

# Oxford Energy Comment

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### **GAS-OPEC: A DISTRACTION FROM IMPORTANT ISSUES OF RUSSIAN GAS SUPPLY TO EUROPE**

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The international press has delightedly seized on president Vladimir Putin's recent references to creating a "gas-OPEC" or at least some sort of cartel which could operate to the detriment of gas importers. Casual readers have been given the impression that this is the most recent manifestation of the Russian quest for world domination of petroleum markets, following the problems with Belarusian oil in January 2007 and Ukrainian gas one year previously.<sup>1</sup> This latest furore began at a press conference on February 1 when president Putin was asked by the BBC to respond to a proposal by the Iranian president to create a gas-OPEC. The Russian president responded that it was "an interesting idea and we will think about it... We have no plans to create some kind of cartel, but I think it would be a good idea to coordinate our activities, especially in the context of achieving our main aim of ensuring certain and reliable supply of energy resources for our main consumers".<sup>2</sup> The subject was not initiated by president Putin and the entire exchange accounted for less than 200 words in a 25,000 word transcript which featured many substantially more important energy and non-energy issues. The following week on a visit to Qatar, the president continued: "We do not reject that idea of creating a gas cartel..But this initiative requires more study."

The very clear message from the Russian president's comments is that, rather than control of export prices and volumes, what is under discussion is the possibility of cooperation and coordination between gas exporters principally to prevent competition. But an organisation with this remit already exists and it will be interesting to see whether the outcome of Russian and Qatari studies come to the same conclusions as our own work, published in June 2006, on the Gas Exporting Countries Forum (GECF) which showed it to be a relatively chaotic organisation with an unstable membership and an uncertain future.<sup>3</sup> The April 2007 meeting of the GECF in Doha will be its first for two years following the collapse of the 2006 Venezuelan presidency, it is unclear whether the initiatives agreed at the April 2005 meeting in

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<sup>1</sup> For details of the Ukrainian and Belarus episodes see: Jonathan Stern, *The Russian-Ukrainian Gas Crisis of January 2006*, Oxford Energy Comment, January 2006, [http://www.oxfordenergy.org/pdfs/comment\\_0106.pdf](http://www.oxfordenergy.org/pdfs/comment_0106.pdf) Katja Yafimava and Jonathan Stern, *The 2007 Russia-Belarus Gas Agreement*, Oxford Energy Comment, January 2007, [http://www.oxfordenergy.org/pdfs/comment\\_0107-3.pdf](http://www.oxfordenergy.org/pdfs/comment_0107-3.pdf)

<sup>2</sup> [http://www.kremlin.ru/eng/speeches/2007/02/01/1309\\_type82915type82917\\_117609.shtml](http://www.kremlin.ru/eng/speeches/2007/02/01/1309_type82915type82917_117609.shtml)

<sup>3</sup> Hadi Hallouche, *The GECF: is it really a gas-OPEC in the making?*

<http://www.oxfordenergy.org/pdfs/NG13.pdf>

Port of Spain, Trinidad have been followed up. This is as much as can be ascertained from an organisation with no website and no official documents about its activities.

There have been major problems for GECF members to know how to cooperate with each other when: some are LNG exporters to the Pacific Basin (Indonesia, Malaysia and Brunei); some are LNG exporters to the Atlantic Basin (Algeria, Nigeria, Libya, Egypt and Trinidad); some are pipeline exporters to Europe (Russia and Norway which only has observer status), and some are barely exporters at all (Iran). Some GECF members are not exporters (Venezuela) and some very important exporting countries are not GECF members: Canada, Netherlands and Australia. The development of global arbitrage and swaps of LNG cargoes, as well as swaps of LNG for pipeline gas, is introducing more flexibility and the prospect of a more globalised gas market. But higher costs and greater relative rigidity of natural gas transportation compared with oil or coal, places limits on what can be expected in future.

Despite the claim by president Putin that Russia and Qatar will not be competing with each other for markets, the opposite will clearly be the case since European importers are seeking to diversify away from Russian gas and Qatar will begin to export substantial additional quantities of LNG to Europe over the next few years. Russia faces the similar problems to the extent that its proposed gas cooperation with Algeria, which has caused so much angst in Europe over the past year, will involve an agreement on European market shares.<sup>4</sup> While much western commentary is very keen to view all Russian foreign energy trade as “political” rather than commercial, it may well be appropriate to view relations with other gas exporters in this light. The example of its relations with OPEC, which Russia has never sought (or been invited) to join, despite its importance in global oil trade, suggests a determination not to allow the commercial rules of its energy trade to be set by others. Rather than suggesting anything sinister, the discussions with Qatar about a gas cartel may simply be a reflection of the lack of other issues which the two countries have in common.

