

COVALENCE ANALYST PAPERS

The role of Gazprom in the economic, foreign and social policy of the Russian Federation

Loic Gaillard | Political Sciences, University Lausanne (Switzerland) | intern analyst, Covalence SA, Geneva, 05.06.2008

The Russian gas company “Gazprom” is currently the larger player in the worldwide gas market in term of production and capitalization. Beyond its impressive results, we will highlight in the framework of it analyse, the multidimensional aspects of Gazprom in the economic, politic and social spheres of Russia. The goal is to demonstrate in which way the Russian government uses the economic Globalization process in order to attract foreign capital and High Technology, to reinforce the position of the country in the international scene and to support the national cohesion through different social and environmental policies.

1) The business strategy of Gazprom

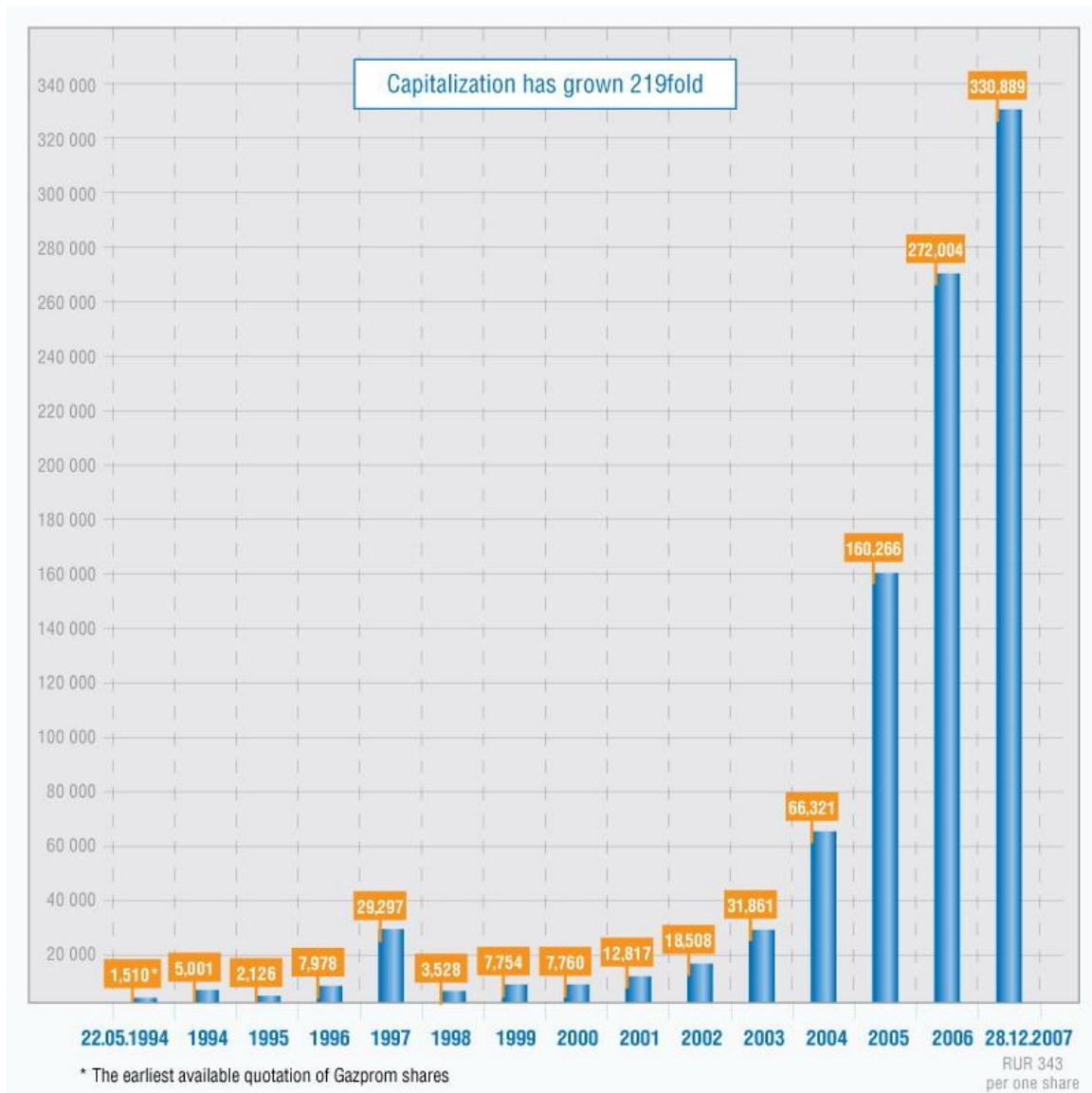
Since the USSR collapse in 1991, Gazprom has ever been a company under state control until today. However, the new Russian government of the President Vladimir Putin (2000-2008) has elaborated an new business strategy toward Gazprom and the national oil and gas industry in general: on the one hand to assure the control of the main Russian oil and gas companies by nationalizing such as Yukos in 2003, Sibneft in 2005 and probably Russneft in the near future. And on the other hand to build ties with Russian managers of private company such as Vagit Alekperov (Lukoil) or Vladimir Bogdanov (Surgutneftegaz) characterized by the loyalties and personal relationships with key actors of the Russian government.

