

Russia and the Geopolitics of Natural Gas LEVERAGING OR SUCCUMBING TO REVOLUTION?

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The changing natural gas landscape—driven by the rise of liquid natural gas (LNG) projects, unconventional boom in North America, protracted global economic slowdown, post-Fukushima recalibration in the nuclear sector, and shifting geography of demand and supply—has renewed debate over the geopolitics of Russia’s energy security. A common refrain is that the increasing interconnectedness and flexibility of global gas markets will introduce a welcome corrective to Russia’s energy policies at home and abroad, encouraging pragmatic commercial dealings and political accommodation with European and Asian partners. Recent steps toward supply diversification and price renegotiation across Europe—especially among heavily import-dependent Lithuania, Bulgaria, and Ukraine—are seen as harbingers of this power shift in Eurasian energy diplomacy.

Others, including the leadership in Moscow, dismiss the enthusiasm for shale as a “soap bubble” destined to burst. They boast that Russia will continue to enjoy incremental supply advantages to promote political ambitions in relations with rival Eurasian producers and vulnerable transit states and European customers. They see new favorable long-term supply deals with Serbia and Armenia, the defeat of the Nabucco bypass pipeline, and the wooing of Gazprom in the sell-off of the insolvent Greek national gas company as suggestive of Moscow’s lingering prowess and as evidence that its pooh-poohing of a global gas revolution may be more than wishful thinking.

This debate is traced to an underlying controversy between realism and its critics over the significance of energy resource nationalism. Yet this formulation presents a false dichotomy between globalization and geopolitics and neglects Moscow’s mixed record with gas diplomacy. As well, talk of the demise of a petro-gas state counts Russia down prematurely by overlooking Gazprom’s lasting competitive advantages in established markets across Eurasia. It also treats the revolutionary effects of the LNG-shale nexus as a given, without fully appreciating either the uncertainties of the latest trends or how Moscow’s current choices can affect future opportunities. Jettisoning such

blindness reveals the promise of elevating joint profit-seeking interests over atavistic power plays for Russian, European, and American energy security.

The Geopolitical Face of Russian Gas: A Mixed Bag

Under President Vladimir Putin, Russia's foreign energy posture has embraced the interrelated goals of protecting shares in established gas markets, preempting competition from other sources and suppliers, and leveraging such efforts for commercial and political gain. Relying on a variety of tactics—e.g. discretionary price cuts/hikes, take or pay obligations, state supported subsidies and centralized control over the domestic sector, export tax exemptions, physical supply disruptions, and veiled threats of orchestrating a new gas cartel and arbitrarily switching deliveries between established import dependent European customers and emerging markets in Asia—Moscow has repeatedly flexed Russia's tremendous natural gas endowments and diffused pipeline network against vulnerable post-Soviet customers and transit states. This has been pursued with seemingly little regard to the pain inflicted upon downstream customers in Europe and Central Asian supply partners. Hence, it is widely believed that geopolitical relief will come with the convergence of sustained weakness in Europe's demand for gas, growth in global LNG markets, the unconventional gas boom in the United States, and the aggressive pursuit of new markets by other suppliers. Together these factors are expected to transform the global gas landscape in ways largely inimical to Russia's great power ambitions, compelling Moscow to rethink its coercive strategy.

Yet this popular storyline is too crude for benchmarking changes to Russia's foreign energy posture. To date, energy policy has been neither well integrated into a coherent Russian grand strategy, nor the primary driver of international cooperation or conflict. At home, structural impediments and institutional opacity have fueled divergent interests across the sector concerning investments, greenfield development, pricing, taxes, distribution, access to pipelines, and corporate governance that, in turn, have marred the Kremlin's capacity to marshal national gas resources from both state and independent companies for discretionary strategic purposes. In retrospect, alarmist characterizations of natural gas as a substitute for the nuclear bulwark to Russia's superpower status simply have been off the mark.

