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# Russian Energy Power and Foreign Relations

Implications for conflict and cooperation

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## 9 US energy policy and the former Soviet Union

### Parallel tracks

*Peter Rutland*

Energy security has been a central concern of US foreign policy at least since the oil crisis of 1973. However, despite the fact that Russia is the world's leading source of natural gas and second only to Saudi Arabia in oil production, the US has viewed Russian energy mainly through the prism of larger strategic considerations, such as competition for influence in the Caspian region, or a Russian threat to the independence of Ukraine. Plans to develop direct energy relations between the US and Russia have been slow to come to fruition, and only a handful of projects involving US companies inside Russia have got off the ground.

Over the past 20 years, US–Russian relations have seen a constant change between giddy cooperation and thinly-disguised hostility. This constant change makes it hard to predict the future path that relations between the two countries might take in the near or long term. The mutual fear that shaped relations in the Cold War was replaced by a period of partnership and cooperation, roughly from 1988 to 1999. Hopes for partnership were revived after the 11 September 2001 attacks united the two countries in what the US government of George W. Bush has referred to as the "war on terror," but this interlude was followed by a relapse into suspicion and disdain after 2003. It would be a mistake to exaggerate the degree of strategic partnership in the 1990s – but it would be equally unwise to underestimate the scope for cooperation in areas of common interest in the future.

In all of these various phases in US–Russia relations, energy has only played a secondary role. This is rather surprising, given the increasingly important place of hydrocarbons in Russian economic development, and the equally prominent role of energy in the US economy and in US foreign policy. But military and diplomatic factors have always taken priority in the relations between Washington and Moscow. Energy has become more visible as a topic of mutual concern in recent years – though its role has been that of a promise unfulfilled, or even a security threat, rather than a concrete partnership. Correspondingly, Russia has barely impacted the general course of US energy policy over recent decades.

The first section of this chapter provides an overview of US–Russian relations, focusing on the place of Russia in US trade and energy in particular. The second part addresses some of the major challenges facing these relations. These relations notably suffer from a Cold War hangover, as they are still largely based on strategic thinking and zero-sum considerations rather than mutual economic

interests. In fact, when it comes to energy, the two sides have clashed most notably in their struggle for influence in the Caspian region. The two sides also have very different views on the functioning of the energy market, with Russia showing increasing reluctance to allow access for US companies in upstream projects. The third part then offers some prospects for the future and argues, in the concluding section, that the scope for partnership is limited, since Russian and US perceptions of their respective national interests are pulling in different directions.

## Overview

This section puts Russian energy in the context of overall US trade and broader US energy policy. After a short historical account of US–Russia relations, the section discusses the various aspects of Russian energy that became relevant to the US and US energy companies after 1991. It also provides an overview of overall trade relations in order to explain the relatively modest place occupied by Russia in the overall foreign economic policy of the US.

### *Dealing with a new partner*

During the Cold War, US diplomacy toward the Soviet Union and US energy policy ran on parallel tracks, with relatively little overlap between the two. Washington's relationship with Moscow was focused on preventing nuclear war and containing the arms race, while also striving to limit Soviet expansionism in the Third World. These strategic concerns crowded out any substantial US interest in the USSR as an energy supplier. The Soviet Union had been exporting oil and gas to Europe since the late 1950s, forging ties with companies such as Italy's Eni that are still relevant today.<sup>1</sup> The US strongly disapproved of these relationships on strategic grounds, trying, for example, to block the construction of the Urengoi–Uzhgorod natural gas export pipeline in the early 1980s.<sup>2</sup>

The 1973 and 1979 oil price surges filled the coffers of the Soviet state, but unrest in East Europe and the foolhardy invasion of Afghanistan increased the burdens of empire to the breaking point. The global oil price fell sharply after 1985, triggered by a Saudi decision to preserve its market share by doubling production.<sup>3</sup> The price slump cost the Soviet budget about \$7 billion a year in lost revenue, increasing the sense of urgency behind Mikhail Gorbachev's desperate attempts at reform – efforts that actually brought about the system's collapse.<sup>4</sup>

After the break-up of the Soviet Union, the US national security interest lay in addressing urgent security concerns: downsizing of the Soviet nuclear arsenal and ending regional conflicts, such as the wars in the former Yugoslavia. Russia and the US did have one important common interest in the post-Soviet states – forestalling the emergence of new nuclear powers, and preventing the spread of nuclear weapons and know-how. Hence, in 1993–4, they were able to cooperate very effectively in persuading Kazakhstan to give up its nuclear weapons, and spirited away the nuclear-weapon materials.

The US was initially optimistic that what President Bill Clinton called a “market democracy” would take root in Russia. If Russia became a “normal” country, its energy resources could become fully integrated into the global market. However, in the meantime, the chaos of transition and the battle to privatize oil industry assets caused Russian oil output to fall by nearly half, from 11.4 mbd in 1987 to 6.1 mbd in 1997.<sup>5</sup> Strobe Talbott was President Clinton's point man for relations with Russia as deputy secretary of state from 1993 to 2000. It is striking that oil and energy are not directly mentioned at all in Talbott's 478-page memoir.<sup>6</sup> Talbott's focus was crisis management: shoring up Yeltsin's authority, arranging International Monetary Fund (IMF) bailouts, dealing with unsecured nuclear weapons in Ukraine, and handling the humanitarian crises in Bosnia and Kosovo. The main energy connection was nuclear power – with the US committed to an ambitious and costly plan to buy and process Russian plutonium. The Gore–Chernomyrdin commission was tasked with developing economic cooperation – including energy – though their focus seems to have been on strategic issues such as space launch and Russian arms sales to Iran.<sup>7</sup> More important for economic relations was the team of Larry Summers and David Lipton at the US Treasury. They concentrated on macroeconomic stabilization, managing Russia's foreign debt, and the conditionality of IMF loans. Energy rarely featured in their deliberations, apart from periodic fruitless efforts to persuade Moscow to liberalize domestic gas and electricity prices as part of the transition to a market economy (domestic oil prices were mostly freed by 1995, and moved up to near world levels).

