INTERVIEW

European Union Now Seems Determined to Reduce the Proportion of Russian Gas in its Future Supplies,

Mike Bradshaw, Professor at **Warwick Business School**, tells **AOG**

- A halt in gas sales to Europe would be very damaging for the reputation of **Russia**
- Without the help of foreign companies, **Russia's oil production** will decline more rapidly than expected
- The **European Union** no longer seems keen to support the **South Stream** gasline project
- Even before the latest turn of events, **Gazprom** was facing serious problems
- The greatest threat to Gazprom probably comes from its arch rival, **Rosneft**

Arab Oil & Gas (AOG): *You do not think that **Russia** will cut off gas supplies to **Europe**. Could you explain why?*

■ **Mike Bradshaw**: President Putin has been at pains to point out that the problem with gas deliveries is a matter for Ukraine to resolve. The various discounts that have been awarded since the last gas dispute in 2009 were rewards for extending the lease on the naval bases in Crimea and for turning away from closer relations with the European Union. An action that brought about the downfall of Viktor Yanukovych and with it the logic of Russia's continued subsidy of gas supplies to Ukraine.

Moscow alleges that since the beginning of the year Ukraine has failed to make timely payments for its gas imports, running up a bill that is now over $2.2 billion. **Gazprom** is now insisting on a price of $485 per 1,000 cubic meters (mcm), compared to an average European price of $387/mcm last year. The Ukrainian Government says that the new price is too high, citing the previous subsidized price of $268 as a fair price and it has started taking Gazprom to an arbitration tribunal in Stockholm. But the gas continues to flow and Moscow is now suggesting that the next step will be to insist on advance payment.

On the face of it the conditions exist whereby Gazprom could, perhaps justifiably, shut off gas supplies to Ukraine. However, Moscow (meaning President Putin) is well aware that Europe is well placed to manage a short-term reduction in deliveries. Just under half of Russia's gas exports to Europe now flow through Ukraine and disrupting supplies would do considerable reputational damage to Russia as a reliable source of gas supplies to Europe and it would also impact on Gazprom's shaky bottom line. According to the **Oxford Institute for Energy Studies**, in 2013 Russia's gas exports to Europe were at a record level, accounting for 39% of Gazprom's total earnings of $162 billion (meaning that 20% of its income was from gas sales to Europe that transited through Ukraine). In the current context, it serves Russia to appear to be magnanimous and continue to supply gas to Ukraine running up debts that it calculates will be paid as a result of financial assistance from the West. However, should events in Eastern Ukraine continue to destabilize and U.S. and EU sanctions start to bite, Moscow may retaliate and cut off gas supplies, figuring that Gazprom's reputational risk is least of the Kremlin's concerns. Thus, the status of gas supplies to Ukraine serves as a litmus test of Moscow's willingness to absorb sanctions and criticisms from the West.

The status of gas deliveries to Ukraine will be a test of Moscow's determination to absorb western sanctions

AOG: *Do you think that the* ***European Union*** *(EU) and the U.S. will adopt new sanctions against Russia as regards the situation in Crimea and Eastern Ukraine, including measures targeting the energy sector?*

■ **M. B.:** The U.S. and the EU are in the process of escalating sanctions in reaction to their perception that Russia has done nothing to deescalate the situation in Eastern Ukraine. Moving beyond targeting individuals and select financial institutions, there is now the suggestion that trade and investment will be next and that the energy sector is an obvious candidate. There is considerable Western involvement in Russia's energy sector: **BP** (which has an almost 20% share of **Rosneft**); **ExxonMobil**, that has the Sakhalin-1 joint venture with Rosneft and substantial agreements for exploration in the Arctic and Black Sea and tight oil in West Siberia; and Shell that has joint ventures with Gazprom at Salym in West Siberia and the Sakhalin-1 project. Others, such as **Statoil**, **Eni** and **Total**, also have major interests and over $14 billion is promised to Rosneft to finance future offshore exploration. These companies are clearly nervous and have tried to distance themselves from events in Washington and Brussels. Russian ministers have also raised the stake by making it clear that they will take a dim view of any of these companies

WHO'S WHO

> Mike Bradshaw

Professor of Global Energy, Warwick Business School

Mike Bradshaw joined **Warwick Business School** (WBS) as Professor of Global Energy in January 2014, where he teaches a course on their Global Energy MBA entitled Energy in Global Politics. Prior to joining WBS he spent 13 years at the **University of Leicester** as Professor of Human Geography. His research deals with the geopolitical economy of oil and gas, with a particular emphasis on developments in Russia. He is currently completing a project funded by the **UK Energy Research Centre** (UKERC) that examines the geopolitical economy of global gas security and governance and its implications for the UK. As part of that project he has been examining the impact of the U.S. shale gas revolution on global gas markets. He is also involved in both UK-based and EU-wide research programmes on the social science aspects of shale gas development. In October 2013 **Polity Press** published his book: *Global Energy Dilemmas*.

Mike has an MA from the **University of Calgary** (Alberta) and a PhD in Human Geography from the **University of British Columbia**. He is a Fellow and former Vice President of the **Royal Geographical Society** (and a holder of their Back Award) and an Academician of the **Academy of Social Sciences**.

Source: Warwick Business School.

taking actions in the light of sanctions. According to *Reuters*, Sergei Donskoi, the Minister of Natural Resources, said that the door would be closed to foreign companies working in Russia if they decide to leave the country over Ukraine-related sanctions. However, Russia needs the technology and investment that is being offered to develop a new generation of offshore fields in the Arctic and Black Sea and also to help develop its unconventional oil and gas resources. Without this assistance, Russian oil production will fall faster than expected, which, while denying the Kremlin of essential revenue, will also deny global markets of Russia's oil exports. Thus, the longer run consequence could be negative for all involved, a case of mutually assured decline.

