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Independent Gas Producers in Russia

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0. Abstract

This article examines the recent changes in the Russian gas sector. The development of the sector is described and the important companies – such as Gazprom, Itera, Novatek, Northgas and the main gas producing oil companies (Surgutneftegas, TNK, Yukos, Lukoil) – are profiled. Additionally, the article tries to determine if the rise of independent gas companies since the mid-1990s can be interpreted as a sign of reform and liberalisation of the Russian gas sector. It concludes that the lack of political will continues to thwart far-reaching gas sector reforms in Russia.

1. Introduction: the Gas Industry in Russia

This article deals with the development of independent gas producers in Russia. Only ten years ago, the Russian gas industry was identified exclusively with Gazprom, while nowadays Russia's natural gas market is shared by a number of independent companies. Today, three major types of natural gas producers can be distinguished in Russia: (1) Gazprom, along with its production subsidiaries; (2) independent gas producers, i.e. smaller gas production companies not controlled by Gazprom; and (3) oil companies selling their non-flared associated gas or producing gas from their own natural gas reserves.

Table 1-1: Gas production in Russia (in bcm)^a

	1998	1999	2000	2001	2002	2003	2004
Russia	590.7	590.8	584.2	581.5	594.9	620.3	625.0
Gazprom	553.7	545.6	523.2	511.9	521.9	540.2	545.1
Oil companies	29.0	30.3	32.4	32.3	33.2	42.3	25.7b
Independent gas producers	N/A	14.1	25.2	35.5	41.3	40.2	25.9b

Notes: a) The figures do not always add up to the total amount of gas produced in Russia. Figures for oil companies and independent gas producers are according to Table 4 and 6.

b) January to July 2004 (NewsBase, FSU Oil & Gas Monitor, No. 33, 18 August 2004).

Sources: International Energy Agency 2002: 137; Landes et al. 2004: 48–49; UFG, Russia Morning Comment, 26 January 2005: 4; NewsBase, FSU Oil & Gas Monitor, No. 9, 9 March 2005; company information.

Nevertheless, Gazprom still dominates the Russian gas business because it owns the largest part of Russia's huge natural gas reserve base and it completely controls the pipeline network through which nearly all gas in Russia has to be shipped. Furthermore, Gazprom controls the marketing of natural gas on the domestic market.

1.1. Reserve Base

Around 80% of Russian natural gas production is concentrated in the Yamal-Nenets region in the West Siberian Basin, which is also where around 70% of oil production is located (Baranov 2003; for a geological overview see e.g. Energy Information Administration 1997).

Despite the fact that Gazprom owned 58.3%, or 28.0tcm, of Russia's explored gas reserves in 2003, independent producers – such as vertically integrated oil companies and specialised gas companies – accounted for 24% of the explored reserves. The remaining reserves belong to the undistributed fund of Russia's gas reserves. Independent producers hold licenses for gas fields containing an estimated 11.7tcm of the total gas reserves, around 60% of which belong to oil companies (Baranov 2003: 1–2). Most of the reserves of independent producers are at depths of 4,000 metres and more. The deposits are generally located in remote regions requiring infrastructure development and special technological endeavours (TNG Energy, Press Release, March 2002).

1.2. Pipeline Grid and Marketing

Gazprom completely owns the interregional high-pressure gas pipeline network, which stretches across most of Russia, and holds monopoly rights over exports of natural gas to Europe and the former Soviet Union (FSU) via its subsidiary Gazeksport (OECD 2002: 107).

In the early phase of the re-construction of the gas industry, in the early 1990s, the vast majority of the low-pressure regional gas pipeline grid was kept outside Gazprom. However, Gazprom has expanded its control over many of these low-pressure networks over the last few years. The company now controls, via its affiliates Mezhregiongaz and Oblgaz, around 90% of these networks, giving it direct access to industrial and household consumers in many Russian regions (Dashevsky 2001: 16; OECD 2002: 107).

Gazprom has also increased its control over the smaller distribution networks for cities and districts through its holding Regiongazkholding or through bilateral contracts with local and regional authorities (OECD 2002: 108). In 2003, Gazprom controlled over 114 and had shareholding in 71 gas distribution organisations, which operate 75% of distribution pipelines and supply 58% of gas delivered by all Russian gas distribution organisations. Almost 70% of gas received by the Russian population is through Gazprom's gas distribution networks (Gazprom 2004: 47).

In May 2004, Gazprom started to restructure its gas distribution organisations, its gas transportation subsidiaries and Regiongazkholding under the umbrella of the new created Mezhregiongazkholding, later renamed Gazpromregiongaz (NewsBase, FSU Oil & Gas Monitor, No. 21, 26 May 2004). Gazprom is still hoping to gain control over every Russian gas distributor, supplying gas to end users. According to Gazprom, gas supplies to customers will become more reliable as a result and their financing more transparent (NewsBase, FSU Oil & Gas Monitor, No. 14, 7 April 2004).

In early 2004, the Russian Anti-Monopoly Service accused Gazprom of monopolising the gas sales market by squeezing out independent distributors. The ministry has initiated proceedings on charges of breach of anti-monopoly laws against the Federal Energy Commission, Mezhregiongaz and Gazprom. The action was initiated on pleas made by the independent gas distribution organisations, which control low-pressure gas supply networks in the Astrakhan and Rostov regions and in the Krasnodar territory. As a rule they buy gas from Mezhregiongaz. In the past, the gas distribution organisations profited from the difference in the price of gas paid to the Mezhregiongaz and the price paid by the end users. However, in 2003 the Federal Energy Commission deprived those organisations of their sales mark-up and instead ordered it to be paid to Mezhregiongaz. As a result the gas distribution organisations began to receive only the fixed

gas transportation rate. The independent gas distributors believe that Gazprom is thus forcing them out of business (NewsBase, FSU Oil & Gas Monitor, No. 1, 7 January 2004).

1.3. Pipeline Access

One of the most crucial and until now unsolved issues for independent gas producers is the access to Russia's pipeline grid control by Gazprom. The principle of third-party access to pipelines is established in law, but it is virtually unenforceable (OECD 2004: 147). Since 1997 the Russian government has repeatedly passed resolutions on access for third-party organisations to Gazprom's pipeline grid, under which independent gas producers would have access to up to 15% of Gazprom's transportation facilities (Interfax Petroleum Report, 8–15 August 1997, pp. 17–18). However, independent gas producers has found it hard to gain access, mostly on technical grounds. Even if all gas producers were to be granted access to the Russian market, there is still the matter of access to foreign markets to consider.

Table 1-2: Third-party access to Gazprom's pipeline grid in 2000 by company

Company	Shipment (in mcm)	Percentage
Itera	56,200.0	69.7
Ditgaz	15,000.0	18.6
Sibur	5,896.0	7.3
Soyuz trading house	1,000.0	1.2
Orsenal Ltd.	952.0	1.2
Transneftegaz UT	500.0	0.6
Inneftegazstroy	305.0	0.4
Gazsbytservice	245.5	0.3
Gazservice MK	200.0	0.2
Optima-Gaz	93.0	0.1
Rosneft-Krasnodarneftegaz	90.0	0.1
Adygeyaneftegaz	42.5	0.1
Kalmgaz	28.0	>0.1
NefteGazPostavka	25.3	>0.1
Uralskoblgaz	6.8	>0.1
Total	80,584.1	100

Sources: PrimeTASS NewsWire, 13 December 2000; Russian Petroleum Investor, March 2001; own calculations.

The current law 'On gas supply', put into force in 1999, already provides third-party access to Gazprom's pipelines. Gazprom has to accept third-party gas for transportation, provided that gas meets certain quality requirements and there is available capacity. In May 2001, the government further improved this law by removing a 15% capacity limit

for non-Gazprom producers (NewsBase, FSU Oil & Gas Monitor, No. 19, 15 May 2001). Nevertheless, Gazprom has successfully fought off attempts by independent gas producers, except Itera, to access its infrastructure by introducing extremely strict access requirements and claiming lack of free capacity, chiefly because the pipelines are clogged with transit gas exports from Kazakhstan and Turkmenistan. This limits independent access to export resources in the name of regional politics ('Standing On Gazprom's Shoulders', in: Oil & Gas Investor, April 2003: R 17–21, here: R 18; Dashevsky 2001: 20).

Gazprom's argument about lack of free capacity seems rather weak because no independent observer is able to scrutinise Gazprom's figures (Dashevsky 2001: 20). However, the company denies that it put independent gas producers at a disadvantage; on the contrary, it points to the threefold rise in volumes of non-Gazprom gas transported through the pipeline grid from 28.1bcm to 83.1bcm between 1998 and 2002 (OECD 2004: 148).

1.4. General Attitude of the Government to Gas Market Reforms

President Vladimir Putin's efforts to bring Gazprom and other major industrial holdings with state ownership in line with general government policy, in addition to the issuing of a government order in November 2000 that was supposed to free up access to the national gas pipeline network, made analysts believe that the new policy on pipeline access was a signal for a comprehensive reform of the gas sector (NewsBase, FSU Oil & Gas Monitor, No. 46, 21 November 2000).

However, over the last few years the government has repeatedly pushed back reform plans for Gazprom as well as liberalisation of the Russian gas market – which is what pipeline access for independent gas producers would mean. In February 2003, President Vladimir Putin said that the government opposed plans to break up the gas giant. It was Putin's strongest statement yet against Gazprom reform. Under CEO Alexei Miller, Gazprom has strenuously fought Economic Development and Trade Ministry plans to split off its production units from its pipeline network in a bid to increase efficiency, even though subsidiaries would remain completely Gazprom-owned. Miller has argued such a shake-up would endanger Russia's gas supplies (Belton 2003).

Even international pressure could not change the position of the Russian government. In May 2004, Russia and the EU reached an agreement over EU support for its WTO membership bid, following a deal over Russian domestic gas pricing. The EU succeeded in securing a Russian commitment to liberalise access to the domestic gas pipeline network. However, the EU failed to obtain any commitment from Moscow to break up Gazprom. The company will remain at the heart of the more market-oriented gas sector, and will retain its monopoly on exports, despite EU efforts to break it. Pipeline access on the domestic market is likely to be a major gain for independent producers, which until now have had to beg Gazprom for access to pipelines – and have often been refused. The extent to which they will benefit is likely to depend on the precise mechanisms for "equal access" and the price. While Gazprom will probably lose some market share domestically to the independents, it is likely to benefit overall. It alone will have access to the highly lucrative European market. Growing independent production will be directed exclusively at the domestic market, allowing Gazprom to "sub-contract" a

larger part of this market to third parties, while it devotes a larger proportion to the foreign customers that provide the lion's share of its revenue (EIU ViewsWire, 24 May 2004).

1.5. Gazprom's Attitude and Behaviour

Gazprom is expected to suffer a shortfall in supply by the end of the decade, largely on the back of fast-rising European demand, but has found it difficult to attract the necessary investment needed to explore and tap new fields in Russia. Already in 2001, Gazprom had to import natural gas from Turkmenistan for the first time since 1997 to fulfil its supply contract with the Netherlands (Heinrich 2001: 112). Inexpensive gas from Central Asia will allow Russia to export its own gas to a greater advantage (NewsBase, FSU Oil & Gas Monitor, No. 25, 23 June 2004).

Russia's Union for Independent Gas Producers (Soyuzgaz) forecasts that Europe's dependency on gas imports is expected to double to 70% by 2020, providing a major opportunity for Russian gas suppliers. Russia is expected to see output grow to 700bcm by 2020. However, the government estimates that its gas consumption will account for less of the country's energy balance by then than they do now. Independent gas producers could alleviate some of the pressure on Gazprom, Soyuzgaz argued. The contribution of independent producers to the gas industry is growing every year and independent gas production has more than doubled since 2001, several times faster than Gazprom's (NewsBase, FSU Oil & Gas Monitor, No. 14, 7 April 2004).

