

# THE CRISIS OF GAZPROM AS THE CRISIS OF RUSSIA'S "ENERGY SUPER-STATE" POLICY TOWARDS EUROPE AND THE FORMER SOVIET UNION

Andrey Kazantsev\*

## Abstract

*The deep and multidimensional crisis of Gazprom in 2009-2010 is analyzed in this paper as a crisis of the specific geopolitical model of the "energy super-state" that was especially important for Russian foreign policy towards Europe and the Former Soviet Union. Russia's attempts to monopolize the sphere of gas production and gas transportation in this part of the world, institutionally represented by the state-controlled monopoly Gazprom, was a key element for sustaining this geopolitical model. It is argued that this policy was based on a configuration of Russian geopolitical and economic interests that could be economically sustained only in the period of high energy prices. After the start of the global gas market crisis and, specifically, Gazprom's crisis, this configuration has started to disappear. This may have a profound influence on Russian foreign policy towards Europe and the Former Soviet Union.*

**Keywords:** *Energy security, Gazprom, Russian foreign policy, gas pipelines, EU, Central Asia and South Caucasus*

## Introduction

Revolution in Kyrgyzstan and the results of the presidential elections in Ukraine have both produced results which have been welcomed by the Kremlin. This has caused many comments about growing Russian influence in what it sees as its "near abroad". However, there is one factor that may very seriously affect Russian ambitions in both the Former Soviet Union (FSU) and in Europe. 2009, especially its first half, was a year of acute crisis for Gazprom. This multidimensional crisis still continues in less acute form in 2010. This crisis has not been yet consistently analyzed from the perspective of its potential consequences for Russian foreign policy and international politics. Below, I will analyze the crisis of Gazprom as a crisis of the specific geopolitical model adopted by Russia (a model of "energy super-state"), the influence of which was most clearly manifested in Russian relations with the FSU and Europe. Gazprom, in many respects, represented the economic basis of such geopolitical model. Therefore, the crisis of this model will undoubtedly have some complex consequences for Russian policy towards these parts of the world.

In order to analyze these potentially complex strategic changes which are under way I will, first, study the link between Gazprom and the Russian policy of "energy super-state", especially, in the context of

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\* **Dr. Andrey Kazantsev** is a Jean Monnet Fellow at the European University Institute, Florence, Italy. His research concentrates on Russian foreign policy and international relations in the Caspian Sea region.

Moscow's "revisionist" foreign policy<sup>1</sup> in the context of the FSU and in the European context. Then I will turn to an analysis of Gazprom's crisis in order to reveal the complex and profound character of these events. Finally, I will analyze strategic consequences of the crisis of Gazprom for the FSU and for Europe.

## **The Link between Gazprom and the "Energy Super-State" Geopolitical Concept in Russian Policy towards the FSU and Europe**

As Peter Rutland has shown, the oil and gas boom in Russia caused by the period of high global energy prices that coincided with Vladimir Putin's two presidential terms (2000 – 2008) increased the fusion of state and oligarchic power<sup>2</sup>, although this time the state, rather than the oligarchs, was leading in this fusion. When Vladimir Putin came to power in 2000, he initiated a campaign directed at diminishing the influence of oligarchs and establishing state control in strategic companies<sup>3</sup>. Gazprom was the focus of his attention from the beginning of his presidency<sup>4</sup> and he could use the fact that the previous leadership was stripping it of the assets transferred to such intermediary firms as Itera.

So the founder of Gazprom Victor Chernomyrdin, a chairman of the company's board of directors, and Rem Vyakhirev the CEO were both fired from their positions. They were replaced by Dmitry Medvedev and Alexei Miller, who had worked together with Putin in Saint-Petersburg's mayoral office. In 2005 different subsidiaries of Gazprom agreed to sell a 10.73% share of Gazprom to the state-owned company Rosneftgaz. Since the State Property Committee had a 38% share, this meant that the state became a key shareholder of this corporation. This created a new interpretation of Russia's interests as coinciding with the interests of Gazprom, according to the formula "what is good for Gazprom is good for Russia" (a rephrase of the well-known American saying about the equality of interests of General Motors and America). There is also a viewpoint that there was a coincidence of these two interests with the personal (often corrupt) interests of key representatives of Russia's political elite. For example, the link between Gazprom and corrupt interests of the representatives of Russian leadership was analyzed in an independent expert report by former vice premier Boris Nemtsov and former deputy energy minister Vladimir Milov<sup>5</sup>.

This new configuration of interests immediately caused specific international consequences. On 20 July 2006, the law "On Gas Export" came into force. It granted Gazprom an exclusive right to export natural gas. This was something that Gazprom de facto had possessed since the early 1990's, but at that time it was challenged by Russia's independent gas producers (vertically integrated oil companies that had their own gas fields) and by the pressure from Europe directed at adopting the Energy Charter Treaty. The establishment of direct or indirect state control over different energy assets was going on in Russia in different forms at that time<sup>6</sup>, from the period of the arrest of Mikhail Khodorkovsky (the former boss

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<sup>1</sup> Pierre Noël, "European gas security after the crisis (paper written for the European Council on Foreign Relations (ECFR), submitted to the EU Policy Seminar on "EU Policy on Russia: The Way Forward in 2009" European Commission, DG Relex & Czech Presidency of the Council, Brussels 23 April 2009).

<sup>2</sup> Peter Rutland, Putin's economic record: Is the oil boom sustainable?, *Europe-Asia Studies*, Vol. 60: 6 (2008): 1051-1072.

<sup>3</sup> Marshall I. Goldman, *Petrostate: Putin, Power and the New Russia* (Oxford: Oxford University Press, 2008), 104-105.

<sup>4</sup> Boris Nemtsov, Vladimir Milov. *Independent expert report. "Putin i Gazprom"* (Moscow, 2008), 3 – 4.

<sup>5</sup> Boris Nemtsov, Vladimir Milov. *Independent expert report. "Putin i Gazprom"* (Moscow, 2008).

