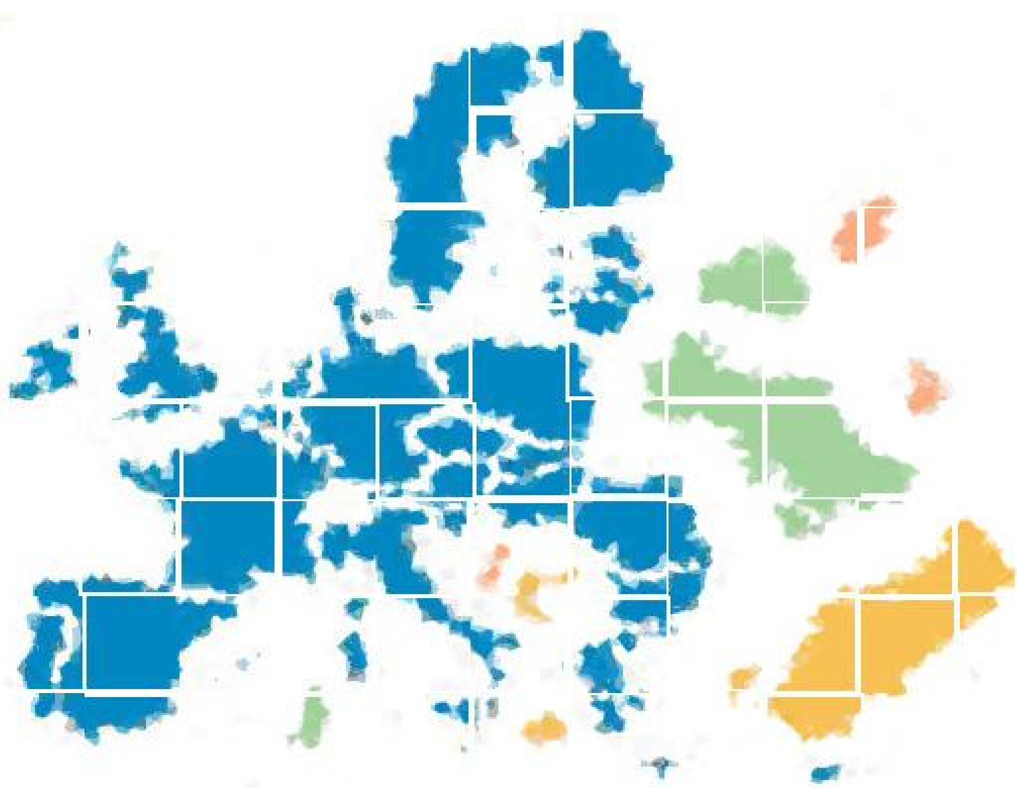
EU Frontiers

Policy Paper

Europe speaks gas, Russia thinks oil?

András Deák



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Abstract

The EU-Russia energy dialogue has been stalled for the past five years. This paper tries to explain some possible factors in Russian energy patterns that might explain low receptivity towards EU initiatives on the Russian side. The paper argues that Brussels should widen its scope of negotiations and focus less on natural gas issues. Putting more issues on the table might trigger some progress in relations.

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Introduction - Europe and its gas imports – concern or obsession?

The external energy policy and infrastructure promotion agenda of the EU is heavily dominated by the issue of natural gas. The "EU energy security and solidarity action plan" of 2008 defined six priority infrastructure actions, of which five are related to natural gas. [1] Furthermore, the EU signed Memoranda of Understanding with five key energy partners –, Azerbaijan, Kazakhstan, Turkmenistan, Egypt and the Ukraine – in all of which natural gas plays an evidently dominant role. Besides energy efficiency measures and the promotion of renewable energy, gas dependency is certainly one of the dominant energy issues on the mind of Brussels policy makers, a position only enhanced by the gas supply crises between Russia and the Ukraine in 2006 and 2009 respectively.

Europe's "obsession" with natural gas is due to a number of factors. One of the most important drivers is the boom of consumption of this fuel all over Europe. As Table 1 shows, gas took from coal a significant share of the energy consumption balance between 1991 and 2008. While gas production in the EU was almost flat in this period, the growth was met by imports, leading to a deteriorating dependency situation on the market. According to all projections, European gas demand will cover most of the incremental demand growth in the coming decades. IEA reference scenarios for EU-30 gas demand projected a more than 50% increase until 2020 in WEO 2003. [2] These estimates and expectations constituted the conceptual fundaments of the emerging EU energy security thinking, [3] since the deterioration of the dependency situation is mostly due to gas, not oil or coal. Growing dependency concerns played a crucial role in putting the common EU energy policy into a coherent framework and calling its external dimension into being in 2006. What is important to note, however, is that, a) European dependency on oil, rather than gas, has always been much higher, and b) that even despite significant decreases in demand, the import of coal grew also steadily. Looking at the raw data then, natural gas does not appear to hold a distinguished position, despite its prominence in rhetoric.

[1] Second Strategic Energy Review : an EU energy security and solidarity action plan http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2008:0781:FIN:EN:HTML

[2] International Energy Agency, World Energy Outlook 2004, p. 155. The Outlook suggested a surge in net imports from 233 bcm in 2002 to 639 bcm in 2030.