Similarly, Moscow's bark has been greater than its bite. Notwithstanding pointed attempts at manipulating the fixed and regionally-defined natural gas infrastructure, success has been both more mixed and less effective than commonly presumed. To the extent that Moscow has realized gains by playing pipeline politics, it has been more successful at wrangling preferential commercial terms for prices and volumes than at altering the politics or foreign policies of highly dependent customers. Physical shutoffs too have been rare and, as evidenced by successive gas wars with Ukraine, have escalated uncontrollably and at great financial and reputational costs to Russian companies and the Kremlin. That Moscow had to follow through on threats to disrupt delivery and has been "co-dependent" on European gas exports to fill federal coffers and offset loss-making across the sector reveal the limited, if not double-edged, coercive

potential of the gas weapon. Accordingly, any talk of a geopolitical chastening brought on by a shifting gas landscape must distinguish cheap talk from the nuances, dilemmas, and variation in Russia's track record of gas diplomacy.

Russia Down....

That said, there is no question that Russia as a conventional gas supplier, accustomed to relying on traditional pipelines and long-term contracts, is feeling the pinch of competition across all azimuths. The diversification of supply from the Middle East and West Africa, coupled with opportunities to purchase LNG displaced by the shale boom in the United States (which has overtaken Russia as the biggest producer) and prospects for unconventional production in Eastern Europe, has loosened Russia's grip over established markets in the EU. Disputes over gas prices and oil indexation spearheaded by France, Germany, and Italy in response to the global supply glut paved the way for renegotiating delivery terms. They also prompted the freezing of European joint development with Gazprom in the Barents Sea, as well as Norway to cut its prices and grab a larger EU market share in 2012. In addition, an adverse judgment in the ongoing EU antitrust probe may foil Moscow's strategy for restricting competition and dominating the European gas market via ownership of both supply and distribution. China's persistent harping on price differentials and success at keeping Moscow at bay on a new gas pipeline deal only underscore how Russia is likely to remain captive to its formerly captive gas markets.

Gazprom's market share also is being tested across post-Soviet Eurasia. Notwithstanding Russia's determination to advance the commercially suspect Nord and South Stream bypass pipelines, Ukraine is poised to cast off Gazprom's supply monopoly by attracting investment into domestic shale plays and diversifying procurement of natural gas from European suppliers. In an intriguing twist, Germany's RWE contracted to deliver small but growing supplies (some of Russian provenance via re-export rights) to Ukraine, using Polish and Hungarian transit services. This reversal of flow in European gas has caught on with the Visegrad Four and emboldened Kiev to renege on extant take-or-pay contracts with Gazprom for a second consecutive year. Lithuania, too, threatens to break out of Russia's stranglehold and discretionary pricing, with the development of an offshore LNG processing facility capable of eventually providing up to 60 percent of domestic needs. That the vessel slated to provide relief to this "energy island" of the EU is named "Independence" is especially pointed. Furthermore, the recent defeat of the Nabucco pipeline is likely a pyrrhic victory for Gazprom, given the uncertainty that confounds the South Stream project and that the preferred Trans-Adriatic Pipeline portends enhanced opportunities for rival Caspian gas in Russia's prized European and Balkan markets.

Diversification in foreign markets has been complemented by a deterioration of Gazprom's privileged position at home. Lower prices in Europe have put a crimp in Gazprom's revenues just as it confronts significantly higher costs for development of new fields and pipelines. Furthermore, pressure from independent gas companies has prodded the Russian government to double taxes on extraction. Competition stirred by

independent gas producers, such as Novatek, and the state-owned oil behemoth, Rosneft, has lowered prices and lured away lucrative industrial clients. The decision to liberalize LNG exports in 2014, coupled with the transfer of assets to Novatek and that company's own opaque association with Putin, also betrays the Kremlin's preference for a hedge against Gazprom's troubled position in the increasingly competitive European market.

... But Not Out

Notwithstanding the blows to Gazprom's monopoly position, Russia is not on the ropes, especially in European gas markets. The main reason stems from the structure of the natural gas industry. What matters for energy security is not simply physical supply but reliable and affordable access. With knife-edged differences among competitors in the global economy, utilities, firms, and states are acutely sensitive to fluctuations in price. The sector's history of price volatility and need to lock in stable delivery for base-load power generation make it difficult to dislodge Russia and increase investment risks for ensuing future supply diversity amid episodes of cheap gas. Unlike the globally integrated oil sector, natural gas markets will remain regionally segmented for the foreseeable future. This is largely due to thorny above-ground problems related to storage and unlocking the transportation sector for gas, as well as to the high costs of long distance delivery and political resistance to market reforms in most countries. The deregulated U.S. gas market and attendant incentives for private and medium-sized gas-on-gas competition—so critical to spawning the shale revolution—are difficult to replicate, even in Europe where national energy companies and existing contracts remain entrenched. Although the U.S. shale boom has replaced or displaced previous natural gas supply, it has not fundamentally altered the import dependency of large gas customers in Europe or Asia. Should the knock-on effects eventually pose a drastic challenge to Russia's deliveries to Europe, they also will hurt the interests of key Caspian long-distance suppliers, post-Soviet transit states, and Turkey as an emerging gas hub—potentially driving them closer to Moscow.

