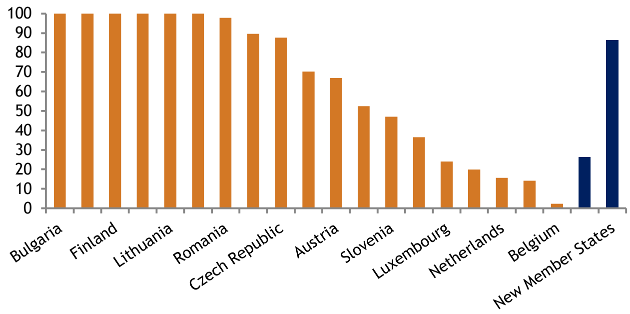

Chart 1: Dependence on Russian gas (% of total gas imports) 2010
Source: Eurostat

Gazproblems

For Gazprom, the investigation is the latest in a growing list of problems – both in its export markets and at home. Firstly, European gas demand, reflecting a weak economy and improving energy efficiency, has fallen to its lowest level since 2000. The volume of gas shipped by Gazprom to Europe has fallen over the past five years by a fifth from its 2007 peak.

The position of Gazprom in Europe has also been weakened by the combined impact of the global growth of supplies of Liquid Natural Gas and the rise of shale and other unconventional sources of gas in the United States. The surge in volumes of shale gas in the US has effectively removed the need for the country to import LNG from markets such as Qatar.

The United States had expected to be a major destination for the rapidly growing supplies of LNG, instead those supplies have headed to Japan to fill the country's post-Fukishima nuclear power plant closure energy gap, and to European markets. The growth in LNG supplies is increasing the amount of gas in Europe bought and sold on spot markets or on terms that are more flexible than the oil-price linked contracts insisted upon by Gazprom.

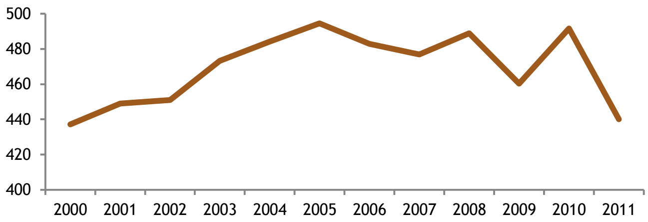

Chart 2: EU27 Gross inland gas consumption 2011 (Mtoe)

Source: Eurostat

This combination of weakening European gas demand and growing alternative gas supply sources (along with coal proving to be surprisingly resilient as a fuel for electricity generation at times when gas prices are high) has weakened Gazprom's hand. European energy utilities signed up to Gazprom contracts have seen the price they pay for gas soar to uncompetitive levels as the oil price has risen in recent years.

In response they have put increasing pressure on Gazprom to adjust its contractual terms. The company has been reluctant, but reflecting its weakened hand has been forced to make some concessions with its larger partners. Meanwhile in its home market, Gazprom faces falling prices and demand, and aggressive competition from private sector competitor Novatek. The company's share price has fallen by half since 2008.

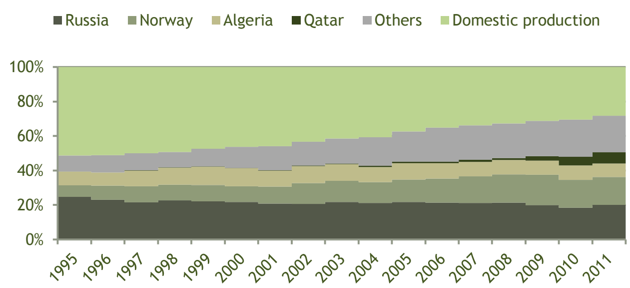

Chart 3: European gas production and imports by partner
Source: Eurostat

Taken together these pressures may leave Gazprom poorly positioned for the future . It recently announced it would not progress with its proposed development of the Shtokman gas field in the Barents Sea. The company also faces challenges in maintaining production in its key western Siberia gas field. To maintain current production levels it has been estimated by BP that investments of $730 billion by 2035 will be needed.

A potential source of funding is the Russian government and the country's oil revenues. This would obviously reinforce the anxiety outside the country that the company is an adjunct of the Russian government. Moreover, Putin's government may not have the appetite to write the company a blank cheque. Novatek, the fast rising competitor to Gazprom in Russia, is politically well connected through its owner Genady Timshenko. Some analysts have interpreted the announcement of the recent suspension of purchasing arrangements with Gazprom's own independent Russian suppliers, including Novatek, as a challenge to Putin.

Biting the hand that fuels you

The combination of Europe's ambition for further gas market reform, and Gazprom's perceived and real weaknesses has led some to conclude that the Commission will attempt aggressively to undermine Gazprom's place in the European energy supply. This seems both overstating Europe's strength and Gazprom's weakness, and in any case it is hard to see how confrontational tactics on either side end well.

Any idea that the prospect of shale gas discoveries would allow Europe to turn its back on Russia looks well off the mark. The scale of Europe's future demand for gas and the reduction in output from its traditional sources means that as recent Commission analysis shows, even with significant shale production the EU would still depend on imports for a majority of its consumption. And there remain significant questions about the commercially recoverable scale of shale in Europe and the appetite of government and citizens to agree to the 'fracking' required to extract it.

As always on Russian issues, the politics will play out in Brussels as much as between Brussels and Moscow. The decision by the European Commission to open an anti-trust investigation is a victory for Vilnius, which is entirely dependent on Russian gas and has long suspected that it pays over the odds for the privilege for reasons that ultimately go back to the frosty relations between the Baltic States and Moscow.

But if Vilnius has an ally in the European Commission it is likely to get less of a hearing in Berlin. Germany with its strong trade and investment links with Russia, as well as high gas imports from the country, has eschewed confrontation. the size and diversity of supply to feel more than capable of handling Gazprom with whom it has been dealing in one form or another since 1973. Germany's EON negotiated a $1bn discount on its long term contracts with Gazprom in April and has just signed a huge new 15 year $22bn deal with Novatek.

One of the key imponderables in the debate is the role of gas in Europe's energy future. For a long time gas has been mentioned as a 'bridging technology' which as a relatively clean fossil fuel would allow Europe to affordably reduce its CO_2 emissions whilst moving to an energy system based on renewables. There is however also a growing argument in Europe that compared to the relative expense of continuing support for renewables, gas represents the cheapest way for European countries to fulfill its carbon emissions reduction obligations – particularly in the UK (see GCI12/26).

On the other side, it would be dangerous for the Commission to underestimate the strength of Gazprom. Gazprom may have struggled in recent months to extract tax breaks from a straitened Russian government that is more used to using revenues from Gazprom than putting money in, but as Putin's aggressive response demonstrates, it can still count on the Kremlin's support in a tight spot.

It is in the interests of both sides to find a modus vivendi. In the medium term, Russian and Gazprom will benefit from more inward investment to develop the gas fields Europe needs and in return Gazprom would gain from having more opportunities to build its downstream activities in European markets. That kind of outcome would be desirable, but still looks ambitious.

The odds are probably that buyers in Eastern Europe will get a politically negotiated price discount while the EU and Russia continue to 'consult' on how exactly Gazprom might seek to meet the requirements of the EU's Third Energy Directive. What is certain is that this will ultimately be settled between Vladimir Putin and his European counterparts and not by a European Commission anti-trust case.

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