### *Russia as an energy source*

The 1990s produced few concrete results for US energy interests in Russia. The privatization program mostly excluded foreign buyers from the energy sector, and Russia took in only \$3.7 billion foreign direct investment in the course of the decade. The first energy project involving a foreign partner to come on-stream, in 1994, was Conoco's Polar Lights joint venture in the northern Timan–Pechora field (that proved to be only marginally profitable because of the ever-changing tax regime).<sup>8</sup> By the end of the 1990s, joint ventures still only accounted for about 5 percent of Russian oil output.<sup>9</sup> US companies did acquire stock in some of the newly-privatized Russian firms, but such investments rarely led to more active cooperation. ARCO purchased 8 percent of Lukoil stock in the early 1990s, but this did not lead to the joint projects that ARCO had hoped for.<sup>10</sup>

The first big direct investment in Russian energy came when British Petroleum (BP) paid \$484 million for a 10 percent stake in Sidanco in 1997. But within a year, the venture was bankrupt due to the loss of a key subsidiary, rival Tyumen Oil. After BP took over Amoco, it quietly dropped Amoco Priobskoe joint project with Yukos in March 1999. A persistent BP returned to the Russian market in 2003, paying \$7.7 billion to form a 50/50 joint venture with Tyumen Oil (now renamed TNK). In September 2004, ConocoPhillips bought the last remaining Russian government block of shares in Lukoil, paying \$2 billion for 7.5 percent of Lukoil's stock.<sup>11</sup> ConocoPhillips subsequent

increased its holdings to an agreed limit of 20 percent, gaining a seat on Lukoil's board. Conoco is working with Lukoil in the Timan-Pechora basin, helping to develop the Varandei oil terminal on the Barents Sea. The company also pledged to support Lukoil's efforts to regain access to Iraqi oil fields, such as the West Qurna field, the rights to which it lost after the US invasion.

Three production sharing agreements (PSAs) were signed in 1993-4: two projects on the island of Sakhalin, led by Royal Dutch Shell and ExxonMobil, and the Kharyaga project in the Arctic, led by France's Total. PSAs exempt foreign investors from most tax liabilities until they recoup their investment costs. They are often seen by politicians, in Russia and elsewhere, as unfair deals that favor international corporations at the expense of weak states. Their advocates argue that PSAs may be the only way to get companies to invest in marginal fields and in countries where the risk of expropriation is high. The State Duma passed a law regulating PSAs in December 1995, but parliamentary opposition prevented any new projects from actually being authorized under the law. In January 2004, the Commission on PSAs cancelled a 1993 tender for the Sakhalin-3 bloc of oil and gas fields granted to Exxon, Mobil, and Texaco. Disputes delayed completion of the three initial PSAs, which did come on-stream in the early 2000s. Still, the Russian side complained that although \$18 billion had been invested in the three projects by 2006, they had generated only \$407 million revenue for the federal budget.<sup>12</sup>

By the 2000s, Russia had emerged as the world's second largest oil exporter, accounting for nearly 10 percent of global exports. But more than half of the world's oil reserves are still located in countries adjacent to the Persian Gulf. Russia's proven and probable oil reserves are nearly all located in remote regions of Siberia or north of the Arctic Circle, and it will be very costly to bring them to market. Russia has no spare capacity in either production or transportation to market, so it cannot hope to play the role of a swing producer, affecting the global price, now or in the foreseeable future. That role will continue to be played by Saudi Arabia. On the other hand, global discovery and development costs tripled between 1999 and 2006, to nearly \$15 a barrel, so if this trend is sustained in the future, it is more likely that Russia's expensive reserves will be brought into production.<sup>13</sup>

In the 1990s, Russia's newly-privatized oil companies started looking for investment opportunities in Western markets to capture more of the downstream profits from refining and retailing. The US market was also in their sights, since it accounts for one-quarter of the world's gasoline consumption. A breakthrough came in 2000, when Lukoil bought Getty Petroleum with its 1,300 gas stations in the US northeast.<sup>14</sup> It started re-branding some of them as Lukoil outlets in 2003. Led by Lukoil and Yukos, Russia started serious exports of oil to the US in 1999, averaging some 100,000 b/d (crude plus refined combined).<sup>15</sup> Deliveries increased to roughly 300,000 b/d in 2003 – though with strong fluctuations, peaking at 550,000 b/d in July 2003. In 2006, Russia exported an average of 100,000 b/d of crude and 223,000 b/d of refined oil to the US, rising to 120,000 and 420,000 in 2007. Still, that only accounted for 2 percent of US imports and less than

4 percent of refined imports, making Russia the fourteenth largest source of crude imports and the seventh largest in terms of refined product imports.<sup>16</sup>

Russia is the world's leading natural gas producer.<sup>17</sup> Sooner or later, should lead to closer economic cooperation with the US. To date, Gazprom only exported through pipelines to Europe, and has not operated any facilities to produce liquefied natural gas (LNG) that can be shipped in tankers to global markets. LNG sales accounted for 24 percent of the global gas market in 2002 and are expected to double by 2020.<sup>18</sup> The US, starting from nearly zero, is projected to become the second largest importer of LNG in the world (after Japan) by 2010 and the biggest in 2015.<sup>19</sup> Gazprom is keen to break into these lucrative new markets, but massive investments are needed. It is building two LNG facilities on Sakhalin, each with a capacity of 4.8 mt/y, which are expected to come on-stream in 2008. However, in February 2008, Gazprom announced it was dropping plans to build a \$3.5 billion LNG plant in the Baltic, given the priority of completing the Nord Stream undersea pipeline to Germany.<sup>20</sup> That decision forced PetroCanada to cancel its plan to build a new \$1 billion re-gasification plant at Gros Cacouna, Quebec, since that was expecting to be supplied with Russian LNG. Pending construction of its own LNG facilities, Gazprom Maritime began selling LNG it had purchased from other countries to the US. Gazprom made its first LNG delivery to the US in September 2005, in cooperation with British Gas, and in September 2006 delivered to Maryland another shipment of gas it had bought from BP's plant in Trinidad.<sup>21</sup>

US companies were disappointed to find themselves shut out of development plans for Gazprom's giant Shtokman Arctic off-shore field. The original shortlist of five possible foreign partners issued in 2006 included ConocoPhillips and Chevron. After repeated delays, Gazprom announced in July 2007 that it had selected France's Total as a partner, giving them a 25 percent stake, and in October 2007, another 24 percent stake was awarded to Norway's StatoilHydro.

