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A feigned liberalisation: Russia is restricting Gazprom's monopoly on exports

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An act restricting Gazprom's monopoly in Russian gas exports came into effect on 1 December 2013. Previously Gazprom had had a legal guarantee to its monopoly position. The changes are an effect of consultations between various ministries that had been conducted for many months and were affected by lobbying from Novatek and Rosneft (Gazprom's competitors on the domestic gas market); they need not, though, be seen as system changes. The 'liberalisation' they appear to bring in is feigned. Proof of this are found for example in both the limited material scope of the new law (it concerns only exports of liquefied natural gas, LNG) and the small number of the beneficiaries of the new regulations (the new solutions will be beneficial for Novatek and Rosneft). Contrary to initial announcements, the right to export LNG has not been restricted to South-Eastern Asian markets, which means that Russian liquefied natural gas is also likely to be sold to Europe in the coming years. Although these changes have been motivated above all by the individual interests of Gazprom's competitors, they are also to a certain extent a response to the processes taking place on regional gas markets. They may, therefore, turn out to be beneficial for the state (increasing Russia's share on the global LNG market and attracting foreign investors to gas extraction projects being implemented in Russia). The new regulations are probably the first step down the long road to breaking Gazprom's monopoly in gas exports via the pipeline system.

The origins of the liberalisation

Gazprom was formally recognised as an export monopoly in the Federal Law on Gas Export of 18 July 2006. The company was thus vested with the exclusive right to export both gas transported via pipelines and LNG. This regulation did not extend to projects which were implemented by energy companies under production sharing agreements (PSA), which concerned, for example, Rosneft's project in the Far East. Other companies interested in gas exports could enter into 'agency agreements' with Gazprom Export, a company which was acting as an agent in relations with foreign partners.

The need to put limits on Gazprom's privileged position has been mentioned on numerous occasions in discussions within government circles[1]. Formally, the change process was initiated in 2012 by Novatek, the key 'independent' gas producer in Russia. As Novatek's position progressively strengthened on the domestic gas market, it started demanding to be given the right to export liquefied natural gas by itself as it was planning to produce LNG as part of the Ya-

[1] The options being considered included splitting Gazprom by establishing separate companies in charge of gas production and transport (this was suggested by German Gref in 2000, who was then minister for the economic development of Russia) and restricting the company's export privileges (a proposal from the Federal Anti-Trust Service).

mal-LNG project. Its management argued that this would not only facilitate the conclusion of export contracts, but would also contribute to attracting more foreign investments in the gas extraction sector[2]. In November 2012, Novatek submitted a formal motion to this effect to the Ministry for Energy. Along with other ministries[3] one month later the Ministry for Energy granted this motion and sent a special report to the presidential administration. Prime Minister Dmitry Medvedev also expressed his support for the gas export rules to be liberalised at the World Economic Forum in Davos in January 2013[4].

However, the key event which triggered the change process was the meeting of the Presidential Commission for Strategic Development of the Fuel and Energy Sector and Environmental Security on 13 February 2013, when Novatek's proposal, backed during the discussion by the CEOs of Rosneft and Zarubezhneft, Igor Sechin and Sergey Kudryashov, was approved by Vladimir Putin.

The form of the liberalisation

The changes were introduced via the amendment of two laws: the Federal Law on Gas Export (Articles 1 and 3) and the Federal Law on the Grounds for Governmental Adjustment of the Foreign Trade (Articles 13 and 24). Pursuant to initial demands, **the liberalisation of gas exports should be gradual,** as regards both the depth of the planned changes (limiting the scope of the regulations in terms of the subject matter and the entities covered by them) and the procedures set for introducing the changes (export licences to be issued upon conclusion of contracts with LNG importers).

The liberalisation covers only LNG exports, and its beneficiaries will be primarily Rosneft and Novatek.

As regards the entities covered by the regulations, the new acts set general criteria which need to be met by companies applying for the right to export LNG. Export licences can be granted to: 1) companies which operate on fields under a licence which as of 1 January 2013 provides for a liquefying plant to be built or the liquefaction of the extracted gas; and 2) state-owned companies (and their subsidiaries) controlled by the state to more than 50% which operate on fields located within the internal waters, territorial sea and the continental shelf, including the Black Sea and the Sea of Azov, that make LNG from the natural gas extracted from these fields, not excluding the natural gas extracted as part of production sharing agreements.