[3] „This debate should take into account that current energy demand is covered by 41% oil, 22% gas, 16% coal (hard coal, lignite and peat), 15% nuclear and 6% renewables. If nothing is done, the total energy picture in 2030 will continue to be dominated by fossil fuels: 38% oil, 29% gas, 19% solid fuels, 8% renewables and barely 6% nuclear." In: Green Paper - Towards a European strategy for the security of energy supply (COM/2000/0769 final), Executive Summary, http://eur-lex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexplus!prod!DocNumber&lg=en&type_doc=COMfinal&an_doc=2000&nu_doc=769

Table 1: Some indicators of EU27 energy consumption, 1991-2008 (%)

	1991	*2000*	*2008*
Share in total energy consumption			
Gas	18,36	23,25	25,52
Oil	40,61	40,89	40,66
Coal	25,63	18,5	17,43
Import/consumption ratio			
Gas	41,99	47,29	61,17
Oil	81,03	76,13	84,93
Coal	22,12	34,48	43,06

Source: BP Historical Review of World Energy

The second factor is that the growing importance of natural gas went hand-in-hand with a twenty year long EU liberalization process on the gas and electricity markets. While the EU did not play a leadership role on the oil market - where security of supply efforts were coordinated by the International Energy Agency, OECD and even NATO - or on the coal markets - where national policies remained dominant, - the Commission has been an active policy-maker on the gas market since the beginning of the 1990s. Electricity and gas directives in 1996 and 1998 were landmark events with regards to creating a single market. Since 2004 the European Council also has created a common network development instrument (TEN-E) exclusively for gas and electricity systems. Such permanent liberalization and regulatory efforts worked as a hotbed for network security and external energy policies, providing a solid institutional fundament for common action. EU directives, experiences with the Energy Charter Treaty, competition issues and past negotiations with suppliers helped further to increase incentives for the shared regulation and liberalization of markets. Thus, the emergence of security of supply considerations and external gas policy actions is best understood as a gradual shift, which is due to the ambitious policies under the leadership of the Commission, rather than a brand new nation state initiative.[4]

The third factor is EU enlargement. The main proponents of energy solidarity and common action to improve gas supply security are the Eastern 'new' member states. In these countries the import dependency situation is concentrated almost exclusively on one supplier and two transit countries (except in the case of the Baltic states) without any source flexibility or interconnectivity between the East-West trunk pipelines. The spectacular gas transit wars between Russia and the Post-Soviet transit states clearly underlined the necessity for EU intervention. From the viewpoint of the EU, the 2004 and 2007 enlargement rounds brought a high number of small and medium - but noisy - capitals into

[4] Sami Andoura, Leigh Hancher, Marc van der Woude: „Towards a European Energy Community A Policy Proposal", www.notre-europe.eu

the community who are urging for a more consistent infrastructure and a common external gas policy.

It must be remembered, however, the new members' gas security concerns also have some peculiarities of their own. As shown in Table 2, the general energy dependency of EU10 countries is significantly lower than that of the EU27 group. The share of the gas sector - as a proportion of the total energy consumption - is also 3% lower in the EU10 as in the EU27 (Gross gas cons./Gross energy cons. 23.7% vs. 20.7%). The deviation of gas import dependence is very high: Poland is one of the most self-sufficient in its energy supply, while Hungary has the highest gas import ratio in the EU. Thus new members have some common interests as far as interconnectivity issues, or diversification projects regarded, but for many representatives of this group, like Hungary or Slovakia, gas dependency is an economic problem pushing for fuel change, while for Poland or the Czech Republic it is rather a security and foreign policy issue. Hence, these countries could form coherent positions in foreign and development policy, but have potentially divergent climate and energy policy targets. With time the linchpins of the Visegrad and new members' positions might weaken, leading to a substantial reallocation of coalitions in the region.

Table 2: Energy and gas dependency in EU10 (For TPES 2008, for gas 2007)

EU Member State	Gross energy cons. (Mtoe)	Net imports (Mtoe)	Energy depend. Imp./Cons.	Gross gas cons. (Mtoe)	Net gas imports (Mtoe)	Gas depend. Imp./Cons.	Gas Imp./ Total Energy Cons.
Latvia	4,6	3,2	65,70%	0,5	0,5	100,00%	10,87%
Lithuania	8,4	5,5	64%	3,3	3,3	100,00%	38,73%
Slovakia	18,8	12	64%	5,1	5,0	98,04%	26,54%
Hungary	27,8	17,3	62,50%	10,8	8,8	81,46%	31,62%
EU27	1825,2	1010,1	53,80%	432,8	265,5	61,34%	14,55%
Slovenia	7,3	3,8	52,10%	0,6	0,6	100,00%	8,22%
Bulgaria	20,5	9,5	46,20%	2,9	2,7	93,18%	13,34%
EU10	278,2	97,6	35,00%	57,7	42,2	73,14%	15,17%
Estonia	5,4	1,9	33,50%	0,2	0,2	100,00%	3,70%
Romania	40,9	11,9	29,10%	14,5	5,3	36,44%	12,90%
Czech Republic	46,2	12,9	28%	7,6	7,5	98,68%	16,14%
Poland	98,3	19,6	19,90%	12,3	8,4	68,30%	8,55%

Source: EU, Eurostat, BP

Even independently from the new members' general energy dependency concerns, Russia represents one of the key challenges of EU security of supply and external energy policies. With its distinguished role as the biggest supplier of oil, gas and coal to the EU, its statist tendencies in domestic energy industries and gradual shift to a more assertive foreign policy towards Europe after 2004, Moscow triggered a major rethinking of future security perceptions in Brussels.[5] Gazprom in the gas sector and the emerging Rosneft in the oil industry – with their state ownership, the re-nationalizating and monopolistic tendencies – symbolize the "villains" for the Commission's liberalization mindset. Coupled with tense foreign policy relations, new members' complaints and a series of spectacular supply cut-offs through Belarus and Ukraine, the dialogue with Moscow has stalled. The Kremlin has gradually moved away from ratifying and implementing the Energy Charter Treaty, demonstratively ignoring Brussels.[6] As a result, the two sides have started to formulate their energy sector policies unilaterally and Russia became an increasingly difficult partner for Brussels.[7]

What is important to note in the recent history of energy relations between Europe and Russia is that it was always the gas industry that was at the core of conflict. Discord in relation to oil and oil product supplies - where Russian exports also have a 29% share in satisfying total European demand – have come only sporadically to the fore, while the question of the booming coal supplies remained totally ignored in Europe. [8] The Russia-EU controversy has been limited to gas exports, despite the fact that it only represents a minor share of the total energy trade. To a certain degree this phenomenon is understandable in the light of the EU's "gas focus" and the lack of specific security measures on the gas market. However, in view of the general picture, hardly anything has changed in the sphere of Russian gas exports – apart from much well publicized Ukrainian transit wars – to justify such differing perspectives. Gazprom has always enjoyed a de facto monopoly in Russia and its total exports grew by only 15% between 2000 and 2008. The change in perceptions happened almost wholly due to developments on the consumer's side. Looking at the big picture: the ultimately limited nature of the gas conflicts may act as support for the argument that, when viewed in their full complexity, EU-Russia energy relations are – or should be regarded as - much closer to being neutral rather than problematic.

