



Feng Chia University *Outstanding Academic Paper by Students*

The Main Challenges of Gazprom Corporation

Author: Yekaterina Sakovich (Kate)

Class: 2nd year of International trade

Student ID: M 9843162

Course: Business Case Study

Instructor: Dr. Yvonne Han

Department: International Trade

Academic Year: Semester 2, 2010-2011



ABSTRACT

This paper is devoted to Gazprom Joint Stock Company, one of the world's largest energy companies which main issues are geological exploration, production, transportation, storage, processing and marketing of hydrocarbons as well as generation and marketing of heat and electric power. The main aim of this paper is to investigate the activity of this company on the internal and external markets and find out the main challenges of Gazprom Corporation on these markets. We decide to divide basic challenges in two basic categories, macroeconomic and microeconomic and investigate how they influence the activity of corporation. During our researching we determine the company's activity as successful and lucrative in many areas, but some problems are still exist, such as the damping prices on the natural gas within the country, the problem of non-payments for natural gas, the authoritarian management system and centralization, dissociating of the owner from a property and they negatively influence the productivity and image of Gazprom Corporation. According the professional opinion of well known Russian specialists and analytics we are trying to find out all the possible resolutions of existing problems and perspectives of further company's strategy.

Keywords: The Gazprom Joint Stock Company, gas, macro-, microeconomic challenges.



Table of Content

An Industry Overview

The main macroeconomic challenges.

References



An Industry Overview

Gazprom is one of the world's largest energy companies. Its major business lines are geological exploration, production, transportation, storage, processing and marketing of hydrocarbons as well as generation and marketing of heat and electric power. Gazprom's mission is to ensure maximally efficient and balanced gas supply to Russian customers and reliably fulfill long-term gas export contracts. Gazprom pursues the strategic objective of becoming a leader among global energy companies.

Natural gas lanterns were first lit in Russia on the Aptekarsky Island of Saint Petersburg back in 1819. The history of "big gas" in the Soviet Union began in 1946 upon commissioning of the Saratov – Moscow gas trunkline. Gazprom State Gas Concern was established in 1989 on the basis of the USSR Gas Industry Ministry. In 1993 the Concern laid the foundation for setting up Gazprom Russian Joint Stock Company, which was renamed in 1998 as Gazprom Open Joint Stock Company.

The Company has registered trademarks in Russia and abroad, with the exclusive right to use them held by Gazprom.

Strategy

Gazprom's strategic goal is to become a leader among global energy companies by developing new markets, diversifying business activities and securing the reliability of supplies.

Gazprom is unique for enjoying the advantage of being simultaneously an energy producer and supplier owning a potent resource base and a manifold gas transport infrastructure. Due to Russia's geographical location, the Company has the potential to become an energy "bridge" between the European and Asian markets by supplying its own natural gas and providing gas transit services for other producers. This predetermines the essence of the Company's strategy in its key business areas.

Production

Gazprom Group holds the world's largest natural gas reserves. As of December 31, 2009 the Group's A+B+C1 gas reserves (Russian standards) were estimated at 33.6 trillion cubic meters while oil and condensate reserves – at 3.1 billion tons.

The Main Challenges of Gazprom Corporation

As for the gas production volume amounting to around 14.5 per cent of the global total, Gazprom Group is one of the leading petroleum companies worldwide. In 2009 the Group produced 461.5 billion cubic meters of natural and associated gas, 10.1 million tons of condensate and 31.6 million tons of oil.

Natural gas from Central Asia is an essential element in Gazprom's resource base. Gazprom Group purchased 37.3 billion cubic meters of Central Asian gas in 2009.

Gazprom owns the world's largest gas transmission system capable of continuously conveying gas over long distances to Russian consumers and abroad. Gazprom's gas trunklines length exceeds 160.4 thousand kilometers.

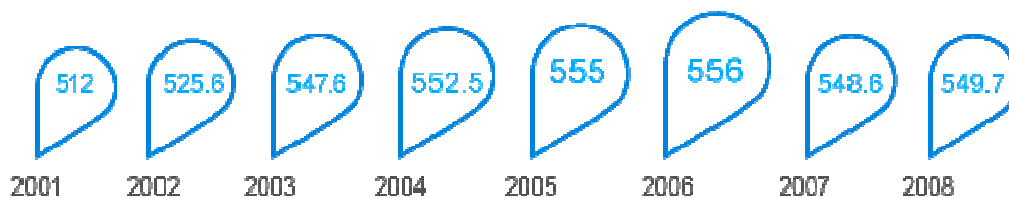
Gazprom is Russia's leading gas distributor. Gasification of Russian regions is therefore a major goal of the Group. In 2009 the gasification program covered 69 Russian constituents and investment in gasification projects is earmarked for 65 regions of the country in 2010.

