Reform of the Russian Gas Sector

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Reform of the Russian Natural Gas Sector

This Chapter was written by Peter Thomson.

Executive Summary

Russia is endowed with significant natural gas assets. The sector, however, faces a number of challenges that must be addressed if the country’s gas resource base is to be optimally exploited. There have been extensive discussions in recent years concerning reform options for the sector. This Policy Note offers a number of proposals that are designed to support reform in the sector while addressing the concerns of the various stakeholders. The conclusions and recommendations in this Note can be summarized as follows:

- Incentives must be provided to all producers (that is, to independent producers as well as Gazprom) to encourage them to develop natural gas resources. Key incentives include price levels that reflect the true economic value of Russia’s gas, nondiscriminatory access to the domestic transmission system, access to markets, and provisions to support the development of gas resources in areas that present both geographic and geologic challenges. Russia should also consider conforming the structure of its energy markets to the internal European Union (EU) market.

- Natural gas prices in the domestic market are not, at present, sufficient to cover the real economic value of the gas. Long-run marginal cost (LRMC) is a good indicator of the true economic value of Russia’s gas. The World Bank estimates that, on an undiscounted basis, the LRMC of the Russian gas supply is in the range of $35 to $40 per thousand cubic meters (MCM). A medium-term tariff policy should be established to bring prices up to these levels. As part of this process, prices should be rebalanced to avoid cross-subsidization.

- While it is in Russia’s best economic interest to maximize the overall revenues associated with gas exports, it is not in the country’s best interest to see domestic prices rise significantly above LRMC levels.

- A discrete transportation tariff should be established to apply, on a nondiscriminatory basis, to all shippers (that is, Gazprom and others). The tariff should be set and monitored by the regulator. Regulatory oversight should also apply to gas processing and to gas storage. In addition, the regulator should establish and monitor service quality standards.

- To assure nondiscriminatory access to transportation facilities, a “reservation of capacity” methodology should be introduced to allocate gas pipeline capacity within Russia. It may be necessary, in the initial stages, to allocate a portion of capacity (for

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1 Monetary values are in U.S. dollars.
example, 10 to 15 percent of the entire domestic system) to independent producers to be assigned under this approach.

- Independent producers should be accorded the opportunity to compete immediately for all domestic gas markets, and to access future export market opportunities. No attempt should be made, however, to abrogate Gazprom’s existing export contracts.

I. Structural Issues and Key Challenges

While Russia is endowed with significant natural gas assets, structural issues in the gas sector constrain optimum exploitation of these assets.

Russia possesses over 30 percent of the world’s proven natural gas reserves, and over 20 percent of the world’s gas production capacity. It is the world’s largest exporter of natural gas, supplying over 25 percent of Europe’s requirements. It also has an extensive domestic network of transmission and distribution facilities, and it is the second-largest consumer of natural gas in the world (after the United States). The sector has been a significant and consistent source of hard currency revenues, and a major contributor to Russia’s economic growth. The sector, however, faces a number of key challenges that must be addressed if the country’s gas resource base is to be optimally exploited.

To understand these challenges, Table 1 analyzes the strengths and weaknesses of, and opportunities for and threats to, the sector. Russia should seek to exploit the opportunities for the sector while neutralizing the threats. To do so it needs to take full advantage of the sector’s strengths, while addressing the weaknesses.

Table 1. Summary Analysis of the Gas Sector in Russia

<table>
<thead>
<tr>
<th>Strengths</th>
<th>Weaknesses</th>
</tr>
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<tbody>
<tr>
<td>• Unparalleled gas reserves</td>
<td>• Lack of competition</td>
</tr>
<tr>
<td>• Extensive domestic infrastructure</td>
<td>• Existing fields are in decline</td>
</tr>
<tr>
<td>• Strong export market position</td>
<td>• Deteriorating infrastructure</td>
</tr>
<tr>
<td>• Reputation as a reliable supplier to</td>
<td>• Low domestic tariffs</td>
</tr>
<tr>
<td>international markets</td>
<td>• Limited access to external financing</td>
</tr>
<tr>
<td>• Large domestic market</td>
<td>• Inefficient domestic consumption</td>
</tr>
<tr>
<td>• Gateway for a significant portion of</td>
<td>• Underutilization of associated gas</td>
</tr>
<tr>
<td>Central Asian exports.</td>
<td>• Majority of exports depend on multi-</td>
</tr>
<tr>
<td></td>
<td>country transit routes</td>
</tr>
<tr>
<td></td>
<td>• Limited regulatory authority and capacity</td>
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<td></td>
<td>• Magnet for corruption.</td>
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</table>

