



Is Gazprom a Threat to European Energy Security?

Myths, Assertions and Facts

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Introductory Remarks

Ø We have witnessed an increasing number of attacks on the reputation and reliability of Gazprom over the past several years. These attacks are based on a small number of key assertions that through endless repetition have achieved the status of general assumptions about Gazprom. An examination of the underlying facts will show that these assertions have been used to construct a serious of interlocking and dangerous myths.

Ø Previously we ignored these attacks because they seemed to be so transparently untrue and politically motivated that there was no reason to reply. However the endless repetition of these assertions against us now threatens to undermine not only our reputation, but our ability to implement important projects in Europe.

Ø The fundamental direction of these assertions is to show that Russia, acting through Gazprom, is a threat to European energy security.

Ø Myths present a distorted assessment of reality and the energy policy that rests on myths leads to inadequate actions.

Ø We and our business partners see Gazprom as the cornerstone of energy security for Europe, now and in the years to come. So we feel that it is time to openly discuss the assertions being made against us and to exam the reality behind these assertions.

Ø I am not a politician or representative of the Russian government, so I will not speak about politics or geopolitics in order to counteract negative assertions about our company. The topic of my discussion today is business matters.

Ø My assumption is that those politicians and analysts who do not correctly understand Gazprom are simply lacking information and my role is to full in this gap.

Five Most Popular Myths About Gazprom

#1 Gazprom is an energy weapon of the Kremlin

#2 Gazprom is involved in pipeline wars in Europe to exert political influence

#3 Gazprom is a threat to competition in the gas market in Europe

#4 Gazprom is an unreliable supplier

#5 Gazprom is managed by kleptocrats, not professional managers



Myth #1 “Gazprom is an Energy Weapon of the Kremlin”

Ø Assertion 1.1: “Gazprom exerts political pressure on neighboring countries by shutting off gas supply in the middle of the winter”.

Ø Assertion 1.2: “Gazprom’s pricing policy is politically driven”.

Ø Assertion 1.3: “Russia’s key political leaders – Mr. Medvedev, Mr. Putin and Mr. Zubkov – control Gazprom and use it as a political instrument”.



GAZPROM'S VIEW

- Ø The fundamental question in examining these assertions is to decide whether Gazprom is a business entity operating under normal business consideration; or, a quasi-business, quasi-political organization that carries out the political programs of the Russian government?**

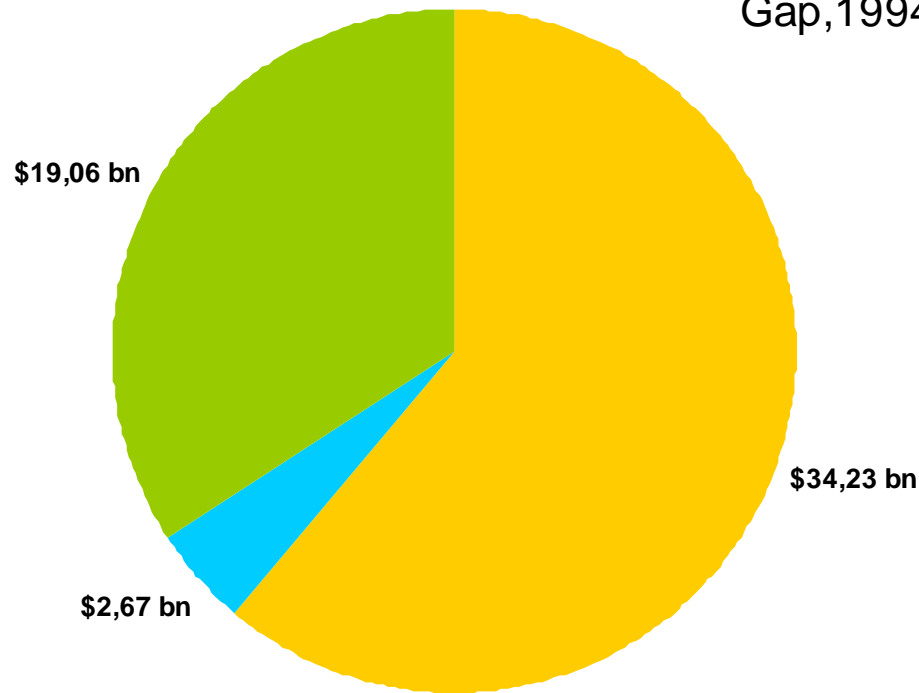
- Ø The answer to this question underlies all of the assertions that I will discuss today with you. I hope to show you clearly that Gazprom is a normal business organization with understandable business goals and objectives. I hope that the open-minded members of this audience will give a fair hearing to my arguments today that will show that Gazprom operates on business principals, not on political or geo-political considerations.**