But the control of Gazprom and other companies by the government doesn’t mean that its shares are completely nationalized. Indeed, in 2005 the Russian Parliament has approved the partial privatisation of the Gazprom’s share until 49%, which is today listed on the main financial market as illustrate the following graph:

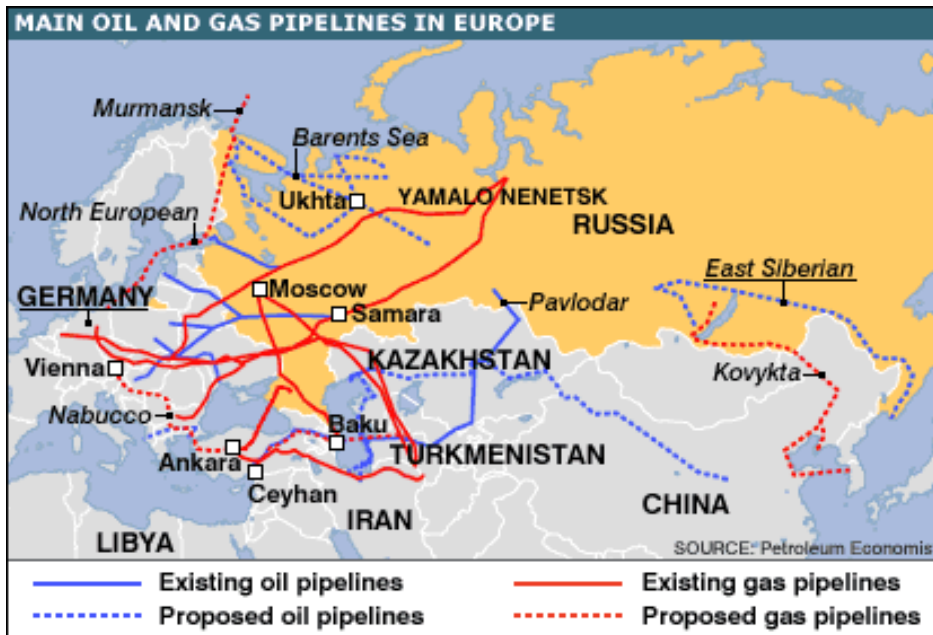
Date & Time (GMT+3): 21.05.2008 17:04

Share	Bid	Ask	Last	(+/-)	%	High	Low	Volume (shares)
Gazprom (MICEX)	364,77	364,95	364,95	4,45	1,23 ↑	366,70	358,25	47 455 739
Gazprom (RTS)	15,43	15,46	15,45	0,19	1,24 ↑	15,48	15,20	538 500
Gazprom ADS (LON)	61,80	61,90	61,90	0,90	1,47 ↑	62,20	61,30	7 539 388
Gazprom ADS (FRK)	39,24	39,43	39,32	0,32	0,82 ↑	39,60	39,00	54 433

As we see, the Gazprom’s shares are currently listed in New York (MICEX), London and Frankfort markets. In Parallel of the privatisation process, the Direction of Gazprom has integrated a new Corporate Governance which tends to apply the international standards in term of transparency. It is essential to underline that the Russian Government has never applied this liberal economic reform (privatization and new Corporate Governance) in order to transform Gazprom in a worldwide company. On the contrary, the goal consists exclusively in attracting massive private capital and as well foreign High Technology for the Russian national interest. This strategy has been very effective as shows the following graph on the capitalization’s growth of Gazprom during the last decade:



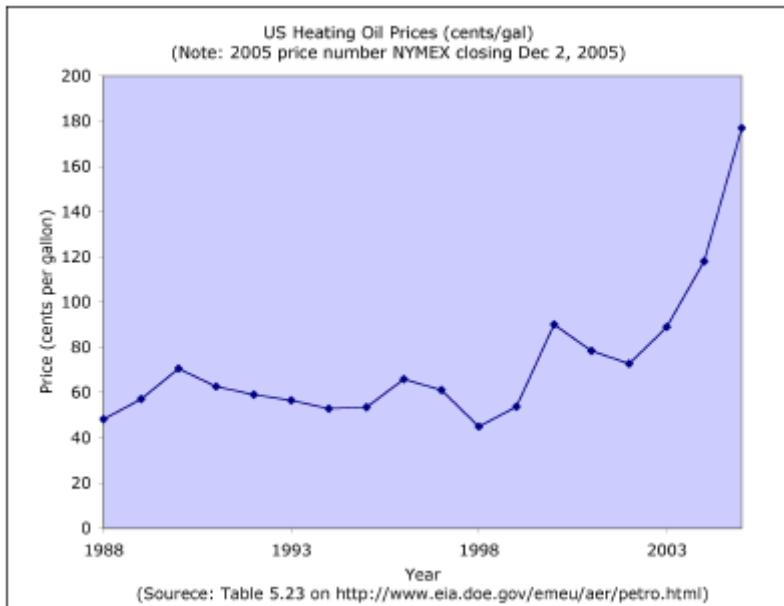
As we see on the graph the capitalization of Gazprom has increased very fast since 2005 to reach more than 330 billions dollars the 28.12.2007. If the Russian Government strives to improve the financial and technical aspects of Gazprom, it is because Gazprom represents the first financial revenue of the Federal Budget (20%) through its gas exports mainly towards the European market. Moreover, Gazprom and the national oil and gas Industry is the main motor of the current Russian economic growth (more than 7%) since the last years. Therefore the Russian government is completely aware about its dependency toward its European gas customers for its federal revenues and the development of the national economy. Accordingly, the authorities tend to extend its gas pipeline network in order to access new potential markets in the future essentially located in Asia (especially China, South Korea and Japan). The following map presents the current Russian oil and gas pipelines network and the proposed project:



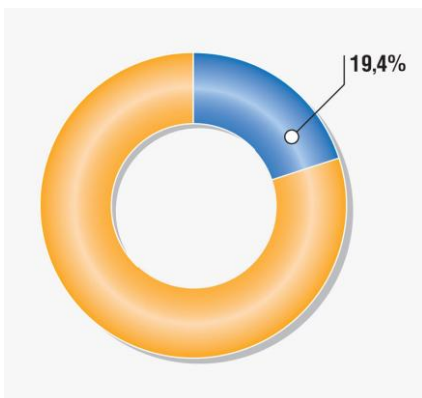
As we can see, the majority of Russian oil and gas pipelines are focused on the western market. When Gazprom will have access to new gas market in Asia through new pipeline, the Russian authorities will not only reduce its dependency toward the European customers but also launch violent concurrency between Europe and Asia in terms of price and volume gas export. In addition to this new pipeline project, Gazprom has recently elaborated LNG project in the Island of Sakhalin (rich hydrocarbon fields) which allow to transport by sea the Russian gas not only to Asia but even to North America through Pacific Ocean. The following map shows the Russian LNG project in Sakhalin:



As we can see on this map, the Russian LNG can easily be transported by sea to new attractive markets such as USA, Australia or Canada. Finally, the diversification process of the Russian gas exports seems unavoidable in the near future in regard of the evolution's worldwide energy market characterized by a limited capacity of main producers, a regular demand's growth from big consumers as China and India and geopolitics troubles in oil countries such as in Iraq, Nigeria, Iran or Venezuela. The following graph presents the growth the crude oil price during the last years:



As we see, the oil price continues regularly to increase under pressure of the demand. In these circumstances, the role of Gazprom in the near future should reinforce. Today, the part of Gazprom's share in the global gas production reaches 19,4% as shows the following graph:



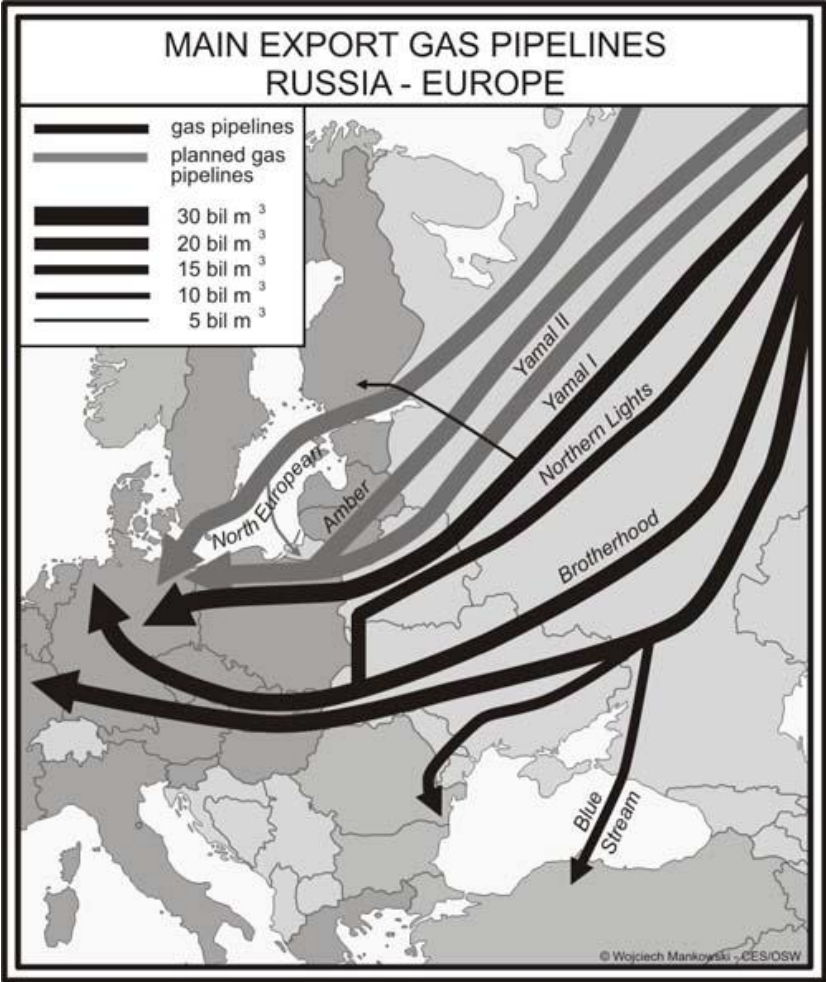
Gazprom's share in the global gas production