As a consequence, Gazprom changed its attitude in early 2002 and started a dialogue with independent gas producers. The company offered them increased access to its pipeline network of 40–60bcm a year but only to supply the domestic market. Gazprom predicts that between 2010 and 2020 the share of independent producers will grow to 150–170bcm of gas a year (RusEnergy.com, 26 April 2002; Petroleum Argus, FSU Energy, Vol. 7, No. 6, 15 February 2002, p. 7). The company also announced that it would allow independent gas producers access to export markets provided that the government raises domestic gas tariffs in order to compensate for the potential drop in European gas prices. Moreover, Gazprom said that it would ship associated gas supplied by oil companies to Russian consumers without any restrictions (UFG, Russia Morning Comment, 11 February 2002).

In addition to Russian sources, Gazprom is looking for larger gas supplies from Central Asia to meet export contracts and maintain deliveries to Russian customers as it competes with Itera, an independent gas producer and trader, for gas-producing assets and markets in the FSU (Todres 2004). Thus, Gazprom wants to expand the existing Turkmen gas transportation capacity from 40bcm to 50bcm per year. Under Gazprom's contract for Turkmen gas transportation, if the amount of gas carried is to steadily increase, bank financing is needed to expand the gas transportation system. To this end, RUR500mn (USD17.2mn) has been earmarked for Gazprom's investment programme for 2004 (NewsBase, FSU Oil & Gas Monitor, No. 25, 23 June 2004).

Moreover, Gazprom wants to link pipeline access with investments from independent gas producers for developing and reconstructing the gas transport system. Gazprom's CEO Miller suggested the introduction of long-term contracts for the purchase of gas, the participation of independent gas producers in the reconstruction, modernisation, and creation of new gas transport capacity, and the improvement of rules of access to the gas

transport system that prescribe bilateral obligations to ensure and pay for transport. He added that independent producers should receive equal rights, but should be equally responsible for the development of the gas sector. They may either directly invest in the reconstruction or take part in repaying Gazprom's debts for the reconstruction, Gazprom said (NewsBase, FSU Oil & Gas Monitor, No. 37, 18 September 2002; NewsBase, FSU Oil & Gas Monitor, No. 7, 18 February 2004).

However, despite having started the dialogue with independent producers, Gazprom disconnected independent gas producers – such as Itera, Northgas and Rospan – from the pipeline grid several times during 2002 and 2003. Independent gas producers protested and blamed Gazprom for unfair competition (Lelyveld 2002; Landes 2003: 1; Pravda.ru, 22 October 2003).

In October 2004, the Federal Anti-Monopoly Service ruled that Gazprom – through its subsidiaries Mezhhregiongaz and Surgutgazprom – had discriminated against independent gas producers Rospan, Northgas and Novatek by not providing them access to the gas pipeline system. In particular, Gazprom stopped the in-take of gas from Rospan completely in June 2004 and endeavoured to reduce that of Northgas by 50% and Novatek by 15%, based on the allegation that these producers effectively used Gazprom's pipeline system as a storage facility. The independent producers and their contractors (traders) were unable to take 2bcm from the system. As Gazprom announced, "this leads to an overload on the gas transportation system and to a reduction in its throughput capacity" (RIA Novosti, 9 August 2004). Although this decision may at first glance look like a positive development for independent gas producers, UFG raises objections that Gazprom may nevertheless continue to discriminate against independent gas producers for as long as it remains the sole owner of the pipeline network. According to existing regulations, Gazprom is only required to provide pipeline access if it has available capacity, but this remains one of Gazprom's best-kept secrets (UFG, Russia Morning Comment, 21 October 2004; NewsBase, FSU Oil & Gas Monitor, No. 43, 27 October 2004).

The ruling against Gazprom was based on the fact that the proportion of gas in Gazprom's pipeline system is lower than that allocated by the Ministry of Energy and Industry in its plans for the year. Furthermore, Gazprom only applied sanctions to the independents who did not off-take gas from the system, but not to its own subsidiaries (UFG, Russia Morning Comment, 28 October 2004). The Federal Anti-Monopoly Service has continued to persecute Gazprom. In November 2004, the Service ordered the gas monopoly to stop restricting gas intakes from independent producers in its unified gas supply system. According to the Service, Gazprom is spending its own gas balance for 2004 and not the balance approved by the Ministry of Industry and Energy. The share of independent producers in the Ministry's gas balance exceeds Gazprom balance by 7bcm (NewsBase, FSU Oil & Gas Monitor, No. 46, 17 November 2004).

Meanwhile, Rospan stopped natural gas production after Gazprom refused to accept its gas into the pipeline system. According to Gazprom, the company has accumulated a large amount of unsold gas, 80 times the daily supply rate (NewsBase, FSU Oil & Gas Monitor, No. 46, 17 November 2004).

In November 2004, Gazprom's CEO Alexei Miller signed the 2005 gas budget. Russian consumers will get about 80.7bcm from independent gas suppliers. The gas budget pro-

vides for the supply of about 70bcm of gas from Central Asia to customers in FSU countries (NewsBase, FSU Oil & Gas Monitor, No. 46, 17 November 2004).

Gazprom's board of directors asked the management in early 2005 to finish work on regulations of independent gas suppliers' gaining access to Gazprom's gas transportation system, providing for a streamlined access procedure. The drafting of a financial and legal mechanism for involving independent gas suppliers in expanding, renovating and modernising Gazprom's gas transportation capacities is also to be finalised (NewsBase, FSU Oil & Gas Monitor, No. 8, 2 March 2005).

2. Gazprom's Weakness and the Rise of the Independent Producers

Despite the fact that Gazprom is still the leading company in the Russian gas market, the company has experienced bad times. Gazprom's portion of Russia's total market share of gas output has already fallen (from 94% in 1998 to 87% in 2003). And with the independent producers putting in double digit output growth, this share will continue to fall (Aris 2004a). Moreover, 75% of the working fields are nearly worn out. The development of new fields, which are located in remote regions and do not have proper infrastructure but are characterised by deep reserves, would also require significant investments. Maintenance of gas production on a stable level requires massive investments, and it is becoming increasingly difficult for the gas giant to find the money to meet both foreign and domestic needs of gas consumers (RusEnergy.com, 26 April 2002; TNG Energy Press Release, February 2002).

Additionally, weak corporate governance mechanisms (cf. Heinrich 2004) allowed the management under Rem Vyachirev to strip assets out of the company until mid-2001, to give away lucrative sales markets in the FSU and to strengthen the position of independent gas producers, namely Itera's.

Seven dubious transactions that stripped enormous value away from Gazprom came under scrutiny after 2000, when the representative of minority shareholders – Boris Fedorov – obtained a seat in the board of directors. In particular, between 1997 and 2001, Gazprom lost control over Rospan, Purgaz, Tarkosaleneftegaz, Sibneftegaz, Achimneftegaz, Zapsibgazprom and Severneftegazprom, worth more than USD5bn, as well as holding licences for nearly 10% of its total reserve base. In these transactions Gazprom either has given production assets to Itera directly (Rospan, Severneftegazprom), through dilution (Tarkosaleneftegaz, Sibneftegaz, Zapsibgazprom) or through joint ventures (Purgaz, Achimneftegaz) (Browder 2002; UFG 2000a: 3; UFG 2000b).

Gazprom's management under Rem Vyachirev and Itera tried to justify these transactions with economically plausible reasons. They claimed that Itera had released Gazprom from intergovernmental contractual obligations to deliver natural gas to FSU countries which are unable to pay as well as from non-payments in the Sverdlovsk region (Gel'man 2000). Itera, being a private company, has no liabilities like Gazprom's obligation to deliver cheap gas to domestic consumers. As compensation, Gazprom provided Itera with rights to its gas fields (LeBras 2000b).

Additionally, Itera took over licenses of low profit and "smaller" gas fields for which Gazprom lacked the capability to develop and explore. Gazprom's management asserts that Gazprom did not have enough capital to develop the fields while the term of the

licenses was expiring and could have been revoked (Gel'man 2000). However, despite financial difficulties, Gazprom was able to give Itera a loan guarantee of over USD472.5mn between 1997 and 2000. Thus, Gazprom provided financial assistance to a competitor to develop gas fields that it formerly operated by itself (UFG 2000b).

Therefore, it is widely believed that Gazprom's management until mid-2001 used Itera as a vehicle for asset-stripping for years. However, many of the individuals under suspicion on this front were dismissed during the reshuffle of Gazprom's management team in 2001 (NewsBase, FSU Oil & Gas Monitor, No. 42, 23 October 2001).

2.1. Recovering the Assets

With the explicit support of Russia's President Vladimir Putin, Gazprom's new CEO Alexei Miller and his management team embarked on a campaign to return valuable gas fields to Gazprom's balance sheet. At its annual general meeting in July 2001, Gazprom's board of directors ordered management to undertake efforts to establish control over its subsidiaries, to exercise options to buy back its 32% stake in Purgaz (at this point of time Itera's key production unit) and to take urgent measures to prevent the loss of Gazprom's indirect interest in Servneftegazprom, a Zapsibgazprom subsidiary (UFG, Oil Comment, 1 August 2001).

One year later, in July 2002, Gazprom and Itera signed an agreement to settle all their mutual claims. Under the agreement, which brought an end to Gazprom's campaign to recover lost assets from Itera, the independent producer returned the licence for the Gubkinskoye gas field and a 32% stake in Purgaz and swapped 52% in Severneftegazprom for Gazprom's small shareholdings in two gas firms which Itera already controls – Tarkosaleneftegaz and Sibneftegaz (Petroleum Argus, FSU Energy, Vol. 7, No. 28, 19 July 2002, p. 4; NewsBase, FSU Oil & Gas Monitor, No. 34, 28 August 2002).

Moreover, Gazprom agreed to a swap deal with Yukos: in return for Yukos' 25.58% stake in Gazprom's subsidiary Zapsibgazprom, the oil company received 12% of the gas company Arktikgaz, in which it already held 68% of the share capital (Petroleum Argus, FSU Energy, Vol. 7, No. 26, 5 July 2002, pp. 6–7).

Gazprom restored control over the companies Purgaz, Severneftegazprom and Zapsibgazprom (Russia Journal Daily, 27 June 2003). However, the production units Rospan, Takosaleneftegaz and Sibneftegaz remained lost.

Nevertheless, Gazprom announced that it will continue to recover its former assets in order to boost output and increase proven natural gas reserves. The company's output has also risen because of the return and acquisition of assets from independent gas producers and oil companies (see below) (NewsBase, FSU Oil & Gas Monitor, No. 22, 8 June 2005).

2.2. Recovering Export Markets in the FSU

In June 2002, Gazprom announced that it wanted to recover the market share lost to Itera in the FSU (Landes et al. 2004: 50). To achieve this goal, Gazprom used its monopoly over the pipeline grid.

First, in 2002, Gazprom took several measures to regain its position in the Baltics. As a result, Gazprom increased its share of gas deliveries to Estonia from 75% to 100%, to

Lithuania from 78% to 92% and to Latvia from 74% to 84% in 2003. The interest of Gazprom toward the Baltics, which consumes only 2.4% of all deliveries of Gazprom in the FSU, is the countries' entry into the European Union. This gives Gazprom great opportunities for trading natural gas on the European market (Rosbalt, 6 May 2003).

Table 2-1: Gazprom's FSU exports 1997–2004 (in bcm)

	1997	1998	1999	2000	2001	2002	2003	2004
Total exports	188.9	173.0	174.0	173.7	166.5	168.9	175.5	193.0
Trans-Caucasus								
Armenia	—	—	—	—	—	—	0.6	1.3
Azerbaijan	—	—	—	—	—	—	—	0.8
Georgia	0.1	—	—	—	—	—	0.3	1.2
Baltic republics								
Estonia	0.8	0.8	0.5	0.6	together 4.0	0.6	together 1.4	0.9
Latvia	1.1	1.3	1.0	1.0		1.1		1.5
Lithuania	2.2	2.2	1.8	2.0		2.4		2.9
Belarus	15.2	14.7	12.2	10.8	11.6	10.2	10.2	10.2
Kazakhstan	0.1	—	—	—	—	—	—	0.8
Moldavia	3.3	2.9	2.1	1.8	2.1	2.1	1.5	1.8
Ukraine	49.3	30.5	29.6	27.2	21.9	25.9	26.0	34.3
Exports FSU	72.1	52.4	47.2	43.4	39.6	42.3	42.6	55.7
Percentage of total exports	38.2	30.3	27.1	25.0	23.8	25.0	24.3	28.9

Sources: Company information (including Gazeksport); Dashevsky 2001: 44; Landes et al. 2004: 51; NewsBase, FSU Oil & Gas Monitor, No. 34, 25 August 2004; NewsBase, FSU Oil & Gas Monitor, No. 6, 16 February 2005; own calculations.