Assertion 1.1: “Gazprom exerts political pressure on neighboring countries by shutting off the supply of gas in the middle of the winter”

- ∅ From the time of the break-up of the Soviet Union and until now, Russia has subsidized the countries of the former Soviet Union through below market prices for gas and other commodities. The amount of this subsidy consists of the difference between European gas price and the below-market price that Gazprom has charged its customers in these countries. Chart 1 shows that these subsidies were very substantial.
- ∅ Gazprom finalized its transition to a full-fledged joint stock company in 2003 and began the process of ending these subsidies to countries of the former Soviet Union. Maintaining Soviet-era subsidies is incompatible with protecting the interests of company shareholders in a normal business operating company. Gazprom informed all of the countries that were then receiving subsidies that Gazprom planned to enter into new agreements that would eventually bring them to world prices.
- ∅ Not all the countries were willing to accept this transition to world prices. At that point Ukraine refused to discuss any changes to the price policy. As a result, the contract to provide gas to Ukraine expired on December 31, 2005 and Gazprom stopped shipments of gas to Ukraine for three days in January 2006. This stoppage was the result of a commercial dispute and of Ukraine’s intransigence in the face of losing its subsidy from Gazprom. This was an economic dispute, not a political one.
- ∅ How can anyone claim that we “brutally” treat our neighbors if we subsidize their industry with billions of dollars?

Gazprom Price Subsidies to Neighboring Countries

Chart 1. Accumulated FSU-Europe Gas Price Gap, 1994-2007



■ Ukraine

■ Baltic States

■ Other

Assertion 1.2: “Gazprom’s pricing policy is politically driven”

- Ø It is true that at the present moment different FSU countries pay different prices for gas from Russia. But Gazprom is doing its best to move beyond the legacy of the administrative and subsidized prices. Price differential will stay for a short transitional period until 2011. By that time, all FSU customers of Gazprom will pay world market prices, without exception.
- Ø It is also true that at the present moment the price of gas on the internal Russian market is lower than world market price. But this divergence is not politically driven. It is a result of the financial crisis of August 1998. Before August 1998, gas prices on the internal Russian market and world market prices were exactly the same. In the aftermath of the ruble devaluation that followed from the August 1998 crash, these prices began to diverge. The divergence between the two price levels will be eliminated also by 2011. By that time, there will be a parity between domestic and export prices. Gazprom and the Russia Government agree with analysts who state that the existing price distortions lead to overconsumption of gas and have a negative effect on the economy.
- Ø How can one say that Gazprom pricing policy is politically driven when the essence of this policy is a transition towards true market pricing?

Assertion 1.3: “Russia’s key political leaders – Mr. Medvedev, Mr. Putin and Mr. Zubkov-control Gazprom in the political interest of the Kremlin”

- Ø It is true that Mr. Medvedev was president of the Board of Gazprom, prior to become President of Russia and that Mr. Zubkov, currently the president of the Board of Gazprom was formerly Prime Minister of Russia. It is also true that our current Prime Minister, Mr. Putin knows a great deal about energy, energy policy and Gazprom. Since the Russian Government is a majority shareholder in the private company Gazprom, it is not unusual that it would be represented on the Board at a high level.
- Ø However, this does not mean that as a result of government participation on the Board, Gazprom is a political instrument. In fact, the Russian government decided in 2003 that Gazprom would be run purely on business principals and has abided by that decision every since. It is true that the Russian government assists Gazprom, but it is not true that Gazprom is a political instrument of the Russian government.
- Ø 20% of the tax receipts for the Russian budget come from Gazprom. In point of fact, it would not make any sense for any Russian leader to jeopardize the business of an entity that is a “sacred cow” of the state budget for any political purpose. In point of fact, Western governments restrict business activities with certain countries for political reasons. In contrast, the Russian government imposes no such political restrictions on Gazprom operations.

