

Changes on the European Gas Market: Implications for Gazprom

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A thesis

Submitted in partial fulfillment of the

Requirements for the degree of

Master of Arts in International Studies: Russia, E. Europe & Central Asia

University of Washington

2013

Committee:

Judith Thornton

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Program Authorized to Offer Degree:

The Henry M. Jackson School of International Studies

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**Abstract**

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Following the recession of 2008-2009, Gazprom has faced declining demand and rising competition on the European gas market. In addition, the company has encountered rising competition on the domestic gas market and an alternative buyer of the Central Asian gas. Cheaply priced supply of the Central Asian gas helped the exporting Russian gas giant to maximize its profits, while meeting its supply obligations in Europe. This paper analyzes the aforementioned changes and the response of the company to those changes; namely, acquiring joint ventures with monopolistic power, as well as distribution channels in Europe; building new pipelines, especially South Stream pipeline; and creating a positive self-image through different media outlets. All of Gazprom's decisions represent its efforts to retain its market share and thus the ability to extract partial monopoly profits from the European market.

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## **Abbreviations**

BCM – billion cubic meters

CIS – Commonwealth of Independent States

FSU – Former Soviet Union

LNG – Liquefied Natural Gas

NGPs – non-Gazprom Russian gas Producers

TANAP – Trans-Anatolia pipeline

UGSS – Unified Gas Supply System

USSR – Union of the Soviet Socialist Republics

## **Introduction**

Gazprom is the biggest natural gas company in Russia in gas exploration and deliveries, it owns all of the pipelines and pumping stations in Russia, and it is given an exclusive right to use pipelines for the export of natural gas abroad. The European energy market is by far the most important for Gazprom, because it brings the biggest part of revenue to the exporting giant. As the sole exporter of natural gas abroad, Gazprom is very important for the overall wellbeing of the Russian economy, contributing a considerable portion of Russian GDP, as well as the largest chunk of the Russian state budget.

Unfortunately for Gazprom, the situation on the European gas market has changed substantially since the recession of 2008-2009. The demand for gas in Europe has substantially fallen due to the recession. As a result, there has been over-supply of natural gas on the European gas market. The over-supply of the gas on the market in its turn caused a separation of gas prices: the high-price gas was linked to oil prices and was sold on long-term contracts; while the lower-price gas was not linked to oil prices and was sold on the gas-to-gas markets, so called hubs.

As a result of the price difference between the oil-linked gas and the hub gas on the European market, a form of new trade has emerged. The long-term contracts did not provide much flexibility for the gas buyers with the amount of gas that they bought, restricting their off-take even with the varying demand. Some of the gas buyers that needed more flexibility in the supply reserved to using the gas hubs as trading markets, buying gas from hubs when they needed it, and selling gas to hubs when they did not need it.

Consequently, the price formation method for the gas that was linked to the price of oil became unmanageable for many of Gazprom's consumers. They demanded renegotiation of the

contracts with the Russian gas supplier, including the contracts for the gas sold in previous years. Gazprom was forced to renegotiate, losing a substantial part of its profits and lowering gas revenues for the Russian government as a result. That was not the only bad news for the gas giant.

As Gazprom's gas prices kept rising, it faced growing competition on the European market from alternative suppliers. The competition grew not only abroad, but on the domestic market as well, bringing marginal changes to the Russian gas sector with it. These marginal changes include non-Gazprom Russian Gas Producers (NGPs) expanding their supply on the domestic market and some even selling gas abroad; this situation poses potential competition for Gazprom outside of the domestic market and brings the possibility for Gazprom to lose its export monopoly rights in the future. As if things did not look bad enough already; the Central Asian states that Gazprom grew dependent upon to supply its customers in the west started developing infrastructure to export their gas east to China, a country with the ability and the willingness to purchase gas in large quantities. This meant not only that the Central Asian states were taking away Gazprom's potential sales to the Asian market; it also meant higher prices for the gas purchases from Turkmenistan, Uzbekistan and Kazakhstan, and likely competition on the European market in the future.

Turning our attention back to the European market brings us to yet another issue: Europe questioning Gazprom's ability to fulfill its contractual obligations for the following reasons. First, Russian domestic demand is on the rise and, as Gazprom keeps relying on purchases from NGPs to fulfill its domestic commitments, there is a possible scenario that the company might shift some of its European gas deliveries toward domestic consumers. Second, as Central Asian states find a new customer eastwards with a rising demand for natural gas; Gazprom is losing its

monopsony<sup>1</sup> power over these states. With the dependence on the gas supplied by the Central Asian states, the exporting giant faces lower quantities of gas available for its customers to the west, plus the quantities that remain available from those states have to be purchased at a higher price. The third reason is the decline in the production of the current fields and insufficient development of new fields by Gazprom. To implement the Liquefied Natural Gas (LNG) projects and to develop new fields, Gazprom needs help from foreign partners in funding investment and providing state-of-the-art technologies. But, because of government favoritism towards state-owned companies in Russia, it is hard to attract that needed cooperation with foreign partners. Thus, the development of new fields remains stagnant.

In fact, ever since the 1980s, Gazprom has been gradually losing its market share on the European market. The dependence on Russian gas is not a problem for Europe as a whole anymore, but it still remains a problem for some of the Eastern and Central European states, as they are landlocked and lack LNG capacity to import gas from alternative suppliers. Europe as a whole faces another problem, however, – Gazprom holding significant market power in Europe. After the collapse of the USSR, during the 1990s, the Russian government was extremely unhappy with the existing balance of power and was determined to shift it closer towards Moscow. Thus, through the means of Gazprom, Moscow has been able to set up joint ventures with monopolistic power in several Eastern and Central European states in order to import natural gas. Furthermore, it has been able to secure its position on the distribution channels in several European countries.

Additionally, the Kremlin has gone through substantial efforts to prevent Europe from diversifying its energy suppliers. It has been able to prevent construction of the Norway-Poland

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<sup>1</sup> Monopsony is similar with monopoly in the way that it creates imperfect competition on the market; except that unlike monopoly, there are multiple sellers and only a single buyer, dictating the price for the good or service.

pipeline, as well as the Nabucco pipeline; moreover, it has been able to deter the construction of the Trans-Caspian pipeline so far; and I argue in this paper that the South Stream pipeline is the company's further effort to prevent Nabucco's alternative – TANAP – from being constructed as well. Even with the construction of South Stream started, TANAP is likely to be built due to having one major investor that is willing to cover the bulk of the pipeline's costs regardless of having contracts signed in Europe for the future gas from its fields in Azerbaijan – Shah Deniz.

I argue that by building new pipelines, especially the South Stream pipeline, Gazprom is trying not only to prevent alternative gas suppliers from entering the European gas market, but it is also trying to create an image for itself as a reliable supplier. While bypassing the delivery of gas through the transit states of the Former Soviet Union (FSU) to deliver gas directly to the high-paying customers in Europe, the company is showing its dedication to serve gas without interruptions, and thus a long-term commitment to European customers.

Chapter I of this paper is concentrated on a broad scope of issues revolving around the latest changes on the European market and the reaction of Gazprom to those changes. Chapter II, however, focuses on a very specific topic – creation of a positive self-image by Gazprom and promotion of it not only domestically, but internationally as well. To accomplish that task, the company is trying to appeal to a different audience through different media outlets.

First audience that Gazprom appeals to is the Russian general public. It is important for the company to present itself in a positive light for the first audience, because it wants the general Russian public to support certain privileges that the company holds, such as gas export monopoly and certain tax breaks. The second audience that Gazprom appeals to is the European consumer; the company is trying to convince its customers in Europe that natural gas is the best choice of an energy source and that Gazprom is the best choice among the world suppliers. The

company is appealing to the third audience – foreign investors – in order to obtain cooperation needed for expensive projects, such as the development of the new fields and the development of the new LNG projects.

In Chapter II, I analyze three different medium outlets that Gazprom uses to appeal to the audience mentioned above. The first media outlet analyzed is the company's website; it is different from the other two, because it is targeting all of the aforementioned audiences at the same time. The company is trying to appeal to the Russian general public, European customers and foreign investors on its website by fostering a self-image of a beneficent, socially conscious partner, who cares about the environment and is essential for the Russian economy. The second media outlet analyzed is the interview conducted domestically by the state news agency "Vesti" with Alexei Miller, Gazprom's Deputy Chairman of the Board of Directors; it is targeting the Russian general public. To appeal to this audience, the company presents itself as the dominating power on the European market. Third media outlet that this paper analyses is an interview conducted by the European independent source "Natural Gas Europe" with Sergey Komlev, the Head of the Contract Structuring and Pricing Directorate at Gazprom Export; it is targeting European customers specifically. In order to appeal to the European consumers, company is trying to portray itself as a politically neutral entity, operated purely by the rules of the market.

It is not surprising to see such a difference between the image of the company presented in the second and the third media outlet, because two of them target completely different audience. Gazprom succeeds in achieving a positive image in the first media outlet, since it is the one intended for all audiences; the company succeeds in achieving a positive image in the other two medium outlets as well, as long as they are viewed only by the intended audiences.

To summarize, this paper evaluates both “hard” and “soft” actions undertaken by Gazprom to secure its share on the European market following the recession of 2008-2009. The first chapter will show the “hard” actions carried out by the company to secure its market share in Europe and to prevent alternative gas suppliers from entering the European gas market. Among the “hard” actions are the following: setting up joint ventures with monopolistic power in several Eastern and Central European states, securing its position on the distribution channels in several European countries and starting the construction of new pipelines, South Stream in particular. The second chapter will show the “soft” actions that the company is currently taking on. By fostering a positive image for itself, Gazprom is trying to persuade Russian general public, European customers and foreign investors to put their trust in the company and therefore to continue supporting its operations and to continue purchasing gas from Gazprom.

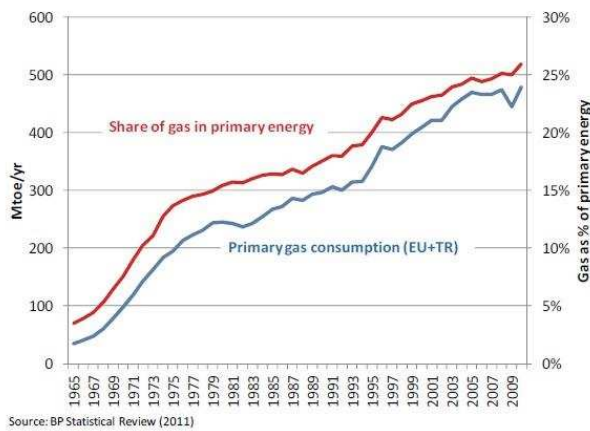
# Chapter I. Changes on the European Gas Market: Implications for Gazprom

## 1. Background Information

### a. Importance of Natural Gas in Europe

Natural gas has been growing in its importance for the European market since the mid-sixties up until the recession of 2008, accounting for roughly 24% of its energy source in 2008 –

Figure 1: 1960s-2000s - The Gasification of Europe (Noël, 2012, p. 5)



the second most important energy source for Europe after oil, which accounted for 43% during the same period (Anderson, 2008). Figure 1 portrays the share of gas in primary energy of EU, as well as the primary gas consumption in EU and Turkey.

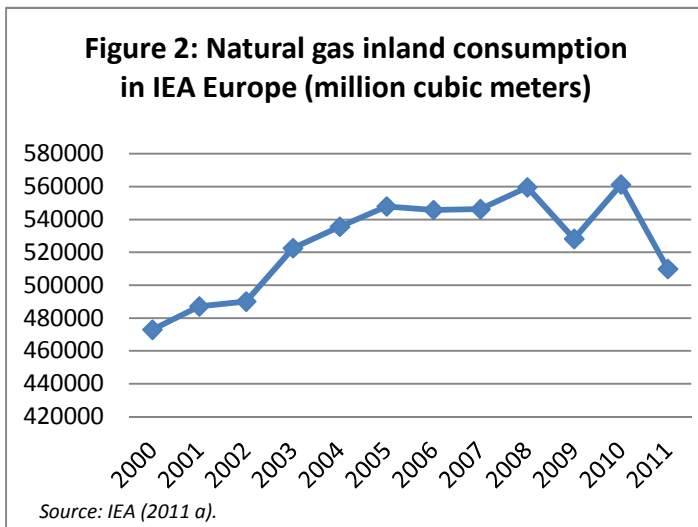


Figure 2 portrays natural gas inland consumption in IEA Europe<sup>2</sup> in the past decade. BP energy (2011) estimates that by 2030 demand for gas in Europe will grow by 26% relative to the level of 2011, while demand for oil will fall by 15% and demand for coal will fall by 33%; the share of gas

<sup>2</sup> International Energy Agency (IEA) member countries in Europe: Austria, Belgium, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Luxembourg, Netherlands, Norway, Poland, Portugal, Slovakia, Spain, Sweden, Switzerland, Turkey and United Kingdom.

in the power sector of Europe will also grow from 18% to 21% within the same timeframe, surpassing nuclear and coal and taking second place after renewables.

There are several reasons that increased the importance of natural gas on the European market: it is the cleanest burning hydrocarbon for electric power generation and one of the least polluting fuel sources for combustion engine vehicles, it “produces 70 percent less carbon monoxide, 89 percent less non-methane organic gas, and 87 percent less nitrogen oxides than gasoline and diesel powered vehicles.” Additionally, natural gas is one of the cheapest energy sources for the European consumer and electricity generation; it is comparable in production cost with nuclear power, at an average production cost of 3.2 euro-cents per kWh, while coal fueled power generation cost is about 3.7 euro-cents per kWh and is much more polluting. Electricity produced by renewable sources such as solar, wind and geothermal is far more expensive: the average cost of producing one kWh by a wind turbine is about 8 euro-cents (as cited in Anderson, 2008, p. 6).

