

Testimony before the United States Senate Committee on Foreign Relations

“Russia: Back to the Future?”

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Russia’s status as a current and future energy producer is close to unrivaled. It holds the eighth-largest proven oil reserves in the world, but ranks a close second in oil production to Saudi Arabia (at 9.3 million barrels a day), far ahead of most other world suppliers and well ahead of the United States (at 5.1 million b/d) and Mexico (3.4 million b/d). In fact, when both oil and natural gas exports are considered, Russia exports more hydrocarbons than Saudi Arabia.

Thus, Russia’s position as a major energy supplier has great significance not only for its own foreign policy development but also for its relationships with major energy consuming countries. During President Putin’s first administration, in the aftermath of the September 11, 2001 terrorist attacks on the United States, Moscow responded to its geopolitical circumstances as a growing supplier of hydrocarbons by initiating high level energy cooperation dialogues with important oil consuming countries, including the United States, China, Japan and the EU. Breathtaking reorganization and privatization in the Russia industry, while creating growing pains and financial inequities inside Russia’s economy, opened the promise to a steady expansion in Russian energy supply and a great opportunity for Moscow to tap its new position as a world energy superpower to build constructive and important links with other world powers.

By President Putin’s second term, however, a retrenchment back towards fuller state control and centralization of investment and export policy has aggravated political,

bureaucratic, commercial and regulatory barriers that could plague Moscow's ability to deliver secure and expanding supply. Indeed, Russian oil production has been relatively stagnant over the past year, after showing rapid gains between 1991 and 2003 (recovering from a low of 6 million b/d to 9 million b/d). There is still huge potential, with some analysts projecting that identified projects could contribute a further 2 million b/d or more to Russia's oil export rates over the next five years. But it remains unclear whether internal conflicts over ownership and control will adversely impact Russia's production rates, ongoing stability of supply and future export availability. It happens that the areas with the greatest expansion potential are production areas previously controlled by Yukos-- whose assets' ownership has been under a disruptive reorganization-- as well as prolific areas currently controlled by Lukoil, BP-TNK, and Sugutneftegas, the latter two who are currently fending off interference and investigations by the Kremlin.

The insecure nature of competitive and tense relations between the Russian government, the Russian government-controlled oil and gas monopolies, domestic private industry, and foreign investors remains a barrier to stability of Russian energy supply --both oil and natural gas. It is an area where creative American or multilateral diplomacy (say, under the framework of G-8 cross investment protocols or the European Energy Charter) could perhaps ease pressures on some key projects. But the current trend towards the "politization" of energy, culminating in the short but unexpected cut-off of Russia gas supplies by Russian state gas monopoly Gazprom last January during a conflict between Russia and the Ukraine over pricing and politics, has left a bad taste in everyone's mouth and bodes poorly for Russia's potential status as an energy superpower whose supplier bona fides are willingly and comfortably accepted in the West. To quote Ambassador Keith Smith, "Gazprom's January 1 cutoff of natural gas to the Ukraine was a much delayed wake up call for Western Europe and the United States regarding Moscow's willingness not only to use its energy resources as political leverage in Europe, but also to undermine the new democracies that most recently emerged from decades of Kremlin control."¹

¹ Testimony Before the House Government Reform Subcommittee on Energy and Resources and the Subcommittee on National Security, Emerging Threats, and International Relations

As energy markets have tightened in recent years, the issue of energy security has risen to a higher order concern among major economies. At the same time, key oil producing nations have recognized their enhanced geopolitical position, increasing the leverage of these key suppliers in markets and opening the possibility for greater politization of oil as a commodity as seen in the rhetorical statements of leaders such as Venezuelan president Hugo Chavez and in new concerns about Russian energy politics. U.S. foreign policy has not yet adjusted to this new reality of politization. A hint emerged on the U.S. political scene with the debate whether China's national oil company CNOOC should be allowed to purchase U.S. oil firm UNOCAL. But the U.S. is not fully preparing to deal diplomatically with the emerging challenges of the politization of oil and the Energy Diplomacy and Security Act (S.2435) recognizes this deficit. There are multilateral institutions and trade and investment protocols that can be tapped to optimize U.S. energy diplomacy to address the politization of oil by large oil exporters and the U.S. could do a great deal more to enhance energy security by developing a more coherent, less reactive diplomatic strategy.

