

## The Deceptive and Unwanted Gas Liberalization Process in Russia

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### Abstract

This paper argues that this perception of the gas liberalization process in Russia is far too rosy. The analysis of the gas liberalization process in Russia demonstrates that there have been very few changes made in the legislative framework that would favor the opening of the market and the involvement of all independent gas players. We find that many of the gas “reforms” undertaken are still such that favor Gazprom and the Kremlin’s control over the sector. We find that the changes in market share are not an outcome of the gas liberalization process, and that many of the reforms (i.e., liberalization of the export market and more favorable regulatory conditions) only apply to two purportedly “independent” gas companies (Rosneft and Novatek) that are in reality owned by Russian President Vladimir Putin’s close circle of friends.

**Keywords:** Gas liberalization; Russia; Foreign investors; Economic

### Introduction

Gas liberalization in Russia has been a slow process that started in the late 1990s with pressure from foreign investors, but little domestic support. However, in the eyes of some, the process seemed to accelerate in the 2000s. With the decline of Gazprom’s share in the Russian market (from 85% in 2007 to 73% in 2013)<sup>1</sup> and the increase in the market share of independent gas companies (15% in 2008 to 27% in 2013)<sup>2</sup>, it appeared that Russia had begun liberalizing its gas sector—meaning, it would allow independent gas companies to compete equally with its gas monopoly, Gazprom.

This paper argues that this perception of the gas liberalization process in Russia is far too rosy. The analysis of the gas liberalization process in Russia demonstrates that there have been very few changes made in the legislative framework that would favor the opening of the market and the involvement of all independent gas players. We find that many of the gas “reforms” undertaken are still such that favor Gazprom and the Kremlin’s control over the sector. We find that the changes in market share are not an outcome of the gas liberalization process, and that many of the reforms (i.e. liberalization of the export market and more favorable regulatory conditions) only apply to two purportedly “independent” gas companies (Rosneft and Novatek) that are in reality owned by Russian President Vladimir Putin’s close circle of friends [1].

Thus, the paper moves to address a broader question: why has the process of gas liberalization in Russia been so inconsistent? In other words, while certain reforms have implied growing gas liberalization, why are there limited changes in the domestic market?

The answer given to this question was by analyzing the approach of the institutions that are cited as the main advocates for the gas liberalization process in Russia. First, we examine the economic and political rationale for the Kremlin’s support of gas liberalization. Based on this analysis, we conclude that the political costs of liberalization outweigh the economic benefits. Then, we analyze how the two independent gas companies that are portrayed as the main supporters

of the process—Rosneft and Novatek<sup>3</sup>—have approached the issue of gas liberalization. This analysis shows that the two companies support the opening of the gas market only for themselves, and that they do not support full-scale gas liberalization. Finally, I show that the Kremlin’s support for the opening of the gas market to Rosneft and Novatek actually helps Gazprom.

In light of these analyses, I refute the claims that the Kremlin,<sup>4</sup> Rosneft and Novatek are supporters of full gas liberalization, and that Gazprom is losing favor with the Kremlin.<sup>5</sup> Accordingly, the decline in Gazprom’s market share should not be interpreted as a sign that Russia’s gas sector is liberalizing; the energy sector remains tightly controlled as neither the government nor the corporations supported by it sufficiently benefit from a level playing field to fight for full-scale liberalization.

<sup>3</sup>Examples of Rosneft and Novatek cited as supporters of the process: Kardas, Szymon, “A feigned liberalization: Russia is restricting Gazprom’s monopoly on exports,” *OSW*, November 28, 2013, <http://www.osw.waw.pl/en/publikacje/osw-commentary/2013-11-28/a-feigned-liberalisation-russia-restricting-gazproms-monopoly>.

<sup>4</sup>Examples of Kremlin cited as supporting gas liberalization: C., Weaver, “Putin suggests ending gazprom export monopoly,” *FT.Com*, July 22, 2014, Retrieved from <http://search.proquest.com.ezp-prod1.hul.harvard.edu/docview/1555166058?accountid=11311> “Russian Gas Market,” *Institut Thomas More*, December 3, 2014, <http://www.institut-thomas-more.org/en/actualite/russian-gas-market-liberalization-a-la-russe.html>.

<sup>5</sup>Examples of Gazprom losing favor with Kremlin: Raamat, Mart, “Developments in the Russian Internal Gas Sector: Cosmetic Changes or Concrete Reforms,” *International Centre For Defence and Security*, [http://www.icds.ee/fileadmin/media/icds.ee/failid/Developments\\_in\\_the\\_Russian\\_Internal\\_Gas\\_Sector\\_Cosmetic\\_Changes\\_or\\_Concrete\\_Reforms.pdf](http://www.icds.ee/fileadmin/media/icds.ee/failid/Developments_in_the_Russian_Internal_Gas_Sector_Cosmetic_Changes_or_Concrete_Reforms.pdf), p. 9. and, Stephen Bierman and Elena Manznava, “Rosneft May Top Gazprom as Kremlin’s Crown Jewel of Energy,” *Bloomberg*, March 13, 2016, <http://www.bloomberg.com/news/articles/2016-03-14/rosneft-may-top-gazprom-as-kremlin-s-crown-jewel-of-energy>.

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<sup>1</sup>“How is Gazprom adapting to changing market conditions?,” *Enerdata*, May 7, 2014, [http://www.enerdata.net/enerdatauk/press-and-publication/energy-news-001/how-gazprom-adapting-changing-market-conditions\\_28540.html](http://www.enerdata.net/enerdatauk/press-and-publication/energy-news-001/how-gazprom-adapting-changing-market-conditions_28540.html).

<sup>2</sup>Tatiana Mitrova, “The Corporate Landscape,” *Oxford Energy*, August, 2014, <https://www.oxfordenergy.org/wpcms/wp-content/uploads/2014/09/OEF-97.pdf>, p. 8.

## Origins of Control in the Russian Gas Sector

To understand why the current gas liberalization process in Russia has been slow, it is first important to examine the origins of the controlled Russian gas sector.

In 1992, Viktor Chernomyrdin, the then head of Gazprom, wanted to maintain a vertically integrated structure for Gazprom and prevent its restructuring. In that same year, the Russian government described the gas sector as a natural monopoly, meaning that the gas sector should be kept outside competition. However, this definition of natural monopoly was unusual, as the concept normally applied to the exclusion of networks and not sectors from outside competition.<sup>6</sup> Thus, as a natural monopoly with control over the Unified Gas Supply System (UGSS), Gazprom (through its transport subsidiary, Transgaz) has been able to pressure other gas producers to sell to Gazprom at below market prices.<sup>7</sup>

The formation of this natural monopoly in Russia should not be taken as a surprise given that Russia has the world's largest proven natural gas reserves—a status it has used to its advantage in carrying out its foreign policy. Furthermore, the nature of natural gas markets makes them especially susceptible to manipulation for foreign policy purposes. Natural gas markets are much more prone to supply disruptions than oil markets.<sup>8</sup>

More specifically, natural gas is supplied within pipelines and through long-term contracts, which establish a long-term connection between the producer and the consumer [2-5]. This long-term relationship in the natural gas market gives producers an opportunity to use the market to their political advantage. Liquefied natural gas (LNG) is just as inflexible in transport and also depends on long-term contracts.<sup>9</sup> In contrast, oil is traded on the international market and in short-term deals. The transport of oil is also much more flexible than natural gas. This makes it more difficult for oil producing countries to unilaterally manipulate oil markets for foreign policy purposes.<sup>10 11</sup>

## Russia's Unsuccessful Gas Liberalization: A False Perception of Change

The Russian government has made several attempts to liberalize the gas market, but most of these measures have been limited in scope and still favor the Kremlin and its gas giant, Gazprom.