Second, in 2003, Gazprom returned to the abandoned and explored new markets of the FSU, launched gas deliveries to Georgia and Armenia, and signed a gas supply contract with Azerbaijan. Gazprom was thus able to squeeze Itera out of the Trans-Caucasian markets in 2004 and to meet the requirements for natural gas in these republics in full, whereas in 2003 those markets were under Itera's control. Itera, which had contracts with Georgia, Armenia and Azerbaijan, was to meet about 50% of local gas demand, but had failed to reach a gas transportation agreement with Gazprom. The company announced that there was no room for Itera's contracted Turkmen gas supplies in the Gazprom gas transportation system and that no other mutually advantageous supply scheme could be worked out (NewsBase, FSU Oil & Gas Monitor, No. 5, 4 February 2004).

Gazprom therefore planned to export more gas from Central Asian deposits in 2004, which was then supplied to industrial complexes and inhabitants of Azerbaijan, Armenia, Georgia and Moldavia. A total of up to 9.4bcm of Central Asian gas was to be exported to these countries, compared with 1.5bcm of gas in 2003 (NewsBase, FSU Oil & Gas Monitor, No. 25, 23 June 2004).

From January to October 2004, Russian gas exports to the FSU peaked at 5.12bcm, an increase of 420% compared to the same period in the previous year. Higher sales were a result of higher output by Gazprom and the monopoly on natural gas exports from Turkmenistan (NewsBase, FSU Oil & Gas Monitor, No. 47, 24 November 2004).

In addition to the Trans-Caucasian markets, Gazprom wants Belarus to deny independent suppliers services in 2005. Gazprom is ready to cover the country's demand for gas in full. Belarus' plan is to continue buying gas from Gazprom and independent suppliers. In 2004, Belarus was to receive 18.5bcm of gas, with 10.2bcm to come from Gazprom, while 8.3bcm had already been supplied by independent gas suppliers, including Itera (NewsBase, FSU Oil & Gas Monitor, No. 35, 1 September 2004).

However, in its 2005 gas budget Gazprom plans to supply the Ukraine with 23bcm of Russian gas in barter for gas export transit and 37.1bcm from Central Asia (of which about 34bcm is to come from Turkmenistan). Belarus is to get 18.6bcm of gas in 2005, with no independent suppliers involved in the contract (NewsBase, FSU Oil & Gas Monitor, No. 46, 17 November 2004).

3. Independent Gas Companies

According to Leonid Mikhelson, CEO of Novatek, independent producers do not have any problems as far as production is concerned. Their difficulties stem from the fact that the gas business in Russia is entirely calculated on the basis of Gazprom. Transportation costs, market prices and taxes are based on the economics of Gazprom, bearing in mind that their export sales finance their losses on the domestic market. Since independent producers do not have access to export markets and sell only domestically, they have totally different economics – although the growing demand from Russian consumers and enterprises has already risen to a point which makes production economically viable ('Standing On Gazprom's Shoulders', in: Oil & Gas Investor, April 2003: R 17–21, here: R 21; Aris 2004a).

Table 3-1: Gas production by independent gas companies (in bcm)

	1998	1999	2000	2001	2002	2003	2004
Itera	2.0	6.6	17.9	23.0	23.2	13.3	14.0
Novatek	—	—	N/A	8.8	14.2	19.5	21.4
Northgas	—	—	—	—	3.9	4.0	4.8 (plan)
Yakutgazprom	N/A	1.6	1.6	N/A	Belongs to Yukos		
Norilskgazprom	N/A	3.8	3.7	3.7	N/A	3.4	3.4 (plan)
Others	N/A	2.1	2.0	N/A	N/A	N/A	N/A
Total	N/A	14.1	25.2	35.5	41.3	40.2	25.9

Sources: Company information; OECD 2002: 109; Mikhelson 2003; Dashevsky 2001: 13; Landes et al. 2004: 49; NewsBase, FSU Oil & Gas Monitor, No. 27, 10 July 2001; NewsBase, FSU Oil & Gas Monitor, No. 27, 10 July 2002; NewsBase, FSU Oil & Gas Monitor, No. 4, 28 January 2004; NewsBase, FSU Oil & Gas Monitor, No. 9, 9 March 2005.

The government and Gazprom agree that Russia's independent gas producers need to play a key role in bringing new fields on stream as currently producing fields decline.

The tariff, tax and transportation regime will have to change drastically to create an attractive business environment (TNG Energy, Press Release, March 2002).

However, the tax increase on the production of mineral resources (representing the second rise in 2004) drafted by the Russian government will make it impossible for gas producing companies other than Gazprom to boost the output of gas, warned Soyuzgaz. Starting on January 1, 2004, the production tax rose by 150%. In 2005, a new 26% hike is expected from RUR107 (USD3.67) to RUR135 per 1,000cm. According to Soyuzgaz, the 26% hike in the tax will halve investment in gas production.

4. How Itera, Gazprom's Darling, Fell out of Favour

The US-registered company Itera has emerged as another major player in the Russian gas business since the end of the 1990s (OECD 2002: 108). Entering the market in 1994, and participating in the delivery of Turkmen gas to Ukraine and other former Soviet republics, Itera first arranged barter deals that exchanged Russian gas for imports of FSU countries. It was during this period that the foundations were laid of its cooperation with Gazprom. By that time, Itera had developed an unusual payment scheme through clearing settlements using its ramified marketing infrastructure. Itera was willing to accept almost anything in exchange for gas, from machine tools and food stuff to weapons (Adams 2002: 15). Within a few years, Itera became the single supplier of the Sverdlovsk region, one of Russia's largest industrial centres, as well as that of Georgia and Armenia. It delivered 60% of Ukraine's gas imports and 25% of the amount required by Belarus as well as 70% of the gas demand of the Baltic States (Makarov 2000). In 1999, Itera made profits of USD3bn from the sale of 67bn of gas, most of it supplied by Gazprom (Ostrovsky 2000). In 2000, Itera sold 85.6bn cm of gas in Russia and the FSU (Dashevsky 2001: 13) and reported turnover of USD30bn (NewsBase, FSU Oil & Gas Monitor, No. 42, 23 October 2001). "In less than a decade it had become the world's second-largest gas company in terms of the amount of gas it was delivering under contract" (Adams 2002: 15).

In mid-1998, Itera turned from a gas trader into a producer of natural gas. A holding company, Itera Holding Ltd., was established to co-ordinate the activities of several subsidiaries in Russia, including the development of gas fields (Adams 2002: 15). The company became a co-owner of five gas fields in the Yamalo-Nenets region that formerly belonged to Gazprom, which sold or transferred major stakes in Rospan, Purgaz and Tarkosaleneftegaz to Itera. Total deposits in the gas fields – which include Gubkinsky, Vostochno-Tarkosale, Novo-Urengoysky, Vostochno-Urengoysky and Vinraychinsky – are estimated to exceed 1.2tcm (LeBras 2000a; Dashevsky 2001: 12–13).

Itera's output has grown quickly from 2bcm in 1998 to around 18bcm in 2000 (OECD 2002: 109). As a result, Itera and its affiliates accounted for more than half of non-Gazprom natural gas production in Russia. The rise of Itera as a gas producer parallels a decline in the quantity of gas produced and sold by Gazprom. Itera has also moved into the gas distribution business, taking over from Gazprom supplies to the Sverdlovsk region (Dashevsky 2001: 13; OECD 2002: 109).

Table 4-1: Itera's gas sales in the FSU (in bcm)

	1996	1997	1998	1999	2000	2001	2002	2003	9M 2004
Armenia	1.1	1.4	1.5	1.3	1.4	1.4	1.5	—	—
Azerbaijan	—	—	—	—	0.3	3.1	4.0	—	—
Belarus	—	0.5	1.1	3.8	5.8	5.1	6.3	6.2	1.4
Estonia	—	—	—	0.2	0.2	0.2	0.2	N/A	—
Georgia	0.9	0.9	0.9	1.1	1.1	1.0	1.0	1.0	—
Kazakhstan	3.1	1.9	2.0	1.7	2.7	2.9	2.0	—	—
Latvia	—	0.2	0.3	0.3	0.4	0.4	0.4	0.3	0.5
Lithuania	0.05	0.3	—	0.5	0.6	0.5	0.5	—	—
Moldavia	0.3	0.4	0.4	0.7	0.6	0.6	0.5	—	—
Russia	0.7	1.7	10.5	19.8	40.1	20.0	N/A	16.7	10.7
Ukraine	17.5	13.6	22.9	31.1	32.4	34.8	34.8	—	—
Uzbekistan	2.3	0.6	—	—	0.2	—	—	—	—
Total	25.9	20.8	39.6	60.5	85.6	70.0	63.0	24.2	12.6

Sources: Company information; ANCENTR 2002: 36–40; Todres 2004; own calculations.

4.1. The Times, They are A-Changing

The development of Itera as a gas trader and producer was closely linked to the Gazprom management under Rem Vyachirev. In mid-2001, the management team under Alexei Miller was successively changed to restore state control over Gazprom. Thus, times for Itera have got harder.

After the break-up with Gazprom, Itera seems to be a truly independent gas producer that now has to deal with the same problems all alternative gas producers in Russia have faced and, in most cases, have been unable to cope with. Protection of its positions in the most attractive markets will most likely become Itera's main concern in the near future.

Itera found its access to the pipeline network limited and it had to pay a higher tariff for gas transport than that paid by Gazprom affiliates. Furthermore, the Russian government did not allow Itera to export its own gas or charge more than USD16 per 1,000cm for gas delivered to domestic customers. The company's production costs were already higher than those of Gazprom and the burden of relatively high transportation costs and low sale prices makes it even harder for Itera to turn a profit (NewsBase, FSU Oil & Gas Monitor, No. 42, 23 October 2001).

Additionally, in 2002 Itera lost its status as the operator of Turkmen gas sales to Ukraine, a business in which Itera earned USD1.4bn in revenues in 2000. With Gazprom's blessing, Itera had been the operator of Turkmen gas supplies to Ukraine since 1999 (UFG, Russia Morning Comment, 5 November 2001; NewsBase, FSU Oil & Gas Monitor, No. 36, 8 September 2004).

However, the worst problem Itera had to cope with was a rapid disappearance of its reserve base. In 2002, Gazprom's new management started a campaign to recover lost assets, which since 1998 had mostly been handed over to Itera. Thus, Itera has lost its stakes in the production companies Rospan and its interest in Purgaz was reduced to 49%, a reduction of total reserves of around 1tcm. Itera also lost control over the producer Zapsibgazprom and its subsidiary Severneftegazprom (with estimated reserves of 800bcm in May 2002) after Russia's securities commission ruled that a share issue used by Itera to boost its stake in the Gazprom subsidiary to 51% was void (Kruchkova 2002).

Therefore, Itera and the little-known Russian firm Novafininvest signed an agreement to establish a united gas producing holding company with equal share participation of the parties on 5 April 2002 (Petroleum Argus, FSU Energy, Vol. 7, No. 17, 3 May 2002, p. 4). The new holding company was planned to bring together 20 gas extracting, managing and sales companies previously owned by Itera and Novafininvest and their allies. The new holding was supposed to have total assets of 2tcm of gas (NewsBase, FSU Oil & Gas Monitor, No. 21, 29 May 2002). The value of the merged assets is estimated at about USD2.07bn (RusEnergy.com, 26 April 2002).

By forming the new production partnership, the parties aimed to improve the economic performance of entities already under their control and to reduce production and sales costs (RIA Novosti 22 April 2002). The investment company Aton stated that the merger is a logical step, because Itera and Novafininvest own a number of assets in cooperation and closely co-operate in gas production and sale (RusEnergy.com, 26 April 2002).