In theory, the criteria for granting LNG export licences are general. However, in practice, considering the situation in the Russian gas sector, the group of companies that will benefit from the new solution will be very small, and will include Novatek, Rosneft and Zarubezhneft (though this has not yet been confirmed since the licence granted to this company does not provide for the construction of a liquefying plant).

As regards the subject matter of the new regulations, Gazprom's export monopoly will be restricted only in the case of liquefied natural gas. Nevertheless, the act **does not provide for a geographical restriction** which

2 Regular output growth (during the first two quarters of this year it was 9% higher when compared to the same period last year) and an increase in the share in the gas trade on the Russian domestic market (a 17% growth in the first two quarters of this year); http://vid1.rian.ru/ig/ratings/oil11.pdf. Novatek argued that the agency agreement it concluded in 2010 with Gazprom Export failed to offer it the opportunity to gain adequate financial support from banks or foreign partners. An anonymous source from the ministry for energy stated that some banks (for example, Société Générale) would be ready to provide financial backing at a level as high as US$18 billion, but only on condition that Novatek has obtained the right to export LNG on its own.

3 The Ministry for the Natural Environment, the Ministry of Economic Development and the Federal Anti-Trust Service.

4 'Pravitelstvo mozhet dopustit Novatek k eksportu gaza', *RBK Daily*, 24 January 2013.

was originally planned (this was the standpoint taken by President Putin, Prime Minister Medvedev and Rosneft). Initially, it was announced that gas export liberalisation will only concern projects under which LNG would be supplied to Asian markets.

However, LNG exports will be subject to rationing, since prospective exporters will have to obtain export licences. In order to obtain these licences, they must meet the general statutory criteria and sign contracts with gas importers (contracts or general terms and conditions of contracts).

One of the most disputed issues during legislative work was how to identify the authority in charge of issuing export licences and the possible coordination of LNG exports. The Ministry for Energy insisted that these competences should be assigned to it or possibly to a newly created authority reporting to the government. Another vision, which Igor Sechin was lobbying for, provided that these competences should be granted to the Presidential Commission for Strategic Development of the Fuel and Energy Sector and Environmental Security[5]. Finally, following special presidential instructions, the competences were given to the Ministry for Energy. The ministry will also be in charge of enforcing the statutory obligation which gas exporters will have to provide information on export volumes and directions.

The rationale behind the restriction of Gazprom's export monopoly

The main **reason** behind the introduction of the changes were the **economic interests** of the political-business groups who are close to Vladimir Putin. The key figures among them are Gennady Timchenko, co-owner of Novatek, and Igor Sechin, the CEO of Rosneft, both of whom are interested in their firms launching a gas expansion both on the Russian market[6] and abroad (however, considering the limited domestic demand, only gas exports to foreign markets can guarantee profits).

The recent moves are also a response to **changes taking place on gas markets worldwide,** in particular the rapid development of the global LNG market. Proof of this can be found in President Putin's statement; when pointing to the need to gradually liberalise LNG trade he argued that budget incomes from gas sales had been regularly falling partly due to a significant reduction in supplies to Europe in 2012.

Russia made this decision not only due to the economic interests of political--business groups, but also considering the changes on regional gas markets.

He also expressed his concern that if Russia fails to act quickly, it may lose its chance of **entering the rapidly developing LNG market in South-Eastern Asia**[7]. This has also been confirmed by declarations from energy companies indicating that LNG output from Russian fields (primarily those located on the Yamal Peninsula) is to be sold mainly to the promising Asian markets, especially to China, Japan, India, South Korea and Taiwan. The forecasts available so far indicate that gas demand in this region will grow significantly until 2025 (up to 600–800 billion m^3 annually), almost 50% of which will be demand for LNG[8].

Although the Asian direction for Russian LNG exports was initially seen as the main reason for

[5] The commission is chaired by Vladimir Putin. Igor Sechin serves as executive secretary.

[6] This concerns primarily Rosneft. Rosneft plans to have increased it to 100 billion m^3 annually by 2020 (in 2012, it was 12.6 billion m^3 according to data from CDU TEK; and 16.4 billion m^3 according to data published by Rosneft), which will account for 20% of total Russian output. This goal will be achieved partly owing to the takeover of Itera and several gas companies from Alrosa group.

[7] http://state.kremlin.ru/commission/29/news/17511 .

