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Working Paper

Gazprom: From rent distributor to tax collector?

OIES Paper: NG, No. 193

Provided in Cooperation with:

The Oxford Institute for Energy Studies, Oxford

Suggested Citation: Henderson, James; Moe, Arild (2024) : Gazprom: From rent distributor to tax collector?, OIES Paper: NG, No. 193, ISBN 978-1-78467-252-2, The Oxford Institute for Energy Studies, Oxford

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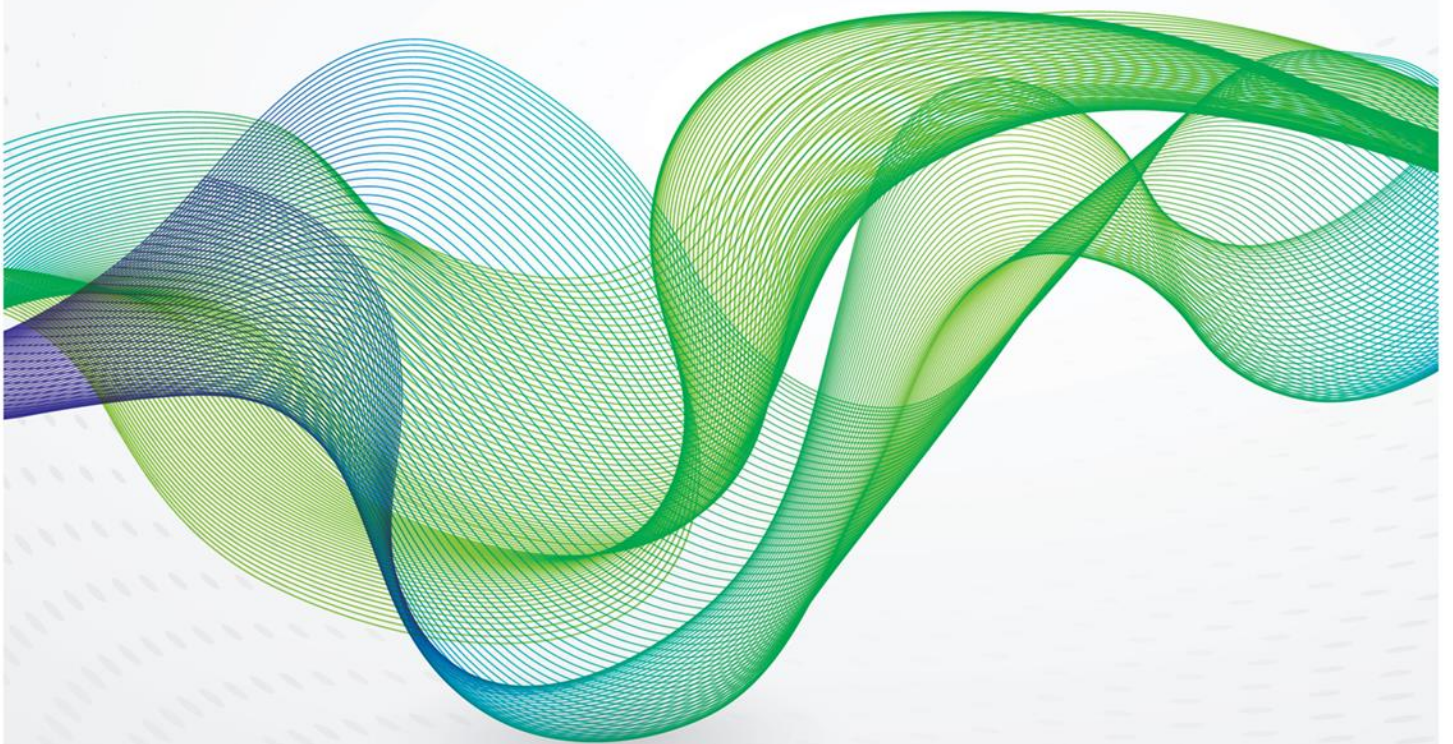
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September 2024

Gazprom: From rent distributor to tax collector?



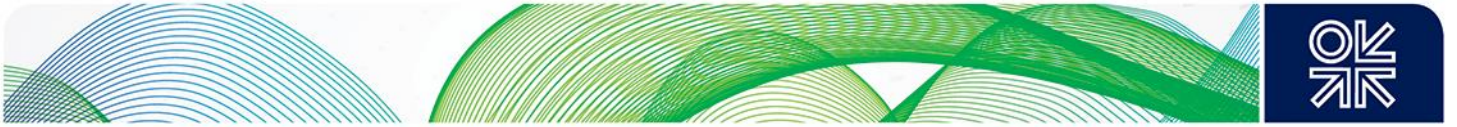


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ISBN 978-1-78467-252-2



Acknowledgements

Arild Moe is a Research Professor at the Fridtjof Nansen Institute in Norway. His contribution was financed by a research grant from the Norwegian Ministry of Defence, with additional funding from the Climate Strategies Russian Energy & Climate Policy project.



Executive Summary

Gas is at the heart of Russia's economy, accounting for over 50% of primary energy demand, and Gazprom has been its most important player since it was corporatized out of the Ministry of Gas at the end of the Soviet era. Throughout the next three decades, it subsidised prices in the domestic market thanks to its monopoly on pipeline exports, which generated huge profits mainly from European customers. However, the war in Ukraine has changed this dynamic completely and has called into question Gazprom's business model and its role in the political economy of Russia as well as in the global gas market.

Gazprom's financial results for 2023 revealed just how much the situation has changed. Loss of gas export revenues led to Gazprom making an operating loss and an overall loss for the first time in 20 years, and although this was explained in part by asset impairment charges, a number of key indicators revealed worrying trends. The results for the first half of 2024 saw a return to profit, gas still accounted for less than 40% of overall revenues, with sales of liquids coming to the rescue and highlighting the declining role of gas as a tool of geopolitical influence as its commercial importance falls. The company is diversifying its sources of gas revenues, with China and Asia more broadly a particular focus, but Gazprom has much less bargaining power in these markets. As a result, new export destinations will not replace Europe in the short- or even medium-term from a volume or value perspective meaning that the domestic market is becoming ever more important.

However, Gazprom's role in the domestic market exposes some interesting challenges. Firstly, it is no longer able to provide as beneficial a price subsidy as previously. The regulated price at which it sells gas has been rising sharply and will continue to do so through to 2025 at least. Secondly, there is likely to be increased competition with domestic rivals such as Rosneft and Novatek as Gazprom seeks to sell its surplus gas. Thirdly, much of the increase in prices is now being passed to the government in higher taxes, which increased sharply as a proportion of Gazprom's revenue in 2022 and 2023. Fourthly, as a result of this Gazprom will also have less money to distribute to the political and business elites who have historically benefited from favourable commercial dealings with the company. Finally, Gazprom may also have to make some difficult decisions about cost cutting, particularly regarding staff costs, which could also undermine its influence and support.

With Gazprom now becoming more of a *de facto* government revenue collector than a rent distributor, and with the company's much weaker financial position, highlighted by the deterioration in its balance sheet as well as its profit and loss account, meaning that it now needs the support of other state institutions, questions can justifiably be asked about its future. However, any potential conclusions about possible restructuring or reform need to be treated with caution. Gazprom has for many years acted as a hybrid between a publicly quoted company and a state bureaucracy and as a result its financial decline, and the collapse in its market value, do not necessarily presage dramatic change. It has acted as a bastion of stability for the Russian economy for the past thirty years and the Kremlin is likely to be very reluctant to risk significant reform under current circumstances. Whether this is a sustainable point of view over the medium term is open to question, but even then, two outcomes are possible. Gazprom could be reformed and its business either broken up or become more exposed to market forces. Alternatively, it could be allowed to absorb more profitable rivals in the hope that, for example, an LNG export business could bolster the company's outlook. And of course there is always a third alternative, that the status quo remains and gradual stagnation back into a Ministry of Gas-style bureaucracy is the ultimate outcome.

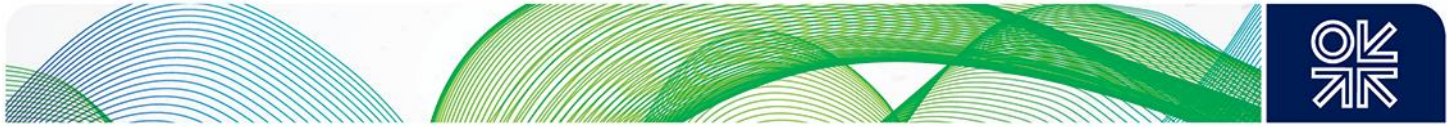


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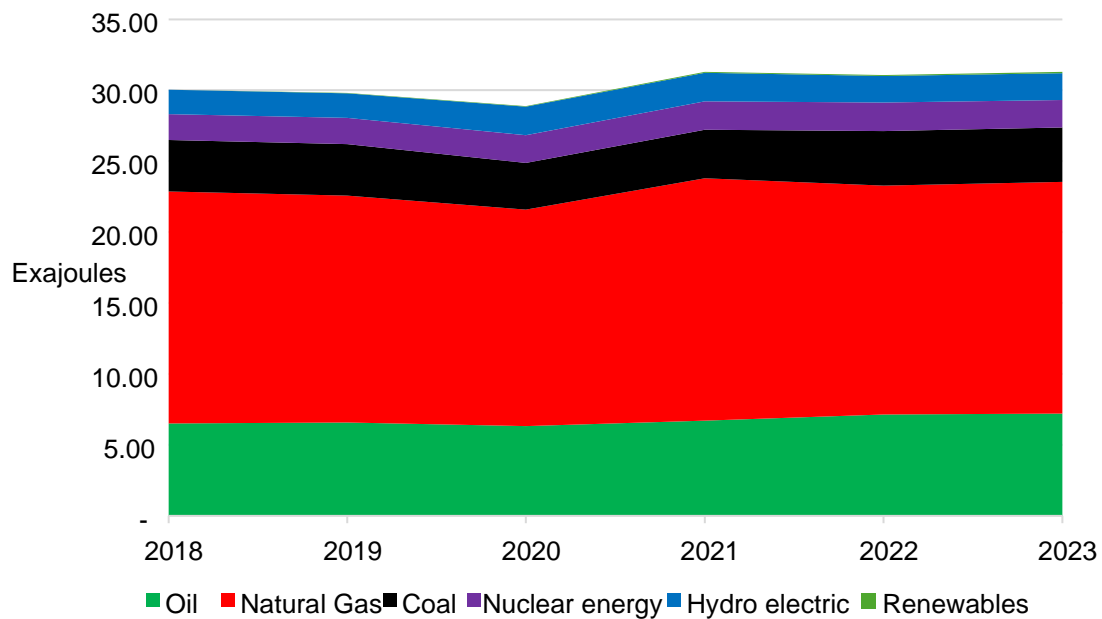
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1. Natural gas in the Russian economy and the role of Gazprom

Natural gas plays a dominant role in the Russian energy economy. Natural gas has accounted for more than half of the country's energy needs for many years and made up 52 per cent of primary energy consumption and 43 per cent of electricity generation in 2023.¹ This is a unique position among industrialized countries and is explained by a combination of natural, economic, and political factors.

Figure 1: Russia's energy consumption by fuel (2018-2023)



Source: Energy Institute Statistical Review of World Energy 2018-2024

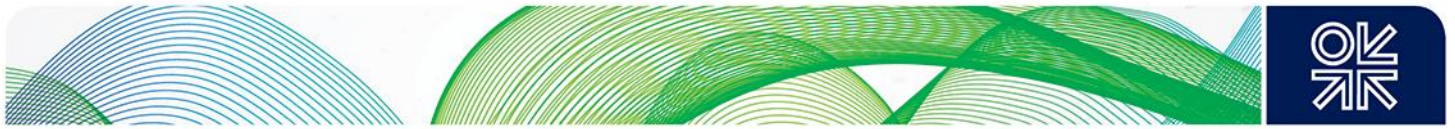
With the dissolution of the Soviet Union and its centrally planned economy in 1991, almost the whole gas sector was left to one company. The Soviet Ministry of the Gas Industry (Mingazprom) had become the Russian company Gazprom, a state-dominated entity that controlled gas production, the trunk pipeline system and pipeline exports. Thanks to the fact that it inherited giant gas fields and pipelines where huge investment had already been made by the Soviet state, initially Gazprom did not have to worry about new investment and capital costs. Moreover, the gas in its “super-giant fields” was dry and located in relatively shallow layers, which meant low unit production costs.

However, the *quid pro quo* was that, even though it was supposed to be a commercial actor, its domestic operations were heavily regulated, with low prices being set by the Russian state and access to resources being controlled according to the political and economic priorities of the authorities. Nevertheless, during the political upheavals and economic problems of the 1990s, Gazprom became a key element in sustaining social stability. Uninterrupted supplies at low gas prices (which also ensured low electricity and heat tariffs) provided energy security for large parts of the population, despite other economic hardships, and underpinned the economics of Russia's industrial base.²

However, Gazprom has not been the only player in the Russian gas market as, unlike the trunk pipeline and export businesses, which were monopolized by law, production and domestic sales have always been open to independent companies. Indeed, Gazprom has historically often been positive about the

¹ Data from Energy Institute Statistical Review of World Energy, 2024.

² For details of Gazprom's early history and its place in the Russian gas sector see Stern, J. (2005), “The future of Russian gas and Gazprom”, Oxford University Press for the Oxford Institute for Energy Studies



expansion of gas production and sales by third parties as they could relieve the company of some of its domestic obligations, enabling it to concentrate on more profitable export activities. The 'independent' suppliers could also help Gazprom to postpone costly investments in new fields (in Russian legal terminology, non-Gazprom gas producers are known as 'independent' gas producers.)³ However, as domestic gas prices started to rise sharply at the end of the 2010s their role in domestic gas supply grew more than Gazprom had expected and by 2020 they covered 52 per cent of the domestic market.⁴ Moreover, they have primarily targeted well-paying industrial customers, whereas Gazprom has been left with households and other segments where the prices were kept low by government regulations. The main independents, Novatek and the state dominated oil company Rosneft, have also challenged Gazprom in other business areas. They have lobbied both for better terms for use of Gazprom's pipelines and for access to export markets. Indeed, Rosneft and its President Igor Sechin led a very loud campaign against Gazprom, but it was Novatek that finally managed to breach Gazprom's export monopoly when the law was amended in 2013 to give export rights for Novatek's Yamal LNG project and some other LNG projects despite Gazprom's vehement protests.⁵

Despite these challenges and the inherent conflicts within the Russian gas sector, Gazprom's dominance of the industry was largely intact when Russia carried out its full-scale invasion of Ukraine. In 2022 Gazprom remained a huge domestic and societal influence, with 492 thousand employees⁶ and acting as a guarantor of cheap energy to the population and responsible for connecting remote regions to the gas grid – known as 'gasification'. Importantly, in its role as a state-controlled entity it was and remains obliged to supply gas to poorly paying regions, and although this remains a financial problem for the company, the federal government regards stable and inexpensive gas supply, especially to the poor regions in the south, as contributing to societal peace in an otherwise volatile part of Russia.⁷

2. Gazprom's export monopoly

The other important role that Gazprom inherited from the Soviet era, specifically from Soyuzgazeksport, a subsidiary of the Ministry of Foreign Trade,^{8 9} was the export of Russian gas via the Unified Gas Supply System (UGSS), of which it became the monopoly owner.¹⁰ Russian law gives the owner of the UGSS the exclusive right to export gas from Russia via pipeline,¹¹ and Gazprom has exploited this right to generate huge revenues from sales to European markets, and more recently from selling gas to China. Figure 2 demonstrates that Non-FSU markets have always contributed a much greater share of Gazprom's gas revenues than of its gas sales volumes, in some years bringing more than two thirds of the revenue total thanks to the higher price generated outside Russia. This has historically allowed the company to remain profitable while supplying FSU markets at lower prices, while supplying the Russian market at breakeven prices (or even below in some cases) and while paying significant export and other taxes to the government. In addition, the company has also been profitable enough to pay dividends to its shareholders (see discussion below), with the Russian government being the largest beneficiary thanks to its 50% plus one share stake.