### **b. Russia’s Reserves and Production on the World Arena**

Russia is the owner of largest natural gas reserves in the world, its proved reserves accounted for 21.4% of world’s share in 2011, as shown in Table 1. In terms of proved reserves,

Table 1: Proved natural gas reserves (trillion cubic meters)						
	1991	2001	2010	2011	Share of total (2011)	R/P ratio
Algeria	3.6	4.5	4.5	4.5	2.20%	57.7
Netherlands	1.8	1.5	1.1	1.1	0.50%	17.2
Norway	1.3	2.2	2	2.1	1.00%	20.4
Qatar	6.4	25.8	25	25	12%	> 100
Russian Federation	n/a	42.4	44.4	44.6	21.40%	73.5
Total World	131.2	168.5	196.1	208.4	100%	63.6

*Source: BP Statistical review of world energy (2012, June. a).*

Russia is followed by Iran (15.9%), Qatar (12%) and Turkmenistan (11.7%). Russia’s production accounted for 18.5% of world’s share in 2011, second only to the United

States (20.0%). Table 2 shows natural gas production, compared to the world's total production<sup>3</sup>. At the current rate of reserves to production ratio, natural gas is estimated to last Russia for 73.5 years.

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Share of total (2011)
Algeria	78.2	80.4	82.8	82	88.2	84.5	84.8	85.8	79.6	80.4	78	2.4%
Netherlands	62.4	60.3	58.1	68.5	62.5	61.6	60.5	66.6	62.7	70.5	64.2	2.0%
Norway	53.9	65.5	73.1	78.5	85	87.6	89.7	99.3	103.7	106.4	101.4	3.1%
Qatar	27	29.5	31.4	39.2	45.8	50.7	63.2	77	89.3	116.7	146.8	4.5%
Russian Federation	526.2	538.8	561.5	573.3	580.1	595.2	592	601.7	527.7	588.9	607	18.5%
Total World	2477	2519	2617	2689	2770	2869	2939	3047	2956	3178	3276	100%

*Source: BP Statistical review of world energy (2012, June. a).*

### c. Gazprom

Gazprom is the biggest natural gas company in Russia in gas exploration and deliveries. Its share of Russia's gas reserves and production in 2011 accounted for 72% and 77% respectively, which is 18% and 15% of world's gas reserves and production respectively (OAO Gazprom, 2012). Gazprom owns all of the pipelines and pumping stations in Russia, and it is given the exclusive right to use pipelines for the export of natural gas abroad (Anderson, 2008). Russia is the biggest natural gas supplier to the European market, as may be seen in Table 3. According to OAO Gazprom (2012) itself, natural gas imports from Russia accounted for 27% of all imported natural gas to the European gas market in 2011. Table 4 and 5 provide some figures on the dependence of some European countries on Russian gas in 2011, some figures vary slightly between the two tables, possibly because of the way gas imports are calculated: the

<sup>3</sup> For the convenience of the reader, both Table 1 and 2 show only five largest natural gas suppliers to the EU.

bigger figures might include the Central Asian gas delivered through Russian pipes as part of the Russian gas, while smaller figures might count the same Central Asian gas as being delivered by a separate supplier.

**Table 3: Natural gas imports to IEA Europe by origin (Billion cubic meters)**

Time	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
<b>Origin</b>										
Algeria	56.9	57.4	54.4	60.4	57.9	53	54.4	51.3	53.9	48.8
Netherlands	41.7	41.4	48.1	45	51.6	53.8	51.9	47.5	47.7	44.7
Norway	66.9	69.5	70.1	78.2	83.8	91.1	99.8	103.9	101.2	93.2
Qatar	2.2	2	4	4.9	5.8	6.9	7.9	18.2	34.6	40.9
Russian Federation	118.7	127.3	129.2	137.6	139	136.7	144.6	129.3	120.6	128.3
<b>Total Imports (Trade)</b>	<b>331.2</b>	<b>351.6</b>	<b>367.9</b>	<b>399.7</b>	<b>420.6</b>	<b>421.2</b>	<b>447.6</b>	<b>441.3</b>	<b>463.2</b>	<b>452.9</b>

*Source: IEA (2011 b).*

**Table 4**

Dependence of some EU countries on Russian gas in 2011.  
Sources: Gazprom, Annual Report 2011, Moscow; BP Energy Statistical Review, 2011.

Countries	Volume Bcm	Gazprom's market share (/gas imports), %
Germany	34.1	36.7
Austria	5.4	51.0
Bulgaria	2.5	100.0
Estonia	0.7	100.0
Finland	4.2	100.0
France	8.5	18.2
Greece	2.9	78.9
Italy	17.1	24.6
Latvia	1.2	100.0
Lithuania	3.2	100.0
Hungary	6.3	85.0
Poland	10.3	86.1
Czech Rep	8.2	57.5
Romania	3.2	100.0
UK	12.9	26.6
Outside EU: Turkey	26.0	56.2

(as cited in Boussena & Locatelli, 2012, p. 3)

**Table 5: Gazprom's gas market share in 2011**

Country	%
Germany	40
Austria	63
Bulgaria	98
Finland	100
Greece	53
Hungary	65
Poland	63
Czech Republic	72
Slovakia	98
Slovenia	56
Overall EU	26

*Source: Congressional Research Service (Ericson, 2012).*

The European energy market is by far the most important for Gazprom because prices of gas in Europe are roughly four times the prices of gas on the domestic market, and with respect to volume, accounting roughly for one third compared to Russian domestic consumption at about 140bcm per year, bringing the biggest part of revenue for the exporting giant (Pirani, 2013).

Natural resources altogether are very important for the overall wellbeing of Russia; they comprise a large share of Russian GDP and the Russian state budget. In 2004 export revenues of oil and gas amounted to about 25% of GDP and about 40% of the Russian state budget; in 2011, those figures amounted to 10.4% and 50% respectively (Ericson, 2012). So the success of Gazprom is not only important for the company, it is also very important for the Russian economy.

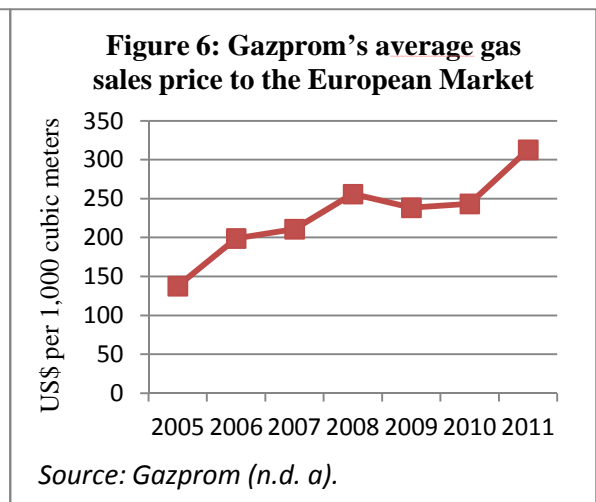
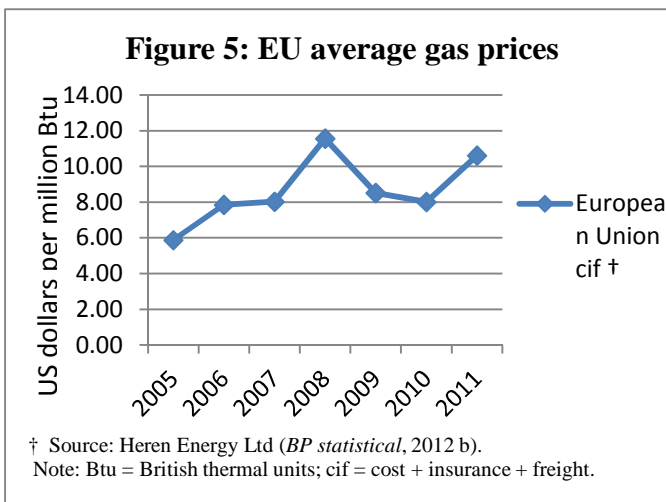
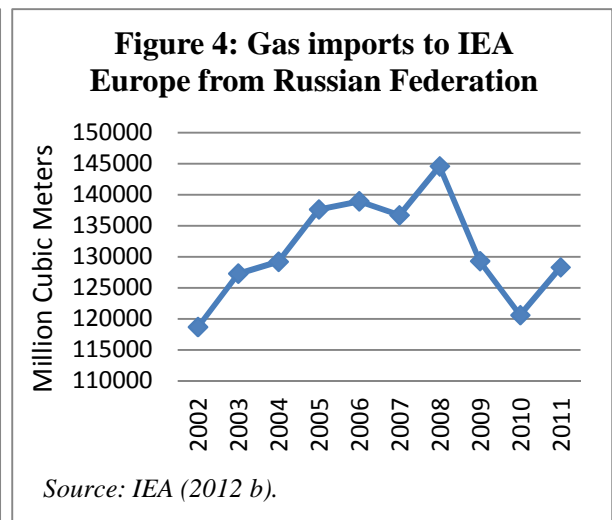
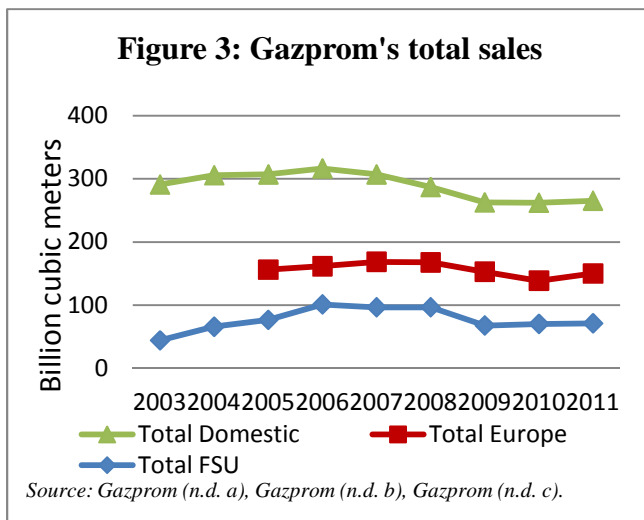
It is not surprising therefore that the company is controlled by the Russian government. In 2005, the purchase of 10.74% of Gazprom's shares by Rosneftegaz<sup>4</sup> made the Russian government the majority owner of the company. With six out of eleven seats on the company's board of directors reserved for members of the Russian government and 50% ownership, the government has a deciding voice on all of Gazprom's corporate matters. Thus, Gazprom has been used by the state to achieve its political and economic agenda (Anderson, 2008).

## **2. Recent Changes on the European Market**

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<sup>4</sup> Another oil and gas company, its majority is owned by the Russian state.

In the last three years, the situation has changed for Gazprom on the European energy market. First, the demand for gas in Europe has substantially fallen due to the recession. As can be seen in Figure 3<sup>5</sup> and Figure 4, the demand in Europe has dropped after 2008 to the levels of 2002-03; it started to grow again in 2010, but so far has reached only the levels of 2004. Second, there has been over-supply of natural gas on the European market due to decrease in demand of natural gas. Because of that over-supply, there has been gas on the market with two separate



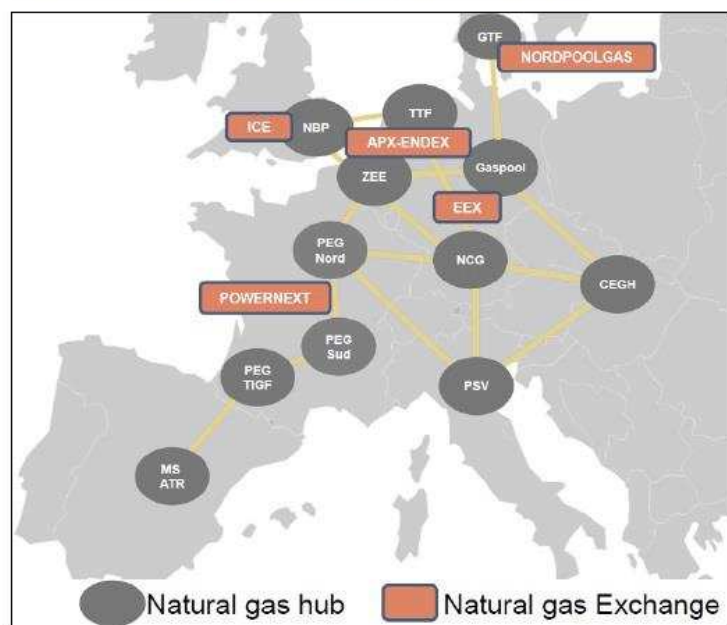
<sup>5</sup> Total Europe figure includes amounts of gas sold to Austria, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Italy, Macedonia, Netherlands, Poland, Romania, Serbia, Slovakia, Slovenia, Switzerland, Turkey and UK. Total FSU figure includes amounts of gas sold to Armenia, Azerbaijan, Belarus, Estonia, Georgia, Kazakhstan, Latvia, Lithuania, Moldova and Ukraine, as presented on Gazprom's web site.

prices: the high-price gas linked to oil prices and sold on long-term contracts; and the lower-price gas not linked to oil prices, and sold on the gas-to-gas markets (Pirani, 2013). The difference in prices after 2008 can be seen on the two following graphs. Figure 5 shows EU average gas prices and Figure 6 shows average gas prices sold by Gazprom to the European Market. Both prices follow the same pattern up until 2008, but then after 2008, average EU gas price falls to the levels of 2007 in 2010 and rises after that, but does not quite reach the level of 2008. However, the average gas price supplied by Gazprom to Europe drops only slightly in 2009 and starts rising after that, and by the middle of 2010 already surpasses the price level of 2008.

The sales on the gas-to-gas market have been facilitated by the rise of the number of hubs in Europe, which has been growing for the past ten years. Patrick Heather (2012) identifies three types of gas hubs on the North Western European gas market: first, trading hubs – those hubs that are open to trade with a variety of participants and that proved to be reliable markets. Second

– transit hubs, those hubs that are actual transit gas locations, but that are also used for trading purposes among market participants. And the third one – transitioning hubs, those hubs that are also used for trading purposes, like trading hubs, but that have not been proven to be reliable markets yet. The author specifies that

Figure 7: European gas hubs and gas exchanges (Heather, 2012, p. 4).



transition hubs might never develop sufficiently to service participants beyond the national markets. In Figure 7, Heather presents the biggest hubs in North Western Europe, trading hubs are pictured in red and transit hubs are pictured in dark gray.

### **3. Implications for Gazprom**

As a result of the price difference between the oil-linked gas and the hub gas on the European market, a form of new trade has emerged. The long-term contracts did not provide much flexibility for the gas buyers with the amount of gas that they bought, restricting their off-take even with the varying demand. Some of the gas buyers that needed more flexibility in the supply reserved to using the gas hubs as trading markets, buying gas from hubs when they needed it, and selling gas to hubs when they did not need it (Stern & Rogers, 2011).