### *US-Russian trade and investment*

The gradual and limited evolution of US involvement in Russia's energy sector reflects the general pattern of US-Russian trade and investment. According to Russian figures, the post-2000 Russian economic boom was accompanied by a doubling of Russian exports to the US, from \$4.6 billion in 2001 to \$8.9 billion in 2006. But as a proportion of total Russian exports outside the CIS the US share fell from 4.9 percent to 3.0 percent (see Table 9.1). Russian imports from the US also doubled during that period, from \$3.3 billion to \$6.4 billion, while declining as a share of total imports from 10.6 percent to 4.6 percent. In 2006 the US ranked ninth as a destination for Russian exports and fourth as source of imports (again, not counting CIS trade, which would push the US rank even lower). The falling US share of Russia's total trade means that at a macro level Europe remains the most important player in Russian trade policy.

According to the US International Trade Commission, Russia was the twenty-fifth largest trade partner for the US in 2006, taking 0.4 percent of



Table 9.1 US trade with Russia, 1995–2006 (Russian data)

	1995	2000	2001	2002	2003	2004	2005	2006
Exports to US (\$ mn)	4,315	4,644	4,198	3,989	4,216	6,624	6,323	8,922
% total*	6.8	5.2	4.9	4.4	3.7	4.4	3.0	3.0
Imports from US (\$ mn)	2,648	2,694	3,253	2,980	2,692	3,200	4,563	6,397
% total*	8.0	12.1	10.6	8.3	6.1	5.5	5.7	4.6

Source: Federal State Statistics Service, Foreign Trade of the Russian Federation with Far Abroad Countries, [www.gks.ru/free\\_doc/2007/b07\\_12/25-05.htm](http://www.gks.ru/free_doc/2007/b07_12/25-05.htm) (accessed 27 August 2008).

Note

\* Percent of all Russian trade outside CIS.

Table 9.2 US trade with Russia, 2005–07 (US data)

	2005	2006	2007 (11 months)
Exports	3,658	4,215	6,148
% of total US exports	0.4	0.4	0.6
Imports	15,325	19,642	17,675
% of total US imports	0.9	1.1	1.0

Source: United States International Trade Commission, <http://dataweb.usitc.gov> (accessed 27 August 2008); U.S. Census Bureau, Foreign Trade Statistics, [www.census.gov/foreign-trade/statistics/highlights/index.html](http://www.census.gov/foreign-trade/statistics/highlights/index.html) (accessed 27 August 2008).

exports and providing 1.1 percent of US imports (see Table 9.2). That means the Russia trade is even less significant at a macro level for the US than is US trade for Russia. But the absolute rise in trade is encouraging, and it suggests that increasing numbers of Russian and US companies are engaged in and profiting from the relationship. Fuel accounted for 48 percent of the US imports from Russia, followed by steel (11 percent) and aluminum (10 percent). US exports were led by nuclear machinery (29 percent), meat (15 percent), and vehicles (14 percent). Russia is the fifth largest export market for US-made oil and gas field equipment. In 2002, US exports of oil and gas field machinery to Russia totaled \$328 million.<sup>22</sup>

Foreign direct investment (FDI) has loomed large in the economic revival of many transition economies, from oil-rich Azerbaijan to the manufacturing giant of China. But post-Soviet Russia generally kept foreign investors at arm's length, despite its need for new capital to rebuild its obsolete industrial base. Total accumulated FDI as of June 2007 was \$179 billion – less than 10 percent of GDP, compared to more than 60 percent for Kazakhstan and 85 percent for Azerbaijan.<sup>23</sup> One peculiarity of FDI in Russia is that a very large proportion of the money appears to be Russian export earnings recycled through offshore bank accounts, since Cyprus accounts for \$37 billion and Luxembourg accounts for \$29 billion of the incoming FDI.<sup>24</sup> The US was in sixth place, the source of

\$7.4 billion of investments in Russia – 3 percent of the total stock. The pace of foreign investment has accelerated in recent years, hitting \$29 billion in 2004 and \$27 billion in 2005. US firms invested \$1.6 billion in the first nine months of 2004 and \$1.2 billion in the same period of 2005.

The United Nations Conference on Trade and Development (UNCTAD) data has the US as the top investor in Russia in 2002 (the most recent year for UNCTAD data), accounting for 22 percent of FDI stock, followed by Cyprus (19 percent) and Holland (12 percent).<sup>25</sup> The sectoral breakdown was for manufacturing (\$3.1 billion), petroleum (\$2.4 billion), telecommunications (\$2.8 billion), and transport and retailing (each \$1.6 billion). By 1999, two of the top ten foreign subsidiaries by sales were US companies: Nevamash, a joint venture of Caterpillar and Kirovskii Zavod in St. Petersburg, founded in 1994 (65 percent owned by Caterpillar), and the Svetogorsk paper mill, bought by International Paper in 1999. Conoco ranked twenty-second, just behind Coca Cola. GM and Ford opened construction assembly plants in Russia in 2002.

The largest single US investment in Russia is Chevron's 1,500-km, \$1-billion pipeline, built to carry crude oil from Kazakhstan to the Russian Black Sea port of Novorossiysk. In 1993, Texaco (now Chevron) entered Kazakhstan to develop the giant Tengiz field, in which it held a 50 percent stake, along with ExxonMobil (25 percent), Kazakhoil (20 percent), and Russia's LUKOIL (5 percent). Chevron and Lukoil formed the Caspian Pipeline Consortium (CPC) to build a new export pipeline with an initial capacity of 600,000 barrels per day. Construction began in 1999, and the first oil was loaded in October 2001.