First, following the recommendation of the IMF in 1997, Russia passed the Common Carrier Principle (later to become the Third Party Access Principle) to grant independent gas producers access to the

Gas Transportation System (GTS).<sup>12</sup> However, the Principle has not functioned well since Gazprom has been in charge of its enforcement.<sup>13</sup> This is not to say that independent gas producers have had no access to the transmission system. Independent producers have had access to Russian gas reserves and control 20% of Russian gas reserves.<sup>14</sup> Furthermore, with the introduction of Third Party Access (TPA) in 1998 and the integration of it into Federal Law in 1999, independent gas producers have shipped their gas through GTS.<sup>15</sup> In 2007, Gazprom planned to finalize the new "Policy Governing the Preparation and Issuance of Permits to Independent Entities Seeking Access to Gazprom's Gas Transportation System," which would further ease independent gas producers' access to the pipeline network.<sup>16</sup>

Changes have also been made to the Subsoil Law, which is one of the main operating frameworks in Russia that oversees the relationship between the state and the subsoil user. The law was created in 1992 and a new version was proposed by the Ministry of Natural Resources in 2005 [6]. This draft introduced a civil law contract-based relationship for producers in exploration and production activities. By this law, investors would be better protected; the law would provide a more equal platform between the state and the investor.<sup>17</sup> In the existing regime, licenses have an unclear status and therefore were not treated as property rights in international capital markets. The new law would bring clarity to the definition of property rights. However, the principle in an earlier draft that benefitted the investor additionally by stripping the government's right to reconsider contracts already agreed to without the court was removed from the draft.<sup>18</sup> Furthermore, existing licenses remained obstacles to the new subsoil law even if passed. There was no ban on new licenses governing older ones. To make matters worse, the new subsoil use contract was not defined in "section II of Russian Civil Code or in the General part of the Code." With no clarity on the enforcement mechanism and in the presence of existing licenses, investors were unsure of the effectiveness of the new law.<sup>19</sup>

In 2006, Putin called for gas prices to reach netback parity or to be equal to export gas prices.<sup>20</sup> This presented domestic gas independent companies with the opportunity to sell at profit [7-10]. Indeed, the government raised domestic prices by 15%-27%<sup>21</sup> annually, which contributed to the increase in the market share of gas independents: from 6% in 1999 to 27% in 2014.<sup>22</sup> However, Russia never met its goal of reaching netback parity by 2011. This was due to the fact that, in the period between 2005-2008, commodity prices had increased with the increase in global demand for gas products; the "price reference for Russian pipeline gas exports to Europe" increased 2.5 times. This

<sup>6</sup>Andrei Belyi, "Trends of Russia's Gas Sector Regulation," *Competition and Regulation in Network Industries*, November 25, 2012, <http://www.crninet.com/2011/a4a.pdf>, p. 3.

<sup>7</sup>Yuli Grigoryev, "The Russian Gas Industry, Its Legal Structure, and Its Influence on World Markets," *EnergyLawJournal*, <http://www.eisourcebook.org/cms/The%20Russian%20Gas%20Industry,%20its%20Legal%20Structure,%20%26%20its%20Influence%20on%20World%20Markets.pdf>, p. 132.

<sup>8</sup>Brenda Shaffer, Natural gas supply stability and foreign policy. *Energy Policy* (2013), <http://dx.doi.org/10.1016/j.enpol.2012.11.035> or [http://poli.haifa.ac.il/~bshaffer/Shaffer\\_Natural\\_Gas\\_Supply\\_Stabiity\\_and\\_Foreign\\_Policy.pdf](http://poli.haifa.ac.il/~bshaffer/Shaffer_Natural_Gas_Supply_Stabiity_and_Foreign_Policy.pdf), p. 2.

<sup>9</sup>Ibid, 2.

<sup>10</sup>Ibid, 1.

<sup>11</sup>However, oil can be used as an effective tool by consumers, who can block access to their markets. Brenda Shaffer. 2009. *Energy Politics* (Philadelphia: University of Pennsylvania Press, 2009), 33–36 in Shaffer, B., Natural gas supply stability and foreign policy. *Energy Policy* (2013), <http://dx.doi.org/10.1016/j.enpol.2012.11.035> or [http://poli.haifa.ac.il/~bshaffer/Shaffer\\_Natural\\_Gas\\_Supply\\_Stabiity\\_and\\_Foreign\\_Policy.pdf](http://poli.haifa.ac.il/~bshaffer/Shaffer_Natural_Gas_Supply_Stabiity_and_Foreign_Policy.pdf), 2.

<sup>12</sup>Yuli Grigoryev, "The Russian Gas Industry, Its Legal Structure, and Its Influence on World Markets," *EnergyLawJournal*, <http://www.eisourcebook.org/cms/The%20Russian%20Gas%20Industry,%20its%20Legal%20Structure,%20%26%20its%20Influence%20on%20World%20Markets.pdf>, p. 132.

<sup>13</sup>Ibid, 133.

<sup>14</sup>Ibid, 133.

<sup>15</sup>Ibid, 133.

<sup>16</sup>Ibid.

<sup>17</sup>Ibid, 138.

<sup>18</sup>Ibid, 138-39.

<sup>19</sup>Ibid, 139.

<sup>20</sup>Mart Raamat, "Developments in the Russian Internal Gas Sector: Cosmetic Changes or Concrete Reforms," *International Centre For Defence and Security*, [http://www.icds.ee/fileadmin/media/icds.ee/failid/Developments\\_in\\_the\\_Russian\\_Internal\\_Gas\\_Sector\\_Cosmetic\\_Changes\\_or\\_Concrete\\_Reforms.pdf](http://www.icds.ee/fileadmin/media/icds.ee/failid/Developments_in_the_Russian_Internal_Gas_Sector_Cosmetic_Changes_or_Concrete_Reforms.pdf), p. 2.

<sup>21</sup>Ibid, 3.

<sup>22</sup>Ibid, 4.

increase in price created a large gap between domestic and export prices making Russia delay its goal of reaching netback pricing until 2020.<sup>23</sup>

It is also important to note that the original call for net back pricing was made to support "Gazprom's investments into developing new expensive gas fields and infrastructure" and at a time of economic growth in Russia.<sup>24</sup> Therefore, when Russia's economy slowed down with the collapse of oil prices and later, the Crimea crisis, Russia had to abandon its goal of netback pricing and even decrease domestic gas prices by 3% for Gazprom's industrial consumers in 2014.<sup>25</sup> In the context of this economic slowdown, support of regulated domestic pricing increased.<sup>26</sup>

In 2007, another attempt at improving access for independent gas companies to the benefit of Gazprom came in the form of a new electronic platform within the Gazprom subsidiary, Mezhregiongaz. This platform was intended for exchange operations, providing independent gas producers an opportunity to sell their natural gas in the spot market, and allowing Gazprom to focus on export. The amount the independent producer could commercialize was originally limited. For example, Gazprom would initially sell 5 billion cubic meters (bcm) on the spot market, and the independents could sell for another 5 bcm. However, despite a decrease in gas stock exchange during the financial crisis of 2008-2009, in 2011 Gazprom planned to increase competition by 40 bcm for the year 2014.<sup>27</sup>

In 2011, Medvedev approved amendments of the law "On Foreign Investment into the Strategic Sectors of the Russian Economy," which alleviated some of the restrictions placed on foreign investors under the Strategic Investment Law (adopted in 2008 by Putin). The 2008 law placed restrictions on foreign entities investing in subsoil deposits of federal significance; the law made it difficult for domestic investors to also operate such deposits. However, the amendments only slightly eased the restrictions [11].

First, while the restriction on a foreign entity's acquisition of an interest was raised from 10% to 25%, the entities must still inquire for approval for an interest of 5%. Second, although the amendment exempts foreign companies under Russian entities from seeking approval, this exemption does not apply to Russian entities who are not tax residents or hold dual citizenships.<sup>28</sup> Thus, the Russian government still reserves the right to control investments made in deposits of foreign significance. This benefits Gazprom: the government may deny a license to an investor that discovers a deposit of federal significance and grant the discovery (especially in the upstream sector) to Gazprom.<sup>29</sup>

The lifting of the ban on LNG export in December 2013 has been noted as the biggest step to raise the expectations for Russia's gas liberalization. However, it is important to note that this ban was lifted

for only two independent gas producers, Novatek and Rosneft.<sup>30</sup> All other producers are still not allowed to export LNG gas. Second, the lifting of the ban is in no way a loss for Gazprom. Gazprom with all of its state duties and focus on piped gas has not been able to compete in LNG. Sanctions particularly hurt its LNG plant in Vladivostok.<sup>31</sup> Finally, the government needed to cancel Gazprom's monopoly not because it no longer favors the company, but because it needs to increase its global LNG market to 10% by 2020.<sup>32</sup>

## Changes in Market Share Not an Outcome of Gas Liberalization

In accordance with my previous discussion of how unsuccessful reforms have painted a deceitful image of the gas liberalization process in Russia, I would now like to show that the changes in market share are not an outcome of the gas liberalization process. In doing so, I further demonstrate that gas liberalization is not underway in Russia.