Gazprom's accounts for 84 per cent of Russia's total gas production and more than 17 per cent of the worldwide natural gas output.

Figure 1. Gazprom share in the world gas production.



Figure 2. Gas production by Gazprom Group, bcm.



Marketing

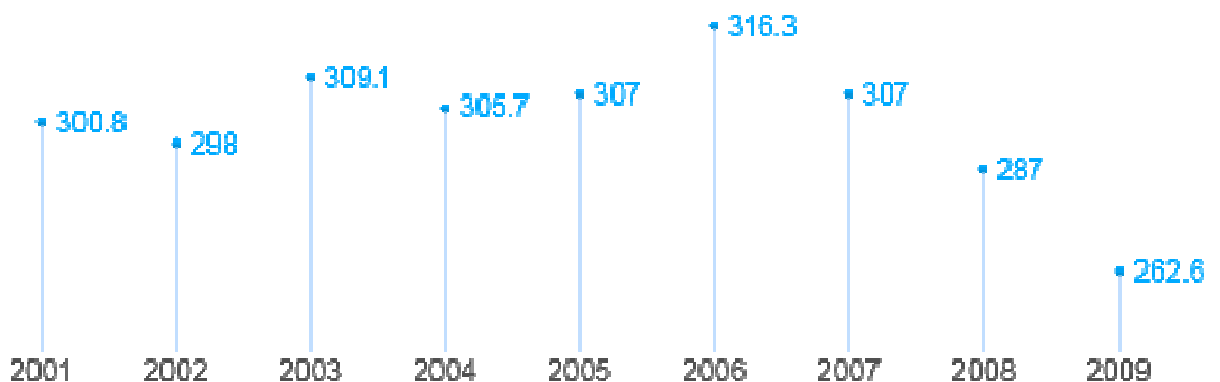
Gazprom views its mission in maximally efficient and balanced gas supply to consumers in Russia and highly reliable fulfillment of long-term gas export contracts.

Gas supplies to the domestic market exceed 50 per cent of Gazprom's overall gas sales. Together with the Russian Government, the Company takes efforts to develop the domestic gas market in a competitive environment. The efforts are primarily focused on enhancement of the pricing system and implementation of exchange trading technologies for gas.

Gazprom dominates the gas distribution sector in Russia. Subsidiary and affiliated gas distribution companies (GDC) of Gazprom Group hold over 80 per cent of the national gas market.



Figure 3. Gazprom Group's domestic gas sales, billion cubic meters.



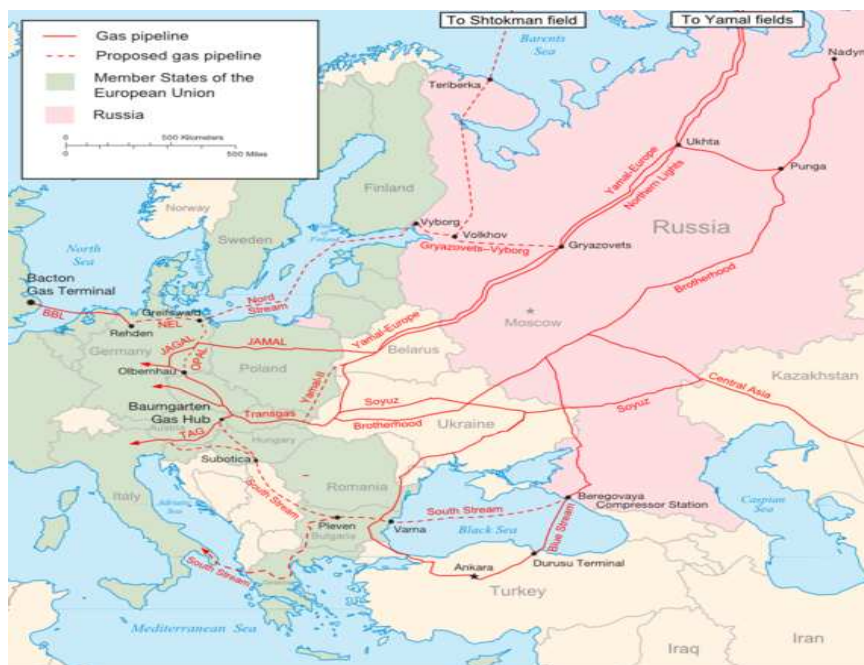
Nowadays, Gazprom supplies around a quarter of the total amount of gas consumed in Continental Europe and about a half of the amount imported there. Among the major buyers of Russian gas are Germany, Turkey, Italy and France.

