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Gazprom Facing Challenges at Home and Abroad

By Howard Amos

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Putin hailed the opening earlier this month of the first phase of the $12.7 billion South Stream pipeline to Europe. **Sergei Karpukhin**

A landmark gas-supply agreement with Germany signed late last month by Norway's Statoil put the challenges facing Gazprom's business model in the spotlight and prompted a quick response from the Russian gas giant's executives.

It is just one of many recent setbacks for the country's largest company that experts see as signs of its diminishing power.

The $17.4 billion deal between Statoil and Germany's Wintershall was the largest of its kind. It is based on flexible spot-market pricing arrangements, which Gazprom shuns in favor of more rigid long-term contracts.

And it is likely to mean that in 2013 Statoil will replace Gazprom as the biggest supplier to the stagnating German gas market. The response from Gazprom was immediate.

"We will defend the system of long-term contracts with all our energy," Gazprom deputy chairman Alexander Medvedev said at a conference in Moscow the same day the Statoil-Wintershall contract was signed.

Supply and production partners should never forget what it's like to be in each other's shoes, he said, adding that "they are dancing together forever."

But experts are saying with increasing frequency that there is nothing permanent about the dominance long enjoyed by the behemoth that emerged out of the Soviet Gas Ministry in the 1990s.

Gazprom's stubborn resistance to the dynamics of the European gas market is placed alongside its high operating costs, failure to conclude an export deal with China, loss of domestic contracts and sputtering Arctic projects.

Taken together, it all suggests that the writing is on the wall for one of the world's biggest energy companies. Some experts even predict that if current trends are not reversed, the Kremlin will break up Gazprom into smaller companies by 2020.

The company will begin losing money in 2013 or 2014, said Mikhail Korchemkin, director of eastern European gas analysis. He said Gazprom will probably be carved up into several smaller companies around the time of the 2018 presidential election.

Flagging European Demand

The European gas market will determine Gazprom's fate. Gazprom is Europe's biggest supplier of gas, and European revenues account for about 80 percent of the company's income.

European demand for gas has been falling because of macroeconomic troubles, efforts to reduce carbon emissions and an influx of cheaper alternatives, including coal.

Demand peaked in 2006 and, with the exception of 2010, has fallen steadily since. It dropped 11 percent in 2011, according to the International Energy Agency.

And if there is a recovery in demand, it is expected to be slow. Europe's gas needs won't reach 2008 levels again until 2020, Bank of America Merrill Lynch analysts said in a November report.

The downward momentum is partly driven by higher prices associated with Gazprom's long-term contracts with European suppliers. The contracts are tied to the price of crude oil and refined oil products, which have a time lag as long as nine months.

The 2008 crisis dragged down gas prices on the spot market — a virtual hub where gas is bought and sold in real time — to below that of long-term oil-indexed contract prices, where they remain.

The disparity between the two pricing systems is so large that Gazprom has been forced to renegotiate some its contracts before they expire. Faced with the threat of legal action, it has even dipped into its profits to make some retroactive payments to major European energy firms. It paid out about $4.25 billion in the first six months of this year alone.

Gazprom's pricing policies in Europe will continue to push down demand, said Jonathan Stern, founder of the Oxford Energy Studies' Natural Gas Programme.

"If the suppliers are happy to see gas decline in Europe, then they can carry on doing what they're doing," he said. "Gazprom could move away from oil contracts very quickly if it wanted to, but the question is: Does it want to, and is this Gazprom's policy or [President Vladimir] Putin's policy?"

Only Pipeline Gas

Far from looking to revolutionize its business model in the face of the changes to the global gas market and the situation in Europe, Gazprom seems set on continuing with the policies it has pursued for more than a decade.

Earlier this month, Putin attended a ceremony in Anapa, near the Black Sea, that marked the first phase of construction of the South Stream, a $12.7 billion gas pipeline project that will pump natural gas under the Black Sea and into southern and central Europe.

The second line of the giant Nord Stream pipeline, which takes gas from Russia under the Baltic Sea to Germany and other western European countries, was opened in October. Almost $10 billion has been spent on the project, and more lines are likely to be added.