Attempts to politicize oil are not new. Indeed, even the U.S. itself is guilty of politicizing oil through its use of economic sanctions against oil exports and investment in countries of concern such as Iran and previously Iraq and Libya. But the impact of politically motivated linkages between geopolitical goals and oil were muted in the past because market supply alternatives were abundant enough to prevent any large supplier from gaining much leverage. Indeed, as history showed, Saudi Arabia's King tried to organize the use of the so-called oil weapon against U.S. support for Israel in 1967 but failed due to plentiful market conditions and lack of consensus among a group of suppliers. It wasn't until market conditions changed in 1973 that a boycott was able to be implemented in a more effective fashion. So it is today. Political actions tied to oil will have more impact because of the greater likelihood of creating a large price swing and the greater difficulty of shifting to alternative supplies.

During the Bush Administration's first term, oil market conditions facilitated the possibility of a commercially oriented strategy towards Russian energy. Indeed, a high

level dialogue was begun, led in the U.S. by our Secretary of *Commerce*, Donald Evans. The dialogue was even labeled as “commercial” with bilateral sessions entitled the U.S.-Russia Commercial Energy Summit. But as the trend line on U.S.-Russian relations has worsened and on oil and even natural gas to be viewed more in political terms, the U.S. commercial strategy towards energy dialogues has become less effective. A new strategy is needed that rests more with institution building in the international energy arena and taps the strategic and economic interests of key suppliers while simultaneously protecting the interests of major consumers.

It is in this broader context that the U.S. needs to consider its evolving relationship with Russia and the question of Russia’s geopolitical motivations in setting its international energy policies.

The security concerns of our European allies with regards to the supply of natural gas from Russia has come front and center since the brief tangle with Gazprom last January. However, in the technical community, even prior to the January conflict with Ukraine, questions were being raised about whether Russia was making the kind of investments needed to meet rising European demand for natural gas.

European demand for natural gas currently totals more than 18 trillion cubic feet (tcf) per year. As natural gas production in the U.K. North Sea declines, Russian market share could rise from around 28% in 2005 to 40% in 2015, according to some analyst projections. The Russian state-monopoly Gazprom supplied European countries with 4.8 tcf of gas in 2003, and contractual obligations portend an increase to 6.6 tcf by 2010. To meet rising European demand for gas, it was projected that Russia would need to expand development of natural gas fields and associated export routes on the Yamal peninsula and Shtokmanovskoye region but Gazprom was showing no inclination to press forward with these needed investments. Instead, the state gas monopoly was resisting needed reforms and liberalization in the Russian gas industry and embarking on a new strategy to diversify its asset base to include oil, power generation and now even a discussion of investment in nuclear power. Gas production has been relatively flat in Russia in recent

years, and many analysts were already predicting that Russian gas production could actually decline in the coming years. Some believe that without an influx of private capital, new exploration and transportation construction activities will fall short of both domestic and export market requirements. Major projects such as field development in the Yamal peninsula take as much as ten years to implement and discussion of such projects has not progressed in recent years. Instead, Gazprom has spent hundreds of millions of dollars acquiring new diversified assets such as Sibneft, a Russian independent oil and gas producer. The purchase raised new questions about how revenue constrained Gazprom will be able to raise financing for important gas export projects such as the \$35 to \$40 billion Bovanenskoye and Kharasaveiskoye fields of the Yamal Peninsula and the \$20 billion Stockman LNG project.

Thus, the question of the security of Russian gas supply to Europe goes beyond President Putin's near abroad policies towards Central Europe. It also rests with the state of internal policy of reform in the Russian gas industry where independent producers would be able to supplement production by Gazprom were the industry to be properly restructured.

Problematically, Russia is biding its time by grabbing trapped gas resources in Central Asia at very reduced prices and using those to supplement its own higher priced, lucrative gas sales to Europe. Negotiations between China and Turkmenistan to conclude an elaborate gas export plan that would create an export grid from Turkmenistan and including Uzbekistan and Kazakhstan to pipe natural gas to Western China and into China's existing West-East pipeline would throw a monkey wrench in Gazprom's ability to control Central Asian supply. Were the Central Asian states to find an independent outlet for their gas, it would reduce Gazprom's flexibility to meet European demand with its purchases from these Caspian producers. The geopolitics of such machinations is complicated by Russia's own gas sales dialogue with Beijing that includes a planned sale of 80 billion cubic meters of Russian gas per year to China via two pipelines. The sale of BP-TNK's Udmurtneft subsidiary to China's Sinopec is the first step in this process, and senior Russian officials linked the sale, which involved the vast majority of the asset to be retransferred back to Russian state monopoly Rosneft, to a demonstration that the

Kremlin was serious in its threat that it could shift its supplies to Asia, were Europe to be too belligerent to growing tensions over the Ukraine incident and Russian aspirations to buy into key gas and power companies in Europe.