The Main Challenges of Gazprom Corporation

In addition, Gazprom is deeply engaged in spot gas trading in Europe. The Group's Gazprom Marketing & Trading Ltd. makes gas deals at trading floors in the UK, Belgium, the Netherlands and France selling part of Russian and European gas in the spot market.

The amount of gas sold to end consumers in the UK and France totaled 1.8 billion cubic meters showing a 1.9-fold increase versus 2008.

Figure 4. Major Russian gas pipelines to Europe.

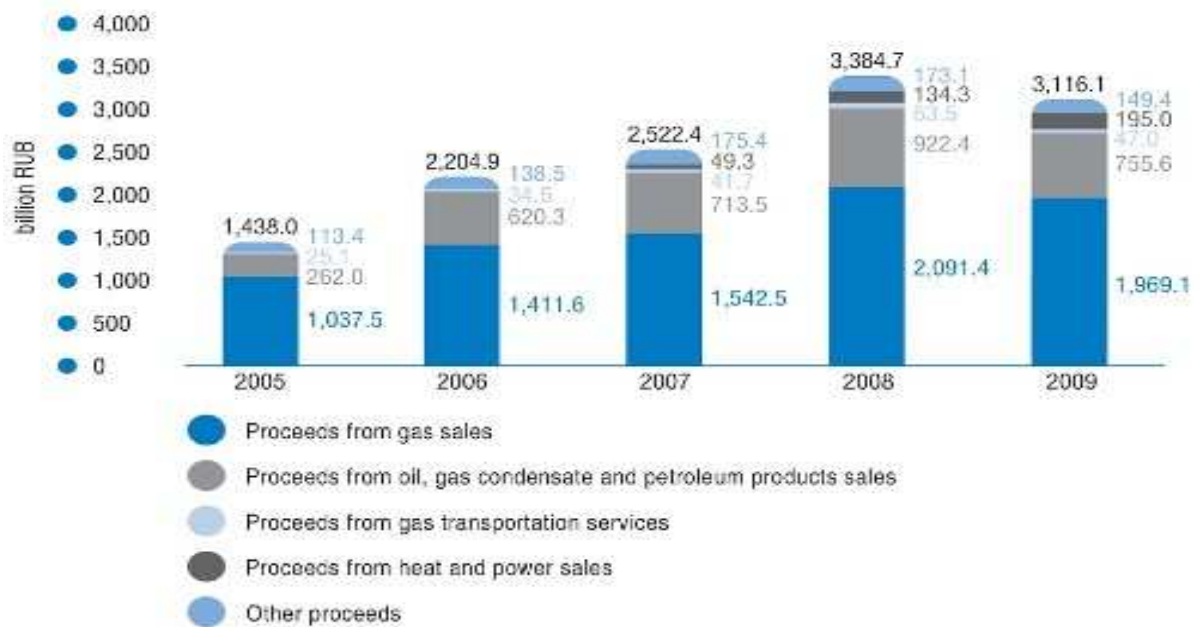


In its relations with the CIS and Baltic states Gazprom adheres to the policy of phased transition to the contractual terms and conditions, and the pricing mechanisms for gas delivery and transit services similar to those applicable in the European countries.

Moreover, the gas price formula stipulated by the effective contracts for gas supply to the Baltic states enables Gazprom to approach the European profitability level in the region.

Like in the European market, Gazprom's strategy in the former Soviet Union is aimed at reaching the end consumer.

Figure 5. Gazprom Group's sales proceeds.