<sup>6</sup> Heinrich Andreas, Under the Kremlin's thumb: does increased state control in the Russian gas sector endanger European energy security?, *Europe-Asia Studies* 60: 9 (2008): 1539-1574.

of Yukos)<sup>7</sup>, however, only in the gas sector was monopolization so significant. This had very deep roots in the specific character of privatization in Russia, since all state-owned gas assets were transferred to Gazprom, whilst to control oil assets, vertically integrated companies were created<sup>8</sup>. There was also a very important peculiar feature of the gas sector in Russia: only in this sector of the economy there was such a strong link between Russia's domestic economic and foreign policies. One of the reasons of this link between economics and foreign policy in this particular industry was that subsidized gas prices could be regularly used in Russia's relations with other former Soviet republics as a political instrument, which was very rarely the case with oil<sup>9</sup>.

This link was, for example, manifested in Russia's decision not to ratify the Energy Charter Treaty. In Europe this refusal, combined with such events as the energy crises in Ukrainian-Russian gas trade in 2006 and in 2009, made energy security concerns associated with Russian gas supplies a key political priority. In Russia this refusal to ratify promoted the perception of gas supplies as a new strategic instrument of influence in foreign policy. Russia signed the Energy Charter Treaty in 1994, but never ratified it. In December 2006 Putin said that the ratification of the treaty was unlikely. One of the reasons why Russia did not support it was due to the provisions requiring third-party access to Russia's pipelines.<sup>10</sup> It could mean that Gazprom would lose control over gas transportation from Central Asia. So, it is no wonder that Gazprom was the main lobbyist behind the decision not to ratify the ECT, while all other key Russian energy companies (oil corporations also having gas fields and interested in independent access to gas pipelines) and official bodies, in principle, agreed to its ratification<sup>11</sup>. See, for example, the position of deputy chairman of Gazprom Alexander Medvedev, expressed at an economic forum in London in 2006, where he declared that the Energy Charter Treaty and the transition protocol to it were "born dead" and "not reflecting the conditions of real market"<sup>12</sup>.

A leading expert in energy security, Pierre Noël of Cambridge University's energy policy research group, has described the political and international aspects of European energy security problems with Russia which subsequently developed by observing that "...under the leadership of Vladimir Putin, Moscow has merged its gas export policy with its resurgent and largely 'revisionist' foreign policy towards Europe"<sup>13</sup>. Russia tried to fuse Gazprom's dominant position in East European markets with attempts to return, at least, elements of its political influence and strategic control over this part of Europe (that was manifested, for example, in Russian opposition to American anti-missile shield plans in this part of Europe or with the attempts to increase gas leverage by constructing the North Stream

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<sup>7</sup> Richard Sakwa, *The quality of freedom: Khodorkovsky, Putin and UKOS affair* (Oxford: Oxford University press, 2009); David Hoffman, *The Oligarchs. Wealth and Power in the New Russia* (New York: Public Affairs, 2003).

<sup>8</sup> Stephen Fortescue, *Russia's Oil Barons and Metal Magnates. Oligarchs and the State in Transition* (Basingstoke: Palgrave Macmillan, 2006).

<sup>9</sup> Ogorodnikov Yevgeny, "Truba mechty". *Expert*, №4 : 91 (2010), [http://www.expert.ru/printissues/d/2010/04/truba\\_mechty?esr=4](http://www.expert.ru/printissues/d/2010/04/truba_mechty?esr=4) (accessed 14 March 2010).

<sup>10</sup> Dempsey Judy, "Russia gets tough on energy sales to Europe: No foreign access to pipelines, official says", *International Herald Tribune*, December 12, 2006.

<sup>11</sup> Alexey Grivach, Andrey Denisov, "Neudachi "energeticheskoy sverhderzhavy", *Rossia v globalnoy politike*, № 2 (2008), <http://www.globalaffairs.ru/numbers/31/9478.html> Accessed 6 March 2010 (accessed 10 April 2010).

<sup>12</sup> Ies-holding, "Medvedev: Mezhdunarodnaya energeticheskaya hartia – document mertvorozhdenny i neadekvatny rynku, 26 April 2006". Ies-holding, [http://www.ies-holding.com/industry\\_id1755.html](http://www.ies-holding.com/industry_id1755.html) (accessed February 10, 2010).

<sup>13</sup> Pierre Noël, "European gas security after the crisis (paper written for the European Council on Foreign Relations (ECFR), submitted to the EU Policy Seminar on "EU Policy on Russia: The Way Forward in 2009" European Commission, DG Relex & Czech Presidency of the Council, Brussels 23 April 2009).

and the South Stream pipelines). It has caused deep energy security concerns in these countries<sup>14</sup>, especially given their traumatic experiences of Soviet dominance. These concerns became an important subject of discussions both in the EU and NATO.

There appeared energy security problems with Russia not only for the European countries, but also for the FSU. Moreover, these problems were tightly interconnected, as in the case with the crises in Russian-Ukrainian gas trade that interrupted gas supplies for the European market in 2006 and 2009. “Many European officials viewed the Russian action as an attempt to use gas as a political weapon to blackmail a neighboring consumer state that depends heavily on Russian supplies of natural gas”<sup>15</sup>. The Russian leadership and Gazprom were accused by the Europeans of artificially linking political issues to economic disputes and using the dependence of Europe and the FSU on Russian gas for achieving political purposes.

The main idea of merging Russia’s energy with foreign policy came, in fact, from Russia’s weakness: a structurally weak economy based on the export of raw materials as the main source of revenues. However, there was a desire amongst the Russian political elite, supported by broad layers of society which were tired of failed liberal reforms, to return to, at least, some elements of Russia’s superpower status of the Soviet period. A return to this superpower status could be, from an economic point of view, supported only by Russia’s role in the energy markets, especially its near-monopoly in gas supplies to some Eastern European countries and the FSU.

President Putin’s speech at the meeting of the Russian Security Council at the end of 2005 gave rise to discussion of a new foreign policy idea – Russia as an ‘energy super-state’<sup>16</sup>. Russia also put energy security at the center of the Saint-Petersburg G8 Summit in 2006. For Russia’s political leadership this energy discourse played the role of a bridge, a trade-off between political and strategic considerations, on the one hand, and economic rationality, on the other hand. So, now Russia, according to this logic, could simply use some of its existing advantages (big energy deposits and control over energy transportation routes in the FSU) in order to become richer, and, at the same time, raise its international status, at least in relations with Europe and the FSU. However, as illustrated below, this logic worked well only in the period of high energy prices.

Simultaneously, the discourse of using energy as a “new armament”, an instrument of political influence became widespread in Russia’s officially controlled mass-media, mostly due to the works of Konstantin Simonov<sup>17</sup>, who developed very cautious official formulations<sup>18</sup> into the discourse of “a new Russian strategic armament”<sup>19</sup>.