Such huge levels of investment in pipeline projects that dramatically increase export capacity to Europe during a period when the gas market on the Continent appears to be contracting have raised eyebrows.

Stern said energy suppliers either try to sell less energy for a higher price or increase quantity and cut price, but Gazprom's position appears to fit neither model.

"If Gazprom's strategy is to sell less of its product at a higher price, why is it building all this new export capacity?" he asked.

Gazprom is also facing serious legal challenges in the European Union as the Continent's authorities enforce the third energy package, which seeks to split companies' production operations from their transmission networks.

The EU is also investigating allegations that Gazprom breached antitrust legislation.

While attending the South Stream opening in Anapa, Maria Van der Hoeven, head of the International Energy Agency, said committing to such a multibillion-dollar investment was a "brave choice."

Capital Expenditure

The high costs and low efficiency associated with Gazprom's huge infrastructure developments are a perennial concern for investors. And these concerns have become more acute, as market conditions appear to be turning against the company.

Gazprom's capital expenditure, excluding GazpromNeft and utilities investment, will be about 3.1 trillion rubles ($100 billion) over the next three years, sources told Vedomosti and Interfax last week. But most analysts expect the figure to increase.

"Gazprom tends to revise these projections upward as the year proceeds," Sberbank Investment Research analysts warned in a note to investors on Dec. 12.

The company has long been dogged by allegations that corruption is rife and contributes to such large and unpredictable capital outlays.

Gazprom is perceived as the Russian company providing the most lucrative employment opportunities. A survey released by state-run pollster VTsIOM earlier this month showed that 44 percent of Russians would like to work at Gazprom, up from 33 percent in 2009.

And the company is burdened by its obligations toward the state.

"Gazprom is a big state company, and since the government is a key shareholder in Gazprom, the government decides whether it wants to pay dividends, boost market capitalization, or increase Gazprom's social responsibilities," said a source close to the company's top management who requested anonymity because he was not authorized to speak to the media on the topic. "You have to understand that Gazprom plays an important role as an instrument of government policy."

Hope In The East?

In late October, Gazprom chief executive Alexei Miller told Putin that the company planned to spend about $37.9 billion by 2017 to develop Far East gas fields and infrastructure to export liquefied natural gas from Vladivostok.

But the company has not overcome pricing differences with China to sign a gas contract that has been under negotiation for nearly a decade and is estimated to be worth about $700 billion over 30 years.

During the haggling, China has not stood still. Beijing has secured alternative sources of gas, including LNG, from Australia, domestic shale gas reserves and the pipelines of Central Asian countries.

"While eastern expansion is the right strategic decision for Gazprom in the current environment, lack of agreement with China makes the returns of the program uncertain at best," Bank of America Merril Lynch analysts wrote in a note to investors last month.

Competition At Home

Even Gazprom's mutually beneficial relationship with the Kremlin — the company is expected to funnel 91.3 billion rubles to statecoffers in 2013 — appears to be showing signs of strain.

Its key competitor in the domestic gas market, Novatek, has been steadily expanding by winning supply contracts traditionally held by Gazprom.

In a revealing twist, at the beginning of December, Novatek even captured a $4 billion gas supply contract from MosEnergo, a Gazprom subsidiary. And government discussions are ongoing about ending Gazprom's export monopoly to allow Novatek to export LNG from its Arctic Yamal Peninsula project.

Gazprom is even facing direct competition from the other state-owned energy behemoth, Rosneft, which signed an $80 billion contract in November to provide state-owned power giant Inter RAO with gas for 25 years.

Kremlin heavyweight and Rosneft head Igor Sechin reassured industry analysts during a meeting in Khabarovsk in late November that under his leadership Rosneft would never become an "oil Gazprom" burdened by inefficiencies and high capital expenditures.

While Gazprom was formed from the Soviet Union's Gas Ministry, he reminded his listeners, Rosneft has always been a commercial company.

Others suggest openly that Gazprom is now a first among equals rather than the dominant player it once was.

The trend is reflected in the share prices. While Gazprom's shares have fallen 25.5 percent since January 2011, Novatek's have climbed 1.3 percent.

"The rise of Rosneft and Novatek shows that there has definitely been weakening support for Gazprom," Stern said.

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