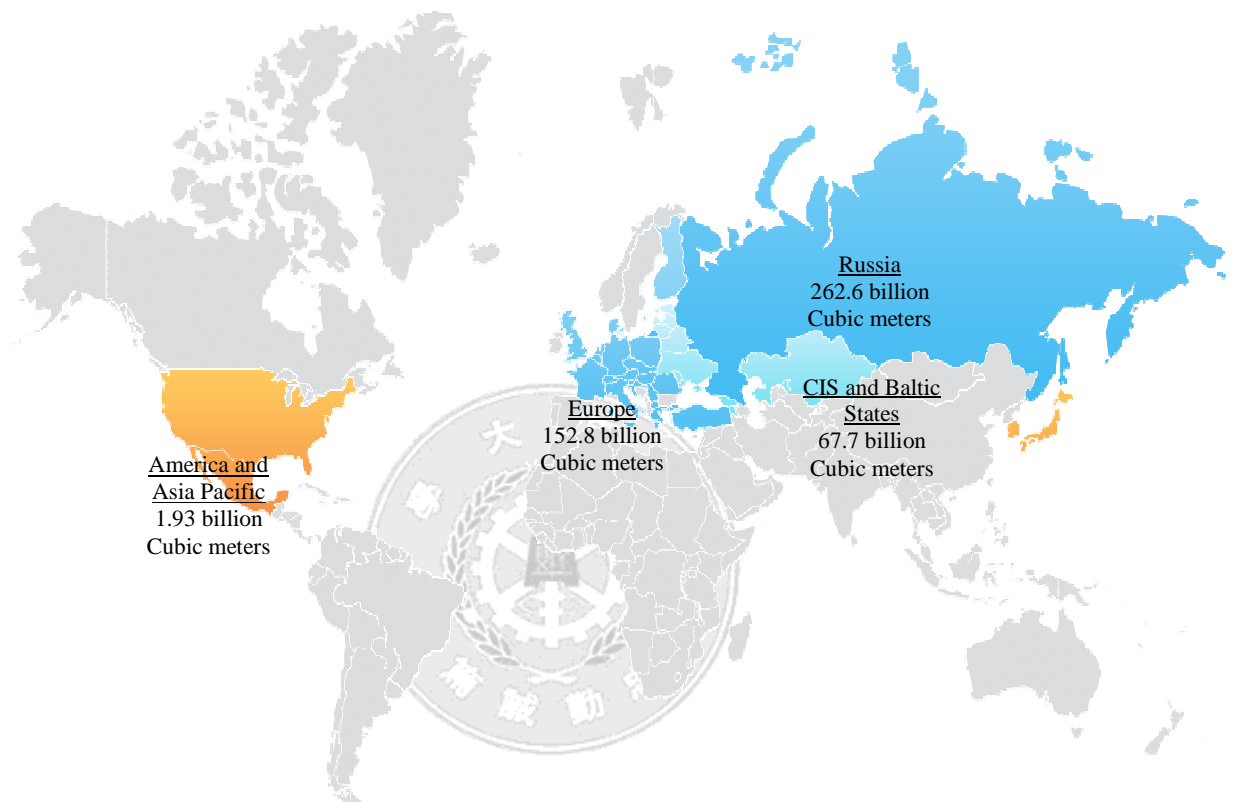


Gazprom's marketing strategy in the American and Asia-Pacific markets stipulates consecutive boosting of liquefied natural gas (LNG) supplies. LNG sales through spot deals totaled 2.55 million tons (3.63 billion cubic meters) between 2005 and 2009.

Gazprom is the majority shareholder in the Sakhalin II project. In 2009 the first Russian LNG plant was brought on stream as part of the project. The entire output of the plant will be supplied to Japan, South Korea and North America under long-term contracts.

In future, Gazprom is planning to implement new LNG projects in Russia: the Shtokman field gas will be fed into the Unified Gas Supply System and converted into LNG as well. Moreover, the Company investigates the opportunities to join economically viable gas liquefaction projects abroad.

Figure 6. Gas supplies by Gazprom Group in 2010.



Management

The supreme body of Gazprom Open Joint Stock Company is the General Shareholders Meeting held on an annual basis. The General Shareholders Meeting also convenes for extraordinary meetings.

Board of directors

The Board of Directors carries out the general management of the Company except for the issues falling under the General Shareholders Meeting competence.

Among other issues, the Board of Directors defines prioritized areas of the Company's activities, approves the annual budget and investment programs, adopts decisions

onconvocation ofGeneral Shareholders Meetings and onformation ofGazprom' s executive bodies aswell asrecommends ondividend amount per share.

Executive Bodies

The Management Committee Chairman (sole executive body) and the Management Committee (collective executive body) manage the current activities ofGazprom. They ensure observance ofthe decisions taken bythe General Shareholders Meeting and the Board ofDirectors, and are accountable tothem. Chairman and Members ofthe Management Committee are elected bythe Board ofDirectors for afive-year term.