The Russian Government is aware of the increased Gazprom's role as an unavoidable gas producer in the worldwide market. Therefore, the Russian authorities aim to use it in the framework of its foreign policy.

2) Gazprom as leverage of the Russian foreign policy

During the Soviet time, Moscow conducted its communism messianic as geopolitical strategy in order to dominate its influence sphere. After the USSR collapse, Russia has abandoned any ideology and lost its main satellite countries. When Vladimir Putin became the president of the Russian Federation in 2000, he claimed that the "USSR collapse has been a geopolitical catastrophe". In order to restore its "historical influences

sphere”, the Putin’s government has renounced in any geopolitical strategy motivated by an ideology and it currently endorse a new geo economical strategy based on energy. In others words, Russia is passed from the geopolitics to geo economy. Concretely, Russia aims to dominate it “close neighbours” (ex soviet republics: Baltic countries, Ukraine and Belarus in Europe; Azerbaijan, Armenia and Georgia in Transcaucasia; Kazakhstan, Turkmenistan, Uzbekistan, Tajikistan and Kirghizstan in Central Asia) in using the leverage's energy to dominate economically these countries in order to control it thereafter politically. In focusing on the European zone, the Russian gas export toward the European market has to cross different ex soviet Republics as shows the following map:



As we see, the Russian gas delivery to European customers has to cross the ex USSR territories, named Ukraine, Belarus and Baltic countries. In order to restore the influences soviet sphere, the Russian authorities want to dominate geo economically these transit countries in using the leverage's energy. This Russian geo economic gas strategy can be illustrated through the Ukrainian and Belarus gas crisis in 2006-2007:

a) Ukrainian gas crisis 2006: In March of 2005 Gazprom first suggested to raise the price its gas exports to Ukrainian market to 300% and later to 460% (from US\$50 per 1,000 cubic meters to US\$150 to US\$230). The old price Ukraine paid was about 486% lower than Turkey or different western European customers. Indeed, Ukraine received gas subsidies since the soviet time which allow the main Ukrainians industries to reduce seriously its cost production. The issue is very critical for the Ukrainian economy, which depends strongly of the Russian energy subsidies. In aligning the gas price to European market, the Russian government aims to dominate geo economically Ukraine. In others words, Putin’s government wants to control the Ukrainian industries through Gazprom in order to dictate thereafter the Ukrainian government. This case illustrates exactly the change of the Russian foreign policy from the geopolitical communism during the soviet time to the current energy geo economy in order to dominate its “close neighbours”. The two parties were unable to reach an agreement to resolve the dispute, and Gazprom has cut gas exports to Ukraine on 1 January 2006. Gas supplies were affected, with all customers reporting varying degrees of reduction in gas flow: Austria (supplies

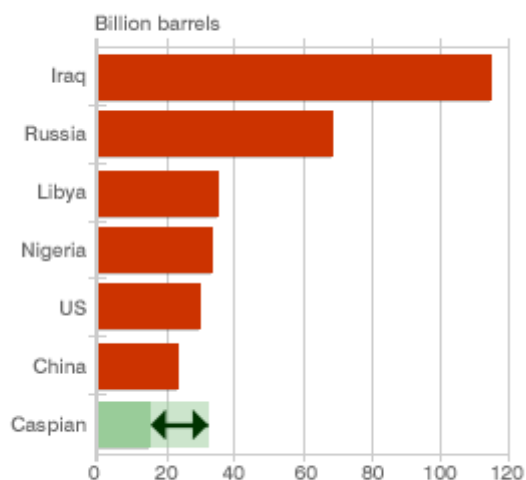
down by around 33 %), Croatia (supplies down by around 33 %), France (supplies down by 25–30 %), Germany (supplies down by an unspecified amount), Hungary (Russian imports down 40 %), Italy (Russian imports down 24 % (6 % of total imports)), Poland (supply down by 14 %), Romania (supplies down by around 20 %), Slovakia (supplies down by around 33 %) and Slovenia (Russian supplies down by around 33 % (40 % of average annual gas supply)). Gazprom accused Ukraine of taking gas destined to European market; Ukraine's state-owned energy firm Naftogaz admitted withholding some Russian gas intended for other European countries to cope with the especially cold January 2006 weather. Finally a compromise contract was reached, where gas prices were roughly doubled, but Ukraine transit fees also increased, offsetting the increase in cost. The supply was restored on January 4 2006.

