Former Russian President Vladimir Putin and Gazprom ceo Alexei Miller meet for talks. Photo: Zhukov Sergei/ITAR-TASS/Corbis

Since Alexei Miller became chief executive of Gazprom, the company has pursued a consistent pricing strategy. But as a monopolist, Gazprom may be its own worst enemy.

Gazprom's risky strategy

by Anders Åslund

Gazprom is the most controversial and enigmatic company in Europe, and it is certainly the largest in terms of energy production, market capitalisation and reserves. But what kind of an animal is it? Gazprom's management insists that the company is purely commercial, but its European critics claim that this state-dominated corporation is all about politics.

In fact, Gazprom's actions appear predominantly commercial, but they arouse new concerns. First, the corporation's strategy focuses on the short term. Second, the corporation behaves like an unreliable monopolist, guaranteeing neither future supplies nor prices. In the long term, such a manner is likely to harm Gazprom's own interests, because it is no real monopolist abroad and it is likely to alienate its customers.

In May 2001, Rem Vyakhirev was ousted by the Kremlin as ceo of Gazprom and replaced by Alexei Miller. Since then, Gazprom's strategy has been rather clear and consistent. Pricing has formed a centerpiece, but it has varied between Europe, former Soviet republics, and Russia itself.

Export prices to Europe have been non-controversial, because they have been based on a long agreed formula including market prices of different kinds of oil, so with a certain delay they have risen with world oil prices.

Supplies to former Soviet republics have aroused the most acrimonious disputes. Their prices were ludicrously low until 2005. Since then, Gazprom has moved aggressively to raise them. It has claimed to depoliticise them, but it has boosted prices in big steps, which have varied greatly between different countries. Prices rose faster and higher to weak and not very friendly countries, such as Georgia and Moldova, than to its close and powerful Western neighbor Belarus. Moreover, neither the old nor the new prices have been set according to any objective standard. Admittedly, no world market prices exist for piped natural gas, because all prices are local depending on local supply and demand through one or a few pipes, but Gazprom has long solved that problem in Europe.

Naturally, each customer country has tried to delay price hikes, but their resistance has resulted in supply disruption for virtually all former Soviet republics – Georgia, Azerbaijan, Moldova, Ukraine, and Belarus. Few disagree with the principle of gradual transition to market prices, but the transition needs to be transparent and founded on agreed principles.

Prices must rise inside Russia too. Sensibly, Gazprom has been pushing for gradual price increases, aiming at full price liberalization in 2011. But no prices should be truly liberalised in the presence of one monopoly supplier, because a rational monopolist pursues price gorging. Another concern is that Russia maintains large export tariffs for gas, which are hardly compatible with World Trade Organization rules, and the European Union demands that Russia phase them out before entering the WTO. Furthermore, domestic gas prices should rise three-four times which is always politically difficult.

Overall, Gazprom's policy to let all gas prices approach plausible market prices makes sense. The higher gas prices have sent its profits and stock prices skyrocketing, rendering Gazprom the third largest company in the world by market capitalisation.

The second part of Gazprom's strategy is much more controversial, namely to extend monopolistic control over the production of gas in Russia and over sales and transportation beyond its borders. State ownership and monopolization restrict production, efficiency, transparency and thus reliability. Russia's natural gas production has long been close to stagnant with the only real dynamism coming from a few emerging independent gas companies, especially Novatek, and private oil companies that produce associated gas.

The problem is that Gazprom is not very good at producing gas

But Gazprom has maltreated the efficient independents. It has utilised its trading monopoly to force them to sell at artificially low prices. Often, it refuses to buy gas from independent companies, which are forced to flare gas or abstain from production. Several small independent producers, such as Nordgas, have been forced to sell themselves to Gazprom.

The problem is that Gazprom is not very good at producing gas. Most disturbing, three of Gazprom's four giant fields (Urengoy, Yamburg and Medvezhye) are past their peak and declining, while its fourth giant field, Zapolyarnoe, is at its summit. For sheer administrative reasons, it cannot develop the many secondary or tertiary fields that are known but remain undeveloped, and it is increasingly reluctant to allow independents to do so. Last year, Russia's gas production fell by half a percent. Gazprom's management claims that it can easily expand output from secondary fields, but its track record suggests the opposite.

Gazprom needs to develop one of two truly gigantic fields, Yamal in Northern Western Siberia or the Shtokman off-shore field north of Murmansk. Either is likely to cost something like $50 billion to develop, and development will take a decade. Gazprom has agreed to exploit the Shtokman field with Total and Statoil-Hydro, while it intends to develop Yamal on its own.

Alas, if Russia's future gas production hinges on either of these fields, it is likely to decline from 2010 to 2016, and it might fall into sharp decline. Moreover, the required investment is so large that Gazprom might be forced to choose one of the two projects, probably Yamal, as it is technologically easier. If so, the company might let its foreign partners down at Shtokman, further undermining confidence in its partnership.

The Gazprom management has responded to this threat of declining production by extending its control over Central Asian supplies, primarily Turkmenistan's rather stable production and Kazakhstan's rising output of associated gas. Gazprom has swiftly raised its previously very low purchasing prices and it is projecting a new pipeline from Turkmenistan and Kazakhstan. But this volume will hardly be enough, and energy-hungry China is competing with Russia over access to Turkmenistan's gas.

In the last two years, Gazprom has received much publicity for its projected Nordstream and Southstream pipelines. It has also developed cooperation with or purchased energy companies in Germany, Italy, Austria, Hungary, Bulgaria and Serbia. This has aroused fears among Europeans of excessive dependence on Russian gas. Trade statistics, however, reveal another reality. Europe's imports of gas from Russia are no longer rising but declining. The higher energy prices have led to energy savings, but the apparent unreliability of Russian gas deliveries is also scaring consumers. Sweden has decided against participating in Nordstream. So has Finland.

Gazprom has increased control over production in Russia and Central Asia, but invests primarily in equity and logistics rather than production and development. It has hiked prices and forged strong alliances with distribution companies, but scares off its customers. Gazprom needs to breed confidence among its customers rather than frighten them. Natural gas is an excellent fuel, and Europe badly needs Russian gas, but all successful business is based on trust. ■

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