[8] Szymon Kardaś, 'Russia activates the LNG sector', *EastWeek*, OSW, 16 January 2013.

the liberalisation, the final form the regulation has taken proves that **another major reason was the need to protect the Russian position on the strategic European gas market.** The geographic restriction initially planned (excluding Europe as an LNG export direction for entities other than Gazprom) was primarily aimed at avoiding competition between Russian gas companies (in particular, protecting the position of Gazprom, which supplies gas to Europe via pipelines). The final stance taken by the Russian government is proof not only of Novatek's lobbying success (this company was openly opposing the imposition of geographical restrictions and also declared its interest in exporting LNG to Europe[9]) but also of an evolution in the approach to LNG market development in Europe. As recently as January 2013, Yuri Sentyurin, the deputy minister for energy, emphasised that Russia does not see Europe as a promising direction for LNG exports. In turn, in October 2013, when stating the rationale behind the bill restricting Gazprom's export monopoly, the government envisioned a rapid development of the European LNG market and thus made it one of the key arguments for the introduction of changes[10].

The president's decision was also influenced by the fact that **Gazprom's efficiency is constantly falling** (in particular since it underrated the consequences of the shale gas revolution in the USA for the implementation of the Russian gas strategy, the slow rate of implementing LNG projects resulting in Gazprom's low share in global LNG trade, and its weakening position on the European gas market) and it is thus decreasingly useful as a foreign policy instrument[11].

The consequences for the Russian gas sector of the liberalisation

The introduction of this regulation should not be treated as a systemic change. This is because the initiators of the changes and also the sole beneficiaries of them are Gazprom's competitors, so-called "independent gas producers": Novatek and Rosneft (the latter, being the largest state-owned oil company, is more and more engaged in energy projects on the Russian sea shelf, and a great part of the licences it holds cover gas field operation). Their new right to apply for export licences will strengthen their position in the Russian gas sector, while Gazprom's position is continually weakening.

The changes are not system changes, but they may have positive consequences for the Russian gas sector.

The changes, however limited their nature may be, may nevertheless **have positive consequences for the Russian gas sector.** The promises that gas export rules will be liberalised have alone contributed to an **intensification of efforts taken by Russian energy companies in the LNG sector, including above all speeding up negotiations regarding new contracts and, as has been the case with Gazprom, the announcement of new LNG projects** (the complete list of LNG projects in Russia is provided in Appendix I). By creating makeshift internal competition, they can gain more opportunities for attracting foreign partners, and thus the investments and technologies necessary to implement expensive extraction projects in Russia. The first example is the purchase of a 20% stake in the Yamal-LNG project by China's CNPC.

It is very likely that the curb on Gazprom's export monopoly **marks the first step on the way towards a demonopolisation of pipeline gas exports.** This has been incidentally hinted at by representatives of government circles (the Ministry for Energy is considering

[9] http://energo-news.ru/archives/109705
[10] http://government.ru/dep_news/8006
[11] Gazprom has been operating on the LNG trade market since 2005 via Gazprom Global LNG Ltd. However, over the past few years its LNG output has not increased, and its turnovers in LNG trade have fallen (Gazprom's share in LNG trade fell from 1.3% in 2011 to 0.6% in 2012). In 2003, Gazprom's share in domestic output was 97%. At present, its share has shrunk to around 70%. As regards foreign markets, its position has been undermined most visibly in Ukraine. A. Topalov, 'Monopoliya prevyshe vsego', 9 July 2013, http://www.gazeta.ru/business/2013/07/09/5418225.shtml

a scenario under which Nord Stream and South Stream will form a separate company, which could have a positive effect on excluding both pipelines from being covered by the third energy package regime). On the one hand, voices rejecting such proposals can be heard (for example, Igor Sechin in his statement in October this year pointed only to the need for ongoing solutions to problems concerning tariffs for gas transport using Gazprom-controlled pipelines). Nevertheless, this option has not been ruled out by the Russian Minister for Energy, Aleksandr Novak. Furthermore, Rosneft's deputy CEO, Vlada Rusakova (who is in charge of the gas sector at the company) said that this scenario was very likely.

Although the new regulations do not provide for any special mechanism for the coordination of Russian LNG exports *de iure*, the arbitrary manner of granting export licences by the Ministry for Energy *de facto* will mean that ultimately **it is the state who will decide on export directions and volumes.** Another instrument for export control is export duty imposed on liquefied gas. The fact that a 0% rate has been imposed means that the financial effect will be the same as if the duty had not been imposed. However, the imposition of this duty means major procedural restrictions during the customs clearance of goods and can be seen as a form of registration of LNG export volumes[12].