Myth #2 “Gazprom is Involved in Pipeline Wars in Europe to Exert Political Influence”

Ø Assertion 2.1: “Gazprom’s pipeline projects are politically motivated”.

Ø Assertion 2.2: “Gazprom is buying up Central Asian and Azeri gas to deprive the Nabucco pipeline of a resource base”.

Ø Assertion 2.3: “The main objective of the war with Georgia was to expand Russia’s control of energy transit pipelines”.



GAZPROM'S VIEW

- ∅ The fundamental question is whether Gazprom pipelines and pipeline projects are intended for the business purpose of bringing gas to their clients at a low cost or are they a hugely expensive instrument of political influence?
- ∅ Construction and operations of export pipelines is a normal business for integrated gas and oil companies. Gazprom owns and operates these pipelines together with nationally-owned companies in the transit countries. The “ship-or-pay” provisions in Gazprom’s long-term contracts require Gazprom to meet the clients’ volumetric requests on a daily basis. Ownership rights over the pipelines are the best guaranty of safety of supply. Gazprom has been a reliable supplier of gas to Europe for 40 years and has always had to construct its own pipelines in order to act as a reliable supplier. The costs of construction for export pipelines are so high that in most cases the only way to secure external financing is to have Gazprom participation and ownership of the pipeline.
- ∅ Gazprom has never used its pipelines for purposes other than gas delivery. Our activities as supplier and transporter are fully governed by commercial contracts which contain no political provisions. While it takes years to negotiate a viable commercial contract, any kind of political blackmail would put at risk the multibillion dollar investments required for gas pipeline construction.

Assertion 2.1: “Gazprom’s pipeline projects are politically motivated”

- Ø The International Energy Agency estimates that Europe will need an additional 105 BCM of pipeline gas by 2020 from Russian, North African and Asian sources. We are already seeing bottlenecks in supply during peak periods. Gazprom has developed plans to construct new pipelines to supply a portion of the gas that Europe will need for its future economic security. All of our plans for Nord Stream and South Stream are built on sophisticated business modeling that takes into account all aspects of development costs. As a result, these projects rest on a firm economic foundation.
- Ø We would be happy to compare the result of our economic modeling with those economic models for alternatives proposed by our critics. However, we have never seen such models and doubt that they exist. Our critics have only general unsupported assertions that look increasingly to be political, not economic.
- Ø I would also like to state unequivocally that we do not oppose any other pipeline projects being planned to supply gas to Europe, including the Nabucco project, although politicians in Brussels in Washington strongly object our participation in this project. Given the level of projected demand, we feel that there is room in the market for many projects and suppliers. This is the reason why we are interested in contracting for the Trans Sahara pipeline, and gas production in Northern Africa.

Assertion 2.2: “Gazprom is buying up Central Asian and Azeri gas to deprive the Nabucco pipeline of a resource base”

- Ø Gas produced by Turkmenistan, Kazakhstan and Uzbekistan has been part of the Gazprom supply-demand balance for years and could not be replaced by any other gas for years ahead. To meet competition for purchasing this gas in Central Asia from the EU and China we increased our prices to be paid to Central Asian producers to European levels.
- Ø We also plan to build new pipelines to bring Central Asian gas to Europe and fully utilize the capacity of the existing pipelines. Gazprom’s pipeline that brought gas to Azerbaijan in the past could work in reverse to import 5 BCM of Azeri gas. It is a common knowledge that long-term contract arrangements under which Azerbaijan sells gas to Turkey and Georgia are not favorable to the Azeris. Meanwhile, Gazprom can offer Azerbaijan purchase price contract terms which will allow them to accelerate the development of their fields, a prospective resource base for Nabucco. In short, our motivation is purely economic in respect to Central Asian and Azeri gas.
- Ø Nabucco has several alternative sources of gas beyond Central Asian gas. Iraq with pre-war production of associated gas of over 40 BCM and Iran with largely untapped resources that are estimated to be the second largest reserves in the world each could fill the Nabucco pipeline. Gazprom has nothing to do with the political obstacles that stand in the way of upstream projects in these two countries that could also supply Nabucco. As a result of the current opposition to Gazprom’s pipeline development plans, Europe could lose access to 86 BCM of pipeline gas coming from Russia, which equals to 18% of its projected imports in 2020.

