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Russia – will the economic hardships lead to changes in its energy policy?

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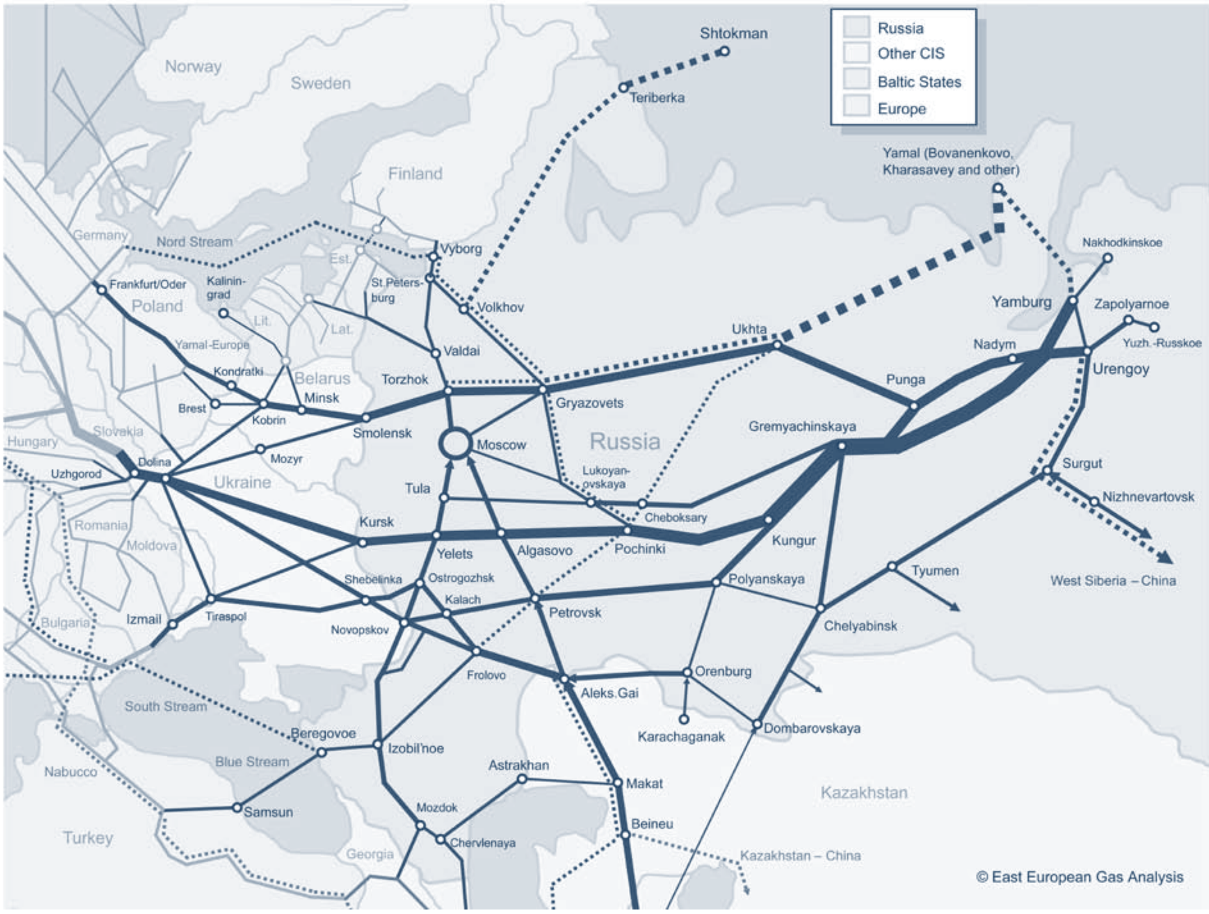
Russia is currently in economic turmoil triggered by the financial crisis and a low price of fossil fuels. As a result, the Russian state giant Gazprom has problems financing its activities, including the development of new gas fields. Such developments will be important for continued delivery of Russian gas to Europe, and to maintain the Russian market share in the expanding European marked. This article identifies the main problems facing Russia and what consequences they may have for Russia's future role as gas supplier to Europe.

In recent years, the Kremlin's economic strategy has aimed at, to be blunt, using the high energy prices to consolidate domestic support for the regime. In exchange for stability and an overall increased standard of living, the Russian people have for the most part accepted limitations on democratic rights such as the freedom of speech. The current crisis, however, could destabilise this arrangement. The low price of oil is about to leave the Russian government short of cash to dole out, and if the oil price stays low, it cannot continue the current strategy. Already, Prime Minister Putin has approved possible federal budget cuts by thirty per cent in 2010 and 2011, which will probably leave significantly less money for social spending. In addition, non-petroleum sectors of the economy have been struck hard, unemployment is rising sharply, and wages are being withheld. This can affect the legitimacy of the regime. A recent poll suggests that a majority of the Russian population is surviving, but struggles to make ends meet. More than forty per cent are blaming the Russian government. In comparison, only twenty per cent follow the Kremlin's official line and blames the US for the hardships. Trust in the government is declining, and it could become clear for ordinary Russians that the current economic strategy is not successful.

One important consequence of the Kremlin strategy of using the spoils of high energy prices to ensure regime support is the neglect of reinvestments in the energy sector. Capital has been spent on popular projects rather than being directed toward developing new oil and gas fields and maintaining existing pipelines. In addition, the high oil price has allowed the oil and gas companies to become inefficient and wasteful; corruption thrives and graft is endemic. Kremlin's twin goals of power and legitimacy have dwarfed the need to preserve the economic basis for those ambitions.

