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## Gazprom, the Fastest Way to Energy Suicide

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**Christophe-  
Alexandre Paillard**

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**IFRI**

27 RUE DE LA PROCESSION  
75740 PARIS CEDEX 15 – FRANCE  
TEL. : 33 (0)1 40 61 60 00  
FAX : 33 (0)1 40 61 60 60  
E-MAIL : [ifri@ifri.org](mailto:ifri@ifri.org)

**EUR-IFRI**

22-28, AVENUE D'AUDERGHEM  
B – 1040 BRUXELLES  
TEL. : 32(2) 238 51 10  
FAX : 32 (2) 238 51 15  
E-MAIL : [info.eurifri@ifri.org](mailto:info.eurifri@ifri.org)

WEBSITE : [www.ifri.org](http://www.ifri.org)

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## Author

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Christophe-Alexandre Paillard is Head of the Industrial and Technological Trends Department within the French Ministry of Defense's Strategic Affairs Office. In particular, he focuses on problems linked to natural resources and the analysis of industrial, economic and financial risks that could have consequences for national security. A former student of the National School of Administration (ENA) and the Diplomatic Institute of the Ministry of Foreign Affairs, he was graduated from the Paris Sciences-Po, holds a Masters in Russian History and a post-graduate qualification in Workforce Management. He is also a Senior Lecturer on International Issues and Economic Warfare at Paris Sciences-Po. He has written many articles on energy issues and two books—*Géopolitique du pétrole* [Oil Geopolitics] (2005) and *Quelles stratégies énergétiques pour l'Europe ?* [What Energy Strategies for Europe?] (2006).

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## Summary

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Russia is an unavoidable actor in world energy geopolitics. It is also the biggest energy partner of a European Union (EU) that is becoming ever more dependent on outside sources for its energy needs. However, the future of Russia's largest company—Gazprom—and the development of its future production capacities are at the center of a complex financial and political game dominated by numerous uncertainties, including Gazprom's actual reserves, its ability to invest in exploration and production, and its very capacity to develop production. Indeed, back in state hands, Russian gas and oil companies—Gazprom included—do not appear to be in a position to meet their future production commitments. Gazprom's ability to honor its contracts with gas companies in the EU is in fact already the subject of numerous interrogations.

# Introduction

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Europe's present energy situation is a problem. No one can today ignore that the continued growth in global energy needs in both developed and emerging countries will, in the medium- to long-term, be met with lacking supplies; not necessarily because of any geopolitical spat or lack of reserves, but because of the absence of a driven investment policy within producing regions, particularly in regard to hydrocarbons.

This situation can be explained by a number of factors, among which is the failure of producers and consumers to agree on what the security of energy supply and demand means. On the producer's side, moreover, certain states have been noticeably keen to turn energy reserves into instruments of political blackmail, helping to contribute—at least in the short-term—to the uncertainties surrounding energy markets and therefore future investments. From the point of view of the largest consumers, the difficulties that many countries are experiencing in trying to change their bad energy habits means they cannot envisage a significant reduction in their needs within the next 20 years, thus limiting their room for maneuver in regard to reducing their dependency on producing countries.

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Translated from English by Victoria Bryan.

The opinion expressed in this article is the authors' alone and does not necessarily reflect the official views of the French Ministry of Defense.

# The Future Capacity of Russian Gas Production: The Great Unknown

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Russia, thanks to the size of its reserves, its status as the largest supplier to the European market (15% of the oil and 30% of the gas needs of the EU in 2005), but also to the uncertainty surrounding its politics, is and will remain a key player in guaranteeing the stability of global energy markets. In the absence of a technological revolution in this industry or within the field of transport and excluding a possible geopolitical crisis concerning energy, the worldwide growth in demand for natural gas will continue to ensure that Russia (which contains a quarter of the world's current estimated gas reserves) remains at the heart of this issue.

The future of its quasi-monopolistic gas company, Gazprom, is now more than ever the subject of much scrutiny, from an economic, financial, but also political and security point of view, and key to understanding the Russian gas sector—its potential, constraints and especially its limits. Indeed, using our understanding of the Russian gas sector, comparing Gazprom's production prospects for the next five years with the needs of the European market clearly reveals the fact that Gazprom will be unable to honor its contracts. As a result, Europeans will have to find their gas on the world market and/or at a far higher price than today, and this in spite of the contracts signed between Gazprom and its industrial partners in the EU.

