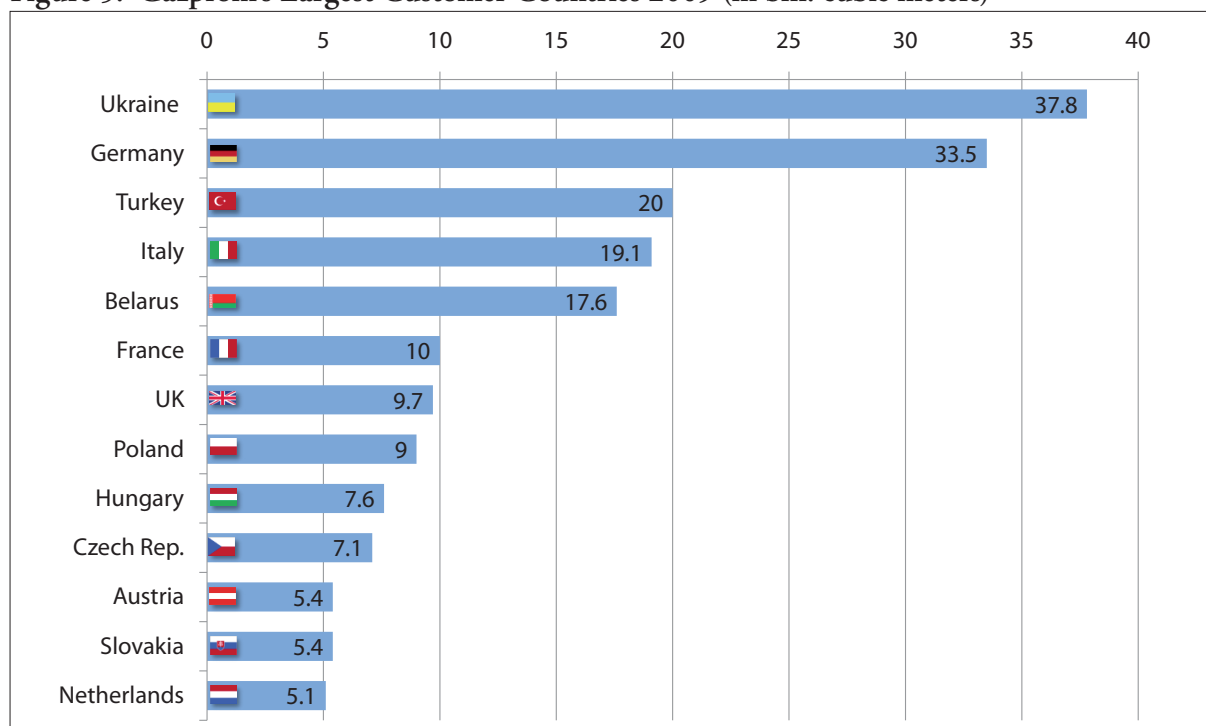


Figure 5: Gazprom's Largest Customer Countries 2009 (in bln. cubic meters)



Source: Gazprom company data, http://www.gazprom.com/f/posts/55/477129/gazprom_databook-en_1h_2010_1.xls

ANALYSIS

Conflict over Arctic Energy: States, Corporations, Politics

By Robert Orttung, Washington

Abstract

Most of the Arctic's oil and gas resources are located in Russian territory. While violent inter-state conflict is unlikely in the area, Arctic resources will be subject to business and domestic political disputes. Russia's unstable political system and thorny investment environment will make it difficult to conduct a far-sighted policy for developing Arctic resources.

State to State Conflict Unlikely

The extent of the resources available in the Arctic is unknown due to a lack of sufficient data, but the United States Geological Survey has concluded, based on a probabilistic model, that the Arctic contains 30 percent of the world's undiscovered gas and 13 percent of its undiscovered oil, mostly offshore in less than 500 meters of water (Gautier, 2009). Despite this treasure, conflict over Arctic resources is unlikely to involve violent state-to-state confrontation, though there are many unresolved issues among the various Arctic states that

are current subjects of dispute. Therefore, the region is not likely to be a focus of security concerns. Rather, the main forms of conflict are expected to be among business partners and within countries' domestic politics. These disputes are probably going to be acrimonious, but largely non-violent.