In this short paper I argue therefore that Russia's "gas hand" over Europe is overrepresented in EU thinking. Both fears of Russian gas expansion in Europe and perceptions regarding the importance of gas

[5] Mark Leonard, Nicu Popescu: „A Power Audit of EU-Russia Relations", European Council on Foreign Relations, http://www.ecfr.eu/content/entry/commentary_pr_russia_power_audit/
[6] Even if the role of ECT is obviously overestimated in the relations. Vladimir Milov: „Russia-EU Energy Dialog: Filling a Vacuum", In: Russia in Global Affairs, October - December 2007, http://eng.globalaffairs.ru/numbers/21/1157.html
[7] Tatiana Romanova: „The Confusing Results of the EU-Russian Energy Dialogue – Market Making vs. Clean Energy Agenda", EU Frontiers, Policy Brief, 2010 In:https://cens.ceu.hu/publications/romanova/2010/16118
[8] Hard coal imports from Russia have risen from 7,9% in 2000 to 22,5% in 2006 in the total EU coal imports. In: http://epp.eurostat.ec.europa.eu/statistics_explained/index.php?title=File:Main_origin_of_primary_energy_imports,_EU-27,_2000-2007_%28%25_of_extra_EU-27_imports%29.PNG&filetimestamp=20100503141336

exports in Moscow's mindset are exaggerated. To support my thesis I will analyze three factors: First, the lack of European prospects for Russia i.e. the fact that EU and Eastern European markets do not provide an easily attainable growth potential for Russian gas exports. Second, the domestic social and economic patterns, specifically the regime's expectations from the gas industry that put a serious restraint on Gazprom's ambitious expansion plans. Third, Gazprom has been put into a relatively difficult situation by the economic crisis and European gas market trends, limiting its bargaining power in the short- and medium-term considerably.

What European export prospects for Russian gas?

Europeans are relatively alone in the world with their gas dependency problems. Oil is on the global agenda, but natural gas is usually not very interesting for many exporters or consumers. One of the major deficiencies of the transatlantic energy dialogue is, for example, that while Europeans tend to speak about gas the United States does not show too much enthusiasm for the topic. The US has clear preferences on the oil market, but without substantial imports, it has only a few selective considerations with regards to natural gas.[9] Middle Eastern suppliers - with the exception of Qatar - have been forming their gas agendas extremely slowly. The situation is somewhat different in Europe's immediate neighborhood. The huge European market provides good opportunities for developing and purchasing natural gas from nearby producers. In Algeria and Norway gas exports equal 80% of oil exports in terms of quantity. This is, however, not the case in Russia, where natural gas exports have a surprisingly small proportion of total production.

Table 3: Share of exports in total production at major European suppliers (Mtoe, 2008)

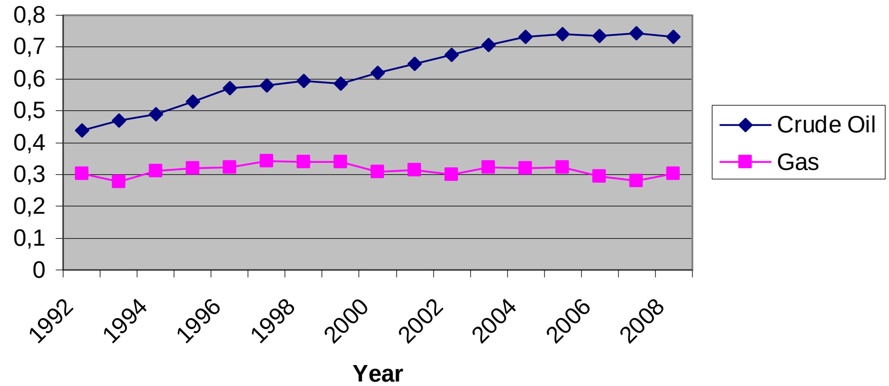
	Net gas exports	Exports/ Prod.	Net oil exports	Exports/ Prod.
Algeria	55,1	*70,70%*	71	*83,50%*
Norway	85,3	*95,50%*	104,4	*91,40%*
Russia	163,3	*30,10%*	358,1	*73,30%*

Source: BP Statistical Review

Normally, gas exports "lag behind" the proportion of oil exports. Oil is easily transportable and purchasable, while gas network expansion is slower and more complex in many regards. In Norway, for example, it was a special governmental policy and the vicinity of European markets that made such a high export/production ratio possible. In the case of Russia, however, the share of gas exports did not grow at all between 1992 and 2008, while oil exports were booming permanently during this period. Russian crude oil exports have more than doubled and represented 13,3% of the global oil trade in 2008. At the same time Russian gas exports have been almost flat on a world market, which has been expanding by an average 6% yearly after 2000. Russia appears to be unable or unwilling to increase its gas exports substantially, while there is little doubt that during the past two decades Moscow had the biggest input into world oil markets on the supply side.

[9] See: Council of Foreign Relations: „National security consequences of u.s. oil dependency", www.cfr.org/content/publications/attachments/EnergyTFR.pdf. Understandably hardly anything similar can be found in the US in regards of gas.