First, after the 2008 financial crisis, Russian gas producers had to cut back on production due to lower demand. Gazprom thus had to limit its activities and increasingly share the market with independent suppliers. Independent producers increased their production from 15% (2008) to 27% (2013).<sup>33</sup> Gazprom's share of the market fell from about 85% (2007) of Russia's total production to 73% of production in 2013. Many more contracts were awarded to producers beyond Gazprom. Second, the increase in regulated pricing for Gazprom allowed independents to price at levels similar to Gazprom.<sup>35</sup> Third, independents have had a more favorable taxation and regulatory environment than Gazprom. Independents are able to sell at prices that are not regulated. They have offered 3-10% discounts on Federal Tariff Service set prices<sup>36</sup> and have been able to offer more flexible contracts and supply volumes.<sup>37</sup> Gazprom, however, is required to sell at regulated prices and therefore cannot offer any discounts.<sup>38</sup>

Fourth, the Federal Antimonopoly Services has pressured Gazprom

<sup>30</sup>Mart Raamat, "Developments in the Russian Internal Gas Sector: Cosmetic Changes or Concrete Reforms," *International Centre For Defence and Security*, [http://www.icds.ee/fileadmin/media/icds.ee/failid/Developments\\_in\\_the\\_Russian\\_Internal\\_Gas\\_Sector\\_Co](http://www.icds.ee/fileadmin/media/icds.ee/failid/Developments_in_the_Russian_Internal_Gas_Sector_Co)

[smetic\\_Changes\\_or\\_Concrete\\_Reforms.pdf](http://www.icds.ee/fileadmin/media/icds.ee/failid/Developments_in_the_Russian_Internal_Gas_Sector_Co_smetic_Changes_or_Concrete_Reforms.pdf), p. 10

<sup>31</sup>James Henderson and Tatiana Mitrova, "The Political and Commercial Dynamics of Russia's Gas Export Strategy," *Oxford Energy Group*, 9, <https://www.oxfordenergy.org/wpcms/wp-content/uploads/2015/09/NG-102.pdf>.

<sup>32</sup>Tim Boersma, Tatiana Mitrova, Geert Greving and Anna Galkina, "The Impact of the Crisis"

<sup>33</sup>Tatiana Mitrova, "The Corporate Landscape," *Oxford Energy*, August, 2014, <https://www.oxfordenergy.org/wpcms/wp-content/uploads/2014/09/OEF-97.pdf>

<sup>34</sup>"How is Gazprom adapting to changing market conditions?," *Enerdata*, May 7, 2014, [http://www.enerdata.net/enerdatauk/press-and-publication/energy-news-001/how-gazprom-adapting-changing-market-conditions\\_28540.html](http://www.enerdata.net/enerdatauk/press-and-publication/energy-news-001/how-gazprom-adapting-changing-market-conditions_28540.html).

<sup>35</sup>Mart Raamat, "Developments in the Russian Internal Gas Sector: Cosmetic Changes or Concrete Reforms," *International Centre For Defence and Security*, [http://www.icds.ee/fileadmin/media/icds.ee/failid/Developments\\_in\\_the\\_Russian\\_Internal\\_Gas\\_Sector\\_Co\\_smetic\\_Changes\\_or\\_Concrete\\_Reforms.pdf](http://www.icds.ee/fileadmin/media/icds.ee/failid/Developments_in_the_Russian_Internal_Gas_Sector_Co_smetic_Changes_or_Concrete_Reforms.pdf), p. 3 and 10.

<sup>36</sup>Tatiana Mitrova, "The Corporate Landscape," *Oxford Energy*, August, 2014, <https://www.oxfordenergy.org/wpcms/wp-content/uploads/2014/09/OEF-97.pdf>, p. 8.

<sup>37</sup>Mart Raamat, "Developments in the Russian Internal Gas Sector: Cosmetic Changes or Concrete

Reforms," *International Centre For Defence and Security*, [http://www.icds.ee/fileadmin/media/icds.ee/failid/Developments\\_in\\_the\\_Russian\\_Internal\\_Gas\\_Sector\\_Co\\_smetic\\_Changes\\_or\\_Concrete\\_Reforms.pdf](http://www.icds.ee/fileadmin/media/icds.ee/failid/Developments_in_the_Russian_Internal_Gas_Sector_Co_smetic_Changes_or_Concrete_Reforms.pdf), p. 10.

<sup>38</sup>Tatiana Mitrova, "The Corporate Landscape," *Oxford Energy*, August, 2014, <https://www.oxfordenergy.org/wpcms/wp-content/uploads/2014/09/OEF-97.pdf> 8

<sup>23</sup>Ibid, 3.

<sup>24</sup>Ibid, 3.

<sup>25</sup>Ibid, 3.

<sup>26</sup>Ibid, 3.

<sup>27</sup>Andrei Belyi, "Trends of Russia's Gas Sector Regulation," *CRNI*, November 25, 2011, <http://www.crninet.com/2011/a4a.pdf> p. 6.

<sup>28</sup>Jennifer A. Josefson and Alexandra A. Kotlyachkova, "Russia: Expanding Opportunities For Foreign Investment In Major Oil and Gas Deposits," *King and Spalding LLP*, January 2012, <http://www.kslaw.com/imageserver/KSPublic/library/publication/2012articles/1-12MCCJosefsonKotlyachkova.pdf>.

<sup>29</sup>Andrei Belyi, "Trends of Russia's Gas Sector Regulation," *CRNI*, November 25, 2011,

<http://www.crninet.com/2011/a4a.pdf> p. 4.

to open access to the transmission grid, thereby increasing the independents' confidence regarding access to the UGSS, particularly in the case of their development of new production facilities.<sup>39</sup>

Fifth, the growth in gas producers indicates a growth in regional monopolies. In 2013 the number of gas producers in Russia reached 260: "16 Gazprom subsidiary companies (providing 71.3% of total Russian production); 97 companies belonging to the 8 VIOCs (11.4%); 2 companies affiliated to Novatek (7.9%); 140 independent gas companies (just 5.3%) and three PSA operators (4.1%)."<sup>40</sup> However, these have only strengthened the formation of regional monopolies. For example, Novatek controls about 100% of supplies to Chelyabinsk and Rosneft controls the Sverdlovsk region.<sup>41</sup>

## Reforms Needed for Gas Liberalization

To further demonstrate how far Russia's current gas sector is from gas liberalization, this section describes three reform measures that are critical to successful liberalization that Russia has yet to put in place.

### Unbundling of Gazprom

Unbundling Gazprom (particularly separating transmission and storage) is necessary for granting full access to transmission for gas independents. Gazprom still owns the GTS and thus has control over access to the system. There is only one condition under which Gazprom is required to provide access to independents: if there is "spare capacity from the connection zone to the gas collection zone in the proposed delivery period for the independent's contract with a buyer and if the gas meets the technical standards." Furthermore, there are no legal mechanisms for competitive bidding on capacities or for the allocation of transport routes in Russia. In this context, Gazprom can prioritize its own supplies.<sup>42</sup> It can use the secret information it attains as a natural monopoly to control the UGSS, making it difficult for competitors to access the pipeline network.<sup>43</sup>

### Removal of the Export Ban

Likewise it is important to remove Gazprom's monopoly on export of piped gas and to further open access for LNG export to all gas independents. Export of piped gas is still only possible for Gazprom and its subsidiary Gazprom Export. Access to international markets for independents is also granted through Gazprom Export. Such a system severely restricts activities of domestic companies in the international market [12].