In the case of Russian policy towards the FSU, this new officially supported discourse of Russia as an “energy superstate” relocated the trade-off between economic and political considerations within

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<sup>14</sup> Tomas Valasek. NATO, Russia and European security (London: Centre for European Reform, 2009), 37 - 38.

<sup>15</sup> Gawdat Bahgat. Europe’s energy security: challenges and opportunities. *International Affairs*, vol. 82: 5 (2006): 962.

<sup>16</sup> Vladimir Putin, “Opening Address to the Meeting of Security Counsel of Russia on the Role of Russia in Guaranteeing International Energy Security”, 22 December 2005, Official site Kremlin.ru, <http://www.kremlin.ru> (accessed December 15, 2007).

<sup>17</sup> Konstantin Simonov, *Energeticheskaya sverkhderzhava* (Moscow, Eksmo-Press, 2006); Konstantin Simonov. *Globalnaya energeticheskaya voyna. Tayny sovremennoy politiki* (Moscow: Algorithm, 2007).

<sup>18</sup> Andrey Kokoshin. *Mezhdunarodnaya energeticheskaya bezopasnost*. (Moscow: Evropa, 2006).

<sup>19</sup> Marshall I. Goldman, *Petrostate: Putin, Power and the New Russia* (Oxford: Oxford University Press, 2008).

another strategic dilemma. On the one hand, the Russian leadership wanted to optimize its foreign policy in terms of diminishing subsidies to the FSU, which was especially clear in the case of gas trade. This economically rational type of Putin's reasoning was most famously expressed in his phrase that one should not mix "flies and cutlets" that so deeply insulted President Lukashenko of Belarus in 2002 and heralded the start of Russia's new campaign to diminish the costs of its involvement with the FSU. This campaign turned later into attempts to make gas prices for former Soviet republics equal to European prices. On the other hand, Russia's leadership still kept and even increased the rhetoric which defined the FSU as a "near abroad" of Russia, a territory where Russia had specific influence and interests. That was very useful for domestic propaganda through state-controlled media. It was also considered as a guarantee of saving, at least, some of the elements of Russia's privileged status in international affairs as a kind of regional power.

As a result of this combination, the geopolitical combination of Russian power and Gazprom in the FSU was built in the period of high energy prices according to the following formula. Russia was interested in control over the European FSU, especially Ukraine, because the lion's share of Russian gas to Europe went through this country. Also, Gazprom had to supply its cheap gas (or redirect Central Asian gas) to Ukraine and Belarus because they controlled Russian energy and automobile transportation routes to Europe. Russia was interested in Central Asia because it gave cheap gas for the Ukrainian market (or to some other FSU markets) or to compensate for the deficit of gas on Russia's domestic market.

The business of re-selling Turkmen gas (or redirecting it to Ukrainian market) was very profitable for Gazprom in the 1990s. However, from 2002 to 2008 the costs of Gazprom associated with the purchases of Central Asian gas grew more than 20 times<sup>20</sup>. According to the assessments of some experts Gazprom's trade in Central Asian gas was only marginally profitable already in 2007<sup>21</sup>. Since the beginning of 2008 Gazprom agreed to buy Turkmen, Uzbek and Kazakh gas at the European price (300 dollars per 1000 cubic metres) which made it totally unprofitable. Nevertheless, in 2006–2008 Gazprom every year purchased more than 60 billion cubic meters (bcm) of Central Asian gas, of which more than 40bcm came from Turkmenistan.

Russia was, and still is, alarmed by the possibility of cheap Central Asian gas appearing on European markets because it would compete with Gazprom's gas. A related fear was the danger of the South Caucasus being used for the transportation of Central Asian gas (through a Transcaspian gas pipeline and the Nabucco project) to Europe. As a result of this, Russian geopolitical power in the CIS serves the commercial purpose of keeping Gazprom's position in European gas markets. So power considerations were mixed with the aspiration for profits, as it was in the case of European trade companies of the Early Modern period (like the European East- and West-Indian Trading Companies of the seventeenth–nineteenth centuries).

As a result of this combination of Russian power and Gazprom's gas both in the EU and in the FSU "...Mr Putin had overseen a period of empire-building by Gazprom that saw it lock in supplies at market prices from Central Asian producers to head off potential competition from the European Union, while also attempting to increase its hold over European markets – where it has traditionally

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<sup>20</sup> Kirill Martynov. "Zatraty na pokupku gaza za granizey lozhatsya tyazhelym bremenem na bydjet Gazproma, stav uzhe osnovnoy statyey rashodov", *Kommersant*, June 24, 2008.

<sup>21</sup> Ibid.

supplied about 25 per cent of the continent's imports – via the building of North Stream and South Stream pipelines. Not all of these costly politically driven projects, however, appear to have had a strong economic foundation.<sup>22</sup> Moreover, as demonstrated below, this house was built on sand. The whole combination of energy economics and politics was based on high energy prices. It therefore started to collapse at the beginning of the world economic crisis, when Gazprom's long-term problems, as well as the structural weaknesses of Russia's "energy super-state" policy, became apparent super-state.

## Gazprom's crisis in 2009-2010

In 2009 due to a combination of reasons that included a gas dispute with Ukraine, the influence of the global economic crisis, the competition from liquefied natural gas from the Persian Gulf, increased volume of gas production in the USA due to the changes in technologies, and so on, the volume of Russian gas export to Europe, the main export market for Gazprom, fell by 12.3%<sup>23</sup>. The biggest drop was in the first half of the year. This was accompanied by quickly falling income from gas sales; as a result, net income fell 19%. According to the Deputy Director of "Gazprom export" (one of the subdivisions of Gazprom) Sergey Chelpanov,<sup>24</sup> the Russian gas export monopoly managed to sell in Europe and other non-FSU' and non-Baltic states' markets 140 billion cubic meters (bcm) of gas in 2009, which is 20bcm less than in 2008<sup>25</sup>. Due to the improving global economic situation Gazprom managed to somewhat recover sales in the first quarter of 2010. According to Alexei Miller, the Gazprom, CEO, sales to some European states increased 40% in the first quarter of 2010 compared with the first quarter of 2009<sup>26</sup>. However, even in the first quarter of 2010 Gazprom's income from gas sales in Europe was more than 20% lower than in the same period of 2009, when there was the most acute crisis in the European gas market. Gas sales to the FSU countries and Baltic states continued to fall even in 2010, and are 10 % lower than in the first quarter of 2009.

