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Big Setbacks Give Gazprom Impetus for Change

By Anders Aslund

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Finally, something is happening to Gazprom, perhaps the most mismanaged and corrupt company of its size in the world. On Aug. 28, Gazprom announced that it would shelve its development of the Shtokman field in the Barents Sea. On Sept. 4, the European Commission opened an antitrust case against Gazprom. Both these events are momentous. Will Gazprom's dominant owner, the Russian government, face up to its crises?

The shelving of the Shtokman field was a sensible strategic decision. The Shtokman field is gigantic, but everything else is wrong. Far off the Arctic shore, it would have been technically difficult and exorbitantly expensive to develop. Gazprom had insisted on an impractical option with both pipeline and liquefied national gas, which would have made the project exceedingly expensive. It offered Norway's Statoil and France's Total unattractive conditions. After Statoil abandoned the project, Gazprom had little choice but to shelve it.

The European Commission's decision to pursue an antitrust case against Gazprom is also an important move. The commission may often seem like a paper tiger, but it holds true powers in disputes involving competition, as Microsoft learned at its peril. Competition Commissioner Joaquin Almunia is a respected and experienced commissioner, and he is firm in his antitrust principles. The case is big and broad, involving Gazprom's sales to eight new eastern members of the European Union. One year after mass raids against Gazprom and its partners in many countries, the commission must have plenty of evidence.

The EU case against Microsoft took many years, but the commission did not ease up. Instead it got tougher as the years passed, imposing both stricter standards and higher fines. In July 2004, it fined Microsoft 497 million euros ($640 million). In July 2006, the company was fined 281 million euros ($363 million) and in February 2008, 899 million euros ($1.1 billion). Microsoft protested by all means, but eventually it obeyed and paid. Also, Intel was fined 1 billion euros ($1.3 billion) for anti-competitive practices in 2009.

The only surprise is that the EU has taken so long to bring up the Gazprom case, because no monopoly case could be more obvious. The EU complaints focus on three anti-competitive practices. First, Gazprom may have divided European gas markets by hindering the free flow of gas across member states. Second, it may have prevented the diversification of gas supply. Third, it may have imposed unfair prices on its customers by linking the price of gas to oil prices.

The proceedings can take years, but the outcome appears obvious. The oil-linked prices are likely to be deemed anti-competitive, as the very long-term contracts with fixed prices and volumes. The Gazprom take-or-pay clauses that force a customer to take the whole volume or pay for it in any case will be prohibited, and prohibitions against reselling are evidently anti-competitive. Finally, Gazprom will in all likelihood be fined billions of euros for its long-lasting malpractices.

Meanwhile, the implementation of the EU's third energy directive is proceeding. EU countries are asking Gazprom to either sell its pipelines or separate them into another company.

Yet the biggest challenge to Gazprom is the shale gas revolution. The United States is now self-sufficient in natural gas. Currently, U.S. gas prices are less than one-fifth of those in Japan, with European prices somewhere in the middle. U.S. gas prices are actually lower than Russian domestic gas prices.

The abundant LNG output planned for the U.S. market is now being diverted to Europe, where plenty of regasification terminals are being built. Moreover, after Gazprom cut off its gas supplies to Europe in January 2006, Europe established large storage capacity and converters that allow gas to be transported back and forth in the same pipeline.

Although Gazprom monopolistic practices are likely to be punished, its monopoly power is actually on the wane. Gas markets are going through a revolution, and future European prices might be about half of current oil-linked Gazprom prices. Gazprom's production costs are excessive, and its giant fields are aging and need to be replaced.

In the coming decades, natural gas is likely to become the preferred source of fuel. It is environmentally friendly, as it generates only half as much carbon dioxide per calorie as coal. Rather than fighting the market, the Russian government should join the new low-price market and cut Gazprom's absurdly high costs.

To begin with, Gazprom should abandon gigantic construction projects that can never be profitable, ranging from its planned high-rise headquarters in St. Petersburg to the inordinately expensive and useless South Stream pipeline. This is symptomatic of Gazprom's bizarre mega approach to conducting business. The South Stream project costs at least $30 billion, requires extremely difficult engineering and involves far too many transit countries. What's more, Russian supplies are lacking, and demand is dubious. Rather than doubling Nord Stream at high cost, Russia could use existing pipelines through Ukraine.
The construction of superfluous pipelines for large kickbacks must come to an end.

The Russian government must realize that the European Commission can impose competitive conditions on the gas market in Europe. Instead of fighting the commission, as Microsoft so futilely did, Gazprom should abandon its oil-linked prices and pay-or-take contracts. It should start treating its customers as clients rather than subordinates. But President Vladimir Putin's first comments about the case revealed a complete lack of understanding of market forces. "The EU subsidizes the economies of eastern European countries," he said on Sept. 9 at the APEC summit in Vladivostok. "Now it seems someone in the EU has decided to shift part of the burden, some of the subsidies, onto us."

Similarly, the EU's third energy directive will not be stopped. The Russian government should revive plans first proposed in 1997 by then-First Deputy Prime Minister Boris Nemtsov to separate pipelines from production. Reacting to its plummeting output, Gazprom has just stopped purchasing gas from more efficient independent Russian gas producers. Initially, the government should compel Gazprom to accept transportation of any gas at equal tariffs and then divide pipelines and production between different companies. Sensibly, Gazprom could become a pure pipeline company like Transneft.

Gazprom's gas production is highly inefficient. It could be divided into several medium-sized production companies to be privatized. In this way, they could become more competitive, like Novatek or the private Russian oil companies, and exploit existing large onshore fields, which Gazprom has proved unable to do.

Putin needs to realize that Gazprom is in a deep crisis. Paradoxically, the nominally most profitable company in the world may not be viable.

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