Inparticular, the Management Committee elaborates the annual budget, investment programs, long-term and short-term plans, prepares reports, arranges gas flow management and exerts control over Russia' s Unified Gas Supply System operation.

Structural Units

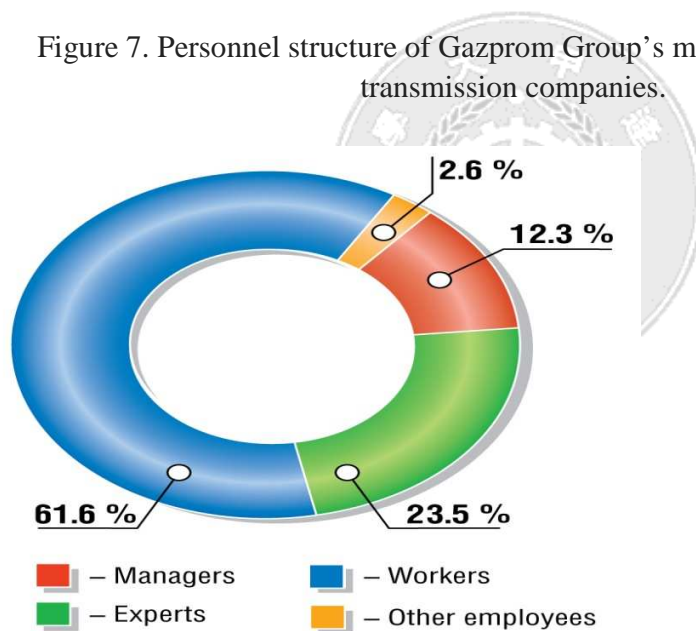
The Gazprom Administration comprises the following departments:

- — Accounting Department
- — Administrative Department
- — Asset Management and Corporate Relations Department
- — Central Production and Dispatch Department
- — Department for Relationships with Russian Regional Authorities
- — Economic Expert Analysis and Pricing Department
- — Finance and Economics Department
- — Gas and Liquid Hydrocarbons Processing and Marketing Department
- — Gas, Gas Condensate and Oil Production Department
- — Gas Transportation, Underground Storage and Utilization Department
- — Information and Communications Department
- — Internal Audit, Finance and Economics Department
- — International Business Department
- — Investment and Construction Department
- — Legal Department

- — Personnel Management Department
- — Process Control System Automation Department
- — Project Management Department
- — Strategic Development Department

As at the end of December 2009 the total number of Gazprom Group's personnel amounted to 393.6 thousand people. The core subsidiaries dealing with gas production, transmission, underground storage and processing employed 216.8 thousand people.

Figure 7. Personnel structure of Gazprom Group's major gas production and transmission companies.