<table>
<thead>
<tr>
<th>Opportunities</th>
<th>Threats</th>
</tr>
</thead>
<tbody>
<tr>
<td>• To increase exports to Europe</td>
<td>• Loss of market share in Europe</td>
</tr>
<tr>
<td>• To open up new export markets to the East</td>
<td>• Disruption to exports</td>
</tr>
<tr>
<td>• To improve the efficiency of domestic gas</td>
<td>• Inability to fully meet future domestic</td>
</tr>
<tr>
<td>use</td>
<td>demand</td>
</tr>
<tr>
<td>• To reduce and ultimately eliminate gas</td>
<td>• Financial insolvency (particularly as and</td>
</tr>
<tr>
<td>flaring.</td>
<td>when European gas prices fall)</td>
</tr>
<tr>
<td></td>
<td>• Problems with World Trade Organization</td>
</tr>
<tr>
<td></td>
<td>accession.</td>
</tr>
</tbody>
</table>
Note: An analysis of strengths, weaknesses, opportunities, and threats (a SWOT analysis) takes account of factors that are both controllable and uncontrollable. It also, of necessity, offers potential contradictions—specific threats are often the mirror image of specific opportunities.

The key challenges may be briefly summarized as follows:

- How to ensure optimum exploitation of Russia’s gas assets
- How to create the incentives to (a) encourage development of the sector, (b) improve the efficiency of domestic gas use, (c) maximize export earnings, and (d) reduce and ultimately eliminate gas flaring.

To address these challenges, particular attention needs to be given to the issues of pricing, access to transportation capacity, and access to markets.

Russia is already a neighbor of the EU, and its proximity to the EU increased following the accession of new members in May 2004. The EU will become an increasingly important trading partner for Russia. To take full advantage of the trading opportunities that will be available, Russia should consider harmonizing its energy markets with the EU internal market, while keeping in mind the underlying economic principles that will ensure maximum sustainable benefit to Russia. This would require Russia to pay close attention to the evolving structure of the European energy markets in order to ensure that its own market structure is sufficiently compatible to optimize trade relations. The resultant benefits include enhancing the prospect that the EU countries will commit to higher gas purchases from Russia in the future, and, on a related basis, expanding the trade in electricity between Russia and the EU countries.

II. Reform of the Russian Natural Gas Sector

This section offers 11 recommendations to reform the Russian natural gas sector.

1. An effective reform program must address the issues and concerns of the various stakeholders, but should do so within the context of an overarching objective of achieving optimum results for the State.

Key gas sector stakeholders include Gazprom and its shareholders (which includes the State as a significant shareholder in its own right), independent producers of both associated and nonassociated gas, domestic consumers, the State Budget, regional authorities, and international customers. More broadly, the population as a whole will be affected by the economic consequences associated with the performance of the gas sector, and by the environmental impact of sector operations.

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2 This could be effected by, for example, applying the principles embodied in the EU Directive 03/55/EC to the Russian gas sector.
2. *To ensure effective exploitation of Russia’s gas assets the sector must provide adequate incentives, both financial and structural, to promote optimum production and consumption of gas.*

The sector is dominated by Gazprom, which exercises monopoly control over transmission and a substantial portion of the country’s distribution activities, and manages all gas exports. Gazprom also controls about two-thirds of proven reserves and about 90 percent of production.