Russian gas production—589 billion cubic meters (bcm) in 2004<sup>1</sup>—should be 555-645 bcm between 2010 and 2012. Such a production level would not be enough to cover the volume of contracts signed with European companies for this time frame.<sup>2</sup> In 2012, Russian domestic consumption is expected to be between 440 and 480 bcm if nothing is done to curb it. In 2005, the 22 EU countries (not including the three Baltic states) imported around 140 bcm from Russia.<sup>3</sup> In 2012, it is estimated that the EU-27 will need at least 168 bcm of Russian gas.<sup>4</sup> In regard to Russia's other consumers, 40-45 bcm will be transported to Ukraine, 15 bcm to China, 15 bcm to Turkey and approximately 20 bcm to other markets. Adding all this

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<sup>1</sup> Source: BP.

<sup>2</sup> See, for example, the 2004 *World Energy Outlook* from the International Energy Administration which focuses on these issues, the *Energy Strategy of Russia for the Period Ending 2020: Main Provisions*, report published in Moscow in November 2003, or the online review <[www.gasmatters.com](http://www.gasmatters.com)>.

<sup>3</sup> Eurostat, 2007. Some of this gas actually came from Turkmenistan.

<sup>4</sup> Source: Gaz de France.



up reveals a 63 bcm shortfall in terms of Russian contractual obligations, even when considering the most optimistic scenario. The most catastrophic scenario, which is based on the lowest level of production and the maximum level of consumption, reveals a shortfall of nearly 200 bcm.

Not all Russians underestimate the problem. In October 2006, Vladimir Milov, former Deputy Minister of Energy in 2002, concluded that the Russian gas deficit could reach 126 bcm in 2010, based on estimates from the Moscow Institute of Energy Policy, which he heads.<sup>5</sup>

European gas and electricity companies that have recently signed contracts with Gazprom (including E.ON Ruhrgas, RWE, ENI or Gaz de France) are therefore running the risk of not being able to supply the European market. This in turn would trigger a real confidence crisis between the industry, leading EU politicians, and public opinion in the member states who will certainly feel cheated when their gas or electricity bill surges further, all because the industry's trust in Gazprom prevented timely questions from being asked and measures from being taken, such as finding other industrial solutions or suppliers in order to avoid technical difficulties that could be experienced by the Russian company.<sup>6</sup>

But even if all those involved seem to be aware of Europe's interdependency when it comes to energy, everyone currently acts as a "lone rider", hoping that their own national market will survive when the crisis hits. This is the strategy of Italy's ENI, for example. It may be the case that those European states that do not have enough money to pay for expensive gas, particularly Central and Eastern European states, will find themselves in a critical political and economic situation. Even if there has been no official acknowledgment of the "lone rider" strategy, it is clear that the deepening economic and industrial ties between Gazprom and ENI lend particular weight to this theory.<sup>7</sup>

From a strictly commercial point of view, the partnership signed in November 2006 provides for Gazprom to sell gas directly to the Italian market from 2007, at volumes intended reach 3 bcm by 2010 and then throughout the duration of the contract. In exchange, Gazprom has extended its gas supply contract with the Italian group until 2035, making ENI the most important customer of the Russian giant. In terms of production, the two groups have identified a series of major projects for joint development, both in Russia and elsewhere, with the projects to be finalized by the end of 2007. The two groups, along with ENI's Snam Rete Gas unit, will also cooperate on long-distance gas transport in order to improve the

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<sup>5</sup> Quoted in A. Riley, *The Coming of the Russian Gas Deficit: Consequences and Solutions*, Centre for European Policy Studies, *Policy Brief*, October 2006, Brussels, Belgium, <[http://shop.ceps.eu/BookDetail.php?item\\_id=1389](http://shop.ceps.eu/BookDetail.php?item_id=1389)>.

<sup>6</sup> For example, the ENI/Gazprom agreement of 19 November 2006, the Gazprom/E.ON Ruhrgas agreement of 12 July 2006 and the RWE/Gazprom agreement of 26 December 2006 on the extension of gas supplies until 2035 and the Gazprom/Gaz de France agreement of 19 December 2006 on extending supply contracts until 2030.

<sup>7</sup> Italy is Europe's third largest natural gas market. Natural gas accounts for more than 30% of the country's energy supply; 86% of Italy's natural gas needs are imported, mainly from Algeria and Russia.

transportation of Russian gas. In addition, they will also develop joint liquefied natural gas (LNG) projects for the global gas market.