Assertion 2.3: “The main objective of the war with Georgia was to expand Russia’s control of energy transit pipelines”

- Ø British Petroleum temporarily shut down South Caucasus (SCP) gas pipeline as a precaution during the conflict. The Baku-Tbilisi-Ceyhan (BTC) oil pipeline had been previously been shut from sabotage by Kurdish rebels on Turkish territory. In reopening the SCP, BP announced that there was no evidence of Russian attack on any pipeline.
- Ø Russia provides gas to Armenia through the Georgian pipeline system, for which Georgia receives payment in kind in gas supplies. Transit and payment continued despite the conflict.
- Ø When Gazprom announced that it end subsidized pricing, Georgia switched to Azerbaijan as its gas supplier. Other than the payment in kind for transit fees, Russia has no commercial gas relationship with Georgia.

Myth #3 “Gazprom is a Threat to Competition in the Gas Market in Europe”

Ø **Assertion 3.1:** “Gazprom is becoming a monopoly supplier to Europe”.

Ø **Assertion 3.2:** “As a monopoly supplier, Gazprom can manipulate gas prices to its advantage”.

Ø **Assertion 3.3:** “The current linkage of gas prices and oil prices is outdated and causes Europe to pay higher prices than it would using other price mechanisms”.

Ø **Assertion 3.4:** “Gazprom has a policy of divide and rule towards Europe”.



GAZPROM'S VIEW

- Ø It is a fact that Gazprom is a prominent part of the European gas market, but it is not the only supplier. However, it is important to accept that for reasons of geography, there are a limited number of potential suppliers of gas to Europe. The question is whether this fact alone means that Gazprom or Gazprom in combination with other suppliers could extract above market prices from European customers.
- Ø The primary guaranty that neither Gazprom, nor any other supplier, could extract above market prices is the pricing mechanism contained within LT contracts. Gazprom is bound to supply gas for long periods of time in accord with a formula that it does not control. This means that there is no possibility for Gazprom to manipulate or change prices to take advantage of its market position. These LT contracts protect Europe from any possibility of market abuse. So it is difficult to understand exactly what the critics of Gazprom's prominent role in Europe are complaining about. No political or business leader can unilaterally change gas prices even in cases when 100% of gas comes from Gazprom.

Assertion 3.1: “Gazprom is becoming a monopoly supplier to Europe”

- Ø The current oligopolistic gas supply structure is the result of geography and location of possible suppliers of gas to Europe, not conspiracy. Principal suppliers are Gazprom 26%, Statoil 12%, and Sonatrach 9%.
- Ø Even with diversification of supply, there cannot be any substantial change in the oligopolistic structure of supply given the level of demand in Europe and the location of potential suppliers.
- Ø In 2000, Gazprom supplied 50% of Europe’s gas, its share dropped to 40% and is expected to reach approximately 50% by 2018, roughly equal to the market position of 2000.
- Ø Gazprom has only a small percentage of Western European domestic market share – Germany, less than 7%; Italy, France, UK and Turkey, less than 2%. Total target market share for Gazprom in these countries is 5% - 10%.
- Ø All Gazprom subsidiaries active in Europe are subject to EU rules and regulations, including TPA and anti-trust regulation.

Assertion 3.2: “As a monopoly supplier, Gazprom can manipulate gas prices to its advantage”