Gazprom’s existing fields, however, are in decline, and there is, therefore, a need to bring on new production. An optimum future production profile needs to take account of all existing proved reserves (that is, those owned by other producers as well as those owned by Gazprom), and probable and potential (that is, yet to be discovered) reserves. This means that appropriate incentives have to be in place to encourage other companies to develop their reserves and to promote exploration activity.

The World Bank estimates that Gazprom alone will need to invest about $80 billion to $100 billion over the next 10 years simply to keep its production at current levels (of about 530 billion cubic meters [BCM] per year), while ensuring that the domestic infrastructure is adequately maintained. In addition, Gazprom has capital requirements to support its export-related investments such as the Blue Stream pipeline to Turkey, the Yamal pipeline, and the proposed North Transgas line, and its direct investments in certain export markets. Thus, investment requirements could well exceed $10 billion a year. This compares with actual investment levels of about $2.8 billion in 2001 and $4.7 billion in 2002, and an estimated level of $6.1 billion in 2003.

Net cash provided by operating activities amounted to $3.3 billion in 2001 and $4.0 billion in 2002. It is estimated that in 2003 it increased to about $8 billion, but this is largely the result of the current oil price environment, and there is a very real prospect that the current level of prices will not be sustained. This means that Gazprom (and the rest of the sector) faces a significant challenge in generating sufficient funds from operations to meet the likely investment needs. This problem is in large part attributable to the current level of domestic tariffs.

3. *Gas prices in the domestic market are not, at present, sufficient to cover the real economic value of the gas consumed. A medium-term tariff policy is required to bring prices up to these levels in a manner that will minimize potentially adverse social consequences on consumers. Such a policy should be formally established in 2004.*

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3 Gazprom’s plans call for the production of 536.2 BCM of gas in 2006, with production increasing to 580 BCM to 590 BCM by 2020. These plans imply an even greater need for capital than is referenced in the text.
5 Ibid.
Despite the size of its gas reserves and its potential production capacity, Russia is, at present, forced to import gas to meet its overall requirements (that is, domestic consumption plus exports). Purchases from Turkmenistan are priced at $44 per MCM at the Turkmen border, and result in an implied delivered cost to Russian markets of about $50 to $55 per MCM. This currently represents the short-run marginal cost (SRMC) of supply. While exports show a positive margin relative to this cost, sales into the domestic market do not generate sufficient revenues to cover the SRMC. Domestic prices were increased in 2004, but still average only about $28 per MCM.\(^7\) At the margin, therefore, there is significant underrecovery of gas costs in the domestic market.

Imports from Central Asia, however, do not (and should not) represent the LRMC of gas supply in Russia. Box 1 provides an estimate of the undiscounted LRMC of gas supply from Russian sources in the range of $35 to $40 per MCM, and suggests that such supplies are a lower-cost option than Central Asian imports.

<table>
<thead>
<tr>
<th>Box 1. Estimated Long-Run Marginal Cost (LRMC) of Russian Gas Supply</th>
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<tbody>
<tr>
<td>Three components make up the calculation of the undiscounted LRMC of natural gas:</td>
</tr>
<tr>
<td>1. <em>Upstream development costs.</em> Given the existing proven reserves, no exploration component is required. Development costs are estimated in the range of $7 to $9 per MCM.</td>
</tr>
<tr>
<td>2. <em>Transmission costs.</em> The major gas fields, including the yet to be developed Yamal field, are located over 2,000 kilometers away from major domestic markets. The LRMC associated with trunk transmission gas lines is estimated at about $1 per MCM per 100 kilometers.</td>
</tr>
<tr>
<td>3. <em>Distribution costs.</em> These are estimated to average in the range of $5 to $10 per MCM.</td>
</tr>
<tr>
<td>The total undiscounted cost may be summarized as follows:</td>
</tr>
<tr>
<td>$/MCM</td>
</tr>
<tr>
<td>Development Cost</td>
</tr>
<tr>
<td>Transmission Cost</td>
</tr>
<tr>
<td>Distribution Cost</td>
</tr>
<tr>
<td>Undiscounted LRMC</td>
</tr>
</tbody>
</table>

*Source: World Bank staff estimates.*

Prior to the financial crisis of 1998 and the associated devaluation of the ruble, domestic gas prices had been at a level sufficient to cover the LRMC. In 1997, for example, the average price for gas sold to industrial customers was the equivalent of $45.3 per MCM.\(^8\) Following the financial crisis and the devaluation of the ruble, however, prices dropped to a small fraction of LRMC levels and, although they have been increasing in recent years, as noted above, they are still well below the levels required to reflect the true economic value of the gas. As a result, significant subsidies are provided to the economy by the gas sector. As Table 2 indicates, these are estimated to have amounted to about $8 billion, or about 2.6 percent of GDP, in 2002.