A bilateral investment treaty between the US and Russia was signed in 1992 and approved by the US Senate that same year, but has still not been ratified by Russia. In 2005, the Overseas Private Investment Corporation (OPIC) provided \$119 million in guarantees and insurance for 29 projects, compared to \$99 million for 22 projects in the fiscal year 2004. President Clinton's International Clean Energy Initiative included efforts to promote US involvement in upgrading district heating systems, working through the joint Russian–American Center for Energy Efficiency in Moscow, founded in 1992.<sup>26</sup>

## Challenges

What are the major challenges facing US–Russian energy relations? The key question is whether US energy policy will continue to be heavily influenced by military-strategic considerations, under the general rubric of “energy security.” This approach has prevented the US from engaging with Russia on a more constructive basis on concrete economic and business considerations. Instead of strengthening the energy relationship with Russia, the US has looked for ways to contain the country's influence, especially in the energy-rich Caspian region. There were brief periods of rapprochement in the early Yeltsin years and after the 2001 attacks in the US, but otherwise, negative perceptions based on stereotypes from the Cold War have prevailed and form a major obstacle for the US to foster the partnership with Russia. Russia also must shoulder its burden of the blame for

the sorry state of the relationship, since domestic political considerations have repeatedly thwarted efforts to promote international business cooperation.

### *Shifting the trajectory of US energy policy*

For the past century, oil has been a key element driving the US economy, shaping US society, and propelling the US to superpower status. Japan's search for oil and the US embargo on oil sales to Japan were crucial factors triggering the Pacific War, from which the US emerged as the dominant world power.<sup>27</sup> The US itself began to import oil in the late 1940s, and securing a steady supply of oil for the world market became a key goal of US foreign policy. US domestic oil production peaked in 1970, and the share of imports in US oil consumption climbed from 34 percent in 1973 to 60 percent in 2007. Oil was viewed not just as a commodity, but as a component of national security, with uninterrupted supply seen as vital to US national interests. Given that the US alone accounts for one-quarter of global demand, for the past half century, US strategy has aimed at maintaining the *global* supply of oil. In contrast, for Europeans, energy security is more narrowly focused on diversity of supply, given that they get 44 percent of their natural gas imports and 30 percent of their oil imports from Russia.<sup>28</sup>

US energy policy has been built around the principle of maximizing supply to ensure cheap gasoline, preferably from a diverse range of sources to minimize the possibility of disruptions. The global price shocks of 1973, 1979, and 1990 rattled, but did not topple, this *laissez-faire* approach. The economic boom of the 1990s drove up commodity prices, with oil rising from \$17 to \$70 a barrel between 1997 and 2007. US dependence on imported oil became increasingly costly – to the tune of \$450 billion a year.<sup>29</sup> World demand for oil is projected to rise by 47 percent by 2030, driven by the opening of huge new markets in China and India, so there is no relief in sight in the future.<sup>30</sup> Adding to the US woes is the fact that since the 1970s, there has been a shift of control over reserves from international oil companies to sovereign states. By 2006, only 30 percent of OPEC production was in the hands of the oil majors, and 13 of the top 15 firms in the world league table of proven oil and gas reserves were state-owned, national oil companies.<sup>31</sup>

In February 1991, then-US President George H.W. Bush announced a new National Energy Strategy that tried to stimulate domestic energy production, but his initiatives were largely blocked by the Democratic-controlled Congress.<sup>32</sup> Likewise, President Clinton did not implement any new policies to reduce US dependence on foreign oil. Despite mounting evidence of global climate change, the US did not join the 1997 Kyoto Protocol.

How can the stubborn continuity of US energy policy in the face of mounting global challenges be explained? The critical school, exemplified by Michael Klare's book *Blood and Oil*, argues that since the 1930s, US policy has been predicated on military action to ensure the flow of cheap oil.<sup>33</sup> The 1980 Carter Doctrine pledged military commitment to ensure the continuity of oil supplies.<sup>34</sup> The fall of the Soviet Union made it easier for the US to use its military force –

hence the 1991 and 2003 Iraq wars, which were at least in part aimed at securing the vast deposits of oil in and around the Gulf.<sup>35</sup> Klare's approach is dismissed by the mainstream of US policymakers, but it is taken seriously in Moscow and elsewhere around the world. For example, in a January 2008 speech, retired General Makhmut Gareev, the president of the Academy of Military Sciences, said: "With the growth of the dependence of its economy on access to world markets and natural deposits, the military-force component of US policy will be systematically intensifying, including toward Russia."<sup>36</sup>

Since 2000, US energy strategy has continued to follow familiar principles: diversification of sources; moderate efforts to reduce consumption; and political interventions to build stability in the Middle East and Africa.<sup>37</sup> The mainstream US approach, which can be found in the authoritative collection on *Energy and Security*, edited by Jan Kalicki and David Goldwyn, is to assume that business as usual will persist for the foreseeable future. For example Adam Sieminski's chapter on world energy futures, written in 2005, assumes that the price of oil will drift down to a level of \$35 a barrel – which was the average price over the past 30 years.<sup>38</sup>

US strategy is driven in large part by the simple geo-economics of oil. More than half of the proven oil reserves are located in the Gulf. Those fields have low extraction costs, and Saudi Arabia alone has sufficient excess capacity to serve as a stabilizing force on the global market, if it chooses to play that role. However, Saudi spare capacity has halved over the past decade, from 3–4 mbd to 1–1.5 mbd, while the Middle East's share of global output has fallen from 40 percent in 1974 to less than 30 percent today.<sup>39</sup>

The inertia of US policy in the face of these global changes is somewhat puzzling. Why is it that no new auto emissions targets were introduced between 1986 and December 2007 and gas taxes are still one-quarter of European levels?<sup>40</sup> The monthly petroleum-related trade deficit went from \$6 billion in January 2002 to \$26 billion in June 2006, and in 2007, oil accounted for about one-third of the US \$450 billion annual trade deficit. The market has not forced adjustments in the US economy to correct this imbalance: the volume of imports has not decreased as price increased. Energy demand is inelastic, at least in the short run. Half of US oil consumption is for transportation, where machinery has a 10–15-year lifespan.