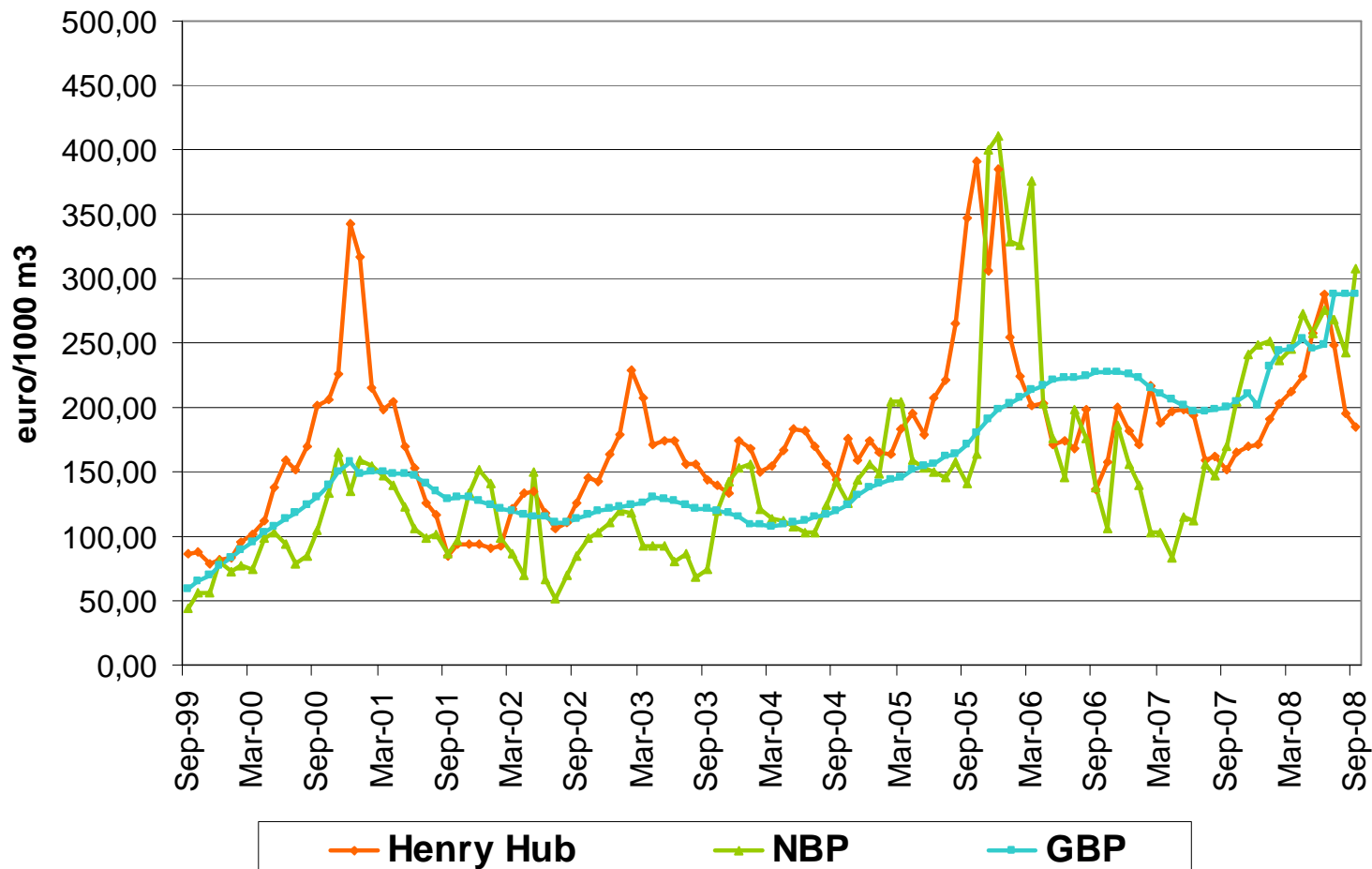
- Ø Gazprom has no absolute monopoly over any aspect of the gas supply chain for Europe and does not intend to gain this power. Any form of OPEC-style volumetric restrictions on production are not possible on the European gas market because of ship-or-pay provisions in the LT contracts.
- Ø Gazprom supplies gas under LT contracts in which price is determined by a pricing mechanism linked to oil as an independent reference commodity and there is no ability for Gazprom to unilaterally alter price under such contracts.

Assertion 3.3: “The current linkage of gas prices and oil prices is outdated and causes Europe to pay higher prices than it would using other price mechanisms”

- Ø The linkage to oil in gas pricing protects Europeans from any possible price manipulation by oligopolistic supplier.
- Ø One can only expect gas prices below those of oil-indexed in the over supply situation. But amid a growing energy deficit, it would be naïve to bank on the emergence of buyer’s market on the Continent within the coming 10 years.
- Ø By switching to pricing based on supply and demand, European consumers will not receive lower prices. However, they are guaranteed to getting higher price volatility, one that is only made stronger by the speculators. See following chart.