However, in October 2002 Itera and Novafininvest decided to postpone their assets merger, citing legal difficulties in the consolidation process (NewsBase, FSU Oil & Gas Monitor, No. 43, 30 October 2002). This decision was definitive; no further consultations about a merger have taken place.

4.2. Sale of Production Assets

Itera could not even replace its asset losses, as it has been forced to offer some of its few remaining assets up for sale in an apparent effort to resolve the deadlock surrounding pipeline access from the remaining Beregovoye gas field in West Siberia. In exchange for access, Gazprom is seeking to buy Itera's 49% stake in Achimneftegaz as well as its stakes in Armenian gas distributor Armrosgazprom and in Sibneftegaz, its major production unit (Renaissance Capital, Morning Monitor, 17 May 2004).

While Sibneftegaz is still majority owned by Itera, the company sold its 49% share in Achimneftegaz in July 2004. Achimneftegaz, which develops deep, high-pressure reservoirs in the Urengoy deposit, was founded in 2000 by Itera's CTI Sigma (49%) and Gazprom's subsidiary Urengoygazprom (51%). It has been over a year since Itera offered Gazprom its 49% interest for USD3.5mn. Yet Itera has since withdrawn its offer, having explained that it has no confirmation on Gazprom's consent to the deal. Therefore, Itera opted to sell this stock to Northgas, another independent gas producer (NewsBase, FSU Oil & Gas Monitor, No. 18, 5 May 2004; Vedomosti, 23 July 2004).

Itera is also negotiating the sale of its 10% stake in Armrosgazprom to a West European investment corporation. The company is Armenia's exclusive wholesale gas buyer and

supplier (NewsBase, FSU Oil & Gas Monitor, No. 41, 13 October 2004). However, the deal has not taken place yet.

4.3. Loss of Sales Markets

Itera's planned sale of its stake in Armrosgazprom might also be a result of Gazprom shutting Itera completely out from the Trans-Caucasian gas market. Early in 2004, Itera had to suspend its gas supplies to Azerbaijan and other Trans-Caucasian countries because Gazprom had denied permission to the company to export natural gas from Turkmenistan in 2004. Gazprom had completely cut Itera off from Turkmen gas supplies under the pretext of full pipelines (NewsBase, FSU Oil & Gas Monitor, No. 1, 7 January 2004; NewsBase, FSU Oil & Gas Monitor, No. 2, 14 January 2004).

However, Georgia, which signed a strategic co-operation agreement with Gazprom to guarantee gas supplies to the republic, is interested in keeping Itera as an alternative gas supplier (NewsBase, FSU Oil & Gas Monitor, No. 4, 28 January 2004). Meanwhile Itera announced it has no plans to renew gas export contracts in the Trans-Caucasus (NewsBase, FSU Oil & Gas Monitor, No. 34, 25 August 2004).

Despite its problems supplying the Trans-Caucasian republics, Itera was able to meet in full its contractual obligation for gas supplies to Belarus. Itera has an annual contract with Belarus for 7.5bcm (NewsBase, FSU Oil & Gas Monitor, No. 6, 11 February 2004). However, Itera is not included in Gazprom's 2005 gas budget as a supplier of Belarus (NewsBase, FSU Oil & Gas Monitor, No. 46, 17 November 2004).

4.4. What is Left

Itera, which used to be a leading independent gas producer in Russia and a dominant player on the FSU gas market, has been steadily losing its position since Alexei Miller became Gazprom CEO in May 2001 (UFG, Russia Morning Comment 30 April 2004). However, investing over USD1.5bn in the Russian gas sector since 1998, Itera's total reserve base still comprises 1.17tcm of natural gas. Altogether there remain successfully implemented gas production projects in the company's track record, such as the Gubkinskoye, Vostochno-Tarkosalinskoye and Beregovoye gas fields (Itera company information 2004).

However, the Beregovoye deposit currently stands idle, thanks to Gazprom, which blocks pipeline access. Itera cannot rule out the very real possibility that Gazprom will continue to refuse to pump its gas by trunk gas pipelines in order to force Itera to sell Sibneftegaz. Therefore, Itera has taken a USD200mn Sberbank loan on the majority stake in Sibneftegaz, to finance the construction of a gas pipeline from the Beregovoye deposit to a trunk gas pipeline in Urengoy (NewsBase, FSU Oil & Gas Monitor, No. 5, 4 February 2004). Gazprom announced it will hold talks with Itera on the terms of link-up with the Beregovoye deposit (NewsBase, FSU Oil & Gas Monitor, No. 22, 8 June 2005).

To pool efforts to develop new oil and gas deposits, Itera and Tatneft signed an agreement to form a strategic partnership in prospecting and developing oil and gas deposits. The two companies intend to draft a programme for prospecting for hydrocarbons in some Russian regions and foreign lands. Joint ventures are to be formed to implement future projects (NewsBase, FSU Oil & Gas Monitor, No. 43, 27 October 2004). Itera is

already active in other parts of Russia and the FSU – such as Kalmykia and Turkmenistan.

Geological prospecting in Kalmykia is the largest project, on which Itera pins great hopes for future development. Itera has 11 licences for exploration in Kalmykia, which might contain huge oil and gas reserves (NewsBase, FSU Oil & Gas Monitor, No. 6, 11 February 2004). Itera invested about USD36mn in Kalmyk oil and gas deposit development in 2003 and plans to invest a further USD160mn over the next five years (NewsBase, FSU Oil & Gas Monitor, No. 41, 13 October 2004).

Itera is also participating in the Zarit joint venture which is interested in a production-sharing agreement (PSA) for the development of three Caspian offshore fields. Zarit, which was set up in 2002, is hoping to sign a 25-year PSA for its three offshore blocks. The Zarit fields are believed to hold around 408mt of oil and 300bcm of gas. Equity in Zarit is divided up among four shareholders: 31% to Gazkhiminvest, a subsidiary of Itera; 31% to Rosneft; 23% to Zarubezhneft, a Russian state vehicle for foreign oil development project; and 15% to Turkmenneft, Turkmenistan's state oil concern (NewsBase, FSU Oil & Gas Monitor, No. 13, 31 March 2004; NewsBase, FSU Oil & Gas Monitor, No. 37, 15 September 2004).

From its sales markets only the Sverdlovsk region is left. Since 1999, Itera has operated in the Sverdlovsk region delivering about 17bcm of gas per year. In 2003, it was contracted with the regional government that Itera will deliver 88bcm to the region between 2004 and 2008, including 17bcm of gas in 2004 (Itera company information 2004; NewsBase, FSU Oil & Gas Monitor, No. 7, 18 February 2004). The Sverdlovsk region has no intention to replace Itera as its current natural gas supplier, said local governor Eduard Rossel. The regional administration is satisfied with Itera's stable supplies and involvement in social projects (NewsBase, FSU Oil & Gas Monitor, No. 40, 6 October 2004).

Due to its weakened position in the Russian gas business, Itera has been seeking out new types of activities over the past three years. It has been forced to diversify into gold mining and metallurgy to stay afloat. Additionally, the company has recently sent investment proposals to the Belarussian leadership covering a variety of areas. In the meantime, Itera's proposal to buy the controlling stake in the Belarussian cellular operator MTS (51% owned by the Belarussian government, 49% by Russia's Mobile Telesystems) has been denied, along with the transfer of the Grodnoazot state holding to Itera. Itera's offers to take part in the construction of a power plant in Belarus and the creation of insulin production are still under consideration (NewsBase, FSU Oil & Gas Monitor, No. 35, 1 September 2004).

Itera is also in negotiations about co-operation with Tanzania in the exploration for and production of oil and gas, rare earth and precious metals, as well as the creation of the infrastructure of new deposits. Additionally, the company is studying exploration and production at oil and gas deposits in India (NewsBase, FSU Oil & Gas Monitor, No. 22, 8 June 2005).

To summarise, Itera is still Russia's third-largest gas supplier but its sales plunged 51% in 2003, to 30.7bcm from 63bcm in 2002, as Gazprom squeezed it out of some markets and regained some gas fields. The company's net income – which was reported for the first time – totalled USD57.9mn in 2003, and over USD191mn was invested in gas extraction and gas pipeline construction projects. Itera's own production of gas fell by

more than a third to 14bcm in 2003. The company received about 16bcm of gas from Novatek and Gazprom. Itera bought another 7bcm of gas from Turkmenistan to be re-sold in the Caucasus and received 6.3bcm on commission from Gazprom, which thus saved Itera from defaulting on the Sverdlovsk region and partially compensated its own losses from gas deliveries to Belarus (Todres 2004; NewsBase, FSU Oil & Gas Monitor, No. 12, 24 March 2004).

However, the downward trend continues. In the first nine months of 2004, Itera posted a RUR1.139bn (USD39.7mn) net profit. This is a 79.2% drop from the RUR5.523bn netted in the same period last year, according to a company report in Russian accounting standards. In the period under review, Itera's receipts rose by 40% to RUR15.2bn while production costs went up 120% to RUR10.2bn (NewsBase, FSU Oil & Gas Monitor, No. 46, 17 November 2004).

5. Novatek – the New Prince of the Independent Gas Producers

Novatek, known up until March 2003 as Novafininvest, was established in 1994 in the Samara region. Originally specialised in oil and gas pipeline construction, the company began to diversify into the oil and gas industry at the end of the 1990s. Between 1998 and 2000, Novatek acquired majority stakes in several production companies, such as Tarkosaleneftegaz, Purneftegazgeologiya, Geoilbent, Yurkharoneftegaz and Khancheyneftegaz as well as joint venture stakes in Selkupneftegaz (34%), Tambeyneftegaz (25.1%) and Pur-Land (47.5%). The company's largest fields – East Tarkosalinskoye, Yurkharovskoye and Khancheyskoye – are located in close proximity to the existing transport infrastructure. Novatek holds net estimated hydrocarbon reserves of 1.5bcm of natural gas, 91mt of gas condensate and 131mt of crude oil (based on the Russian reserve classification system A+B+C₁ and C₂ as of 1 January 2003) (Novatek, Press Release, 15 April 2004; Trust Investment Bank 2004: 2).

Since 2001, the company has been developing the Yurkharovskoye field through its wholly-owned subsidiary Yurkharovsneftegaz. The commencement of the natural gas production at the Yurkharovskoye field was responsible for Novatek becoming the largest independent gas producer in Russia in 2003 (Novatek company information).

In 2003, Novatek extracted 19.5bcm of gas, with the company supplying 13.2bcm to its customers. Since December 2002, Novatek has been actively selling natural gas under direct contracts with end users. The company supplies its gas to energy companies in various regions and republics throughout Russia, including the regions of Moscow, Yaroslavl, Samara, Tyumen, Chelyabinsk, Perm, Kirov and the Chuvashia and Komi republics (Novatek company information; NewsBase, FSU Oil & Gas Monitor, No. 17, 28 April 2004).

Novatek also acquired downstream processing facilities, such as Novakhim, Truboplast and Truboizolyatsiya, which are located in the Samara region (Novatek company information; Trust Investment Bank 2004: 2). The company has ambitious plans to diversify its business by becoming both a leading natural gas producer – including liquefied natural gas (LNG) – and an active player in the market of refined and petrochemical products (Novatek company information).

During 2003, Novatek began to build the Purovsk gas condensate plant, with an annual capacity of 1.4mt of stable condensate and 600,000t of liquefied hydrocarbon gas, as well as the BOPP wrap film plant in Novokuibyshevsk. Both construction projects are to be put to commercial use in 2005 (Novatek, Press Release, 15 April 2004; Novatek, Press Release, 10 August 2004; NewsBase, FSU Oil & Gas Monitor, No. 17, 28 April 2004).

5.1. Far-Reaching Plans

Novatek intends to start exporting gas condensate to Western Europe in mid-2005 and export as much as 3mt by 2008. The company has formed a joint venture with the White Sea Shipping Company to implement a gas condensate handling and storage terminal at the Vitino port in the Murmansk region (NewsBase, FSU Oil & Gas Monitor, No. 40, 6 October 2004).