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6 This price is paid half in cash and half through the provision of barter goods.
7 Source: Gazprom.
8 Source: Ibid.
Table 2. Implicit Subsidies in the Gas Sector in 2002

<table>
<thead>
<tr>
<th>Consumption</th>
<th>Average Tariff</th>
<th>Economic Value</th>
<th>Implicit Subsidy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash shortfall (10%)</td>
<td>390 BCM</td>
<td>$16/MCM</td>
<td>$35/MCM</td>
</tr>
<tr>
<td>Total</td>
<td>$0.6 billion</td>
<td>$8.0 billion</td>
<td></td>
</tr>
</tbody>
</table>


Arguments have been made within Russia that tariffs should not increase until a focused cost-reduction effort has been undertaken by Gazprom. Certainly, there is validity to the argument that a focused effort on cost reduction is desirable, but this does not negate the need to bring tariffs up to levels that reflect the true economic value of the gas. One significant associated benefit of increasing prices is the creation of appropriate incentives to conserve gas and to improve the efficiency of its use. There is also a need, however, to modify the tariff structure.

4. Russia should establish a discrete natural gas transportation tariff to apply, on a nondiscriminatory basis, to all gas using the transmission system, whether transported on behalf of Gazprom or on behalf of other shippers. This tariff should be introduced in 2004.

As Box 1 indicates, transportation makes up the major component of delivered gas costs. In owning and operating the gas transmission network, Gazprom operates in the role of a natural monopoly (as distinct from its role as a seller of gas, where it acts as a monopoly simply on the basis of its share of the market). In many established markets unbundling of supply, transmission, and distribution is mandated. In the EU, for example, Directive 03/55/EC, enacted on June 26, 2003, requires the legal unbundling of vertically integrated gas system operators (that is, transmission and distribution systems have to be operated through legally separate entities). Unbundling effectively separates the natural monopoly components of the sector from those components that are potentially competitive. The natural monopoly components remain subject to full regulatory oversight, while the competitive segments can operate in an unregulated environment.

An integrated gas sector can operate effectively provided its operations are transparent and it is subject to adequate regulatory oversight. However, to ensure that the competitive components of the sector have appropriate incentives to develop, the natural monopoly components must be operated and regulated in a discrete fashion and provide all services on a nondiscriminatory basis to system users. A transportation tariff that reflects the true cost of gas transportation and is applied on a nondiscriminatory basis to all shippers will help level the playing field and allow independent producers and gas suppliers to compete fairly with Gazprom. This, in turn, will promote the delivery to the market of the most cost-effective sources of gas.

In setting gas prices in Russia, the Federal Energy Commission (FEC) has implicitly recognized the transportation cost component by establishing different
wholesale prices in defined regions.\textsuperscript{9} A transportation tariff, however, should be explicitly identified and applied in a nondiscriminatory fashion to all gas shipments. The concept of distance-based gas transportation tariffs is well established in the Russian gas sector. The tariff needs to cover operating and maintenance costs and provide sufficient funds to meet capital investment requirements and to deliver a reasonable return on investment to the Gazprom shareholders.

5. \textit{To determine the correct level of transportation tariffs, it is essential that accurate data be made available concerning the costs of operating the transmission network.}

The role of establishing transportation tariffs belongs to the regulator. However, the regulator cannot perform this function effectively without access to accurate data. To ensure that accurate data are available, Gazprom’s transmission activities need to be managed in one or more discrete units. These units do not necessarily have to be separated into distinct legal entities, but they do need to function as entirely separate entities (possibly as subsidiaries). The accounts of these entities must be open and transparent, and their management must have sufficient independence and accountability to demonstrate to third parties that the transmission network can provide true nondiscriminatory access with nondiscriminatory terms not only for pricing but also for service and other facilities.