Figure 1: Russian oil and gas export/production ratios



Source: BP Statistical Review

There has been a significant geographical redistribution of Russian exports during the last two decades. The economic recession has taken a considerable toll on the demand in traditional European export markets in Eastern Europe and the Post Soviet space. Post Soviet consumption, excluding Russia, fell by 15 bcm (appr. 8% of total Russian exports) between 1992 and 2008, reaching its lowest point at 160 bcm in 1998, 45 bcm below the 1992 level.[10] Eastern European imports grew only slightly during the past 15 years mainly due to flat consumption. Until 1995 Gazprom could increase its exports to Germany considerably, but since then its expansion has been rather modest. Since 1995 Gazprom has had to look for new markets, like Turkey (a 17,9 bcm increase between 1995 and 2007), the United Kingdom (Gazprom purchased 15,2 bcm altogether in 2007), Belgium, the Netherlands, and the "old" destination, Italy, which also provided an approximately 8 bcm increase. These markets account for almost all the incremental increase in Gazprom exports. Total "European" (including the Balkan states and Turkey) sales grew by 30% from 121,8 to 158,3 bcm between 1995 and 2007.[11]

These numbers reveal the serious constraints on Gazprom's export prospects on the European market after 1992. The EU27 gas demand has increased by 29,5% between 1995 and 2007 mainly due to growing imports in the – for Russia – unconventional markets, such as Spain, the United Kingdom and France. Moscow has made efforts to enter these new markets, but despite the increase in the amount of exports, its share in European demand was flat during the whole period. Russian gas imports were at the same 28% level of total EU27 consumption both in 1992 and 2007. Excluding some success stories like Turkey, Gazprom

[10] BP Statistical Review.
[11] Jonathan Stern: „Future Gas Production in Russia: is the concern about lack of investment justified", NG35, 2009.

had to fight bitterly for new markets, if it wanted to increase its sales. It is highly questionable, whether it could have gained more in these Atlantic and Mediterranean countries, in view of the fierce competition with Algerian, Norwegian, Dutch supplies and LNG. Looking back from 2010, it is difficult to say, what Gazprom could have done differently in order to increase its exports. It was only the false prospects of the pre-crisis period that made rapidly increasing imports from Russia into an alarming possibility.

Table 4: Gazprom exports to EU27 markets 1992-2008, bcm*

	1992	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*
Austria	5,1	5,3	5,1	6,1	6	5,6	5,7	5,4	5,1	4,9	5,2	6	6,5	6,8	6,6	5,4	5,8
Belgium												0,1	0,6	2	3,2	4,3	4,9
Finnland	3	3,1	3,4	3,6	3,7	3,6	4,2	4,2	4,3	4,6	4,6	5,1	4,9	4,5	4,9	4,7	4,8
France	12,1	11,6	12,2	12,9	12,3	10,9	10,9	13,4	12,9	11,1	11,4	11,2	13,3	13,2	10	10,1	10,9
Germany	22,9	25,8	29,6	32,1	32,9	32,5	32,5	34,9	34,1	32,6	32,2	30,6	35	36	34,4	34,5	38
Greece						0,2	0,9	1,5	1,6	1,5	1,6	1,9	2,2	2,4	2,7	3,1	2,8
Italy	14,1	13,8	13,8	14,3	14	14,2	17,3	19,8	21,8	20,2	19,3	19,7	21,5	22	22,1	22	22,4
Neth.										0,1	1,4	2,3	2,7	4,1	4,7	5,5	6,7
UK												1,1	2,9	3,8	8,7	15,2	20,9
Bulgaria	5,3	4,8	4,7	5,8	6	4,9	3,8	3,2	3,2	3,3	2,8	2,7	2,8	2,6	2,7	2,8	2,9
Czech R.	6,8			8,4	9,4	8,4	8,6	7,8	7,5	7,5	7,4	7,4	6,8	7,4	7,4	7,2	8
Hungary	4,8	4,8	5,2	6,3	7,7	6,5	7,3	7,4	6,5	8	9,1	10,4	9,3	9	8,8	7,5	8,9
Poland	6,7	5,8	6,2	7,2	7,1	6,7	6,9	6,1	6,8	7,5	7,3	7,4	6,3	7	7,7	7	7,9
Romania	4,4	4,6	4,5	6,1	7,1	5,1	4,7	3,2	3,2	2,9	3,5	3,2	4,6	5	5,5	4,5	4,2
Slovakia	6	13,2**	13,8**	6,5	7	7,1	7,1	7,5	7,9	7,5	7,7	7,3	7,8	7,5	7	6,2	6,2
Slovenia					0,5	0,5	0,5	0,6		0,6	0,6	0,7	0,2	0,7	0,7	0,6	0,6
EU27	**91,2**	**79,6**	**84,7**	**109,3**	**113,7**	**106,2**	**110,4**	**115**	**114,9**	**112,3**	**114,1**	**117,1**	**127,4**	**134**	**137,1**	**140,6**	**155,9**

* without the Baltic states ** data for Czechoslovakia

Source: Gazprom

In comparison to the above, Russian oil has flooded the European markets. This was due to both the more even geographical distribution of EU27 incremental import growth and Moscow's successful entry into new European markets. According to IEA Country Reviews, FSU crude oil and oil product supplies grew by almost 70% in Germany, increasing their share from 25% to 33% in less than a decade. V4 markets also grew by 70% after 1992, almost totally accounted for by FSU imports. Russian supplies also reached a number of new destinations both in the area of the North Sea and Mediterranean and their diesel exports became a substantial factor in keeping the European diesel-gasoline markets in balance.

