



The Political and Commercial Dynamics of Russia's Gas Export Strategy

Executive Summary

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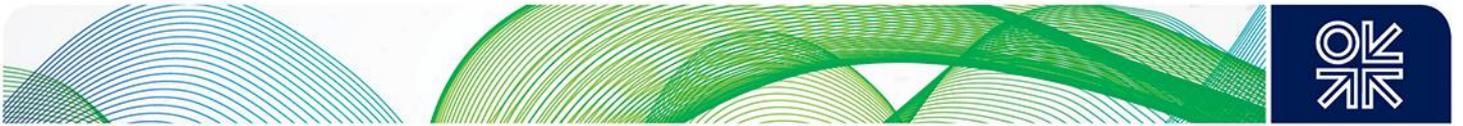
A variety of competitive and political forces have left Russia, and its main gas company Gazprom, in a difficult position in all of its west-facing markets. Demand for its gas in Europe has stagnated due to a variety of competitive pressures, exports to the FSU have fallen thanks to Gazprom's strategy of increasing prices and to the obvious impact of the political crisis in Ukraine, while in Russia Gazprom has also come under pressure from increased competition and has seen its sales fall sharply. When this commercial reality is combined with the political issue that many countries in Europe and the FSU are keen to diversify away from Russian gas, seeing it as a security risk, then it is clear that Gazprom needs to create alternative options for selling its gas, while the Kremlin is keen to demonstrate that Russia need not be reliant on sales to countries which are currently imposing sanctions on it. However, the vast number of political as well as commercial influences on the country's gas export strategy appear to have led to a degree of improvisation that often makes it difficult to interpret the logic of individual tactics as they are frequently announced with surprising timing.

Eastern gas sales have long been seen as an obvious diversification for Russian gas exports as Gazprom seeks new markets, but political as well as commercial factors have affected the "pivot to Asia", which has been undermined by uncertainty over Chinese gas demand, the fall in gas prices and a lack of clarity over the priority of export routes. It would therefore appear that, although exports to the Asia-Pacific region can provide some diversification for Russian gas exports over the longer term, it is unlikely to offer the strong insurance policy that Russia desires, while any threat to European supply that it theoretically implies is already being seen as relatively empty.

As a result it seems inevitable that the mutual dependency between Europe and Russia over gas supply will remain for the foreseeable future. However, the nature of the relationship is changing as global forces start to disturb what has historically been a regional gas market. In particular the imminent arrival of new LNG supplies from an over-supplied and increasingly inter-connected market are presenting a challenge to Gazprom's traditional sales model and an opportunity for European buyers to diversify their sources of supply.

Gazprom has shown that it is willing to respond to competitive pressure by adjusting its price level and its contractual terms, but its tactics to date been reactive rather than proactive as once again it has appeared to seek short-term solutions to immediate problems and to create multiple options for negotiating purposes rather than developing a coherent long-term strategy. Indeed the evolutionary and somewhat improvised nature of Gazprom's export strategy to Europe is best exemplified by its infrastructure plans, which over the past 12 months have involved multiple changes of direction and little in the way of a definitive strategy.

The positive news for Gazprom is that if it needs to compete to maintain its position in the European gas market then it has enough low-cost supply to meet its long-term market share objectives. Furthermore, the impact of EU legislation and regulation is forcing the company to operate in a more market-oriented manner, which could ultimately be to its benefit as it is clearly in a position to



compete with any alternative sources of supply. The key question will therefore be the speed with which both the Kremlin and Gazprom management are prepared to countenance a move towards a competitive pricing strategy that is less reliant on its traditional oil-linked model. One factor that could influence this outcome is the development of Russia's LNG strategy, where it appears increasingly likely that a new player, Novatek, could become the primary mover, meaning that Gazprom may be forced to react to internal as well as external challenges in the global gas market.

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