

Gazprom Is the Essence of the Energy Curse

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Gazprom is Russia's leading company, but few enterprises have been as badly beaten during the global financial crisis. The Russian economy has recovered as the crisis has abated, but Gazprom may suffer from a profound structural crisis. It needs to downsize, cut waste and reform.

In May 2008, Gazprom's market capitalization exceeded \$350 billion, but it has dropped to \$135 billion today. The Russian oil sector increased its production and exports last year, but gas exports fell by 11 percent and Gazprom's production decreased by 16 percent because of low demand.

Gazprom's problems are largely because of the following six factors:

1. By repeatedly cutting its deliveries, Gazprom has earned a reputation as an unreliable supplier. Its customers are forced to diversify their purchases, build up stocks or find alternative sellers.
2. Gazprom has run into new competition from liquefied natural gas and shale gas. Traditionally, Gazprom delivers gas only to Europe and through pipelines. Now LNG is flooding the European market, not least because the United States has suddenly started mass-producing cheap shale gas, replacing the anticipated U.S. demand for LNG. Steadily increased European demand for gas has been replaced by a permanent glut. The International Energy Agency predicts that this will remain the case for the next three to five years.
3. The gas surplus is depressing gas prices. Gazprom's long-term contracts with prices that change quarterly in relation to a mix of oil indexes half a year earlier are being challenged as LNG is traded on the spot market at prices that were at times half of the Russian gas prices in 2009. Have European gas prices decoupled from oil prices for good?
4. The demand for gas after the crisis could easily decline. Gas is primarily used in power generation, heating, and chemical and metallurgical industries. In a recent study, McKinsey & Company points out that Russia can make its greatest energy savings in exactly these sectors. Therefore, much of the gas demand could disappear in the medium term.
5. After high energy prices from 1973 to 1980, the world saw massive, unanticipated energy saving that may occur also this time around. Three countries that can save energy most easily are Russia, Ukraine and Belarus. Today, Russia consumes twice as much primary energy as China and six times as much energy as the United States for each \$1 of gross domestic product measured in purchasing power parities. The situation is similar in Ukraine and Belarus, two of Gazprom's largest export markets.

As a consequence, gas demand from these three countries is likely to decline.

6. With its unwieldy bureaucracy, Gazprom can only produce from giant fields, leaving plenty of accessible medium-sized and small fields undeveloped, which agile independent companies exploit when allowed.

Russia doesn't need to develop inaccessible new giant fields for the foreseeable future if it utilizes its medium-sized fields.

In sum, Gazprom may have far too much gas in the medium term because of likely energy savings both at home and abroad, whereas the prices that Russian gas can fetch abroad are likely to stay low and decouple from oil prices. Even if domestic gas prices in Russia rise, Gazprom's finances are likely to be squeezed.

Gazprom's management — that is, the Russian government — does not seem to understand the severity of these challenges. After a long time in denial, it has reacted ad hoc. It is trying to maintain the old European demand while ceding new markets and cutting its supplies. It has reduced purchases from Central Asia and postponed the development of the giant fields Yamal and Shtokman.

Gazprom is moving to a new defensive strategy, but strangely it is still intent on building the two new huge European pipelines, Nord Stream and South Stream, for which neither new demand nor new gas supply is available. If actually built, these two pipelines might become wasteful white elephants, as it is far cheaper to use the existing pipelines through Ukraine.

Less demand, less production, lower prices and excessive capital investment will render Gazprom smaller, less profitable and less valuable. But the advantage is that Gazprom will cease to be a state within the state, and Russia could become a more normal and open society. The current crisis offers an excellent opportunity for long-desired reform. The crucial insight is that what is good for Gazprom's management is bad for Russia since Gazprom is the essence of the country's energy curse.

An alternative policy should start by dividing Gazprom from the state.

Even if the majority of Gazprom remains state-owned, it must gain integrity as an autonomous joint stock company. It should be deprived of its regulatory functions to be transferred to an independent regulatory agency. Since the Gazprom management has failed so miserably, it should be replaced by competent managers from the private sector. Nord Stream and South Stream should be abandoned immediately because neither appears commercially viable.

In a rational market economy, a conglomerate such as Gazprom wouldn't exist. Noncore assets from farms to television companies should be sold off. Production of gas should be separated from transportation and sales in different companies. Undeveloped medium-sized and small fields should be auctioned off to independent gas producers. The gas pipeline system could stay state-owned but be separated from production and be open to

all on equal pricing. As a result of reduced flaring, Russia would benefit from a huge cheap additional supply of gas, while air pollution would decline.

In accordance with the long-accepted policy, domestic and post-Soviet prices should be raised to the market level in 2011, and conditions would be created for a free gas market in Russia. Differentiation in taxation between the oil and gas industry will no longer be justified, and equal taxation should be introduced, increasing tax revenues.

For the European Union, Gazprom's current weakness offers an opportunity to clean up gas trade with Russia. The EU could take up President Dmitry Medvedev's proposal to draft a new legal framework for energy cooperation to replace the Energy Charter of 1994 that almost all other European countries have ratified. The centerpiece should be an all-European gas reform, including the unbundling of transportation and production of gas leading to full marketization.

Gazprom's current crisis offers the best opportunity ever for Russian and European energy reform. The arguments for a profound reform of the country's gas sector have never been stronger. This is no longer a pipedream, while restoring the old Gazprom is.

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