Consequently, the price formation method for the gas that was linked to the price of oil became unmanageable for many of Gazprom's consumers. The price at which they were forced to sell gas to their final consumers was 20-30% less than the oil-linked prices under which they purchased gas from Gazprom (Stern & Rogers, 2013). Again, this situation arose because these companies were committed to the purchase of gas on long-term contracts, but were faced with competitors selling gas for cheaper prices at the gas hubs. Facing non-payments from its European customers and constant pressure to change the pricing of its gas, Gazprom had to renegotiate the contracts with many European purchasers of most Russian gas sold to Europe, including the contracts for the gas sold in previous years (Pirani, 2013).

Stern and Rogers (2013) argue that the pricing of natural gas in Europe will inevitably move from oil-linked pricing to the hub-based pricing. According to the estimation of Thierry Bros, in 2012 around 45% of all the gas sold in Europe was based on hub prices, and in 2013 this number should rise over 50% and continue to rise henceforth (Stern & Rogers, 2013).

Indeed, even Gazprom is transitioning to hub-based prices of natural gas. During negotiations with European purchasers Gazprom agreed to implement the following changes to the pricing of its gas. First, it agreed to change the price indexation<sup>6</sup> of 15% of its gas, imported for three previous years<sup>7</sup>. The agreement specified that the indexation would be related to hub prices, instead of oil prices. In addition, new contracts specified that Gazprom would allow a rollover of take-or-pay volumes that were not used by consumers to following years. Second, Gazprom settled with numerous European customers to reduce the levels of long-term contracts to 60% of its previous volumes; and to reduce base prices<sup>8</sup> by 7-10% of its previous prices. And third, by early 2012, it agreed to implement hybrid prices for all of its gas – prices that are partly linked to gas hubs and partly to oil (Pirani, 2013). What these changes led to is lower profits for Gazprom and lower gas revenues for the Russian government. Gazprom stated that its price adjustment to the European customers during the first half of 2012 has reached 133.19 billion rubles<sup>9</sup>. (Vedomosti, 2012 November 2).

As Gazprom's gas prices kept rising, Europe tried to diversify its natural gas suppliers. As a direct result, the Russian export monopoly faces rising competition from alternative suppliers. The LNG imports alone to Europe have grown by more than 50 bcm per year between 2008 and 2011; which corresponds to more than 10% of total EU consumption in the times when European demand declined by more than 10% and net imports stayed approximately the same (Noël, 2013 April, p. 6).

To see the rise in competition for the Russian gas on European Market, it is useful to look first at the biggest European natural gas consumers and at the biggest natural gas suppliers to

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<sup>6</sup> The price indexation for natural gas is based on a basket of fuel prices, mostly oil products (Stern & Rogers, 2011).

<sup>7</sup> The change in the price indexation began in October 2009.

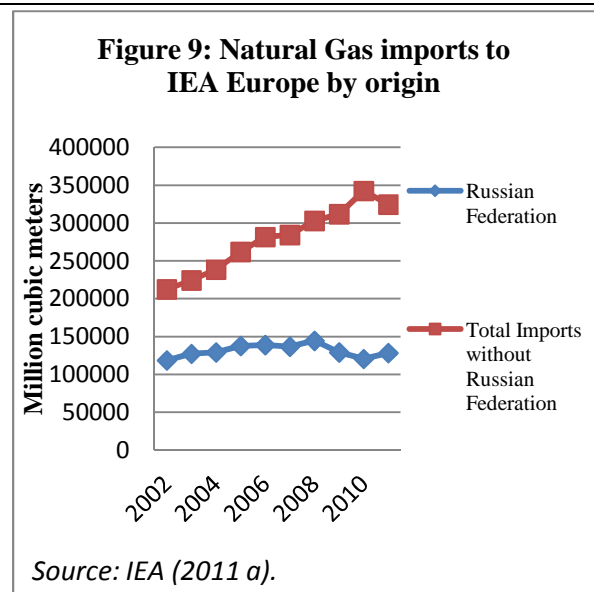
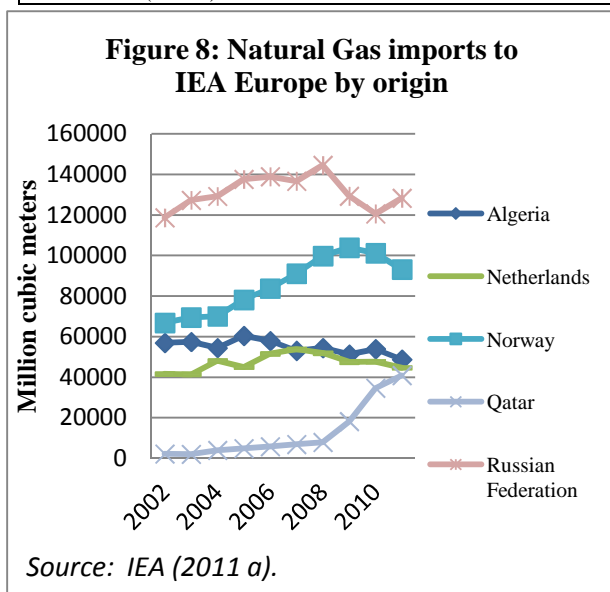
<sup>8</sup> The base price for natural gas is derived from the prices of the competing fuels (Stern & Rogers, 2011).

<sup>9</sup> At a rate of \$0.03US per ruble this figure would roughly amount to 4 billion \$US.

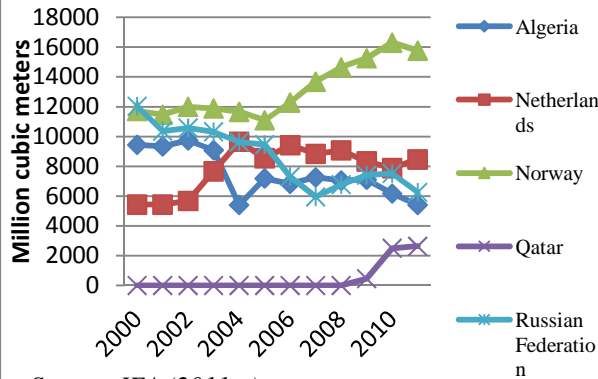
Europe, as summarized in Table 6 and Table 3 respectively. Second, it is useful to take a look at the correlation between the amount of gas supplied by Gazprom and amounts of gas supplied by the biggest alternative suppliers to the IEA Europe, as shown in Figures 8 and 9. After 2008, the fall in the amount of natural gas supplied from Russia is correlated with the rise of gas supplied from Norway and Qatar. After 2010, as the Norwegian and Algerian gas supply falls, the Russian gas supply rises.

Table 6: Natural gas (billion cubic meters) inland consumption (observed)												
Time	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
France	39.8	41.7	42.2	44.4	45.5	47.2	45.4	44.4	46.1	44.6	49.1	41.2
Germany	87.7	91.7	91.2	101.3	100	98.2	99.9	96.8	98.1	93.5	90.1	77.6
Italy	70.7	70.9	70.5	77.7	80.6	86.3	84.5	84.9	84.9	78	83.1	77.9
Netherlands	48.9	50.1	50	50.2	51.3	49.3	47.9	46.5	48.5	49	54.8	47.9
Poland	13.3	13.6	13.4	14.7	15.5	16.2	16.2	16.2	16.3	16	17.2	17.2
Spain	17.6	18.9	21.7	24.5	28.5	33.6	36.1	36.8	40.3	36	35.8	33.6
Turkey	14.8	15.9	17.6	21.2	22.4	27.4	31.2	36.6	36.6	35.1	38.1	44.7
United Kingdom	101.8	101.3	100	100.5	102.3	99.6	94.8	95.9	99.1	90.8	98.9	82.6
IEA Total	1357	1339	1374	1393	1412	1412	1409	1474	1489	1444	1521	1515

Source: IEA (2011 a).

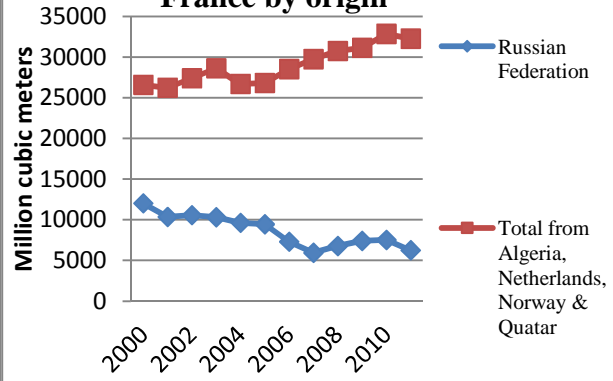


**Figure 10: Nat. gas imports to France by origin**



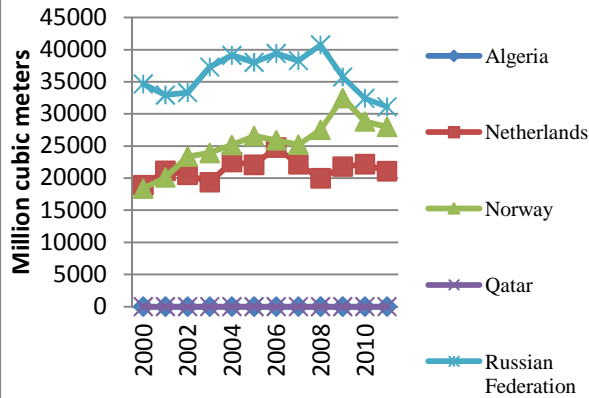
Source: IEA (2011 a).

**Figure 11: Nat. gas imports to France by origin**



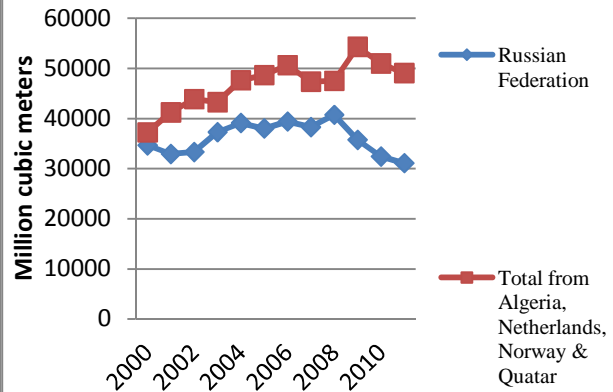
Source: IEA (2011 a).

**Figure 12: Nat. gas imports to Germany by origin**



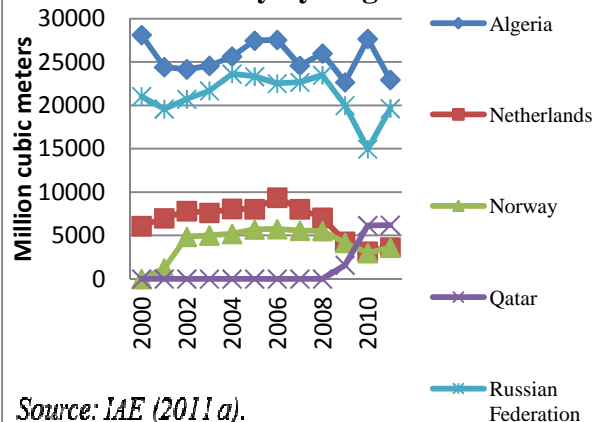
Source: IAE (2011 a).

**Figure 13: Nat. gas imports to Germany by origin**



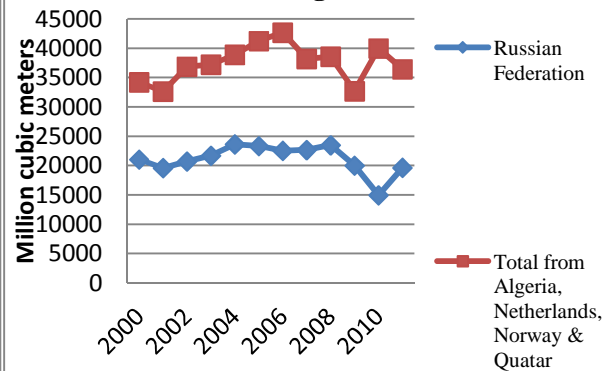
Source: IAE (2011 a).