### Reform of Tariff Structure

The structure of tariff regulations in Russia is also problematic.

<sup>39</sup> Mart Raamat, "Developments in the Russian Internal Gas Sector: Cosmetic Changes or Concrete Reforms," *International Centre For Defence and Security*, [http://www.icds.ee/fileadmin/media/icds.ee/failid/Developments\\_in\\_the\\_Russian\\_Internal\\_Gas\\_Sector\\_Cosmetic\\_Changes\\_or\\_Concrete\\_Reforms.pdf](http://www.icds.ee/fileadmin/media/icds.ee/failid/Developments_in_the_Russian_Internal_Gas_Sector_Cosmetic_Changes_or_Concrete_Reforms.pdf), p.10.

<sup>40</sup> Tatiana Mitrova, "The Corporate Landscape," *Oxford Energy*, August, 2014, <https://www.oxfordenergy.org/wpcms/wp-content/uploads/2014/09/OEF-97.pdf> 8

<sup>41</sup> Ibid, 7-8.

<sup>42</sup> Marc-Antoine Eyl-Mazzega, "Market in flux: What's next for Russian gas?," *International Energy Agency*, November 3, 2014, <http://www.iea.org/ieaenergy/issue7/market-in-flux-whats-next-for-russian-gas-.html>.

<sup>43</sup> Yuli Grigoryev, "The Russian Gas Industry, Its Legal Structure, and Its Influence on world Markets,"

*Energy Law Journal*, <http://www.eisourcebook.org/cms/The%20Russian%20Gas%20Industry,%20Its%20Legal%20Structure,%20Its%20Influence%20on%20World%20Markets.pdf>, p. 5.

Tariff formation falls under Federal Tariff Services (FTS), which sets the price (taking into account the country's social needs and costs of production) by consulting Gazprom<sup>44</sup>—a rather strange process for the FTS. Also with regard to tariffs on gas shipment, FTS uses the distance-based approach—which does not consider supplied volumes or the time used for shipment and is not close to a market based system. This distance-based approach does not incorporate the "possibility of trading of available capacity, which remains the major limit for both independent gas producers and oil companies for market access." Thus, tariff reform is needed to establish prices that are market-based in order for independents to be interested in selling their gas.<sup>45</sup>

## Is There a Real Demand for Gas Liberalization in Russia?

To further understand the gas liberalization process in Russia and its prospects of success, it is important to identify who demands liberalization and how the costs and benefits of full-scale liberalization influence each proponent's perspective on the best liberalization strategy.

For the most part, it has been NGOs, foreign energy companies, and academics who have called for the liberalization of the gas industry.<sup>46</sup> Domestic demand from gas independents for gas liberalization has been rare and began only after President Putin's pricing reforms. As described in the previous sections, the reforms still favor an unliberalized market, but the current media notes that the Kremlin favors gas liberalization by supporting the two interdependent gas companies that have been described as advocates of gas liberalization—Novatek and Rosneft.

The following sections will analyze: the internal debate for gas liberalization in Russia to understand the Kremlin's approach to gas liberalization; Rosneft and Novatek's approach to gas liberalization to examine whether they are true advocates of the process; and finally whether the Kremlin's support for Rosneft and Novatek indicates a decline in Kremlin's support for Gazprom.<sup>47</sup>

### Gas Liberalization for Russia

This section analyzes the economic and political rationale for gas liberalization in Russia, demonstrating first how Russia cannot afford gas liberalization at a time of economic slowdown, and second how political costs outweigh the economic benefits of the process.

#### A. The Economic Debate

The potential economic benefits of full gas liberalization in Russia are:

<sup>44</sup> Andrei Belyi, "Trends of Russia's Gas Sector Regulation," *CRNI*, November 25, 2011, <http://www.crnet.com/2011/a4a.pdf> p. 6.

<sup>45</sup> Belyi, Andrei, "Trends of Russia's Gas Sector Regulation," *CRNI*, November 25, 2011,

<http://www.crnet.com/2011/a4a.pdf> p. 6-7.

<sup>46</sup> Yuli Grigoryev, "The Russian Gas Industry, Its Legal Structure, and Its Influence on world Markets," *Energy Law Journal*, <http://www.eisourcebook.org/cms/The%20Russian%20Gas%20Industry,%20Its%20Legal%20Structure,%20Its%20Influence%20on%20World%20Markets.pdf>, p. 132.

<sup>47</sup> Examples of Gazprom losing favor with Kremlin: Mart Raamat, "Developments in the Russian Internal Gas Sector: Cosmetic Changes or Concrete Reforms," *International Centre For Defence and Security*, [http://www.icds.ee/fileadmin/media/icds.ee/failid/Developments\\_in\\_the\\_Russian\\_Internal\\_Gas\\_Sector\\_Cosmetic\\_Changes\\_or\\_Concrete\\_Reforms.pdf](http://www.icds.ee/fileadmin/media/icds.ee/failid/Developments_in_the_Russian_Internal_Gas_Sector_Cosmetic_Changes_or_Concrete_Reforms.pdf), p. 9. And Stephen Bierman and Elena Manzneva, "Rosneft May Top Gazprom as Kremlin's Crown Jewel of Energy," *Bloomberg*, March 13, 2016, <http://www.bloomberg.com/news/articles/2016-03-14/rosneft-may-top-gazprom-as-kremlin-s-crown-jewel-of-energy>.

- Rise in domestic competition for gas production, and thus better management of existing and new gas reserves;
- Improved investment climate, which Russia needs for technical improvements in its gas sector; Removal of subsidies and higher gas prices which will decrease domestic consumption of gas and therefore, make more gas available for export in Europe and in new markets in Asia.<sup>48</sup> According to one study by the Norwegian University of Life Sciences, the removal of gas subsidies for power plants and industry could lead to a 40% increase in net exports in 2020 from 2009 level.<sup>49</sup> Removal of subsidies for electricity and industry will also increase total welfare, and according to some studies to more than 3 billion euros per year;<sup>50</sup> and
- Price liberalization (increasing domestic prices) appears to accrue only a small economic cost: it will not cause huge inequity in the regions.<sup>51</sup> Also if price liberalization is accommodated by the modernization of the energy sector then the Russian gas sector will be on a more sustainable path.<sup>52</sup>

However, Tatiana Mitrova (Head of Oil and Gas Department) claims that there is no economic rationale for gas liberalization in Russia. From Mitrova's standpoint, granting gas independents access to the European market will not be beneficial for the Russian economy. She states that export liberalization will not allow more independents entry into Europe. Independents like Novatek and Rosneft will have difficulty entering the "stagnating European market" with falling demand. Without the long-term contracts that Gazprom has secured in Europe, Mitrova argues that Rosneft and Novatek will have to sign new contracts. However, due to Gazprom's large presence in the European market, they will not have much left to do but to offer customers price discounts. And so, according to Mitrova, independents will "start to dump and eat Gazprom's share but total revenues of Russia in this situation will decline." She also claims that such liberalization will not benefit EU customers, as access of independents to the European market would worsen the issue of preferential pricing for the EU—which Russia has used as a foreign policy tool.<sup>53</sup>

Furthermore, in the context of sanctions and economic stagnation, it is not a good strategy to fully liberalize and increase the tensions between the companies. Given that gas in Russia provides for 53% of Russia's primary energy consumption, any fault in reform at this point would put the government in a difficult position.<sup>54</sup>

## B. The Political Debate

The political benefits of full-scale gas liberalization are few. The

<sup>48</sup>Finn Roar Aune, Rolf Golombek, Arild Moe, Knut Einar Rosendhl and Hilde Hallre Le Tissier, "Liberalizing Russian gas markets-an economic analysis," *Norwegian University of Life Sciences School of Economics and Business*, [https://www.nmbu.no/sites/default/files/pdfattachments/hh\\_wp\\_11\\_2015\\_2.pdf](https://www.nmbu.no/sites/default/files/pdfattachments/hh_wp_11_2015_2.pdf), p.2.

<sup>49</sup>Ibid, 18.

<sup>50</sup>Ibid, 20 and 26.