³ For a detailed analysis of Russia's independent gas producers see Henderson, J. (2010) "Non-Gazprom gas producers in Russia", Oxford Institute for Energy Studies

⁴ Gazprom, Annual Report 2021.

⁵ Mitrova, T. (2013) "Russian LNG: The Long Road to Export", IFRI, Paris

⁶ <https://www.gazprom.ru/f/posts/56/691615/gazprom-in-figures-2018-2022-ru.pdf>

⁷ Gazprom Bond Prospectus, 4 Nov 2016, Risk Factors, p.16 "We are required to supply natural gas to customers in Russia at prices that are regulated by the Government and are below those which may be economically viable to us"

⁸ Hogselius, P. (2013) "Red Gas: Russia and the origins of European energy dependence", p.63, Palgrave Macmillan, New York

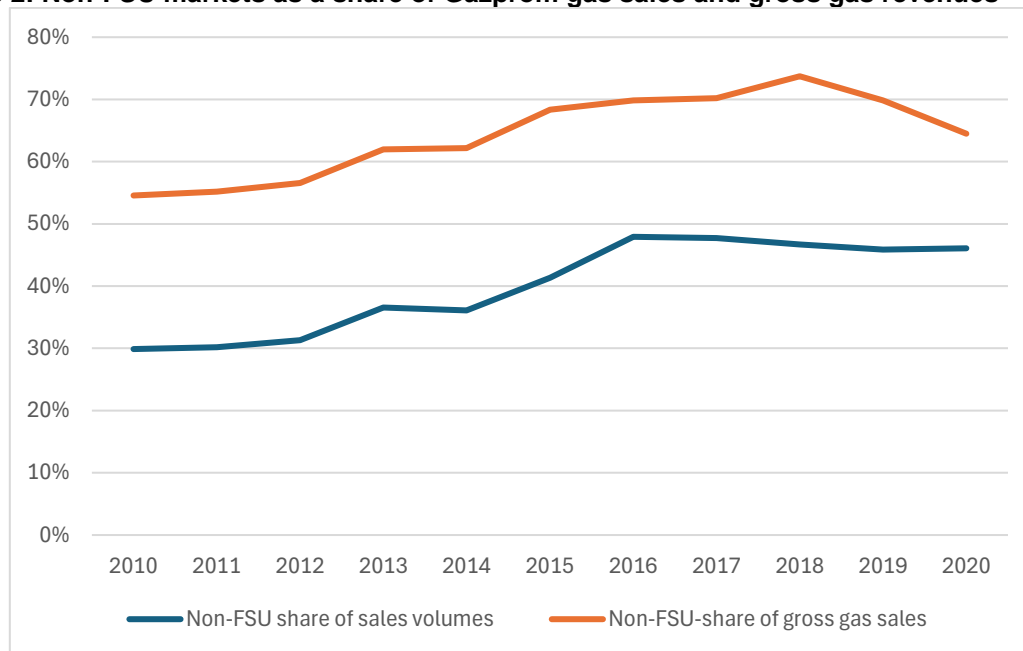
⁹ For details see Kryukov, V. and Moe, A. (1996) "Gazprom: Internal structure, management principles and financial flows", pp. 67-68, The Royal Institute of International Affairs, London

¹⁰ Kryukov, V. and Moe, A. (2013). "The Russian Natural Gas Sector", in M. Alexeev and S. Weber (eds.): *Oxford Handbook of the Russian Economy*, Oxford University Press, pp. 363-382

¹¹ Mikulska, A. (2020) "Gazprom and Russian Natural Gas Policy in the first two decades of the 21st century", *Orbis*, Vol. 64, Issue 3, pp.403-420



Figure 2: Non-FSU markets as a share of Gazprom gas sales and gross gas revenues



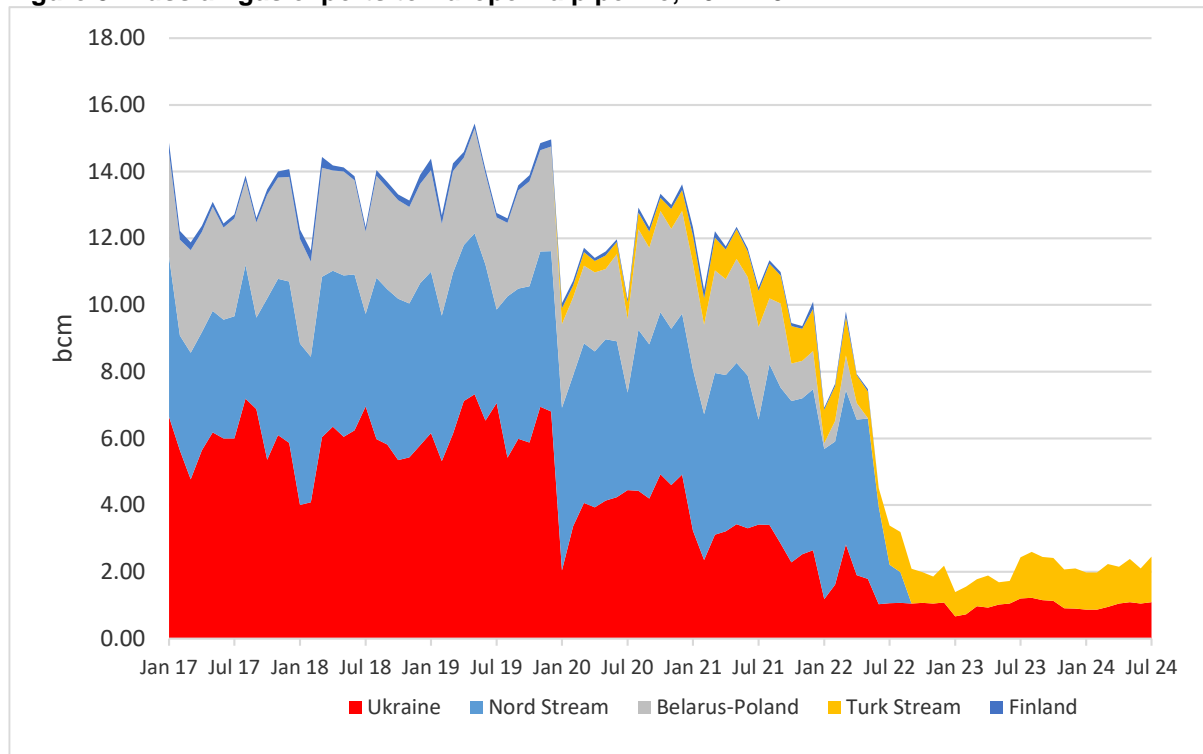
Source: Gazprom in Figures, 2010-2020

As a result, the collapse in export sales to Europe following the invasion of Ukraine in February 2022 was always going to cause Gazprom significant financial and operational problems. Initially, it appeared that the outcome would not be too dramatic, at least in the short-term. EU and European buyers did not introduce sanctions against Russian gas supplies due to the heavy dependence of many countries on them, although in early March 2022 the EU Commission announced a target of cutting imports of Russian gas by two thirds by the end of 2022. Gazprom, acting on a Russian presidential decree on 31 March, then demanded payment for gas in roubles instead of Euros or US Dollars— as stipulated in the contracts – from EU countries.¹² Deliveries were cut to countries who refused to pay in the Russian currency and Gazprom also reduced supplies by commencing what it argued were necessary repairs to the Nord Stream pipelines. Then in late September 2022, an explosion made the Nord Stream 1 pipeline – with an annual capacity of 55 BCM – effectively unusable, and also blew up one line of the Nord Stream 2 pipeline, which had already been blocked by the German regulator. With the Yamal pipeline via Belarus and Poland also empty due to sanctions and counter-sanctions by the Polish and Russian governments, and with the flows through Ukraine reduced by the Russian occupation of one of the transit points, the Turk Stream route via the Black Sea and Turkey was left as the only fully operational route for Russian gas to Europe. Overall, as can be seen in Figure 3, total flows have fallen from a high of 15bcm per month in 2019 to a current level of around 2bcm per month, with approximately half coming via Turkey and half continuing to flow via Ukraine.

¹² Holly Stebbing and Majdie Hajjar (2022). Turning the taps off? Arbitration and the European gas crisis. International arbitration report published by Norton Rose Fulbright— Issue 19. Pp. 29-30. [Turning the taps off? Arbitration and the European gas crisis | Global law firm | Norton Rose Fulbright](#)



Figure 3: Russian gas exports to Europe via pipeline, 2017-2024



Source: Graph created by Author from data sourced from Argus Media

The complicated breakup of gas trade between Russia and Europe – caused by actions of the seller as well as buyers – has not been without legal consequences. A number of arbitration cases have been opened by Gazprom’s customers as its actions were regarded as breach of contract by many buyers - but not by Gazprom, who insisted that they could not take responsibility for a presidential decree they were forced to respect.¹³ One case, brought by Uniper, has been resolved in favour of the European company, which has been granted significant compensation and the right to terminate its contract early.¹⁴ However, although it is unclear whether this will set a precedent for other cases and if it means the legal end of Russian gas exports to Europe, there is no doubt that it marks another step in the journey towards meeting the EU’s goal of being completely free of dependence on Russian energy by the end of this decade and specifically suggests that Gazprom’s historically most important source of revenue will never be as significant a market again.

3. The financial and operational consequences for Gazprom and their implications for the company’s future

Given the importance of European exports to Gazprom’s revenues and profitability, one useful lens through which to analyse the future of the Russian gas sector is through its most important company’s financial performance. Amid the increasingly scarce data available on the Russian energy sector, Gazprom continues to produce its IFRS financial results and also its Data Book containing some key operational information.¹⁵ The detail has been reduced somewhat since 2022, but nevertheless some interesting insights can still be gleaned from both sources. The analysis provided in the next section

¹³ Gazprom in arbitration proceedings with ENI, Engie, RWE, PGNIG, Gasum, Naftogaz – report, *Interfax*, 16 March 2023. <https://interfax.com/newsroom/top-stories/88758/>

¹⁴ For details see Stern, J., Yafimava, K. & Ason, A. (2024) “The Uniper-Gazprom Arbitration Ruling: is the final curtain coming down on remaining long-term Russian gas supply contracts to Europe?”, Oxford Institute for Energy Studies

¹⁵ For access to the reports used in this section please see <https://www.gazprom.com/investors/>

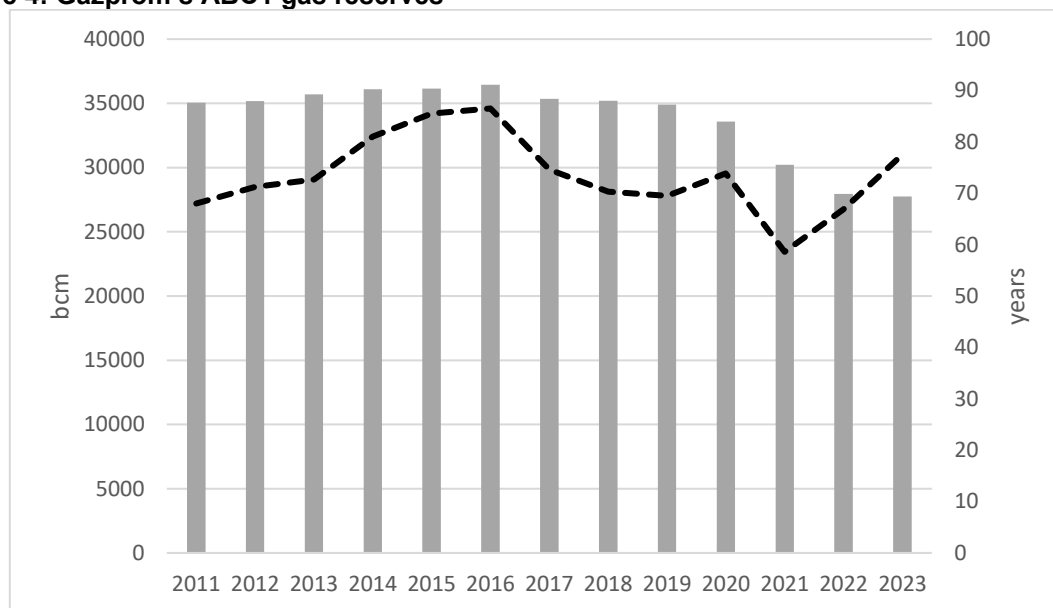


looks in detail at the latest annual results, as well as the recent release of numbers for the first half of 2024,¹⁶ and draws conclusions about the company's current financial position and its main challenges, and opportunities.

Some high level operational observations

As has been well documented over the three decades of its existence, Gazprom is the world's largest gas company by reserves, production and exports. However, it is now shrinking on all three measures. The decline of production and exports is clearly driven by the reduction in exports to Europe discussed above, but the fall in reserves is slightly more surprising. Gazprom reports that its reserve replacement ratio (the amount of new discoveries compared to annual production) remains above 1, but nevertheless the company is certainly shrinking on the only measure of reserves it still reports – ABC1 under Russian accounting standards.¹⁷ Figure 4 shows the size of Gazprom's ABC1 reserves since 2011, with consistent growth to 2016 before a gradual decline which accelerates from 2021. The company's current total ABC1 reserves are stated at 27.75 trillion cubic metres (tcm), an enormous figure but still almost 25% below the 2016 total. There are a number of reasons for this, including disposals and downgrades of specific assets, but the overall picture is of a company that is getting smaller over time. Indeed, this may also be reflected in the financial write-offs that the company has made in its financial accounts over the past three years (see discussion below).

Figure 4: Gazprom's ABC1 gas reserves



Source: Gazprom in Figures, 2011-2023

Figure 4 also shows the company's reserve life, a measure of how many years of current output could be produced from current reserves. Despite the decline in reserves, this figure has rebounded from a low of 59 years in 2021 to over 77 years in 2023, but this has been driven by the sharp decline in gas production shown in red in Figure 5. This of course has been caused by the decline in gas sales in Europe, which have not been replaced in other markets, and Gazprom's gas output has fallen by more

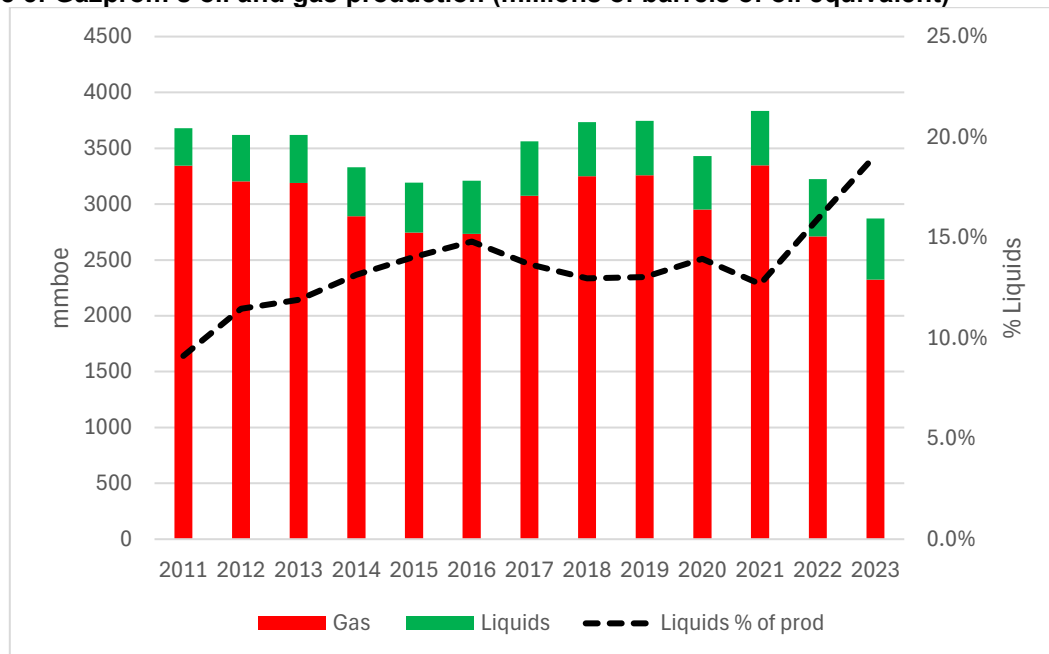
¹⁶ Gazprom released its IFRS report for H1 2024 on 29 August.