**Figure 14: Nat. gas imports to Italy by origin**

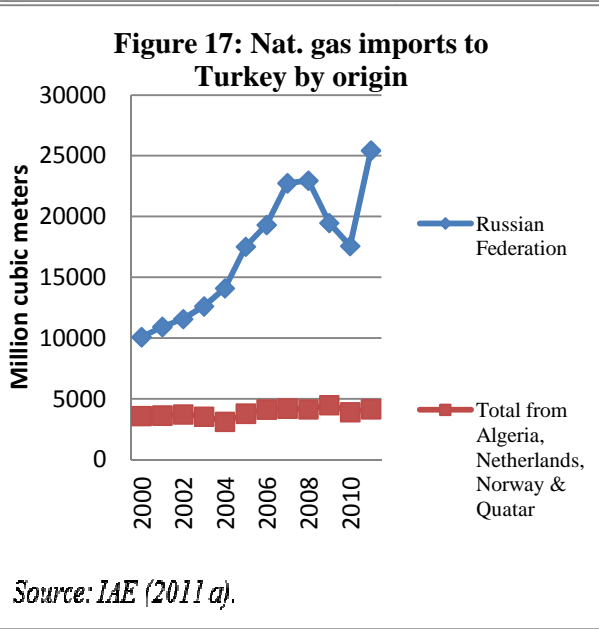
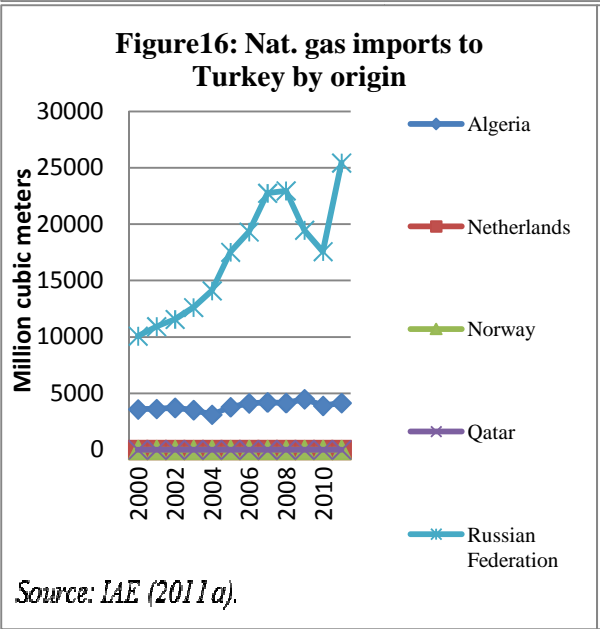
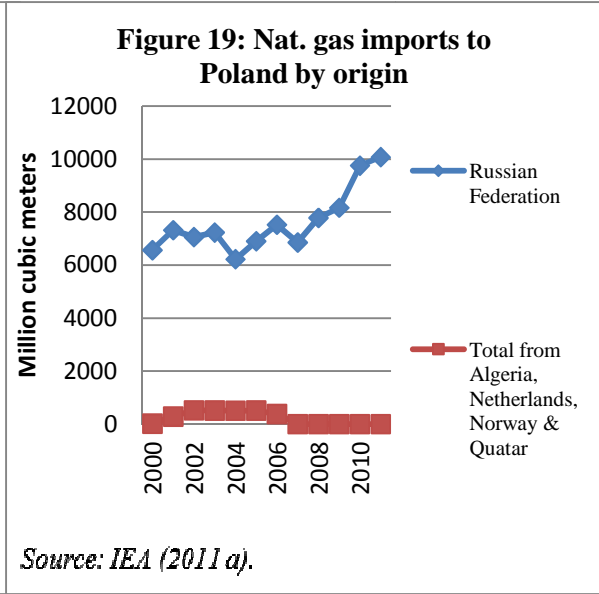
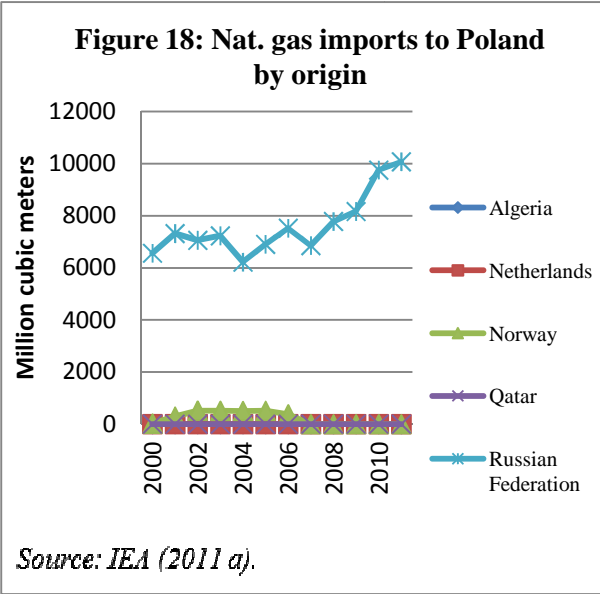


Source: IAE (2011 a).

**Figure 15: Nat. gas imports to Italy by origin**



Source: IAE (2011 a).



Individual examples of the biggest gas consumers in the IEA Europe give us similar results: in France, 2005 through 2007, as Norwegian gas supply goes up, while Algerian and Dutch gas stay at the same level, Russian supply goes down, as shown in Figure 10. There is also a correlation between the fall of gas supplied from Russia and the rise of gas from alternative suppliers, as shown in Figure 11. In Germany, during 2000-2002, 2003-2004, 2005-2006, 2008-2009 as the quantity of gas supplied from alternative suppliers goes up, the quantity of Russian

gas supplied goes down; and during 2002-2003 the opposite picture, as shown in Figure 13. In Italy, there is a direct correlation during the years 2009-2010 between the rise in the quantities of gas supplied from Algeria and Qatar and the fall of the quantities of gas supplied from Russia (as well as from Netherlands and Norway) and vice-versa for the years of 2010-2011.

Individual examples of Turkey and Poland give us different results: there is no significant correlation between the fall of quantities of gas supplied by Russia and the rise of quantities of gas supplied by alternative suppliers, simply because Gazprom supplies most of their gas and there is merely no gas supplied by the alternative suppliers relative to the Russian gas. Poland and Turkey are not the only states heavily dependent on Russian gas; other Eastern and Southern European states find themselves in the same predicament. As I mention in Section 7 of this chapter, this Russian gas dependence arises from having no access to the gas hubs, as well as from having no access to the liquefied natural gas (LNG), since the area is mostly landlocked.

As we will see in the following section, Gazprom faces growing competition not only on the European gas market, but on the domestic gas market as well, bringing marginal changes to the Russian gas sector. These marginal changes along with other factors discussed later in this chapter leave the possibility open for Gazprom to lose its export monopoly rights sometime in the future.

#### **4. Growing Competition on the Russian Domestic Gas Market**

In the beginning of 2012, Gazprom's regulated price surpassed that of Novatek for the first time. (Henderson, 2013). Gas price increases have finally introduced some form of competition on the Russian domestic gas market. Even though, the gas sold to residential consumers is still sold at the regulated prices, the price for the industrial sector is no longer fully regulated. Industrial consumers, as well as the electric power generating sector, can buy gas in

excess of their quotas from the “free” market, which is mostly supplied by the independent gas producers and Russian oil companies at a non-regulated price. Gazprom also sells gas on the free market for industrial customers, but the volumes that it sells are relatively small. (Boussena & Locatelli, 2012).

In 2012, there were numerous contracts signed between non-Gazprom Russian gas Producers (NGPs) and the Russian industrial and power consumers. Novatek, the largest independent gas producer in Russia, signed contracts with companies such as MMK, Mechel, Uralchem, Severstal, Fortum and E.On Russia, directly replacing Gazprom as the main supplier. Even Mosenergo, a Gazprom subsidiary, signed a contract with Novatek for gas delivery in the period 2013-15 to supply 27 billion cubic meters (bcm) annually, roughly a third of its needs. This is a good example of the industrial companies in Russia, even the ones owned by Gazprom, looking for the best deals in the gas supply instead of simply relying on Gazprom. (Henderson, 2013).

The change in the Russian gas sector, something that had been out of debates two or three years ago, is being discussed in Russia at the moment. Russian NGPs are even starting to sell their gas to customers outside of Russia. Novatek signed a contract with ENBW, a German company, to deliver 2bcm annually from 2012 to 2022, is a good example of this. LUKOIL signing a contract with China to deliver gas from its Uzbek fields in the amount of 19bcm annually over the next few years is another example. These “small” contracts are enhancing the bargaining power of foreign consumers in relation to Gazprom, especially in the case of China. (Henderson, 2013).

In Novatek’s example it is not fully clear how the gas is going to be delivered to the German consumer. What is clear is that such an agreement certainly required approval from the

Russian government. Although these “small” deals are not a direct threat to Gazprom’s export monopoly yet, they are opening a discussion for open access to the Russian export pipelines. (Henderson, 2013).

Even in the face of new opportunities for the NGPs, the Russian gas market remains only partially competitive. The Russian natural gas giant remains in control of the Unified Gas Supply System (UGSS) and allows only restricted access for the NGPs, amid the Third Party Access regulation, controlling levels of NGP production and deliveries for its own benefit. (Henderson, 2013).

Restricting NGPs contracts to access the UGSS to a maximum of three years raises the cost of transportation for them and drives away potential consumers. Without the long-term security of the supply, NGPs face limited options. Many of them choose to sell their natural gas directly to Gazprom. As a result, Gazprom has become dependent on the NGPs’ gas for resale, in order to meet its supply obligations on the domestic and European gas markets within the past couple of years (Henderson, 2013). To speculate further on this topic, as competition keeps growing on the domestic market and independent gas producers gain wider access to the Russian consumer; the possibility arises for the NGPs to expand their supply even further and to meet part of Gazprom’s demand on the European gas market as well. European customers would welcome that possibility; it would lower the market power of the Russian gas giant<sup>10</sup> in Europe, but that would only happen if the Russian government makes some major changes to the domestic gas sector.

## **5. Losing Central Asian Gas. Potential Competition from Central Asian States and Azerbaijan**

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<sup>10</sup> Even though, this situation would lower the market power of Gazprom in Europe, it would not reduce the price of Russian gas, according to Tarr (2010), because it would be in Russian government’s interest to continue extract monopoly profits on its gas exports to Europe through export taxes.

Russia has been the biggest net supplier, as well as the key transit provider of nearly all of the natural gas produced in the Former Soviet Union (FSU) for exports. Gazprom holds the control over all of the transit pipelines in Russia, except for the local transportation networks; it is also granted a legal monopoly by the Russian government to import Central Asian gas to Russia and to export Russian gas to Europe. Up until 2009, Gazprom was the only purchaser of Central Asian gas, aside from minor amounts sold to Iran and Turkey. Using its monopsony power<sup>11</sup>, Gazprom purchased Central Asian gas for exceptionally low prices and distributed it for consumption on the domestic market, as well as for consumption on the markets of the FSU countries to the west. That way, FSU consumers could enjoy relatively cheap Central Asian gas, while more of the Russian gas could be exported to Europe, where it earned much more netback returns from the European consumers. Hence, Gazprom was able to maintain a significant and stable source of revenue that played an important role in Russia's economy and state budget. The Russian government has been dedicated to maintaining Gazprom's position and countering any entity or its actions that would compete for Gazprom's revenues (Ericson, 2012).

The monopsony of Gazprom in the imports of Central Asian gas was finally broken in December 2009, when Central Asian states started to develop new outlets to consumers other than Russia; China being a particularly important alternative customer. That is when Gazprom offered a higher price to its Central Asian importers (Ericson, 2012).

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<sup>11</sup> Monopsony is similar with monopoly in the way that it creates imperfect competition on the market; except that unlike monopoly, there are multiple sellers and only a single buyer, dictating the price for the good or service.

There have been long negotiations with high-paying customers from Europe to develop a trans-Caspian southern route through Turkey that would connect Uzbek, Kazakh and Turkmen gas to Europe. But these negotiations have not been conclusive: the construction of the pipeline has not been arranged<sup>12</sup>. Still, Central Asian suppliers were able to find a decisive customer to the East – China. The Trans-Asia Pipeline was built, as shown in Figure 18, financed by the Chinese,

connecting  
Turkmen gas  
through  
Uzbekistan and  
Kazakhstan to  
China. The  
pipeline with a  
capacity of 30bcm



**Figure 18.** Route of the Turkmenistan-China pipeline (solid line) and northern portion of proposed TAPI (Turkmenistan-Afghanistan-Pakistan-India) pipeline (dashed line). (Ericson, 2012, p. 627).

per year began gas transmission in December 2009; full capacity is expected to be reached in 2013. The original contract between China and Turkmenistan has been renegotiated twice; during the second negotiation in 2011, both sides agreed to increase its annual deliveries to 65bcm by building a third line in 2015. Kazakhstan and Uzbekistan have also reached an agreement for access to the pipeline going through their territory in order to export their own reserves of natural gas to China. Furthermore, an additional Kazakhstan-China pipeline was built in a mutual project between Kazakhstan and China. And China is proposing to diversify the transit route from Turkmenistan by building another pipeline through northern Afghanistan and

<sup>12</sup> Nevertheless, Turkmenistan started building a 30bcm pipeline in preparation from its interior to the Caspian shore. Further development has met opposition from the Russian government (Ericson, 2012).

Turkmenistan with a capacity of 30bcm per year (Ericson, 2012). Ericson (2012) adds that, even though China can potentially buy off all the gas produced by Central Asian states, there might be additional demand for that gas from the south – India, Pakistan and other potential customers east and west, accessing Central Asian gas through Iran – the closest neighbor to Turkmenistan with the access to the sea.

Farther west, Turkmenistan's neighbor across the Caspian Sea – Azerbaijan – anticipates a total production of 50-55bcm of gas per year by 2025; it is looking for a way to reach European consumer, while avoiding delivery of its gas through Gazprom. According to Ericson (2012), its first original alternative to Gazprom's pipelines was to deliver its gas west through the Nabucco pipeline, but the construction of the pipeline has been frozen in its initial stage for a decade. Thus, Azerbaijan signed a series of agreements with Turkey in 2011-2012 to build a new Trans-Anatolia pipeline (TANAP) that would deliver gas from the Georgian to the European border, essentially replacing previously planned Nabucco. Azeri government is willing to cover the bulk of the pipeline's costs regardless of whether it has any contracts signed in Europe for the future gas from its fields in Azerbaijan – Shah Deniz (Ericson, 2012).

The construction of TANAP is financed and owned mainly<sup>13</sup> by the Azeri State Oil Co., Socar, and it is scheduled to be finished by 2017 (Cook, 2013 February 5). The South Caucasus pipeline that currently runs from Shah Deniz gas field in Azerbaijan to Ceyhan, Turkey is being expanded in support of TANAP from 8 to 23bcm. The capacity of the TANAP pipeline itself is planned to increase to 60bcm, if Turkmen gas becomes available across the Caspian Sea (Ericson, 2012). The Trans-Caspian pipeline is proposed to connect Turkmenbasy, Turkmenistan with the Sangachal Terminal in Baku, Azerbaijan under the Caspian Sea. But both Russia and

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<sup>13</sup> Socar holds 80% of Tanap.

Iran have opposed the project on environmental grounds, stating that approval of all five countries bordering the Caspian Sea is required (Tarr, 2010).

The changes mentioned above are very significant for Gazprom: since Gazprom is dependent on gas imports from the Central Asian states, it might have difficult time fulfilling its supplier obligations to its customers both in the CIS and in the EU as part of Central Asian gas goes somewhere else. Long-term contracts signed between China on one side and Turkmenistan, Uzbekistan and Kazakhstan on the other side present already forgone quantities of gas for the years to come. If Gazprom wants to secure at least part of the Central Asian gas, it is going to have to offer even higher prices for it. In the case of Azerbaijan, Gazprom has already attempted to buy all of the Azeri gas that its massive Shah Deniz field is planning to produce starting in 2018; but president Aliyev has refused the proposal, committing to the Trans-Anatolia project instead (Cook, 2013, February 5).