ENI also has an option to take a stake in the massive Yuzhno-Russkoye Siberian gas field (in which Germany's E.ON was also seeking a stake) and is predicting that a 3% increase in annual production by investing in deposits with solid long-term prospects, such as those in the Barents Sea. ENI may also, with the help of Gazprom and ENEL, acquire the Arktikgaz group, a former Yukos subsidiary. In exchange, ENI has offered Gazprom access to its technology.<sup>8</sup> In this way, ENI hopes to build on its position as a privileged partner of Russia<sup>9</sup> and avoid a repeat of the situation experienced by Italy on 18-20 January 2006, when Russia halted gas deliveries as a result of technical and weather problems.

All of these projects would in fact help boost Russian production if there were an actual desire to develop large-scale production. Indeed, the view that Gazprom will not be able to honor its contracts in the next few years is based not only on the extremely subjective idea of "Russian reliability", but also on the state of the gas fields and on the insufficient level of investment effort being put in by the Russian company. Some top-level managers at Gazprom have discreetly tried to sound the alarm,<sup>10</sup> but nothing seems to be able to overturn the Kremlin's current policy which will, whether intentionally or not, place Europe in a very precarious situation in energy terms. This lack of apparent reliability gives Gazprom a negative reputation. In order to repair the damage done by the recent gas crises, Gazprom, via its Gazpromexport subsidiary, has been negotiating advertising contracts worth more than 11 million dollars with a consortium of agencies headed by US communications company PBN since January 2007.

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<sup>8</sup> SAIPEM, 43%-owned by Italian oil group ENI, which has been its major shareholder since 1969 and which itself is 20%-controlled by the Italian state, has offered engineering, construction, installation, drilling and maintenance services for oil and gas, both onshore and offshore which could in theory help Gazprom in exploration/production.

<sup>9</sup> See the comments of P. Scaroni, CEO of ENI, in *La Repubblica*, 14 November 2006 at the time when the Gazprom/ENI agreement was signed, describing these deals as historic and as representing a new strategic alliance between the two companies.

<sup>10</sup> See, for example "Na vseh ne hvatit. Gazprom priznalsya v deficite gaza", [There Won't Be Enough for Everyone. Gazprom Acknowledges the Gas Deficit], *Vremia*, 21 April 2006 and the comments made by A. Ryazanov, named Deputy Chairman of Gazprom on 5 November 2001, who "resigned" on 16 November 2006 and was replaced by a former KGB officer, V. Golubyev.

# Gazprom, or the Trap of Russian State Control<sup>11</sup>

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Originally, Gazprom was an offshoot of the Soviet Gas Ministry, set up in 1965 when the USSR decided to develop the production and consumption of gas. In 1989, Gazprom became an “independent” company. Its first chairman was Viktor Chernomyrdin, a former prime minister of Boris Yeltsin<sup>12</sup> and current Russian Ambassador to Ukraine. In 1993, the company was reorganized into a joint-stock company named RAO Gazprom, before becoming OAO Gazprom in 1998, the name it retains to this day.

In 2005, the Russian state became the company’s majority shareholder with 50.01% of the share capital.<sup>13</sup> Today Gazprom controls 25%<sup>14</sup> of the world’s gas reserves and 94% of Russia’s natural gas.<sup>15</sup> Gazprom owns the entire gas transport infrastructure in Russia—some 144,000 kilometers of pipelines—and all of the country’s compressor stations. It is the only company legally authorized to sell gas outside Russia. Gazprom employs around 300,000 people and represents 25% of Russia’s total budgetary revenue. Gazprom is also at the heart of a network of companies, including Gazprombank, insurance company Sogaz, media holding company Gazprom-Media and the St. Petersburg football team Zenith. Also worth noting are its recent acquisition of a German football team (Schalke 04), of stakes in Central and Western European downstream markets, as well as failed attempts to buy assets in the UK (electricity company Centrica, for example).

It is a well-known fact that Gazprom’s extremely close ties with the Kremlin explain this privileged position. The Chairman of the Board of Directors, Dmitri Medvedev, was formerly Putin’s Chief of Staff and is

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<sup>11</sup> See C. Locatelli, “Le modèle organisationnel de Gazprom” [The Organization Structure of Gazprom], December 1999, IEPE/CNRS.

<sup>12</sup> From 12 December 1992 to 23 March 1998.

