Commentary

The EU May Soon have Gazprom and Vladimir Putin Running on Fumes

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For all of President Vladimir Putin's rhetoric about Russian nationalism and economic self-reliance, he finds himself surprisingly constrained in his ability to respond to the European Commission's action against Gazprom.

The European Commission's decision to bring antitrust charges against the Russian energy giant sparked an immediate complaint from Russian Foreign Minister Sergei Lavrov. He loudly protested that the European Union was changing the rules in midstream. The European Union, however, was trying to send a different message to Russia: institutions matter, and Gazprom does not get a free pass around its rules.

The commission charged Gazprom with abusing its dominant market position and overcharging customers in several countries. As a state-owned firm with geo-strategic implications, Gazprom is no ordinary company. In addition, because the potential fines are significant — up to 10 percent of the company's global revenues — these antitrust allegations cannot go unanswered.

Yet Putin will have to respond at a time when the country's energy and economic options are limited. He also has to swallow the European Union's reminder that even after Ukraine, Russia is not an international rule maker.

The commission's "statement of objections" focused on Gazprom's use of market partitioning, which demands that gas only be used in the purchasing country and prohibits its re-selling. Such territorial restrictions violate the European Union's competition requirements, according to the commission, and have directly resulted in higher prices in five EU states — Bulgaria, Estonia, Latvia, Lithuania and Poland.

Russia insists, however, that because Gazprom is a state-owned enterprise, Europe's competition rules should not apply. Instead, as a "strategic" company (as designated by the Russian government), the European Union and Russia should resolve these charges on an inter-governmental level — not through the normal regulatory process.

Gazprom's designation as a strategic company has existed under Russian law for several years. The classification was created to make it more difficult for foreign investors to buy controlling interests in dozens of domestic Russian industries, including energy, technology and natural resources. Yet this term has no legal meaning outside Russia and is unlikely to persuade the commission to drop the charges.

It turns out that Gazprom has been seeking special status in Europe for years. To no avail. The EU Third Energy Package of 2009 calls for the separation of European energy suppliers and distributors. This requirement would undermine Gazprom's business model for Europe. For the energy monolith does not want to share its pipelines with other companies. Moscow ultimately refused to ratify the energy charter treaty and, in 2014, filed a request for consultations at the World Trade Organization, but with no evident change in policy.

Judging by the European Union's previous actions, the commission appears unwilling to grant any special exemption to Gazprom.

The charges against Gazprom confirm what has become increasingly apparent during the Ukraine crisis — Russia is far more integrated into the global economy than originally believed. These relationships can only be disentangled at a significant financial cost.

In reality, Putin's options on the energy front are limited. He could, of course, threaten the European Union with gas cut-offs, as he has done in the past. But that would deprive Russia — and Gazprom — of crucial hard currency earnings at a time when Russia finds itself in dire financial straits. Gazprom's net profits are already down 70 percent this year. With Russia facing major budget deficits and domestic workers grumbling about not being paid, Putin can't afford to lose even more money.

Putin could also pursue alternative markets for Russia's gas. Much fanfare accompanied the $400 billion Russia-China gas supply deal in May 2014. The ultimate profitability of this agreement, however, remains in doubt, primarily because the parties failed to divulge any price terms.

The pipeline's construction is years away from completion in any case, and there are already suggestions that, due to inflation and the decline in the ruble, significant cost overruns will occur. In the near-term, China cannot replace Europe as the major energy market for Russian gas.

Similar constraints exist in the financial markets. Putin, for example, wants to encourage Russian individuals and companies that have their money located in offshore accounts, to return it to Russia under a proposed amnesty. Such a repatriation of funds — without proper checks of the non-criminal origins of the money — runs afoul of the Financial Action Task Force anti-money-laundering recommendations. Russia does not want to be identified as a non-compliant jurisdiction by the task force, though, so the amnesty remains in draft form. And the Russian money stays overseas.

The lesson is clear. Russia is an integral part of the global energy and financial markets. Until such time that Putin can persuade other countries that Russia has a better rules-based system, he will have to abide by the present one.

Integration, it must be stressed, should not be equated with deterrence. As Putin has shown throughout the Ukrainian crisis, he is willing to act in open defiance of international norms no matter what the economic consequences. Putin's primary leverage remains his control over the level of violence in Ukraine — the world listens when fighting is threatened or ongoing.

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Putin cannot truly triumph, however, until he gets to re-write the rules of the game — whether on security, energy, trade or finance. Otherwise, he constantly will have to react to prevailing laws that Russia had no role in drafting.

The European Commission has reminded Putin that such a victory is a long way off.

The opinions expressed here are solely those of the author.

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