AOG: *Gazprom is trumpeting that the* ***South Stream*** *gasline will be built on time. Do you think that this project can be completed despite the worsening of the political relationship between the EU and Russia and the strong objections of the* ***European Commission*** *regarding competition issues?*

■ **M. B.:** In the past the problem was perceived as one of transit insecurity caused by disputes between Russia and Ukraine. The solution was to bypass Ukraine, first by the construction of **Nord Stream** that now delivers gas via the Baltic Sea directly to Germany. This is why the share of Europe's gas imports from Russia transiting Ukraine has fallen from around 80% to just under 50%. The next stage is a southern bypass pipeline—South Stream. This is an evenly more costly venture that is of questionable economic sense; but Gazprom seems willing to pay a very high price for guaranteeing transit security to its European customers—the two pipelines would not necessarily deliver more gas to Europe, it just would no longer transit through Ukraine.

However, Europe's perception of the problem has been rather different. It favoured the development of a '**Southern Corridor**' but saw it as means of diversifying gas supplies away from Russia by connecting to Azerbaijan and beyond. Various pipeline projects have been proposed and Gazprom has gone of its way to undermine them. Gazprom now maintains that the construction of South Stream is underway, but even before the conflict in Ukraine the EU has concerns about issues like third-party access.

Now the situation has changed and it is Russian gas, rather than transit insecurity, that is the problem to be addressed. The EU now seems unwilling to support South Stream, added to which there is the on-going anti-trust case against Gazprom that seems likely to change the way that its does business in the EU in the future (there are many long-term contracts still in place) and could even result in a substantial fine.

Russia remains the most economic source of gas for Europe

More generally, the EU now seems determined to reduce Russia's future share of European gas markets and to dictate the terms upon which gas will be sold into Europe. But, the reality is that in the short- to medium-term there is little that Europe can do to reduce significantly its reliance on Russian gas. That said, imports have fallen from 45.1% in 2003 to 31.8% in 2010. A combination of energy efficiency and demand reduction, the continued development of low-carbon power (nuclear and renewables) and a further diversification of gas supplies (including new sources of LNG and domestic shale gas) could reduce Russia's market share. The problem is that all of this will come at a cost to the European consumer as Russia is the most economic source of gas imports and the alternatives require considerable new investments, subsidies and higher prices.

AOG: *More generally, what are in your view the main challenges facing **Gazprom** on a short, medium and long-term basis inside and outside Russia?*

■ **M. B.:** Even before recent events Gazprom was in trouble. It was facing increased competition in the domestic market from independent producers - **Novatek** and the oil and gas companies - who have been granted third party access to its pipelines. The gas exporters in Central Asia have built pipelines to China, reducing their need to sell gas to Gazprom at low prices that it then re-exported to Europe for high prices. It has invested considerable amounts in expensive pipeline projects - Nord Stream and the Sakhalin-Khabarovsk-Vladivostok pipeline -, gasification of new regions in the Russian Far East and in developing new fields on the Yamal Peninsula and offshore of Sakhalin. It remains extremely inefficient as it favours overpayments to its own subcontractors as a way of redistributing 'rent' in the domestic economy. Until recently it has suffered a decline in the volumes of exports and market share in Europe, initially due to cheap LNG, and more recently the high price of oil-indexed gas relative to coal has resulted in falling gas demand. Gazprom has sought to preserve price, rather than market share; even so, it has been forced to offer rebates to its European customers and was fighting a losing battle even before current events. It is not that long ago that Gazprom was the world's third largest company with a market value of $360 billion. By mid-2013 its market value had fallen to $77 billion.

Gazprom's greatest threat probably comes from its arch rival Rosneft that is seizing this opportunity to lobby for greater access to Gazprom's pipeline network. Rosneft and Novatek have already broken Gazprom's monopoly over LNG exports and, if Gazprom fails to deliver a deal with China this year, Rosneft may convince the Kremlin that it can succeed where Gazprom has failed. Thus, Gazprom faces challenges on all sides with limited ability to dictate its future.

AOG: *Will **Russia** and **China** sign a long-term gas supply agreement next month, when President Vladimir Putin will visit China, or at least by the end of 2014?*

■ **M. B.:** For decades Russia and China have negotiated a possible deal to deliver pipeline gas from Siberia to Chinese consumers. Projects have come and gone and step-by-step China has homed in on what it wants, a dedicated field to supply a pipeline to China at a price that reflects the domestic market's ability to pay. Even before recent events, it was announced that all that remained to be agreed was the price. The field has been identified; the Chayandinskoye field in Sakha-Yakutia and Gazprom had committed to build the 'Power of Siberia' pipeline at vast cost. The dominant school of thought seems to be that current events make a deal this May, when President Putin visits Beijing, more likely as both the Kremlin and Gazprom need to find a new market for Russian gas (it is not the same gas that goes to Europe at present). However, I wouldn't be surprised if China compromises on price to get what it really wants, an equity share of the upstream resource.

In other words, China will use the current situation to get the best possible deal. If this means that in the future China burns less coal and more gas then we are all winners, but it remains to be seen if the economic benefits are sufficient to throw Gazprom a lifeline as it faces renewed pressure on its market share in Europe and increased competition at home.

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