Gas Price Volatility and Level

German Border Price (GBP) versus Prices in the USA (Henry Hub) and UK (NBP)



Assertion 3.4: “Gazprom has a policy of divide and rule towards Europe”

- Ø As a commercial enterprise, Gazprom has to take its market as it finds it. If Europe is divided over a general energy policy, this is not the fault or responsibility of Gazprom. We enter the European market as a company seeking to sell our products to willing buyers and to defend our interests as a company. In this sense, we have defended the mechanism of LT contracts as beneficial to both Europe and to Gazprom. We have made our proposals to expand our supply of gas to Europe to meet growing demand to prevent any de-industrialization of Europe that might come from lack of power supplies. We have acted in the best interest of our company and of our clients as we understand those interests. We hire capable and experienced Europeans to assist us in our business and pay them competitively. This is all as it should be.
- Ø In fact, we are also somewhat victimized by the lack of consistency in European energy policy. We are receiving conflicting signals from different countries whether we are welcome in Europe or not. This makes our decisions on LT investment much more difficult. However, at the end of the day, whether Europe has a single energy policy or a variety of policies is an internal European decision. We cannot and will not make energy policy for Europe. However, if those who argue for a single voice from Europe are really saying that this voice should be anti-Russian, we simply do not understand the basis for such a position, economically or politically.

Myth #4 “Gazprom is an Unreliable Supplier”

Ø Assertion 4.1: “Russia could abandon Europe and focus on Asian and Russian domestic markets”.

Ø Assertion 4.2: “Diversification increases the reliability of European supply”.

Ø Assertion 4.3: “Russia is not making sufficient investments in new deposits to meet all of its supply obligations”.



GAZPROM'S VIEW

- ∅ The main source of the assertion that Gazprom is an unreliable supplier is connected with the dispute with Ukraine already discussed as part of Myth 1. This is supported by a similar short dispute with Belarus that was also quickly resolved. Both of these disputes were connected with Gazprom's ongoing process of price normalization to world price levels. The movement to world price levels has been a demand that Europe has been making on Russia for some time. Although Gazprom has never stopped supplying its European customers, none of which was hurt, an entire superstructure of fear and doubt has been constructed out of these two brief incidents with the transit countries.
- ∅ The real facts are that Gazprom is one of the most reliable suppliers of gas in the world. Consider that during the entire course of the Cold War, Gazprom maintained its deliveries to Europe. Consider also that during the period when oil was selling for \$9/barrel and thus forcing gas prices below the costs of production, Gazprom continued to meet its obligations. Consider also that Gazprom's long-term contracts are structured such that the company is subject to severe penalties and fines if it does not meet its obligations to ship gas under these contracts. There is simply no real basis for the assertion that Gazprom is an unreliable supplier.

Assertion 4.1: “Russia could abandon Europe and focus on Asian and Russian domestic markets”

- Ø The future of Gazprom is economically bound to Europe in ways that prevent either side from abandoning the other. Russian gas supplies to Europe are under “ship or pay” terms that would impose fines on Russia equal to the cost of gas not shipped if Russia even attempted to curtail supply. Currently 80% of Gazprom’s cash flow comes from the trade with Europe.
- Ø By 2011, the Russian domestic gas market will reach price parity with world prices for industrial and commercial gas customers, but subsidies will remain in the domestic market for households. Given the ongoing household subsidies, it will remain economically advantageous to export gas.
- Ø Gazprom exports to Asian markets will grow, but the resource base for these exports will come from Eastern Siberia, Sakhalin and Kamchatka. The resource bases for Europe and Asia are separate. Increases in exports to one market do not mean decreases in exports to the other.