## **6. Questioning Gazprom's Supply**

The contractual relations between Russia and the EU were relatively stable during the 1970s and 1980s, but started to deteriorate in the mid-1990s. The EU is striving to insure that it has a natural gas supply for the future that is both secure and reasonably priced (Boussena & Locatelli, 2012). Currently, Russia is perceived by the EU as a risky supplier for the following reasons: first, steeply rising domestic demand for gas that might reallocate some of the gas exported to the EU for the domestic market, and dependence of Gazprom on the gas produced by the NGPs, as discussed in Section 4. Second, dependence on gas supplied by the Central Asian states and the gradual shift of this gas to alternative markets, as discussed in Section 5. And the third reason is insufficient development of new fields by Gazprom to cover for the decline in the production of the current fields.

Gazprom's investment into the development of new fields was not sufficient to cover for the decline in the Urengoi, Yamburg and Medvezhe fields. Given the steeply rising domestic demand, there is doubt whether Gazprom can meet its future contractual commitments (Boussena & Locatelli, 2012). In 2011, Gazprom produced 515bcm of gas on its own, its plan was to produce 529bcm in 2012; but according to Henderson (2013), its production for 2012 was calculated to be 40bcm behind schedule. Henderson's calculations showed that Gazprom's production was going remain low in 2013 as well, dipping below 500bcm once again.

Gazprom already purchases a substantial part of its natural gas exports to Europe from both domestic producers and Central Asian states. In 2011, Russia imported 30 bcm of natural gas altogether from Azerbaijan, Kazakhstan, and Turkmenistan (Ericson, 2012), it purchased 42 bcm for re-sale from the NGPs in the same year (Henderson, 2013), while supplying roughly 140 bcm to Europe.

To cover the decline in its biggest gas fields, "Gazprom plans to be producing 95 bcm additional natural gas from Shtokman, 335 bcm from Yamal, 135 bcm from new fields in Nadym-Pur-Taz West Siberian region, and 100 bcm from East Siberia and the Far East" by 2030 (Ericson, 2012). However, the development of Shtokman and Yamal have been much slower than initially planned for two major reasons: effects of the demand shocks from the 2008-2009 economic world crisis; and Russia's refusal to allow foreign energy companies to form full production partnerships with Gazprom on those projects (Ericson, 2012). According to RT (2012 August 31), Shtokman has been put completely on hold in 2012 due to the high financing costs, "the shale gas revolution in the United States which had been viewed as a primary export market for Shtokman" and disagreements among the partners of the project (par. 4). The partners of the project are: Norway-based company Statoil, which owns 24% of the project; French-based

company Total, which holds 25% and Gazprom, holding the majority of the project of 51%. It is not clear when the project will resume, if it ever will. Although Total claimed that the project has not been postponed indefinitely, Gazprom's failure to comment signifies uncertainty in the future of the project.

In order to diversify the market for its domestic gas, to meet its export obligations and compete with Middle Eastern suppliers to the European market, Russia has demonstrated a growing interest in new Liquefied Natural Gas (LNG) projects. There has been agreement on forming joint LNG projects on the Yamal Peninsula and the Gydan Peninsula between Gazprom and Novatek (Kardaś, 2013 January 16). According to Kardaś (2013 January 16), the Russian government currently supports joint projects, and has stepped up to encourage them in different ways: by exempting the Yamal LNG project from taxes, up to 250bmc, on the extraction of the natural gas and fossil fuels (NDPI) that is processed into LNG; and by exempting the project from export duties<sup>14</sup>.

Still, the progress in getting the LNG projects running has not been very significant. To implement some of the LNG projects, the help of the foreign partners in funding investment and providing state-of-the-art technologies is needed. But, because of government favoritism toward state-owned companies in Russia, such as Gazprom, it is hard to attract cooperation with foreign partners in the expensive LNG production projects (Kardaś, 2013 January 16). The direct access to the Russian gas fields for non-Russian companies has been denied; exploration licenses are *only* granted to those companies that establish joint ventures with Russian counterparts and *only* under certain rules that secure the control over the Russian energy resources in the hands of the Russian companies (Orban, 2008).

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<sup>14</sup> To read more about the amendments to the Russian hydro-carbon legislature, please, refer to (Hines & Marchenko, 2013 June 3).

## **7. Improving Security of the Gas Supply to the EU**

Noël (2013 April) argues that dependence on Russian gas might be still a problem for some European states, but it is not a problem for the EU as a whole since the EU has actually diversified its imported gas continuously over the past thirty years; if Russian gas contributed to 80% of all EU gas imports in 1980, today it constitutes only 35%. But even though the supply of natural gas to Western Europe has diversified substantially, Central and Eastern Europe remain heavily dependent on Russian gas (p. 2).

Following the gas supply crisis of January 2009, there have been improvements in the security of the gas supply to the EU. First, Gazprom launched development of new pipelines to its European customers while bypassing Ukraine as a transit state: Nord Stream and South Stream. The first line of Nord Stream, which lays across the Baltic Sea connecting Russia and Germany directly, came online in 2011; as soon as the second line becomes operational, the pipeline will have a capacity of 55bcm per year, which is about one third of all Russian exports to Europe and almost 15% of total European gas consumed (Noël, 2013 April). The construction of another pipeline – South Stream – has begun in 2012, linking Russian gas across the Black Sea with Romania, Bulgaria, Greece, Hungary, Serbia, Slovenia, Greece, Italy, Croatia and Austria. At the time the construction of the land section of the pipeline was inaugurated in Bulgaria, Gazprom has agreed to comply with Bulgarian law; not only during the construction stage, but also throughout the time that pipeline operates. That would mean that the Russian government is agreeing to the fact that the pipeline will be covered by EU legislation, specifically the principle of third-party access<sup>15</sup>. But according to Kardaś and Dąborowski (2013

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<sup>15</sup> For more information on the third energy package and the third-party access principle refer to Yafimava (2013 April).

November 6), current prospects show that it is unlikely for the third-party access principle to be upheld.

Once finished, South Stream should reach a capacity of 63 bcm per year. Noël (2013 April) argues that by 2015 or 2017 Gazprom and its partners will have enough transit capacity to completely bypass Ukraine<sup>16</sup>, reducing the risk of gas supply disruptions for the EU.

The second improvement in securing the gas supply to the EU has been in the attempt to transform the European gas market through underlying forces of integration, commoditization and globalization. North-Western Europe has accomplished the greatest degree of integration, while Eastern and Central Europe has lagged. In Eastern and Central Europe, the rise of competition to the Russian gas supplier is only marginal. The majority of the Eastern and South-Eastern EU does not have any gas hubs; neither does it have LNG importing capacity, since the area is mostly landlocked. This fact makes this region principally vulnerable to the dangers of supply security and consequently market abuse (Noël, 2013 April). Thus, Gazprom has been able to uphold its substantial market power in Eastern and Central Europe, holding partial or full ownership of the domestic and transit pipelines, as well as maintaining access to the direct distribution channels to consumers in the region. This paper evaluates more on the issue in the next section.

Possible means for Eastern Europe to shift away from dependence on Russian gas is to deliver gas from the hubs in the west. There is a problem with that however: certain Eastern and Central European countries, Poland and Romania having the largest gas markets in the region, maintain the price of gas below the imported price by calculating an average price between imported and local gas. Since local gas is sold at prices that are close to its cost, it maintains the

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<sup>16</sup> Assuming that Europe continues to import from Russia around 150 bcm per year.

imported gas subsidized, destroying the incentives to import non-Russian gas from Western Europe, as Noël (2013 April) suggests.

According to Noël (2013 April), importing spot-priced gas from Western to Eastern Europe would put significant pressure on oil-indexed contracts in Eastern Europe and would eventually cause a transformation of the gas market. So far, the only market that has great pressure on the oil-indexed contracts from the spot-priced gas in this region is the Czech Republic, a country lying between Germany, Austria and Slovakia on the same pipeline system. But Noël articulates that current legal arrangements with Gazprom prevent Western European importers from reselling Russian gas to the Central and Eastern European countries. Therefore, the large economies of East-Central Europe will continue to rely on coal, as they do now – Poland and the Czech Republic for instance – unless gas supply security improves<sup>17</sup>.

### **8. Gazprom's Market Power in Europe**

During the 1990s, after the collapse of the USSR and the subsequent NATO expansion, Russia's influence in Central and Eastern Europe seemed to erode; and according to Anita Orban (2008), the sign of its erosion became more apparent when the United States pushed on to establish its missile defense system on Polish and Czech territory. The Russian government was extremely unhappy with the existing balance of power and was determined to shift it closer towards Moscow. It pursued a strategy of regaining control of key energy assets in the former Soviet Bloc to reach both its foreign policy and its economic goals; initially, it made attempts to gain control of the distribution systems in Belarus, Ukraine, the Baltic States, Poland, Slovakia and Hungary. Extending its influence through Russian oil and gas companies, the Russian

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<sup>17</sup> The transformation of the European gas market might prove to be possible once the third energy package comes into effect on the territory of the EU. For more information on the third energy package refer to Yafimava (2013).

government tried to privatize strategic energy assets of these countries and to gain control of their key sections of energy infrastructure.

According to Boussena and Locatelli (2012), gaining substantial market power on the market would enable Gazprom to change the structure of the European gas market, to manipulate the volumes of gas, and therefore the prices; and it would allow Gazprom to influence the competition policies in the gas directives. Additionally, this would raise downstream rivals' costs and reduce rivals' access to suppliers, and potentially eliminate those rivals. From the information gathered in this paper, it is clear that Gazprom has already secured substantial market power in Europe – not only in Eastern and Central Europe, but also parts of Western Europe – it has been able to manipulate the volumes of gas, as well as the prices, and it has been successful in influencing the competition policies in the gas directives.

In its initial attempts to expand, Moscow set up joint ventures with monopolistic power in several Eastern and Central European states to import natural gas, using its powerful tool, the Russian natural gas export monopoly – Gazprom. Next, Gazprom pushed to acquire 50 or more percent shares in key transmission systems, and it would not settle for a minority stake, unless it came with management rights; “as we saw, the Russian company does not like to be a financial investor” (Orban, 2008).

According to Orban (2008), when Moscow saw a cooperating environment in each individual state, it showed its intentions openly; but, when it predicted difficulties in cooperation, it concealed its goals. Gazprom promised the same benefits for the governments that it foresaw cooperating – usually lower gas prices, however, it is hard to tell, whether it has delivered its promises: the contracts signed were secret and could not be analyzed or compared. Moscow also promised preferred access to Russian markets for all of the governments that Gazprom signed

contracts with in order to lower their bilateral trade deficits. The Russian government could easily use the threat of lowering imports from these countries, if these particular states tried to shift the balance in gas contract negotiations. Additionally, because of the secret nature of the contracts, the Kremlin could easily set up competing countries against each other in their pursuit for better gas prices and for the rights to transit gas west through their territory.

When the Russian government foresaw difficulties in convincing any particular state to give in their key energy assets, it created nontransparent circumstances for that particular state to give in those assets.

The gas contract of 1993 created nontransparent circumstances when it came to Europol Gas, the Russian-Polish joint venture, which later proved a Trojan horse for Moscow to gain a foothold in Poland. Moscow tried to gain control of the Polish section of Yamal through the joint venture, relying on the original contract and financial and legal measures. It pushed Europol Gas to take a loan from Gazprombank to construct compressor stations and set a transit fee that would ensure the company's failure to pay back its loan. It exploited every opportunity to hinder the company's daily operation by postponing the appointment of a chairman to its supervisory body (Orban, 2008, p. 174).

Gazprom has also been trying to seize control of as many channels of distribution of gas in Europe as possible through equity acquisition and operating agreements. Thus, gas imported from Russia is sold by the companies that are partially or fully owned by Gazprom. With ownership of final distribution, Gazprom can sell directly to the final consumers, and negotiate the contracts on both sides. That way it earns profits from both: gas sales to the channels of distribution and sales from channels of distribution to the final consumer. This strategy has been met with substantial opposition in Europe, but the opposition has not achieved much success. On September 4, 2012, the European Commission started an anti-trust investigation against Gazprom. The Russian government responded by taking the matter in its own hands: to protect Gazprom's income flow, it prohibited any facilitation by Gazprom officials to the foreign

investigation. Instead, the investigation is being resolved by governmental officials themselves (Ericson, 2012).

So far, the EU has been unsuccessful in its attempts to separate the ownership of distribution and supply of natural gas in Europe. According to Ericson (2012), with the means of Gazprom, Russia has been able to secure its position on the distribution channels in Austria, Italy, Netherlands, Germany, Great Britain, southeast Europe, as well as in Armenia and Moldova. Gazprom has also secured control over the transit pipelines in Armenia, Moldova, Poland and Belarus in return for contractual price concessions. It is similarly trying to convince Bulgaria and Ukraine to cede control of its transit pipelines for the favoring price agreements. Additionally, according to the Financial Times, Gazprom has shares of domestic pipelines in Belarus, Bulgaria, Germany, Serbia and Turkey; as well as shares of transit pipelines in Germany, Hungary and Serbia; and it is able to sell gas directly to some of the consumers in Bulgaria, Estonia, France, Hungary, Latvia, Lithuania and Ukraine (as cited in Goldman, 2008, p. 153).

In addition to the Kremlin's strategy establishing its monopoly supplier position and acquiring key assets in Europe, Moscow has gone through substantial efforts to prevent Europe from diversification of its energy suppliers. Although, the Russian government has been unsuccessful in preventing Europe from establishing LNG importing capacity and from acquiring cheaper gas from hubs<sup>18</sup>, as we saw in Section 2; its attempts to prevent the construction of alternative pipelines, such as Norway-Poland pipeline and Nabucco pipeline, proved to be fruitful. According to Orban (2008), Moscow renegotiated the gas contract with Poland through Gazprom for an additional 20 years, making the Norway-Poland pipeline impracticable.

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<sup>18</sup> That does not apply to Eastern and Central European states, as discussed in Section 7.

To successfully deter the construction of the US and EU supported Nabucco pipeline, Gazprom has built its own Blue Stream pipeline and later started the construction of another – South Stream pipeline. As a result, the construction of the Nabucco pipeline has been aborted (Weiss, 2013 July 13); nevertheless, its alternative TANAP might see a better future, as it has a major investor – Azeri State Oil Co., Socar – that proved to be resistant to Moscow’s pressure. It is nevertheless important to underline that the costs of the Blue Stream and the South Stream are several times as much as the cost of the competitive pipelines<sup>19</sup>; yet, Gazprom has been able to convince Eastern and Central European governments to build them instead of the competing ones (Orban, 2008). This success can be easily attributed to the leverage exercised by Gazprom’s market power in the region.