¹⁷ Historically Gazprom has reported reserves under both Russian and international standards. The Russian (ABC1) standard reflects a more technical assessment of reserves in place and tends to be larger than the international (proved and probable or P&P) standard which assesses which reserves can be commercially produced.



than 30% in only two years. This would be a shock to any company, but as will be discussed later it has led to a significant deterioration in Gazprom's underlying condition.

Figure 5: Gazprom's oil and gas production (millions of barrels of oil equivalent)



Source: Gazprom in Figures, 2011-2023

The second point of note in Figure 5 is the rise in the share of liquids as a proportion of the company's overall hydrocarbons output. The role of Gazprom Neft, Gazprom's oil subsidiary, has become increasingly important as gas production has fallen and more importantly sales of high value gas exports to Europe have collapsed. As will be discussed in the next section one consequence has been a remarkable shift in the contribution of Gazprom's different businesses. However, even in volume terms the situation is changing, and Figure 5 shows the share of liquids rising to just over 19% of total production in 2023. Gazprom also produces a significant amount of electricity as well as selling transportation and other infrastructure-related services which are becoming crucial to the company's survival.

The key financial headline – Gazprom makes its first loss for over 20 years

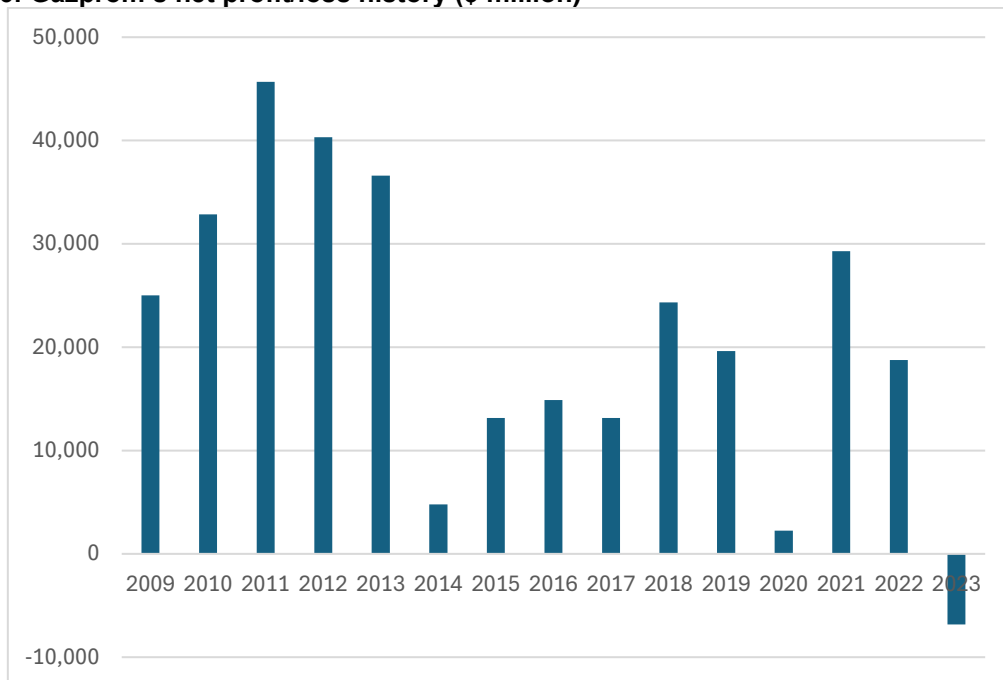
Turning to Gazprom's financial performance, the headline announcement has been that in 2023 Gazprom made its first overall net loss since the early 2000s,¹⁸ underlining how sensitive the company's finances are to the revenues generated from exports and how the fall in volumes and prices in 2023 affected it. Perhaps more worryingly though, Gazprom also reported a loss at the operating level, before any financing costs and other non-operating expenses are taken into consideration, meaning that its underlying business model was not profitable. Adding back depreciation provided a positive EBITDA figure (a proxy for operating cashflow) of \$7.2 billion, but even this was the lowest figure since 2002, and as we will see later it is inadequate to cover the company's ongoing investments.¹⁹

¹⁸ Bloomberg, 2 May 2024, "Russia's Gazprom Group falls to first net loss in 24 years"

¹⁹ All financial data comes from Gazprom's IFRS Financial Report for 2023 published www.gazprom.com



Figure 6: Gazprom's net profit/loss history (\$ million)



Source: Gazprom IFRS statements for 2009-2023

One caveat, which will be discussed in more detail below, is that the loss does include some significant write-offs for the impairment of assets that have been taken at the operating level. This presumably reflects the fact that the company views a number of its assets, including in Europe, as now being worthless, which is obviously a concern in itself, but it does also skew the reporting of profits as these write-offs are not part of normal operations and may not be repeated in future. As a result, although they are clearly not good news, they do need to be born in mind when considering the company's financial results for 2022 and 2023 in particular.

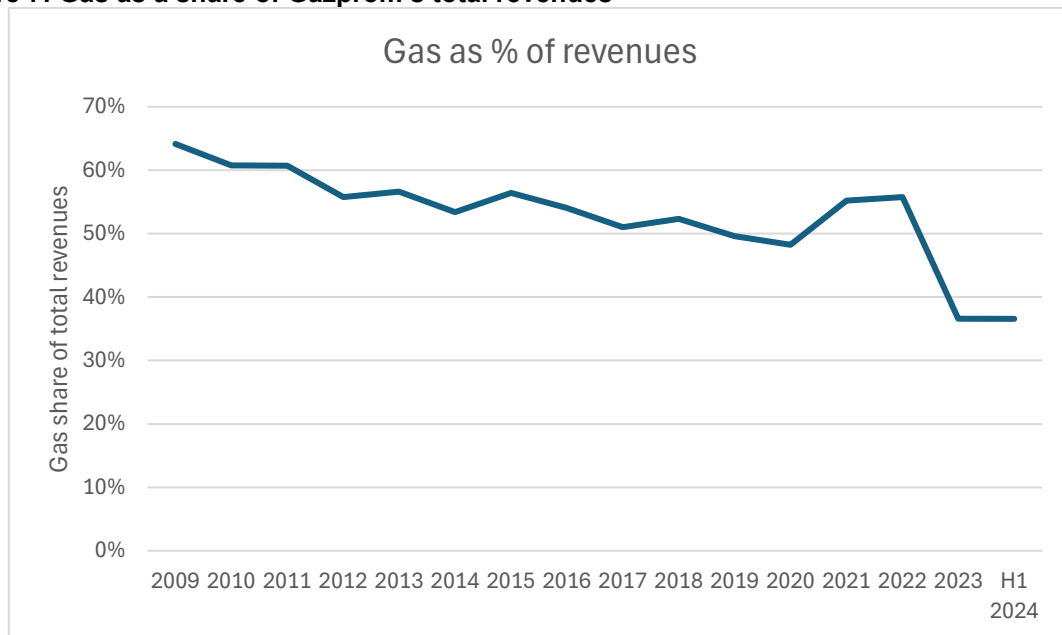
Analysis of revenues – is Gazprom still a gas company?

Breaking down the financial results in more detail, the top line reports the company's revenues, and it is important to record that these do not just come from gas but, as noted above, also include liquids (crude oil, condensate and refined products), power and heat, and other (including transport services). Gazprom no longer breaks down the details of these revenues in quite as much detail, but nevertheless some interesting conclusions can be drawn.

Firstly, overall revenues fell by 27% in 2023, but that fall was entirely accounted for by the 52% decline in net gas revenues. Indeed, non-gas revenues actually rose by 5% (in rouble terms). The overall consequence of this has been that net gas revenues now account for less than half of the company's overall revenue base for the first time. As can be seen in Figure 7 below, gas revenues made up 37% of the total in 2023, and with liquids revenues making up three quarters of the remaining 63% this implies that Gazprom is now heavily exposed to the oil price and is no longer a hedge of sorts for the Russian energy economy. Furthermore, it underlines the importance of its Gazprom Neft subsidiary to the company as a whole and suggests that it may command ever more influence over the company's future strategy. The situation was replicated in the first half of 2024, confirming the trend and underlining the importance of liquids sales, which rose to an even higher 77% of non-gas revenues during the six month period.



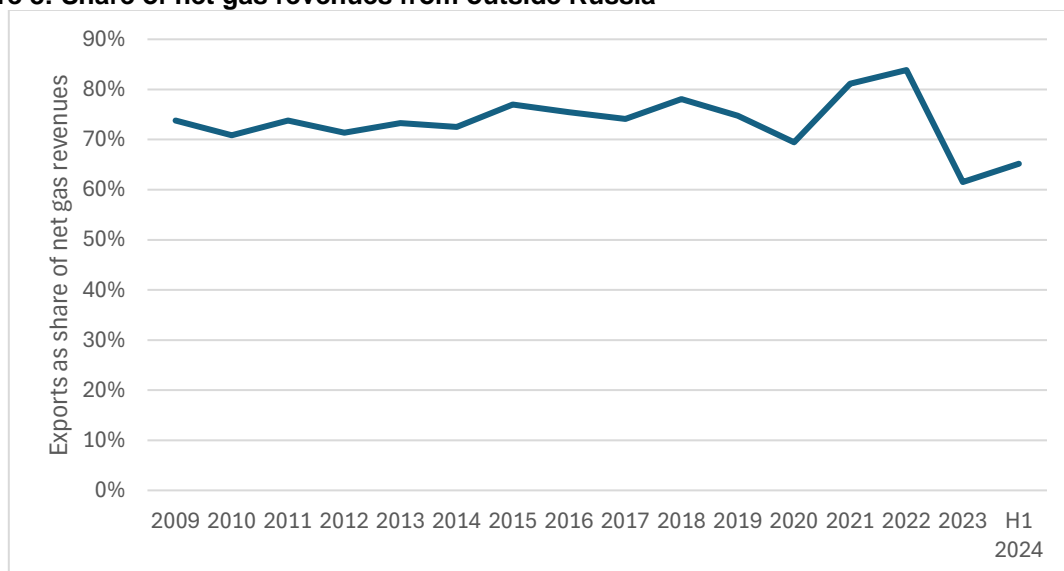
Figure 7: Gas as a share of Gazprom's total revenues



Source: Gazprom IFRS statements for 2009-2024

This collapse in the share of gas revenues has been caused by the dramatic shift in Gazprom's export business, with the result that domestic sales are becoming more important to the company. However, although this is likely to be a continuing trend, it is interesting to note that sales outside Russia (including sales to the FSU and China) still account for over 60% of the gas total on a net basis (Figure 8).²⁰ Again, the trend has been continued in H1 2024, with exports accounting for 65% of net gas sales.

Figure 8: Share of net gas revenues from outside Russia



Source: Gazprom IFRS statements for 2009-2024

²⁰ Gross revenues need to be adjusted for customs duties paid on export sales as well as for some price adjustments that Gazprom offers in some of its export contracts. In addition, excise taxes are removed to reach the net figure

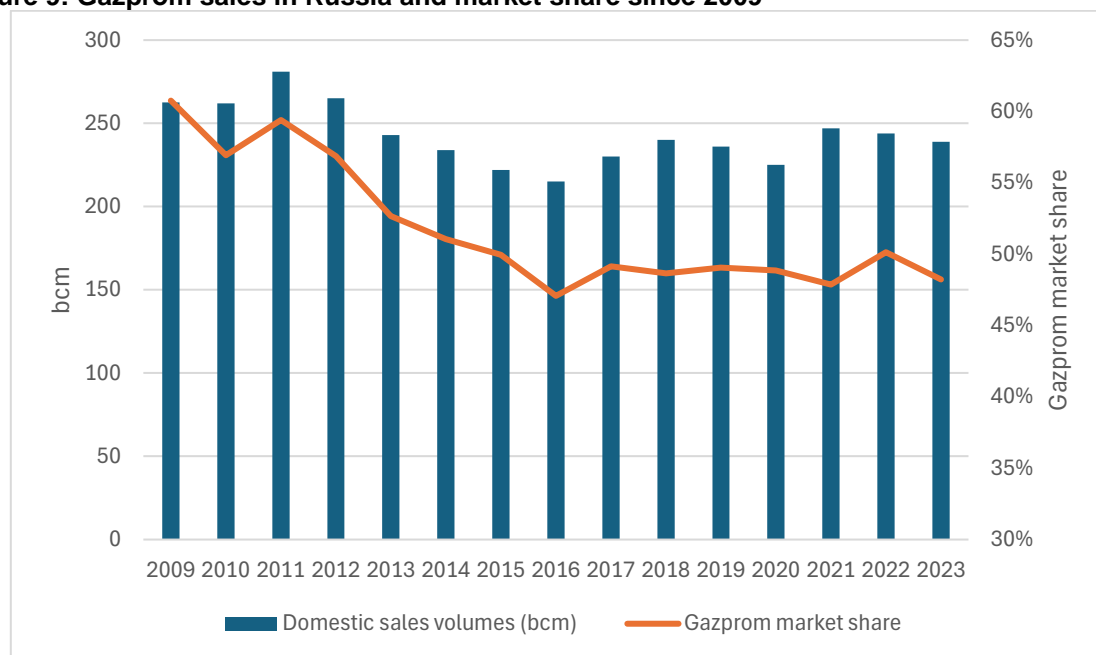


In terms of the trends in 2024, it is also worth noting that overall revenues rose by 24% compared with the first half of 2024, but that gas revenues rose by 9% while other revenues increased by 34%. While this certainly suggests that the prospects for the full year are better than in 2023, it yet again underlines how important non-gas revenues are to the company.

