



The domestic gas sector in Russia – gradual progress towards a competitive market?

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In the mid-2000s the Russian authorities were firmly in control of the country's gas sector; their influence was

primarily reflected in their right to set the regulated price for gas sold by the dominant producer, Gazprom. This

regulated price was on an upward trajectory, growing at around 15 per cent per annum, as the government

attempted to balance Gazprom's needs for more funds with the desire of domestic industry and the population for low gas prices. However, demand was rising across all the markets for Russian gas at that time, with increasing exports to Europe and the FSU, mainly for use in power generation. Meanwhile, economic growth at home was catalysing annual gas demand growth of 2–3 per cent per annum as gas retained its position as the most important fuel in the energy economy by far, accounting for 50 per cent of primary consumption. The key issue, therefore, appeared to be the need to incentivize the development of Gazprom's new Yamal fields, in order to secure sufficient supply to meet anticipated demand. With this in mind, President Putin stated in 2006 that domestic gas prices should reach export netback parity by 2011; this meant a doubling of the tariff to reach a level of approximately \$120–130/mcm, given the prevailing oil price of \$50 per barrel at the time he spoke. This price would have allowed Gazprom's new Bovanenkovo field on the Yamal peninsula to break even in the Moscow market.

Impact of US shale gas

However, a combination of global and domestic factors have combined to alter this growth picture and to change the supply and demand balance for Russian gas fundamentally; this has significant implications for gas price formation in Russia and for the control that the government can realistically have over the sector. The first important catalyst was the shale gas revolution in the USA, which caused LNG to be diverted away from North America (where it was no longer needed) towards Europe, where it caused an oversupply of gas and a decline in spot prices. This fall in spot prices coincided with a rise in the global oil price to over \$100 per barrel, meaning that

Gazprom's oil-linked contract prices to Europe also jumped, with the result that Russian gas became increasingly uncompetitive and export volumes were reduced to minimum take-or-pay levels.

Reduced demand for gas

This pricing environment was then exacerbated by the 2008/9 economic crisis which caused a sharp decline in energy (especially gas) demand in Europe, which in 2014 still remains 10 per cent below its 2008 level. As a result, demand for high-priced Russian gas fell even further, with impoverished European utilities insisting on contract renegotiations to reduce prices and volumes.

This decline in demand for Russian gas in Europe coincided with a fall in demand from FSU countries, which were also reacting to the economic crisis and to the increasing price of Russian gas. Furthermore, the consistent growth of gas demand in Russia also came to a halt due to the recession in 2008/9, and although some growth later recommenced, consumption has fallen in 2012 and 2013, meaning that all the markets for Russian gas have essentially stagnated or declined over the past six years.

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Bovanenkovo and the rise of independent producers

Unfortunately for Gazprom, just prior to this coincidence of events, it had committed to the full development of the Bovanenkovo field, with its potential 140 bcm/year of output, meaning that the company now has production capacity of 600 bcm/year or more, while it produced only 487 bcm in 2013. At the same time Russia's 'independent' gas producers, such as Novatek and

the oil companies, have increased their output by almost 60 per cent since 2008 to 180 bcm, with the implication that Russia now has a significant potential oversupply of gas in its domestic market.

These production statistics also indicate that independent producers have been able to increase their market share in comparison to Gazprom (they now produce almost 30 per cent of Russia's gas), and the main reason for this is because they do not have to price their gas at Gazprom's regulated level. The regulated price continued to rise at 15 per cent per annum between 2008 and 2013, despite the increasing burden this placed on the Russian economy, and by 2013 it had reached the level of \$115/mcm. While this price was close to the original target set in 2006, it was still far from netback parity due to the doubling of the oil price since that time.

During most of this period independent producers would offer their gas at a premium to the still relatively low regulated price, thus confining their potential market to customers who wanted surplus gas. However, from 2012 the regulated price reached a level at which the independents could profitably offer their gas at a discount for the first time, transforming the psychology of the domestic gas market. Gazprom's regulated gas shifted from being the preferred option for customers to being the less desirable option, as buyers opted to sign new contracts with Novatek, Rosneft, and others. Suddenly the regulated price became a burden not a subsidy and Gazprom was put at a competitive disadvantage, with the result that it has had to cut back production while the independents continue to grow their output. Indeed the level of contract switching means that this trend is set to continue for the rest of this decade, with non-Gazprom output set to reach a level of 250–300 bcm by 2020 while Gazprom's production may be no



higher than 500 bcm, a level 50 bcm below its recent 2008 peak.

In this new situation, where independent producers are now marketing to all Russian gas consumers rather than just to a premium segment, the relevance of the regulated price and the government's role in setting it are called into question. Gazprom itself has requested the right to offer gas at a discount, and has been granted the right to sell within a band 20 per cent below or above the regulated level, implying that all producers can now sell gas either above or below the government-set price. In effect, then, the regulated price has become a guide price around which trades can be agreed, rather than a specific level at which the majority of sales are made.

Pricing structure and the role of government

This change in market dynamics has some potentially significant implications for both producers and consumers. In the near term, the government now appears to have accepted that a price level has been reached which represents an equilibrium of sorts between supply and demand, albeit that it has forced Gazprom to re-assess and cut back its potential production levels. The regulated price will not increase in 2014 (a 15 per cent increase had been planned for 1 July) and future growth is unlikely to exceed the rate of inflation (forecast to be around 5–7 per cent per annum). As all the discounts that have been offered by the independents are set relative to the current and future regulated price, this means that the revenues for all producers will be constrained and consumers will be protected from sharp increases in price. However, given the theoretical

oversupply situation in Russia the suspicion is that if the regulated price were to be removed altogether the gas price would actually fall rather than rise, meaning that producers are also being protected by the continuation of government regulation. As such, the government does appear to have a continuing role as a definer of the price range as both consumers and producers adjust to a more competitive market place.

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An important question, however, is how long this government influence will, or should, remain relevant. A sensible answer would appear to be: until other elements of the gas supply chain have been reorganized to allow a balance between supply competition and state control over a strategically important sector of the economy. An important first step has been taken in the adjustment of the gas tax royalty (MET), which has been shifted from a fixed rate payment to an adjustable rate based on the gas price (domestic or export) received by any producer. This means that one important element of the netback margin for suppliers is now comparatively stable relative to the gas price, providing some comfort for suppliers as they invest in upstream gas projects.

A second step has been the initial loosening of the export monopoly that has historically been enjoyed by Gazprom, with LNG exports now allowed for specific third parties. This has started the process of allowing

all gas companies to compare opportunities in the domestic and export markets, although until this ability is fully extended to pipeline sales, it will have little impact on the domestic gas price.

The third and final step would be the separation of Gazprom's transport business away from its upstream and downstream operations, to create a model of government control of the trunk pipeline system (as in the oil sector) with full competition between producers in the domestic, and ultimately even the export, market. In this scenario the government could cease its role as a price regulator and could control the gas sector through its setting of transport tariffs, as envisaged in the 1999 Gas Law. This outcome is not imminent, in particular because Gazprom is still engaged in a number of large pipeline construction projects – such as South Stream and Power of Siberia – but the increasing level of discussions about independent producer involvement in export sales via these new pipelines suggests that the issue is now at least on the Russian government agenda. As such, the prospect of a fully liberalized domestic gas market by 2020, with state regulation of domestic prices being replaced by a more market-oriented gas price formation system combined with greater access to export markets via a state-controlled gas transport sector, is becoming more of a realistic option than might have been envisaged even three years ago.

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