One additional factor contributing to the inertia of US energy policy is the fact that the countries with trade surpluses – not just the Saudis, but also China and Russia – prefer to save rather than buy goods. The recycling of super-profits from the petroleum industry has led to a surge of cheap capital that has made it easy for the US to fund its external and budgetary deficits (and its wars) through borrowing. In the long run, if high oil prices persist, we can expect investment to shift to less energy-intensive machinery. But in the short term, profits from oil go to elites and corporations with a vested interest in postponing policies to develop sustainable alternatives.<sup>41</sup>

In 2001, President Bush set up a controversial task force led by Vice President Dick Cheney, allegedly packed with oil and coal lobbyists, and whose membership the VP refused to divulge.<sup>42</sup> Despite conspiracy theories that hinted at far

machinations, the Cheney group produced an anodyne public report that reiterated long-standing policy principles of maximizing production, diversification of sources, and moderate promotion of conservation and renewable energy (including subsidized ethanol, a favorite of the farm lobby).<sup>43</sup> Russia only merited five paragraphs in the 170-page document. It was four years before the new national strategy was passed into law, in the form of the 2005 Energy Policy Act. Once again, this new legislation did not make any major changes in US energy policy.

In sum, the particularities of US domestic policy toward energy, which have very deep roots in the US political economy, have not been conducive to the emergence of a more fruitful relationship with Russia despite its role as a major energy exporter and the corresponding potential for mutually beneficial economic cooperation.

#### *Getting beyond the great game: US–Russian rivalry in the newly independent states*

While US companies encountered obstacles and delays in seeking involvement in energy projects inside Russia, they were generally welcomed as partners for the exploitation of oil and gas fields in Azerbaijan and Kazakhstan. The US had a strong strategic interest in bolstering the viability and legitimacy of the newly-independent states in Central Asia and the Caucasus. Oil-driven economic development would strengthen those regimes and help them secure their independence in the face of a possible resurgence of Russian influence. At the same time, developing a new export route for oil and gas across the Caucasus that by-passed Russian territory would be a way to reduce Western, especially European, dependence on Russia as an energy source. In addition, US corporations believed that the new governments of Azerbaijan and Kazakhstan would be more malleable than that of Russia, and perhaps offered better prospects for stable long-term partnership.

In September 1994, BP signed “the contract of the century” with the State Oil Company of Azerbaijan, and became the lead investor in the Azerbaijan International Operating Company (AIOC) developing the Azeri–Chirag–Guneshli (ACG) offshore fields. Production started in 1997, though the oil reserves proved to be below expectations and may peak as early as 2012.<sup>44</sup> BP operations in Azerbaijan became closely entwined with the rule of President Heidar Aliiev, who had returned to power through a coup in June 1993.<sup>45</sup> A complicating factor for the US government was that the strong Armenian–American lobby persuaded Congress to enact Section 907 of the Freedom Support Act, effective January 1993, which barred direct US aid to the Azeri government so long as it maintains a blockade and state of war against Armenia. In addition to Chevron’s involvement in Kazakhstan’s Tengiz field, in 1997 the company signed a joint venture with Lukoil to develop Kazakhstan’s Karachaganak gas field.

The main challenge was building a pipeline to bring Caspian oil to Western markets without crossing Russia. The US government put considerable effort into promoting the project. After several years of negotiation, in 2002, work

started on a pipeline to carry the oil from Baku via Tbilisi to Ceyhan, a port on Turkey’s Mediterranean coast. The BTC line became operational in 2006 with a capacity of 1 mbd. The \$3.9 billion project received loans from the World Bank and European Bank for Reconstruction and Development. The consortium that built the pipeline is led by BP (with a 30 percent stake) and includes the State Oil Company of Azerbaijan (25 percent), Chevron (8.9 percent), Statoil (8.7 percent), and half-a-dozen others. ExxonMobil declined to participate in BTC, considering it too risky and expensive.<sup>46</sup> The US government delayed approving OPIC insurance for the pipeline, insisting that the project must be commercially viable in order to receive government assistance.<sup>47</sup> In 2003, OPIC did provide \$142 million of financial support, but later criticized BP for failing to report corrosion problems with the pipeline that were revealed by environmentalists to the London *Sunday Times* in 2004.<sup>48</sup>

US interest in developing Caspian basin hydrocarbons was driven primarily by strategic concerns – the desire to build local state capacity and forge new partnerships with Western allies in the region, and to isolate Iran and Russia – rather than by a wish to increase the flow of oil to world markets, though these strategic and energy benefits were seen as developing in tandem. Despite US protestation that its involvement in the region was not aimed against Russia, Moscow tended to see the rivalry for Caspian oil and gas as a zero-sum game in which US advances would come at Russian expense. So the completion of the BTC probably hardened Russian resolve to continue its support for Armenia and separatist regions in Georgia, in a bid to block US strategic projection into the region.

The stakes increased with the realization in the early 2000s that there was insufficient oil in the Azeri sector of the Caspian to fill BTC. This meant that oil and gas supplies would have to be brought from the rich fields of Kazakhstan and Turkmenistan. Russia vigorously opposed such proposals, citing the lack of agreement over the legal status of the Caspian Sea to challenge plans to build pipelines across the seabed. At the same time, Moscow wooed Turkmenistan by offering higher prices for long-term gas delivery contracts, closing the gap between the price offered to Ashgabat and the price being paid by the Europeans.<sup>49</sup> Beginning in 2009, Russia will pay Turkmenistan “European” prices for the gas it buys.