Gazprom still has positive plans about the volume of gas sales in Europe in 2010 and it expects price growth. However, according to the assessment of Jonathan Stern, director of gas research at the Oxford Institute for Energy Studies, these hopes are not justified. "The situation is not easing. We are going into summer when demand will go down. For the next 2 to 3 years it is going to be very very difficult for anyone trying to sell into Europe on oil-linked prices."<sup>27</sup> Long-term perspectives for the global gas market are also not good; there is a prognosis that global gas production may exceed demand by up to 200bcm a year by 2015.<sup>28</sup> One of the reasons of this is technological change, especially, associated with shale gas (a natural gas produced from shale, one of "unconventional" sources of natural gas). This technology has existed in the USA for a long time, however, only recently that new technologies such as hydraulic fracturing have made it profitable. Shale gas has in 2009 significantly boosted American gas production. As a result, new LNG facilities in the Middle East originally aimed at supplying the United States have reoriented to the European market. Big investments into LNG

<sup>22</sup> Belton Catherine, "Sweeping market changes leave Gazprom in an unenviable position", *Financial Times*, May 25, 2010.

<sup>23</sup> "Poteryali liderstvo". *Expert* # 4: 91 (2010), [http://www.expert.ru/printissues/expert/2010/04/news\\_poteryali\\_liderstvo/](http://www.expert.ru/printissues/expert/2010/04/news_poteryali_liderstvo/) (accessed 13 April 2010).

<sup>24</sup> *Vremya Novostey*, "Gazprom hochet povysit zeny. Kompania provela "Den investora posle provalnogo goda", February 08, 2010.

<sup>25</sup> *Ibid.*

<sup>26</sup> Belton Catherine, "Sweeping market changes leave Gazprom in an unenviable position", *Financial Times*, May 25, 2010.

<sup>27</sup> *Ibid.*

<sup>28</sup> IEA/OECD. *World Energy Outlook* (Paris, 2009), 363 – 507.

infrastructure in the Middle East and in Europe are a guarantee that liquefied natural gas will continue to push Russian pipeline gas out of European markets<sup>29</sup>.

According to the assessment of one expert, shale gas will constitute half of the natural gas production in North America by 2020<sup>30</sup>. There are also some assessments that shale gas will also significantly expand worldwide energy supply<sup>31</sup>. Some analysts “said they believed that gas reserves in many countries could increase over the next two decades, comparable with the 40 percent increase in the United States in recent years”.<sup>32</sup> Most strategically important for Gazprom and the Russian economy are the plans to develop shale gas production in Europe, especially in Hungary<sup>33</sup> and Poland<sup>34</sup>, i.e. in Eastern Europe where European dependency on Russian gas is mostly concentrated<sup>35</sup>: “... energy analysts are already predicting that shale could reduce Europe’s dependence on Russian natural gas”<sup>36</sup>. In a recent study by James A. Baker’s Institute for Public Policy in Rice University it is underlined that shale gas resources in the United States can play an important role in containing Russia’s leverage over the global natural gas market<sup>37</sup>.

During 2009 Gazprom’s representatives tried to be as optimistic about the competition from shale gas as possible. They used different economic considerations to prove that Europe could not afford using shale gas technology. However, at present the cost of shale gas in the USA is lower than the price of imported gas. It is less than \$90 per 1000 cubic meters. At the same time, Gazprom’s gas sales in the domestic Russian market stopped bringing financial losses only in 2009, when the price for gas on the domestic market approached \$80 per 1000 cubic meters. So some Russian experts think that the cost of shale gas is, in fact, not much higher than the cost of Gazprom’s conventional gas<sup>38</sup>. Gazprom was therefore made to recognize the importance of the new technology. In October 2009 it announced that it may buy a US shale-gas producing company to gain expertise which it could then apply to Russian shale gas prospects<sup>39</sup>.

If the assessments of long-term excess gas supply on the world markets (due to the new technologies and the continuation of short-term shortage of demand in Europe due to the financial crisis) are true, then Gazprom will have to completely rethink its export strategy.

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<sup>29</sup> “Poteryali liderstvo”. *Expert* # 4: 91 (2010), [http://www.expert.ru/printissues/expert/2010/04/news\\_poteryali\\_liderstvo/](http://www.expert.ru/printissues/expert/2010/04/news_poteryali_liderstvo/) (accessed 13 April 2010).

<sup>30</sup> Shaun Polczer, “Shale expected to supply half of North America's gas”, *Calgary Herald*, April 9, 2009.

<sup>31</sup> Clifford Krauss, “New way to tap gas may expand global supplies”, *New York Times*, October 9

<sup>32</sup> *Ibid.*

<sup>33</sup> Jack Z. Smith, “Barnett Shale seen as model for drillers worldwide,” Fort Worth Star-Telegram, 29 September 2009, <http://www.star-telegram.com/business/story/1645247.html> (accessed 11 October 2009).

<sup>34</sup> Reuters, Conoco sees promise in Polish shale gas-exec, 9 September 2009, Reuters, <http://uk.reuters.com/article/idUKN0935751320090909> (accessed 12 September 2009); Louise S. Durham, “Poland Silurian shale ready for action”, (AAPG Explorer, February 2010), p.14-18.

<sup>35</sup> Pierre Noël, “A Market Between us: Reducing the Political Cost of Europe’s Dependence on Russian Gas” (EPRG Working Paper 0916, Cambridge, 2009), p. 2.

<sup>36</sup> Clifford Krauss, “New way to tap gas may expand global supplies,” *New York Times*, October 9, 2009.

<sup>37</sup> James A. Baker’s Institute for Public Policy in Rice University, “Russia and the Caspian States in the global energy balance” (Executive summary by Amy Myers Jaffe, 2009), 29.

<sup>38</sup> Ogorodnikov Yevgeny, “Truba mechty”, *Expert*, №4 : 91 (2010), [http://www.expert.ru/printissues/d/2010/04/truba\\_mechty?esr=4](http://www.expert.ru/printissues/d/2010/04/truba_mechty?esr=4) (accessed 14 March 2010).