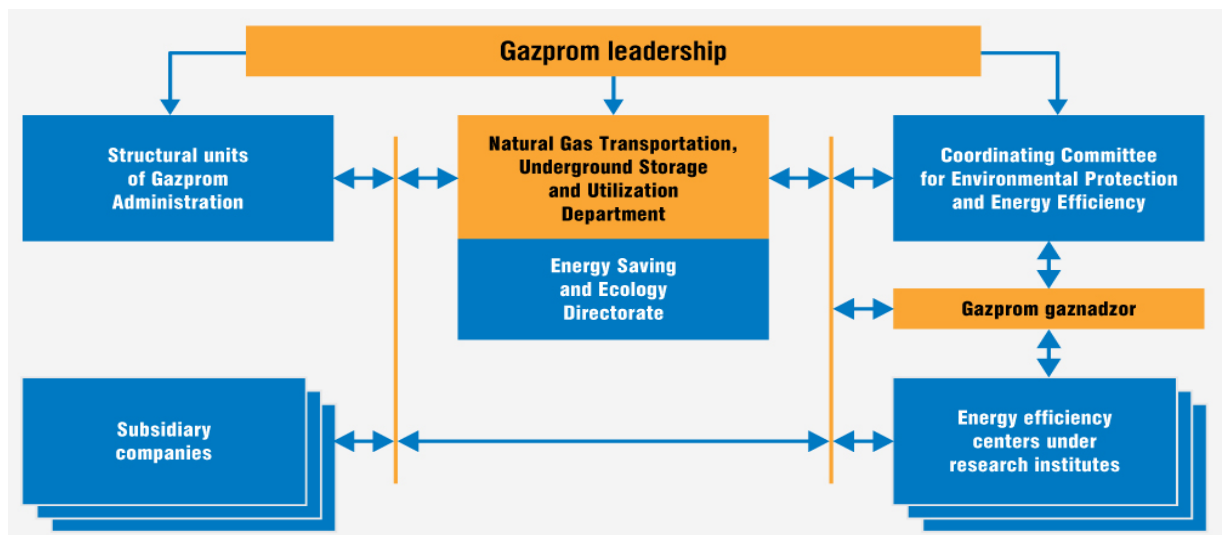
Environmental protection

Gazprom gives priority to environmental impact minimization in its production business. The large-scale gas production and transmission projects are implemented in the regions with a highly fragile ecosystem requiring a very careful approach. We are fully aware of our responsibility for environmental impact with regard to the present and future generations.

In its business operations Gazprom pursues an environmental policy focused on resource saving, environmental impact mitigation and climate conservation.

As part of its environmental activities Gazprom focuses, inter alia, on energy saving, namely, on efficient utilization of natural gas, electric and thermal power, diesel and boiler-furnace fuel in all of its production activities.

Figure 8. Gazprom energy saving structure.



Utilization of natural gas, an environmentally friendly product, as a vehicle fuel is one of Gazprom's environmental priorities. A relatively low cost and eco-friendliness make natural gas a fuel of choice.

Social Responsibility

Gazprom's large-scale activities are of strategic importance for the national economy development and affect the interests of a huge number of people. This is where a variety of Gazprom Group's key operating principles stem from, namely: pursuing the public interests, maximally contributing to the socioeconomic development of the Russian Federation regions, stimulating a favorable business climate throughout the country and supporting worthy labor conditions, social and spiritual welfare of the people.

It is striving to secure the sustainable development of business, paying great attention to both the economic and social aspects. Every year Gazprom actively participates in social support projects by creating new jobs, rendering assistance to economically disadvantaged people, servicemen, veterans and invalids of the Great Patriotic War, implementing social support programs for the inhabitants of the Far North, making investments in new production and social infrastructure facilities construction throughout the Russian Federation. Gazprom's social activity is oriented at supporting the culture, sports, education and science and is an integral part of the corporate development.

The "Gazprom to Children" Program is a key social project intended for backing Russia's children and youth. As part of the Program the Company builds and upgrades sports facilities, and financially supports sporting events throughout the country.

Gazprom takes great care of the culture and sports. The Company traditionally patronizes the national Olympic teams and acts as the general sponsor of the Zenit Football Club, a partner of the All-Russian Gymnastics Federation and backs up national sports federations, teams and individual sportsmen (both professionals and amateurs).

In modern Russia business pays more attention to the questions of perfection of corporate management. In this area Gazprom has advantages as compared to the enterprises of other industries of the Russian economy.

1. Gas industry has never experienced so deep crisis as other industries of national economy (for example, agriculture).
2. As forming of the modern Russian model of management is impossible without foreign administrative experience, the best pre-conditions for this is long-term collaboration of Gazprom with the largest oil and gas companies of Europe, and also realization of international projects, oriented to China, Korea, USA and other countries.
3. A concentration of considerable part of gas complex of country in the structure of Gazprom, a maintenance of principles of the centralized management, traditional for the Russian economy, is an important element of succession, which at all conservatism can become a forming guarantor for the Russian model of management. Thus in administrative practice must be inculcated only those foreign models which correspond the Russian specific.

4. The skilled and corporate policy of Gazprom follows one of basic principles of strategic management - estimation of human capitals as a major factor of successful activity of economic organization.

At the same time company faces serious macro and micro economic problems.

The main macroeconomic challenges.

The dumping prices on the natural gas within the country

During the last years administration of Gazprom declares that prices on natural gas at the internal Russian market are dumping, that a price on gas does not cover a cost an expense on his production. In practice of many developed and developing countries there are the special governmental committees which establish the level of dumping prices for all sectors of national economy. Realization of products on prices which is below this level is forbidden.

Moreover, from the artificial cheapness of natural gas administration of enterprises does not aim to use new energy saving technologies and technique. Another consequence of artificial cheapness of natural gas is the aggressive expulsiing other power sources as coal and oil. It takes place not as a result of strengthening of competition positions of company, but under influence of governmental policy. For example, in power balance of Russia natural gas makes about 50%. Such accent on one power source can lead to ecological catastrophe. Obviously, it is necessary to move in the direction of providing of proportional power balance with the use of different types of power energy.