NATO’s decision to enlarge into Central Europe in 1997 was accompanied by an eastward expansion of the activities of the Partnership for Peace organization, with the first joint exercises in Uzbekistan in 1998. The leaders of Georgia and Azerbaijan welcomed the prospect of NATO projecting influence into their region, and looked to Western help to regain control over breakaway regions that had established de facto independence with Russian military support. Meanwhile in Central Asia, guerrilla incursions into Uzbekistan and Kyrgyzstan in 1999–2001 threatened the stability of those regimes, and stimulated Russia to adopt a more proactive security role in the region. China has also become involved, through what became the Shanghai Cooperation Organisation (SCO), and through the construction of a pipeline to carry oil imports east across Kazakhstan.<sup>50</sup> China’s active policy of involvement in Central Asia was not



welcomed by the US, but neither was it resisted through any concrete actions or statements from Washington.

US policy has been contradictory. The US wants to limit Russian influence in the newly-independent states, while at the same time trying to maintain a working relationship with Moscow by insisting that US policy in the region is not directed against Russia. Russian policy has been more consistent, and over time, the Russians have persuaded Kazakhstan and Turkmenistan to continue shipping oil and gas across Russia, in part by using the legal ambiguity of the Caspian Sea to block plans for a trans-Caspian pipeline. It has invested in expensive new gas export pipelines across the Baltic Sea and Black Sea to reduce its own dependency on transit countries. Domestically, the Kremlin has effectively renationalized the oil sector and has been forcing foreign partners, one after another, to give up their majority control over joint ventures on Russian territory. The US has not been able to stop these developments, and has often been reduced to carping from the sidelines.

### *Hopes of a new partnership*

With the departure of Presidents Clinton and Yeltsin in January 2001, there were hopes that the two new leaders, Vladimir Putin and George W. Bush, could forge a new relationship. Initial conditions were not promising. The August 1998 financial crisis had shattered any illusions that Russia had completed the transition to a stable "market democracy." The angry Russian reaction to NATO's use of force in Kosovo in 1999, followed later that year by Yeltsin's nomination of 17-year KGB veteran Vladimir Putin as his replacement, and the outbreak of the second Chechen War, made Russia an even less attractive partner for the US.

However, President Putin espoused his commitment to market institutions and integration with the West. In June 2001, at his first summit with Putin in Slovenia, President Bush famously "looked the man in his eye" and "was able to get a sense of his soul."

Then came a series of attacks on the US in September 2001, and Putin's prompt offer of support. Putin seized the opportunity to align his interests with those of the US and fold the invasion of Chechnya into the so-called "global war on terror." US–Russia relations were back on track, and it looked as if a strategic partnership based on the solid ground of mutual national security interests might still be a realistic goal. At the same time, the fact that 15 of the 19 hijackers involved in the 11 September 2001 plot were Saudis raised severe doubts about the reliability of Saudi Arabia, the lynchpin of US energy strategy. Perhaps Russia, the world's second largest oil exporter, could be used to break the OPEC stranglehold on the global oil market.<sup>51</sup>

US business interests were also bullish because finally, in 1999, the Russian economy started rapidly growing, spurred by a 75 percent depreciation of the ruble and a rebound in the world oil price. By 2000, 70 percent of Russian oil production was in the hands of private companies, whose owners were aggressively

modernizing their operations: hiring Western managers, introducing international accounting standards, and seeking foreign share listings and asset acquisition. Russian oil output started to climb, accounting for 48 percent of the increase in world oil supply between 1998 and 2004.<sup>52</sup> Several of the Russian oil majors were actively looking for partnerships with Western companies. The merger of TNK with BP went through in September 2003, and Mikhail Khodorkovsky's Yukos, the largest Russian oil company, seemed to be preparing for a similar sale. Yukos was moving to break the monopoly of state-owned Transneft and build privately-owned export pipelines to Daqing in China and (in cooperation with other companies) to Murmansk on the Arctic Ocean.<sup>53</sup> It was argued that the rise of oil oligarchs was creating a new, pro-Western elite who could take control once Putin, a transitional post-Yeltsin figure, had stepped down. Khodorkovsky himself actively promoted such a scenario, investing heavily in Duma deputies (and Washington think-tanks) and hinting that he might challenge Putin for the presidency in 2004.

In this new spirit of cooperation, a joint US–Russian Energy Working Group met in Washington in April 2002. The following month, Bush and Putin issued a statement in Moscow promising "to develop bilateral cooperation on a mutually beneficial basis in accordance with respective national energy strategies and to reduce volatility and enhance predictability of global energy markets".<sup>54</sup> The first meeting of a new US–Russia dialog convened in Houston in October 2002 attended by the two sides' energy and commerce ministers and dozens of oil and gas company executives.<sup>55</sup> Russian producers hoped for access to the US market where margins are higher and demand was more buoyant than in Europe, where oil consumption is flat due to high taxes and conservation policies. The US government also promised to support Russian entry into the World Trade Organization, and to lift the 1974 Jackson–Vanik amendment that tied Russia's trade status to its emigration procedures. In return, there was talk of the creation of a US–Russian Strategic Energy Reserve, whereby the US would pay for reservoirs of Russian oil at sites such as Singapore and Nova Scotia that could be released in the event of a global market squeeze. The US side did acknowledge there were some "challenges" still to be overcome – such as the need for Russia to establish a clear legal framework and expanded export infrastructure. The US was still pushing for the revival of PSA agreements, which the Russian participants thought were no longer needed. Khodorkovsky was an enthusiastic participant in the Houston gathering, arguing that "Russia is a quite stable place" while recognizing that "there is clear resistance within the Russian energy sector elite and parts of the Russian government to changing the status quo."<sup>56</sup> The next year saw Russia attending an OPEC meeting for the first time as an observer in June 2003, followed by a state visit by Crown Prince Abdullah to Moscow in September 2003.

Even at the time, many independent US observers were skeptical about the scope for closer US–Russian cooperation. Victor and Victor wrote:<sup>57</sup>

Both governments do have a durable common interest in boosting Russia's oil exports: this benefits the United States through a more diverse world



supply and helps Russia by creating revenue and jobs. Intergovernmental relations, however, are not capable of exerting much influence over the business conditions that actually determine private investment in Russia's oil sector.