This structure of the industry perpetuates Russia's competitive advantages in established European markets. Soviet legacy investment, production, and large-diameter cross-border pipelines effectively reduce actual costs and ensure Gazprom suitable margins for landing cheap gas to Europe. Although volumes and revenues may take a hit, Russia is nonetheless poised to increase market share in a coming era of spot price competition. It is also true that Russia faces daunting challenges and rising costs to opening up conventional greenfields in East Siberia to manage the decline in West Siberia or to realizing its shale potential. But such difficulties must be measured against the resistance to shale across Europe, startup costs for new LNG facilities worldwide, and prospects for tapping methane hydrates and other unconventional in Russia and the Arctic.

Russia also does not cast a uniform shadow across Europe. As successive gas conflicts made clear, European customers are not equally dependent on Gazprom, with both prices and market shares varying widely among Eastern and Western customers.

Recent studies underscore that these divisions not only cut across EU member states but also hound relationships between host governments and powerful energy firms within Western Europe, with the latter consistently welcoming established profit-maximizing business alliances that draw them closer to Gazprom. Despite Russia's tarnished reputation as a reliable supplier, these intimate corporate relationships forged out of experience and mutual interests present it with a material and normative foothold in Europe that will be difficult to dislodge, and perhaps even an opportunity for imposing selective price discrimination.

Contending With Moving Targets

It is premature to predict Russia's geopolitical fate amid the uncertainty in scale and scope of the global transformation in gas. Although it will remain commercially significant, the political content and effectiveness of Moscow's gas diplomacy will be more circumscribed. Ultimately, this stature will turn on game changers beyond Moscow's control, including the future of U.S. gas exports; prospects for bringing conventional supplies on line from Iraq and Iran, offshore gas from the Arctic and Eastern Mediterranean, and unconventional exploitation across Eurasia and beyond; the fate of global climate change policy; the commercialization of gas in the transportation sector and appeal relative to cheap coal and other base-load sources; China's pursuit of energy diversity and security; and the implications of each of the above for rebalancing power between regional consumers and suppliers. Such developments will be interdependent and beyond the grasp of any one state to control.

Yet policymakers in Europe, Moscow, and Washington face choices on gas that could affect the character of their noncommercial relations. European customers could benefit from working closer with Russia's gas independents to extend reciprocal influence forged out of historical ties with Gazprom. They could invite different Russian firms to join in the development of diversity via new storage facilities, decoupled pricing, access to transmission lines, and shale exploration. This would limit Gazprom's room to maneuver while increasing the number of new Russian stakeholders in gas-on-gas development across the continent.

Similarly, Moscow could enhance its commercial edge in both established and emerging gas markets, as well as reclaim its reputation as a reliable supplier, by continuing to open up Russia's domestic business to competitive non-Gazprom production and foreign investment. Even with retention of state ownership and Gazprom's export pipeline monopoly, by systematically redressing regulatory opacity, improving the competitive environment for domestic sales, and integrating renewed conventional production with new LNG projects into regional markets, the growth of Russian gas can benefit consumers at home and abroad.

U.S. policymakers, too, should remain cognizant that there will be winners and losers with a coming shale-LNG nexus in global gas markets. To the extent that the American gas boom displaces significant Russian and Caspian exports to Europe while raising the bar for entry into Asia, the concern will be with discouraging risky adventurism. Accordingly, by promoting reciprocal commercial ventures, technical

assistance for managing the negative externalities of new production, and technology transfer to efficiently develop Russia's unconventional and LNG facilities, Washington can reinforce emerging Russian stakeholders in the new era of gas. This could facilitate, on the margins, the tough decisions needed in Moscow to confront the institutional legacy of arbitrary regulation that could preserve the commercial competitiveness of Russian gas exports while escalating the political and economic costs to Moscow of aggressively flexing its waning and residual market power across Europe and Eurasia.

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