

THE MANY FACES OF GAZPROM

Philip H de Leon examines whether the demonisation of giant Gazprom is justified

Gazprom faces regular opprobrium for its bullying ways of using energy as a pressure and political tool. Seen by some, mostly Russians, as the symbol of a successful and strong Russia, others see it as a dominating juggernaut, economic right arm of the Kremlin implementing, or as some would say imposing, its policies by using energy as a weapon.

Just like Louis XIV used to say "L'Etat c'est moi" (I am the State), Gazprom could say the same in light of its commercial power and the

unconditional governmental backing it enjoys. However, just like Monsanto generates passionate debates with its genetically engineered seeds, Gazprom's activities cannot be simply labelled as right or wrong and subject to final judgments.

Though far from being an angel, Gazprom is not necessarily a demon either. It is easy to point fingers and to forget that oil and gas is a merciless sector where every major is trying to position itself for the next 20 to 30 years and secure predictable supply and demand at

home and abroad. After all,

large Western energy companies were not born nice and proper. It took decades for codes of conduct, tacit or written, to be adopted and enforced. It is also easy to forget that all energy companies have in mind the interests of the country they come from.

Why would it be any different for Gazprom? And why should Gazprom take upon itself to act differently if it can get away with what it does and not be sanctioned by its own government?

The main issue with Gazprom could be summarised by using the famous quote of former US Secretary of Defense Donald Rumsfeld who said about Iraq

"there are known unknowns. That is to say, there are things that we now know we don't know. But there are also unknown unknowns. These are things we do not know we don't know." Because of all the things we do not know about Gazprom sensitivity to what Gazprom does is greater because, ultimately, what it decides to do today and how it does it will impact energy supplies for years to come and how the game is played.

The lack of information on the personal relationships between the business and political world, on its exact ownership structure, on the exact identity and role of business intermediaries, on the flow of money through a labyrinthine network of offshore and shell companies, and on its modus operandi is what leads Gazprom to be subject to greater scrutiny and interrogations. Its efforts to maintain an export monopoly for gas flowing to Europe and Asia at a huge cost, possibly over-committing dwindling resources at a time of lower energy prices and lower consumer needs from consumers is another concern as would happen if Gazprom was to fail?

Gazprom: The Lord of the Rings

Gazprom is a behemoth: it is Russia's largest company, State-controlled and the world's largest gas producer. Engaged in gas exploration, processing, and transportation, it operates an extensive pipeline network stretching thousands of kilometres across Central Asia and Europe. Gazprom ranked #22 in the 2009 annual ranking of the world's largest corporations published by *Fortune* magazine and has 456,000 employees. With close ties to the Kremlin – President Dmitry Medvedev used to be chairman of Gazprom's board of directors – and accounting for about 25% of Russia's federal tax revenues according to pre-crisis data, Gazprom has a unique leverage and has no qualms about flexing its muscles.

Gazprom has an uncanny ability to do things that are morally reprehensible by Western standards and to be oblivious to the criticism that ensues. Image building and public relations are concepts that have not sunk in, even more so as Russians have the deep belief to be justified in their actions, be it with its dealings with Chechnya or Georgia, or

when cutting gas to Europe in January 2009. Russians like to push situations to the limits.

Gazprom and the Ukraine

Russians are full of contradictions, and so is Gazprom. One can only be amused to read its mission statement extracted from its Gazprom in *Figures 2004-2008* and *2008 Annual Report* that states: "OAO Gazprom's mission is to ensure an efficient and balanced gas supply to consumers in the Russian Federation and fulfill its long-term contracts on gas export at a high level of reliability." That did not prevent Gazprom from bluntly cutting the gas supply to Ukraine in January 2009 over non-payment issues and quantities to be supplied, impacting 18 European countries in the mix in the midst of a cold winter.