<sup>51</sup>Christophe Heyndrickx, Victoria Alexeeva-Talebi, and Natalia Tourdyeva, "To raise or not to raise?, Impact assessment of Russia's incremental gas price reform," *ZEW Discussion Papers*,

<http://ftp.zew.de/pub/zew-docs/dp/dp12052.pdf>, p. 1.

<sup>52</sup>Ibid, 23.

<sup>53</sup>Marina Zvonareva, "Russia's "Perfect Storm," *Natural Gas Europe*, April 27, 2015, <http://www.naturalgaseurope.com/most-read-article-for-april-2015-27330>.

<sup>54</sup>Ibid.

most important is that liberalization would further align Russia with the EU's regulations on the prevention of anti-competitive behavior in the European market. This increased level of compliance with EU rules has the potential to improve relations with Central and Eastern European countries, who have turned against Russia and Gazprom for being the main supplier in Europe.

However, there are many political costs. First, liberalization would amount to a loss of power on the part of the government. Following liberalization, the government would be less able to give priority to investments and deals that are of political significance. Furthermore, the state-owned gas sector has created a system in which "scarcity can be created politically and used for various ends, for example, to play consumers off against each other."<sup>55</sup> This is a crucial advantage for the government as it can pit the companies against each other to vie for the support of the Kremlin.

Liberalization would also mean the unbundling of Gazprom and thus the loss of Kremlin's control over one of its most important domestic and foreign policy tools. Gazprom serves state functions that are of utmost significance to Russia. Gazprom has helped the government use gas to "[serve] the interests of centralization and influence... difficult regions like Chechnya and socially sensitive groups of consumers in a way of hidden subsidies." In the words of Tatiana Mitrova, "[i]f there is no company like Gazprom which takes care of the state interests, who will be a 'guarantying supplier' to all these groups? Most likely the government will not take such a risk, at least in this decade."<sup>56</sup>

From my own research this summer in Turkey, I witnessed the incredible international leverage that Gazprom holds abroad—political power in the energy market similar to US military bases around the world. Gazprom's acquisitions in Europe, Middle East and the FSU are of great significance to Russia, which needs to retain control over these new resources and use them to its advantage in negotiations with countries where Gazprom's gas supply dominates. Thus, with liberalization, the Russian state will no longer have the luxury of cutting gas volumes to countries where it plans to sign a deal (the reduction in volumes in the Western Pipeline before the signing of the MOU on Turkish Stream).

On a similar note, liberalization would also mean that the Kremlin could no longer force Gazprom into unprofitable acquisitions (i.e. KazMunayGaz), and to build expensive and unprofitable pipelines (i.e. South Stream, Turkish Stream, and Nord Stream)—which it needs to maintain and enhance political control over a region that it deems significant for Russia.

## Blurry Demand for Liberalization by Rosneft and Novatek

While many look to Rosneft and Novatek as the standard-bearers of gas liberalization in Russia, this view is shortsighted. Both companies are fundamentally disincentivized to support gas liberalization. In particular, Rosneft and Novatek critically rely on the Kremlin and are able to achieve their goals without gas liberalization. In addition, Rosneft and Novatek have not agreed on the reforms necessary to make gas liberalization a reality.

### A. Reliance on the Kremlin

<sup>55</sup>Jonas Gratz, "Energy Relations with Russia and Gas Market Liberalization," *Internationale Politik Und Gesellschaft*, no. 3 (2009): 66-80. [http://library.fes.de/pdf-files/ipg/ipg-2009-3/06\\_a\\_graetz\\_us.pdf](http://library.fes.de/pdf-files/ipg/ipg-2009-3/06_a_graetz_us.pdf), p. 68.

<sup>56</sup>Marina Zvonareva, "Russia's "Perfect Storm," *Natural Gas Europe*, April 27, 2015, <http://www.naturalgaseurope.com/most-read-article-for-april-2015-27330>.

Full-scale liberalization would mean that Novatek and Rosneft (both owned by entities in Putin's inner circle of friends) would no longer be able to benefit from their links to the Russian government. In this section, I show that this is a cost that neither company can afford, as their major accomplishments have been an outcome of the Kremlin's support.

In the case of Novatek, Gazprom owns about 10% of the company and the two other major shareholders are Leonid Mikhelson (CEO of the company for more than 10 years with 35% of the shares), and Gennadi Timchenko (former head of the oil trading company Gunvor with 23% of the shares). The latter has been the more significant of the two.<sup>57</sup> Timchenko has been part of Putin's St. Petersburg clan. Having joined Novatek in 2009, Timchenko was one of the main reasons the company emerged as a competitive rival.<sup>58</sup> For example, with the help of Timchenko, Novatek was able to acquire the Yuzhno-Tambeyskoye gas field—a property that was also of interest to Gazprom.<sup>59</sup>

In the same year that Timchenko joined (2009), Novatek completed a 64 bcm supply agreement for six years with Inter RAO (power producer), which was previously supplied by Gazprom. Many more contracts were signed by Novatek in the following years.

In comparison to Gazprom, Novatek is much more flexible in its price offering and capacity contracts. The average premium price for contracted gas prices offered by Novatek and Gazprom was at a difference of 15% in 2007, but in 2010 this difference was only 0.3%.<sup>60</sup> It should be noted that the decrease in the price difference was not due to Novatek lowering its supply price but instead due to an increase in Gazprom's regulated annual price.<sup>61</sup> Thus, Novatek simply benefitted from the change in Gazprom's price.

Another advantage for Novatek was that it received generous tax breaks from the government for gas production in the Gydan peninsula basin—which helped the company save more than \$ 4 billion and increased its resource base by 16.5 million ton/y.<sup>62</sup> These tax breaks were offered to Novatek by Putin, particularly for supplying the Yamal LNG plant. With this political advantage, Novatek has also acquired important exploration and production licenses on Gydan. Tax breaks offered to Novatek in gas activities have been lower by 35% than those for Gazprom. It is important to note that the lower tax breaks were secured at time when many individuals in the Kremlin pushed for higher taxes on energy companies to increase the revenue from the gas sector for the state budget.<sup>63</sup>

<sup>57</sup>Mart Raamat, "Developments in the Russian Internal Gas Sector: Cosmetic Changes or Concrete Reforms," *International Centre For Defence and Security*, [http://www.icds.ee/fileadmin/media/icds.ee/failid/Developments\\_in\\_the\\_Russian\\_Internal\\_Gas\\_Sector\\_Co\\_smetic\\_Changes\\_or\\_Concrete\\_Reforms.pdf](http://www.icds.ee/fileadmin/media/icds.ee/failid/Developments_in_the_Russian_Internal_Gas_Sector_Co_smetic_Changes_or_Concrete_Reforms.pdf), p.7.

<sup>58</sup>James Marson, "Novatek: The Challenger Takes on Gazprom in Russia," *Wall Street Journal*, June 19, 2013, <http://www.wsj.com/articles/SB10001424127887323836504578553323525867116>.

<sup>59</sup>"Novatek vs. Gazpro: Timchenko Will Not Let it GO," *Russian Intelligencer*, December 14, 2011,

<http://www.russianintelligencer.com/articles/novatek-gazprom.html>.

<sup>60</sup>Mart Raamat, "Developments in the Russian Internal Gas Sector: Cosmetic Changes or Concrete Reforms," *International Centre For Defence and Security*, [http://www.icds.ee/fileadmin/media/icds.ee/failid/Developments\\_in\\_the\\_Russian\\_Internal\\_Gas\\_Sector\\_Co\\_smetic\\_Changes\\_or\\_Concrete\\_Reforms.pdf](http://www.icds.ee/fileadmin/media/icds.ee/failid/Developments_in_the_Russian_Internal_Gas_Sector_Co_smetic_Changes_or_Concrete_Reforms.pdf), p.7.

<sup>61</sup>Ibid, 8.

<sup>62</sup>Nadezhda Sladkova, "Russia's New Tax Breaks to Benefit Yamal LNG Project," *International Oil Daily*, October 21, 2013, <http://www3.energyintel.com/WebUploads/gei-moscow/media-files/ioid-story-24-10.html>.