<sup>13</sup> The stock market capitalization of Gazprom was US\$ 269 billion in May 2006 according to the Moscow stock exchange; 29.47% is held by unspecified “legal Russian entities”; 13.07% is held by private Russian persons and 7.45% by shareholders not-residents in Russia, including E.ON.

<sup>14</sup> Russia holds around 26.7% of the world’s gas reserves according to estimates from the International Energy Agency.

<sup>15</sup> Other local producers (Lukoil, Itera, Novatek to name a few) make up the remainder and are not interested in investing and producing more. Lukoil, for example, sells its gas at US\$ 22 per 1,000 cubic meter to Gazprom, which sells it on to the international market at US\$ 230, therefore discouraging it to produce more.

currently Deputy Prime Minister, and often mentioned as a possible successor to Putin. The current chairman of Gazprom, Alexei Miller, is also a close friend of President Putin.

This combination of energy and politics has made Gazprom an instrument of politico-social regulation in Russia. Russia is the world's second-largest consumer of gas after the US, although its economic power is almost 20 times less that of the US. Russia therefore wastes its energy. Those who have been to Russian towns know that the urban landscape is characterized by an abundance of heating inside buildings and many open windows in all seasons, even in mid-winter. Although this evidence may appear anecdotal, it serves to show the obsolescence of Russian installations, which do not allow residents to change the heating in their own apartments. Nine out of ten households in Russia do not have a gas meter. The excessive use of gas in Russia can also be explained by the large amounts wasted in the transportation sector equal to at least 30% of Russia's oil needs.

Some experts estimate that Russia could cut its domestic gas needs by up to one-quarter. Many electricity generators run on gas and have an efficiency rating of just 33% when a level of 55% would be technically possible if they were correctly maintained.<sup>16</sup> There is no public or private policy aimed at reducing consumption and waste, improving isolation or encouraging transportation and construction standards in order to make them more energy-efficient.

Neither private households nor businesses are encouraged to reduce consumption because gas is so cheap in Russia. The average price of 1,000 cubic meters of gas for a Russian household has remained for a long time near US\$ 15, although it did come close to US\$ 40 in 2006. The low gas prices also reflect political interests: companies, which are not very competitive and major users of energy, can use them to lower their costs; low gas prices also prevent many Russian households from experiencing financial difficulties, which would happen were prices to rise. Lastly, Russia's harsh climate means that heating costs would account for a major part of the budget for Russian households should prices come into line with those of the EU.

The Russian government's decision to use natural gas as a "social shock absorber" helps to explain the regime's cautious stance toward any price increase on the domestic market. President Putin announced on 22 November 2006<sup>17</sup> that gas prices would remain fixed in 2007 (a decision

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<sup>16</sup> Western companies have managed to become active on this market, which remains difficult to enter. On 15 December 2006, Alstom gained its first order to build a production unit with output of 420MW from Russia's Mosenergo, one the main electricity producers in Moscow.

<sup>17</sup> *Nezavisimaya Gazeta*, 23 November 2006. According to this paper, which quoted Igor Shuvalov, an adviser to President Putin, the aim of the Kremlin is to bring domestic gas prices in line with those paid outside of Russia. Russian consumers would therefore pay US\$ 150 per 1,000 cubic meter of gas, in line with the price paid by their European neighbors, from 2010-2012. If this were the case, which seems unlikely given the political and social reasons already outlined, it could have an impact on Gazprom's investment policy. But,

taken in view of the 2008 presidential elections), resulting in estimated losses of US\$ 16 billion for Gazprom. By way of comparison, the price of gas is US\$ 110 per 1,000 cubic meters in Georgia, US\$ 159 in Finland, US\$ 735 in Denmark, while averaging over US\$ 200 in the EU.

As Jonathan Stern, gas expert from the Oxford Institute for Energy Studies, recently stated, "Gazprom's predicament is that major new explorations are not economically viable, given that domestic gas prices, set by the state, are so low."<sup>18</sup> This view was confirmed in 2006. For the first nine months of the year, Gazprom doubled its net profits compared to the same period in the previous year, to 13.43 billion euros (US\$ 16.78 billion). Seventy percent of Gazprom's profits come from gas exported to the EU. The domestic market does not positively impact Gazprom's growth.<sup>19</sup> Despite this, Russia is unable to limit its domestic consumption in order to increase the amount it can export, as energy efficiency is not on top of the Russian government's list of priorities.

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even if Gazprom's capacity for investment were increased in this way, it would not be so easy to catch up the delay in making the necessary investments to improve production.