The consequences of the liberalisation for Russia's position on external gas markets

The changes may turn out to be beneficial for Russia as **its position on foreign gas markets could become stronger.**

This primarily concerns the **South-East Asia** region, one proof of which are the contracts already concluded with potential importers of Russian gas (Appendix II). At the World Economic Forum in Saint Petersburg in June 2013, Rosneft signed LNG supply contracts with Japan's Marubeni and SODECO, and with the trading company Vitol. In turn, Novatek signed initial agreements with China's CNPC (general contract terms and conditions were agreed in September, and the contract is to be signed by the end of this year). Another consequence of the liberalisation is the intensification of actions by Gazprom itself; by announcing the decision to expand its LNG plant operating as part of the only active LNG project (Sakhalin-2) and by building another one as part of the new project, Vladivostok LNG, it hopes to increase its share in the Asian liquefied natural gas market.

One consequence of the liberalisation may also be a strengthening Russia's position on the gas markets in Asia and Europe.

The new regulations may also result in Russia's position on the **European gas market** being reinforced. This will mean both an increase in its share in LNG trade and the emergence of new Russian gas exporters in Europe. This has been illustrated by **Novatek's** plans: the company announced on 1 November 2013, one day after the bill was accepted by the government, that it has signed a 25-year contract with Spain's largest importer of liquefied natural gas, Gas Natural Fenosa. In May 2013, (unconfirmed) information was leaked that Yamal-LNG and Britain's BP had signed a framework agreement on supplies of liquefied natural gas to the United Kingdom[13]. Seeing Novatek's activity, **Gazprom** has also intensified actions in the LNG sector aimed at supplies to Europe. Gazprom's board of directors updated the company's strategy of 2008 regarding the production and supplies of liquefied natural gas already in October 2012. The company also announced in May 2013 that it would embark on new LNG projects by the Baltic Sea: the construction of a new LNG plant in Leningrad Oblast (the exact location is not certain yet, probably the Ust-Luga port) and a regasification terminal in Kaliningrad.

[12] 'D. Medvedev utverdil nulevuyu eksportnuyu poshlinu dla SPG', http://top.rbc.ru/economics/19/11/2013/889794.shtml

[13] Furthermore, the output of the Yamal-LNG project will also be sold to Novatek's trader companies (for example, Novatek Gas & Power) and France's Total, which holds shares in Yamal-LNG.

The fact that Gazprom's competitors have been granted the right to export LNG to Europe poses no essential threat to the interests of this state-controlled company. This is because Russian gas exported to Europe in liquefied form would be supplied primarily to those countries which do not import gas via pipelines (Spain, Portugal and the United Kingdom). A certain degree of rivalry could only be expected should Gazprom become more active on the European LNG market. However, it seems quite unrealistic that Gazprom will achieve its ambitious plans, considering its financial troubles and the fact that infrastructural pipeline projects (South Stream) are being pushed through. **The adopted solution thus *de facto* means that the European market might in a way be divided between Russian exporters.** It cannot be ruled out that the emergence of many new Russian suppliers on the European market will trigger a broader process of demonopolisation of Russia's gas presence in Europe; this would facilitate Moscow's functioning under the conditions of the third energy package which is being implemented by the EU member states.

Conclusions

Both the change process itself (it took longer than expected) and the final form the changes took prove that rivalry between Russian energy companies is intensifying[14]. The position of energy lobbyists in the Russian economy and their personal links with Vladimir Putin are making it difficult for him to play the role of arbiter and key decision-maker in this strategic sector of the economy. This is illustrated by the form of the regulations adopted, which are an expression of a kind of compromise. It was the president's intention on the one hand to take into account the interests of Novatek and Rosneft, and on the other hand to protect Gazprom which, despite its weakening position resulting from rivalry in the Russian energy sector at home and also the difficult situation on foreign markets, is still an important source of funds needed for the implementation of Russia's flagship projects (including financial support for Sochi 2014) and probably a major source of income for members of the Russian political elite.

The new regulations will not bring about any major changes in the system. Instead, they will rather serve to legally sanction a reconfiguration of influences in the Russian gas sector (the weakening position of Gazprom, and the increasing significance of Novatek and Rosneft). However, it cannot be ruled out that the scope of liberalisation will be extended to gas exported via pipelines as the ambitions of the 'independent' gas players grow and the needs to recapitalise the Russian energy sector become greater, and also considering the challenges resulting from the evolution of foreign gas markets. However, a complete system change would require not only ownership transformation but also a revision of the principles upon which the functioning of the energy sector is based. This is rather unlikely in the immediate future.