Furthermore, building new pipelines can be seen as a strategic move by Gazprom to ensure *two additional outcomes* besides the one just described, that is, deterring the construction of competing pipelines. The first additional outcome is bypassing the CIS states that hold the transit pipelines on their territory, thus ensuring prompt gas delivery to the high-paying European consumers. As soon as both South Stream and the additional branches of the Nord Stream are fully complete, Gazprom (and the Russian government) will be able to undercut the “hold-up power” of those CIS transit states, and therefore eliminate their power to negotiate gas prices. Additionally, as Ericson (2012) suggests, Russia will be able to selectively “punish” transit states without jeopardizing its deliveries to the European consumers. "Thus the Baltic States, Belarus, Moldova, Ukraine, and Georgia have faced cutoffs of energy supplies as Russia tries to make a point about their domestic policies or international stance, as well as gas pricing and pipeline control" (p. 633).

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<sup>19</sup> The higher costs may be attributed to reasons of corruption; however, this topic falls outside of the scope of this paper.

The second additional outcome originates directly from the first one; as Nord Stream and South Stream improve the security of gas deliveries directly to the Western European consumers, they make sure that the image of the company improves to credible and reliable<sup>20</sup>. From the words of Igor Shuvalov, the first deputy prime minister in Dmitry Medvedev's cabinet as well as the first deputy prime minister in Vladimir Putin's second cabinet, it is very clear that the company is trying to establish an image of a reliable supplier: "we are the most reliable supplier, in any circumstances, for the European market. The most reliable. Like it or not, even if people question it. Europe will never have a more reliable supplier of energy than Russia." (as cited in Goldman, 2008, p. 163). Even President Putin himself has emphasized reliability of Russian supply during a press conference on the first of February, 2007: "The Russian Federation has always abided by all of its obligations fully and completely, and it will continue to do so." (as cited in Goldman, 2008, p. 164).

## **9. Summary of Findings**

Having faced falling demand in Europe following the recession of 2008-2009, as well as the pressure to renegotiate contracts with its customers; Gazprom keeps facing continuous pressure to lower its gas prices by re-indexing it to the hub-based price. Being reluctant to fully switch to the hub-based gas prices, Gazprom has been faced with rising competition on the European market. As a result, its quantities of gas sold in Europe have been falling. Counter-intuitively to the logic, the company is building additional pipelines to deliver gas in large quantities to European consumers. While building additional pipelines to sell gas at prices higher than the market price in Europe might seem irrational, I argue that this strategy is justified by the long-term goals of the company. Despite the fact that building new pipelines can be motivated by the corruptive practices, those practices cannot be the sole purpose of these major projects. And

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<sup>20</sup> Chapter II of this paper is devoted entirely to the image of Gazprom.

so, I argue that the new pipelines – Nord Stream and specifically South Stream – are Gazprom’s sign of the long-term commitment to European customers.

As I mentioned earlier, natural gas is one of the cleanest and cheapest energy sources available in Europe; if BP’s predictions are true, the demand for gas will grow substantially in the following two decades, replacing some of the demand for oil and coal; increasing the share of gas in the power sector as well. If Europe commits to adjust its infrastructure accordingly, it will need additional quantities of gas in the future. The important question is: should Europe commit to increase its reliance on gas, including Russian gas, in the following years? Although previous literature shows that Europe has been concerned with Russian dominance on the European energy market; findings collected in this paper illustrate that situation has changed: dependence on Russian gas is not a problem for the EU as a whole anymore. Gazprom has already faced rising competition from alternative suppliers in Europe; there is the possibility for the additional gas to come to Europe from Central Asian states, Azerbaijan and possibly other alternative sources, perhaps even the United States. Thus, Europe as a whole would have a perfectly natural tendency to commit to heavier dependence on natural gas. In that case, Russia would not want to lose the share it currently holds of that market.

The Russian government has been supportive of Gazprom’s operations on the world arena, it benefited greatly from Gazprom’s contribution to the Russian GDP and state budget and it has used Gazprom as a tool to reach its own agenda. However, competition on the domestic market and new forms of competition from NGPs abroad suggests that the Russian gas sector is changing. As far as we know, NGPs might get access to the UGSS to export gas to Europe in the near future, hence breaking Gazprom’s export monopoly. I argue that Gazprom is trying to secure its share of the European market before any further changes occur. The company already

has joint ventures with monopolistic power set up in several Eastern and Central European states in order to import natural gas; additionally, it has been able to secure its position on the distribution channels in several European countries. It is currently building new pipelines to bypass CIS transit states altogether to deliver gas directly to high-paying European customers. Thus, Gazprom is trying to appear to the European customers as a reliable supplier, hence showing its dedication to serve gas without interruptions. The company's image of reliability combined with its substantial investments into the construction of new pipelines is a sign of the long-term commitment to European customers.

From the findings I gathered so far in this paper, evidence seems to suggest that Gazprom understands that further changes on the European gas market are inevitable; it is going to have to adjust its prices to the hub-based prices at some point. And indeed, it has already done so – it changed the price indexation of 15% of its gas<sup>21</sup>. It is only a matter of time until Gazprom adjusts its price indexation even further. It is clear that Gazprom would rather do that as a price concession during contract renegotiations, or in the process of striking a deal over the new shares acquisition, whatever it be. It would be hard for a researcher to see that price change however, since the contracts signed are usually kept secret.

In any case, following this logic, the strategy of the Russian export monopoly to build new pipelines to Europe (South Stream especially), while still selling gas at prices above the market price, might be reasonable; taking into account the fact that Gazprom understands the inevitable need to change the current pricing of its gas. For the time being, while fixed costs of building South Stream pipeline have not been fully covered, Gazprom will continue charging European customers prices substantially above the market price. However, when these fixed costs are fully covered, Gazprom can lower its prices for European customers. Although Russian

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<sup>21</sup> As I mentioned in Section 3.

gas prices are not very likely to fall as low as the market price, since Gazprom holds roughly a third of the European market share and therefore partial monopoly power<sup>22</sup>; Russian average gas price will have to adjust over time to a level somewhere between the market price and the average price currently charged by Gazprom in Europe, at least in real terms.

Thus, the construction of the South Stream pipeline is reasonable; it demonstrates Gazprom's efforts to secure its current European market share in two ways: first, by showing its commitment to the European customers and, second, by deterring other potential competitors from developing an infrastructure to deliver its gas to Europe. Forestalling the construction of the Norway-Poland and Nabucco pipelines is one example, averting the development of the LNG importing capacity in Eastern and Central Europe is another example. While the construction of competing TANAP pipeline from the Azeri to the EU border is very likely to be completed, it is not likely to take too big of a share away from Gazprom, at least not in the short run. The information gathered in this paper suggests, however, that competition to the Russian gas giant will continue to grow in the long run. Growing competition together with expanding European demand will cause Gazprom's market share to shrink, unless it develops new fields and establishes different strategy to attract new customers. Therefore company's monopoly power will shrink and with it the ability to charge prices above its long-run marginal costs.

Consequently, further questions arise: amid the rising competition on the European market, how to convince the European consumer to continue purchasing gas from Gazprom? How to make sure the Russian general public supports Gazprom's monopoly over the use of the UGSS to export natural gas abroad? Amid the decline in the production of current fields, how to attract foreign investors in order to develop new fields and to implement new LNG projects? In

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<sup>22</sup> Even if Russian government decides to give NGPs the access to the export pipelines, it would not reduce the average price of Russian gas on the European market, as Tarr (2010) illustrates; because it would be in Russian government's interest to continue extract monopoly profits on its gas exports to Europe through export taxes.

this paper, I argue that Gazprom uses both “Hard Power” and “Soft Power” to reach its goals<sup>23</sup>. While Chapter I provides examples of the “Hard Power” used by both Gazprom and the Russian government to reach their goals, Chapter II will concentrate mostly on Gazprom using “Soft Power” to reach its agenda. Thus, I will attempt to answer questions posed above in the following chapter.

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<sup>23</sup> As Cooper (2004, January 01) describes it: “Hard power is coercive force. Soft power (it seems) can be just about anything else” (p. 2).

## Chapter II. Gazprom: Creating a Positive Self-Image

Gazprom, one of the largest natural gas producers and exporters in the world, uses many media outlets to create and promote a positive image for itself both on the domestic and international arena. This chapter analyses three such media outlets, namely: the company's website; an interview conducted domestically by the state news agency "Vesti" with Alexei Miller, Gazprom's Deputy Chairman of the Board of Directors; and an interview conducted by the European independent source "Natural Gas Europe" with Sergey Komlev, the Head of Contract Structuring and Pricing Directorate at Gazprom Export.

The first media outlet, Gazprom's website, is the easiest one to analyze, since it is a pure self-portrayal by the company without outside intervention. This outlet is different, because unlike the other two media outlets, it is targeting different audiences at the same time. Let's take a look at what kind of audience might the company target and why.

### 1. Targeted Audience

Natural resources altogether are very important for the overall wellbeing of Russia; they comprise a large share of Russian GDP and the Russian state budget. In 2004 export revenues of oil and gas amounted to about 25% of GDP and about 40% of the Russian state budget; in 2011, those figures amounted to 10.4% and 50% respectively (Ericson, 2012). So the success of Gazprom is not only important for the company, it is also very important for the Russian economy. Consequently, it might be important for the creators of the web-site to appeal to *the Russian general public* and to show the importance of the company's operations for the national economy; so that the public would support certain privileges that the company may hold, such as a gas export monopoly and certain tax breaks, for example, customs duty (ECD) and mineral extraction tax (MET) breaks (Hines & Marchenko, 2013 June 3).

Gazprom is the biggest natural gas company in Russia in gas exploration and deliveries. In addition, Gazprom owns all of the pipelines and pumping stations in Russia, and it is given the exclusive right to use pipelines for the export of natural gas abroad (Anderson, 2008). The European energy market is by far the most important for Gazprom, because the prices of gas in Europe are roughly four times the prices of gas on the domestic market, and with respect to volume, equaling roughly one third of Russian domestic consumption, bringing the biggest part of revenue for the exporting giant (Pirani, 2013). Thus, it is natural for the company to appeal to *the European consumer* – the European general public, industry sector and electricity-generation sector – in order to convince them that, first, natural gas is the best choice of preference as an energy source; and, second, that Gazprom should be the best choice of world suppliers. So as a consequence, European consumers would continue to purchase Russian gas from Gazprom.

Another fact worth mentioning is that the current gas fields of Gazprom are being gradually depleted and there is the need for the company to develop new fields along with the new Liquefied Natural Gas (LNG) projects<sup>24</sup>. To implement some of the LNG projects and to develop new fields, the Russian export giant needs the help of foreign partners in technologies and in funding those projects (Kardaś, 2013 January 16). That is why Gazprom is very likely to appeal to *the foreign investors* on its web-site. It is hard to obtain cooperation with foreign partners in these expensive projects however, because Russia is perceived as a risky place in which to invest. This perception exists due to the amendments made to the Russian hydrocarbon legislation<sup>25</sup>, which create favorable conditions for state-owned gas companies, such as

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<sup>24</sup> New LNG projects are important for Gazprom to stay competitive on certain natural gas markets, especially on Asian and European Markets.

<sup>25</sup> To read more about the amendments to the Russian hydro-carbon legislature, please, refer to (Hines & Marchenko, 2013 June 3).

Gazprom<sup>26</sup> (Boussena & Locatelli, 2012). Thus, the creators of the Gazprom web-site have incentives to exaggerate the company's value and to avoid mentioning the risk associated with investment in the company, while appealing to foreign investors.

## **2. First Media Outlet Analysis: Gazprom's Website**

Before this section of the paper goes into comprehensive analysis, it is important to mention that Gazprom's website has an option to be viewed in three different languages with three different web addresses: in Russian at <http://www.gazprom.ru/>, in English at <http://www.gazprom.com/> and German at <http://www.gazprom.de/>. While Russian and English web pages have almost the same outline, imagery and content, except for only few minor differences; German page has somewhat different outline and very different imagery and content. A visitor to these three web pages can see the contrast between the imagery and content right away. While Russian and English web pages display green landscape with pink flowers in the forefront and blue skies and mountains in the background, notifying the visitor that the South Stream project has been started in Bulgaria; the German web page portrays the Berlin Brandenburg gate with "Energie" written across it. Additionally, instead of the information on the stock prices and the news feed right below the image, as in the Russian and English versions of the page; German version displays the fact that Gazprom has been on the German market for forty years. To the left of that message, there is a video outlining the significance of Gazprom on the German market. Further down the page an image of two players from German football team "FC Schalke 04" is displayed with a message notifying the visitor that the team has been sponsored by Gazprom since 2007 (Gazprom, 2013. b).

Farther differences are seen, if a visitor decides to compare "Geschichte" and "History" links of German and English web pages found in sections "Gazprom im Überblick" and "About

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<sup>26</sup> Please, refer to Section 6 of Chapter I for more information.

Gazprom” respectively. While English (as well as the Russian) version shows the detailed history of the company since its “birth”, that is restructuring from the USSR Gas Industry Ministry in 1989; the German version shows the events relevant mostly to the Russian-German cooperation in gas industry, starting in 1969 – before Gazprom was even formed. Germany is the largest export market for the company, thus it is not surprising to see Gazprom designating an entirely separate page for German consumers in a hope to improve and strengthen this partnership even further in the following years: “*In diesen Jahren sind wir zu weit aus mehr als nur zu zuverlässigen Geschäftspartnern geworden. Wir sind gute Freunde geworden. Und diese Freundschaft wird mit den Jahren nur noch starker.*” (“In these years, we have become far more than just reliable business partners. We have become good friends. And this friendship only gets stronger with the years.”) (Gazprom, 2013. d, par. 4).