As part of ongoing restructuring efforts, Gazprom has taken steps to improve transparency and performance within its core business. This has included establishing transmission subsidiaries as independent legal entities. Gazprom has also reported that work is under way aimed at streamlining its organizational structure. This further work will provide an opportunity to ensure that the transmission function is able to operate in a discrete and independent fashion.

6. \textit{Gas processing and storage are also, at present, de facto monopoly functions, and terms and conditions for processing and storing gas should, therefore, be regulated and applied on a nondiscriminatory basis.}

Sibur is the dominant gas-processing organization in Russia, and Gazprom has a controlling ownership stake in the company. As a result, gas processing functions as a de facto monopoly controlled by Gazprom. Consequently, until such time as true competition in gas processing develops, access to processing facilities and the associated terms and conditions should be subject to antimonopoly control and should be closely regulated to ensure that gas processing services are provided in a consistent and nondiscriminatory fashion. Similarly, Gazprom controls gas storage and this should also, therefore, be subject to antimonopoly control and to regulatory oversight and the application of nondiscriminatory provisions to all users.

\textsuperscript{9} Gazprom does charge explicit tariffs to third-party shippers. These are regulated by the FEC. Gazprom’s subsidiaries are not subject to these tariffs, but are charged through an intracompany accounting mechanism.
7. **Subsidies provided by the gas sector to individual customers through price regulation should be eliminated. The required time frame to eliminate these subsidies may have to extend over several years, and this should be addressed in the development of a medium-term tariff policy.**

At present, gas prices to households and certain other end users are substantially lower than prices to industrial and commercial users, despite the fact that the cost of delivering gas to the households and other small consumers is significantly higher than the cost of delivering gas to large consumers. As prices increase toward levels that recover the full economic value of the gas, it is important that cross-subsidies among categories of customer also be eliminated. A failure to do so will constrain the entry of new suppliers into the market. To the extent that subsidies are needed to address social mitigation concerns, these should be provided through the social safety net.

Regulatory oversight of the monopoly components of the gas sector (including the application of discrete tariffs for transportation, gas processing, and storage) coupled with a rebalancing of tariffs would create an environment in which all producers could compete to supply gas at the wholesale level. In an environment of fair competition, gas supplies that result in lower delivered costs as a result of either location advantage or a low cost of production (for example, associated gas) should be able to access the market. However, as long as Gazprom maintains a dominant market position, there remain the risks of monopoly abuse, whether in the form of excessive prices or in the form of predatory pricing policies (that is, policies designed to force competitors out of the market). There will, therefore, be an associated need for antimonopoly controls and regulatory oversight.

8. **As long as Gazprom retains a dominant market position, price caps will be required.**

The initial risk in a liberalized market environment is that Gazprom will seek to use its monopoly position in the market to bring domestic price levels up to export parity. (Gazprom has expressed the view that export parity is the appropriate price level for gas sold in the domestic market). However, while it is in Russia’s economic interest to maximize the revenues associated with gas exports, it is also in Russia’s best economic interest to establish domestic gas prices at levels that allow full recovery of the LRMC, but not at levels significantly above that. In a fully competitive market environment, the market price would likely move toward LRMC levels. While the price could exceed these levels from time to time, it would be unlikely to remain well above these levels for extended periods. In a market where one supplier has monopoly power, however, this will not be the case. This means that controls have to be placed on the upward movement of domestic gas prices, at least for gas sold by Gazprom.

The most efficient means of applying such controls is to place a cap on domestic price levels. At the wholesale level, this cap should take into account the LRMC of gas.

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production and the cost of processing and transportation. Retail prices should also take into account the cost of distribution. In all cases, the price cap should allow for a reasonable profit margin for gas sellers. Beneath the cap, prices should be liberalized, since this will ensure that the most competitive sources of gas supply access the market.