<sup>63</sup>Mart Raamat, "Developments in the Russian Internal Gas Sector: Cosmetic Changes or Concrete Reforms," *International Centre For Defence and Security*,

After Novatek, Rosneft is the largest rival of Gazprom. Following the acquisition of Yukos' assets in 2004 and the TNK-BP deal in 2013, Rosneft became an important rival of Gazprom.<sup>64</sup> Rosneft's acquisitions of TNK, ITERA, and Sibneftegaz have all increased its natural gas production.<sup>65</sup> Russia's third largest gas company at the time of its acquisition, ITERA was a particularly significant addition as it raised Rosneft's output levels to parity with Novatek's.<sup>66</sup>

Like Novatek, Rosneft is state-owned and operated by Rosneftegaz (a state holding company that has 69.5% shares in the company).<sup>67</sup> The CEO, Igor Sechin is a member of the Kremlin's siloviki faction and thus is in Putin's inner circle. Sechin was Deputy Prime Minister heading energy policy during Putin's service as Prime Minister and in 2012 Sechin became the Secretary of the Energy Commission under Putin.<sup>68</sup> With this connection, Rosneft has secured access to huge resource basins. It has attained access to more than 3 trillion bcm of gas through its acquisitions. It has also gained access to many licenses for drilling in the Arctic.<sup>69</sup>

Full-scale liberalization will mean the breaking of this link between the independents and the Kremlin—the cost of which will be very high given how much the two companies have benefited from the government.

#### B. Can Achieve What They Want Without Full Gas Liberalization

Given their close connections with the Kremlin, Novatek and Rosneft can secure the Kremlin's support for their immediate goals and do not have to look to full gas liberalization. Rosneft wants access to piped gas exports in order to access Gazprom's Power of Siberia pipeline (which is to supply 38 bcm of Russian gas to China).<sup>70</sup> While the export permit has not been granted, it is likely that Rosneft will receive access to the pipeline with support from the Kremlin. First, Rosneft has already been entering several successful deals with China (i.e. construction of an oil refinery<sup>71</sup> and the 25 year agreement for Rosneft's supply to China<sup>72</sup>). Additionally, Putin has ordered a review on granting access to Rosneft in a similarly contested deal with Gazprom—Trans-Sakhalin Pipeline.<sup>73</sup>

[http://www.icds.ee/fileadmin/media/icds.ee/failid/Developments\\_in\\_the\\_Russian\\_Internal\\_Gas\\_Sector\\_Co\\_smetic\\_Changes\\_or\\_Concrete\\_Reforms.pdf](http://www.icds.ee/fileadmin/media/icds.ee/failid/Developments_in_the_Russian_Internal_Gas_Sector_Co_smetic_Changes_or_Concrete_Reforms.pdf), p.8.

<sup>64</sup><http://www.bloomberg.com/news/articles/2016-03-14/rosneft-may-top-gazprom-as-kremlin-s-crown-jewel-of-energy>.

<sup>65</sup>"Gas Strategy," *Rosneft*, 2016, <http://www.rosneft.com/Upstream/GasStrategy/>.

<sup>66</sup>Mart Raamat, "Developments in the Russian Internal Gas Sector: Cosmetic Changes or Concrete Reforms," *International Centre For Defence and Security*, [http://www.icds.ee/fileadmin/media/icds.ee/failid/Developments\\_in\\_the\\_Russian\\_Internal\\_Gas\\_Sector\\_Co\\_smetic\\_Changes\\_or\\_Concrete\\_Reforms.pdf](http://www.icds.ee/fileadmin/media/icds.ee/failid/Developments_in_the_Russian_Internal_Gas_Sector_Co_smetic_Changes_or_Concrete_Reforms.pdf), p.8-9.

<sup>67</sup>"Shareholder Structure," *Rosneft*, 2016, [http://www.rosneft.com/Investors/structure/share\\_capital/](http://www.rosneft.com/Investors/structure/share_capital/)

<sup>68</sup>Mart Raamat, "Developments in the Russian Internal Gas Sector: Cosmetic Changes or Concrete Reforms," *International Centre For Defence and Security*, [http://www.icds.ee/fileadmin/media/icds.ee/failid/Developments\\_in\\_the\\_Russian\\_Internal\\_Gas\\_Sector\\_Co\\_smetic\\_Changes\\_or\\_Concrete\\_Reforms.pdf](http://www.icds.ee/fileadmin/media/icds.ee/failid/Developments_in_the_Russian_Internal_Gas_Sector_Co_smetic_Changes_or_Concrete_Reforms.pdf), p.9.

<sup>69</sup>Ibid, 8.

<sup>70</sup>"Rosneft Wants to Break Gazprom Monopoly," *The Moscow Times*, March 11, 2013, <http://www.themoscowtimes.com/business/article/rosneft-ratcheting-up-pressure-to-access-pipelines-and-compete-with-gazprom/495885.html>.

<sup>71</sup>"Construction of a refinery in China and of a petrochemical refinery in the Far East," *Rosneft*,

2016, <http://www.rosneft.com/Downstream/refining/Construction/>.

<sup>72</sup>"Russia-China energy deals worth more than \$ 500 bn by 2013—Rosneft CEO," *Russia Today*, September 4, 2015, <https://www.rt.com/business/314342-rosneft-china-cooperation-strengthening/>.

<sup>73</sup>Courtney Weaver, "Putin suggests ending Gazprom pipeline monopoly,"

Third, in a meeting with China's Vice-Premier in a ceremony for the Power of Siberia Pipeline, Putin indicated his support for Rosneft's proposal to sell a stake in its third largest onshore subsidiary, Vakor, to the Chinese.<sup>74</sup> Finally, while Sechin's plan to open access to Russia's transmission network was firmly rejected the first time it was proposed to Putin, it did not elicit the same strong rejection from Putin the next time it came to his attention.<sup>75</sup>

Likewise, Novatek does not have any goals that require gas liberalization. Its most significant reserve field, Yamal LNG (which it shares with Gazprom), has passed the final investment review and the initial output is to come out in 2017.<sup>76</sup> Therefore, Novatek currently does not need gas liberalization to gain further access to the system.

### C. Lack of Cooperation on Gas Liberalization

In order for liberalization to happen, all of the gas independents must cooperate with one another to achieve certain basic goals. However, both of the main "advocates" are split on two reforms that are essential to successful gas liberalization—liberalization of the export market and the unbundling of Gazprom. While Rosneft has expressed its full support for liberalization of the export market and of the dismantling of Gazprom, Novatek does not share the same enthusiasm. In fact, Novatek's support of the process is more limited in light of its more restrained ambitions and existing capacities.<sup>77</sup>

#### 1. On Liberalization of Export Market:

As mentioned, Rosneft wants to liberalize the export market because it wants access to international markets, particularly in China. While Gazprom already has a 38 bcm/y contract for supply (through Power of Siberia) to China, the operational capacity of the pipeline is much larger (61 bcm/y). Sechin thus has been lobbying for access to Power of Siberia, and has even offered a financing plan for the construction of the pipeline infrastructure.<sup>78</sup> However, Novatek does not have similar ambitions for piped gas and therefore does not agree.

Novatek supported Rosneft on LNG export liberalization. However, with respect to the issue of piped gas liberalization, Novatek has supported Gazprom. Novatek already shares an LNG terminal with Gazprom and knows that it is unlikely to garner support for liberalization from the Kremlin in light of the currently problematic relationship between Russia and the EU. First, as mentioned before, Novatek supplies the Yamal LNG (which it shares with Gazprom) from its gas fields in Gydan peninsula and is expecting an increase in output from the plant.<sup>79</sup> Second, Novatek realizes that liberalization would only make sense if liberalization improves Novatek's access to

*Financial Times*, July 22, 2014, <http://www.ft.com/intl/cms/s/0/d87d224a-11af-11e4-b356-00144feabdc0.html#axzz48VKcitDH>.