<sup>39</sup> Bloomberg, “Gazprom takes a look at U.S. shale-gas producer,” *Moscow Times*, 22 October 2009, available: <http://www.themoscowtimes.com/business/article/gazprom-takes-a-look-at-us-shale-gas-producer/387930.html>

The crisis of demand for Russian gas has coincided with the crisis of supply caused by internal Russian and Central Asian developments. In 2009 Russia lost the position of top global gas producer because of the growth of shale gas production in the USA and diminished gas production in Russia. In 2009 Gazprom's gas production fell to 462.16bcm, which is 16% less than the level of production in 2008<sup>40</sup>. The situation with gas production in Russia started to improve in the first quarter of 2010 due to the improving world economic situation. 181.65bcm of gas was produced in Russia in this period, which is 18.3% more than the results for the first quarter of 2009<sup>41</sup>. However, different long-term problems with supply, demand, management, technology, organization, and so on have remained and this means that the crisis of Gazprom continues, although a general improvement of economic situation in Russia and in the world can alleviate this crisis and even make it latent, in some respects.

Russian experts are underlining the fact that the Russian oil companies that are not so monopolized, not so tightly controlled by the state and are not linked with Russian foreign policy ambitions, did very well in 2009 irrespective of the global crisis. In 2009 Russia produced more oil than Saudi Arabia. In 2009 oil production in Russia increased 1.25 % and reached 494,228 million tons<sup>42</sup>. Every day Russia pumped out 9.925 million barrels of oil, while Saudi Arabia, due to OPEC's production-cutting decisions, diminished oil production to 8 million barrels per day<sup>43</sup>. Russian oil exports to non-FSU and non-Baltic states' markets in 2009 have increased 467%<sup>44</sup>. In the first quarter of 2010 oil production in Russia grew 3.2% compared to the same period of the previous year<sup>45</sup>. This good performance of Russian oil companies poses many questions about the nature of Gazprom's crisis and, according to many experts, indicates a necessity of deep structural reforms.

The most important thing is that the crisis of Gazprom's production is long-term. The crisis of production of 2009 was not only a result of falling gas consumption in Europe and the FSU. It was also a logical result of the long-term tendency of falling productivity in Gazprom's older gas fields. And from this point of view it, in its present form, does not already fulfill the function that it was created for – to supply the Russian economy with large amounts of cheap gas. This was underlined in the independent report by former Russian deputy prime premier Boris Nemtsov and former deputy energy minister Vladimir Milov published in 2008, where this crisis of production was predicted: "...Gazprom's gas production all these years was not increasing, in 2007 it lowered to the level of 1999. Taking into account depletion of old gas deposits in the nearest time stagnation of gas production will turn into deep decline of production"<sup>46</sup>.

The problems with Gazprom's gas production inside Russia are amplified by the crisis with Central Asian (especially Turkmen) gas which has become especially acute since 2009. The business of re-selling Turkmen gas was very profitable in the 1990s. However, from 2002 to 2008 the costs of

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<sup>40</sup> V 2009 godu RF dobyla bolshe nefi, 11 January, 2010, Reuters, <http://ru.reuters.com/article/businessNews/idRUMSE60A0AR20100111> (accessed 20 January 2010).

<sup>41</sup> Rosbizneskonsulting, "Rossia v 1 kvartale 2010 uvelichila dobychu nefi, gaza i uglja", 02 April, 2010, Rosbizneskonsulting, <http://top.rbc.ru/economics/02/04/2010/388094.shtml> (accessed 20 April 2010).

<sup>42</sup> Lenta.ru, "Rossia v 2009 gody uvelichila dobychu nefi", 11 January, 2010, Lenta.ru, <http://www.lenta.ru/news/2010/01/11/oil/> (accessed 20 January 2010).

<sup>43</sup> V 2009 godu RF dobyla bolshe nefi, 11 January, 2010, Reuters, <http://ru.reuters.com/article/businessNews/idRUMSE60A0AR20100111> (accessed 20 January 2010).

<sup>44</sup> Ibid.

<sup>45</sup> Rosbizneskonsulting, "Rossia v 1 kvartale 2010 uvelichila dobychu nefi, gaza i uglja", 02 April, 2010, Rosbizneskonsulting, <http://top.rbc.ru/economics/02/04/2010/388094.shtml> (accessed 20 April 2010).

<sup>46</sup> Boris Nemtsov, Vladimir Milov. *Independent expert report. "Putin i Gazprom"* (Moscow, 2008), 5.

Gazprom associated with the purchases of gas (mostly Central Asian) grew more than 20 times<sup>47</sup>. According to the assessments of some experts Gazprom's trade in Central Asian gas was only marginally profitable already in 2007<sup>48</sup>. In 2008 the costs of purchasing Central Asian gas became the main article of Gazprom's operational costs. From the beginning of 2008 Gazprom, due to growing Chinese competition (a new pipeline project to Turkmenistan was started) had to agree to buy Turkmen, Uzbek and Kazakh gas at the European price (\$300 per 1000 cubic metres).

When the crisis of demand for Russian gas in Europe became especially acute Gazprom unilaterally stopped purchasing Turkmen gas because its losses from this operation became unbearable. On 8 April 2009 the pipeline blew up due to a pressure imbalance caused by Gazprom's unilateral decision to stop receiving Turkmen gas: the Turkmen leadership directly blamed Gazprom for this catastrophe<sup>49</sup>. Gazprom became even less important for Turkmenistan when, on 14 December 2009, the Turkmenistan-China pipeline was inaugurated. Simultaneously, one more pipeline to Iran from Turkmenistan has been added to the country's existing pipeline network.

So, although Turkmenistan has lowered prices somewhat (to \$222 per 1000 cubic meters) and although Gazprom is still trying to save, at least, an illusion of its former omnipotence in Central Asia, in 2010 Gazprom has contracted only 10bcm (which is even less than in 2009, when for the most part of the year Gazprom did not receive Turkmen gas at all due to the accident on the Dawletabad-Darialyk pipeline)<sup>50</sup>.

Since China as well as Iran usually refuses to pay European prices for the raw materials that it buys, Central Asians will try to rebuild their energy relationship with Russia because they do not want to fall into complete dependency on these Asian energy purchasers. But Gazprom can return only if the European market provides the company with financial stability. In the short-term and, probably, if the prognoses about the excessive gas supplies are correct, in the medium-term perspective this is impossible.