Furthermore, the company announced that it hoped to start exports of liquefied natural gas (LNG) to the USA by 2009. Its plans call for the construction of a gas liquefaction plant on the Yamal Peninsula as well as a pipeline from the Tambeiskoye field, a terminal on the Kara Sea, four LNG tankers and a re-gasification facility in eastern Canada. The cost of the project is expected to reach USD5bn. Meanwhile, Novatek has done a good job of raising funds from foreign lenders (DeLay 2004).

This undertaking will put Novatek in direct competition with Gazprom, which has been talking about liquefying some of the gas extracted from Shtokmanovskoye, an offshore field in the Barents Sea, for export to the US market (DeLay 2004).

“Nevertheless, there is one major obstacle in the company’s path: the Russian government’s policy on private export pipeline ownership. The Kremlin is talking about reforming the gas industry so that independent producers have an easier time gaining access to Gazprom’s transport network, but it has repeatedly expressed objections to proposals for the construction of privately owned export lines” (DeLay 2004).

However, Novatek is already involved in a pipeline project in the Arkhangelsk region. To speed up the construction of the Nyuksenits-Arkhangelsk gas pipeline, the Arkhangelsk regional administration and Novatek have set up a new company, Arkhnovagaz. 51% of Arkhnovagaz shares belongs to Novatek, 25% to the Arkhangelsk regional administration, and 24% to Severgaz. Construction will be conducted in tandem with Gazprom, which is building a gas pipeline to Plesetsk in the Arkhangelsk region (NewsBase, FSU Oil & Gas Monitor, No. 11, 17 March 2004).

The year 2003 was the most successful for Novatek so far. The company announced (according to IAS) a 5.1 fold increase in net profit to RUR3.3bn (USD113mn) in 2003, up from USD21m in 2002. Sales proceeds rose by 3.4 times to RUR15.27bn, and proceeds from gas sales in 2003 totalled RUR12.02bn, up 420% from 2002. The company’s operating expenditure equalled RUR13.16bn against RUR5bn in 2002. According to the company, the main factors behind the profit increase are the steep rises in the output of gas and high prices of oil and petroleum products during 2003 (NewsBase, FSU Oil & Gas Monitor, No. 33, 18 August 2004). Under the 2004 investment plan, Novatek is to invest USD260mn, up from USD178mn in 2003. The company plans to extract 27bcm of gas this year and boost its natural gas output to an annual 50bcm by

2010, thus raising its share of Russian gas output to 7% (Novatek, Press Release, 10 August 2004; NewsBase, FSU Oil & Gas Monitor, No. 17, 28 April 2004).

From January to August 2004, Novatek produced more than 13.7bcm of gas, up 8.3% year-on-year. Liquid hydrocarbon production grew by 48% year-on-year to 2.4mt (NewsBase, FSU Oil & Gas Monitor, No. 40, 6 October 2004). In the first half of 2004, Novatek was already able to more than double its net profit to RUR2.3bn (according to IAS) compared to the same period of the previous year (NewsBase, FSU Oil & Gas Monitor, No. 43, 27 October 2004).

5.2. The Merger

However, the further development of Novatek will depend on its ownership structure. In September 2004, the French oil and gas major Total, the world's fourth-largest privately owned oil and gas company, has signed an agreement to buy a 25% plus one share in Novatek. The amount agreed upon was not revealed (NewsBase, FSU Oil & Gas Monitor, No. 37, 15 September 2004). Total would purchase its blocking stake in Novatek from Cyprus-registered SWGI Growth Fund, which earlier owned 37.5% of Novatek.¹ Novatek could have issued new shares to complete the deal, but the purchase of the shares from the fund shows that an existing core shareholder is cashing out of the company, analysts say (Nefte Compass, September 30, 2004).

In early 2005, Novatek sold 3% to institutional investors, while in May two more deals became known. One of the shareholders, the Yamal development fund, sold 5.6% to Vneshekonombank and International Finance Corporation (IFC) announced the acquisition of 1% of Novatek shares. Simultaneously, the company began IPO (initial public offering) preparations. The company obtained a permit from the Federal Service for Financial Markets to place 20% of shares. Novatek representatives have stated on many occasions that majority shareholders have no plans to reduce their stakes below 51% (NewsBase, FSU Oil & Gas Monitor, No. 22, 8 June 2005).

However, the regional prosecutor's office in the Yamal-Nenets Autonomous District brought a civil lawsuit in the local arbitration court in May 2005 claiming that the Yamal Regional Development Fund had no right to sell a 5.6% stake in Novatek to Vneshekonombank. The prosecutor's office also challenged the legality of the Fund's original establishment and continued existence. The Fund had originally received a 7.58% stake in Novatek in exchange for minority stakes in Tambeineftegaz and Yamalneftegazdobycha.² Although the court hearings could lead to the cancellation of these

¹ According to second-quarter results for 2004, Russian-registered company Levit (controlled by the company's CEO Leonid Mikhelson) had a 49.23% stake in Novatek. Other shareholders were listed as Cyprus-based SWGI Growth Fund Ltd (which is supposed to present the interests of vice-governor of Yamalo-Nenets region Iosif Levinson) with a 37.54% stake, non-commercial Regional Fund of Development of Yamal with 7.58%, and a company called Kopitek with 5.05% (Korchagina/ Belton 2004; Orechi/ Skorniyakova 2004). An extraordinary shareholders meeting decided in December 2004 to sell 3% of Novatek. According to unofficial information, 3% will be sold by Cypriot fund SWDI, which owns 37.54%. The funds will be used to refinance the bulk of Novatek's debt of around US\$530 million (NewsBase, FSU Oil & Gas Monitor, No. 51, 22 December 2004).

² Novatek sold a 40% stake in Yamalneftegazdobycha to Lukoil in November 2003. Although a court ruling to return the minority stake in the unit to the Fund would pose a risk to Lukoil, the company would most likely be considered a 'good faith buyer' in law.

transactions, they do not cover Novatek's key operating subsidiaries. The company's operations and financials should not therefore be affected by the legal proceedings (UFG, Russia Morning Comment, 22 June 2005).

In anticipation of a deal with Total, Novatek was in a hurry to settle its earlier differences with Gazprom as well as to consolidate its gas assets and get rid of its oil assets. Novatek shareholders have decided to sell a 66% stake in Geoilbent worth an estimated USD30mn. Novatek assumed control over Geoilbent in the autumn of 2003 and had planned to contribute financing to the building of an associated petroleum gas processing works, with an annual capacity of 0.9bcm. Yukos is the other Geoilbent shareholder, controlling 34% of company shares (NewsBase, FSU Oil & Gas Monitor, No. 45, 10 November 2004).

After Novatek had failed to sell its 66% stake in Geoilbent to Rosneft (NewsBase, FSU Oil & Gas Monitor, No. 8, 2 March 2005), the company sold it to Lukoil in June 2005. The acquisition also makes Lukoil a natural contender for the Geoilbent shares held by Yukos, if these assets are put up for sale (UFG, Russia Morning Comment, 7 June 2005).

However, Broadwood Trading and Investments is trying to interfere with Lukoil buying a 66% stake in Geoilbent from Novatek. A court of the Stavropol region has forbidden Novatek to sell its stake in Geoilbent, the Federal Anti-Monopoly Service to approve the sale deal and Transneft to receive oil and oil products from Geoilbent. Broadwood deems the sale of the 66% of Geoilbent shares illegal because it has never renounced its priority right to buy the stake from Novatek and even informed the latter of its desire to buy the stake (NewsBase, FSU Oil & Gas Monitor, No. 24, 22 June 2005). Neither Novatek nor Lukoil have so far known Broadwood Trading and Investments to be a shareholder in Geoilbent (UFG, Russia Morning Comment, 17 June 2005).

Moreover, the production license to the West-Tarkosalinksoye field (held by Purgazdobycha) was exchanged for Gazprom's 8.34% stake in Novatek's major extracting subsidiary Purneftegazgeologiya in October 2004 (NewsBase, FSU Oil & Gas Monitor, No. 43, 27 October 2004). The principal agreement was made by the parties in May 2004. By that time, Purgazdobycha, built out of Purneftegazgeologiya and reducing Novatek's stake to 69.6%, had been assigned the licence for the West-Tarkosalinksoye field previously held by Purneftegazgeologiya. Novatek has brought its stake in Purneftegazgeologiya to 77.94% again. In addition, Novatek will be able to buy up to 10% of gas and oil from the Cenomanian reservoirs of the West-Tarkosalinksoye deposit and 50% from the Neocomian reservoirs (NewsBase, FSU Oil & Gas Monitor, No. 43, 27 October 2004). Noyabrskneftegas, a subsidiary of Gazprom, already pumps 15.3bcm per year of gas from the West-Tarkosalinksoye field and transfers 10% of the production to Novatek (International Oil Daily, 23 September 2004). Gazprom's control over the deposit will better chances attracting investment and making the project more efficient, said Gazprom (NewsBase, FSU Oil & Gas Monitor, No. 48, 1 December 2004).

Novatek announced that it has increased its equity stakes in Tarkosalenftegas and Khancheyneftegas to 100%. The acquisition is part of an ongoing process of restructuring and consolidating the company's core assets. In August 2004, the General Shareholder Meeting of Novatek approved the decision to increase the company's share capital through a closed share emission. TNG Energy AG and ZAO Levit paid for the addi-

tional share subscription by contributing their shares of Tarkosaleneftegaz and Khancheyneftegas to the charter capital of Novatek (Novatek, Press release, 27 December 2004).

In the aftermath, Itera sold its stake in TNG Energy, which held a nearly 20% stake in Novatek. TNG Energy on the other hand has pulled out of Novatek, selling its stake to Levit and SWGI Growth Fund (Cyprus) which raised their holdings in Novatek from 42.43% to 46.56% and from 26.73% to 40.65%, respectively (NewsBase, FSU Oil & Gas Monitor, No. 5, 9 February 2005). At the same time Itera concluded a five-year contract with Novatek to buy more than 40% of gas extracted from Tarkosaleneftegaz and 26% of gas to be extracted by Khancheineftegaz (NewsBase, FSU Oil & Gas Monitor, No. 2, 19 January 2005).

However, the much-advertised acquisition by Total will finally – after a series of struggles and obstacles – not take place. A Russian newspaper reported in November 2004 that Novatek's shareholders want to raise the price to USD1.2–1.3bn. In the meantime, Total has offered less than USD1bn (NewsBase, FSU Oil & Gas Monitor, No. 45, 10 November 2004). Meanwhile the Federal Anti-Monopoly Service (FAS) became involved and had to give its approval for the sale. While the French company was waiting for the Federal Anti-Monopoly Service decision on the deal, Novatek shareholders began selling company shares and is planning an IPO for 20% of its shares. The FAS subsequently announced that approval of the deal would be delayed until after the IPO. Thus, Total cannot buy more than 19% of shares, which is not in the French company's interests. Therefore, Total has announced that the deal to buy a blocking stake in Russia's Novatek may not take place if the Russian company conducts an IPO (NewsBase, FSU Oil & Gas Monitor, No. 22, 8 June 2005).

The Total case appears to mimic other decisions made by the Kremlin recently in the oil and gas industry, with Russian authorities eager to ensure that the country's strategic industries remain under domestic control. But in the case of Novatek, Total was seeking to acquire a blocking stake that would give it a major say in the corporate decision-making process. This proved to be the fatal flaw in the deal. Since September 2004, the FAS has successfully delayed the deal and it appears that Novatek's owners have got the message. In the past few months, they have done virtually everything in their power to squirm out of the deal with Total without losing face, and it now seems they have achieved their goal (Pustilnik 2005).

Instead of selling its shares to Total, Novatek and Gazprom are drafting an agreement on strategic partnership. The agreement will set forth the possible joint projects between Novatek and the gas monopoly, primarily focusing on the processing of raw materials (NewsBase, FSU Oil & Gas Monitor, No. 22, 8 June 2005).

6. Northgas

Northgas (or Nortgaz) was originally established in October 1993 as a joint venture between the Gazprom subsidiary Urengoygazprom (51%), Bechtel, USA, (44%) and what became Farco Group from UK (5%) to develop the Neocomian reservoirs in the North-Urengoy (Severo-Urengoykoye) deposit. The main licence holder in the area, Urengoygazprom, had been developing the shallower Cenomanian gas horizon since 1987. In 1994, a separate license was granted to Northgas to develop the much deeper Neo-

comian reserves, which were harder and more costly to develop and were left for a later date. The two foreign shareholders were brought in to share the burden of financing the development of such a large project (Northgas company information; O'Sullivan et al. 2003).