<sup>74</sup>Jack Farchy, "Rosneft Proposes Chinese Company Take Stake in Russian Oilfield," *FT.com* (London), September 01, 2014, [http://www.ft.com/intl/cms/s/01ab7166-31f0-11e4-a19b-00144feabdc0,Authorised=false.html?siteedition=intl&\\_i\\_location=http%3A%2F%2Fwww.ft.com%2Fcms%2Fs%2F0%2F01ab7166-31f0-11e4a19b00144feabdc0.html%3Fsiteedition%3Dintl&\\_i\\_referer=https%3A%2F%2Fwww.google.com%2F666cd76f96956469e7be39d750cc7d9&classification=conditional\\_standard&iab=barrierapp#axzz48fNSav6O](http://www.ft.com/intl/cms/s/01ab7166-31f0-11e4-a19b-00144feabdc0,Authorised=false.html?siteedition=intl&_i_location=http%3A%2F%2Fwww.ft.com%2Fcms%2Fs%2F0%2F01ab7166-31f0-11e4a19b00144feabdc0.html%3Fsiteedition%3Dintl&_i_referer=https%3A%2F%2Fwww.google.com%2F666cd76f96956469e7be39d750cc7d9&classification=conditional_standard&iab=barrierapp#axzz48fNSav6O).

<sup>75</sup>Mart Raamat, "Developments in the Russian Internal Gas Sector: Cosmetic Changes or Concrete Reforms," *International Centre For Defence and Security*, [http://www.icds.ee/fileadmin/media/icds.ee/failid/Developments\\_in\\_the\\_Russian\\_Internal\\_Gas\\_Sector\\_Cosmetic\\_Changes\\_or\\_Concrete\\_Reforms.pdf](http://www.icds.ee/fileadmin/media/icds.ee/failid/Developments_in_the_Russian_Internal_Gas_Sector_Cosmetic_Changes_or_Concrete_Reforms.pdf), p .11

<sup>76</sup>Ibid, 11.

<sup>77</sup>Ibid, 13.

<sup>78</sup>Ibid, 12.

<sup>79</sup>Ibid, 13.

the European piped gas market, as the geographic advantage of its main fields is in Europe.<sup>80</sup> However, given the currently strained energy relations between Russia and the EU over inconsistent European energy sector regulations,<sup>81</sup> Novatek understands that the Kremlin would not consider the company's request for access to the European market for piped gas.<sup>82</sup>

#### 2. On Dismantling Gazprom:

Rosneft's proposal to the Ministry of Energy to liberalize the Russian gas market includes reforms that would break up Gazprom's functions into different companies (transportation, storage and export) by 2025.<sup>83</sup> Rosneft's interest in unbundling Gazprom stems from the deep rivalry between the CEOs of the two companies. Miller has always fought to preserve Gazprom's position as a monopoly and Sechin has fought to force Gazprom to provide equal third party access. The two have personal disdain for each other.<sup>84</sup> The companies' interests also clash in the Arctic where the two are competing over exploration licenses.<sup>85</sup>

Novatek does not agree on breaking apart Gazprom as it has less need to do so to advance its self-interest. Novatek already has significant power in the sphere of energy politics and maintains a less acrimonious relationship with Gazprom. Its major shareholder, Gennadi Timchenko, has political influence and became the head of the Russia-China Business Council in 2014. Timchenko's new position means easier LNG agreements with China. Furthermore, Novatek has not experienced problems in accessing the Gazprom-controlled UGSS and thus has been able to book the necessary capacity for its natural gas production output. In addition, Gazprom and Novatek have concluded a 3 million tonnes of LNG/y deal on a long-term basis.<sup>86</sup>

Finally, it is important to note that the rivalry between Novatek and Rosneft also contributes to their limited cooperation on gas liberalization. The top managers of Rosneft and Novatek compete with one another. In 2012, Rosneft signed an \$ 80 billion deal with Inter Rao (the chairman of which is Igor Sechin himself), eliminating Novatek as the main supplier of natural gas for the power producer.<sup>87</sup>

### Kremlin's Support for Rosneft and Novatek Doesn't Mean Declining Support for Gazprom

In this section, I show that it is wrong to assume that the

<sup>80</sup>Ibid, 11.

<sup>81</sup>Russia has been struggling with EU's energy reforms particularly its Third Energy Package, which prohibits simultaneous operation and ownership of pipeline infrastructure. The EU claims that Gazprom has violated this principle.

<sup>82</sup>Mart Raamat, "Developments in the Russian Internal Gas Sector: Cosmetic Changes or Concrete Reforms," *International Centre For Defence and Security*, [http://www.icds.ee/fileadmin/media/icds.ee/failid/Developments\\_in\\_the\\_Russian\\_Internal\\_Gas\\_Sector\\_Cosmetic\\_Changes\\_or\\_Concrete\\_Reforms.pdf](http://www.icds.ee/fileadmin/media/icds.ee/failid/Developments_in_the_Russian_Internal_Gas_Sector_Cosmetic_Changes_or_Concrete_Reforms.pdf), p .11.

<sup>83</sup>Nadia Kazakova, "Rosneft seeking to dismantle rival Gazprom," *Tradingfloor*, July 24, 2015,

<https://www.tradingfloor.com/posts/rosneft-seeking-to-dismantle-rival-gazprom-5668226>.

<sup>84</sup>Quentin Buckholz, "Squabbling energy Oligarchs Threaten Moscow's LNG Plans," *The Diplomat*, July 24, 2015, <http://thediplomat.com/2015/07/squabbling-energy-oligarchs-threaten-moscows-lng-plans/>.

<sup>85</sup>Mart Raamat, "Developments in the Russian Internal Gas Sector: Cosmetic Changes or Concrete Reforms," *International Centre For Defence and Security*, [http://www.icds.ee/fileadmin/media/icds.ee/failid/Developments\\_in\\_the\\_Russian\\_Internal\\_Gas\\_Sector\\_Cosmetic\\_Changes\\_or\\_Concrete\\_Reforms.pdf](http://www.icds.ee/fileadmin/media/icds.ee/failid/Developments_in_the_Russian_Internal_Gas_Sector_Cosmetic_Changes_or_Concrete_Reforms.pdf), p .12.

<sup>86</sup>Ibid, 13.

<sup>87</sup>Ibid, 10

Kremlin's support for Rosneft and Novatek is indicative of a decline in its support for Gazprom. Contrary to this assumption, I argue that Gazprom benefits from gas liberalization. Gazprom's internal research center, NIIGazekonoma (Science and Research Institute of Economics and Management for the Gas Industry), actively calls for liberalization reforms, stating that such reforms could make Gazprom more efficient and profitable. Thus, it is possible that the Kremlin could view partial liberalization as a way to meet some of Gazprom's demands. In doing so, the Kremlin ensures that Gazprom will continue to fulfill its state duties, on which the Russian government vitally depends.

I focus on the Research Center because I view the comments of NIIGazekonoma to be more representative of the interests of Gazprom as a profit-oriented entity, than the comments of the CEO, Alexei Miller. Thus, while the Research Center expresses what is beneficial for Gazprom as an independent corporation, Alexei Miller represents what is beneficial for Gazprom as a state-owned entity with state duties.

As early as 2003, NIIGazekonoma created a presentation that emphasized the openness of Gazprom to liberalization, which would promote the company as an independent business rather than hinder its progress. To be more precise, Gazprom's Research Center supports unbundling of Gazprom in the following form:

- "Separation of non-specific assets and Gazprom's activities as different businesses, and
- Unbundling Gazprom's activities: production, transportation, processing, underground gas storage services."<sup>88</sup>

The reforms highlight Gazprom's inefficient management, which is a high cost for the company. Undertaking too many functions that it cannot effectively manage, Gazprom has not been able to focus on profitable gas production—which has been an outcome of the requirements placed on the company by the Russian state. Unbundling reforms would help the company improve its management from a bureaucratic one to one that is more technical and business oriented, allowing the company to focus on production activities and find cost synergies.