9. **Regulatory oversight is important to avoid monopoly abuse. Such oversight is also required, however, to ensure quality of service.**

Much attention has been given to date to the role of the regulator in overseeing tariffs, which are a source of potential monopoly abuse. This should be accompanied, however, by a demonstrated oversight of the quality of service provided. The FEC should, therefore, establish and monitor quality-of-service standards for the gas sector. These standards should be developed in 2004 and implemented no later than 2005. Higher gas prices are much more palatable if accompanied by assurances of quality.

In the current environment, where prices are below true economic values, the issue of predatory pricing has not arisen. However, Gazprom has been able to limit market access by independent producers through its control of the transmission system. The transmission system is, nominally, open to other shippers, but access is always predicated on the availability of spare capacity. The fact that Gazprom is the sole determinant of the availability of spare capacity has given rise to accusations that the system is not being administered fairly. While Gazprom denies these accusations, what the current approach does do is ensure that Gazprom is able to secure priority access in the transmission system for its own supplies. Consequently, if fair access to the market is to be provided, changes are required in the way capacity is allocated.

10. **Access to transmission capacity should employ a “reservation of capacity” approach in which some capacity may initially have to be allocated to independent producers.**

Gazprom inherited a transmission system within Russia that had essentially operated as a common carrier. The concept of common carriage was initially developed in the United States in the late 19th century, and was designed to encourage the provision of carriage services to the entire public at reasonable prices. As a practical matter, the pure form of common carriage is not generally applied to the so-called “common carriage” gas pipeline systems where shippers routinely enter into contract arrangements. For these systems, however, the “common carriage” approach does provide for broader access to a

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11 There are differing views on the extent to which this limitation is applied. The terms and conditions for third-party access to the transmission system owned and operated by Gazprom are governed by Resolution number 858 of the Government of the Russian Federation, “On Ensuring Access by Independent Entities to the Gas Transmission System of the Russian Joint Stock Company Gazprom,” dated July 14, 1997. It is Gazprom’s contention that there are no constraints with regard to third-party access to “available capacity” in Gazprom’s trunk transmission system. Independent producers, however, point to the fact that it is up to Gazprom to determine whether or not capacity is available. While there is disagreement with regard to the limitations that can be imposed on access to existing capacity, there is general agreement that a mechanism needs to be developed to address issues related to construction of and access to new capacity.
system than may be available in a dedicated contract carriage system. For example, such arrangements may stipulate that any potential shipper is entitled to access the gas system under a set of clearly defined terms and conditions. In the event requests for shipment exceed available capacity, the pipeline operator may be required to pro-rate access to the capacity, and could potentially be obligated to install additional capacity provided the requesting shippers are prepared to pay the cost for installing and operating this additional capacity.

The bulk of the transmission system within Russia should be operated on a basis that is consistent with “common carriage” principles. Possible exceptions are pipelines that were designed and dedicated to meet specific contractual commitments, such as the Blue Stream pipeline. Several options exist to allocate capacity in the system. These include the use of auctions, allocation on the basis of production, and allocation on the basis of sales. Capacity can also be allocated on a “reservation of capacity” basis. Under such a system, once the capacity has been reserved, the shipper accepts an obligation to “ship or pay.” At the same time, the pipeline company takes on an obligation to ensure the contracted gas volumes are transported.

A “reservation of capacity system” should be introduced in Russia to take effect no later than 2005. It remains very likely, however, that, at least in the initial stages, requests to reserve capacity will exceed what is deemed to be available capacity. This would necessitate some form of allocation procedure. Options such as a pro-rata allocation on the basis of requests could be used. However, to make it demonstrably clear to independent producers that they will be able to secure access to the system, it may be necessary, initially, to allocate preemptively a portion of available domestic capacity (say, 10 to 15 percent of the entire domestic system) to independent producers to be assigned under a “reservation of capacity” system.  

11. Independent producers should be able to compete immediately for all domestic gas markets. They should also be accorded the chance to compete for future export market opportunities, but no attempt should be made to abrogate Gazprom’s existing export contracts.