Although, German web page is designed to target mostly German customers; both English and Russian web pages target a wide variety of audience. That could be due to the fact that regular German citizen would be less likely to access the Russian or the English web pages instead of the German one; while foreign investors, including German, would be more likely to visit either Russian or English web pages, since Russian is the native language of the company and its employees, and English is an international language well suited for business purposes. Because this paper is looking at company’s gas exports to the whole Europe and because an average *European customer* or *foreign investor* is more likely to access the English page; this paper analyzes English version of the company’s web site. Besides, even though *the Russian general public* would be more likely to visit the Russian web page, it is very similar to the English version; and so English version fits well for our purposes.

The overall layout of the main page is done in a very professional manner; it upholds the image of the company as a credible institution with an answer to any question, to any visitor – be it *the Russian general public, European consumer, or foreign investor*. The page is user-friendly, since it is very easy to find any topic of interest, interactive and “positive”, with the picture of Alexey Miller, the head of the company, smiling on the side of the page. There are several aspects of positive image that the company is trying to create on its website. First, an image of *the environmental stewardship* of the company, commitment to production that is clean and safe for the environment. This commitment is shown both directly and indirectly. Most pictures taken in Russia or abroad have one piece or another of nature in it, showing environmental commitment indirectly: blooming trees, green grass, tall mountains, clear shiny water, white snow or clear blue skies; refer to Figure 19 for an example. Gazprom represents its commitment to environmental stewardship directly on a separate page named “Environment”. That separate page highlights water, land, atmosphere protection and waste reduction.

The second positive image that Gazprom is trying to create on its web site is *social consciousness*. The site’s news feeds announce support of various sports, social projects, cultural events



**Figure 19: Gazprom's headquarters (Gazprom, 2013. c).**

and education developments in Russia. Creators of Gazprom’s website demonstrate directly its commitment to the community on the page called “Social Responsibility”. This page is meant to

show that Gazprom helps not only the Russian economy as a whole, but also individual communities and its people.

The third positive image that is shown on the web page is *progress*. This image is represented in the establishment of important international connections, development of new technologies and cooperation with the Russian government. Even though the Russian government holds most of the company's shares (Anderson, 2008), news articles treat the relationships between the two entities as cooperation, rather than hierarchy. The editors of the article "Russian President Vladimir Putin entrusts Gazprom with getting back to Yamal-Europe-2 and gas branch to Kaliningrad Region project" (Gazprom, 2013. a) use the word *entrusts* rather than *commands* or *orders*, symbolizing not only cooperation, but also mutual *trust*. If the Russian president has trust in the company, Russian people should too.

The page "About Gazprom" is the company's self-evaluation, treating itself as a person in this short narrative<sup>27</sup>. The first sentence can be viewed as an abstract: "Gazprom pursues the strategic objective of establishing itself as a leader among global energy companies" (Gazprom, 2013. c, par. 1). It offers an evaluation for the rest of the narrative: Gazprom wants to be a leader among global energy companies. In this section, the company is trying to appeal to the *European customers* and *foreign investors*.

The subsequent two paragraphs define what kind of company Gazprom is, that is, what it does, and what its mission is. The picture on this page signals environmental stewardship as a part of its mission through the portrayal of the Gazprom headquarters in Moscow on the background of blue sky with white clouds and a green pine tree in front of it (Refer to Figure 19 above), similar to other images described earlier.

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<sup>27</sup> The evaluation of a narrative is adopted from Linde (1993). Linde specifies four distinctive structural parts of a narrative in a life story: abstract, the orientation, one or more narrative clauses, and the coda.

The entity is using such adjectives as *reliable*, *efficient*, and *balanced* to describe its supply. Gazprom says that it views its mission in *reliable* supply, it does not specifically state that its supply is reliable; so it acknowledges that it might not have been as reliable in the past, as with the supply disruptions in 2009 during the price conflict with Ukraine, but that its priority is to make it reliable – that is why it is building Nord Stream and South Stream. Gazprom also acknowledges that its supply might not have been *efficient* or *balanced*, but that its mission is to make it such through introduction of new technologies and through the start of new LNG projects respectfully; but to do that the company needs new investors. Gazprom also emphasizes the word *global* to appeal to foreign readers and investors:

Gazprom is a global energy company. Its major business lines are geological exploration, production, transportation, storage, processing and sales of gas, gas condensate and oil, as well as generation and marketing of heat and electric power.

Gazprom views its mission in reliable, efficient and balanced supply of natural gas, other energy resources and their derivatives to consumers (Gazprom, 2013. c, par. 2).

In the next four following paragraphs Gazprom establishes itself as a national, as well as a world leader of natural gas in production and exploration; it also establishes itself as the wealthiest natural gas reserves holder. Then the entity goes on to define itself again as a *reliable* supplier of gas to both Russia and abroad. Next, it defines itself as *the only* producer and exporter of LNG in Russia; it omits to say that its development of new LNG projects has been dramatically slowed down, especially in Shtokman, due to the lack of foreign investments (Ericson, 2012).

Next, Gazprom acknowledges that it is not first in the country in oil production, but it still defines itself as being in the top five – still being among the leaders. Gazprom also mentions that it is the biggest owner of the power generating assets in Russia. This time the number is different

– 17% of total installed capacity of the Russian energy system, compared to 70% of Russian gas reserves or 78% of Russian gas output. What can be read between the lines here, and what is not explicitly stated in the text, is that Gazprom faces strong domestic competition in the power generating area with the strong possibility of other domestic firms surpassing Gazprom in power generating in the near future (Gazprom, 2013. c).

The narrative is concluded with the coda by summarizing everything that was said previously: “Gazprom pursues the strategic objective of establishing itself as a leader among global energy companies by entering new markets, diversifying its activities and ensuring reliable supplies” (Gazprom, 2013. c, par. 7).

On its website, Gazprom is trying to appeal to the Russian general public; it is also trying to attract foreign investors and European customers through its portrayal as a reliable supplier and a leader in the production of natural gas, LNG and oil. Certain content in the text on the web-site is omitted as to slightly exaggerate self-image and signal to the European, as well as domestic customers that Gazprom should be indeed the supplier of their choice. The company is also trying to appeal to both the European and domestic public as a beneficent, socially conscious partner, who cares about the environment and is essential for the Russian economy.

### **3. Second Media Outlet Analysis: Interview with Alexei Miller<sup>28</sup>**

The Moscow-based “Vesti” news report that features an interview with the head of Gazprom, Alexei Miller, starts off with an introduction. In the introduction, the reporter informs the viewers about the topic of the interview: natural gas being transported to Ukraine not as traditionally expected – westwards from Russia through Gazprom, but instead – eastwards from the gas hubs in Europe (Vesti, 2013, March 30). The first thing that attracts attention in this introduction is the way the news reporter names the topic for the interview: “*Ukrainian*

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<sup>28</sup> The analysis of this and the following sections is conducted using the techniques outlined by Gee (2011).

*illness/scab (Украинская болячка)* in the Russian-European oil-gas relations”. There are two important implications of this report’s nickname. First, it assumes familiarity of the viewer with the previous issues in the oil-gas relations between Russia and Ukraine. And second, because that nickname is presented to viewers within the first ten seconds of the report, it sets up the attitude towards the rest of the news report – Ukraine being a sore place on the Russian-European oil-gas relations that needs to be cured.

Overall, it sounds like the interview has been shaped to cover two main points: first, whether Ukraine is on its way towards independence from Russian natural gas; and second, whether alternative gas suppliers to Europe pose genuine competition to Gazprom. Although the interview has been shaped to cover these two main questions, the interview has not been staged. Both Alexey Miller and the interviewer seem to have a natural conversation float rather than reading previously written speeches; this can be inferred by rephrasing, numerous pauses and a couple of overlaps. But at the same time, it is possible to tell that the interviewer has certain guidelines to follow. Firstly, there are no controversial questions: the Chair of Gazprom has all of the answers for the interviewer’s questions that show the company in a very positive and powerful way. Secondly, Alexei Miller seems to follow the topic of the discussion without any deviations. The fact that Mr. Miller does not avoid answering any of the interviewer’s questions symbolizes his sincerity and openness, which is supposed to create trust between himself and the viewer. And since he is the head of Gazprom and speaks of the company and for the company, using such pronouns as *мы* (*we*), *нас* (*us*), *нам* (*our*), *нам* (*to us*), his openness is also supposed to create trust between the viewer and the company as well.

At the same time, it is possible to tell that the interview has been edited and some of the contents of the interview have been removed. Some of removed parts could have been irrelevant

to the topic, or the company simply did not like its content. For example, when Alexei Miller is talking about the fraudulent scheme set up on the Ukrainian border to make it seem like the gas is coming from the west, and after he suggests that there is a need to deal with such scheme, the footage is cut to the next question of the interviewer. A.B. Miller could have evaluated more on the ways to deal with such schemes, or brought more evidence of such schemes to the picture, it does not really matter what was said. What matters is that the message of “dealing” with those schemes became more powerful, as it became the last words of his thought after the editing.

Even though there are no controversial questions directed towards the head of the company, the interviewer tries to create an illusion of such questions, when he proposes “*a little conspiracy theory*” (“*небольшую теорию заговора*”) (Vesti, 2013, March 30). And that “conspiracy theory”, instead of uncovering or revealing a negative part of the company turns out to do the complete opposite – show Gazprom in a positive light. The question that the interviewer asks is whether *Gazprom/Miller* (addressed as *вы*) has persuaded Qatar to redirect its gas exports from Europe to Asia, “*where the gas prices are higher*” (*где цены выше*) (Vesti, 2013, March 30). What this question does, even though it poses as a controversial question, it allows the audience to assume that Gazprom indeed could persuade Qatari gas exporters to redirect their exports from Europe just because it is in the Russian interests. Alexei Miller answers that the company did no persuasion and that it is rather “*pure market logic behavior*” (*чисто рыночная логика поведения*) (Vesti, 2013, March 30). What this answer does is say that there is no need for Gazprom/Miller to do such persuasion, because it is already in Qatari gas exporters’ interest to redirect its gas exports, simply because it yields higher returns. What can be

inferred between the lines here is that Gazprom does not act as a dictator<sup>29</sup>, but plays by the rules of the “invisible hand<sup>30</sup>” of the market to achieve efficient outcome.

Another interesting thing about the interview is that the interviewer seems inferior to the head of Gazprom, even though the interviewer is the one leading the discussion. Instead, he asks A. Miller just the basic noncontroversial questions, he lets Miller talk the most and interrupts him only once to clarify what he means. By the end of the interview he gives Alexei Miller a compliment: “*Мимо вас не пройдёшь, похоже*”, which means: *one cannot go past you unnoticed, or so it seems* (Vesti, 2013, March 30). At large, the interviewer switches his role to be both the interviewer and the spectator in order to relate more to the *Russian general public*, and therefore to make the conversation with the head of Gazprom closer to the public. That is why the interviewer’s name is never mentioned throughout the whole interview. Perhaps for the same reason, the interviewer uses the colloquial word *скукоживаться*<sup>31</sup>, which means *to shrink* in relation to the gas supply to Ukraine from the west – to relate more to the general public, and to transfer its attitude toward Ukraine to the spectators.

Now that the stage is set, the message can be analyzed. First, the question of whether Ukraine is on its way towards independence from Russian natural gas. The very first thing that the interviewer asks is not whether the news of the reverse supply is *true*, instead he asks, whether the talk about it is *realistic*. By *realistic*, the interviewer does not mean the actual possibility that there is talk about it, but the possibility that the talk is true. Thus, the interviewer does not ask whether the news is true, but instead whether the news could be true. The message

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<sup>29</sup> Gazprom is commonly accused of charging a price that is above the long run marginal cost, which is a property of a monopoly, rather than a firm in a competitive market

<sup>30</sup> The concept of the “invisible hand” originated from Adam Smith’s writing about the self-regulating behavior in the marketplace. The main idea of the “invisible hand” was that the market brings the most efficient outcome to the society if it is unregulated, guided by the invisible forces of the supply and demand.

<sup>31</sup> The word has a root of *кожа* – *skin*, and is often used with relation to skin, or at other occasions to a scab that is ready to fall off. That perfectly connects to the opening introduction and the idea of Ukraine being a *scab* in the Russian-European oil-gas relations that might soon fall off.

of the question is straight to the point – there can be no discussion about the existence of the reverse supply from the west. And so, even though Alexei Miller does not have the facts to prove his theory, the viewer is predisposed to take Miller’s answer as a legitimate fact following the interviewer’s question. Furthermore, Miller refers to the possibility of the reverse supply as to the “*fraudulent schemes*” («мошеннические схемы») and he adds that “*there is a need ... to deal with them*” («с ними надо ... разбираться») (Vesti, 2013, March 30). This message predisposes the viewer to the idea of the legitimacy of the actions undertaken towards Ukraine in the past, such as shutting off the gas supply to Ukraine and subsequently to the rest of Europe in 2009; and it legitimizes Gazprom’s plan to build new pipelines to avoid Ukraine altogether, while supplying gas to Europe<sup>32</sup>.

The second question discussed in the interview is whether alternative gas suppliers to Europe pose genuine competition to Gazprom. This is not a question directly asked by the interviewer, but the issue that directly relates to the whole video. The actual question asks whether the American shale gas revolution affects Gazprom’s strategy of supply to Europe, whether the United States brings additional competition to the company on the European Market. Miller’s answer is “no”. He says that he is very skeptical about the United States being able to export its gas, because the country uses more gas than it extracts. He further argues that the US is not a competitor to Gazprom, because all of the US wells bring negative rents. That fact is not reasonable, because US firms would not operate under negative profits, unless they were subsidized by the government. Then A. Miller states that Russia has the same technology and is already using it to extract gas from coal in Kuzbass. Even if Gazprom did have that technology, what would make it profitable for Gazprom to use that technology, while it was non-profitable

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<sup>32</sup> As described in Section 8 of Chapter I.

for the US firms? And if it wasn't profitable, why would Gazprom use it, let alone invest to develop that technology?

On the whole, the interviewer and Alexei Miller discuss only two rival suppliers to the European market throughout the interview. The first one is the United States, whose quantities supplied to the European market so far have been marginal, and Qatar, whose gas deliveries have been redirected towards Asia, according to Miller himself. The head of Gazprom avoids mentioning other gas competitors; thus, by discrediting the only two mentioned competitors on the European Market, Qatar and USA, he creates an illusion that Gazprom controls the market. Hence, talking about the United States as a competitor, while its exports to Europe are marginal, is the strategy to take attention away from three other major competitors and create a positive image for the company – that is an *image of dominance on the European market*.