Thus, it is an unprecedented case in international practice, when state structures compel a company to realize products on dumping prices. But why the company is still no bankrupt according dumping prices? In some analysts opinion, the export of natural gas allows Gazprom to get a certain income and "kick" these financial resources on problem areas.

The problem of non-payments for natural gas

Gazprom have the problem of non-payments for natural gas for many years. Among the debtors there are legal entities, state organizations, including Department of defense of Russian Federations and other countries. In the middle of 1990th non-payments on the enterprises of Gazprom accounts 40 - 60% commodity turnover of the company. Experts of the World Bank, IMF and other international organizations warned of possible catastrophic consequences of similar practice for both, the Russian economy on the whole and for gas industry in particular and advised to disconnect gas defaulters. R. Vyakhirev named practice of non-payments the "interest-free crediting" of the Russian economy by Gazprom and examined it as a positive contribution of company in overcoming of crisis processes and in socio-economic development of the country.

The consequences of non-payments in gas industry of Russia are ambiguous. From one hand, it is indeed possible to talk about certain support which a company rendered an economy and defensive complex of Russia, realizing the products practically in a loss. In the other hand, exactly non-payments in gas industry stimulated high power-hungryness of the Russian enterprises.

The main Microeconomic Challenges:

The authoritarian management system and centralization

The power of management of organization in the hand of external shareholders - legal entities, enterprises and organizations but not managers. It is a serious problem for the model of corporate management of Gazprom as it can be a barrier of adaptation to any changes in an external environment. At the same time such control system is optimum in the case of military operations, threat of terrorism and any "nonmarket" situations.

There two models of cooperative management in theory of management, insiders (when power concentrated in the hands of its managers) and outsiders (when power is concentrated in the hands of external shareholders - legal entities, enterprises and organizations, and also physical persons). Insiders model is considered more conservative, but outsiders - more modern and democratic, allowing to adapt oneself to the dynamics of oversea market. The property of outsiders is Gazprom's stocks which belongs to government, Russian legal entities and foreign investors, 86, 68% in whole. In addition, 13,32% of stocks belongs to people who works in a company.

According to this theory we may conclude that Gazprom follows the outsider model of management and the biggest external shareholder (over 50%) is the government, instead of the development of democratic tendencies in a management it actually reproduces principles of authoritarianism.

Dissociating of the owner from a property

Another serious microeconomic problem of Gazprom is the existence of two legal forms within the framework of one company. Gazprom consists of enterprises, accepting status of the companies with limited responsibility. The company does not suppose the presence of a mechanism of bringing in workers to the process of acceptance of administrative decisions. A worker of a company, owning its shares, actually is not the owner of that enterprise and cannot realize the power in the scales of all company.

The vertically-integrated companies of the international gas and oil market, as a rule, have a form of holdings, at which enterprises, being joint-stock companies, are incorporated in a group, including one or a few associated companies, headed by a holding. The associated companies interfere in the management of other members of the group, coming forward as the holders of their share holdings and participating in meetings of shareholders'. Although Gazprom is named holding, the mechanism of functioning at the internal Russian market is not fully exhausted.

Conclusion

In the present paper we investigate the activity of Gazprom Corporation on the internal and external markets. According to our research we determine the activity of the Corporation as successful and lucrative in many areas, some macroeconomic problems such as the damping prices on the natural gas within the country, the problem of non-payments for natural gas, and microeconomic such as authoritarian management system and centralization, dissociating of the owner from a property still exist and they negatively influence the productivity and image of Gazprom Corporation. The first group of problems usually happens because of incorrect policy of the government which de facto owns the corporation and establishes its own policy within the company. Actually the company should be less governmentally oriented and it is necessary to move in the direction of providing of proportional power balance with the use of different types of power energy. The next group is the consequence of irrelevant management policy of the company itself, as the outsider model of management is inappropriate for such a form of company and it will be better to follow the European model of management and give more rights and opportunities for workers to participate in the decision-making process.

References

Buckley N., and T. Buck (2006). "[Duma votes for Russian gas export monopoly.](#)" *The Financial Times*, 16, 34-45.

Bush J. (2006). "[Gazprom: Open for Global Investors](#) by Jason." *Business Week*, 13, 12-22.

Dmitriev D. A. and V. I. Loginov (2009). "The International Positions of Russian Gas and Oil Companies." *World Economy and International Relationships*. 12(1). 56-72.