What are the future prospects for Russian oil and gas exports? Though there was a substantial European call for more Russian gas exports before the crisis, Gazprom doesn't seem to be winning the competition for EU incremental imports. Following the 2003 oil price boom, the impact of higher prices and the accompanying investments have just started to be felt recently. In the coming five years more than 100 bcm incremental LNG capacities are to be expected on the supply side, mainly from Qatari sources, which is likely to result in not only lower LNG-prices, but also an easier entry into this market on the consumer's side. Western European countries have invested into their gas networks heavily during the time of high gas prices and booming demand. Due to these developments, LNG re-gasification capacities will increase in Europe by more than 60 bcm in 2009-2010 (almost 10% of the European demand)[12]. At the same time, the increasing share of domestic shale gas production in the US has decreased the prospects of large-scale future LNG imports significantly, putting more supply pressure on Europe. All these effects are magnified further by the scale of the economic crisis: European gas demand fell by 7% in 2009, while in traditional Gazprom export markets this drop was well over 10%.

In such a situation the margin between spot-prices and oil linked prices increased significantly all over Europe. At the National Balancing Point (UK) and in Germany spot-prices were almost 50% lower than Gazprom's European average prices. European companies have decreased their imports from expensive Russian sources, switching to cheaper spot-priced imports. The major headache for Gazprom is that this unfavorable market situation is likely to continue in the long term. Growing LNG supplies and decreasing US imports in the Atlantic Basin might significantly shift import patterns towards cheaper LNG sources. Economic recovery in Europe will be slower than in other parts of the globe, while the appearance of shale gas technology has major downsizing potential for future import projections on the continent.[13]

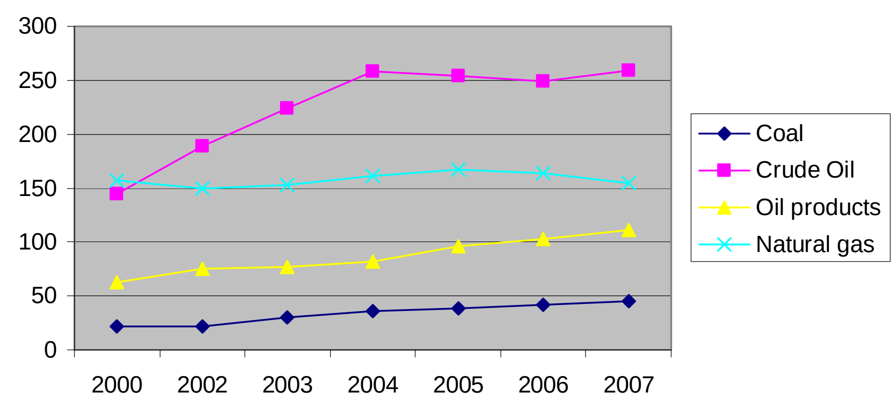
While weak demand and slow recovery does not favor Russian expansion in the "new" Western markets, even old Eastern European markets might come under pressure. Here Gazprom's primacy is a well-established fact and there are no significant challenges to its market dominance. However, the mix of political sensitivities and high gas prices, coupled with a bigger economic slump in the region provide bleak prospects for the next couple of years. The trade-off between Gazprom's price rises and post Soviet export volumes are already to be felt, particularly in Ukraine. Some years ago Gazprom pushed for higher prices in these countries in the good faith that exports will be redirected to Western markets – a near-impossible task in the current climate.

Compared with gas, the impact of the crisis on the oil industry was much lower. OPEC supply cuts saved the Russian oil sector from the worst, providing a good buffer against the international credit crunch

[12] „O marketingovoi politike OAO «Gazprom» v usloviyah mirovogo finansogo-ekonomocheskogo krizisa", „Ustupka Evrope", *Vedomosti*, 24.02.2010.
[13] Howard Rogers: „LNG Trade-flows in the Atlantic Basin: Trends and Discontinuities", Oxford Institute for Energy Studies, NG43, 2010.

and preserving Russian market shares. What is more, the Russian oil industry indirectly benefited from the situation. Referring to the problems of external funding, Igor Sechin, deputy prime minister in charge of the energy industry, successfully lobbied for tax releases and indirect subsidies for Far Eastern field developments, accelerating export diversification efforts substantially.[14] The European call on further exports of diesel to the EU27 is still present, offering an attractive prospect for Russian oil companies. This might even lead to a qualitative shift from crude oil to oil products exports in the coming years.

Figure 2: Russian exports by fuel, 2000-2007 (Mtoe)



Source: Institute of Energy Strategy[15]

To sum up, it was the geopolitical environment, but not the actual numerical dependence on Russian gas supplies that changed perceptions throughout the last decades. Gazprom could not increase its market share during the last 20 years and market mechanisms coupled with political reservations provide a significant constraint for Moscow in the future as well. Gazprom will have to accommodate itself with the new situation and fight for its market positions. The major uncertainties they face are: how long will the current trends dominate the market and which new instruments to adapt to counter it adverse effects? Gazprom has lost markets during 2009 and this seems to be only the beginning of the road. Recent cautious concessions in European long-term contracts, providing some spot-pricing, and the continued insistence on take-or-pay clauses underscores the Russian fear of loosing further shares. Unlike gas, Russian oil exports have climbed to much higher volume and profitability levels, providing for far the most tangible fundament of the EU-Russia energy trade sector.