The image of Russia as a reliable partner has been severely damaged, even more so as this was not the first time gas supply to Ukraine was cut like in January 2006. Even the Soviet Union did not tamper with gas supply, knowing how important the energy cash machine was to its economy and survival. Those cuts prompted (i) end-user countries to find alternative suppliers and (ii) producing countries that rely on the Gazprom pipeline network, to find alternative export routes for existing clients, in addition to finding new clients.

In this context, the Nabucco pipeline that bypasses Russia gains momentum while Turkmenistan can sigh with relief with the new Central Asia – China gas pipeline inaugurated in December 2009 that takes gas from the Caspian Sea via Uzbekistan and Kazakhstan to China.

Russia makes no efforts to work on its international image but Russia and Gazprom would have benefited from elaborating over the payment mechanisms in place with Ukraine. For many years, Ukraine has enjoyed discounted prices, significantly below world market prices. It also has resisted price adjustments sought by Russia. Those sweet deals have been detrimental to Ukraine and to the competitiveness of its industry. According to the European Bank for Reconstruction and Development (EBRD): "Ukraine is one of the most energy-intensive countries in the world and is only one-third as energy-efficient as the average European country."

The following facts would have been good to communicate to show that Russia and Gazprom were sensitive to the challenges that gas price increases represent for Ukraine, both economically and socially. At the end of 2008, Ukraine was enjoying heavily discounted prices and resisted Gazprom's price adjustment efforts, despite a very preferential rate being offered. Gazprom went as far as to lower its price offer from US\$418 to \$250 for 1,000 cubic metres. When the Ukrainians made a counteroffer of \$235, Gazprom reverted to its initial offer of \$418. The lack of agreement over pricing by 31 December, 2008 led to the January crisis. After the crisis, Ukraine still paid 20% less than European prices. Starting in 1 January, 2010, a 10-year contract stipulates that Ukraine will switch to market prices.

Needless to say that the door was swung right back at Gazprom by the countries through which Gazprom's gas transit. Ukraine raised transit fees by almost 60% from \$1.70 per 1,000 cubic metres per 100km of transit to \$2.70 in 2010. On top of this, Gazprom accuses the likes of Belarus and Ukraine of siphoning gas out of its pipelines, in other words, taking gas out of the pipelines without having agreed to pay higher prices.

Russia would also have benefited from addressing the issue of the intermediaries involved in gas transactions such as RosUkrEnerg which according to its Web site "plays the role of a mediator of interests between Russia and Ukraine with regard to collaboration in natural gas issues. On the one hand, it acts as guarantor for natural gas deliveries to Ukraine at prices that are tolerable for the economy of that country and, on the other hand, RosUkrEnerg is financial guarantor for Gazprom, to which it makes the appropriate payments for natural gas supplied to Ukraine." That mediation role, notably in paying Gazprom for gas going to Ukraine is where sand got into the mechanism as the money transfer seems to not have proceeded properly and in a timely manner, resulting in the January 2009 conflict. Middlemen need to be cut out of energy transactions and interestingly this was already agreed between Prime Minister Yulia Tymoshenko of Ukraine and Vladimir Putin in 2008.



Too big to fail?

In 2008 the company reportedly ended 2008 about \$50bn in debt and its net profits fell by almost 50% in the first two quarters of 2009. With ageing fields and equipment, ambitious development plans, numerous procurement contracts signed, 2010 will be the year of many challenges for Gazprom and anyone dealing with Gazprom, be they countries or companies. Multiple issues should be kept on the radar screen...

What is the financial situation of Gazprom? One may think that since an international auditing firm, namely Pricewaterhouse Coopers (PwC), is the auditor of Gazprom, the books are in order. That's possible but one should not forget that PwC has recently been involved in multiple high-profile stories, with over \$1bn involved in each case. These scandals involve the Satyam case in India, where a large IT outsourcing company cooked the books saying it had \$1bn when it fact it was less than \$78m, and the Bernie Madoff Ponzi scheme as PwC was the auditor of Fairfield Sentry, one of the feeder funds that channeled \$7.2bn to Madoff which disappeared in the debacle.