<sup>18</sup> J. Stern, *The Future of Russian Gas and Gazprom*, Oxford University Press, 2005.

<sup>19</sup> See R. Ahrend et W. Tompson, *Russia's Gas Sector: The Endless Wait for Reform*, OECD Economic Department Working Papers, no. 402, September 2004.

# Bad Strategic Choices under Political Constraint<sup>20</sup>

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According to various estimates,<sup>21</sup> the gas sector will need to build an additional 26,000 km of pipes between 2004 and 2020<sup>22</sup> as well as 137 new compressor stations if it is to honor the contracts signed with European countries.

By 2020, it is estimated the gas industry will need between US\$ 25.5 billion and US\$ 33 billion for exploration, US\$ 44.4 billion to US\$ 52.5 billion for production, US\$ 21 billion to US\$ 22 billion for product conversion (for example into LNG) and US\$ 83 billion to US\$ 96 billion for transportation (boats, gas pipelines, etc), putting total investment at US\$ 173-203 billion.<sup>23</sup> The profits recently achieved, although substantial, will not be enough to finance such investment.

Gazprom's three major gas fields—Medvezhye, Urengoy (discovered in June 1966 and accounting for a quarter of Gazprom's production) and Yamburg (discovered in 1971)—together known as “The Big Three” and all located in Western Siberia, represent 70-80% of Russia's total natural gas production. These fields are, respectively, 50%, 65% and 80% exhausted.<sup>24</sup> Gazprom needs to invest elsewhere. If this investment is carried out by 2020, these fields could account for just 23% of Gazprom's production,<sup>25</sup> compared to one-third for the Zapolyarnoye field, where production began in October 2001.

Beyond merely needing cash for these investments, Gazprom also needs political agreement to carry out such work. Questions have been asked on why an agreement is not forthcoming: Gazprom ought not to meet any obstacles due to its ties to the Kremlin, and it would seem legitimate that it should seek to benefit from a situation that bestows political advantage. Moreover, Gazprom enjoys a solid financial base, even if the Kremlin does not hesitate to use it as its own. However, neither the Kremlin nor Gazprom

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<sup>20</sup> On this subject see K. Rosner, *Gazprom and the Russian State*, London, Global Market Briefing Publishing Ltd., May 2006.

<sup>21</sup> Among others VNIIGAZ, a unit of Gazprom <[www.vniigaz.ru](http://www.vniigaz.ru)> and *The Russian Gas Industry to 2020*, Emerging Markets Online, January 2003.

<sup>22</sup> These pipes have a diameter of 1,420 mm and pressure of 100 bar.

<sup>23</sup> P. Thomson, *Reform of the Russian Gas Sector*, The World Bank, May 2004.

<sup>24</sup> V. Milov, Institute of Energy Policy, UFG Russia One on One Conference, London, 4 February 2004.

<sup>25</sup> IEA, Gazprom, United Nations Economic and Social Council.

are pushing for investment, even though their long-term interests relies on doing so. The Russian authorities' behavior does not therefore appear logical.

Gazprom's debts to the Russian state and various banks are currently estimated at US\$ 29.71 billion,<sup>26</sup> due in large part to the acquisitions of Sibneft—renamed Gazpromneft in 2005—for US\$ 10 billion and 19.9% of the capital of rival Novatek in the summer of 2006. According to Gazprom, these debts are affecting the company's ability to gain credit and mean that investment is limited to infrastructure repairs. Between 2000 and 2006, Gazprom invested just US\$ 12.6 billion in gas exploration, compared with US\$ 30.6 billion for financial transactions<sup>27</sup> such as the purchase of Sibneft.

Active in 18 EU countries (subsidiaries, joint ventures and various stakes included), Gazprom is currently looking to strengthen its position in western Europe. The company is for example interested in Suez's assets in Belgium, which GDF would have to sell in the event of a GDF-Suez merger. Having failed to get its hands on Centrica, the UK's largest energy company, Gazprom has managed to enter the UK by acquiring Pennine Natural Gas Limited in June 2006. The deepening of its political ties with Algerian counterpart Sonatrach, as shown in the trip made by Viktor Khristenko, Russian Minister for Industry and Energy, to Algiers in January 2007, and the rising number of comments from the Russian government on the creation of a "gas OPEC"<sup>28</sup> prevents any clear understanding of Gazprom's industrial strategy.<sup>29</sup>

It would thus appear wise to put in perspective the Russian statement that Gazprom's debts are a weight on the group's structural investments. In actual fact, this sort of declaration is predominantly intended to justify the lack of investment decisions.