[14] Even if fiscal considerations and Finance Minister Alexei Kudrin permanently threaten these exemptions: „Rosneft Says Russian Oil Tax Spat May Threaten Record Output” 16 March 2010, In: http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a9FwO6QjfuZc

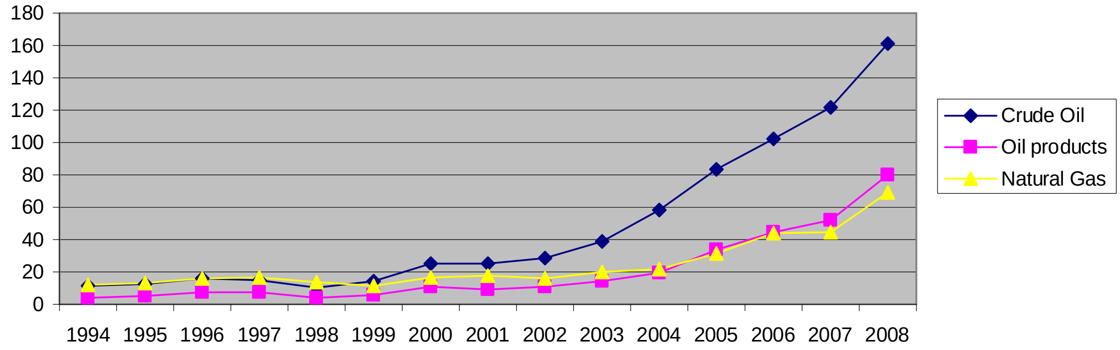
[15] „Toplivno-energeticheskiy komplex Rossii, 2000-2007”, Institut Energeticheskoy Strategii, Moscow, 2008. pp. 73-75.

“King Oil” and “Queen Gas”

Differences in the significance between oil and gas exports are due to the general characteristics of the Russian energy sector. Gas plays a significant role in terms of cheap domestic supplies for the local population and the industry - a responsibility mainly born by Gazprom. More than two-thirds of Russian gas production is purchased on the internal market at relatively low prices. This means that, in effect, Gazprom’s main mission is to provide social and economic benefits to a high number of domestic actors. Financial instruments, the “monetization” of this subsidy and export markets are only of secondary importance for the regime. Even if Gazprom were interested to turn towards more profitable foreign markets, the main purpose of gas export revenues - from the Kremlin’s point of view - is really only to compensate for the losses of the under-priced domestic market. Gazprom’s rise in the Russian political system came much more from its domestic leverage, rather than its size in terms of finances and/or external influence.

Oil was, and is, the real trophy in post-communist Russia. The oil industry – in comparison with the gas industry - is incomparably larger with regards to finances. In terms of gross revenues, Gazprom is only one among the other major Russian energy companies, like Rosneft or Lukoil. Oil and oil product exports are four times larger than those of gas while overall federal tax revenues from the oil industry exceed more than five times the revenues stemming from the gas sector. Even after these reductions, net aggregated company income in the oil industry is almost three times higher than in the gas industry. The oil sector is export oriented and financially mature. After the basic “tribute” paid to the state, the few national oil companies may use their income as they want. While there is an in-kind redistribution of cheap energy in the gas sector, in the oil industry the divide between the companies and the state is a fiscal one. Rational rent-seekers are more likely to go into oil, than into gas.

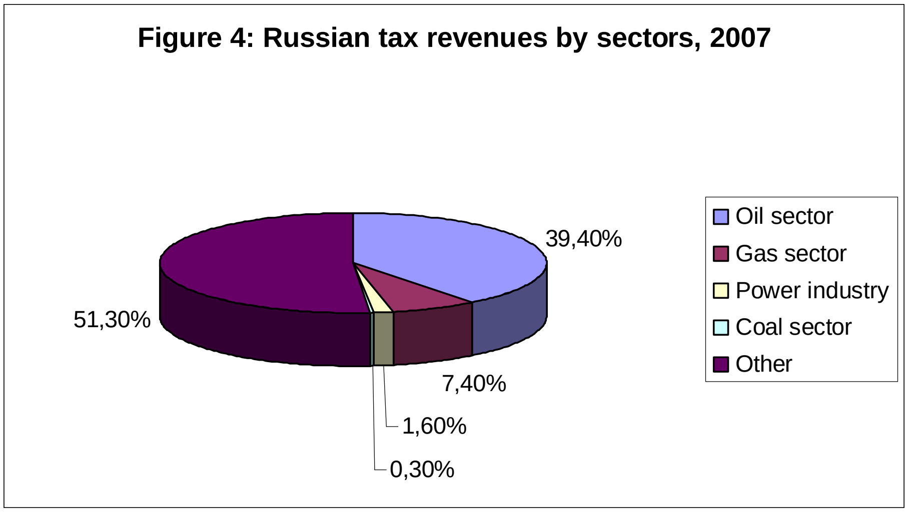
Figure 3: Export of Hydrocarbons, 1994-2008 (billion USD)



Source: Federalnaya Sluzhba Gosudarstvennoy Statistiki

These facts have a number of very important consequences. First of all, while the gas industry plays a significant role in social consolidation and industrial competitiveness, oil exports are meant to provide fiscal and macroeconomic stability. Fiscal and social expansion, foreign debt repayment, budget surpluses and the build-up of stability funds are all managed mainly from oil money. The mission of the oil industry is to yield export revenues for the country. This is a very important short-term goal of the regime, since macroeconomic stability decreases its external dependence and saves it from social and political unrest. However, while oil revenues are more important, the income from the sector is not as stable as that from the gas sector. In the Russian oil industry the revenues and the fate of 40% of federal taxes depend on volatile foreign markets and world prices, while in the latter case there is only a domestic bargain between two Russian subjects - Gazprom and the Kremlin - about internal gas prices and export duties that influence incomes.

Considering all data, Russian energy exports mean, first of all, oil exports. Oil and oil product exports have grown from a share of 53,2% in 2000 to 64,6% in 2007 as a percentage of total energy exports. Not surprisingly oil companies show a much higher level of activity on external markets than Gazprom. They have to actively shape their environment, optimize their sales and revenues, and fight for market shares. The oil industry has many more interests, resources and political weight to actively implement its strategies. It has an undisputed primacy in the foreign trade of Russian energy.