Implications for Gazprom's future revenue streams

This shift in the shares of domestic and export sales is likely to have some important consequences for Gazprom's sales strategy over time. From a domestic market perspective, the opportunity is very large (Russia has the second largest gas market in the world behind the USA, with demand totalling just under 500bcm in 2023).²¹ Historically, though, it has not been very profitable because Gazprom is forced to sell at a price regulated by the government and set at a level that provides a subsidy to Russian consumers compared to the export price.²² Gazprom managed to lobby for the domestic price to reach a breakeven level in 2009, but the impact of the rise in the regulated price was to encourage competition. Independent producers found that they were able to compete with Gazprom as they are not forced to sell at the regulated price.²³ In the early 2000s this meant selling at a premium to customers who could not secure sufficient gas from Gazprom, but from 2010 the Independents found that they were able to undercut Gazprom's price, increase their market share and still make money. For many years Gazprom was prepared to tolerate this situation as it freed up more gas for export, where it could command significantly higher prices than in the Russian market.²⁴

Figure 9: Gazprom sales in Russia and market share since 2009



Source: Gazprom in Figures, 2009-2023

²¹ The demand figure is under the Russian classification. The Energy Institute Statistical Review of World Energy reports demand of 453bcm using slightly different temperature and pressure assumptions. Russia remains the second largest global consumer, though

²² Henderson, J. (2011), "Domestic Gas Prices in Russia – Towards Export Netback?", Working Paper NG57, Oxford Institute for Energy Studies at https://www.oxfordenergy.org/wpcms/wp-content/uploads/2011/11/NG_57.pdf

²³ For details on independent gas producers in Russia see Henderson, J. (2010) "Non-Gazprom gas producers in Russia", Oxford Institute for Energy Studies

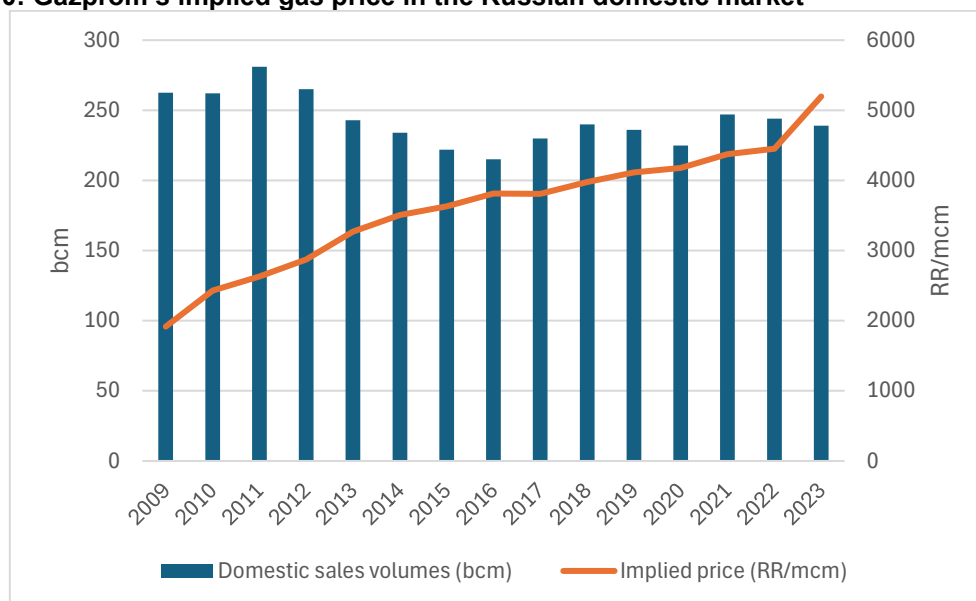
²⁴ For details of this shift see Henderson, J. (2013), "Evolution in the Russian Gas Market – The competition for customers", Working Paper NG73, Oxford Institute for Energy Studies



The gradual decline in Gazprom's market share since 2009 can be seen in Figure 9, reflecting the fact that Novatek, Rosneft and other Russian oil companies increased their ambitions in the domestic market and signed contracts with a number of key industrial customers. Gazprom now accounts for less than 50% of sales in the Russian market, but given the change in the availability of export markets this could start to change in the next few years if overall demand continues to increase (it has been growing at around 0.7% p.a. over the past decade),²⁵ if the regulated price continues to rise and if Gazprom continues to have surplus gas to sell.

The government certainly seems to be supportive when it comes to prices. The graph in Figure 10 shows Gazprom's average realised price for sales in Russia since 2009, and underlines the consistent increase in prices that has attracted competition from the Independents but has also allowed Gazprom to break even on its sales. The price is set at different levels across all the regions of Russia to reflect the different costs of transportation, (the price in West Siberia, where the gas is produced, is lower than the price in Moscow, for example) and different levels are set for industrial and residential customers.²⁶ As a result, the Gazprom price is very much a weighted average of all its sales across multiple regions and customer bases. The consistent but gradual increase indicates that the government has been willing to keep the company's domestic business marginally profitable over the past decade, but it is interesting to note the sharp kick up in 2023 as a potential indicator of future plans. Since the start of the war in Ukraine the regulator increased the price which Gazprom can charge domestic customers by 5% in July 2022, 8.5% in December 2022 and a further 10% in December 2023, meaning that it is already 25% higher in rouble terms than the price in February 2022, (The impact of the December 2023 price was not fully reflected in the average price for 2023 shown in Figure 10).²⁷ Further increases of 11.2% in July 2024 and 8% in July 2025²⁸ mean that the overall growth in three years will be a compounded 46%, which is more than the growth seen in the entire decade before the invasion in 2022.

Figure 10: Gazprom's implied gas price in the Russian domestic market



Source: Gazprom in Figures 2009-2023, Gazprom IFRS reports 2009-2023

²⁵ Data from "Gazprom in Figures" documents from 2013 to 2023 sourced from <https://www.gazprom.com/investors/>

²⁶ Henderson, J., Pirani, S. & Yafimava, K., 2014, "Russia's domestic gas market development, prices and transportation", Chapter 5 in Henderson, J. & Pirani, S. (eds), 2014, "The Russian Gas Matrix: How Markets are Driving Change", Oxford University Press

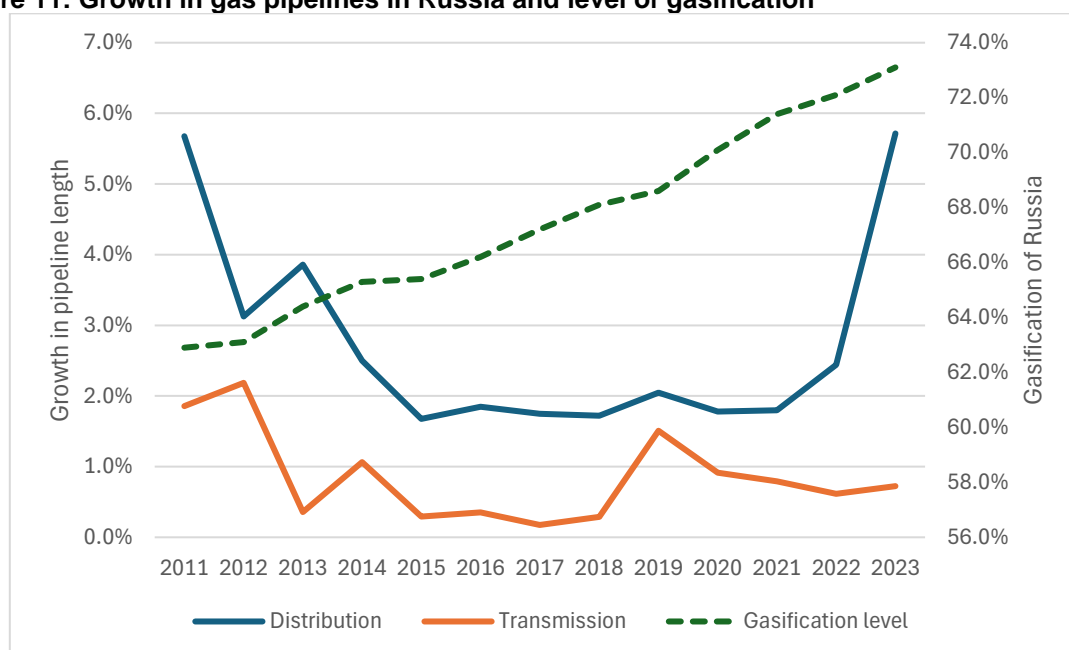
²⁷ Interfax, 25 Sept 2023, "Russia to raise gas prices for industry, except power cos, by 10% in December to help producers pay higher taxes"

²⁸ Interfax, 9 Jan 2024, "Russia's MET on gas rises as of January 1 as part of indexing gas tariffs"



This price growth would certainly suggest that Gazprom is being incentivised to focus on the domestic market as a priority and is being compensated for the loss of its main export market, and it is interesting to note that the company has continued to make efforts to expand its reach within Russia. The gasification programme has been actively progressed, with gas being available to 73% of the Russian population by the end of 2023 (Figure 11, right hand scale), and it is also significant that while the growth in the transmission system has been continuing at its long-term average rate of 0.5-1.0% per annum, the growth of the distribution system has jumped sharply in 2022 and 2023, suggesting that Gazprom is keen to access new customers directly. As a result, it would seem logical to conclude that Gazprom has been forced by circumstance and encouraged by the Russian government to increase its focus on a Russian domestic market which has been something of a burden over the past 30 years, but which is now becoming a more attractive prospect.

Figure 11: Growth in gas pipelines in Russia and level of gasification



Source: Gazprom in Figures 2009-2023

Exports remain a vital source of revenues

Despite this trend, the other key message from Figure 8 is that despite the dramatic decline in gas exports to Europe, overall sales to countries outside of Russia are still a vital component of Gazprom's gas business, still accounting for more than 60% of revenues. Given the 80% decline in sales to mainland Europe since February 2022 (excluding Turkey) this is something of a surprise, although there are a number of mitigating circumstances. Firstly, despite the fall from a historic peak in 2022, the gas price for Gazprom's remaining sales to the continent remains high on a long-term perspective. As reported by the World Bank,²⁹ the average gas price at the TTF hub in Europe in 2023 was \$13.11/mmbtu (\$463/mcm) compared with an average price for the decade from 2011 to 2021 of \$8.43 (\$298/mcm). In other words, the 2023 price remained 56% higher than the long-term average, despite being 67% below the record level reached in 2022. In one sense this is something of a silver lining for Gazprom, as the removal of its gas from Europe has kept prices higher, from which it has benefited in 2022 and 2023. However, as the 2023 results have demonstrated, it no longer compensates for the loss of sales volumes.

²⁹ World Bank Pink Sheet (Commodity Price Data) at <https://www.worldbank.org/en/research/commodity-markets>



This price has been a reference for the contracts for the remaining sales into the EU, mainly to Austria, Hungary and Slovakia, which are supplied both through the Ukraine Transit system (c.14bcm) and via Turk Stream through Turkey (c.12-13bcm). However, the sales through Ukraine are now under threat due to the ending of the transit contract on 31 December 2024, and with no sign of a new contract being signed by the Ukrainians at present it may well be that Gazprom's sales to Europe are set to halve again in 2025.³⁰ There are also some small non-EU sales into the Balkan states, but the largest European market is now Turkey, which purchased just over 21bcm in 2023.³¹ The structure of the Russian gas price to Turkey has fluctuated between a link to the TTF hub and a link to the oil price as the Turkish authorities have sought to find the lowest cost option,³² and Gazprom has also offered payment deferment terms during periods of high prices, reflecting the fact that Turkey has now become Russia's most important gas export market in the West as flows through the Black Sea pipelines that serve the country have not been disturbed by the war in Ukraine. Russia's somewhat turbulent political relationship with Turkey, combined with Turkey's sensitivity over the gas price, could put sales under threat in future, but for the time being it seems that Gazprom is doing all it can to keep this market secure and is even discussing the creation of a Turkish gas hub to enhance relations between the two countries and to facilitate further exports of Russian gas.³³

A second important driver is that sales to China have been on the increase as flows through the Power of Siberia 1 line are ramped up to their 38bcm capacity by 2025. In 2023 just over 22bcm of gas flowed east, providing some compensation for lost sales in Europe, and in the first half of 2024 Gazprom's results have reflected the fact that volumes are increasing towards 30bcm for the year as a whole. However, at full capacity, Power of Siberia 1 will still only be equivalent to one quarter of Gazprom's sales to the EU in 2021, and the price formula under which the gas is sold suggests that it is also less profitable. Although the exact contract terms are confidential, research by the Carnegie Russia Eurasia Centre indicates that an oil-linked formula equates to a calculation of 'gas price (US\$/mcm) = 2.5 x oil price (US\$/bbl) + 20'.³⁴ As Figure 12 shows, at times of low prices on the European hubs this formula can provide price parity with western exports, but over the past three years the price for gas to China has been significantly lower. For context, in H1 2024 the formula gives a gas price of \$6.50/mmbtu based on an average oil price of \$84.01 per barrel over the 6 months, compared with a TTF price of \$9.39/mmbtu, and LNG price in Asia of \$12.89/mmbtu and a (less relevant) US Henry Hub price of \$2.11/mmbtu.³⁵ While this can still be profitable for Gazprom, it is clearly sub-optimal and looking to the future the Russian Ministry of Economy forecasts that the discount will be in the range of 22-28%, suggesting that although volumes will rise, sales to China will remain less profitable than sales to Europe on a 'per cubic metre delivered' basis.³⁶

³⁰ Reuters, 17 March 2024, "Ukraine has no plan to extend Russian gas transit deal"

³¹ OSW Centre for Eastern Studies, 3 June 2024, "Turkey: opportunities and challenges on the domestic market in 2024" at <https://www.osw.waw.pl/en/publikacje/analyses/2024-06-03/turkey-opportunities-and-challenges-domestic-gas-market-2024>

³² New York Times, 12 Dec 2022, "Turkey is strengthening its energy ties with Russia"

³³ Interfax, 27 Dec 2023, "Novak hoping that Turkey gas hub begins operating in 2024"

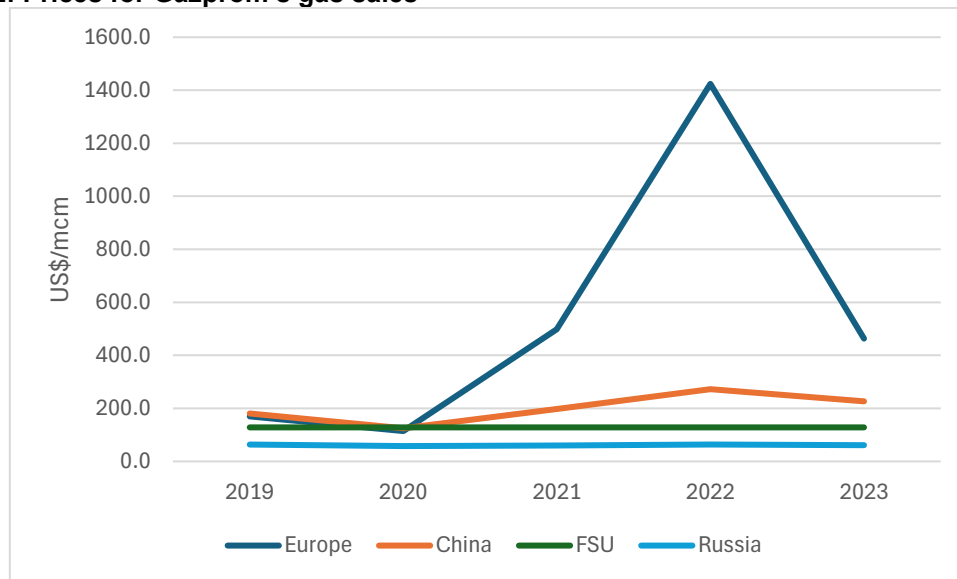
³⁴ Vakulenko, S., 18 April 2023, "What Russia's first gas pipeline to China reveals about a planned second one", Carnegie Politika at <https://carnegieendowment.org/russia-eurasia/politika/2023/04/what-russias-first-gas-pipeline-to-china-reveals-about-a-planned-second-one?lang=en>

³⁵ All prices from the World Bank Commodity Price Data File (The Pink Sheet) at <https://thedocs.worldbank.org/en/doc/5d903e848db1d1b83e0ec8f744e55570-0350012021/related/CMO-Pink-Sheet-July-2024.pdf>

³⁶ Bloomberg, 23 April 2024, "Russia forecasts lower price of its gas to China versus Europe"



Figure 12: Prices for Gazprom's gas sales



Source: World Bank, Gazprom, S&P Global, Carnegie Endowment

The volume of future sales to China will depend on the successful addition of new pipeline routes in the Far East and from the Yamal peninsula via Mongolia. The former, which will bring 10bcm of gas from Sakhalin Island via Vladivostok to NE China, is due to start first exports in 2027 under a contract signed in 2023, but it relies to an extent on Gazprom being able to develop the offshore South Kirinskoye field, which has been delayed by technical difficulties.³⁷ An alternative plan would see gas being brought from the Chayanda and Kovykta fields in East Siberia via an extension of the Power of Siberia pipeline, and so Gazprom remains confident that the 2027 target for first gas will be met. Meanwhile, Power of Siberia 2 would re-direct gas from West Siberia away from the lost European markets to China, and Gazprom is hoping for a contract to sell 50bcm.

