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A new era in Russian gas market: The diminishing role of Gazprom

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The Russian gas industry is in a transition, which can be characterized as modest decentralization. While its gas production continues to decline and competition on the Russian market intensifies, Gazprom will have to adapt to changing conditions. Non-Gazprom producers are increasing their share in total gas production. Major structural reforms may make the market structure in gas and oil sectors more and more similar in the longer term. Although liberalization is partly achieved for LNG exports, the pressure is now building on breaking Gazprom's pipeline gas monopoly. On the other hand, Gazprom is currently facing several challenges on the European market. Gazprom might unbundle transmission sector along with others. All these will, sooner or later, prepare the demise of Gazprom monopoly.

1. Introduction

After the breakup of the Soviet Union, Russia's natural gas sector developed in the opposite way to the country's oil sector. The Russian oil sector was largely decentralized and there was strong competition mainly between the private oil firms in the 1990s and the first half of 2000s, which prevented any firm from dominating the market. This started to change mainly after the state oil company Rosneft acquired TNK-BP in 2013. The deal enabled Rosneft to control nearly half of Russia's total oil output and hence obtain a dominant position in the sector. As a result, the oil sector is progressively grouped around an emerging national champion.[1]

The natural gas sector, however, has remained highly centralized under Gazprom a vertically integrated state behemoth. The Gazprom model resulting from the reforms that took place in the 1990s endorsed a monopolistic structure in the transmission and export segments and in the production to a lesser extent. However, this model is now being called into question as a result of the developments in the domestic and international gas markets, particularly in the European gas market that is the core destination for Russian gas exports. Two main factors have caused Russian decision makers to reconsider the country's gas export policy. The first factor is the high possibility of a demand driven market and the North American shale gas revolution. The second factor is about finding a way to deal with the EU's desire to create a competitive and integrated European gas market as outlined in the EU 3rd energy package in 2009. In addition, starting from December 2013 the export monopoly of Gazprom was abolished in LNG exports. It is possible that the diverse group of non-Gazprom producers[2] will account for more than one third of Russian production, and over half of all domestic gas sales in the future [1]. Such a situation will not only have ramifications on Russian gas exports but could also break Gazprom's monopoly in pipeline gas exports.

The aim of this article is to address the question of whether the monopoly of Gazprom is diminishing. In order to answer that question the article looks at the issue from several angles. First, an analysis is given concerning the evolution of Russian gas market from past to present with particular emphasis on the role of non-Gazprom producers. Second, the main reasons for the market liberalization that caused the decline of Gazprom's share in Russian gas production are investigated. Furthermore, the increasing weight of non-Gazprom gas producers in the market is also considered in terms of their

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1 Other than Rosneft, there are also several Russian oil companies with significant production such as the private company, Lukoil and the state owned Gazpromneft and Surgutneftegaz.

2 The term "non-Gazprom producers" is used rather than "independent producers" in order to describe the increasing role of gas companies in Russia.

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relations with the Kremlin. Thirdly, an overview is presented of the possible impacts of the structural changes taking place in domestic market on Russian gas exports and discussed the role of export infrastructure. The presentation of the evolving competition in the Russian gas industry provides for a comparison with the oil sector. Finally, the alternative options to reduce Gazprom's monopoly are discussed.

2. The Russian gas market and the role OF non-Gazprom producers

Until recently, the Russian domestic gas market was characterized by the lack of competition because of the highly centralized Gazprom model. The state-controlled Gazprom has had a monopoly on the main segments of the gas chain, including the transmission network. Gazprom's daughter transmission company, MRG, usually limited access to the networks due to either available capacities or the different calorific value of the gas produced by other producers [2]. The most significant restriction of competition lay in the tariff structures and access regulation by the Russian authorities. In recent years the Federal Antimonopoly Service played a significant role in pressuring Gazprom to open up norms for access to networks with an aim of bringing competition to the market. The Federal Tariff Service, on the other hand, regulates gas prices in the domestic market. Historically, prices have been very low, even at times below the cost of production. For example, when in 2006 the Putin government set a target of gas prices reaching European levels by 2011, the domestic gas prices were very low [3]. Since then a concerted effort has been made to increase the domestic gas price towards the European netback export prices although the first target of reaching this policy by 2011 failed. Nevertheless, the increase in regulated gas prices in the past decade[3] and the subsequent improvements in the economics of gas sales in Russia have attracted a number of companies to enter in the domestic market. Non-Gazprom producers have enjoyed a tax incentive in Russia since late 2011 after an amendment in the tax law. According to this law, the Mineral Extraction Tax was set for the companies that have a transport system (Gazprom) as 509 rubles for 2012, 602 rubles for 2013 and 700 rubles for 2014 per 1000 cubic meters of gas extracted.[4] The same tax burden, however, is much lower for non-Gazprom producers with a reduced coefficient of the established rate, which is nearly half of that of Gazprom [4].