Assertion 4.2: ‘Diversification increases the reliability of European supply’

- Ø **Diversification of supplying countries does not necessarily bring more reliable suppliers. Under current conditions, it is hard to imagine that Iran, Iraq or Turkmenistan could be more reliable suppliers than Russia.**
- Ø **The Nabucco pipeline project, the principle focus of diversification discussions, is not a competitor to Gazprom’s South Stream. The projected volumes that would travel through Nabucco pipeline would amount to 5% of Europe’s forecasted demand. This small volume is not significant within the scale of Europe’s energy requirements. The emphasis on this project does not correspond to its actual economic consequences.**

Assertion 4.3: “Russia is not making sufficient investments in new deposits to meet all of its supply obligations”

- Ø **Gazprom approved annual investment program of \$34 billion for development of new fields and pipeline construction, despite the current financial crisis.**
- Ø **Gazprom’s investment is on par with or exceeds that of other major oil companies like ExxonMobil (\$21 billion) or Petroleo Brasileiro (\$33.5 billion).**

Myth #5 “Gazprom is Managed by Kleptocrats, not Professional Managers”

Ø Assertion 5.1: “Gazprom is managed by people only interested in their own personal financial benefit”.

Ø Assertion 5.2: “Gazprom systematically acquires unrelated businesses that divert efficiency and investment from the corporate purposes”.

Ø Assertion 5.3: “Gazprom purchases the loyalty of European political figures for extravagant salaries”.



Assertion 5.1: “Gazprom is managed by people only interested in their own personal financial benefit”

- Ø In the period after the Soviet Union was disbanded, Gazprom was plagued by diversion of assets for personal gain and related unethical practices designed to plunder the company for personal benefit. After Vladimir Putin became President of Russia, a fight was begun to put an end to siphoning of assets for personal benefit. A new legal and managerial structure was constructed for Gazprom and assets stolen by insiders were returned to the company.
- Ø As part of the reform of Gazprom, approximately 10% of the management will be fired. Management has been professionalized and a new generation of staff has been recruited into the company.

Assertion 5.2: “Gazprom systematically acquires unrelated businesses that divert efficiency and investment from the corporate purposes”

- Ø It is true that Gazprom has a number of unrelated businesses under its corporate umbrella. These businesses were acquired and subsidized because of their importance to Russian society as a whole and because there were no other sources of financial support available at the time.
- Ø As the Russian economy strengthens and private capital becomes available for such unrelated businesses, Gazprom has a program to dispose of them.
- Ø Gazprom will continue to provide financial support to Russian entities, like sports organizations, that promote the image of the company as is common practice by major corporations around the world.

Assertion 5.3: “Gazprom purchases the loyalty of European political figures for extravagant salaries”

- Ø Important political figures around the world participate in private business, either directly or through participation in boards of directors, when they are no longer in public office. Gazprom, as a prominent international company, has sought the benefit of the knowledge and expertise of foreign political figures in their joint venture or subsidiary projects in Europe per standard international practice.
- Ø The compensation paid to any foreign former politician is commensurate with what such a figure would receive for a similar position in their own country and is no way extravagant by these standards.
- Ø As a result, Gazprom considers the attack on the credibility or honesty of any foreign former political figure now working for Gazprom to be simply a political attack on Gazprom for ideological reasons.

Summary: “Is Gazprom is a Threat to European Energy Security?”

Gazprom does not threaten European energy security and the assertions to the contrary are purely ideological. The interlocking and self-reinforcing myths that support the ideological assertion that Gazprom is a threat to European energy security have gone unchallenged for far too long. This presentation is intended to begin to expose them for the myths that they are. The real facts in brief are as follows:

- ∅ First, Gazprom is a private, commercial enterprise that makes decisions on pricing, pipelines and overall business development on normal business criteria.
- ∅ Second, Gazprom is developing pipeline projects to supply a part of the gas that Europe will desperately need and will find difficult to obtain from other sources.
- ∅ Third, Europe is protected from any threat of price manipulation through well-established contract mechanisms.
- ∅ Fourth, Gazprom is one of the most reliable gas suppliers in the world.

If we look at today’s world with calm and unbiased eyes, we can see clearly that energy policy has been and continues to be manipulated for political purposes. We need look no further than the economic boycott of Iran or Polish-Swedish opposition to North Stream. However it is not Gazprom that is engaging in such policies. Unfortunately, we have been silent too long in defending our reputation, mainly because we thought that the false assertions against us would be self-evident. I hope that my presentation today will help refute these assertions and reassure you about the reliability of Gazprom as a supplier and business partner.