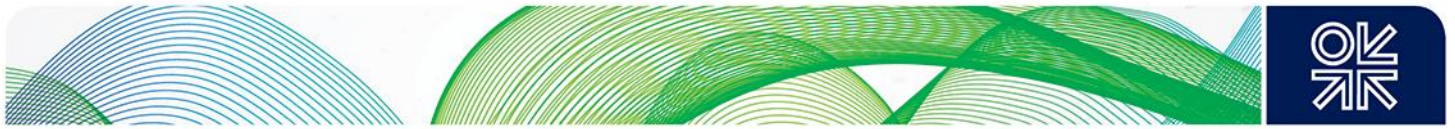
Originally, Gazprom had wanted to construct an east-facing pipeline from its fields in West Siberia via the Altai province and into western China as early as 2014, thus making it possible to switch supplies between Europe and China. China did not want this solution, which clearly could have given Russia a stronger negotiating position, but also because it was not interested in building a long pipeline from western China to the industrialised and energy consuming centres in the eastern part of the country. With the demise of Russian gas exports to Europe, it has become an absolute priority for Gazprom, since it would seem the only real option for disposing of big volumes of gas which have now become superfluous. China has continued to show disinterest, despite the fact that President Putin himself has been pitching the project aggressively.³⁸ The project can be seen as an indicator of the political balance between Russia and China. China's president Xi did not even pay lip service to Putin's overtures when he visited Moscow in March 2023, and did not mention the project in his official statements when Putin came to China in October 2023 with a big delegation including Alexei Miller, the head of Gazprom.³⁹ Nevertheless, many observers still expect that the project will be realised,⁴⁰ most likely in the 2030s, but on terms set by China which will be much less profitable than the previous exports to the West. Financing the project on the Russian side will be a headache, and it seems likely that Chinese

³⁷ Reuters, 8 Feb 2022, "Russia may use field hit by US sanctions for gas exports to China"

³⁸ Reuters, 20 May 2024, "Putin's pipe dream exposes China's energy advantage"

³⁹ Moscow Times, 20 June 2024, "As Power of Siberia 2 pipeline stagnates, so do Russia's hopes for pivoting gas exports eastward"

⁴⁰ «Газпром предварительно определил трассировку МГП Сила Сибири-2» [Gazprom has tentatively decided the routing of the main pipeline Power of Siberia-2], *Neftegaz.RU*, 9 February 2022. <https://neftegaz.ru/news/transport-and-storage/724605-gazprom-predvaritelno-opredelil-trassirovku-gazoprovoda-do-kitaya/>



institutions may have to be involved, further shifting the balance of power east.⁴¹ Although the potential is for gas exports by pipeline to China to reach 100bcm by the mid-2030s, the profitability of these sales will almost certainly be well below the historical returns from exports to Europe and will therefore not provide a similar subsidy to the Russian energy economy.

This leaves one final export market, namely the countries of the Former Soviet Union. Although Gazprom no longer provides a detailed breakdown of sales, historical data shows that in 2020 just under 60% of the 31bcm sold to this group of countries went to Belarus, with Kazakhstan and Moldova being the other significant markets. The FSU price in Figure 12 shows the fixed price which Belarus has negotiated since 2019 and which has now been confirmed through to 2025.⁴² At \$128/mcm it is just over one quarter of the 2023 price for sales to Europe, and although still more profitable than domestic sales for Gazprom, it is obviously no replacement for sales to the EU. In terms of future growth, the main area of interest is Central Asia, where Gazprom has signed contracts with Uzbekistan, Kazakhstan and Kyrgyzstan to increase exports over the next 15 years⁴³ and the price reported in the press is around \$160/mcm.⁴⁴ This would be part of a political move to reassert Russia's influence in the region, but although the gas prices are relatively low they can still be profitable for Gazprom. However, with the sales contracts under discussion likely to add up to 10bcm from 2025, the combination of price and volumes will again only offer marginal compensation for lost European volumes.

Conclusions on revenues and gas sales

Overall, the explanation for the decline in Gazprom's revenues is clear – gas exports to Europe have collapsed. The implications for the future are more complex and interesting. Firstly, the company has become, and is likely to remain, more dependent on non-gas revenues, especially from oil and refined products. Secondly, the domestic market has become more important having for many years been something of a burden. Increases in the regulated price suggest that the government is supportive of an increase in Gazprom's market presence, which could well lead to renewed competition with the "independents", mainly Novatek and Rosneft. However, the domestic market is likely to remain only marginally profitable, as prices remain low compared to export markets, reflected in the share of revenues generated by this segment.

As far as export sales are concerned, Turkey and China have become the key markets, and could become even more important if and when the end of the Ukraine transit contract leads to a further reduction in sales to the EU. China is the big growth market, with the possibility that exports from Russia could reach 100bcm by the mid-2030s if negotiations over future contracts can be concluded. However, as the deal for Power of Siberia 1 gas shows, China is in a strong bargaining position and will not agree to new sales at anything other than very competitive prices.

Finally, the FSU market is, in volume terms at least, becoming more important. However, given the political implications of most of the gas deals with FSU countries, the prices are unlikely to offer a high level of profits for Gazprom, as the agreements with Belarus and Uzbekistan demonstrate. Central Asia markets are becoming more interesting, with a number of countries looking to import Russian gas again, but the political dynamics suggest that prices will continue to be at relatively preferential rates that will allow Gazprom to make reasonable profits but not much more.

Gazprom's cost base is typical of a large state-controlled bureaucracy

Gazprom has to date not responded to the change in its revenue outlook by managing its cost base. While revenue-related costs such as operating taxes and purchased oil and gas have fallen, controllable

⁴¹ China wielding 'bargaining power' with Russia over Power of Siberia 2 natural gas pipeline. *South China Morning Post*, 24 November 2023. <https://www.scmp.com/economy/global-economy/article/3242612/china-wielding-bargaining-power-russia-over-power-siberia-2-natural-gas-pipeline>

⁴² Interfax, 28 Feb 2024, "Russia, Belarus sign protocol on gas price formation until 2025"

⁴³ Interfax, 7 June 2024, "Gazprom signs contracts with Kazakhstan to transit gas to Uzbekistan and Kyrgyzstan until 2040"

⁴⁴ Kun.uz/en/news, 7 March 2024, "Gazprom supplies Uzbekistan with gas at an approximate rate of \$160/mcm"



costs such as employment, materials, repairs and “other” costs have all risen significantly in rouble terms, with the latter rising by a huge 160% in 2023. Figure 13 below shows the movement in staff costs as a share of revenues and indicates that the ratio has only once been as high as in 2023 – during the pandemic in 2020, which was justifiably seen as a one-off event. The current problems at Gazprom appear much more systemic and will clearly require an urgent response if profitability is to be recovered. It will be interesting to see if the Russian government allows the company to make the staff reductions which appear to be necessary, but the results from H1 2024 suggest that the company has not taken much action yet. Gazprom currently employs just under 500,000 people across its entire organisation, a huge figure that reflects its position as one of Russia’s most influential companies, with businesses in almost every region of the country. Staff numbers have increased by 25% since 2011 as the gas sector has become more entwined in the economy through investment in gasification, with the key problem being that these expanded personnel numbers are now working on a less profitable business model than before 2022. Furthermore, the social pressure to maintain employment is intense, given Gazprom’s position as a major state-owned company and as the main employer in many remote areas. Finding a balance between lower revenues and control of costs is going to be a significant challenge over the next few years. One area of potential focus is managing increases in wages, and it is interesting to note that staff costs per employee over the past decade have risen by an average of 8.3% per annum compared with an average inflation rate of 7.1%.⁴⁵ Indeed, in 2023 staff costs per employee rose by over 13% compared to inflation of 7.4%, suggesting that Gazprom has not yet taken any proactive steps to manage this major area of costs.

Figure 13: Staff costs as a share of revenues



Source: Gazprom financial statements, 2009-2023

Gazprom’s write-offs for impairments and their impact on profitability

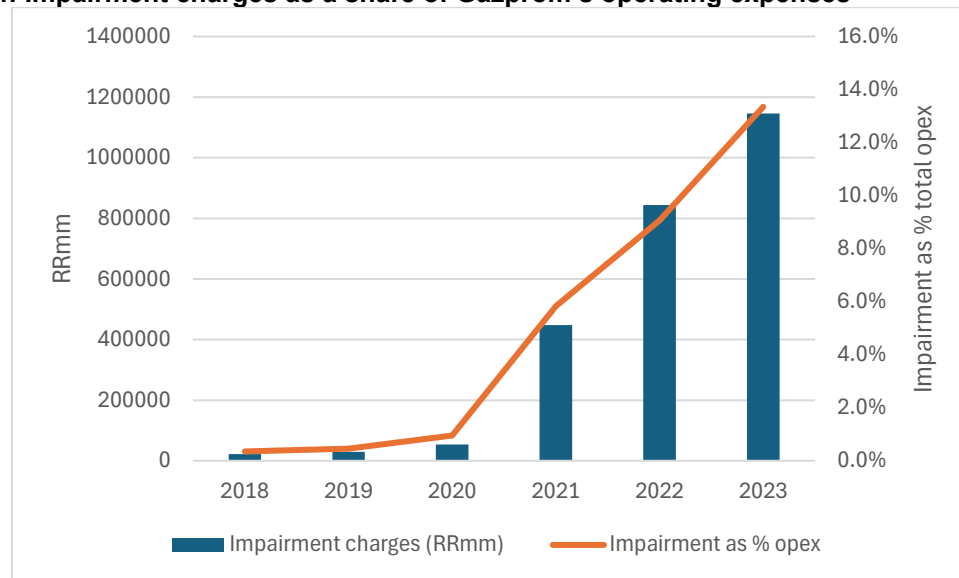
Another important consideration when looking at Gazprom’s financial results is the amount of write-offs which the company has included in its operating expenses as a result of the impairment of its asset base over the past few years, and in particular since export sales to Europe collapsed from 2022 (Figure 14). This clearly reflects a company view that some of its fields and other infrastructure will have no future value, and it has decided to take an immediate write-down against current profits as a result.

⁴⁵ Data from Gazprom Databooks 2013-2023



While it is slightly surprising that this has been treated as an operating expense, as write-offs are often taken as an exceptional item after profits have been calculated, the impact is important to acknowledge.

Figure 14: Impairment charges as a share of Gazprom's operating expenses



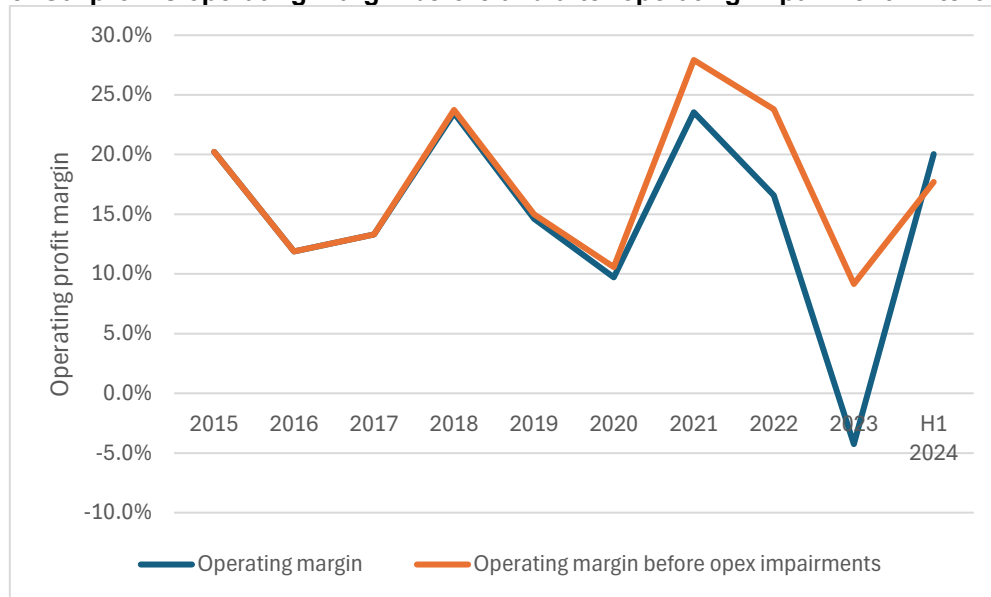
Source: Author calculations from data supplied in Gazprom IFRS statement 2018-2023

The total impairment charges, which are a non-cash item and therefore do not reflect the company's current operating performance, amount to almost RR2.5 trillion, equivalent to \$31.5 billion at the prevailing exchange rates for 2021-2023. This means that the company has written off around 10.5% of its total asset base at year-end 2020, reflecting the change in circumstances since then. It is difficult to know whether this trend will continue as it will obviously depend on how the company and its accountants view the future value of the asset base, and the first half results do not provide much indication as most impairment charges are taken at the year end. For example, in 2023 only 18% of the eventual annual impairment charge was taken in the first half of the year. Having said that, it is interesting to note that in the first half of 2024 Gazprom took an investment write-back of RR120 billion (c.\$1.3 billion), essentially adding back asset value to the company, which improved its operating results accordingly. This could obviously happen again at year end.

As a result, it is important to consider Gazprom's operating results before impairment charges or write backs to get an accurate view of the company's performance. Figure 15 below shows Gazprom's operating margin before and after the impact of impairment charges and write-backs, underlining that although the downward trend in 2022 and 2023 is the same, the impact of the write-offs severely undermined the operating results. Equally, in H1 2024 the write-back improved what was already a strong rebound. Therefore, two conclusions emerge. Gazprom has seen fit to write off a significant share of its asset base, which is a clear sign of the company's changed circumstances in the aftermath of the collapse in exports to Europe. However, these write-offs are likely to be exceptional items and therefore one needs to be mindful that the decline in the company's operating performance in 2023 was not as dramatic as at first appearance. It remains to be seen whether future write-downs are deemed necessary or whether the company will continue to boost its future performance with write-backs.



Figure 15: Gazprom's operating margin before and after operating impairment write-offs



Source: Author's calculations from Gazprom IFRS reports 2015-2024

Operating costs and taxes and other payments to the government

One area of costs that is a cash item vital to the annual results but non-controllable is taxes and other payments to the Russian government. These are reported at various places in Gazprom's profit and loss statement, but they are by far the largest element of operating costs, accounting for 36% of the total in 2023 and 46% in the first half of 2024. While excise tax and customs duties on gas export sales are reported at the revenue line (the difference between gross and net revenues), taxes on domestic production and sales are reported as 'taxes other than profit' under operating costs, with the majority of this coming in the form of Mineral Extraction Tax, or MET.⁴⁶ The Russian tax authorities have come to prefer this form of taxation as it is simple to implement and collect, and MET on gas production has been increased over time such that its share of Gazprom's operating taxes was 80% in 2023, compared with 60% in 2010.