Gazprom seems to have the interview planned, having the interviewer follow specific guidelines, but it tries to make it seem natural at the same time in order to appeal to the Russian general public that views it. The interview is shaped in a way that makes the viewer believe what the head of Gazprom says. That includes creating a negative image for Ukraine and a good image for itself – that is an image of a dominant position on the European Market. That way, the company is able to manipulate public opinion and support its operations and strategies, such as building new pipelines to Europe that deliver gas independently from Ukraine and having exclusive access to the pipelines to export gas abroad.

The Russian general public is not the only audience that Gazprom is trying to reach through media outlets. In an interview with Natural Gas Europe, the head of the contract structuring and pricing directorate at Gazprom Export Sergey Komlev is addressing a different audience – namely, *European consumers*. His message is the opposite of Miller's message,

stating Gazprom's political non-involvement and being operated purely by the rules of the market, rather than being a dominant dictating power on the European Market. We turn to that interview to examine the message.

#### **4. Third Media Outlet Analysis: Interview with Sergey Komlev**

The interview with Sergey Komlev differs dramatically from the other two media outlets discussed earlier, outlets that shape and promote a positive image for Gazprom. First of all, the purpose of the interview is different: it was conducted by an independent European source in advance of the European Gas Conference in Vienna to prepare Gazprom and other participating companies for the conference. Unsurprisingly, the intended audience for the interview is different, educated and informed on the details of the issue – Gazprom's *European customers*<sup>33</sup>. Naturally, the questions asked during the interview appear to be more critical, and have the power to harm the image of the company, unlike the questions asked during the interview with Alexei Miller. Hence, the answers seem to be chosen very carefully, in advance of the interview. Part of Gazprom's strategy, while targeting the company's customers in Europe, was to *present itself as a politically neutral entity*, operated purely by the rules of the market – a positive image of the company in that region, as compared to the image of a politically-led company that is trying to dominate the market. This idea of political neutrality is emphasized twice by Sergey Komlev throughout the interview. The first time, it is in response to the interviewer's question:

Gazprom has been raising concerns over the evolution of the internal gas market in Europe for some time now but Brussels seems to be paying little attention. How do you explain this, knowing that you are Europe's first external supplier? Furthermore, how do you explain the European phobia against Russian gas? [...] (Sahraoui, 2013 January 31, par. 6).

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<sup>33</sup> Even though the European general public might not fit into this category, it still has the access to the interview. The language that the interview was conducted in is English.

Note that the interviewer is referring to Russian gas, not Gazprom's gas – asking the question concerning the whole country rather than the company itself presents a political question; it can be inferred that the company is a tool in Russia's hands to deliver gas to Europe. Furthermore, the interviewer's question also seems to imply that Gazprom's influence on the market is deteriorating – Gazprom, as the first external supplier in Europe, has been raising concerns for some time, but the European Commission (EC) has not been paying attention. Komlev replies with a twofold answer:

Brussels is focused on geopolitics. Our company participates in various discussions held with the EU, but unfortunately, our arguments are often unheard or unwanted. Namely, we haven't yet heard a clear explanation why such a big emphasis is put by the EC on lowering the dependence on Russian gas. On the contrary, our approach is commercial-based: we want to sell as much gas as possible, at prices that provide for balance of interests of both buyer and seller and support investment cycle; we aim at harmonious development of European gas market that's in interest of everyone involved in it. (Sahraoui, 2013 January 31, par. 8).

S. Komlev agrees that the EU pays little attention to the arguments brought up by Gazprom, but he turns the table on the European Commission by reasoning that it is Brussels that is focused on politics, not Gazprom. Then he goes further to say that, on the contrary, the company's approach is commercial-based, and outlines its strategy in support of his argument.

The way the interviewer forms the questions might seem sympathetic towards Gazprom, but it is deceiving, taking into account the underlying assumptions and implications of the questions. The interviewer asks the questions in that way to soften their content, in order not to appear antagonistic, but rather neutral on the subject. And so, when Komlev is asked about the anti-trust investigation started against Gazprom, the interviewer does not specify who the

investigation was started by – she leaves the European Commission<sup>34</sup> out of the question to make it look like an observer, rather than the initiator: “What would you like to say about the anti-trust investigation launched in September against Gazprom?” (Sahraoui, 2013 January 31, par. 14).

Answering this provocative question<sup>35</sup>, Komlev turns the table back on the European Commission once again, asserting that the EC is the one who is trying to achieve a political agenda – to decrease the gas prices for several Eastern European countries. His argument does not seem that convincing this time, because he avoids mentioning the Russian government involvement in the matter. He goes further to refute the accusations against Gazprom of being “monopolistic”, using the word as some sort of a nickname, rather than a fact. Gazprom is the biggest natural gas supplier to the European Market, and its market share gives it substantial power to raise the price of gas above the long-run marginal cost<sup>36</sup> (Tarr, 2010), which by definition makes the company a partial monopoly in this case. This statement defeats the following argument of Komlev and makes him sound defensive, rather than reasonable. It does not mean that his further argument is false, but it does bring a negative image to his overall delivery.

The second time the head of Gazprom Exports brings up the idea of the company’s political neutrality is following the concluding question of the interviewer:

While Russian gas is being "ill-treated" by the European Commission, very little is said about Algerian gas. Is there a real difference in treatment? If so, why? Generally speaking, how do you explain the increasing energy relation tensions between the EU-Russia? (Sahraoui, 2013 January 31, par. 16).

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<sup>34</sup> Refer to (Ericson, 2012) for more information on the anti-trust investigation.

<sup>35</sup> The question is provocative, because following the launch of the anti-trust investigation by the EC, a response came from Russian government. It prohibited Gazprom officials to facilitate the foreign investigation in any way, so the matter was being resolved by governmental officials instead of the heads of the company (Ericson, 2012).

<sup>36</sup> In case of perfect competition, the price of gas would be equal to the long-run marginal cost, because the company’s profit would equal zero.

Sergey Komlev responds with the comment that ‘the Algerian suppliers are not “patted on the back”’ either, implying that there are tensions not just between the EC and Gazprom, but also between the EC and any other gas supplier to the European Market. He agrees that Brussels comments the most on Russian gas, but that is normal, taking into account that Gazprom is the biggest gas supplier to the European Market. Komlev concludes the interview with the echoing statement that the EC is focusing on the politics, rather than economics; and since Gazprom is a politically neutral company, he, as the representative of the company, prefers not to comment on the political issues (Sahraoui, 2013 January 31, par. 17). It is a statement that is dogmatic rather than realistic, taking into account the fact that the Russian government holds the majority of the shares of the company and is able to have a decisive voice on any decision of Gazprom’s corporate matters (Anderson, 2008). But that is the image that the company is trying to depict for itself to this particular audience – the European customers. This image of non-political involvement of the company and it being “non-monopolistic” is particularly fascinating in comparison to the image created during the interview with Alexei Miller – an image of Gazprom being a dominant supplier, having no real competitors and therefore having the European Market under Gazprom’s control. It is not surprising to see such a difference in the message of the company, because both interviews – the outlets to create and promote the company’s positive image, as they are named in this paper – are directed at different audiences through different channels. Either one of the interviews is unlikely to be viewed by the audience other than the one it is intended for.

## **5. Summary of Findings**

The Russian natural gas export giant Gazprom uses many media outlets to create and promote a positive image for itself both on the domestic and international arena. This paper

analyzes three such outlets. The first one, the company's website in English, is the easiest to look at, since it is a self-portrayal by the company – not subject to any criticism or comments directly on the website. This media outlet is different from the other two, because it is intended for several different audiences at the same time: the Russian general public, European consumers and foreign investors. Gazprom appeals to the Russian general public through the direct and indirect portrayal of environmental stewardship, social consciousness and progress as its core values. The company justifies natural gas on its website as the best choice of fossil-fuel on the energy market, and signals that Gazprom should be the supplier of the European consumer's choice, because its supply is reliable, efficient and balanced. To appeal to foreign investors, the company presents itself as “leader among global energy companies” (Gazprom, 2013 b, par. 1) – the best there could be to invest in.

The second media outlet analyzed in this paper is the interview conducted domestically by the “Vesti” news agency with Alexei Miller. This particular outlet targets the Russian general public; it is relatively easy for the company to create a positive self-image, since the news agency conducting the interview is state run. With the help of the interviewer, Alexei Miller achieves two goals with the interview: creating a negative image for Ukraine and creating a good image for Gazprom – that is an image of a dominant power on the European market. That way, the company is able to manipulate public opinion and support its operations and strategies, such as building new pipelines to Europe that deliver gas independently from Ukraine and having exclusive access to the pipelines to export gas abroad.

The last media outlet used to create and promote a positive self-image of Gazprom that this paper examined is the interview conducted by the “Natural Gas Europe” with Sergey Komlev. Unlike in the interview with A. Miller, S. Komlev is interviewed by an independent

European source, so it is harder for the company to maintain a good image. The questions asked by the interviewer are more critical and have the power to harm the image of Gazprom. The interview is intended for Gazprom's European customers; and the image for the company that Komlev strives to produce is the opposite from the one shaped by Miller – the image of a politically neutral entity, operated purely by the rules of the market. It is not surprising to see such a difference in the message of the company, since these two interviews are directed at two different audiences. Gazprom succeeds in achieving a positive image in the first media outlet, since it is the one intended for all audiences; and the company succeeds in achieving a positive image in the other two medium outlets as well, as long as they are viewed only by the intended audiences.

## Conclusion

Following the recession of 2008-2009, Gazprom has faced falling demand for gas in Europe and consequently continuous pressure to renegotiate contracts with its customers. The company has been reluctant to adjust its gas prices initially, which led to the increased competition on the European market from alternative suppliers. With time however, Gazprom has yielded to the pressure and renegotiated the contracts with the European customers, changing indexation of 15% of its gas in addition to other concessions. Evidence from the findings that I gathered in this paper seems to suggest that Gazprom understands inevitability of change on the European market and so the need to adjust its prices even further. Since the company still holds partial monopoly power on the market, it will continue charging prices above the long-run marginal cost and therefore above the market price until it loses a share of the European market substantial enough to lose its partial monopoly power. As Gazprom continues to lose some of its market share, it will continue adjusting prices of its gas in Europe.

European gas market is important for Gazprom, as it brings significant part of company's profits. Moreover, Gazprom contributes greatly to the Russian GDP and state budget and the Russian government continues to use the company as a tool to reach its own agenda on the world arena, especially to exercise leverage on FSU states. Thus, both Gazprom and the Russian government have been trying to prevent the loss of European market share using various tactics. Utilizing help from the Russian government, Gazprom has been able to establish joint ventures with monopolistic power in several Eastern and Central European states; it also has been able to secure its position on the distribution channels in several European countries. In addition, the Russian export giant has built two branches of the new Nord Stream pipeline; it is working on two additional branches of the Nord Stream and it has begun the construction of another pipeline

– South Stream. Both pipelines bypass CIS transit states altogether to deliver gas directly to high-paying European customers and both are designed to prevent European states from diversifying its gas suppliers any further.

Natural gas is one of the cheapest and cleanest energy sources available in Europe. If BP's predictions are correct, the demand for gas in Europe will grow significantly in the following two decades, replacing some of the demand for oil and coal; increasing the share of gas in the power sector as well. Given the likelihood that Gazprom retains its current demand for gas in Europe, the Russian gas exporter will certainly lose some of the European market share, assuming the rising demand; unless it develops new field and implements new LNG projects. To develop new field and LNG projects, Gazprom needs help from foreign partners funding investments and providing state-of-the-art technologies. However, because of government favoritism toward stat-owned companies in Russia, it had been hard to attract cooperation with any foreign partners. Hence, the evidence suggests that Gazprom will continue losing European market share; unless the price of gas goes up, making it worthwhile for the foreign partners to come in and fund the new projects amid the risks associated with these investments.

Moreover, Gazprom is perceived by the European customers as a risky supplier, not simply for the reason of company's inability to develop new fields to cover for the decline in the production of the current fields, but also for two additional reasons. First, steeply rising domestic demand for gas that might reallocate some of the gas exported to Europe for the domestic market, and current dependence on gas produced by the NGPs. And second, dependence on gas supplied by the Central Asian states and the gradual shift of this gas to alternative markets.

Thus, constructing highly expensive South Stream pipeline might seem irrational, when it appears that Gazprom might not even be able to fulfill its contractual obligations; especially

considering the fact that the company already charges prices that are above the market price – an obvious deterrent for the European consumer to purchase Russian gas. Construction of the South Stream pipeline makes sense nevertheless from Gazprom’s point of view; it demonstrates Gazprom’s efforts to secure its current European market share in two ways: first, by showing its commitment to the European customers and, second, by deterring other potential competitors from developing an infrastructure to deliver its gas to Europe. Even though the prices of Russian gas are significantly higher than the market price in Europe, they will inevitably fall in relative terms, not only because the market share of Gazprom will continue to fall; but also because the fixed costs of the new pipelines will be fully covered at one point and thus will not be part of the calculated gas price for the European customers. From the perspective of Gazprom, it is reasonable to build South Stream pipeline to deter alternative suppliers sooner than later, while company’s market share is still high enough to be able to charge prices high enough to cover for the cost of the new pipeline.

At the same time, following the price conflicts between the Russian and the Ukrainian governments; the construction of the South Stream pipeline is important for Gazprom in order to appear to the European customers as a reliable supplier, to show its commitment and dedication to serve gas without interruptions. Consequently, building the new pipeline is one of the strategies of the exporting gas giant to achieve its agenda. The other strategy is to use media outlets to convince the same European consumer that the natural gas is the best choice of preference as an energy source and that Gazprom should be the best choice of world suppliers. Furthermore, using media outlets helps the company to show the Russian general public the importance of the company’s operations for the national economy and overall wellbeing to gain the public support for certain privileges that the company may hold, especially the gas export

monopoly and certain tax breaks. In Addition to the European consumer and the Russian general public, Gazprom uses media outlets to convince foreign investors to cooperate with the company in the development of new fields along with new LNG projects in order to expand its operations and gain bigger share in the growing European gas market.

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