The price of gas is usually linked to the price of oil, and as a result of the global economic crisis, Gazprom's revenues may fall by possibly as much as 26 per cent this year. In first quarter 2009, the company's exports to EU dropped more than 35 per cent compared to 2008. The drop in Russian exports is partly due to lowered demand for gas, and partly to the most recent spat between Russia and Ukraine. It has also become much harder to raise capital as banks have grown increasingly risk averse. In combination, the export slump and credit drought have hit Russia hard.

Europe is expected to increase dramatically its import of gas in the next decade, as Europe's domestic sources are dwindling. Russia, on the other hand, has 23 per cent of the world's proved reserves of gas, and has already existing transport infrastructure to Europe. It would therefore be practical to increase gas imports to Europe from Russia. This demands an increased Russian level of production. Russian gas output has however stagnated, and the three "super giant" fields that are supplying Europe have already peaked in production. No new, larger fields have been put on stream since Soviet times. The reduced Russian extraction has been compensated by transit of gas from Central Asia. The exporting countries in question have however problems of their own and it is not evident that they can increase production to a level sufficient to compensate the fall in Russian output. Currently, Gazprom is quarrelling with the



main Central Asian gas supplier Turkmenistan over deliveries and price, and Turkmenistan is searching for export options eastwards to China. As the lack of available capital and low demand of Russian gas impede investments, it can also potentially threaten Europe's future supplies and Russia's future gas income.

Gazprom intends to develop two large gas fields. The Bovanenkovskoye, situated at the Yamal peninsula, and the Shtokmanovskoye, located off the coast of Kola peninsula. The Bovanekovskoye was until recently projected completed in 2011, while Shtokman was planned on stream in 2013. Gazprom had insisted that despite the economic turmoil the development of both projects will proceed as planned, even as those ambitions were deemed unrealistic by most experts before the current hardships. Gazprom is using most of the company's investment funds in developing the Yamal peninsula, and declared in June that it would postpone the development by one year due to lack of finances. In July, it declared that the Shtokman could also be delayed.

The company could ask Total and StatoilHydro, Gazprom's developing partners on Shtokman, to make a greater contribution to the financing of Shtokman. However, it is unlikely that Total and StatoilHydro accept this demand without further Russian concessions. In 2007 the two companies struck rather disadvantageous deals with Gazprom related to the development of Shtokman. Unless the overall conditions are renegotiated it is unlikely that Total and StatoilHydro will carry any more of the burden than the already agreed-upon framework stipulate.

The Shtokman case is symptomatic for the Russian gas sector. Until now, it has been difficult for foreigners to invest in Russian-led projects. The Kremlin considers energy a "strategic sector" and is reluctant to make concessions to foreign companies. A majority of the decision makers are "silovikis", people recruited from the security structures, and their conception of energy policy as Realpolitik has, at least until now, remained strong. This perception, however, is most true when energy prices are high.

When they fall, gas can quickly change into a more ordinary commodity.

Ironically, preliminary evidence suggests that the energy exporting countries that have pursued strongly nationalist policies, such as Iran and Venezuela, have been hit hardest by the crisis. Both have pursued economic strategies comparable to Russia's by using oil and gas income to shore up support for their regimes, and they are hesitant or outright hostile to foreign investments and influence. Furthermore, oil and gas extraction in Russia is costly and requires a relatively high oil price to be profitable. Russia is therefore far more sensitive to price swings than other oil and gas exporting countries.

Some indicators point toward increased cooperation between Europe and Russia. Russia is increasingly in dialogue with European countries on construction of new pipelines. This is partly because the latest gas crisis in Ukraine underlined the need for Europe to diversify gas supplies, not only among different gas producing countries, but also between different transport routes from producing countries. President Medvedev is still widely perceived as liberal with respect to foreign influence in the energy sector. Depending on his intentions and strength, the crisis could provide a pretext for him to make changes to the Russian economy.

The ongoing conflict between the Telenor and its partner Alfa Group illustrates the legal risks of investing in Russia. A Siberian court has ruled that Telenor must pay a large sum of money to Vimpelcom, a Russian telephone company it owns together with Alfa Group. The case has been described as a litmus test for the quality of the Russian legal system under Medvedev's rule. The circumstances surrounding it suggest that Russian courts are far from independent and predictable. It also underlines that the Medvedev has so far not succeeded in his judicial reforms.

Furthermore, Russia maintains explicit and implicit limitations on foreign ownership in the energy sector. From 2003 and onwards many foreign companies have experienced the erosion of governmental predictability in that sphere. Foreign-funded projects such as the Sakhalin II and the Kovykta gas field have been more or less expropriated by the Kremlin through state owned companies, and British Petroleum has struggled with its partners in the TNK-BP. A company investing in Russian energy sector must be aware that a changing political landscape can often intervene in commercial investments. Given Russia's reputation as a high-risk country to invest in, drawing the necessary foreign capital and know-how to the energy sector is a difficult task.

The global financial turmoil has exposed flaws in Russian economic policy. Russia has been hit hard, and it is not unlikely that the crisis in short term will change the country and its economic and political capabilities. This could affect Russian foreign policy as it is doubtful that Russia can afford to use gas as a tool to exert its foreign policy in the near future. A long term consequence is that Russian gas supplies to Europe could be reduced. This depends on what Russian decision makers will do in the near future to ensure the necessary increase in production by developing new fields. A positive development, however, could be that the crisis reorients Russian decision makers from the understanding of gas as a tool of great power politics to gas being primarily a reliable source of income.

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