Source: Institute of Energy Strategy[16]

In view of this reality, natural gas appears clearly overrepresented in EU-Russia relations. The dynamics of the development of Russian oil exports and the decreasing importance of Europe as a target area, for example, are similarly relevant for future political and energy relations. Russian transit diversification of oil supplies, efforts to increase oil product exports at the expense of crude oil, and the striving for Far Eastern markets will have long-term and far-reaching consequences. The national oil champion, Rosneft invests significant amount into Far Eastern fields and has proclaimed that it would like to increase exports to the Far East. In the near future Russian oil companies will have to make a choice where to invest: into Western Siberia, connected with European markets or Eastern Siberia, supplying the Far East. Chinese capital and loans are already accessible for the latter projects, effectively competing with Western banks. For Rosneft Europe is becoming more and more a simple export destination or a field for potential takeovers, rather than a partner. While Europeans pursue an uneasy dialogue with Gazprom, they should not forget about the fact that it is the Russian gas monopoly's dependence on the EU markets that makes such a dialogue possible in the first place. Rosneft's assertiveness, in comparison, comes not only from its "statist touch", but also from its decoupling from European markets.

[16] Ibid. p. 63.

Emancipating Russian gas

Gazprom is determined to emancipate itself and increase its cash flow at any costs. The Russian monopoly understandably envies its counterparts in the oil industry, who dispose over a lot of resources and invest their high revenues relatively freely. After 2003, Gazprom's cash flow increased rapidly and the monopoly's net revenues from gas sales grew almost fourfold. This was mainly due to booming oil and gas prices on European markets and to a lesser extent to gas price raises in CIS countries and the internal consumers. These were Gazprom's best years since its creation in 1993. But the bonanza is now over and there is hardly any doubt that in the next couple of years the 2008 peak revenues will not be achieved again. Alexei Miller's prognosis about the 250 USD/barrel oil[17] will not come true soon and it is unsure what will happen to European natural gas prices. Unlike the oil tycoons, where profits have been consolidated recently due to the stabilized oil prices and Russian tax releases, the gas monopoly has to face a deterioration of its financial situation. In terms of prices a "return to 2006-2007" levels is unavoidable for the years 2009-2010, purchased volumes will be lower and prospects for further growth are unlikely. This is especially true for the most lucrative "new" markets in the UK, Belgium, France, but also for old partners, like Germany or Italy.

Table 5: Gazprom's revenues from gas sales, 2003-2008, million rubles

	2003	2004	2005	2006	2007	2008
Domestic Market (Russia)	207 056	252 552	311 336	357 274	399 452	479 387
Post Soviet states (without Russia)	58 945	88 440	131 393	243 133	273 550	381 902
Europe and other countries	567 855	607 695	850 017	1 149 582	1 161 549	1 866 933
Gross revenues	833 856	948 687	1 292 746	1 749 989	1 834 551	2 728 222
Excises	-154 051	-3 703	-4 459	-2 637	-96	-81
Custom duties	-29 343	-177 526	-250 812	-335 733	-306 752	-461 740
Net revenues	650 462	767 458	1 037 475	1 411 619	1 527 703	2 266 401
Average price in Russia*	21,8**	28,7**	35,8**	41,5**	50,8**	65,9**
Average price in Post Soviet area*	43,6	46,7	60,7	88,6	110,9	159,2
Average price in Europe*	131,6	137,7	192,4	261,9	269,4	407,3

* including excises, custom duties but excluding VAT **av. price in RUB/av. USD/RUR exchange rate
Source: Gazprom

What can Gazprom do? On the European market it has to contend with some short-term adjustments. In order to minimize its losses Gazprom has to choose between either keeping oil-linked prices or the

[17] Gazprom CEO's $250 Oil Forecast Is Doom Traders Love, 16 June 2008, In: http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aWwoUcZaR5BY

take-or-pay clauses in its long-term contracts. Without conceding one of these mechanisms European consumers are likely to take only the minimal amount of Russian gas and Gazprom's inflexibility would remain a key competitive disadvantage in future European contracts. In the view of recent evidence, Gazprom has chosen to insist on take-or-pay and give up oil-linked pricing but purchase some of the contracted gas at spot-prices – an unwilling step, rather than a reform. Aleksander Medvedev's statement about the temporarily nature of these modifications also suggest some sort of wait-and-see logic in Gazprom's behavior.[18]

This "no rush policy" is understandable. Gazprom's revenues in 2009 and 2010 will still be among the TOP-5 in the ranking list of the company's history and future prospects of European gas markets might turn out better than expected. The seven lean years in this case do not need to be so lean. Some cuts in expenditures, shifts in investment programs and the cancellation of some expensive projects without a painful, major restructuring might prove to be sufficient at this moment.[19] The alternative line of action would be risky indeed. The current oil-linked pricing means the extension of OPEC's consolidatory impact to the gas market. Without any control on the European spot market and without even a minimal influence on its pricing, a bigger shift towards free price setting mechanism, relying purely on the global supply-demand situation is not a reasonable choice for Gazprom at the moment. The other option, giving up take-or-pay clauses would mean a paradigm shift for Moscow and a major change in the notional environment of Russian demand security. This is an extremely unlikely scenario and there are clear indications that this would be among last concessions Gazprom would consider offering to European companies.[20]

Basic caution, however, does not mean that the new situation will not trigger some new trends and strengthen some already existing ambitions to a critical point. In this regard the major ongoing concern is the simultaneous demand crunch in all existing markets. It was not only the Western European, but also the Post Soviet and the Russian markets, where demand decreased sharply during the past two years - a very inconvenient development for Gazprom's notion of 'security of demand'. Furthermore, it is worth taking into account here, that the crisis also washed away some of Gazprom's dedicated achievements in transforming the Russian domestic markets. Prices have fallen sharply because of the depreciation of the rubel and many "long-term" contracts with internal industrial consumers were suspended, giving independent gas producers an opportunity to increase their market share. In all,

[18] "Gazprom Price Change to Last 3 Years", *Moscow Times*, 1 March 2010
[19] This has been partly done in 2009-2010 by cutting the previous investment plans by 20-30%.
[20] Tatiana Mitrova: „Gazprom's Perspective on international markets", In: Russian Analytical Digest, No.41, May 2008.

