

Gazprom is prioritising building new gas pipelines over developing production. Nazrin Mehdiyeva warns that the policy makes the threat of supply deficits a real concern for Europe

Problems in the pipeline

Gazprom makes no secret of the fact that it wants to increase its market share of the European gas supply market from its current 28 per cent to 33 per cent by 2015. Neither is it coy about its ambition to supply one-quarter of the world's liquefied natural gas (LNG) by 2030. But the two goals are seldom articulated in the same policy document, or in public speeches, because putting them side by side draws attention to the enormity of the task Gazprom has set itself and raises questions about its achievability.

A number of factors are conspiring to make Gazprom's job even harder than it would otherwise be. The company needs to develop not just new gas fields but pristine provinces in the north of Russia, yet much of its investment is earmarked for building pipelines. Gazprom is both upgrading its ageing network and building new interconnectors as part of its policy of diversification to bypass "troublesome" transit states.

The Unified Gas Supply System it operates comprises more than 158,000km of pipelines, making it the largest gas network in the world. A quarter of these lines are more than 33 years old and a further 40 per cent are between 21 and 33 years old.

Moreover, domestic demand already accounts for about 70 per cent of Russia's current gas output, and Gazprom has been charged with gasifying the rest of the country, including its eastern regions, some of which lack even basic infrastructure. The scale of the task facing Gazprom is challenging, even for a company of its enormous size and revenues, and clearly it will have to prioritise some projects over others.

The priorities the company will follow are determined both by the policies of Gazprom and the politics of the Russian state. Presently, the priorities of both parties converge on building new interconnectors. The problem is that Gazprom is not only Russia's sole gas pipeline operator, but also by far the country's largest gas producer. It controls 69 per cent of Russia's top proven reserves (equivalent to 33.1 trillion cubic meters of gas), and in 2008 accounted for 550 billion cubic meters (bcm) of Russia's total production of 665bcm. The priority attached to the construction of new pipelines must inevitably be fulfilled at the



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expense of upstream development. This will have direct repercussions for the supply of Russian gas to Europe.

The main pipeline priority, shared by both Gazprom and the Russian government, is to redirect flows around Ukraine. This has been a consistent goal since 1996, when after several severe interruptions of gas supplies from Ukraine to Turkey via the then only existing "western" route, Gazprom announced that it would build a pipeline under the Black Sea called Blue Stream.

Gazprom's determination to bypass all transit states has grown over time to encompass Belarus and Poland. The Nord Stream pipeline from Vyborg, Russia, to Greifswald, Germany, will comprise two lines and will have an annual capacity of 55bcm of gas. South Stream, which will run from Beregovaya in Russia to Varna in Bulgaria, was originally intended to have an annual capacity of 31bcm, but this figure has since been revised upwards, first to 47bcm and then to 63bcm.

Other pipeline developments, such as those in Russia's eastern regions or to China, are more problematic because Gazprom is reluctant to pay for uneconomic networks. Whether or not such schemes climb off the drawing board is frequently determined by behind-the-scenes negotiations, where Gazprom will promise to advance the policy of gasifying remote Russian regions in return for being allocated licences for new fields.

There is also a third category of pipeline, those to which the Russian government awards priority and pressurises Gazprom to action. A recent

example of such a scheme is the Dzuarikau-Tskhinvali line supplying gas to South Ossetia, which was opened in August. South Ossetia is one of Georgia's breakaway regions, which after the Russian-Georgian war last year was recognised as an independent state by Russia (and so far only by Russia). The gas pipeline was clearly intended by Moscow to emphasise Russia's support for the breakaway region. At the opening, prime minister Vladimir Putin stated that "in case of need" South Ossetia would be able to become a transit state for Russian gas.

Looking to the future, the status of Gazprom as the sole exporter of Russian gas (which was enshrined in law in 2006) is unlikely to be challenged. Its monopoly position is widely believed to solidify not only the company's position but also that of Russia. Its ability to control exports helps maintain prices for this strategic export commodity and precludes independent producers from raising output.

But the combination of this monopoly position and the prioritisation of network development is already taking a toll on Gazprom's supply position. The company's capital expenditure fell from £11.8 billion in 2008 to £9.3 billion this year, and it is production that is bearing the brunt of the cuts. Production investment has been reduced from £5.5 billion to £2.7 billion, while transportation investment has been raised to £6.7 billion, and now accounts for 60 per cent of total capex.

An early casualty has been the important Bovanenkovo field on the Yamal peninsula. This

is expected to produce 115bcm of gas annually within three years of its launch, but the launch has been delayed by a year to late 2011. The postponement means that, in the event of prompt recovery in demand (which is likely to take place simultaneously in Europe and Russia), Gazprom's maturing fields in west Siberia may be unable to cope, resulting in supply shortages.

Traditionally, Russia has bridged any deficit in its production by importing gas from Central Asia. Geopolitical shifts in the region, however, are making the sustainability of this policy increasingly uncertain. For example, Turkmenistan is currently building its own pipelines to China and Iran, and since April has refused to sell to Gazprom below the price fixed in a December 2008 contract. It has also expressed interest in supplying the proposed Nabucco pipeline to Europe. The link has European Union support and would be valuable in years of slack supply from Russia, but it has been dogged by delays.

Although the Nabucco line would not pose any serious threat to Russia, Moscow is keen to discourage the entry of this marginal source of gas into Europe, and has done so by promoting the South Stream project. In addition, Gazprom has expressed interest in buying up all the gas from Phase II of the Shah Deniz field in Azerbaijan, intended to supply the Nabucco pipeline. Without the Azerbaijani gas, Nabucco is unlikely to be viable any time in the future because alternative sources – from Iran and Iraq – are not currently available.

Completing the South Stream pipeline will further increase the export capacity of Russia, but this increase does not mean that Europe will not in the future find itself facing a shortage of gas from Russia. ●

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