The founders adopted a time-schedule for additional capital investments, which obligated Urengoygazprom to pay an additional sum of USD41mn into the company during the period between 1993 and 1996. However, Urengoygazprom failed to meet the requirements and the funds have not been received by Northgas. At the time of Northgas' founding, the level of investments required for development of the Western top alone was evaluated as being US\$362 million (Northgas company information).

Northgas also cites an agreement with Gazprom wherein Northgas' gas would be exchanged for Gazprom's gas condensate which Northgas could then export and use as collateral to raise capital for the project. Northgas contends that Gazprom did not fulfil its side of the agreement, thereby preventing development of the project and causing problems with the licence held by the company for the development (O'Sullivan et al. 2003).

In 1996, Bechtel withdrew from the company due to the unstable political situation in Russia at that time, low domestic gas prices, the difficult tax environment and the reluctance of Gazprom to support the project. The shares were purchased by Farco Group, making it a 49% shareholder in Northgas. Ongoing efforts to raise finance for the development of the field by Farco Group proved difficult. Northgas claims that neither Gazprom nor Urengoygazprom were willing to provide collateral for any loans (Northgas company information; O'Sullivan et al. 2003). In this case, Gazprom's behaviour was quite different than in the case of Itera, where Gazprom granted loan guarantees although not officially a shareholder in the company.

Site operation was not launched until 1998. Thus, the regional government via Yamal-Geokom passed a decision to recall the license. Northgas managed to keep the license due only to efforts undertaken by Farco Group, which raised the funds required for gas field construction, and made a commitment to start production. However, the conditions of the new license – given to Northgas on 19 May 2000 – were changed: the site area was reduced, and the right to use the subsurface in part of a geological survey with consequent development of new sites in North-Urengoy deposit was cancelled. However, the deposit's commissioning on a commercial basis had to be postponed until September 2001 (Northgas company information).

To hold further negotiations with Russian credit entities Urengoygazprom and Farco Group agreed to launch an additional share issue in 1999. While Farco Group invested a sum of RUR82mn under the agreement on sale and purchase of shares, Urengoygazprom offered two wells under a barter agreement (Northgas company information). However, the cost of wells invested by Urengoygazprom was not approved by Northgas' board of directors. The charter's capital lawfulness was questioned and impeded further attraction of investment. Farco Group went to court to have the shares returned to Northgas and the funds repaid to Urengoygazprom, thereby making Farco Group the largest shareholder. Urengoygazprom's share was diluted to a mere 0.5%. Since then, it appears as if Northgas has been able to attract western investment and to secure a loan from a Russian bank (Northgas company information; O'Sullivan et al. 2003).

Within the framework of Northgas' long-term capital-raising program for further site development, Farco Group shares were sold to project investors. Now a controlling share in Northgas belongs to REDI Ltd. (UK). Bringing the control stake under English company law, with internationally-recognised standards of disclosure and governance, immediately had a positive impact on Northgas' access to credit, helping it raise funds needed to proceed with development (Northgas company information).

According to estimates by DeGolyer and MacNaughton, the total geological reserves of Northgas' North-Urengoy field comprise 354bcm of natural gas, the proven reserves amount of 224bcm (Northgas company information; NewsBase, FSU Oil & Gas Monitor, No. 40, 6 October 2004).

In 2003, Northgas produced more than 4bcm of natural gas, up from 3.9bcm in 2002. With the Eastern dome of the deposit commissioned in 2008, the company is to double its present production volume. Company specialists estimate capital investment in dome operations at USD230mn (Northgas company information; NewsBase, FSU Oil & Gas Monitor, No. 4, 28 January 2004). From 1999 to April 2004, a total of RUR4.2bn (USD144.7mn) was already invested in deposit development by Northgas (NewsBase, FSU Oil & Gas Monitor, No. 25, 23 June 2004).

Northgas has been able to develop its business in the domestic gas market by identifying and targeting customers in Russia who are willing and able to pay prices higher than the domestic tariff for gas, although its customers can only be those who want more gas than Gazprom can supply (O'Sullivan et al. 2003).

However, the development of the company is harmed by disputes with Gazprom. Originally a joint venture with the Gazprom subsidiary Urengoygazprom, holding a 51% majority stake in Northgas, Gazprom's share was diluted. Since the additional share issuing in 1999, Gazprom has been unsuccessfully suing for the return of its controlling stake in Northgas, demanding the cancellation of the additional share issue. It uses the pipeline access as a tool to put pressure on Northgas. In January 2003, Gazprom threatened Northgas with the cutoff from the gas pipeline network due to unspecified "violations of technical conditions" (O'Sullivan et al. 2003; NewsBase, FSU Oil & Gas Monitor, No. 21, 26 May 2004).

In 2003, Northgas undertook two additional share issues boosting its equity capital elevenfold to RUR1.84bn. Analysts are convinced that the company is trying to beat off Gazprom's attempts to wrest control of the company by securing a court decision invalidating the dilution of the Urengoygazprom stake in Northgas (NewsBase, FSU Oil & Gas Monitor, No. 21, 26 May 2004).

By the end of 2003, Northgas had signed up contracts for its planned 2004 output of 4.8bcm. It said the majority of its counter-parties had already secured access to Gazprom's pipeline network for shipping gas in 2004. "The successful completion of the process of forward selling the gas shows how lively the development of the Russian deregulated gas market is and allows Northgas to plan investments in the future growth of production", the company said. In the past its sales have been hampered by disputes over the quality of the gas delivered to the Gazprom system. Selling to intermediaries may simplify its operations (Interfin Trade, 30 December 2003).

In July 2004, the Moscow Arbitration Court halted proceedings instigated by Gazprom seeking to declare null and void the award of the production licence for the North Uren-

goy deposit to Northgas in 1994; it is now statute-barred. In April 2004, Gazprom took legal action, claiming that the license had been issued to Northgas without any tender, that is, illegitimately (NewsBase, FSU Oil & Gas Monitor, No. 30, 28 July 2004). This court ruling is the second setback for Gazprom in the same month Itera backed out of a deal to sell its 49% stake in Achimneftegaz back to Gazprom and sold it to Northgas instead (Renaissance Capital, Morning Monitor, 28 July 2004). Achimneftegaz is 51% controlled by Gazprom's totally-owned subsidiary UrengoyGazprom. The company was set up to explore and develop the Achimov formations of the second section of the Urengoy gas deposit. Its reserves are estimated at 353bcm of gas and 117mt of condensate (NewsBase, FSU Oil & Gas Monitor, No. 30, 28 July 2004).

The investment bank Renaissance Capital assumes that the gas behemoth will now respond by making life rather difficult for Northgas (Renaissance Capital, Morning Monitor, 28 July 2004). To this effect, Gazprom notified the company that it has stopped accepting its gas in the pipeline system in August 2004. Northgas' gas quota was reduced by 50% because the traders of Northgas have been storing gas in the pipeline. Northgas responded to Gazprom that it is not responsible for the actions of its traders, as it has transferred pre-paid gas volumes and no longer owns it (UralPolit.ru, 16 August 2004; NewsBase, FSU Oil & Gas Monitor, No. 33, 18 August 2004).

Northgas' operating profit (according GAAP of the UK) in 2003 amounted to USD76.8mn, up from USD71.9mn in 2002. The profit after taxation and before exceptional items was USD47.1mn (2002 – USD65.4mn). The result for the year, after taxation and exceptional items, amounted to a loss of USD2.5mn (2002 – USD65.4mn profit) (Northgas 2004: 4). For the first six months of 2004, Northgas said that it was losing profits and that gas production stood at only 76% of the targeted volume due to systematic stoppages. As a result of the dispute, Northgas' first-half net profit to UK GAAP amounted to USD2.5mn, down 87% from 2003, the company reported. Its first-half earnings grew 3.3% to USD71mn (NewsBase, FSU Oil & Gas Monitor, No. 33, 18 August 2004; NewsBase, FSU Oil & Gas Monitor, No. 44, 3 November 2004).

Moreover, Gazprom was granted a new hearing over North Urengoy at the Moscow Court of Arbitration in April 2005, which ruled that the licence granted to Northgas is null and void. Northgas claimed that Gazprom had used "administrative resources" to fight the independent producer. It is likely that Northgas will reject the ruling and submit an appeal; however, its success is extremely uncertain (UFG, Russia Morning Comment, 18 April 2005; NewsBase, FSU Oil & Gas Monitor, No. 15, 20 April 2005).

In the end, Northgas and Gazprom signed an amicable agreement in June 2005, under which the licence will remain at Northgas, but control over the company will pass to the gas monopoly. Under the settlement, a 51% stake in Northgas will be returned to Gazprom at no cost, while the latter will retract all suits from the courts. Both companies state that Gazprom will not demand compensation for benefits lost during the period when it was removed from managing the company. From now on, the partners will manage the company jointly. Analysts note that the agreement is a rare case of an opponent of Gazprom being able to retain at least part of the business. Without this amicable agreement, Northgas' business faced collapse due to revocation of its license and Gazprom's refusal to supply services to Northgas or to transport its gas. Under the agreement, Northgas will be managed as a joint venture (NewsBase, FSU Oil & Gas Monitor,

No. 20, 25 May 2005; NewsBase, FSU Oil & Gas Monitor, No. 23, 15 June 2005; UFG, Russia Morning Comment, 17 June 2005).

7. Other Independent Gas Companies

Despite the suffix on their names, Norilskgazprom and Yakutgazprom have no relationship with Gazprom.³ Norilskgazprom and Yakutgazprom are regional monopolies that are not physically connected to Gazprom's nation-wide pipeline grid and are the gas-supplying organisations of Taymir district and Yakutiya, respectively (Dashevsky 2001: 13; Ernst & Young, *An Eye on Russia*, June–July 2003, pp. 6–9, here: 7). Norilskgazprom is a partly state-owned company and was established in 1968 for the construction of the Zapolyaregaz pipeline. Since 1995 the company has exploited Pelyatkinskoye gas field. The gas production is solely used for the purposes of the metal producer Norilsknikel' (see http://www.norilskgazprom.ru/about_history.html). Yakutgazprom had belonged to Gazprom until 1991, when it was privatised. Yakutgazprom is part of the Sakhaneftegas holding, which is controlled by Yukos (see http://www.oilcapital.ru/main_print.asp?IDR=1817).

Due to the fact that these companies are not connected to Gazprom's nation-wide pipeline grid they work under different conditions than the other independent gas producers. Therefore, their activities are not described in detail.

8. Oil Companies

Several of Russia's major oil companies produce substantial amounts of associated and natural gas. Together, the eight Russian oil companies produced a total of 42.3bcm of associated and natural gas in 2003 (see table 6), which is an 21.5% increase in year-on-year figures. Some oil companies extract associated gas, which they receive from oil fields; others also produce gas from their own natural gas deposits. The companies have enough cash reserves to increase their gas production very swiftly and to compete with the gas companies ('Standing On Gazprom's Shoulders', in: *Oil & Gas Investor*, April 2003: R 17–21, here: R 20; Belton 2003). However, in past years, these firms had few options for their gas. Associated gas is currently not utilised to its full potential; it can be used as natural gas, if cleansed, or as a raw material for the petrochemical industry. It has to comply with Gazprom's technical requirements to be pumped into Gazprom's pipeline grid. As a result, one-fifth of all associated gas is flared off. The share of utilised gas varies for individual oil companies and their deposits (Ernst & Young, *An Eye on Russia*, June–July 2003, pp. 6–9, here: 7).