[14] Initially, the draft changes were to be ready by the middle of March 2013. The government accepted the final version at the meeting on 31 October 2013, and the State Duma passed the act on 22 November. At the final stage of the legislative work, Rosneft made an unsuccessful attempt to limit the scope of the liberalisation, suggesting an amendment following the first reading of the act. Pursuant to this amendment, the energy company holding an export licence would have the right to export LNG only from the fields it operates by itself. This would exclude the possibility of exporting Russian gas in liquefied form obtained on the secondary market. Should it be adopted, this amendment would most of all have adversely affected the interests of Novatek.

APPENDIXIES

Appendix I. LNG projects in Russia

Project name	Destination market	Consortium members	Production volume (millions of tonnes)*						Comments
			2012	2013	2016	2017	2018	2020	
Sakhalin-2	South-East Asian countries	Gazprom – 50% plus 1 share Royal Dutch Shell – 27.5% minus 1 share Mitsui – 12,5% Mitsubishi – 10%	10,9	10,9	10,9	10,9	10,9	10,9	planned development to reach an annual output of up to 15 million tonnes
Vladivostok LNG	South-East Asian countries	Gazprom – 100%	-	-	-	-	5	10	the final investment decision was taken in February 2013 (the target output being 15 million tonnes); investment value: US$13.5 billion
Shtokman	-	Gazprom – 75% Total – 25%	-	-	-	-	-	-	this project is suspended; according to initial assumptions, annual output of 28-30 million tonnes was planned
Baltic LNG	Kaliningrad Oblast European Union	Gazprom	-	-	-	-	10	10	located in Leningrad Oblast; the liquefying plant's planned capacity is 10 million tonnes; will be put into operation in 2018
Regasification terminal in Kaliningrad	-	Gazprom	-	-	-	-	3	3	the terminal's planned annual capacity is 3 million tonnes
Sakhalin-1 (with the option of expanding by Sakhalin 3 and 5)	Japan	Rosneft – 20% Exxon Mobil – 30% ONGC – 20% SODECO – 30%	-	-	-	-	5	5	target annual output of 10 million tonnes
Pechora LNG	-	Alltech group	-	-	-	-	2,6	2,6	target annual output of 8 million tonnes
Yamal LNG	China other South-East Asian countries European Union	Novatek – 60% Total – 20% CNPC – 20%	-	-	5,5	11	16,5	16,5	planned annual capacity of 16.5 million tonnes investment value approx. US$30 billion (initially US$18-20 billion) resources, according to data of 31 December 2012, 481.4 billion m^3 of gas and 13.4 million tonnes of condensate

**Total output in a given calendar year.*

Appendix II.
LNG supply contracts and framework agreements concluded by Russian companies with foreign partners

Russian producer	Foreign partner	Contract type	Contract date	Annual supply volume (in millions of tonnes)	Contract term	Destination market
Gazprom	GAIL (India)	Framework agreement Contract	18.05.2011 1.10.2012	2,5	20 years	India
Rosneft'	Sodeco (Sakhalin Oil and Gas Development Co. Ltd) (Japan)	Agreement setting general contract terms and conditions	21.06.2013	1	n/a Supplies to commence in 1Q 2019	Japan
	Marubeni (Japan)	Agreement setting general contract terms and conditions	21.06.2013	1,25	n/a Supplies to commence in 1Q 2019.	Japan
	Vitol*	Agreement setting general contract terms and conditions	21.06.2013	2,75 Will buy gas produced by Rosneft as part of the project in the Far East	n/a Supplies to commence in 1Q 2019	South-East Asian countries
Novatek**	CNPC (China)	Preliminary contract Agreement setting general contract terms and conditions	21.06.2013 22.10.2013	Not less than 3	15 years (with the option to extend)	China
	Gas Natural Fenosa (Spain)	Contract	1.11.2013	2,3	25 years	Spain

** Swiss-Dutch trader company.*
*** Information suggesting that Novatek entered into a framework agreement with Britain's BP envisaging LNG supplies to the United Kingdom appeared in May 2013 in the Russian press. However, this rumour has not been confirmed as yet by any of the parties concerned.*

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