Overall, though, the key message on payments to the Russian government is shown in Figure 16. While export taxes and profits tax are clearly related to fluctuating gas prices and volumes and the overall profitability of the company, operating taxes are less flexible, with MET being related to production and domestic gas tariffs, which are relatively stable compared to the more volatile international prices.⁴⁷ One major consequence of this is that the tax burden on Gazprom as a share of its overall revenues has increased sharply since the start of the war in Ukraine. Until 2021, Gazprom was paying 25-35% of its revenues to the Russian budget, but this jumped to 56% in 2022 and remained high at 49% in 2023 and 47% in the first half of 2024. This was driven by a desire from the Russian authorities to raise more money for the budget and to access the exceptional profits that Gazprom made in 2022 as a result of historically high export prices. Since those have retreated in 2023, the government has been forced to increase domestic gas prices (see discussion above) in order to allow Gazprom to break even or

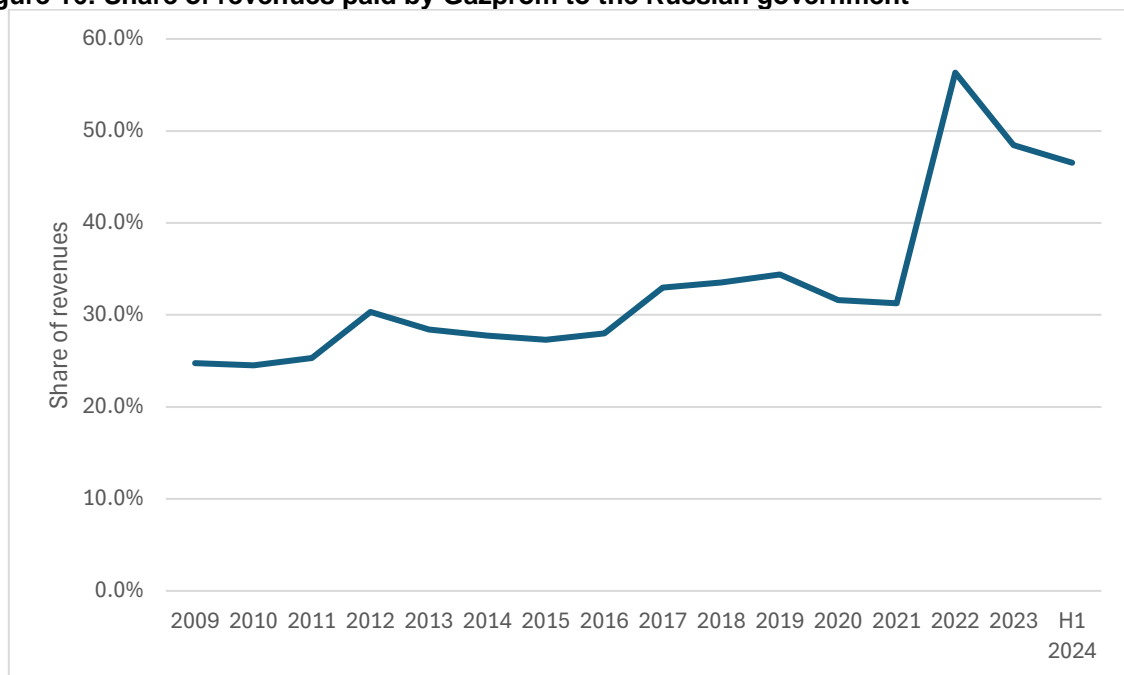
⁴⁶ For a description of Russia's Mineral Extraction Tax on gas see Kasharina, M & Zhuralev, M. (2016), "Current tax issues of the gas industry", World Science, No.1(5), Vol 5, January 2016

⁴⁷ Interfax, 13 Oct 2023, "Gazprom's revenue from unscheduled gas tariff indexation to be 120-130 bln rubles per year, budget to get more than 90% of this via mineral tax – Sazanov"



make a small profit. As a result, one conclusion is that Gazprom is increasingly, de facto, being used as a cash generator for the Russian government to fund its growing budgetary requirements. The company clearly has less money to give and this is certainly an issue, but the fact that payments to the state budget as a share of revenues has risen sharply since the invasion of Ukraine is a clear signal of government intent and is now being funded by significantly higher domestic gas prices.

Figure 16: Share of revenues paid by Gazprom to the Russian government



Source: Author's calculations based on Gazprom IFRS reports 2009-2013

Impact on Gazprom's investments and balance sheet

With more money going to the government, at least as a share of revenues, this clearly means less to be spent elsewhere. One important consequence of Gazprom's redistribution of its income towards the state is that operating cashflows did not cover the company's capital expenditure in 2023, which is a worrying development for any company. In Gazprom's case it is not unheard of, as it has occurred in times of low gas prices such as in 2017-19,⁴⁸ but it is unsustainable on a long-term basis. As a result, although the shortfall in 2017-19 was a concern, it was driven by a short-term phenomenon (a lower gas export price) that was always likely to correct over time. The worry on this occasion is that the drivers of the decline in operating cashflow appear more permanent – a structural reduction in exports to Gazprom's most profitable market and a fundamentally greater need for the state to generate more tax revenue from its major companies.

⁴⁸ S&P Global, 25 Mar 2019, "Analysis: LNG, oil spot price divergence stokes uncertainty over forward deals, hedging"

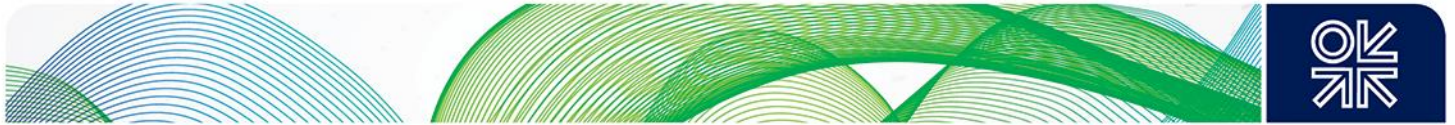
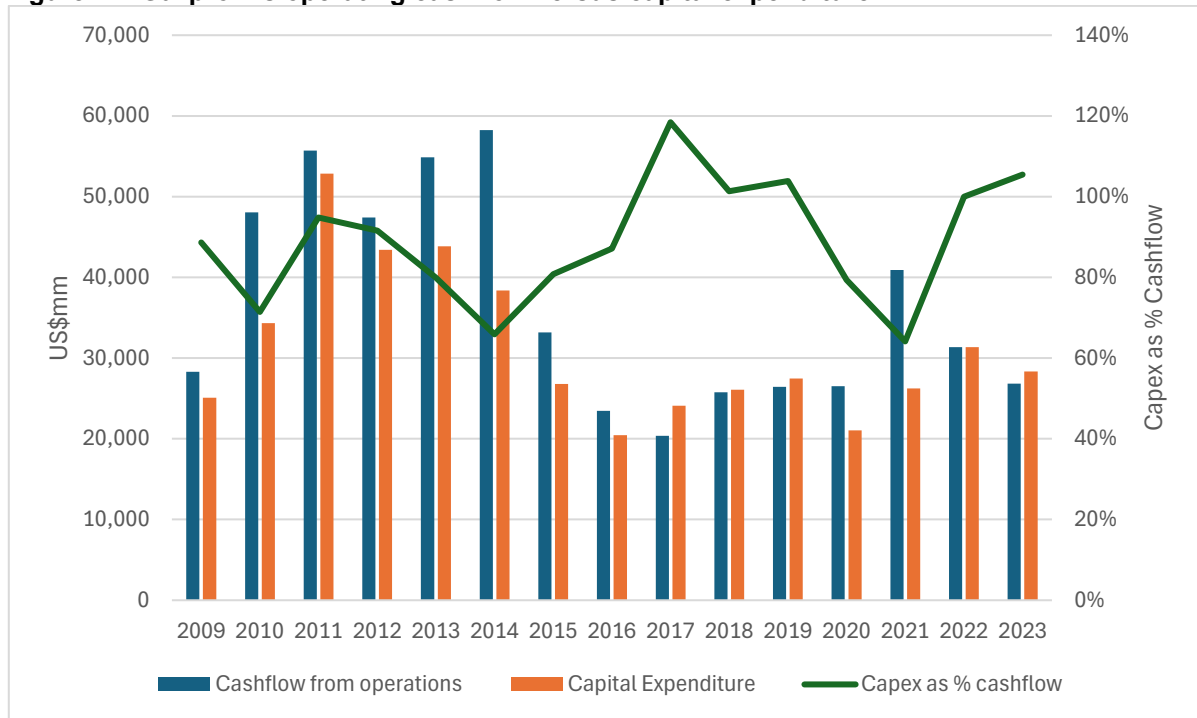


Figure 17: Gazprom's operating cashflow versus capital expenditure



Source: Author's calculations based on Gazprom IFRS reports 2009-2013

The picture from H1 2024 is even worse, with capital expenditure of 246% of net cash from operating activities, suggesting a huge underfunding. However, the half-year figures can give a distorted picture as adjustments for movements in working capital shift dramatically. For example, in 2023 the first half outcome was capital expenditure at 174% of net operating cashflow while the year-end figure was 105%. As a result, although the H1 2024 figure is worse, it needs to be tempered by a likely improvement by year-end.

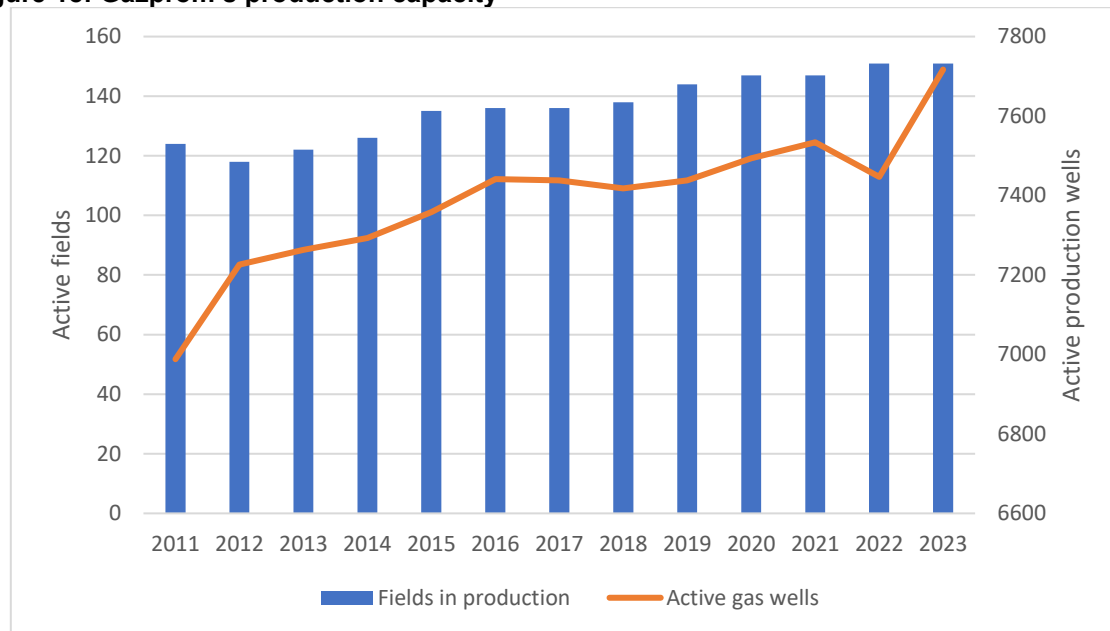
Nevertheless, the results over the past two years would suggest that there is a significant risk that Gazprom's investments in its asset base may have to fall, and it certainly calls into question how the company will be able to finance any major new infrastructure projects. The more positive news for Gazprom is that its need for upstream investment has been reduced because of the fall in sales to Europe. Over the past two years production has declined by just under 160bcm (from 516bcm in 2021 to 358bcm in 2023), but as can be seen in Figure 18 the number of fields and production wells that remain active is at a 12-year high. Although some of the company's upstream assets may have been impaired by enforced shut in (as evidenced by the financial write-offs noted above), it is almost certain that the majority could be returned to full output without significant investment. As a result, there is little, if any, need for Gazprom to spend extensively on new fields if, for example, a new 50bcm export contract is signed with China. However, while the need for upstream spending has fallen, this is not true of pipeline infrastructure, as the existing routes need to be maintained and new routes would need to be financed and constructed. For example, it has been estimated by some commentators that the Power of Siberia 2 pipeline could cost as much as \$14 billion.⁴⁹ While this figure is not unmanageable, being equivalent to around 50% of Gazprom's 2023 capital expenditure but spread over a number of years, it will be interesting to see how easy it is to finance under current circumstances. Neither the Russian government nor the company have discussed the figure, but the suspicion is that further reliance on China could be necessary to raise the funds needed if the project goes ahead. A precedent was set in

⁴⁹ Reuters, 30 October 2023, "Russia's weaker hand undermines case of Power of Siberia 2 link to China"



2009 with loans to Rosneft and Transneft for the construction of the ESPO pipeline in return for oil exports, and a similar deal could be possible in this case.⁵⁰

Figure 18: Gazprom's production capacity



Source: Gazprom in Figures, 2011-2023

Gazprom's balance sheet showing signs of strain

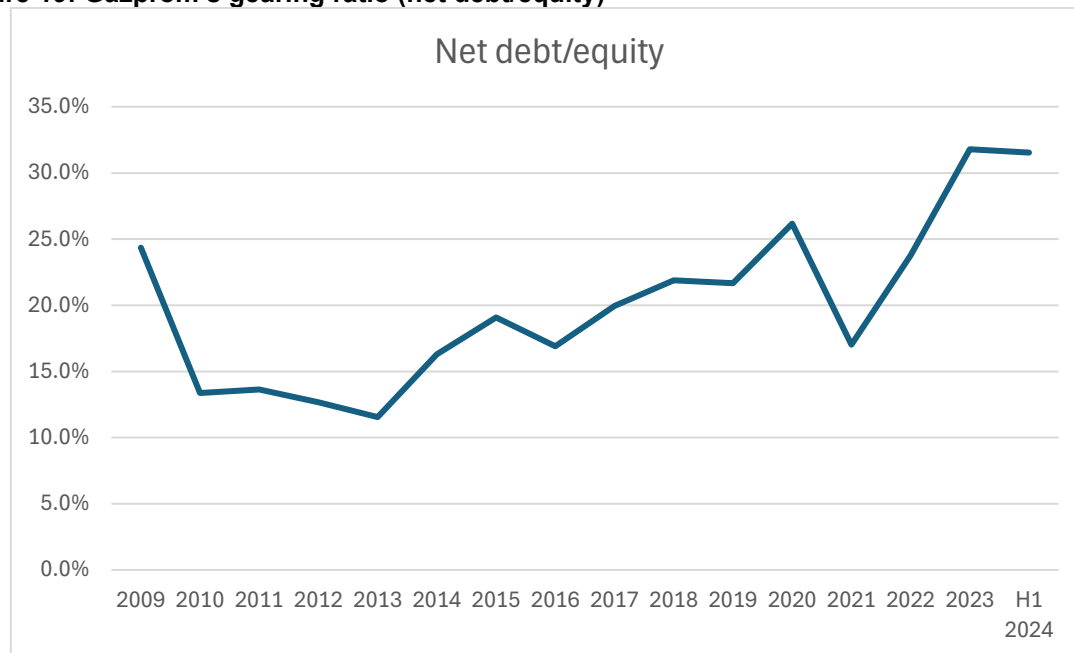
With cashflow falling, the clear alternative for raising finance is borrowing, and Gazprom's balance sheet is starting to reflect this. At 30 June 2024 the company's total debt stands at RR6210 billion (\$72.4 billion at the end of period exchange rate), while net debt (adjusted for cash) is \$64 billion. The split of international and domestic debt is only shown in the annual results, but as of the end of 2023 over half was still denominated in foreign currencies (RR3581 billion or 54%). This is a mixed blessing, as foreign debt comes with a much lower interest rate (3-6% as opposed to 16-17% for rouble debt) but has a significant foreign exchange risk as well as increased political risk in the light of potential reactions to the invasion of Ukraine. More fundamentally, though, Gazprom's net gearing ratio (net debt divided by equity)⁵¹ has jumped sharply as the company has been forced to use cash resources to fund its operations while seeing its total rouble debt grow by more than 30%. Figure 19 shows how Gazprom's gearing ratio stood at 32% at the end of 2023, compared to a historic average around 20%, and remained at that level in the first half of 2024, confirming the big jump in the ratio in 2023.

