

Why Gazprom Resembles a Crime Syndicate

By [Anders Aslund](#)

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Gazprom has been Prime Minister Vladimir Putin's main preoccupation since 2001, but it has been a spectacular failure. Gazprom possesses huge natural resources, however, it is extremely inefficient because of poor management and massive corruption. In addition, it pursues an aggressive foreign policy that harms both the company and Russia. In reality, Gazprom in many ways is more important in advancing the Kremlin's foreign policy than the Defense Ministry or the Foreign Ministry.

In short, the way Gazprom is run is an accurate model for how Putin rules Russia.

In May 2001, Putin ousted the powerful Rem Vyakhirev as CEO of Gazprom. At the time, it seemed that Putin was trying to clean up this pervasively corrupt corporation, retrieving assets that the old managers had passed on to private firms. Yet the only ensuing significant structural reform was the liberalization of sales of Gazprom's stock that led to a tripling of its prices in 2006.

Since 2001, Gazprom's management has been dominated by three groups: CEO Alexei Miller's young St. Petersburg economists, a group of St. Petersburg KGB officers — both closely linked to Putin — and a third group of old Gazprom officials. Putin himself has arbitrated between these three factions, preventing any one of them from gaining the upper hand. Using a classic divide-and-rule strategy, Putin thus retains the ultimate responsibility for the company.

As a result of poor management and corruption, Gazprom's production has been stagnant for the last two decades, and its share of Russia's gas output has fallen to 76 percent. It enjoys a monopoly on gas exports, but its net exports have declined for the last decade.

The company's strategy is problematic. Essentially, Gazprom just sits on its giant fields that comprise a quarter of global reserves of traditional gas, and it pipes this gas from western Siberia to Europe. It maintains its old strategy with remarkable conservatism and does not stand up to new opportunities or challenges.

Meanwhile, the gas industry is going through a revolution with a huge new supply of liquefied natural gas, or LNG, and shale gas, but Gazprom barely participates in this game. It gained some LNG production after it muscled in on Royal Dutch Shell's Sakhalin project, whereas it has largely ignored the shale gas market. Gas prices have fallen sharply in the United States and decoupled from high oil prices, while Gazprom insists on high prices linked to the oil price. It also persists with long-term contracts, trying to avoid spot markets. As a result, Gazprom's export volumes to Europe have fallen and are likely to decline further despite the gas bonanza.

Until 2009, Gazprom could use Central Asia — mainly Turkmenistan — as a cheap additional source of gas. In April 2009, however, Gazprom suddenly stopped the gas flow from Turkmenistan, causing the pipeline to blow up. Turkmenistan reacted sharply and has redirected most of its gas through a new pipeline to China and also to Iran, while deliveries to or through Russia have fallen to third place. Turkmenistan and Kazakhstan have also outwitted Gazprom on the rising Chinese market.

Another Gazprom policy is to squeeze out alternative producers in Russia. For example, in 2007 it forced TNK-BP to abandon the giant Kovykta field in Siberia, which put an end to grand plans for that field. Yet Gazprom's problem is the private Russian gas company Novatek, which is well run and even closer to Putin than Gazprom. There is also state-owned Rosneft, which Gazprom cannot stop.

Gazprom's largest preoccupation is to build pipelines that are not needed. It is building both Nord Stream (55 billion cubic meters) and South Stream (63 bcm). South Stream is likely to cost at least \$30 billion, while Nord Stream may cost half as much. This capacity is not needed because the Ukrainian pipeline system can transit at least 120 bcm of natural gas to Europe and only needs limited repairs for \$3.5 billion. Why throw away \$45 billion? The reason is not cost efficiency. Gazprom's pipelines cost two to three times per kilometer more to build than similar projects.

This is not only poor enterprise management but also disastrous foreign policy. Gazprom has a few friends in giant European energy companies, notably German Ruhrgas and BASF, Italian ENI and Gaz de France, but even Ruhrgas has halved its shareholding in Gazprom. For the rest, Gazprom has created enemies all over.

The European Union pursues its third package of energy liberalization to break up Gazprom monopolies in Eastern Europe. The EU and the United States support the construction of Nabucco and a trans-Caspian gas pipeline in competition with Gazprom's South Stream. China and Central Asia have chosen one another rather than Gazprom. But Gazprom's worst relations are with Ukraine. Putin loves to promote South Stream, but the project makes no commercial sense.

So why is Gazprom insisting on this disastrous policy? Opposition leaders Boris Nemtsov and Vladimir Milov explained why in their 2008 booklet titled "Putin and Gazprom." The two main reasons are Putin's idiosyncrasies and corruption.✕

The biggest shareholder concern is Gazprom's huge and unproductive capital investment. Last year, Gazprom's capital expenditure skyrocketed to \$50 billion. In their private reports, investment bankers write cautiously that they consider 70 percent of Gazprom's capital investment "value destruction," which is their euphemism for corruption and waste. Shockingly, Gazprom thus wasted some \$35 billion last year, money that rightly should belong to both the Russian state and its shareholders.

Nemtsov and Milov also detailed asset stripping within Gazprom. It sold assets, such as Sogaz, Gazfond, Gazprombank and parts of Gazprom Media very cheaply, while it bought Sibneft at an exceptionally high price. And remember all the nontransparent gas trading in the Commonwealth of Independent States. Thus, the total amount of sheer waste and corruption may have amounted to \$40 billion last year, almost equaling Gazprom's net profit of \$44.7 billion. That sounds more like an organized crime syndicate than a legal corporation. If Gazprom were one-tenth as large, due diligence would prevent major international financial corporations from dealing with it.

The stock market has responded appropriately by giving Gazprom a very low valuation, only one-third of the stock market valuation of Exxon Mobil and the Brazilian semistate oil and gas company Petrobras in relation to their profits. This low valuation is even more conspicuous when you consider that no other listed company in the world had larger net profits than Gazprom in 2011. Gazprom is trying to compensate by discussing a doubling of its annual dividends from \$3 billion to \$6.5 billion.

Putin and the corruption connected with him have cost Russia immensely over the past decade. If Putin were sincere in his desire to reduce corruption, he should start by sacking the Gazprom managers he appointed.

Anders Aslund is a✕senior fellow at✕the Peterson Institute for✕International Economics.✕

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