The Russian government's willingness to restore its authority toward Ukraine has been especially motivated by the political event "Orange Revolution", which occurred in winter 2004. The new Ukrainian government of Youshenko is openly pro-NATO and US oriented, fully in opposition with the Russian ambition.

b) Belarus gas crisis in 2006: On April 2006 Gazprom indicated it would triple the price of natural gas sold to Belarus after the 31st December 2006. From January 2007 Belarus pays 100\$ for 1,000 cubic meters, while Ukraine pays 135\$, Germany and other EU country's paid an average of 280\$ in 2007. In the same logic as Ukraine, the Belarusian economy is strongly dependant on Russian energy subsidies. If the Belarusian President Lukachenko agreed to pay more the Russian gas price in 2006, the negotiations have been however difficult when the Russian state-owned pipeline company Transneft stopped provisory pumping oil into the Druzjba pipeline which runs through Belarus. Like Ukraine, the Russian Government aims to dominate geo economically the Belarus in order to thereafter control it geopolitically. Even if Belarus has close political ties with Moscow, Russia tends to restore its authorities on its "historical influences sphere" and refuse to be satisfied with "friendly independent country".

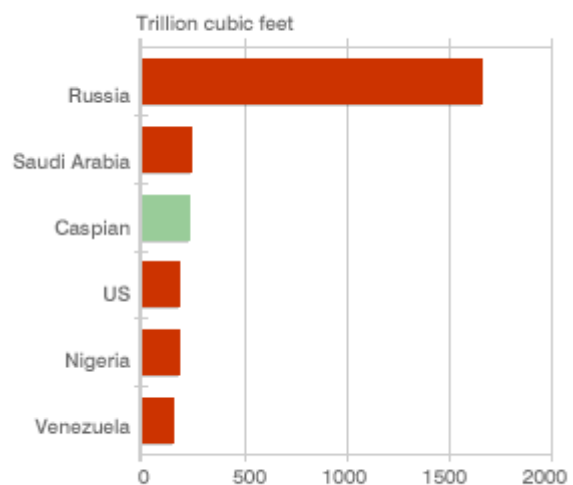
In Transcaucasia and Central Asia/Caspian Sea the situation for Russia is much more complex because these regions have been invested by strong foreign rival powers. Many Analysts uses the term of "The New Great Game", which is a current competition between the United States, Russia, China, India, Iran, Turkey and Pakistan to secure reliable long-term sources of petroleum and natural gas through the construction of pipeline in the post soviet area of Central Asia. The term was coined by Pakistani journalist Ahmed Rashid in reference to the original Great Game between the British Empire and the Russian Empire for strategic supremacy in Central Asia in the 19th and early 20th century. The potential of oil and gas reserve in Caspian Sea/Central Asia is very attractive but subject to strong speculations according to the sources. The two following graph present the Proven oil and gas according to the major BP:

Proven oil reserves



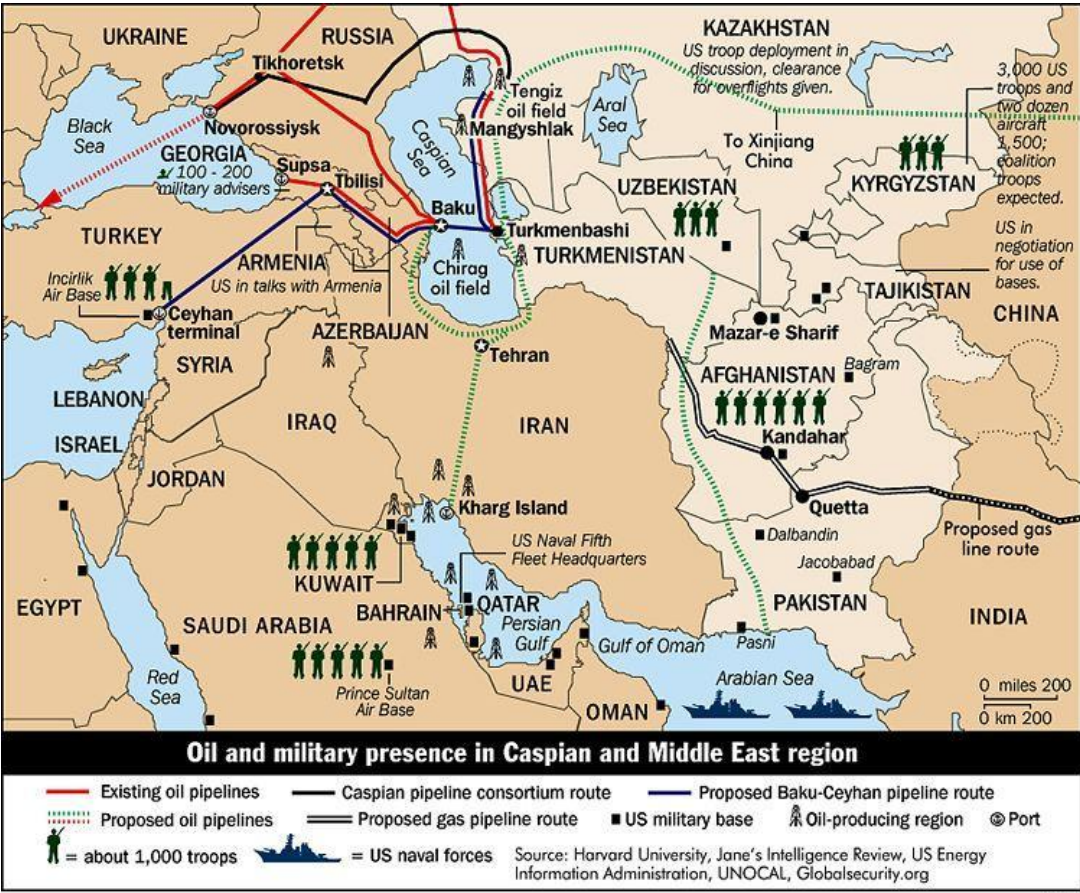
SOURCE : BP, EIA

Proven gas reserves



SOURCE : BP, EIA

As we see, the potential of the Caspian Sea in term of oil production is very attractive. Indeed, according to BP, the proven Caspian oil reserves can be compared with Nigeria and even over pass US. As for the proven Caspian gas reserves, they are more important than US and equal with Saudi Arabia. In these circumstances, the main energy consumer in the world – USA – couldn't be unconcerned in the Caspian/Central Asian region. Indeed, after the event of September 11, the Bush administration has declared the "war against terror" everywhere in the world and especially in Central Asia and the Caspian region. Today, the US troops are located not only in Afghanistan after the invasion of the country in autumn 2001 but as well in Uzbekistan, Kyrgyzstan and have elaborated a close military cooperation with Kazakhstan and Azerbaijan. The following map presents the current US military presence in this region after September 11.



If the US oil major are currently operating on the Caspian Sea (Azeri and Kazakh zone), the geographic position of the Sea is landlocked, therefore The US Administration has elaborated different oil and gas pipeline avoiding the Russian territory. The main US oil and gas pipeline being proposed are:

a) The trans-afghan gas pipeline: this gas pipeline starts from the giant Turkmen gas field to Pakistan port (Indian Ocean) through afghan territory. The following map shows the route of the pipeline:



The US project of Trans-Afghan gas pipeline has been already proposed in 1997 but it has been forbidden by the Taliban authorities at this time. Today, the new afghan government pro US are favourable to the project but the current military conflict prevents it realization. Therefore, the gas production of Turkmenistan has to cross the Kazakhstan and especially Russia as only way to reach the European market. The Russian authorities want absolutely maintain its monopoly's transport toward the Central Asian gas export through its pipeline. It is a fundamental necessity for Russia to prevent all central Asian competitor to access directly to the European gas market, because it will reduce the gas price and therefore the income for the Russian federal budget.

b) The BTC oil pipeline: The Baku-Tbilisi-Ceyhan pipeline (BTC pipeline) is a crude oil pipeline that covers 1,768 kilometres (1,099 mi) from Azeri oil fields in the Caspian see to the Mediterranean see. It connects Baku, the capital of Azerbaijan; Tbilisi, the capital of Georgia; and Ceyan, a port on the south-eastern Mediterranean coast of Turkey. The pipeline is operational since 2006. The BTC pipeline project was adopted in 1998 the US secretary of Energy Bill Richardson expressed strong support for the BTC pipeline. The following map shows the route of the BTC pipeline:



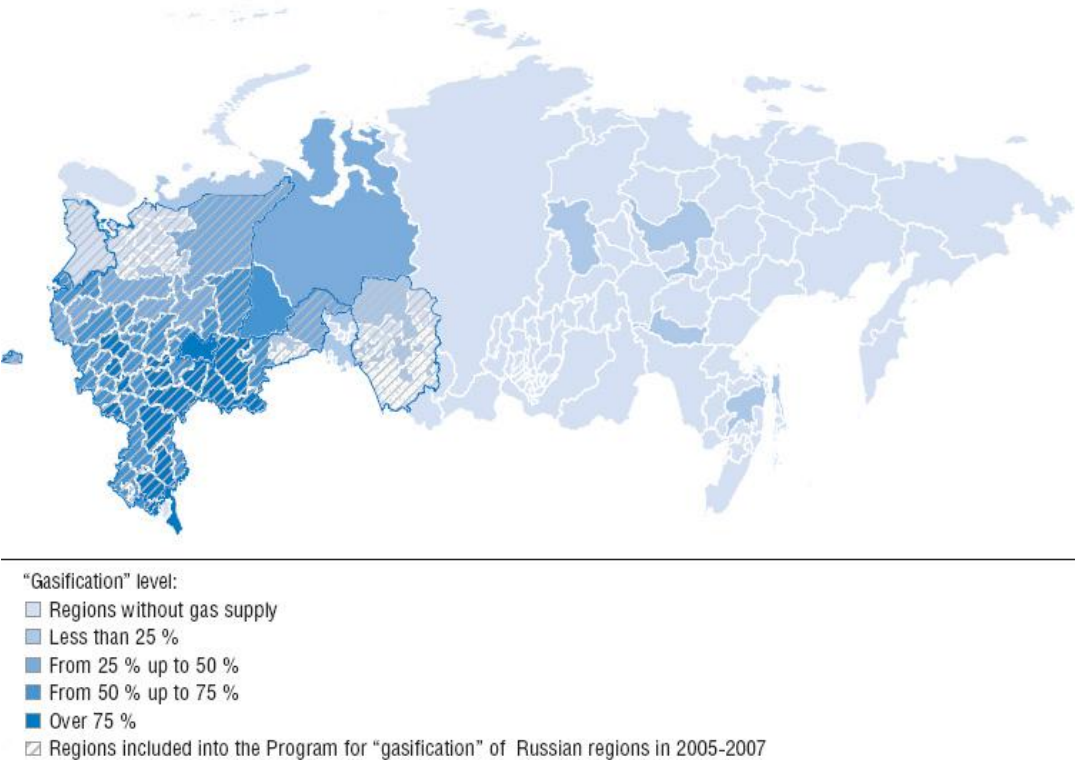
As we see, the BTC pipeline allows freeing the Caspian oil in avoiding carefully the Russian territory through Azerbaijan and Georgia. If the Azeri President has always supported the US project, the last Georgian President Shevardnadze, was sceptic and more close from Russia. The Russian authorities were strongly opposed to the BTC because the Caspian oil production could avoid using Russia as transit country. A powerful coalition of reformists headed by Mikhail Saakashvili and supported by USA was opposed Shevardnadze's government in November 2003 parliamentary elections. The opposition organized massive demonstrations in Tbilisi. After two tense weeks, Shevardnadze resigned on and was replaced as president by the pro US Saakashvili in 2004. Thereafter, the bilateral relationships between Georgia and Moscow deteriorated rapidly. In response of the "revolution", the Russian government used the leverage's energy through Gazprom: in January 2006, two simultaneous explosions occurred on the gas Mozdok-Tbilisi pipeline in the Russian border region of North Ossetia, which interrupted the gas delivery to Georgia. Immediately the Georgian president Mikhail Sakaachvili blamed Russia for putting pressure on Georgia's energy system at the time of the coldest weather. After reparation, Gazprom increased natural gas prices to Georgia the first January 2007. The current price is 235 USD per thousand cubic metres, which is the highest among the CIS countries. Beyond the willingness of Russia to preserve its influence in Transcaucasia region through the leverage's energy, the Putin's government want to "punish" especially Georgia, which became a close ally of USA through Saakachvili.

3) Gazprom's social and environmental policy

a) Environmental policy of Gazprom as leverage to obtain new oil and gas assets: officially the Gazprom's board of director proclaims regularly that's its priorities are to protect Environment, ensure ecological safety in the production operation regions and reduce pollution, industrial and ecological safety during new facilities construction. Financially, Gazprom's environment costs increased in 2006 by 30.6 per cent and reached 12.7 billions roubles (About 5 billions dollars). Gazprom's environment policy is not completely disinterested toward business. Indeed, the Russian government uses different environmental criteria toward foreign oil and gas major in order to force it to yield its assets to Gazprom and other state companies such as Rosneft. As example, Gazprom and the majors Shell, Mitsui and Mitsubishi signed an agreement in 2007 which will see Gazprom, take over half plus one share of Shell's 55% stake of Sakhalin Energy Investment Company. SEIC (Sakhalin Energy Investment Company) is an international consortium, which operates in Sakhalin Island without Russian state participation since 1990 decade. Russia's Ministry of Natural Resources announced that it was going to revoke its environmental certification of the second phase of "Sakhalin 2", a \$20 billion off-shore oil exploration project, citing numerous infractions of environmental requirements (included damage to the sea

bed near a liquefied natural gas plant at Aniva Bay, as well as destruction of forests, river crossings and salmon spawning grounds resulting from the pipe lines used for oil and gas).

b) Gazprom’s Social policy as instrument for the national cohesion: The largest socially oriented project of Gazprom is “the Gasification Program for Russian Federation regions over 2005 to 2007”, which prioritizes gasifying the rural area, with a total of RUR 43 bln (About 1,8 billion dollar US) to be invested in the construction of gasification facilities. The Gazprom’s board of Director affirms that it Program will result in a further 13 millions of the country’s citizens starting to use natural gas Transmission. The program envisages lying more than 13 thousand km of distribution gas pipelines for three years. Established system of cooperation with the Russian Federation entities in the framework of the Gazprom regional policy enables to solve production, financial, social and organizational issues with local administrations. As of the first March 2007, Gazprom has concluded the Agreement of cooperation with 76 regions of the Russian Federation. The followed map presents the Russian regions concerned by the Gasification Program of Gazprom:



As we see on the map, Russia is a mosaic of different regions. In fact, these regions are sometimes completely heterogeneous with various confessions (Christianity, Islam, Buddhism and Judaism), ethnic groups (160 different ethnic groups and indigenous peoples) languages (some 100 languages), culture and history. All the Russian history is characterized by the worry to maintain the national unity, which has been ensured by the strong centralism power during the tsarism and the soviet time. After the USSR collapse in 1991 and the weak new central federal government of Boris Yeltsin, Russia was close from a new implosion with the growth of several separatist's movements such as in Chechnya, in Tatarstan, in Bashkortostan, etc. When Vladimir Putin became the new Russian president in 2000, he claimed immediately his intention to restore the “vertical of power” in order to eradicate every political centrifugal force in the country, which could threaten the unity of the country. And Gazprom is used as leverage to enforce the national cohesion through it “Gasification Program for Russian Federation regions over 2005 to 2007”. Indeed, this social program is leaded by a centralized power in the hands of Gazprom to the detriment of local authorities. In other words, the social policy of the Russian government through Gazprom encourages the centralization process of power against regional politic forces, which could be tempted by separatism.

In conclusion, in focusing on ethics, Gazprom promotes various environmental and social criteria not by conviction or ideology, but to defend the Russian national interest. Indeed, the Russian Government is today obsessed by the quest of a new national cohesion after the implosion of the soviet identity. The lack of national identity is a serious threat for the unity of Russia, which is one of the most heterogeneous countries in the world. Therefore, we can observe the growth of the nationalism in Russia as an ideology allowing building a new Russian identity. To this end, Gazprom offer various *national social projects*, which encourage the *national sentiment*. In other words, the ethical worries of Gazprom in term of social and environmental issues refer to political goal of the current Government to define a new Russian national identity.

References

- Report, *the Gasification Program for Russian Federation regions over 2005 to 2007*, www.gazprom.ru
- Jamie McDuell, Web Editor, Platts.com and Stuart Elliott, , *discuss the potential for, and possible outcome of a new dispute between Ukraine and Russia over the price of gas*; European Editor for Platts Oilgram News, June 29, 2006
- Jonathan Stern, *The Russian-Ukrainian gas crisis*, January 16, 2006. www-oxfordenergy.com
- "*Russia-Belarus Standoff Over Oil Ends, Clearing Way for Accord*", *Washington Post*, 2007-01-11.
- Steven Lee Myers. "*Belarus and Russia spar over crude oil cutoff*", *Herald Tribune*, 2007-01-08.
- *Baku-Tbilisi-Ceyhan (BTC) Caspian Pipeline*, www.HydrocarbonsTechnology.com
- Soner Cagaptay, Nazli Gencsoy, *Startup of the Baku-Tbilisi-Ceyhan Pipeline: Turkey's Energy Role*. Washington Institute, 05 27, 2005
- *Gas pipeline project Turkmenistan-Afghanistan-Pakistan-India approved*", Alexander's Gas & Oil Connections, 2006-11-21.
- *Talks Over Gas Pipeline Project Kick Off In Islamabad*", *Downstream Today*, 2008-04-23.
- *Environmental Groups Develop New Ways to Air Grievances - Financing, Not Pipelines, Becomes the Latest Target*, 11 October 2005
- *Sakhalin Energy's muddy waters - A "few cases" where Sakhalin Energy is endangering wild salmon on Sakhalin Island*, <http://www.sakhalin.environment.ru/en/map/index.htm>
- *Saakashvili Steps Down to Run for Re-Election*, *Civil Georgia*, 2007-11-25.
- *The United States Department of State Country Reports on Human Rights Practices - 2004*
- *World Bank article which states that US\$90 per barrel is the equivalent of the 1980 oil shock*, World Bank
- John V. Mitchell, *A New Era for Oil Prices*; 32 Pages, Chatham House, London, August 2006
- *Belarus - Energy*, www.countrystudies.us/belarus/

- *Russia to adopt market gas price with Belarus from 2007*, People's Daily, 2006-04-17
- *Russia-Belarus gas deal reached*, BBC, 2006-12-31.
- www.bp.com
- www.gazprom.com
- www.lukoil.com
- www.rosneft.com
- www.surgutneftegaz.ru
- www.gazpromneft.com
- www.yukos.com
- www.fc-zenit.ru

Covalence SA 1, avenue Industrielle, CH-1227 Carouge Geneva Switzerland
Tel: +41 (0)22 800 08 55 ; Fax: +41 (0)22 800 08 56
US Rep Office, 20 Riverside Street, Apt. 25, Watertown MA 02472, USA, tel +(1) 617 429 4758
info@covalence.ch ; www.covalence.ch ; www.ethicalquote.com