Because of Gazprom's crisis of production it will have to concentrate on its projects in Russia. According to the opinion of chief analyst of Moscow bank "Uralsib" Chris Weafer, "the primary task of Gazprom will be to develop the deposits on Yamal peninsula, in particular, because this is the only source of gas that can compensate for expected depletion of existing deposits"<sup>51</sup>. Since Gazprom will have to concentrate on its Yamal mega-project, as it still wants to construct both the North and the South Stream pipelines and entered a severe debt crisis in 2009 (its debts approached a level of \$60 billion dollars<sup>52</sup>), Gazprom will simply not have the interest and resources to pay for expensive Central Asian gas.

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<sup>47</sup> Kirill Martynov. "Zatraty na pokupku gaza za granizyey lozhatsya tyazhelym bremenem na bydjet Gazproma, stav uzhe osnovnoy statyey rashodov", *Kommersant*, June 24, 2008.

<sup>48</sup> Ibid.

<sup>49</sup> Deutsche welle, "Turkmenia obvinyaet Gazprom vo vzryve na gazoprovode", Deutsche Welle, 10 April 2009, <http://www.deutschewellemusik.de/dw/article/0,,4168252,00.html> (accessed 20 April 2009).

<sup>50</sup> Rossbiznesskonsulting-Ukraine, "Gazprom snizil zeny na gas dlya loyalnyh Rossii stran", RBC-Ukraine, 03 June 2010, Rossbiznesskonsulting-Ukraine, <http://www.rbc.ua/rus/top/show/-gazprom-snizil-tseny-na-gaz-dlya-loyalnyh-rossii-stran-03062010102400> (accessed June 10, 2010).

<sup>51</sup> Inosmi.ru, "Gazprom menyaet plany: Zdravstvuy, Yamal, do svidanya, Shtockman", <http://www.inosmi.ru/politic/20100201/157917477.html> (accessed 1 June 2010).

<sup>52</sup> *Vremya Novostey*, "Gazprom hochet povysit zeny. Kompania provela "Den investora posle provalnogo goda", February 08, 2010.

In principle, Gazprom's alternative since 1991 was always the same: to produce gas in Siberia, or to buy it in Central Asia. If the cost of producing gas in Siberia is lower than there is no economic reason to buy gas in Central Asia. And especially, after Yamal project is realized, Gazprom, in a long-term perspective, will have even less incentives to go to Central Asia.

## Potential Consequences of Gazprom's Crisis for Europe and the FSU

Below, I will divide the international consequences of the crisis of Gazprom into three respective groups: the Kremlin's abandonment "energy super-state" concept, and the foreign policy consequences for Europe and for the FSU.

**The concept of "energy super-state" is abandoned.** Gazprom's bad performance, especially as compared to Russian oil companies, has caused widespread criticism in the Russian press<sup>53</sup> that reflects dissatisfaction of many representatives of the Russian political elite. Many external observers, for example, Anders Aslund, a senior fellow at the Peterson Institute for International Economics, also think that the crisis of Gazprom may cause some reforms in Russian gas sector<sup>54</sup>. Stacy Closson, a fellow at the Woodrow Wilson Center in Washington, D.C., believes however that one should be cautious in predicting the actual degree of change within Gazprom, although, the changes may spread out of Gazprom to other political and economic spheres<sup>55</sup>. Since Gazprom is a backbone not only of Russian foreign policy, but also of the domestic political system, Closson argues that its crisis may have deep political consequences<sup>56</sup>. One may doubt that the Russian leadership will conduct real reforms as a result of the crisis of Gazprom. However, there is a real conceptual change that may have a significant influence on foreign policy. From the start of the global economic crisis the rhetoric of an "energy super-state" in Russia has been completely forgotten by official mass-media, and the problems of Russia's modernization and excessive reliance on oil and gas exports are extensively discussed<sup>57</sup>.

One can guess that Gazprom's problems are very important from this point of view. It is important to mention in this respect that Russian President Dmitry Medvedev, who initiated this conceptual change, was a chairman of Gazprom's board of directors in 2000-2001 and, after a short interruption, in 2002-2008. Medvedev, in his annual address to the Federal Assembly on 5 November 2009, called for an

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<sup>53</sup> Alexey Grivach, Andrey Denisov, "Neudachi "energeticheskoy sverhderzhavy", *Rossia v globalnoy politike*, № 2 (2008), <http://www.globalaffairs.ru/numbers/31/9478.html> Accessed 6 March 2010 (accessed 10 April 2010); Poteryali liderstvo. *Expert* # 4: 91 (2010), available: [http://www.expert.ru/printissues/expert/2010/04/news\\_poteryali\\_liderstvo/](http://www.expert.ru/printissues/expert/2010/04/news_poteryali_liderstvo/) (accessed 13 April 2010); Ogorodnikov Yevgeny, "Truba mechty". *Expert*, №4 : 91 (2010), [http://www.expert.ru/printissues/d/2010/04/truba\\_mechty?esr=4](http://www.expert.ru/printissues/d/2010/04/truba_mechty?esr=4) (accessed 14 March 2010).

<sup>54</sup> Anders Aslund. Gazprom's new weakness offers opportunity, European dialogue, <http://eurodialogue.org/energy-security/Gazprom-new-weakness-offers-opportunity> (accessed 14 March 2010)

<sup>55</sup> Stacy Closson, The End Of Gazprom's Reign? *Radio Free Europe*, January 05, 2010, [http://www.rferl.org/content/The\\_End\\_Of\\_Gazproms\\_Reign\\_/1921463.html](http://www.rferl.org/content/The_End_Of_Gazproms_Reign_/1921463.html) (accessed 1 June 2010)

<sup>56</sup> Ibid.

<sup>57</sup> Oleg Maslov, Novaya rossiyskaya energeticheskaya doktrina: ot anklavno-arhaicheskoy "energeticheskoy sverhderzhavy" k globalnoy Energeticheskoy Hartii, *Nezavisimoe analiticheskoe obozrenie*, May 24, 2009, <http://www.polit.nnov.ru/2009/05/24/energoconcept8/> (accessed April 10, 2010); Oleg Maslov. Konkurentnaya strategiya prezidenta Medvedeva: kompleksny plan razvitiya energetiki Rossii i novaya rossiyskaya energeticheskaya doktrina. *Nezavisimoe analiticheskoe obozrenie*, February 20, 2009, <http://www.polit.nnov.ru/2009/02/20/rosenergdocr5/> (accessed April 10, 2010).

end to the Russian economy's heavily reliance on oil and gas<sup>58</sup>. This address was preceded by Medvedev's widely discussed article "Forward, Russia", where it was proclaimed that Russia should modernize and decrease its concentration on the raw material sector of its economy<sup>59</sup>.