However, the tide of US–Russia relations turned decisively for the worse in the course of 2003. The arrest of several Yukos executives in July was followed by the detention of Khodorkovsky himself in October, on grounds of tax evasion. That dramatic step came just one year after the heady Houston summit, and just six months after Khodorkovsky had signed a pipeline agreement in the Kremlin in the presence of Putin and President Hu Jintao of China. Khodorkovsky's arrest was triggered by his political ambitions, and Putin's fear that Khodorkovsky could help non-government parties gain a strong foothold in the upcoming December 2003 State Duma elections. The main fear was that a Khodorkovsky-backed candidate could challenge Putin for the presidency in the March 2004 election.

In the wake of Khodorkovsky's arrest, the pro-Kremlin United Russia went on to a sweeping victory in the December 2003 State Duma elections, and Putin sailed to re-election in 2004. Later that year, Putin announced the abolition of direct elections for regional governors. Russia's return to a centralized, authoritarian system of power seemed complete. In the meantime, Khodorkovsky was sentenced to nine years in jail for tax fraud (reduced to eight on appeal), while Yukos assets were progressively seized for tax arrears and sold to the state-owned Rosneft.

The Khodorkovsky affair vividly illustrated the close connections between domestic and international politics. The deterioration in US–Russian relations was not simply caused by Putin's desire to consolidate his domestic power base. It also reflected a growing rift between Moscow and Washington due to international developments. The US-led invasion of Iraq in March 2003 was vocally opposed by Putin (and by the leaders of France and Germany). The US-backed "Rose Revolution" in Georgia in December 2003 set off alarm bells in the Kremlin, which saw a new US plot to encircle Russia's borders with pro-Western governments. A year later, the "Orange Revolution" in Ukraine replicated the victory of pro-Western forces in Georgia. That was followed by a "Tulip Revolution" in Kyrgyzstan in March 2005.

Russia's testy reaction to these developments included a temporary shut-down in Ukraine's gas supplies in January 2006, a step that stoked European anxieties about their dependency on Russian energy. The US saw an authoritarian revival in Russia on both the domestic and international fronts – a development fueled by the surge of revenue due to the rising price of oil. Speaking in Vilnius, Lithuania in May 2006, US Vice President Cheney accused Russia of using energy as "an instrument of intimidation and blackmail".<sup>58</sup> It became common to refer to Russia as an "energy superpower". For example, US National Intelligence Director John Negroponte described Russia as an "energy superpower" (albeit a "regional" one) in a January 2007 Congressional briefing on "Current and Future Threats to the United States" – a point that was not lost on Russian observers.<sup>59</sup> Moscow wants

to protect itself against future threats by building up its military muscle and by using its energy exports as a political weapon. Hostile countries will be punished by denial of energy supplies, while friendly powers will be rewarded by investments boosting energy supplies, perhaps a share for their companies in developing Russian oil and gas fields, and maybe even a price discount.

Over the five years since the Yukos affair, Russia's oil sector has been effectively re-nationalized. Apart from Rosneft's absorption of Yukos, Sibneft was forcibly sold to Gazprom. The future of Russian development is now in the hands of state-owned oil and gas corporations, directly controlled by the Kremlin officials who sit on their boards of directors. There are grave concerns that these quasi-political entities will focus their efforts on rewarding insider cronies and maintaining populist price subsidies. They are less likely to prioritize efficiency and rational investment planning.

The exclusion of TNK-BP from the Kovykta gas field and of Shell from the Sakhalin-2 energy project in 2006–7 were other clear signals of the change in course. A new subsoil resources law will bar foreign companies from holding more than 50 percent ownership of any field deemed "strategic."

The Russian government is confident that Russian oil and gas companies have the managerial skills to be the lead investors on new projects, contracting with Western firms for technical services as necessary. In ten years' time, we will have some idea whether they are correct. But in the meantime, these developments mean that US companies can only hope for service contracts and other junior roles in Russia's burgeoning energy empire.

### Signs of progress

While the overall prospects for the future of US–Russia energy relations look rather dim, there have been some positive developments in the last couple of years. Among these was the US acceptance of Russia's bid for entry to the World Trade Organization (WTO) in November 2006.<sup>60</sup> The US had been holding out for Russian concessions on food imports, liberalization of the market for financial services, and improved legislation on intellectual property rights. Russia had been negotiating for WTO entry for 13 years, and the US was the main hold-out in the round of bilateral negotiations with member countries. After the two sides failed to close a deal at the G8 summit in St. Petersburg in June 2006, Russia's patience was exhausted. Moscow slapped a ban on US chicken imports, citing sanitary concerns, and passed up a \$3 billion option to buy 22 Boeing 787 airliners. The WTO entry issue has some symbolic significance for the US–Russian relationship, but more than two years have passed (during which Ukraine was accepted for WTO entry), and it is still unclear whether Russia will actually join the organization.

Global warming remains an area of some promise for US–Russia relations. Although the two countries stand on opposite sides of the energy fence as an energy importer and exporter, respectively, they are both huge consumers of energy – and are the world's largest and third largest greenhouse gas emitters,

respectively (with China in second place). This means that they have a common interest in developing technologies and incentive systems to promote *mutual* action to reduce greenhouse gas emissions.<sup>61</sup> Russia's energy use per unit of GDP is three times that of Europe, so there is massive scope for cooperative cost-saving. Russia agreed to join the Kyoto Protocol in May 2004, after the EU gave up its insistence that Russia liberalize its internal gas market and agreed to support Russia's entry to the WTO. But the US has to forge a domestic political consensus for its *own* entry into the Kyoto process before it can start making deals with Russia. Interestingly, even the Pentagon is recognizing the problem. The Defense Department released a report on climate change in 2003, and in 2007 sponsored a CNA Corporation report "National Security and the Threat of Climate Change."