The domestic market in Russia is not supplied under long-term contracts. Rather, as a legacy of the Soviet system, the market is supplied on an as-needed basis, and Gazprom performs the role of ensuring that market needs are met, even when prices are below cost. This, however, is a trade-off that Gazprom has had to accept in exchange for the monopoly position it enjoys, and is one that Gazprom will likely have to continue accepting until such time as prices are rebalanced and increased to levels that reflect the true economic value of the gas.

Independent producers can and should be given access to the domestic market through being provided the opportunity to enter into bilateral contracts with large

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12 In mid-December 2003, the head of the Independent Gas Producers Association stated that less than 3 BCM of transportation capacity had been allocated to independent gas producers for 2004.
consumers and with distribution companies. A critical precursor of this access to the market is the access to transportation capacity that was discussed above. The full competitive benefit of assuring increased independent producer access to the market will not be felt until prices have been correctly realigned, but this should not be used as an excuse to delay giving these producers adequate access to this market.

Arrangements to sell gas to a number of Commonwealth of Independent States (CIS) countries have also tended to be relatively short term in nature and, in many cases, offer netback prices that are not significantly more attractive than the domestic market price levels. In contrast, the sales arrangements to Western markets tend to be long term in nature, and to offer substantially higher returns than the domestic market. These arrangements represent a mixture of contracts inherited at the time Gazprom was established and contracts subsequently negotiated. Because the prices under these contracts are more attractive than the prices in the domestic market and, indeed, under the sales arrangements to a number of CIS customers, independent producers are anxious to access the Western markets and secure a portion of Gazprom’s business. It would be inappropriate, however, to abrogate these contract arrangements. Rather, the independent producers should be looking, along with Gazprom, at the potential for future new contractual arrangements.

Europe is likely to be willing to increase its purchases of Russian gas as its demand for imported gas continues to grow. In addition, there is the prospect that markets in China (and potentially further East) will develop. It is in Russia’s interest, however, to maximize the revenues generated from gas exports, and there is a risk that competition among Russian gas producers to access these markets could undermine this objective. This has not arisen as an issue up to this point because Gazprom subsidiaries have handled all these export contract arrangements, and prices are established on a formulaic basis linked primarily to oil.

This issue is not unique to Russia. In the mid-1980s, the Norwegian authorities decided to establish a Gas Negotiation Committee (the GFU) to manage the disposal of gas from the Norwegian Continental Shelf (NCS). The committee was made up of three Norwegian gas producers: Statoil (which chaired the committee), Norsk Hydo, and Saga Petroleum (which was subsequently acquired by Norsk Hydro). Among the guidelines given the GFU was the stipulation that “the Committee shall, among other things, act as a permanent advisory body to the Ministry of Petroleum and Energy on issues relating to the disposal of gas reserves and in the assessment of which fields and transportation systems may most appropriately be developed in order to deliver gas under new contracts.” In effect, the GFU negotiated supply contracts on behalf of the Norwegian gas industry, and then made recommendations to the Ministry of Petroleum and Energy as to how these contracts should be assigned among the various fields. The objectives were to achieve the maximum overall margin (that is, revenues less costs) from the export of gas from the NCS, and to ensure adequate revenue generation to encourage development of NCS reserves, which required significant levels of capital investment. By 2002, the

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13 To some extent this is already happening, and the process should be allowed to continue, but with more liberal access to the market.
Norwegian authorities concluded that the need for joint gas sales to accomplish new projects had been reduced, and on January 1, 2002, the GFU was permanently terminated. Companies operating in Norway are now free to choose the level of their own sales, and to conclude gas sales contracts with buyers within limits determined by production permits issued by the Ministry for each field.

As part of the process of promoting market development, independent producers should also be accorded every opportunity to establish transportation links to new markets. In other words there should be no ownership restrictions placed on the construction and operation of new pipelines both within Russia and for export.

III. Conclusion

Introduction of the reform measures presented above will create increased competition, and will support the long-term viability of the Russian natural gas sector.