The gas-OPEC headlines have been a distraction from important recent developments in the Russian gas sector. The necessary transition to more market-related prices for Russian gas sales to CIS countries has been messy and nasty, creating a firestorm of accusations about Russian energy blackmail and policy statements about “energy security” in Europe. Policy makers, analysts and columnists who first started to look at this subject on January 1, 2006 have trotted out the usual homilies about the need for gas supply diversification, energy efficiency, clean coal and nuclear power. Many of these sentiments could have been (and indeed were) expressed in 1976 rather than 2006. Whatever their merits, even if these policies are suddenly enthusiastically embraced, most have lead times which mean they will have little impact on the European gas situation over the next decade. Political commentators deplore Europe’s inability to “speak with one voice” when it comes to energy relations with Russia. Bilateral relations have always been a feature of this trade because contracts are with national companies backed by national governments. The European Union’s “Energy Dialogue” with Russia ran aground when it became clear in Moscow that Brussels had no authority to speak on behalf of member states on issues such as contracts and investments.

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<sup>4</sup> In fact, most of the specific proposals for Russian-Algerian gas cooperation concern upstream investments and LNG projects rather than markets.

Few seem to have noticed the extension, in the latter part of 2006, of Gazprom's most important long term contracts with German, French, Italian and Austrian buyers for another 15-25 years. These were important not only because they substantially prolong a significant part of European gas supplies, but also because these contracts are legally binding and subject to international arbitration with liquidated damages in the event of non-performance. This is a completely different situation compared with sales to CIS countries, such as Ukraine and Belarus, where contract prices and volumes are renewed annually and where, until 2006, prices were a fraction of what Gazprom was earning from sales to Europe. European gas exports earned Gazprom \$39bn in 2006, a tidy sum which even one of the world's biggest companies might be reluctant to jeopardise, particularly given the investment which it has made – and is continuing to make – in pipeline export infrastructure.

Aside from the rapidly deteriorating state of Russia-EU political relations, probably the greatest threat to future Russian gas exports to Europe is the decision taken in November 2006, and endorsed by president Putin, to bring Russian domestic gas prices up to parity with European prices by 2011.<sup>5</sup> There are many problems in knowing how to interpret this decision: taking into account export taxes and transportation charges, Russian domestic prices can be less than half of those at European borders and still be considered “equivalent”; and who knows what the views of the next Russian president will be post-2008. Nevertheless for the first time a Russian president has endorsed the policy – long demanded by the IMF, WTO, EU and others – that Russian industries should pay similar prices for gas as their counterparts in market economies. What this price will be in absolute terms is difficult to say, as is projecting European gas prices in 2011, but what seems certain is that it will be at least double the current Russian regulated price. This will have several important consequences:

- it will make profitable the development of gas from the huge Yamal Peninsula fields (which will carry Russian gas production through the next 20-30 years) for domestic customers;
- it will, for the first time, make investments in energy saving and efficiency profitable in Russia, finally creating the incentive for large scale capital stock replacement in the power sector and energy intensive industries;
- and it will, eventually, mean that Gazprom will become financially indifferent as to whether it sells additional gas domestically or in Europe. This is of course an entirely logical development: why should gas sold several thousand kilometres from where it is produced, provide a return several times greater than local sales?

This will be a sea-change for both the Russian and European gas companies where the financial advantages of exports, compared with domestic sales, have been so overwhelming for so long that it is difficult to imagine any other situation. Motivations to supply the domestic market – which will not require transit through potentially difficult countries at significantly increased costs – will become much stronger.

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<sup>5</sup> This refers to prices for industrial and power generation customers only, not residential customers who will continue to be subsidised.

Rather than the distractions of a gas-OPEC, European energy policy-makers need to focus on what their countries want from Russia in terms of future gas supplies: more, less or the same. Woolly thinking about security and diversity of gas supplies is not helpful here.<sup>6</sup> An example is the general enthusiasm among politicians and the EU for developing new sources of gas supply, particularly pipeline gas from the Caspian/Middle East region. This is nothing wrong with this enthusiasm but little appreciation that such projects have been under consideration, in one form or another, for at least 30 years with no results. This is less to do with resource availability and economic viability and more with the politics of crossing a large number of countries, many of which have difficult historical relationships. LNG is the new enemy of long distance, multi-country pipeline projects. Why would a Middle East exporter tie itself to a long distance pipeline to a single market, when it could give itself the opportunity to arbitrage between different LNG markets? Central Asian countries have no LNG export opportunities, but are being aggressively courted by China and are enjoying the substantially increased prices which Gazprom is paying them which involve neither financial nor country risk. In such a situation, the attractions of sales to Europe through a Trans-Caspian Pipeline are not obvious.

In that context, will European countries either individually, or represented by the EU, want less Russian gas in the future? My guess would be no. If this is wrong let them say so clearly and unambiguously, and get on with developing alternative gas (and other energy) options. But any such decision should not be confused with improving security of gas supply. Will Russia want to export substantially more gas to Europe in the future? Possibly not, particularly if domestic and other export markets become equally attractive commercially. It is these issues – rather than any development of a gas-OPEC – which will preoccupy energy policy makers in Europe and Russia over the next decade.

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<sup>6</sup> Jonathan Stern, *The New Security Environment for European Gas: worsening geopolitics and increasing global competition for LNG*, Oxford Institute for Energy Studies, October 2006, <http://www.oxfordenergy.org/pdfs/NG15.pdf>