Egorov V. N. and P. K. Alekseev (2011). "Viewing the Perspectives of Gazprom." *Kommersant Newspaper*. 5. 7-12.

Gazprom in figures 2004-2008, Gazprom, 2008

Goldmann, Marshall (2008). "Petrostate: Putin, Power and the New Russia." Oxford University Press

Kahn. G. (2007) "Gazprom Pipeline Plan May Fuel Worry." *Wall Street Journal*, 25, 11-23.

Kramer E. (2011). "Gazprom Group." *The New York Times*. 6. 11-14.

Mitrova, Tatiana (2009). "Natural gas in transition: systemic reform issues". *Russian and CIS Gas Markets and their Impact on Europe*. Oxford University Press.

Matvienko A. S (2010). "Gazprom's Performance in the International Market." *World Economy and International Relationships*. 45(2). 37-49.

Onnerman D. S. (2010). "Russian Blue Gold Come to European Countries." *Izvestiya Newspaper*. 8. 37-47.

Sergeev S. A. (2011). "The History of Gazprom." lenta.ru

Stern, Jonathan P. (2009). "The Russian Gas Balance to 2015: difficult years ahead". *Russian and CIS Gas Markets and their Impact on Europe*. Oxford University Press.

Group discussion

For the further investigation of these issues we decided to take group discussion in class. We divided people into three groups and after short discussion they presented their possible decisions of these problems. And we get some results:

First group (Sebastian, James, Kay) proposed to cut recourses to the countries debtors until they pay money. But in the case of modern economical and political situation I find this impossible as it can lead to the energy boycott and after this as a result to the energy war. There are some cases in the Gazprom's practice when they cut resources to the Ukraine, Belorussia, Georgia and some European countries. Sure, they partly paid money but this situation is also caused tensions in the relationships between Russia and these countries.

In January 2006, Gazprom cut off Ukraine's gas supply—and consequently much of the rest of Europe's—after Ukraine's newly elected, pro-Western government balked at paying gas prices that were much greater than those paid by the previous, pro-Russian government. Being in the midst of winter, Ukraine had little choice but to accept the higher prices.

Georgia has also endured Russian energy punishment. In 2006, relations between Russia and Georgia broke down after Georgia accused four Russian military officers of spying. The Kremlin responded with economic and transport sanctions. In December, after Gazprom threatened to completely cut off gas supplies, Georgia agreed to pay US\$235 per 1,000 cubic meters, up from \$110. These are cruel moves in the midst of this region's infamously harsh winters.

Belarus too succumbed to similar Gazprom strong-arm tactics. On January 1, 2007, Russia forced Belarus into accepting price hikes that more than doubled Belarus's current costs. As part of the deal, Gazprom demanded Belarus sell it 50 percent of the shares in the Belarusian pipeline network, which supplies gas to Poland and Germany.

Estonia, Latvia, Lithuania, Moldova and Armenia are other known victims of Russian energy coercion.

All this activity has revealed the energy weakness of another major global power, one that has to respond strategically to Russia's growing clout.

Second group (Ruth, Livia, Jill and Kelvin) advised to accept the B.O.T (Built, Operate, Transfer) strategy which is common for European and most Asian countries. This mean to make this company more private than state oriented and give workers of

the company more power in decision making process and to follow the resource-based concept.

The solutions of this group are coincide with most analytics' opinion who also argue the more governmental independence of Gazprom Group and follow the management system of foreign gas and oil companies. But it will be difficult for Russia to rebuild the system as they used the old one for many years and government and president of Russian Federation has a strong influence within Gazprom Group. But anyway, I found the opinion of second group most adequate to the reality of modern economy.

Third Group (Dominique and Oogii) introduced their solutions of existing problems. They proposed to use the practice of resource exchanging, we supply gas to the countries and they supply any scarce recourse to Russia. I have to mention this practice is already exist in the case of former Soviet Union countries and some European countries and have some success. As the main principle here is principle of comparative advantage and anyway it is a basic principle of international trade practice along with gravity model and economy of scale.

The group is also give an idea of exporting gas from other countries to protect our own resources to escape energy crises in the future.

The last idea was to increase the income of Russian people than demands will also increases along with prices on natural gas within the country. But it is very difficult to predict demand and forecast the success of this measure. Actually it is the issue of economists and financial analytics who has more experience to predict the possible development.