In 2005, the company posted net profits of US\$ 11.7 billion, a 49% increase on 2004. In 2006, profits rose to US\$ 12.65 billion in the first semester alone, or a 115% increase on 2005. In theory, therefore, net profit for 2006 should be between US\$ 20 and 25 billion, yet this year-end total remains a "state secret".

A recent analysis from the US Energy Information Administration (EIA), based on a Russian report published at the end of 2003,<sup>30</sup> was especially pessimistic concerning the future position of the company on

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<sup>26</sup> Gazprom, 14 February 2007, Results report. Short-term debts increased to US\$ 14.08 billion.

<sup>27</sup> V. Milov, *The Risks of Possible Russian Energy Supply Disruptions*, Institute of Energy Policy, Paris, May 2006, <[www.energypolicy.ru/eindex.php](http://www.energypolicy.ru/eindex.php)>.

<sup>28</sup> V. Putin adopted this idea during a public speech on 1 February 2007.

<sup>29</sup> C. Locatelli, "Les stratégies d'internationalisation de Gazprom, enjeu de la constitution d'une grande compagnie d'Etat russe" [The Internationalization Strategies of Gazprom, Constitutional Risks for a Major Russian State Company], *Courrier des pays de l'Est*, September 2006.

<sup>30</sup> *Energy Strategy of Russia for the Period Ending 2020: Main Provisions*. Moscow, November 2003.

world markets. For the EIA, growth forecasts for Gazprom's natural gas production are and will remain modest in the next 10 years. It estimates production growth at 1.3% for 2007 and 2008, a rate that will be insufficient in order to meet the European market's rising demand. Yet in order to maintain and increase its present level of production, Gazprom must invest US\$ 173 to 203 billion in the next 15 years.

In order to ramp up production, Gazprom would have to urgently develop new gas fields such as Shtokman, discovered in 1988 and located in the Barents Sea,<sup>31</sup> Sakhalin-2 for the Asian market or Angaro-Lenskoye, situated in the Irkutsk region and discovered in January 2007.<sup>32</sup> The development of new fields, such as those in the Yamal peninsula or the Ob plateau, both in western Siberia, require immediate investment in order to become operational by 2015. Developing these fields would cost around US\$ 25 billion, to which US\$ 40 million in infrastructure investment ought to be added to ensure the an efficient use of the field and allow the gas to be exported.<sup>33</sup> Yet because of the Russian energy sector's political and legal problems and the lack of any real investment decisions in the fields, commissioning will not be possible before 2015.<sup>34</sup>

Technically-speaking, five to seven years are required to open up a new gas field in Russia, according to the Western companies that have worked in this country (such as BP and Total), even though Gazprom and other Russian energy companies maintain that it is possible to do so in less time. With the possible exception of the Zapolyarnoye field, 150 km northeast of Novy Urengoy in western Siberia, which is already in partial service, and perhaps Pestovye and Tarkosalinkoye, no other major field will be commissioned in the short- to medium-term. Before being chased out of the company, some of Gazprom's managers, such as Alexander Ryazanov, have admitted that without any additional investment a drop in Russian natural gas production was inevitable between 2008 and 2020. Such voices are becoming increasingly rare however.

Nevertheless, foreign companies cannot take Gazprom's place and make these investments in its stead. Against the backdrop of increasing state control within the Russian energy sector, Western companies, involved in numerous projects via production sharing agreements (PSA), are waiting for the much-differed vote on a law that will limit the access of foreign companies to "strategic sectors" for the Russian economy. The involvement of foreign investors in hydrocarbon exploration in Russia is becoming increasingly limited—even within the framework of PSAs<sup>35</sup>—due to the lack of legal guarantees. The Kremlin shows no sign of depoliticizing energy

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<sup>31</sup> Its reserves are currently estimated at 3,800 billion cubic meters, enough to cover the EU's needs for 25 years. The difficult exploration conditions in this region, located 650km north of Murmansk and which is also subject to waves reaching as high as 25 meters, mean that wide-ranging technology is needed.

<sup>32</sup> Recent estimates put the reserves of this new gas field at 1,200 billion cubic meters.

<sup>33</sup> Source: IEP, Moscow.

<sup>34</sup> Source: European Commission.