In the case of natural gas, oil companies have also been unable to deliver it directly to customers since Gazprom holds the only key to the pipelines. Additionally, oil companies have to haggle with buyers over prices for their gas – no matter what kind of gas it is. Oil companies' gas prices are not regulated by the Federal Energy Commission, but they naturally have to compete with Gazprom's low prices. Current gas prices on the

³ Often Tomskgazprom is also classified as an independent gas producer. However, Tomskgazprom is a subsidiary of Vostokgazprom (see <http://vostokgazprom.ru/company/affiliated/>), which holds 51% of the share capital and is itself a Gazprom subsidiary (see <http://www.gazprom.ru/articles/vostokgazprom.shtml>). Therefore, Tomskgazprom a Gazprom subsidiary and not an independent gas producer.

domestic market, which are depressed by Gazprom's regulated prices, hardly cover production and transportation costs (Ernst & Young, *An Eye on Russia*, June–July 2003, pp. 6–9, here: 7).

Table 8-1: Gas production by oil companies (natural and associated gas in bcm)

	1998	1999	2000	2001	2002	2003	2004
Bashneft	0.4	0.4	0.4	0.4	0.4	0.4	0.1 ^a
Komitek	0.3	0.4	—	—	—	—	—
Lukoil	3.2	3.7	3.8	3.7	4.3	4.2	6.5
Onako	1.7	1.6	1.5	—	—	—	—
Rosneft	4.8	4.9	5.6	6.1	6.4	7.1	9.2
Sibneft	1.5	1.4	1.4	1.6	1.4	2.4	1.1 ^b
Sidanco	2.1	2.1	1.3	1.3	—	—	—
Slavneft	0.7	0.7	0.7	1.4	0.6	—	—
Surgutneftegas	10.3	11.1	11.2	11.1	13.3	13.9	14.3
Tatneft	0.7	0.7	0.8	0.8	0.7	0.7	N/A
TNK	1.8	1.8	4.1	4.2	3.7	7.9	3.4 ^b
Yukos	1.5	1.5	1.6	1.7	2.4	5.7	1.9 ^b
Total	29.0	30.3	32.4	32.3	33.2	42.3	N/A

Notes: a) January to March 2004.

b) January to July 2004.

Sources: Company information; Dashevsky 2001: 11; Landes et al. 2004: 48–49; Landes/ Metnev 2002: 15; Northgas company information; NewsBase, FSU Oil & Gas Monitor, No. 14, 7 April 2004; NewsBase, FSU Oil & Gas Monitor, No. 33, 18 August 2004; NewsBase, FSU Oil & Gas Monitor, No. 6, 16 February 2005; own calculations.

More recently, however, oil companies have been looking to improve their returns from gas extraction by seeking access to the national gas pipeline network. Therefore, several oil companies – such as Lukoil, Rosneft and Surgutneftegas – have opted for partnerships with Gazprom (DeLay 2002).

Most of the major oil companies – Surgutneftegas, Lukoil, Rosneft, TNK-BP and Yukos – have already begun investments in gas production as well as gas refining and clearly expect Gazprom's opposition against third-party access to fall at some point in the near future (Aris 2004a). Some of them, including Surgutneftegas, Rosneft, Lukoil and TNK, are able to take advantage of nearby gas processing plants in order to avoid flaring off their gas at production sites. However, in the short term, these plants' limited access to markets is likely to reduce any gas produced by the companies to a bargaining chip for energy cost with the local utilities. In the medium term, oil companies may integrate heat and electricity production for internal needs and use their gas output to fuel it (Mazalov 2001: 36).

8.1. Surgutneftegas

Surgutneftegas has the largest gas output among Russian oil companies. It produced 13.9bcm in 2003, or 32.6% of all gas produced by oil companies. From January to July 2004 alone, Surgutneftegas raised its gas production by 3% to 8.3bcm compared to same period of the previous year (Interfax Eurasia Business Report, 16 August 2004). It delivers gas to the biggest power plant in the region, Surgutskaya GRES, and uses it at its own small power generation facilities. The company also supplies gas to Surgut Gas Processing Plant, the assets of which it bought from Sibur in 2001 and which processed over 2.8bcm of gas, which accounts for 21% of the annual production in 2002 (Ernst & Young, *An Eye on Russia*, June–July 2003, pp. 6–9, here: 7; Surgutneftegas 2003: 21). In 2003, Surgutneftegas increased gas processing volumes by 36% to 3.8bcm, according to the company. Surgutneftegas plans to increase its overall processing volume up to 6–7bcm annually utilising the capacity with the gas produced at the Lyantorskoye oil field (Surgutneftegas 2003: 21–22, 24; NewsBase, FSU Oil & Gas Monitor, No. 7, 18 February 2004).

As part of its downstream activities, Surgutneftegas has also started to construct five gas turbine power stations with a total capacity of 156MW. On the whole, new gas production and treatment facilities as well as improved ones resulted in the 95.5% gas utilisation rate throughout the company (Surgutneftegas 2003: 19).

Meanwhile, Surgutneftegas entered a pre-agreement with Gazprom for co-development of Gazprom's super-giant Urengoy field, and is considering setting up an infrastructure for treating condensate ('Standing On Gazprom's Shoulders', in: *Oil & Gas Investor*, April 2003: R 17–21, here: R 18). The company is also involved in a consortium with Gazprom and Rosneft sharing financial costs and risks in development projects in Eastern Siberia. However, Surgutneftegas is to develop the Talakanskoye field independently because the company has already invested so much money in development of the field (NewsBase, FSU Oil & Gas Monitor, No. 43, 27 October 2004). Although the deal was announced in April 2004, it is yet to be finalised and Surgutneftegas has problems with purchasing the Talakanskoye deposit infrastructure from Yukos (NewsBase, FSU Oil & Gas Monitor, No. 47, 24 November 2004).

In May 2005, Surgutneftegas announced that it did not want to postpone the development of the Talakanskoye deposit because of the problems of its erstwhile owner and, therefore, began building its own infrastructure at the deposit, including an oil pipeline to Ust Kut (Irkutsk region) (NewsBase, FSU Oil & Gas Monitor, No. 19, 18 May 2005).

8.2. TNK

Another company with great ambitions in the gas business is TNK-BP which expects to produce 40bcm by 2015, up from 7.9bcm in 2003 (Baranov 2003: 3). One way to reach this goal is to tackle the associated gas disposal problem which TNK-BP is willing to cope with in the next four years. While the associated gas disposal rate now stands at 20%, it is to rise to 95% by 2006 (NewsBase, FSU Oil & Gas Monitor, No. 13, 31 March 2004). Another way is acquisition.

Through its merger with the Russian competitor Sidanco in 2001, TNK-BP is, with 62.42%, majority owner of Rusia Petroleum which holds the licence for the massive Kovykta gas field in Eastern Siberia. However, the development of the deposit is com-

plicated due to extreme pressure from Gazprom which is trying to muscle into Russia Petroleum. Analysts say that Gazprom is hoping to get a piece of the project, but is unwilling to pay for a stake in Russia Petroleum. Gazprom was awarded the status of “co-ordinator” for development of the Eastern Siberian resources in 2003, but this move did not solve the problems (Aris 2004b). Until now, Gazprom has been neither the operator of the project, nor has it had a stake in it (Ocnus.Net, 22 October 2004). “Gazprom has said publicly that it is now less interested in Kovykta and is focusing more on Sakhalin after its merger with Rosneft” (UFG, Russia Morning Comment, 9 December 2004).

However, TNK-BP seems to have given in to Gazprom; it is prepared to supply gas from the Kovykta gas field to the domestic market, and not export it as previously planned. The company has just come to a licensing deal with the Natural Resources Ministry, under which domestic shipments of Kovykta gas will commence in 2006, while its exports will be tackled by Gazprom once it builds a pipeline (NewsBase, FSU Oil & Gas Monitor, No. 7, 23 February 2005).

In June 2005, TNK-BP finally offered to set up a joint venture with Gazprom to develop hydrocarbon deposits in Eastern Siberia. TNK-BP will contribute its 62.89% share in Russia Petroleum to the equity capital. Gazprom’s contribution may be the Chayandinskoye gas condensate deposit in Yakutia, if Gazprom wins the licence at auction. Talks on Gazprom’s accession to the Kovykta development project have been going on for several years. Without the gas monopoly, Russia Petroleum cannot begin gas production, because it cannot transport and export gas. The delay in starting operations at the deposit caused criticism of Russia Petroleum by the ministry of natural resources, which is threatening to strip the company of its licence (NewsBase, FSU Oil & Gas Monitor, No. 22, 8 June 2005).

Gazprom – designated by the Russian government as the co-ordinator of all gas development and transport projects in Eastern Siberia several years ago – announced that it had drawn up plans for an integrated production, transport and supply system for natural gas reserves in Eastern Siberia and the Far East. The programme calls for establishing four different production centres and also lays the foundation for exporting gas from these centres to China and other countries in the Asia-Pacific region. Gazprom has analysed potential customers in Japan, South Korea and China and the company believes that South Korea will be ready to start importing Russian gas by 2010, while deliveries to China could begin by 2015. This affects Russia Petroleum because it sets out the parameters for construction of a pipeline to carry gas from Kovykta to China (DeLay 2005).

Originally, Russia Petroleum had planned to build its own export line. However, Gazprom’s programme probably does not leave any room for Russia Petroleum to begin exports to China before the middle of the next decade. This is a problem in light of the company’s development plans. TNK-BP has already suggested that the inauguration of the Kovykta deposit be postponed from 2006 until 2007 for lack of infrastructure. Meanwhile, talks on Gazprom’s joining the project are close to fruition (NewsBase, FSU Oil & Gas Monitor, No. 23, 15 June 2005).

Meanwhile, the company will not have enough customers to use up all the gas it plans to produce. Russia Petroleum has made arrangements to sell gas to both Irkutsk regional authorities and Sayankhimplast, a local chemical plant. However, these two parties will not be able to take all of the company's gas. And it may not be able to sell the surplus on

the domestic market; Gazprom has backtracked on proposals to send the gas westwards to other regions of the country and has made no alternative plans (DeLay 2005).

The issue of surplus production is not likely to derail the project just yet; Natural Resource Ministry officials did say last week that they had decided against revoking Russia Petroleum's license for now and would not reconsider the matter until 2006 (DeLay 2005).

However, it will continue to pose problems. To that end, TNK-BP has been in negotiations with Gazprom on the purchase of a stake in Russia Petroleum for some time. Unfortunately for TNK-BP, there is no guarantee that questions about gas transport will be resolved once the deal is finalised (DeLay 2005).

In February 2004, TNK-BP established the joint venture East Siberia Gas Company with the administration of Irkutsk region for gas processing purposes. Each partner is holding a 50% stake in the venture (<http://www.tnk-bp.ru/press/media/2004/3/451>; <http://www.ria-sibir.ru/viewnews/3435.html?cdate=2005-1-1>).

In August 2004, TNK-BP and Yukos concluded a deal transferring a 56% stake in gas producer Rospan International, in which the company already had a 44% interest, to TNK-BP (MosNews, 18 August 2004). TNK-BP plans to invest around USD1bn in Rospan's development in the next five years and is holding talks with Gazprom on the co-development of certain sections located in close proximity to Rospan sections (NewsBase, FSU Oil & Gas Monitor, No. 41, 13 October 2004).

Meanwhile, Rospan stopped natural gas production after Gazprom refused to accept its gas into the unified gas supply system, leading to losses of almost RUR100mn. According to Gazprom, the company has accumulated a large amount of unsold gas, 80 times the daily supply rate (NewsBase, FSU Oil & Gas Monitor, No. 46, 17 November 2004).

Additionally, Gazprom's petrochemical subsidiary Sibur will get a controlling interest in a joint venture set up with TNK-BP. The venture will process associated petroleum gas, extracted by TNK-BP at two gas treatment plants of Sibur in the Tyumen region. As planned, the oil company will receive natural gas, which it will deliver to the Gazprom transportation system, while Sibur is to process products from associated petroleum gas (NewsBase, FSU Oil & Gas Monitor, No. 22, 8 June 2005).

8.3. Rosneft

State-owned Rosneft had the third largest gas production among Russian oil companies; it produced 7.1bcm of gas in 2003 and had planned to produce no less than 50bcm in 2015 (Baranov 2003: 3). In September 2004, the Russian government announced the company's merger with Gazprom.