Likewise, in addition to unbundling, liberalization would bring an end to unequal government treatment: regulated low wholesale prices and higher corporate tariffs for

Gazprom. Thus, the Research Center states that the internal gas market reforms should include the following:

- "Widening of free prices sector (market prices) with the aim of liberalization of gas prices,
- Raising the regulated gas prices in order to cover expenditures and attract new investments,
- Creating prerequisites for increase of the share of independents in gas production,
- Participation of independent producers in gas exports under the Single Export Channel."<sup>89</sup>

<sup>88</sup>O. Buchnev, T. Shtiklind, "Russian Gas Industry today and tomorrow, *Niigazekonoma Institute*,

[http://www.unece.org/fileadmin/DAM/ie/se/pdfs/wpgas/countries/russia\\_shtilkinderus.pdf](http://www.unece.org/fileadmin/DAM/ie/se/pdfs/wpgas/countries/russia_shtilkinderus.pdf). p, 11.

<sup>89</sup>Ibid, 19.

The inquiry of the Deputy Board Chairman of Gazprom, Valery Golubev, elaborates on the first two points of free and higher gas prices. In 2014, he asked for higher wholesale prices to cover the "expenses for infrastructure maintenance as well as new projects, leaving at least some profit margin"<sup>90</sup> for Gazprom.

All of the discussed reforms—particularly, Gazprom's unbundling and opening access to the Export Channel—change the current perception around Rosneft's request to split the company and Putin's silent response to it. Contrary to some claims,<sup>91</sup> these reforms make it more likely that Putin is considering Rosneft's proposal to help Gazprom, as opposed to turning away and "de-Gazpromizing."<sup>92</sup>

The recent extension of LNG export rights to Rosneft and Novatek also should not be perceived as a move that hurts Gazprom. The company has failed to compete in the sphere of LNG particularly in the European market. Given the rapidly developing LNG market in Europe, Asia and South-East Asia, it was significant for Putin to liberalize the LNG market to secure Russia's position in it.<sup>93</sup> Likewise, the increase in Federal Antimonopoly Services' investigations should also not be viewed as the Russian government's turn against Gazprom, as the latter has underscored a need for increased transparency.<sup>94</sup>

Additionally, it is important to understand that the Kremlin needs to cater to the needs of Gazprom, as the latter has been failing as a corporation for catering to the needs of the Kremlin. As discussed earlier (under "political debate"), Gazprom's focus on state duties has reduced its effectiveness as a gas company; it has not been able to focus on profitable gas production from its existing gas reserves, supply of customers near production bases, and supply of domestic customers at market prices. Under pressure from the state, it has engaged in expensive pipeline projects as well as acquisitions for the preservation of Russia's high international leverage in the energy market—all of which has been a huge cost for the company. While in 2008, its market capitalization was at \$367.27 billion; in August of 2015 its market cap was at a low of \$51.12 billion. This has been the biggest decline in the world's Top 5000 companies.<sup>95</sup>

Finally, it is important to note that the Kremlin's support of gas independents is limited. For example, there have been very important instances in which Rosneft has appeared to fall out of favor with the Kremlin. Rosneft's TNK-BP deal failed when the price of oil had collapsed. This increased the company's debt and lowered its worth to \$45 billion—a third of the target that Sechin had promised to Putin during the acquisition.<sup>96</sup> In March 2015, Putin criticized Sechin for

<sup>90</sup> "Russia's Gazprom Wants to Raise Domestic Gas Prices as Ruble Plunge Hits Margins," *The Moscow Times*, December 11, 2014, <http://www.themoscowtimes.com/business/article/russias-gazprom-wants-to-raise-domestic-gas-prices-as-ruble-plunge-hits-margins/513181.html>.

<sup>91</sup>Example of such claim: Szymon Kardas, "The creeping "de-Gazpromisation" of Russian exports," *OSW*, June 11, 2014, <http://www.osw.waw.pl/en/publikacje/analyses/2014-06-11/creeping-de-gazpromisation-russian-exports>.

<sup>92</sup>Ibid.

<sup>93</sup>Kardas, Szymon, "A feigned liberalization: Russia is restricting Gazprom's monopoly on exports," *OSW*, November 28, 2013, <http://www.osw.waw.pl/en/publikacje/osw-commentary/2013-11-28/a-feigned-liberalisation-russia-restricting-gazproms-monopoly>.

<sup>94</sup>O. Buchnev, T. Shtiklind, "Russian Gas Industry today and tomorrow, *Niigazekonoma Institute*, [http://www.unece.org/fileadmin/DAM/ie/se/pdfs/wpgas/countries/russia\\_shtilkinderus.pdf](http://www.unece.org/fileadmin/DAM/ie/se/pdfs/wpgas/countries/russia_shtilkinderus.pdf). p,11.

<sup>95</sup>"Russia: Gazprom, A Behemoth No More," *Natural Gas Europe*, August 08, 2015, <http://www.naturalgaseurope.com/russia-gazprom-decline-causes-24969>.

<sup>96</sup>Stephen Bierman and Elena Manzneva, "Rosneft May Top Gazprom as Kremlin's Crown Jewel of Energy," *Bloomberg*, March 13, 2016, <http://www>.



indebting Rosneft more than its rivals. Putin publicly criticized Sechin on February 4 for changing his stance on significant gas sector related issues from the time he served in the government to becoming the CEO of Rosneft. Putin asked “Where is the real Sechin—before or after? The company’s interests are important, the company is industry-forming, but there are also the interests of the whole economy.” The remark on the economy stems from the fact that Sechin borrowed money in a “deal that confused the market and helped undermine the currency.”<sup>97</sup> The Russian Finance Ministry also rejected Rosneft’s requests for financial assistance in June 2015.<sup>98</sup>

Another example of where Rosneft was not supported by the Kremlin is when the latter did not interfere in favor of Rosneft in a court decision over granting access to a pipeline on Sakhalin Island controlled by Sakhalin Energy (a consortium primarily owned by Gazprom). For its southern energy terminal, Rosneft needed access to the pipeline; however, Gazprom did not agree to allow access to it. Rosneft went to the courtroom after Prime Minister Medvedev did not intervene in April 2014. The court ruled against Rosneft’s claim that Gazprom was required to provide third party access on February 15, 2015—favoring Gazprom.<sup>99</sup>

## Conclusion

The first half of this paper demonstrates that the changes in market share in Russia’s gas sector do not indicate that a full-on gas liberalization process is underway. The changes have been an incidental, not purposeful, result of liberalization reforms. The lack of rigorous

[bloomberg.com/news/articles/2016-03-14/rosneft-may-top-gazprom-as-kremlin-s-crown-jewel-of-energy](http://bloomberg.com/news/articles/2016-03-14/rosneft-may-top-gazprom-as-kremlin-s-crown-jewel-of-energy).

<sup>97</sup>Irina Reznik, Evgenia Pismennaya and Stephen Bierman, “Putin Said to Blame Energy Chief Sechin

After Rosneft Missteps,” *Bloomberg*, March 13, 2015, <http://www.bloomberg.com/news/articles/2015-03-13/putin-said-to-blame-energy-chief-sechin-after-rosneft-missteps>.

<sup>98</sup>“Russia’s Finance Ministry Rebuffs Rosneft Oil Firm’s Request for State Aid,” *The Moscow Times*, June 3, 2015, <http://www.themoscowtimes.com/business/article/russian-finance-ministry-rebuffs-rosneft-oil-firms-request-for-state-aid/522992.html>.

<sup>99</sup>Quentin Buckholz, “Squabbling energy Oligarchs Threaten Moscow’s LNG Plans,” *The Diplomat*, July 24, 2015, <http://thediplomat.com/2015/07/squabbling-energy-oligarchs-threaten-moscows-lng-plans/>

regulatory changes that still favor the Kremlin and the corporations it supports (Gazprom, Novatek and Rosneft) underscores the extent to which the gas sector continues to be controlled.

The second half of the paper evaluates the prospects for gas liberalization reform by analyzing the approach to liberalization of the main institutions that are viewed as advocates of the process. This analysis demonstrates that the gas sector in Russia is comprised of limited players: the traditional, Kremlin and Gazprom, and the new additions, Novatek and Rosneft. Furthermore, nothing has changed in the interaction of these players to indicate an ongoing gas liberalization process. All players still depend on the Kremlin for support, and the Kremlin supports the players based on its foreign and domestic policy goals.

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