<sup>35</sup> The law of 24 December 1994 on PSAs still has not been followed up.



agreements and is even openly considering reducing the stake held by BP in TNK, as shown by the anti-BP “offensive” in February 2007.

In the meantime, the poor state of Russian gas fields and the lack of new investment have forced Gazprom to buy gas from Turkmenistan in order to honor its contracts. In order to close the gap between its export commitments to Europe and the dwindling production of its western Siberian fields, Gazprom has no choice but to increase its imports from Central Asia. Gazprom has the monopoly on gas purchases from Turkmenistan, which normally supplies Siberian customers while Siberian gas is sent to Europe.<sup>36</sup>

Gazprom’s investment plan, presented by Alexander Medvedev and issued on 15 January 2007, was more about reassuring the participants of the Davos summit than setting up a realistic plan of costs for the company. It was in fact a mere smokescreen only serving to fuel the uncertainties surrounding Gazprom’s long-term activities.

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<sup>36</sup> Turkmenistan is currently bound to sell its gas to Gazprom at US\$ 65 per 1,000 cubic meter. The election of the new Turkmen President will not lead to any major strategic change, as there is no alternative route for Turkmen gas.

# Why Is the Industrial Behavior of Gazprom Suicidal?

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The reasons for Gazprom's mismanagement and the political constraints which shape this management do not always appear very clear to Western observers. It is not easy to clarify the situation when the strategies of Gazprom and the Russian state appear to suggest such economic irrationality in light of Europe's own economic realities. The players indeed seem driven by an irrational logic.

In reality, Russian authority is prisoner of two major constraints. The first concerns personal enrichment and the very survival of Russian leaders. Taking note of the experiences of the last centuries, it is likely that Russian leaders do not want to draw up a long-term economic strategy, which could risk coming unstuck by the harsh realities of Russian politics. Russian leaders could therefore be seen to be following the "Argentine model", whereby the only way to preserve financial interests is to invest abroad and neglect productive interest at home.

The second factor to take into account is the Russian elite's desire to make the West pay for the humiliation of the 1990s after the collapse of the Soviet Union. This view is not that of a West that is suspicious of Russian power, but actually a reasonable conclusion given President Putin's numerous declarations as well as those of his administration, dressed as they may be in diplomatic language. Energy, the one true weapon in the hands of the Russian authorities, may therefore be seen as an instrument of blackmail, used now and then by the Russian elite to regain its old status, at least in regard to Europe. It is more difficult for Russia to use this strategy against the US for three reasons: the latter barely imports any Russian hydrocarbons; its economic might is 20 times that of Russia; and Russia's sway over US political affairs remains generally extremely limited.

These two realities—the preservation of short-term individual interests and the desire to build up Russia's position in the world—are not incompatible, even though such a combination will not, realistically speaking, lead Russia to the path of long-term political and economic power. These theories at least provide a framework with which to understand Russian strategy, even if this reasoning fails to include other Russian realities.

We may also question the rationality of European companies' desire to become involved in Russia, and whether these companies have prism

with which they can analyze the Russian situation based on comparable situations. We could ask why they are keen to sign long-term contracts when they know that gas production is set to fall in the next five years. Rather than being a question of habit, this situation boils down to the fact that there is no real alternative. European companies talk of the economic “irrationality” of the Russian regime, but at the same time feel they have no choice but to continue hoping for a turnaround in Russian investment policy. For all European leaders (and not only leaders of major energy companies), such a turnaround is the key political objective when it comes to Russia.

# Who are the Collateral Victims?

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In January 2007, Viktor Khristenko stated that “Russia and Gazprom have always been serious partners for European consumers. Gazprom has fulfilled its responsibilities since the Soviet era. Therefore Europeans should not cast doubts on Gazprom’s reputation.”<sup>37</sup>

While this statement is true, it holds only for the past and has no bearing on the future. Although there is little threat of Russia taking a political decision to cut off gas to the EU (Russia exports almost 60% of its oil and 88% of its gas produced to the EU and it needs the cash these exports provide), the industrial and technical failings of the gas industry look set to have a major impact on the European gas market, not to mention on the Russian budget. By adopting a policy of non-investment in the short term, Russia is compromising its economic interests in both the medium- and long-term by destroying its credibility as a producer and by cutting off its most important source of foreign currency (gas and oil exports account for 65% of export revenues and 50% of total revenue for the Russian state).