⁵⁰ Henderson, J. & Mitrova, T. (2016) "Energy relations between Russia and China: Playing chess with the dragon", OIES Paper WPM 67, Oxford Institute for Energy Studies, pp.25-27

⁵¹ A company's net gearing ratio is defined as (total short- and long-term debt less cash and cash equivalents)/book value of company equity – see <https://www.stockopedia.com/ratios/net-debt-to-equity-latest-495/>



Figure 19: Gazprom's gearing ratio (net debt/equity)



Source: Gazprom financial statements, 2009-2023

While the overall level of 32% is not extremely high for a company of Gazprom's size, it is significantly higher than the current debt ratios for its major international peers and the change over one year remains particularly alarming, especially in light of the company's changed circumstances.⁵² Another indicator of concern is the sharp change in the "acid test" or "quick" ratio, which measures the company's ability to pay back its current liabilities immediately if required. (It is measured as current assets less inventories divided by current liabilities). Although in normal circumstances this eventuality is very unlikely to occur, banks normally wish to see a ratio higher than 1 to feel comfortable about a company's liquidity (in other words a company which can pay off its short-term liabilities rapidly).⁵³ As can be seen in Figure 20, Gazprom's balance sheet liquidity has always resulted in a ratio higher than 1 until 2023, when it fell to 0.79 and has stayed there in H1 2024, again raising concerns about the company's debt levels and its ability to repay them.

⁵² As of year end 2023 BP's gearing ratio was 19.7% (<https://www.bp.com/en/global/corporate/investors/results-reporting-and-presentations/archive/4q-2023.html>) while Shell's was 23% (<https://reports.shell.com/annual-report/2023/consolidated-financial-statements/balance-sheet.html>) and Exxon's was only 5% (<https://investor.exxonmobil.com/earnings/financial-results>)

⁵³ For a definition of the "quick, or acid test, ratio" and acceptable levels see <https://www.wallstreetprep.com/knowledge/quick-ratio/>

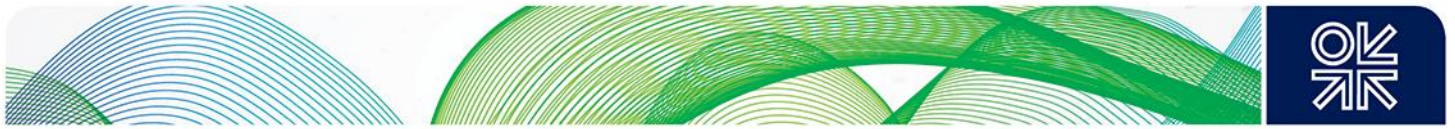
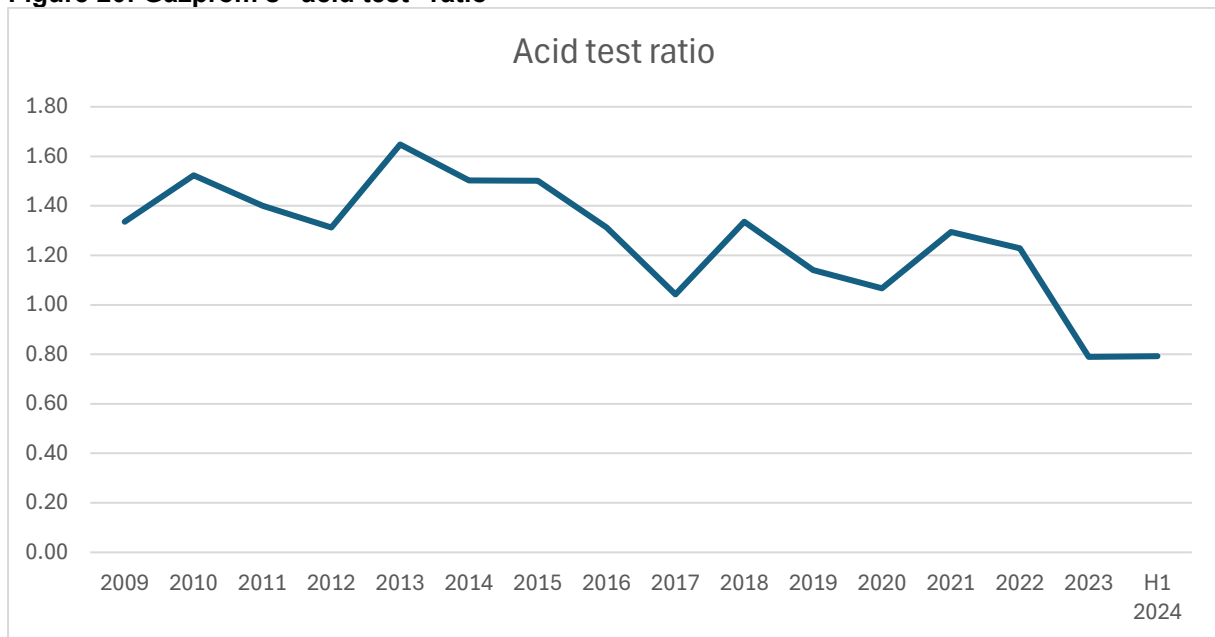


Figure 20: Gazprom's "acid test" ratio



Source: Gazprom financial statements, 2009-2023

Dividend payments have fallen dramatically

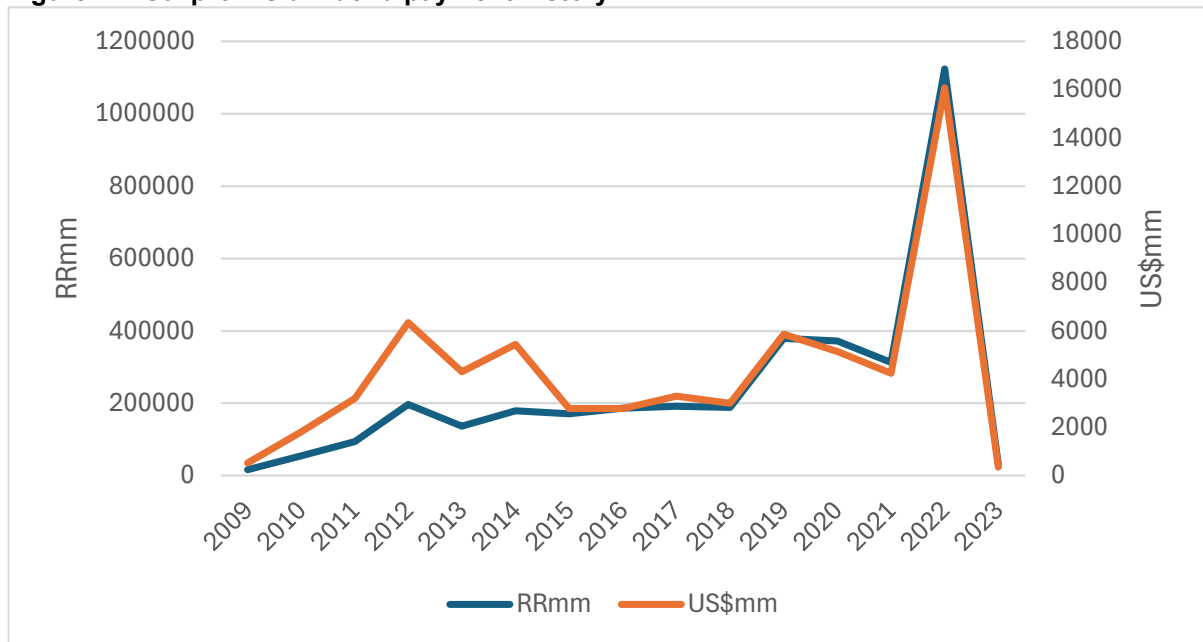
One final consideration is Gazprom's shareholders, which include the Russian government with a 50.1% stake. Dividend payments have been a reasonably significant part of the return to shareholders over the past decade, although they have fluctuated significantly as the company's policy is to pay out 50% of its adjusted profits.⁵⁴ This policy has developed over time and the total annual payout has increased from \$0.5 billion in 2009 to a record \$16 billion in 2022. A small payout of \$360mm was declared in the company's accounts for 2023, but the Russian government has subsequently ordered to company not to pay a dividend given its loss-making status.⁵⁵ As a result, shareholders will receive no payout for the year, with part of the explanation being the very large share of operating cashflows taken by the government. No dividends were paid in H1 2024 as is usual for the first half of the year, but if it remains in profit for the full 12 month period then a dividend should be expected after the year-end.

⁵⁴ For a statement by Gazprom on its dividend policy see Reuters, 30 August 2022, "Gazprom says H1 net profit \$41.8 billion, will pay dividends"

⁵⁵ Reuters, 20 May 2024, "Russian government tells loss-making Gazprom not to pay dividends for 2023"



Figure 21: Gazprom's dividend payment history



Source: Gazprom IFRS statements 2009-2023

Gazprom's valuation has collapsed

Given the analysis above it is no surprise that Gazprom's valuation has fallen sharply, with the added catalyst that many foreign investors have withdrawn from Russian capital markets.⁵⁶ The company's market value reached its all-time high in 2006-2007, when gas prices were at a peak prior to the 2008-09 financial crisis, with the company's valuation reaching \$330 billion.⁵⁷ However, the subsequent collapse in gas prices saw it fall back below \$100 billion rather rapidly and then the annexation of Crimea in 2014 and the subsequent political concerns saw it decline below \$50 billion. Interestingly, its value recovered in the late 2010s and had more than doubled to over \$100 billion by 2021 as export volumes to Europe continued to expand and investors started to ignore the political risks, but the full-scale invasion of Ukraine and the consequent collapse in export sales has led to a sharp decline to around \$40 billion (Figure 22). The significance of this decline, and its implications for the Kremlin, has been diminished by the fact that there is a clear acceptance that the war has inevitably undermined every Russian company's position in international capital markets, and indeed the valuation is now based only on the share price in the Russian stock market rather than on the company's ADRs.⁵⁸ Nevertheless, the fall in value does underline the collapse in Gazprom's international status and its commercial prospects, and is another factor in the destruction of value for Russian citizens as a result of the war in Ukraine.

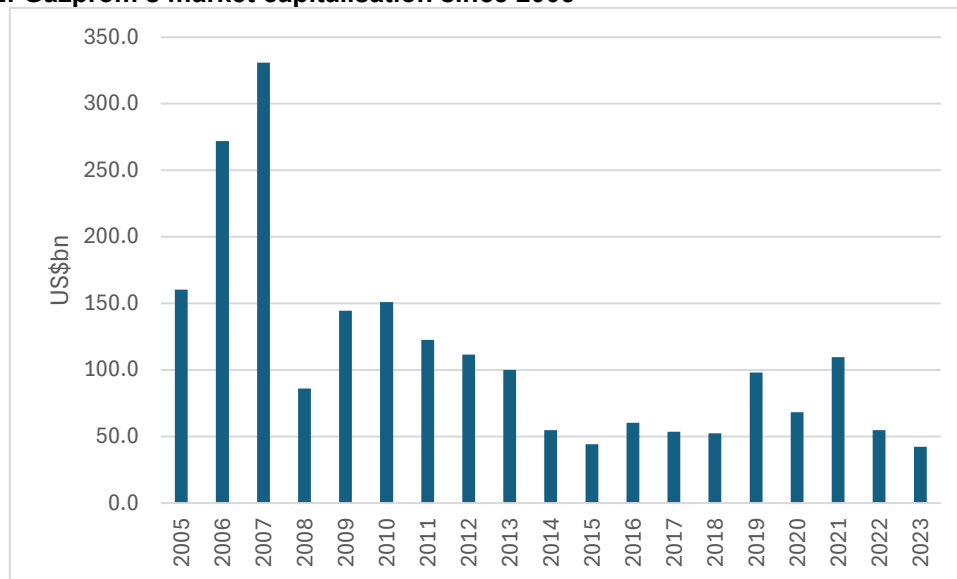
⁵⁶ Financial Times, 28 April 2023, "Russia's trapped domestic investors push stock market to 12-month high"

⁵⁷ Radio Free Europe, 7 May 2006, "Gazprom value soars, becomes world's third biggest company"

⁵⁸ American Depositary Receipts, through which Gazprom shares could be traded in New York and London



Figure 22: Gazprom's market capitalisation since 2005



Source: Gazprom in Figures 2011-2023

4. Initial conclusions on the future of Gazprom and the Russian gas sector

One and a half years of financial results is clearly a limited dataset from which to draw major conclusions on the future of Gazprom, and indeed the Russian gas sector as a whole, but the sharp change in the direction of travel and the known issues facing the company do point to a number of significant indications of future challenges, as well as some opportunities. We summarise these below, and will review them on a regular basis as Gazprom publishes future financial reports on a quarterly, half-yearly or annual basis.

1. Domestic market focus but potential for competition

Until February 2022 Gazprom had fulfilled its domestic market obligations as a state company providing a vital service to a gas-dominated economy. Gradual growth in gasification had underpinned the role of gas in supplying more than 50% of Russia's primary energy demand, and Gazprom's highly valuable export sales had allowed it to provide this source of energy to the domestic market at a barely profitable regulated price, effectively subsidising Russian industrial and residential consumers. As a result, it had been happy to see other producers take a significant market share over the past decade, freeing up its own gas for alternative and more profitable markets outside Russia.

However, the situation has now changed dramatically. Gazprom has a surplus of gas and a shortage of customers, and with the domestic regulated price rising sharply over the past two years it has an increased incentive to compete with companies such as Novatek and Rosneft for the premium domestic customers on which they have focused since 2010. The government may also want to encourage increased Gazprom market share, given that the company is paying a higher share of its revenues to the state in taxes than earlier and also because controlling and securing stable domestic gas supplies will be increasingly important politically if the economic and/or political situation should deteriorate.

With domestic gas demand continuing to rise, there may be space for all the competing parties to find room for growth, but Gazprom's dominant resource base and its spare production capacity means that it is well placed to undercut its main rivals. At present the limitations of the regulated price prevent it from doing this too aggressively and it will be interesting to see whether Gazprom suggests any adjustments to the regulated pricing regime, perhaps making it easier to offer more competitive prices. It will also be interesting to see whether rivals such as Novatek and Rosneft themselves demand any changes to prevent their own positions from being undermined too extensively. Overall, though, it is



clear that domestic consumers have already become a much more important market for Gazprom, in sharp contrast to the past three decades.

2. Change in export markets – lower volumes and value

Despite the growth in importance of the domestic market, export sales continue to provide the bulk of Gazprom's gas revenues, even if they are taxed more heavily. However, the new direction of export flows and their consequent lower profitability are certainly impacting the company. In Europe, sales to the EU have collapsed and may fall further as and when the Ukraine transit contract ends from 1st January 2025. This will leave Turkey as by far the most important European market (Gas purchases from Gazprom were 21bcm in 2023). Political relations between Russia and Turkey have been volatile, but it would seem that energy, and gas, will remain at the heart of the relationship.⁵⁹ However, the Turkish authorities have always been keen to negotiate for cheaper prices, and Gazprom has been instructed by the Kremlin to offer concessions, and so it seems unlikely that these export flows will provide as profitable a market as the EU.⁶⁰

The main growth will come from China, however, although its extent and timescale remains a matter of significant debate. Power of Siberia 1 will reach capacity of 38bcm by 2025, and an existing contract should see a further 10bcm arrive in the Far East via the Sakhalin-Vladivostok pipeline from 2027. The main Russian hope, though, is focused on the Power of Siberia 2 pipeline which could bring 50bcm of gas previously targeted at Europe to NE China via Mongolia. The main caveats are an apparent Chinese reluctance to commit and an obvious desire to use their bargaining strength to reduce the price.