Aside from Medvedev's own texts there was a report, "Russia of the Twenty-First Century: The Image Of The Desired Future" published by the Institute of Modern Development, a think-tank close to Medvedev, which was released on 3 February 2010. According to this report, Russia's future includes a return to democratic practices, the abolition of the FSB, and acquiring membership of the EU and NATO<sup>60</sup>. However, it is underlined that it is only a passive "vision" of Russia's future, not a project to be actively realized. This may reflect the specificity of Medvedev's position within the "tandem" with prime minister Vladimir Putin.

**International consequences for Europe.** Although Gazprom's crisis is not a solution to all of Europe's energy security problems posed by Russian gas, it opens many new opportunities. First of all, since Gazprom's position in European gas markets is threatened, especially if there is a long-term tendency of excessive gas supply, Russian ability to transform European dependence on its gas into political leverage is significantly diminished. So European problems with energy security posed by dependence on Russian gas will be diminished.

Second, taking into account the need to develop new gas fields due to Gazprom's production crisis, there will be some improved investment opportunities for European companies in Russia. Third, "Gazprom's acute crisis offers the best opportunity for Russian and European energy reform"<sup>61</sup>. Since Russia has to abandon its "energy super-state policy", it may be more interested to find a long-term institutional solution to European-Russian energy security problems that would diminish uncertainty and improve investment opportunities and Gazprom's capitalization. In this respect, one can consider, for example, Medvedev's proposal about a new global energy charter<sup>62</sup>. However, the road to finding agreement in this direction may be quite long, especially taking into account Russia's final refusal to sign the Energy Charter Treaty in 2009.

**International consequences for the Former Soviet Union.** Since Central Asian gas is too expensive for Gazprom at present, and since Gazprom's main competition will now come from LNG from the Persian Gulf and shale gas projects in Europe, the South Caucasus and Central Asia are disappearing from the Kremlin's geopolitical scheme of attaching gas interests to foreign policy priorities. This is a key change, because now Russia will have no significant economic interest in its political and military presence in both the South Caucasus and Central Asia. So, in these two regions the political and security logic of the Russian state, on the one hand, and its economic interests, on the other hand, will totally disengage. Taking into account the tendency of the current Russian leadership to trade off between security and economic interests, this could have a profound, although perhaps ambiguous

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<sup>58</sup> Dmitry Medvedev. Poslanie Federalnomu Sobraniyu Rossiyskoy Federacii, November 12, 2009, official site Kremlin.ru, <http://www.kremlin.ru/transcripts/5979> (accessed November 10, 2009).

<sup>59</sup> Dmitry Medvedev. Rossiya, vpered, September 10, 2009, official site Kremlin.ru, <http://news.kremlin.ru/news/5413> (accessed October 9, 2009).

<sup>60</sup> Institut sovremennogo razvitiya, *Rossia XXI veka: obraz zhelaemogo zavtra* (Moscow: Ekon-Inform, 2010).

<sup>61</sup> Anders Aslund. "Gazprom's new weakness offers opportunity", European dialogue, <http://eurodialogue.org/energy-security/Gazprom-new-weakness-offers-opportunity> (accessed 14 March 2010).

<sup>62</sup> Konceptualny podhod k novoy pravovoy baze mezhdunarodnogo sotrudnichestva v sfere energetiki (zeli i principy), April 21, 2009, official site Kremlin.ru, <http://archive.kremlin.ru/text/docs/2009/04/215303.shtml> (accessed 19 May 2009).

effect on Russian foreign policy. However, these changes can differently affect Russian policy in different FSU states. In general, I would argue that the significance of these changes should be higher in the more eastern FSU states and lower in the more western ones. So, it will be very important in Central Asia and in the eastern part of the South Caucasus (i.e. Azerbaijan), and less important for Georgia, Ukraine and Belarus.

Ukraine and Belarus still control Russian key oil, gas and highway transportation routes to Europe. Because of this Gazprom still has an important responsibility to supply gas to Ukraine and Belarus at lower prices than to Europe. The degree of Russian economic interdependency with Ukraine and Belarus, even outside of energy, is also much higher than with the countries of South Caucasus and Central Asia. There is also a great deal of interest amongst the Russian public towards these two Slavic countries which are very close to the Russians by their language, culture and religion. So it is highly unlikely that Russia will abandon its strategic interest towards these two FSU states simply because of the current crisis of Gazprom. The plans to unify Gazprom and Ukraine's Naftogaz, and the growth of Russian pressure on Belarus' leadership, are indicative of this.

Russia may start gradually diminishing its interest towards Belarus and Ukraine only after its dependence on these transit countries (and Gazprom's responsibility to supply them with cheap gas) diminishes, after the realization of alternative pipeline projects such as North Stream and South Stream. But even this process will be very complex and contradictory, since other transportation interests, the deep degree of economic interdependency and identity considerations will still be important.

With the South Caucasus and Central Asia the situation seems to be much clearer. After the realization of the Central Asia-China pipeline project (and even due to the expectation of this before its physical realization) Central Asian gas has become too expensive for Gazprom because now it can compete with China only by giving a better price. Two events (China's entrance into the Central Asian market and Gazprom's crisis in European markets) mutually increase the influence of each other. Gazprom still can compete with the Chinese in Central Asia, but in this case it has to give to the Central Asians a price according to the European formula. This is possible only when everything is fine with Gazprom's business in Europe.

Russian goods have, in general, lost economic competitiveness to European, Turkish and Chinese goods in the South Caucasus and Central Asia. Supporting trade which is based on quickly-disappearing residual elements of the huge interdependency created during the Soviet period does not demand a continuation of military presence or political control. As a result of this, there is now no significant economic interest to support Russia's presence in these two regions.

Therefore if Russia chooses to support the elements of its lost Soviet empire in the South Caucasus and Central Asia, it would have no economic compensation for it. Russian corporations may still continue to purchase strategic elements of infrastructure in some FSU countries like Armenia; however, these acquisitions will not generate such profits as the gas trade in the period of high energy prices did. Russia's presence in these regions basically has no appeal to the Russian public, so it does not pay domestically either. This is underlined by growing racist and xenophobic attitudes in Russia towards migrants from the South Caucasus and Central Asia. In this case identity is even playing the role of a negative factor, diminishing Russian interest in these regions.