It must be said, however, that Gazprom’s credibility has already been hit. The company says it wants to increase its production from 547.9 bcm in 2005 to 560 bcm by 2010 and to more than 580 bcm by 2020, while at the same time promising to deliver 80 bcm to China and more to other countries such as the US—promises which are simply not credible. Without outside support, from Turkmenistan for example—which is more about making up for its shortcomings than helping to boost production—Gazprom runs the risk of a possible deficit to Europe of 60 billion to 100 bcm by 2010. Yet even if the existence of such a deficit in Russian exports to Europe cannot be definitively proven at present, there is no reason to be optimistic when it comes to the general outlook of Russian production. It is likely that the 2003 agreement with Turkmenistan for 60 bcm could be the only factor to cushion this energy crisis. A key issue therefore concerns the ability to foresee what shape this gas deficit will take.

Similar to other promises concerning future production, the North-European Gas Pipeline (NGEP), due to supply Germany via the Baltic Sea while bypassing Poland and the Baltic States, is set to transport 55 bcm of gas in 2013. But there are as yet no concrete agreements on the actual transport of natural gas via the pipeline, with the exception of 10 bcm agreed to by Wingas, a Russo-German company linked to Gazprom. This pipeline may thus encounter the same fate as Blue Stream, the pipeline built under

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<sup>37</sup> <[www.rian.ru/economy/20060104/42853695.html](http://www.rian.ru/economy/20060104/42853695.html)>.

the Black Sea to Turkey, which is currently still only working at 30% capacity. The NEGP therefore represents no guarantee of gas transport to Germany, which is supposed to be financing the majority of its construction.

Even if the costs incurred by Germany may outweigh the plan's actual benefits, the EU countries that have most to fear from Gazprom's haphazard industrial strategy are those countries which, having no real alternatives in terms of energy, depend solely on Russian supplies. At the top of the list are Slovakia (36% of energy needs dependent on Russian gas imports), the Czech Republic, the Baltic States, Hungary, Romania, Bulgaria, as well as Italy. The latter's inclusion in this list explains moves by ENI to agree a strategic tie-up with Gazprom, aimed at limiting the effects of any gas crisis with Russia.

In the event of a problem, most countries will have no choice but to pay a high prices for gas (which could in turn hamper economic growth), restrict consumption or take the initiative and invest in other forms of energy generation, such as nuclear. Poland and the three Baltic countries have already shown that they are anticipating such difficulties, as they signed up to the Trakai summit in March 2006 opting for a successor to the nuclear power station at Ignalina in Lithuania, which is due to be shut down by 2009.

# Conclusion

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It is therefore advisable to question the reliability of supplies from Gazprom starting 2011/2012. By this date, the effects of the Russian company's lack of investment, both in terms of maintaining existing structures and in terms of developing new gas fields, will be felt in Europe. It is clear that Gazprom will be increasingly faced with difficult policy choices. It will have to stop supplying Russian consumers or cut off gas to the West, its main source of income, not for political reasons, but because of technical ones.

Since the Russian government cannot, for reasons of political stability, restrict the gas consumption of its own population very much, in Europe the line will simply be drawn between those who can afford to pay and those who cannot. Many European experts are already aware of this but preventative measures (diversifying supply, restricting consumption) are slow to come. It may already be too late in just two years' time.

In contrast to the fears displayed in 2006 by many Europeans, the Gazprom's choice will not necessarily rest on gas cut-offs to Russian or Western customers, but on "domestic subsidies" or an increase of prices in the international markets where the company is a major player. Although it is a major player, it is not the only one on the market, with rivals in North Africa and the Middle East. Qatar, which holds 14% of the world's gas reserves, has launched a program of LNG development and, by 2015, is aiming to acquire the industrial tools and the transport means to enable it to become the leading, fully international player and a major rival to Russia on the European market. This is at the heart of Qatar's opposition to a gas OPEC and the reason behind Putin's 2007 "charm offensive" toward that country. If demand continues to grow, gas prices may well rise, but Russian gas could find itself in competition with LNG from Qatar.

Russia's options are therefore limited. They include an increase in domestic prices, a reduction in transport losses and the facilitation of foreign investment. For Europe, the only solutions imply the reduction of demand and diversification of its energy and gas supplies. In the short-term, the EU can only encourage Russia, within the framework of EU-Russian talks, to change its strategy and, on the domestic front, try to restrict energy waste in order to reduce European dependency on outside supplies. In the longer term, it is clear that Europe must come up with a joint energy strategy to ward off or at least limit the effects of an energy crisis stemming from Russia.