In analyzing the real impact of Russia's contention that it can shift its sales East, it is important to recognize that this is not an immediate threat. Since Russia does not sell seaborne cargoes of natural gas in the form of LNG, it has little flexibility to change suddenly the flow of its gas exports which are wedded to European markets by pipe. Pipeline connections to China will take years to build, with even the Udmurtneft gas a few years away from delivery. The more ambitious gas pipeline from East Siberia fields to China and Japan remains to be negotiated and would unlikely impact European supplies because supplies from those distant fields were never slated to traverse Russia westwardly. Even if a final deal with China for East Siberia were to move forward this year, which still is questionable, it would be difficult, given the magnitude of the construction entailed, for deliveries to commence before 2009, if even that early. Thus, the United States should not focus its attention on whether Europe's gas is about to be redirected to China because the reality is that for Russia to cut off its sales to Europe, it must spend billions of dollars constructing new infrastructure. In the short term, Russia's only option would be to forego gas exports altogether. The larger risk may well be that Russia cannot meet European needs due to its inability to reform and reorganize its sector in a manner that promotes commercial investment in the supplies needed to fill the new undersea Northern Europe Gas Pipeline (NEGP). There are good reasons to question whether Russia's sector will have the managerial skills, financing, and wherewithal necessary to meet Russia's export goals, even without any interference of intimidation strategies.

There has been no coordinated push by the U.S. and EU together to require that Russia reform and open its energy market to foreign investors as a response to the Kremlin's insistence that it can only meet Europe's growing energy demand if it be allowed to buy large stakes in key Western energy assets. We should be using the leverage of international institutions to press Russia to play by the same transparent, competitive

rules that guide energy investment and trade in the West. The pipeline monopolies of Transneft and Gazprom are contrary to the European Energy Charter (signed by Russia) and few countries are pressing the Kremlin on the subject of full reciprocity in investment policies even as the Kremlin is yelling for attention to its acquisition aspirations.

Gazprom is a monopolist and thus we shouldn't be surprised when it behaves like one, protecting its interests. Moreover, Russian leaders are responding to the popular sentiments of its locals. A recent poll taken in Russia as part of an academic study on energy and environmental issues by the Russian Academy of Science shows that 38% of Russians surveyed believe that keeping the status of superpower for Russia best meets their individual and family interests than strengthening democracy and freedom of speech (12%), with only economic growth mattering more. Less than 10% of those surveyed thought continued privatization was important while at least a third favor state regulation and support of basic industries. Over 68% felt foreign investment in the oil and gas sector was "not acceptable at all." The dismantlement of Yukos and its competitive market principles were highly popular in Russia as are policies that show that Russia remains a great country on par with other superpower nations. Thus, the temptation to use energy to assert itself, when other avenues are so clearly lacking, will be strong.

The extent to which Russia or any small group of gas exporters will be able to exercise monopoly power or utilize a gas weapon effectively will be determined, among other factors, by technological improvements that will affect the cost and attractiveness of other competing fuels such as coal, nuclear or renewable energy. Moreover, privatization of gas reserves and gas transport networks present an impediment to the formation of a successful gas cartel and blocks the monopoly power of a state actor such as Gazprom. It will be easier for national, state owned producers like Gazprom to participate in a cartel than for privately held firms that might have different objectives from the state. Indeed, already, Gazprom responded to pressures on it from Europe by soliciting coordinated strategies with another major European supplier, Algeria, which has long argued for a Gas OPEC.

If a number of private Russia gas producers emerge, it will be more difficult to reconcile their conflicting corporate ambitions, as the Putin Administration has so keenly experienced in recent years. Thus, the retrenchment away from privatization and market competition in Russia's energy sector runs against U.S. and global interests and should remain a target for the U.S.-Russia dialogue and the EU-Russia dialogue.

Options available to consumer countries are well known. Deregulating their own energy sectors, to permit utilities more freedom in setting prices, in choice of technology and in contracting with fuel suppliers will have the effect of increasing the elasticity of their demand for gas and limiting the market power of gas sellers. Consuming countries can also actively promote the technologies that will increase competition between gas and alternative energy sources. Also, as the EU is discussing, strategic inventories of natural gas will help limit the impact of any supply cut-off, reducing the incentive for an ambitious supplier to try to assert its market leverage.