Taking into account the fact that both Putin and Medvedev always keep in mind economic rationality, taking it into consideration in any trade-offs between economic and political considerations, one can assume that they will continue to use some elements of the old rhetoric of the “privileged Russian interests” in “the near abroad”; however, they will try to minimize the real costs of involvement into Caucasian and Central Asian affairs. It could mean that the Kremlin will try to cautiously withdraw from areas where it has less economic interests.

Of course, the security and political considerations of Russia’s elite which defined the Kremlin’s policy in Central Asia and South Caucasus in Putin’s era would remain. However, the long-term character of Gazprom’s crisis indicates that Russia will have objectively far fewer resources for active foreign policy in these regions, even after the end of the global financial crisis. And the idea that Russia can combine its political influence in its “near abroad” with economic prosperity derived from the energy trade, which was an essence of the “energy super-state” concept, will disappear. If Russia wants to still control the FSU, it will have to spend a lot on it, and this contradicts the interests of the Russian economy itself. Of course, since a trade-off between political and economic considerations will be involved, the future policy of Russian withdrawal from these two regions will not become apparent very quickly, since there will be a struggle between different considerations and groups of interests inside Russia.

Most probably, the withdrawal would be accompanied by different symbolic gestures that would conceal the real course of events from the Russian population, because the nationalist discourse of having a “privileged sphere of interest” is still very important for domestic propaganda supporting the existing regime. This is especially important in cases where the most acute recent crises have taken place. Therefore one cannot expect a quick Russian withdrawal, for example, from Abkhazia and South Ossetia, especially if Georgian President Mikheil Saakashvili, such a symbolically important figure for Russian propaganda, remains in power. Withdrawal will continue from the places that do not appear so often in Russia’s mass-media, such as Azerbaijan and Armenia in the South Caucasus, or the Central Asian FSU states.

There is one more factor that will predetermine the continuation of Russia’s economically motivated interest in the South Caucasus, even after the end of Gazprom’s reign in Central Asia. The Chinese presence on Central Asian gas markets harms Gazprom’s interests; however, it is not so dangerous as the potential construction of the Nabucco and Trans-Caspian pipelines, simply because if Central Asian gas goes to China, it is diverted from the European market. The same can be said of the planned Trans-Afghan pipeline diverting Central Asian gas to Pakistan and India. Unlike these projects, Nabucco and the Trans-Caspian pipeline would circumvent Russia’s hold of export routes to Europe.

From this point of view one also can make a prognosis about the continuation of Russian interest in Georgia, since destabilization of this bottle-neck will harm any transportation projects for Central Asian gas to Europe. For example, according to the opinion of John Roberts, an expert at Platts on energy security, the Russian-Georgian war of 2008 harmed the reputation of the South Caucasus as a secure route of oil and gas transportation and, therefore, it was not conducive to the construction of Nabucco and other alternative pipelines<sup>63</sup>. At the same time, Azerbaijan and Armenia (which has still not normalized relations with Turkey) are not so important from the point of view of the construction

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<sup>63</sup> John Roberts, *Gruzia kak zhertva politiki truboprovodov*, August 13, 2008, Russian service of BBC, [http://news.bbc.co.uk/go/pr/ft/-/hi/russian/business/newsid\\_7558000/7558832.stm](http://news.bbc.co.uk/go/pr/ft/-/hi/russian/business/newsid_7558000/7558832.stm) (accessed August 20, 2008)

of alternative pipelines (although, of course, in the case of all-out war in Nagorno-Karabakh, the political risks of constructing alternative pipelines would also significantly rise). This is one more argument that Russia may be less interested in these states in the future due to Gazprom's crisis.

## Conclusion

The concept of the "energy super-state" helped the Russian leadership to solve two different strategic dilemmas connected to the trade-offs between political and security considerations, on the one hand, and economic rationality, on the other hand. First, there was the tension between the weak Russian economy based on raw materials and the desire to raise Moscow's international status by retaining, at least, the status of a great regional power. Second, Russia's leadership wanted to diminish the subsidies to the FSU and, simultaneously, to keep the FSU as a "near abroad", a territory where Russia had specific influence and interests. The geopolitical combination of Russian power and Gazprom in the FSU and Europe was based on the idea of keeping control over the gas deposits in Central Asia and the transportation routes in the South Caucasus, Ukraine and Belarus in order to support Gazprom's privileged position on the European markets. This formula was based on the combination of high energy prices and high gas demand in Europe, on the one hand, and low prices for Central Asian gas, on the other hand.

The crisis of demand on European markets caused by a combination of the global economic crisis and the development of new technologies has significantly affected Gazprom's volume of sales and profits. Simultaneously, Central Asian states (especially after the construction of new pipelines to Turkmenistan) no longer sell gas cheaply. This combination is deadly for Gazprom, since in order to buy Central Asian gas it needs a good situation on the European markets. At the same time, the crisis of production in Russia may make Gazprom concentrate on its Yamal project and not waste resources in the FSU.

This may have a profound influence on Russian foreign policy. First of all, the discourse of "energy-super-state" has been officially abandoned. Second, Russia's ability to transform European dependence on its gas into some kind of political leverage is significantly diminished and new opportunities for investment in Russia may emerge for European energy corporations. Third, economic incentives to keep Russia's "privileged zone of interests" in the FSU have disappeared. So if the Kremlin still wants to control the FSU, it will have to pay the costs for this. From the point of view of economic rationality, it may mean that a Russian withdrawal from some of the FSU will follow. Taking into account political, security and identity considerations one can assume that the degree of Russian withdrawal will be higher in Central Asia, Azerbaijan and Armenia and lower in Georgia, Ukraine and Belarus.

The crisis of Gazprom still creates some uncertainties. For example, it is unknown if the Kremlin will finally abandon its interpretation of Russia's interests which coincided with the interests of Gazprom according to the formula "what is good for Gazprom is good for Russia". I personally think that the probability of this is very low. Furthermore the objective importance of hydrocarbons for the world economy still exists, and energy prices may significantly increase once again. In principle, this may once again change the present-day configuration of Russian power and Gazprom's interests, including the return to some elements of the now-abandoned "energy super-state" concept.