If the Democratic Party should gain control of the White House and Congress in 2008, we *might* see a major shift in US energy security policy, away from unilateralism and output maximization, toward multilateralism and conservation. But then again, we may not: the domestic policy process has been built up around the existing energy paradigm for half a century, and will be hard to transform.

In any event, Russia is unlikely to feature prominently in US policy. Policy papers advocating conservation in the US rarely mention Russia as a relevant actor.<sup>62</sup> A recent study by the Brookings Institution grudgingly concedes that "Russia will remain a major energy player on the global market for the foreseeable future."<sup>63</sup> But as a high-cost producer with no excess capacity, it will not be a market maker. The study also doubts whether Russian oil and gas recovery is sustainable, since "behind the scenes, Russia's entire political and economic system is extremely tenuous."

Either way, it seems that US policy will continue to move in the direction of isolating Russia. If Russian oil and gas stagnates, due to lack of competition and bureaucratic inertia, then the US will have to look elsewhere for increments to the global energy market. If, on the other hand, Russia's oil and gas output grows, it will be seen as a strategic threat, given its willingness to use those petro-rubles to project Russian political influence

## Conclusion

The past 15 years have seen the rise and fall of hopes for a breakthrough to partnership in US–Russian relations. Despite the ups and downs of the relationship, US energy policy toward Russia has remained fairly consistent. Key elements of the enduring US official policy remain as follows:

- Russia will need Western capital and technology to develop its oil and gas reserves. This is best done through foreign direct investment in projects where foreign companies have majority control.
- More oil and gas fields need to be developed and brought on-stream as quickly as possible.
- New producers outside Russia should be encouraged. Alternative export routes to bring their oil to world markets without transiting Russia are a priority.

- Oil and gas transit should not be a state monopoly and should not be used a political weapon.

On almost every point, Russian policy has become diametrically opposed to US interests. Under Putin, the state sector's control has risen from 30 to 70 percent and not even Russian private companies are allowed to have a majority stake, let alone foreign companies. Flush with cash, the Russian government is in no hurry to boost oil and gas production in the short run. Russia has tried its best to block or delay the construction of alternative export pipelines across the Caucasus and has used the North Stream and South Stream natural gas pipeline projects to forge closer ties with Germany, Italy, and other partners while blocking European efforts to develop a common strategy to decrease their dependency on Russia.

Overall, US energy policy toward the former Soviet Union has been something of a disappointment. This failure is partly because of the lack of imagination within the policy itself, and partly due to Russia's success in implementing its own policy agenda, which runs contrary to many of the US goals. US policy toward the post-Soviet states was predicated on false optimism about the speed of the transition to "market democracy" and on reservations about Russia's reliability as a strategic partner. US policy toward energy security has rested on myopic assumption that cheap oil supplies can be secured from the Gulf for the foreseeable future.

## Notes

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- 57 David G. Victor and Nadejda M. Victor, "Axis of Oil?," *Foreign Affairs* 82, no. 2 (2003): 47–61, at 47. They were wrong, however, about oil prices dropping, and wrong about Putin's inability to influence the oil sector. See also William Ratliff, *Russia's Oil in America's Future* (Stanford, CA: Hoover Press, 2003).
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- 59 Artur Blinov, "Moscow's Oil is the Chief Source of Threats to America," *Nezavisimaia gazeta*, 15 January 2007.
- 60 Peter Rutland, "Russia and the WTO: Deal, or No Deal?," in *Russia and the WTO: A Progress Report*, NBR Special Report, no. 12 (Seattle, WA: National Bureau of Asian Research, March 2007), 31–6.
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- 62 See for example Jonathan Elkind, *Building a Secure Energy Future: A Challenge for New Presidential Leadership*, Opportunity 08 Series (Washington, DC: Brookings Institution, August 2007), which concentrates on conservation as the new paradigm, with no mention of Russia or Central Asia.
- 63 The Brookings Institution, *The Russian Federation*, The Brookings Foreign Policy Studies Energy Security Series (Washington, DC: The Brookings Institution, October 2006), 2, [www3.brookings.edu/fp/research/energy/2006russia.pdf](http://www3.brookings.edu/fp/research/energy/2006russia.pdf) (accessed 31 August 2008).

## 10 Chinese perspectives on Russian oil and gas

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In this chapter, we examine the role of Russian oil and gas in the broader China context, including the main actors and perspectives on the Chinese side of the relationship, the exigencies of China's economic geography and energy market and the broader geopolitical situation. We argue that there is a match between Russian natural resources and Chinese markets, and that long-term developments in world politics as well as domestic developments in China and Russia constitute a foundation for extensive energy cooperation in the future. But there are numerous sources of tension in the bilateral relationship, particularly from the Chinese perspective. The most important are the slow speed at which Russia is proceeding with the development of new fields and pipeline construction, the unpredictability of Russian decision-making, latent rivalry in Central Asia, and attempts by Moscow to play off China and Japan against each other.

Beijing nevertheless views Moscow as a key partner, and as the only great power that is not in some way aligned against it. Moreover, Russian oil and gas can be brought to China overland, unlike Middle Eastern, African, or Latin American shipments. Russia's proximity means that its supplies carry a unique strategic significance for Beijing, which lacks a proper blue-water navy. China has regarded Russia as a strategic partner since the mid-1990s. It is possible, although far from certain, that Beijing may seek to employ Russia as a vehicle for a firmer alliance with the Shanghai Cooperation Organisation (SCO), which has sometimes been an effective multilateral shell, at times been a symbol of Chinese–Russian cooperation, and occasionally served as a platform for joint resistance to the increasing US influence in Central Asia. One reason for doing so would be to get stable and predictable access to Russian energy supplies.

The chapter is divided into three parts. The first part starts with a brief analysis of the history of Sino-Russian relations, and then evaluates China's national oil companies, the country's petroleum imports, and the place of Russian oil and gas in this picture. The second part of the chapter explores political, economic and environmental challenges to the Chinese petroleum sector. The third part examines the implications of these challenges for Sino-Russian relations and the rest of the world.