Gazprom's problem in the domestic and Post-Soviet markets appears to be much greater than those that occurred in Western Europe.[21]

Apart from some small tactical adjustments, theoretically, there are also three possible strategic actions available to Gazprom to improve on its current position. One, a long standing effort of the company, is the equalization of profitability on its domestic and export markets. Practically, this would mean price increases both in the Post Soviet markets – much of which has already been done - and domestically. The latter is of bigger significance and as Table 5 shows the government has already started to gradually move prices. For industrial consumers the equalization is planned to be finished in the early 2010's - a process that will, however, be hardly completed in time. Even though the policy has a clear economic rationale, the two key actors' attitudes towards its full implementation are questionable. The government is, understandably, under heavy pressure from the processing industries to sustain the price subsidies. Their arguments fit very well into the popular modernization or "anti-petrolization" discourses of Russia, which emphasize the interests of processing industries vis-à-vis energy companies. The equalization efforts also put Gazprom's export monopoly at risk in the longer term. If profits are equal on the domestic and external markets, why should independent producers be banned from the lucrative export business? Why should the relatively low export custom levels not be raised to the level of oil exports? These privileges were originally granted to Gazprom due to its expensive social "duties" on the domestic market. In all, equalization is a difficult and risky way both for Gazprom and the government, thus the final lifting of domestic-external price differentiation is far from being a decided fact at the moment.

A second option for Gazprom is to turn to other energy sectors in order to diversify its revenues. Such an effort is ongoing since 2004, when Alexei Miller announced Gazprom's global energy strategy. The gas monopoly started to invest into the oil industry (Gazpromneft), and also took its share in the privatization of the Russian electricity industry while showing interest in other processing sectors. While these efforts have received wide coverage they have not, in effect, changed Gazprom's profile too much. The core activity of the company is still gas production. Political and corporate resistance against diversification in Russia and the post-Soviet space is tough, while in the EU Gazprom meets difficult barriers in terms of competition law and governmental attitudes. An easier access to foreign assets would presume a large scale change in the perception of Russia. As a gas monopoly in Russian state property however, Gazprom has to suffer all the negative consequences of the general worsening in the image of the country.

[21] More about these markets: Simon Pirani: „The Impact of the Economic Crisis on: Russian and CIS Gas Markets", Oxford Institute of Energy Studies, NG36, 2009.

Third, Gazprom may also follow the oil sector's path and turn towards Asian markets. There was a lot of talk about this option during the last few years, but hardly anything was done. The fate of the large Kovykta gas field, potentially capable of supplying exports to Asia has been undecided for years. Negotiations with Chinese officials about gas export prices have also been dragging on for 5 years without any conclusion. Moscow's attitude towards a more serious consideration of these alternatives seems to have, however, changed with the outbreak of the global crisis. Gazprom's recent actions have been triggered by the relatively high energy prices, good perspectives in the Far East, the Chinese "opening" in their attitude towards natural gas, and Beijing's increasing influence on Central Asia. Both political and economic factors push for the intensification of relations. One of the few projects, where the budget was not immediately cut back due to the crisis, for example, was the Sakhalin-Vladivostok pipeline, which will be capable of supplying foreign markets in the region. While this project is limited in scope in terms of exports, Gazprom has also decided in the framework of the Eastern Gas Program to start constructing the Yakutia-Vladivostok gas magistral in 2012.[22] There are currently few publicly available details about this project, and there are certainly many challenges associated with it, but the setting of a concrete deadline for this grand undertaking already symbolizes a significant shift in thinking.

All these potential strategic efforts listed above, namely the domestic price increases, the diversification of activities and Far Eastern exports have one major deficit: they are long-term policies, not really capable of delivering significant dividends before 2015. Currently, however, Gazprom has a short- and medium-term problem. Thus, opting for some of the strategic long-term policies does not provide a response to challenges in the current situation. Gazprom's success of choosing successful short-term policies will depend first and foremost on the market situation in Europe and only secondly on the credibility and implementation of its long-term goals. This, again, is an obvious difference with the oil sector. The oil industry has a number of long-standing efforts that have already been felt on the European markets: Far Eastern export diversification has been under way since 2006, European transit diversification has almost finished and oil product exports have been growing steadily.

[22] http://gazprom.ru/production/projects/pipelines/shvg/

Conclusion

Europeans usually overestimate Russia's hand in gas issues. As demonstrated above, market fundamentals in the EU-Russia relations have not changed significantly. Gazprom's sales share has not grown during the last two decades, the contractual relations are almost the same, and projections for future dependency dynamics are contradictory. It is difficult to identify any significant changes in the relations between with the situation under Yeltsin's and Putin's leadership, were it not for the change in the Russian political landscape and the gas policy trends inside the EU. It is very important to realize that it was the Europeans that have set natural gas as a central issue on the energy agenda. It was them who came up with a number of initiatives to change the existing patterns and - except in the case of the transit wars - much of the discomfort with regards to the 'blue fuel' came inherently from the old continent. In the light of other branches, like oil and coal, the Russian gas industry has changed relatively moderately.

At the same time, the future of Russian oil exports might have a similar importance both for Moscow and Brussels. It is oil exports that have grown rapidly during the past two decades, establishing the financial fundaments of welfare and stability of the Putin's regime. The oil industry has transformed its environment rapidly, while the EU has made hardly any attempt to influence Moscow in this regards. The EU dependence on oil imports is much higher than on gas and – unlike with regards to gas - global scarcity in oil is on the mid-term horizon. The EU could, potentially, open up the oil and even the coal "issue" during upcoming EU-Russia negotiations to engage Moscow more directly. Triggering Russian oil production, accelerating Russian optimalization efforts in the oil processing sector and putting the EU-Russia oil trade on a more reliable fundament could have a positive impact on the gas sector as well. Hence, Brussels should not limit itself voluntarily and put more than just natural gas on the EU-Russia energy table.

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