Economically sound deals? Gazprom agreed in December 2009 to buy up to 30bn cubic metres (bcm) of gas a year from Turkmenistan. At a time when many wonder if there will be enough gas to fill the Western-endorsed Nabucco pipeline, such a large deal can be seen as an attempt to short-circuit and challenge the viability of the Nabucco pipeline. Nabucco, a project supported by the United States and many European countries, is in direct competition with the Russian-endorsed South Stream pipeline and there are concerns that there may not be enough gas to supply both pipelines. Nabucco would ultimately have a capacity of 31bcm/y and South Stream of 63bcm/y. The South Stream Web site uses somewhat opaque statements, saying that: "If both South Stream and Nabucco are to be implemented, the South Stream consortium will closely cooperate with Nabucco in order to optimise gas flows and guarantee reliable supplies."

The underlying question is what will Gazprom do with all this Turkmen gas at a time of diminishing demand from Europe, including

Ukraine where a large proportion of Turkmen gas transited or ended. Payment issues are an additional headache and Alexey Miller, chairman of the Management Committee of Gazprom even assessed in December 2009, "the situation with [Ukraine's] payment for Russian gas supplies in December as very alarming."

An evolving world

Gazprom and Russia may see the table turned on them. Despite repeated statements of its desire to be a reliable partner, the 2006 and 2009 events with Ukraine have forced dependent countries to find alternative gas providers and transit routes. For a while



"Gazprom offered the most competitive conditions of gas purchase from Azerbaijan since we had everything needed for that purpose" ALEXEY MILLER

Gazprom may have thought its use of liquefied natural gas (LNG) would have enabled it to regain the upper hand by opening up new export markets and routes but many countries have significant experience in that technology such as Qatar, Algeria and Libya, while more countries are coming to the market, such as Australia and Egypt. Furthermore, in 2009 the United States overtook Russia as the world's largest producer of natural gas. This is concerning for Gazprom as it confirms a growing trend pushing for energy independence, vocally defended in the United States by US billionaire T Boone Pickens in his Pickens Plan that advocates for the use of renewable energy and American natural gas in addition to energy savings.

What is in the pipeline for 2010?

According to the US Energy Information Agency, Gazprom was planning in 2008 to invest around \$45bn in 2010 just to maintain production at its top four gas-producing fields. With a GDP contraction in Russia of nearly 9% in 2009, tumbling energy prices, lower international demand, and stricter borrowing requirements, 2010 will not necessarily be as ambitious as originally planned. That said, the year started well with the resumption of the

gas flow from Turkmenistan after an eight-month hiatus.

For Alexey Miller, as stated in his column: "the beginning of 2010 was marked with a very important event – Gazprom has started up natural gas procurement from Azerbaijan for the first time ever. (...) Objectively, Gazprom offered the most competitive conditions of gas purchase from Azerbaijan since we had everything needed for that purpose: the common borders and the gas transmission infrastructure under operation."

All this comes as a result of intense efforts from Gazprom's top executives that travelled the world in 2009, oftentimes with high-level Russian governmental delegations, to meet

with world leaders to negotiate lucrative agreements.

Russia is often referred as the 'Wild East' in a reference similar to the US 'Wild West' when people and companies operated in a semi-lawless environment.

Russia has laws but its judiciary remains weak and corruption is deeply ingrained. The lack of accountability in Russia that permeates through the society, enabling anyone to do as they please, is on par with the dismissive attitude towards the rule of law, which President Dmitry Medvedev calls "legal nihilism," namely Russians' tendency to disregard the law. That is unfortunate. In this context, it is not surprising to see Gazprom take advantage of the system, even more so as it enjoys the status of national champion.

For an analysis of the dark side of Gazprom, readers can read the well-documented work of Roman Kupchinsky in "Gazprom's European Web." Those interested in Gazprom's perspective and strategy can go directly to Gazprom's Web site at: www.gazprom.com. As to finding an answer to the question: angel or Demon?, it is a very subjective matter as it really depends on what is at stake for whom and on the criteria used to judge... **ep**