However, Gazprom announced that it will not merge with Rosneft in May 2005. The statement ends mounting speculation that the deal was in trouble. The merger has seemed in trouble for some time. The competing Kremlin factions behind Gazprom and Rosneft have been unable to settle their differences about how the merger should be carried out. Also Rosneft's management was doing everything it could to obstruct the deal. The cancellation of the merger raises questions about the future of Rosneft's gas business. After the acquisition of Yukos' main production unit Yuganskneftegaz, Ros-

neft's primary focus might be on its oil activities (NewsBase, FSU Oil & Gas Monitor, No. 19, 18 May 2005).

Eager to expand into the oil sector, Gazprom announced in June 2005 that it is still eyeing the state-owned Rosneft oil company as an acquisition target, despite the two companies' scrapped merger plans (Associated Press, 10 June 2005).

8.4. Yukos

Yukos began to actively participate in acquisitions of Russian gas reserves and other assets in 2001. Yukos – investing some USD514mn – now owns or controls the following four natural gas producers: Sakhaneftegaz (with its production subsidiary Yakutgazprom), Arktikgaz (also known as the Arctic Gas Company), Geoilbent and Urengoil. From December 2001 to August 2004, Yukos also controlled Rospan International (Yukos company information; NewsBase, FSU Oil & Gas Monitor, No. 22, 5 June 2002).

Yukos' total gas production increased 136% from 2.4bcm in 2002 to 5.7bcm in 2003. On the basis of this increase, Yukos planned to produce 15bcm in 2005 and 50bcm in 2015 (Baranov 2003: 2). Yukos had hoped to raise its ambitious production targets through long-term co-operation with Russian gas monopoly Gazprom (NewsBase, FSU Oil & Gas Monitor, No. 7, 18 February 2004). However, the further development of the company as a whole depends on the pending bankruptcy procedure.

8.4.1. Urengoil

In March 2001, Yukos bought a 50% share of Urengoil, a company that holds the license to the Yaro-Yakhinskoye field in Western Siberia, from Canadian Eurogas. The field is believed to hold 179bcm of natural gas. For Yukos, the purchase fits neatly into its apparent development scheme for the area. The Yaro-Yakhinskoye field is located not far from the Vankorskoye field, for which Yukos holds a field license through its subsidiary East Siberian Oil and Gas Company, in which Yukos acquired a 68% stake in 2000 (Nefte Compass, 15 March 2001; NewsBase, FSU Oil & Gas Monitor, No. 17, 1 May 2001).

8.4.2. Rospan

Yukos acquired a 100% stake in the financially troubled Rospan International through a series of arrangements through intermediaries starting in late December 2001 and continuing into the early part of 2002 following an ownership battle with TNK-BP. Rospan, a former Itera subsidiary, contains total reserves of 560bcm of gas (TNG Energy, Press Release, March 2002). In May 2002, 44% of Rospan was sold to TNK-BP. Yukos remains the principal shareholder, while TNK-BP is the operator of Rospan's gas assets (Yukos company information).

However, despite resistance from authorities, Yukos succeeded in selling its stake of 56% in Rospan International in August 2004. In the course of the trial against Yukos and its management for tax evasion and fraud, the company was forced to sell assets to spend the funds of USD357mn on recovering its USD3.4bn tax bill. TNK-BP now fully controls the company (NewsBase, FSU Oil & Gas Monitor, No. 34, 25 August 2004).

8.4.3. Arktikgaz

In February 2002, Yukos raised its gas-producing potential with the acquisition of 68% of Arktikgaz (formerly known as Severneftegaz) from US-based Benton Oil and Gas. Additionally, Yukos bought 20% from Arktikgaz' minority shareholders, so that Yukos' total shareholding aggregated to 88% of Arktikgaz. The remaining 12% interest in Arktikgaz is held by Gazprom. Arktikgaz is a production company with proven reserves of 200bcm of gas. The acquisition of Arktikgaz – which has access to Gazprom pipeline and contracts for delivery of gas to Belarus, Georgia and Ukraine – is part of an aggressive bet on gas that Yukos is making even while market reform policy remains unclear (TNG Energy, Press Release, March 2002; Yukos, Press Release, 28 February 2002).

8.4.4. Sakhaneftegas (and Yakutgazprom)

Through a series of transactions during 2002, Yukos purchased a 50.4% interest in Sakhaneftegas, an oil and gas holding operating in Eastern Siberia, which contains major oil and gas enterprises in the republic of Sakha (the independent gas producer Yakutgazprom as well as Lenaneftgaz, Lenagaz and Yakutskgeofizika) since 2000 (NewsBase, FSU Oil & Gas Monitor, No. 27, 11 July 2000). These enterprises' common resources are estimated at 1.5bcm of gas (NewsBase, FSU Oil & Gas Monitor, No. 32, 14 August 2002). In 2003, the Sakhaneftegas holding, via its production subsidiary Yakutgazprom, produced 1.4bcm of natural gas from the Sredne-Vilyusk gas condensate field (Yukos company information).

Yakutgasprom is a principle natural gas producer in Saha-Yakutia and delivers its gas through the gas distribution grid belonging to Lenagas, which is affiliated with its core shareholder Sakhaneftegas. Thus, Yakutgasprom does not depend on Gazprom's pipelines and sells natural gas directly to end customers. At present, the company delivers its natural gas solely within Saha-Yakutia (CentreInvest 2003: 2, 6).

Yakutgasprom owns sizeable natural gas and gas condensate processing facilities and the natural gas deposits operated by the company have substantial reserves. This could mean significant output growth potential as exports increase following the projected construction of a pipeline to China in the long term. However, the political risks connected with Yukos, which controls the company through Sakhaneftegas and the restricted demand in the Sakha region, which caps the company's output despite substantial natural gas reserves, are a burden for the company's development (CentreInvest 2003: 6).

8.4.5. Geoilbent

In September 2003, Yukos acquired a 34% interest in Geoilbent from the US Benton Oil which controls licenses for oil and gas properties in the Yamal-Nenets region, thus significantly expanding the company's asset base (Yukos, Press Release, 17 September 2003).

The Geoilbent joint venture was established in late 1991 by Purneftegaz, Purneftegazgeologiya and Benton Oil. Benton held a 34% interest in the project and the two Russian companies have 33% each. Later the independent gas producer Novatek acquired the stakes of Purneftegaz and Purneftegazgeologiya, thereby becoming the majority owner. However, in anticipation of the merger with the French Total oil company Novatek has decided to sell its stake (NewsBase, FSU Oil & Gas Monitor, No. 42, 20 October 2004).

In June 2005, Lukoil announced that it is willing to buy Yukos' 34% stake in Geoilbent (NewsBase, FSU Oil & Gas Monitor, No. 24, 22 June 2005).

8.5. Lukoil

Also Lukoil – the fifth largest gas producer among Russian oil companies with 4.2bcm in 2003 – has significant ambitions and a longer term view in the Russian gas business. The company is intending to become Russia's second-largest producer with a production of 31bcm by 2010 and more than 80bcm in 2020 (Ernst & Young, *An Eye on Russia*, June–July 2003, pp. 6–9, here: 8; Baranov 2003: 2). Lukoil plans to invest USD1bn until 2007 in gas fields on the Yamal peninsula (TNG News and Press Releases, March 2002).

Lukoil's ambitions to gain access to the Russian gas pipeline network are based on a good relationship with Gazprom. In November 2002, Lukoil signed a wide-ranging strategic partnership agreement with Gazprom covering a wide range of potential joint projects, including the transportation of natural and associated gas and the co-operation in exploration in the Yamal-Nenets region and in the Russian sector of the Caspian Sea (DeLay 2002). In July 2003, Lukoil and Gazprom established the TsentKaspneftegaz joint venture to develop oil and gas fields in the Caspian Sea (Landes et al. 2003: 50). The strategic partnership with Gazprom was extended to 2014 in early 2005 (NewsBase, FSU Oil & Gas Monitor, No. 12, 30 March 2005).

With its subsidiaries Yamalneftegazdobycha and Nakhodkaneftegaz, Lukoil is developing the Nakhodkinskoye deposit, whose reserves are estimated at 275.3bcm of gas. In October 2003, Lukoil signed a contract with Gazprom to sell gas from the Nakhodkinskoye deposit to the latter. In turn Gazprom pledged to organise and pay for gas transportation through Russia's integrated gas supply system (NewsBase, FSU Oil & Gas Monitor, No. 18, 5 May 2004).

Moreover, Lukoil is considering liquefying gas and exporting it, rather than relying only on Gazprom pipeline access (TNG News and Press Releases, March 2002). Lukoil is also studying power generation opportunities but still flares off a large part of the gas it produces ('Standing On Gazprom's Shoulders', in: *Oil & Gas Investor*, April 2003: R 17–21, here: R 18). "As part of its efforts to increase the utilisation of its gas output, Lukoil acquired the Lokosovsk Gas Processing Plant last year [2002], a transaction that enabled the company's gas refining (now at four plants) to climb materially, to 2.7bcm, in 2002" (Landes et al. 2003: 50).

Additionally, Lukoil has approved including in its investment programme the creation of a system to collect, prepare, transport and utilise associated petroleum gas, extracted by its subsidiary Lukoil Perm (NewsBase, FSU Oil & Gas Monitor, No. 27, 7 July 2004).

9. Conclusion

Gazprom continues to dominate the Russian gas business. The company possesses the largest part of Russia's huge natural gas reserves and it controls the pipeline grid. There is no sign that this will change in the near future because the Russian government is not interested in further liberalisation of the Russian gas market or in breaking up Gazprom's transportation monopoly. Therefore, independent gas producers will also be de-

pendent on Gazprom's goodwill in the future. Despite the fact that Gazprom needs more gas than it produces to fulfil its supply obligations, the company is not co-operative and it has not developed a new, market-oriented attitude. The former gas monopoly still acts like the Soviet gas ministry it emerged from and the regulatory authorities are reluctant to cut Gazprom down to size and/ or lack the power and the support of the government.

Gazprom has not really developed a new, market-oriented attitude, but with Alexei Miller at the helm of the company and the management team successively shuffled since mid-2001, the company has cut its links to Itera and stopped large-scale cronyism. These actions secured state control over the company and strengthened its weakened position in the Russian gas market. However, Gazprom's weak corporate governance situation and the huge asset stripping by its former management between 1998 and 2001 made it possible for independent gas companies to get a foothold in the Russian gas market. Nearly all of these independent gas companies obtained their gas deposits from Gazprom via joint ventures, in which Gazprom lost its stake through dilution and carelessness, or by direct sales. However, with the exception of Itera, there have been no signs of cronyism.

While Itera's success has dried up, the other independent gas producers have shown steep gains, not least Novatek, which became the new independent champion with the second largest gas production in 2003. The company has attracted a lot of attention after the French oil giant Total announced its intention to acquire a 25% share package in September 2004. However, Novatek decided instead to form a strategic alliance with Gazprom – mostly to avoid interference. Northgas was also able to boast positive growth after emerging from Gazprom's shadow (Gazprom, despite being a shareholder, sabotaged the development of Northgas). However, Northgas was once again overshadowed by Gazprom in April 2005, losing its licence to the monopoly. Finally, in order to survive and avoid bankruptcy, the independent producer gave in and reached an agreement with Gazprom. Under the agreement, Gazprom will get a 51% stake in the company; however, the owners are at least able to retain parts of the business. The Russian oil companies – in anticipation of a possible liberalisation of the Russian gas market – have put more emphasis on gas production as well. Some of them have developed quite ambitious gas strategies which include – among others – the acquisition of new gas deposits.

However, all independent gas producers (including the Russian oil companies) face the same problems with pipeline access. Until 2001, only Itera was granted privileged access to Gazprom's pipeline grid. This maybe most crucial issue for independent gas producers is still unsolved. Despite rulings of the Federal Anti-Monopoly Service against Gazprom, the company is still discriminating independent suppliers. Recently, Gazprom has been able to capitalise on the success of independent producers by using its monopolistic power. This might deter both foreign as well as Russian investors.

Therefore, the further development of independent gas production depends on the liberalisation of the gas sector, i.e. the political will of the Russian government. However, the imminent demise of Yukos and the evident that President Putin is more interested in reasserting state control over the economy than in pursuing economic liberalisation are giving reason to doubt.

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