A final source of export sales is countries of the Former Soviet Union (FSU). Belarus, the largest market, has signed a deal at a low price until 2025, and other FSU buyers are likely to have similar preferential deals, although volumes are likely to be limited. Interestingly, Russian interest in sales to Central Asia has been rekindled by a shortage of gas in the region and also by the potential opportunity to use the Central Asia – China pipeline as a route for further eastern exports. However, it will be crucial to see how relations develop with countries that have become used to a more diversified foreign policy and to no longer being subservient to their former Soviet master.

Overall, then, Gazprom's export sales seem very unlikely to recover to their former levels and those volumes which are sold overseas will be less profitable than historic sales to Europe. This leads to the clear conclusion that Gazprom will have less financial ability to provide subsidies, taxes and other sources of rent to the Russian economy. In addition, any hope that LNG sales could supplement Gazprom's export income seems to be forlorn, given the inclination of the US to sanction new projects and the fact that Novatek appears to be the Kremlin's favoured LNG champion for the time being.

3. Growing importance of liquids – what are the implications?

One of the most extraordinary features of Gazprom's 2023 and H1 2024 financial results is that it is arguably no longer a gas company, given that the majority of its revenues now come from other sources. The most important of these is liquids, which combines sales of crude oil, oil products and condensate. The first two of these are managed by Gazprom Neft, which Gazprom acquired under the name Sibneft in 2005 and which has now become its most important subsidiary.⁶¹ While it would be overly simplistic to suggest that the subsidiary is now dominating the mother company, it is certainly true that Gazprom Neft's 2023 and H1 2024 contribution was vital to Gazprom, that its reputation as a successful company is growing⁶² and that its leader, Alexander Dyukov, has been praised by President Putin.⁶³ Indeed the

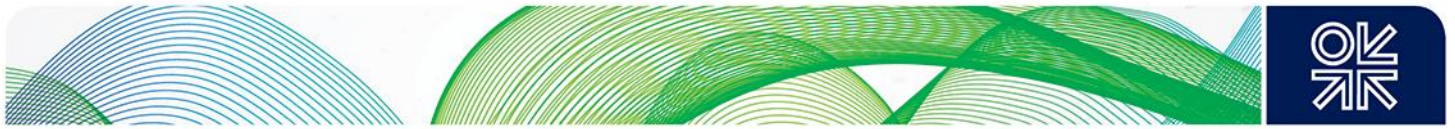
⁵⁹ Musil, P. (2024) "How Türkiye's balancing strategy between Russia and the West matters", Institute of International Relations, Prague

⁶⁰ Upstream Online, 10 May 2023, "Russia makes huge gas concession to Turkey" at <https://www.upstreamonline.com/politics/russia-makes-huge-gas-concession-to-turkey/2-1-1449161>

⁶¹ Financial Times, 28 Sept 2005, "Gazprom buys Sibneft for \$13.1 billion"

⁶² Energy Intelligence, 25 July 2024, "Gazprom Neft shows financial resilience"

⁶³ See Kremlin website at <http://en.kremlin.ru/events/president/news/74444>



market capitalisation of Gazprom Neft has at times been larger than that of its parent company,⁶⁴ again hinting at a change in the balance of power and certainly suggesting that it is sales of liquids that are now underpinning Gazprom's ability to provide gas at regulated prices in Russia. Indeed, it confirms that gas no longer provides a real diversification for Russia in terms of sales revenues, as even its major gas company is now relying on oil and oil products to survive.

The focus on liquids, and the potential importance of Gazprom Neft, is set to increase because of the enormous gas resources that have been identified in deeper layers under Gazprom's super-giant gas fields. Extraction of this gas is more costly and complex, mainly because it contains condensate that must be separated out before the gas can be transported by pipeline. However, the liquids revenue streams are increasingly valuable and can be exported more easily than gas, meaning that the overall economics of the fields is improved and on occasion is even driven by the liquids element. The issue has been on the agenda for several years, but the more technically challenging exploitation of the deeper layers does not fit Gazprom's structure well. As a result, the influence of Gazprom Neft may start to rise even more as it becomes involved in these fields. The Russian government is clearly interested in this area, as it is proposing tax incentives to Gazprom and others to exploit deeper layers.⁶⁵ Given the extra expenditure that will be required for processing and refining infrastructure as well as for transport of the liquids it will be interesting to see how Gazprom addresses this issue and whether it leads to a greater focus on its liquids business or a desire to diversify away from it and to make Gazprom Neft an independent company.⁶⁶

4. Will financial weakness lead to structural problems?

After a record-breaking year in 2022, thanks to historically high gas prices in Europe, it is clearly too early to suggest that Gazprom is in financial trouble after only one year of losses, especially as impairment charges had such a large impact. Nevertheless, the change in the company's fortunes in a short period of time has been alarming and some structural challenges have emerged. Lower operating margins suggest a business model that is now struggling, operating cashflow that does not cover capital expenditures hints at future problems with the asset base and rising gearing levels combined with a 'quick ratio' below one suggests that Gazprom's borrowings are at worryingly high levels relative to the cash being generated by the company. Furthermore, the level of write-offs suggests that even Gazprom acknowledges that some of its assets have no future value. With this in mind it seems clear that Gazprom needs to cut costs, and in late 2023 it announced a twenty per cent cut in planned investments for 2024.⁶⁷ This is unlikely to have a significant impact on its operations in the short-term, due to the excess upstream capacity that the company now has, but in the medium term Gazprom's ability to finance new infrastructure, such as the Power of Siberia 2 pipeline, may be in question. No doubt a solution will be found if a contract with China is signed, but it may be a solution that further undermines Gazprom's influence. Reliance on Chinese financing would create another level of dependency that the Kremlin and Gazprom would prefer to avoid, while support from the Russian state, or from state-owned banks, would underline the fact that Gazprom's position as a powerful source of positive income for the Russian economy has been significantly weakened.

An interesting indicator of Gazprom's intentions may be found in its attitude towards staff numbers. At present they appear excessive for a company with reduced market access, but Gazprom's social responsibilities and its role as a representative of the Russian state across the broad geography of the country may prevent any drastic action being taken. If employee numbers do not fall, and if employee costs continue to rise above the rate of inflation, then this will be one indication that Gazprom is returning to its roots as a state bureaucracy rather than retaining its status as a commercial company.

⁶⁴ Hellenic Shipping News, 13 Nov 2023, "Gazprom market value dips below that of oil subsidiary"

⁶⁵ Налоги на раз-два-ТРИЗ. [Taxes on one-two-TRIZ (short for unconventional oil)]. *Kommersant*, 30 October 2023. <https://www.kommersant.ru/doc/6310314>

⁶⁶ Energy strategy until 2035. Adopted by the Russian government, 9 June 2020.

⁶⁷ «Газпром» решил поменьше тратить. [Gazprom has decided to spend less] *Kommersant*, 23 November 2023. <https://www.kommersant.ru/doc/6352748>



However, there are already signs that Gazprom's social contract within the Russian economy is breaking down. Historically the company has been able to provide low domestic gas prices through an implicit transfer from its very profitable export sales. However, this arbitrage has more or less disappeared, and the government is being forced to increase domestic prices at a level not seen for the past decade or more. Furthermore, the extra funds are not being used to reinvest in Gazprom's business or to increase dividends, but are instead being transferred to the state budget due to the increased tax burden that the company is facing. Essentially, Gazprom is becoming a *de facto* tax collector for the Russian government, via increased domestic gas prices, rather than a rent distributor from the benefits of its export sales. With this perspective, the company's investment in further gasification of the Russian economy is more of an exercise in increasing the tax base for the Russian government rather than providing a benefit to the Russian people, and it will be interesting to see whether perceptions of, and support for, Gazprom diminish over time as a result.

Gazprom's ability to distribute rent has also been impacted in a more specific sense. Critics of Gazprom have often alleged that the company has failed to pay out its cashflows in adequate dividends, but instead has rewarded select individuals via its capital expenditure budget.⁶⁸ Specifically it has been alleged that investments have been steered towards companies controlled by elites with connections to the Kremlin, construction contracts (typically for pipelines) have been awarded at higher than market prices to favoured entities, purchases of assets outside the gas business have been made at excessive prices and gas has been sold at preferential prices to selected customers with strong political connections.⁶⁹ All these transfers have amounted to substantial income for well-connected business and officials, which means they have had an interest in upholding a system within which Gazprom has a dominant and special role. Critics of the structure have always argued that it is economically inefficient, and that more competition and transparency would yield better results for the state, but it may soon be the case that Gazprom can no longer afford to distribute so much rent in this fashion in any case. Reduced cashflow and increased tax payments will diminish the amount of revenue available for capital expenditure and other investments, meaning that support for Gazprom from the Russian elite may start to diminish, potentially threatening the company's dominant position. Indeed, this factor is likely to be even more important than the company's inability to fulfil its more general social contract, as ultimately support from the Russian political and business elite is likely to be a key precondition for the company's future.

5. Risk of restructuring or the road to complete dominance?

This raises the question of the future of Gazprom and whether, in the long-term, it will survive in its current form. In the short-term, and indeed potentially for as long as the Putin regime remains in power in Russia, dramatic change appears very unlikely, as it would destabilize a vital element of the Russian political economy while the country is on a war footing and would undermine the vital societal role that Gazprom still plays. Indeed, verbally President Putin continues to show unwavering support. In his congratulations to the company on the occasion of its thirty first anniversary, he praised its historical role as well as its ambitious plans, stressing that "Gazprom always works for the long term, in a strategic perspective, with understanding of state interests."⁷⁰ However, he did not provide any guarantees for continuation of the structure as it is today. The economic problems of the company make a case for reform but the physical structure of the gas sector - still very much a mirror of the centrally planned economy - limits the potential for rapid change. As such, the main risk to Gazprom would seem to be one of gradual decline into stagnation rather than a sudden reform shock.

⁶⁸ Aslund, A. (2016) "Russia Energy and the European Union", Petersen Institute for International Economics

⁶⁹ Henderson & Moe (2019), pp. 26-28.

⁷⁰ Поздравление по случаю основания ПАО «Газпром», [Congratulatory on the (anniversary of) the establishment of Gazprom] President of the Russian Federation, 17 February 2024. <http://kremlin.ru/events/president/news/73478>



Having said this, proposals for whole-scale gas sector reform have been put forward several times over the years.⁷¹ The argument is that free pricing, competition between suppliers, equal access to pipelines and a reformed taxation system would allocate resources efficiently, to where they are needed most. This would have great benefits for the Russian economy and on average could bring prices down. The downside is that it would create more volatility in the market with the possibility of big price fluctuations,⁷² and the fear of subsequent instability is a major reason why bold reform plans have been rejected to date. The present system is rigid, but the situation is seen as quite predictable with Gazprom playing a key role in the Russian political economy. Whether the stability that it has provided in the post-Soviet era can continue given the company's worsening situation is of course the key question.

A central component in previous reform proposals has been to separate out the ownership and management of the integrated trunk pipeline network to allow equal access and fair competition between producers. This has been a recurrent theme in proposals from Rosneft, which has argued that the sector would become more efficient, to the benefit of the country (but of course also to Rosneft).⁷³ Rosneft's objectives are clear, even if they now are expressed in less aggressive terms than before.⁷⁴ There is no sign at present that the Kremlin is open to this idea, but historical precedent would suggest that this may not be a barrier to long-term change. The example of LNG exports is a case in point. Over a period of 3-5 years in the late 2000s Rosneft and Novatek argued for broader access to the export market, and in 2013 a law was finally introduced allowing exports from specifically defined projects that included those not owned by Gazprom.⁷⁵ Since then, Novatek has demonstrated that private enterprise can produce hugely positive results, including the development of the Yamal LNG project on time and on budget, and prior to the war in Ukraine Russia had been set to become one of the largest LNG exporters in the world.⁷⁶ US and EU sanctions have now undermined progress towards this goal, but nevertheless the case for reform of a state-dominated system has been demonstrated. Furthermore, the fact that Russian LNG sales to Europe now exceed sales of Russian pipeline gas underlines how much progress non-Gazprom actors have made in export markets, and Novatek's partnerships with Chinese companies at its two Arctic projects also demonstrate the company's global reach.

However, the mention of LNG suggests an alternative, but equally controversial, outcome which might see Gazprom becoming more rather than less powerful if the state decides to exert even stronger, and more direct, influence over the country's energy economy. This could involve Gazprom taking over other parts of the gas industry, for example absorbing all the LNG projects via a takeover of Novatek, giving the government greater control over a key strategic sector involving access to global gas markets and use of the geo-politically vital Northern Sea Route in the Arctic. Given Gazprom's poor history in the LNG industry (it has failed to develop any new LNG projects during its entire history, although it has operated the Sakhalin LNG project that was developed by Shell), this would be unlikely to be an optimal economic outcome for Russia. However, given the increasingly political dynamics of the Russian LNG industry, involving sanctions, relations with China, transport through the Arctic Ocean and development of new strategic infrastructure and technology, it may be an option that is considered by the Kremlin. It must be acknowledged that recent indications do not point in this direction, as the latest adjustments of the rules in the sector have meant that Novatek is now allowed to export gas transported via Gazprom's

⁷¹ For example, Kryukov & Moe (2013), pp. 376-379 and Ahrend, R. (2004) "Russia's gas sector: The endless wait for reform", OECD, Paris

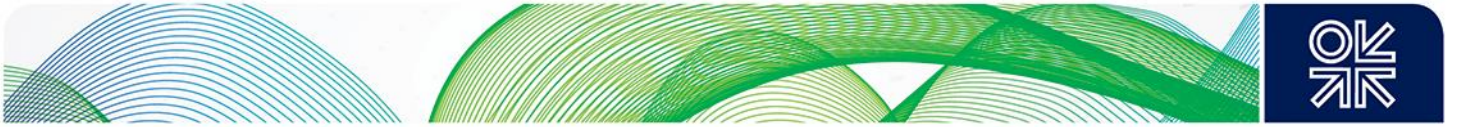
⁷² Gromov, G., S. Kondratyev, A. Shirov (2023). Внутренний рынок газа на историческом перепутье [The domestic gas market at an historical crossroad], *Energeticheskaya Politika*, September. DOI 10.46920/2409-5516_2023_9188_14

⁷³ Henderson & Moe (2019)p. 16.

⁷⁴ Игорь Сечин представил ключевой доклад на Энергетической панели ПМЭФ-2023. Rosneft, [Igor Sechin gave keynote address at the energy panel at St. Petersburg International Economic Forum 2023] 17 June 2023. <https://www.rosneft.ru/press/news/item/214813/>

⁷⁵ Henderson & Moe (2019), p. 137

⁷⁶ Moe, A. (2024). "Russian Arctic LNG Exports: From Success to Uncertainty", in M. Bergmann and O. Svendsen (eds), *Arctic Energy Security*. Center for Strategic and International Studies, Washington D.C. <https://www.csis.org/analysis/arctic-energy-security#essay-1>



pipelines.⁷⁷ Nevertheless, Gazprom has in the past argued for collaboration with Novatek on LNG projects, and if the latter starts to struggle as a result of sanctions on its projects then a politically driven consolidation may not be out of the question. It could, though, raise the question of who would be the dominant partner in any merger or takeover, with Novatek's reputation for operational and financial success being as high as Gazprom Neft's.

⁷⁷ Трубнодостижимый компромисс, [Elusive pipeline compromise] *Kommersant*, 11 October 2023.
<https://www.kommersant.ru/doc/6267915>