In addition, non-Gazprom producers have started to exploit the opportunity to sell their gas in the domestic market at negotiated prices, which seems quite competitive relative to Gazprom's regulated price. In 2012, the share of end customer sales of the total sales of the two big non-Gazprom producers, namely Novatek and Rosneft amounted to 62% [5]. If energy efficiency gains are achieved, especially in the power and industrial sector, the demand for gas in domestic market is likely to be lower than expected. This could make Russian gas sector more competitive since the non-Gazprom producers, benefiting from the lower marginal cost of production, already have sold gas profitably at prices below the regulated tariff charge [6].

Non-Gazprom producers' right to form long-term contracts with end consumers is the clearest evidence of the evolution in the Russian gas market. The first signs of significant competition between domestic suppliers actually emerged in 2009 when Novatek signed a contract to supply Inter RAO, a Russian electricity trader, and its generating subsidiary OGK-1 with 65 bcm of gas from 2010 to 2015. In 2012, Rosneft also signed a gas contract with the state-controlled power company Inter RAO to supply up to 35 bcm of gas annually from 2016 to 2035 [7]. It is clear that a new strategy in gas industry, which pushes non-Gazprom producers to enlarge their activities, is the main reason for the reduction in Gazprom's share. Moreover, the domestic gas market in Russia has tightened in recent years. Gas consumption in 2013 was 456 bcm. For several reasons,[5] the high growth rates of early 2000s are unlikely to be repeated in the future. The expectation for 2020 is around 500 bcm and for 2030 close to 540 bcm [8]. Given the potential for excess gas supply in the Russian market in the next decade combined with the increasing competitive threat from non-Gazprom producers, it seems that Gazprom may lose more ground in the domestic market, even if it is still the largest supplier of gas to the domestic market, accounting for approximately 70% of total gas supplies [9].

3. The decline in the Gazprom share of Russian gas production

The slowdown of growth in both the domestic market and Russia's export markets has caused Russia to limit production since 2008. Although Gazprom reduced its activities, non-Gazprom producers have continued to invest, albeit at a reduced pace given the current economic and financial conditions, and increased their production. The share of non-Gazprom producers in the total Russian gas production has continued to grow. The two biggest non-Gazprom producers, Novatek and Rosneft, deserve special attention (see Table 1).

The largest of the non-Gazprom gas producers, Novatek, has more than doubled its production since 2007, reaching 62 bcm in 2013 [10]. In 2011, Gazprom totally lost its control in Novatek [11].[6] In recent years Novatek acquired gas assets and fields with remarkable gas reserves such as Sever Energiya and Sibneftegaz that were subject to swap deals between the company and Rosneft.[7] Most importantly, it was able to secure incentives from the Russian Government for the development of the Yamal LNG Project. Novatek's success is largely attributed to its influential owners, namely Genady Timchenko, the largest shareholder and owner of Gunvor, an oil trade company, and Leonid Mihailson, the CEO of Gunvor, who have special relationships with political circles in the Kremlin. This claim is supported by the fact that after the sanctions, Novatek did not find any difficulty in obtaining 150 billion rubles from the Government for its Yamal LNG project under the National Wealth Fund, which is supposed to be spent on the national pension system [12].

Increasing competition between two State companies, Rosneft and Gazprom, is a specific characteristic of the institutional reform in the Russian hydrocarbon sector since the presence of competitors enables the Kremlin to reduce the information asymmetry in its relations with Gazprom, which has long been seen as a State within the State [1]. The aggressive entry of Rosneft into the gas sector constitutes a challenge for Gazprom's traditional domination of the political scene of the country. Like Novatek, a large part of Rosneft's success is attributed to the company's CEO, Mr. Igor Sechin, who is a close

[3] If the domestic gas prices had been increased in line with the average inflation rate then domestic prices would have reached European gas market prices in a decade. As Henderson's study explained the increase in domestic gas prices had to stay at minimal levels while the consumer price index was dramatically increasing in Russia after the 2008 world economic crisis. The inflation rate was 14.1% in 2008 and 11.7% in 2009 (http://www.inflation.eu/inflation-rates/russia/historic-inflation/cpi-inflation-russia.aspx).

[4] 1 \$ = 32 rubles in 2012, 33 rubles in 2013 and 40 rubles in 2014.

[5] These include economic slowdown, the Government's plans and investments to increase efficiency in gas consumption and the impact of political developments.

[6] Gazprombank sold its 9.4% share in Novatek and later French Total became shareholder with an option to upgrade its stake up to 19%. Since then the company has become a significant player in the market.

[7] Voice of Russia, Russian gas company ITERA to own 99.9% stake in Sibneftegaz, 24 January 2014. Available at: http://voiceofrussia.com/news/2014_01_24/Russian-gas-company-Itera-to-own-99-9-stake-in-Sibneftegaz-0828/.