In contrast to the South China Sea, where tension has been rising over control of natural resource deposits between China, on one side, and Vietnam and the Philippines on the other, developments in the Arctic are moving in a peaceful direction. In May, the Arctic

Council signed its first legally binding treaty coordinating search and rescue activities in the polar area. Even though the Arctic plays a central role in the way that Norwegians and Russians conceptualize their national identities, on June 7, 2011, they culminated a 40-year process by signing and ratifying a maritime delimitation treaty. The deal included dividing up a large area of sea that is rich in fisheries and likely oil and gas deposits. In making the agreement, Russia had to overcome significant internal opposition, since it came around to a position that the Norwegian side had considered in the 1970s (Moe, Fjaertoft, & Overland, 2011). Some nationalist bloggers claimed that the deal gave Russian territory to Norway and warned darkly that President Dmitry Medvedev was next planning to make territorial concessions to Japan. Russian fishermen also complained about losing some of their prime fishing grounds (though they sell most of their catch to Norway anyway to avoid Russian customs). By drawing a firm line between them, both countries opened the door to exploration for hydrocarbons, which had been banned in the area earlier. The deal will make it easier for Russia to work with Norwegian energy companies who have the technology Russia lacks for off-shore development. Additionally, the visa-free travel for borderland inhabitants is Russia's first such arrangement with a Schengen country and may serve as a useful precedent.

But actual development of the resources is some time off. Given the harsh climate conditions, ice, water, and darkness in the Arctic, extracting hydrocarbons there is difficult and oil prices would have to be well north of \$100/barrel for production to be profitable. A more sensible strategy for Russia would be to develop resources that are more easily available and cheaper to produce in other areas.

The successful treaty signing is a dramatic change in mood from three years ago. On 1 August 2007, Russia planted a titanium flag on the Arctic seabed in order to bolster its territorial claims. Subsequently Canada increased its military presence in the high north and other states expressed displeasure with Russia's move. Russia did not follow up this bold act with further provocations and instead worked more cooperatively with the other Arctic states. On 28 May 2008, Canada, Denmark, Norway, Russia, and the US signed the Ilulissat Declaration, stressing that they were satisfied with the existing international agreements covering the Arctic. These agreements provide mechanisms for resolving territorial disputes, though some charge that they do not do enough to protect the Arctic environment (Casper, 2009).

Despite the apparent agreement, the potential for conflict remains. In 2012 Russia plans to resubmit its claim to the UN for the Lomonosov and Mendeleev ridges and the shelf area's presumed extensive mineral

resources, perhaps reviving the tensions that have been dormant since 2007. In July, the Commander of the Russian Northern Fleet Adm. Vladimir Vysotsky warned that NATO and Asian nation activities in the Arctic threatened Russia's economic interests and Russian Defense Minister Anatoly Serdyukov said that Russia was planning to deploy more troops in the north. Canada is planning its annual Nanook military exercise in the Arctic for August this year, again provoking Russian concern. The amount of ice in the region is shrinking, opening up greater possibilities for hydrocarbon development. It remains unclear if the methods of cooperation in the Arctic Council will be flexible enough to accommodate the quickly changing conditions in the Arctic, particularly as non-Arctic countries like China take a growing interest in resource and shipping potentials available there. In several cases, the Arctic border countries have a variety of overlapping claims that have yet to be resolved.

The United Nations Convention on the Law of the Sea (UNCLOS) remains the main instrument regulating international behavior in the area even though the United States Senate has so far failed to ratify this agreement. Both the Bush and Obama administrations have recommended that it do so, with little luck. Nevertheless, UNCLOS is effectively operating and most of the resources are located within the exclusive zones of the Arctic littoral states, limiting potential sources of dispute (Dolatat-Kreutzkamp, 2011).

Corporate Conflict

The real battles over resources in the Arctic today are among corporations. Since many of the resources potentially available in the Arctic are in Russian territory, international oil companies have sought out Russian partners. By Russian law, the only companies that can work on the Arctic's continental shelf are the state-owned and controlled Gazprom and Rosneft (Baev, 2010). However, these Russian firms lack the technology and financial resources to develop the shelf on their own and must find Western partners to work with them.

The most spectacular conflict so far pitted key Russian players in the energy sector against each other. On 14 January 2011 Rosneft and BP announced that they had signed an agreement to jointly develop offshore deposits in the Kara Sea in a \$16 billion share swap: 5 percent of BP for 9.5 percent of Rosneft. The BP press release described the deal as "the first major equity-linked partnership between a national and international oil company." The agreement looked like a big break for BP, which was still trying to recover from the damage to its reputation caused by its giant oil spill in the Gulf of Mexico during 2010.

Working with the state-owned Rosneft seemed like a good solution to the problems that BP had previously had in Russia. TNK-BP, BP's joint venture with AAR (Alfa, Access, and Renova, controlled in turn by Mikhail Fridman, Viktor Vekselberg, and Leonid Blavatnik) lost its license to develop the massive Kovykta gas field in East Siberia after coming into conflict with Gazprom. Since Rosneft's board chairman was Deputy Prime Minister Igor Sechin, a close ally of Prime Minister Vladimir Putin, this BP deal seemed to be protected from the kinds of conflicts that had derailed its earlier effort.

However, the would-be partners failed to consummate their deal when Fridman and his allies blocked BP from going ahead with its agreement with Rosneft. A Stockholm arbitration court on 6 May supported the oligarchs' argument that according to the deal between AAR and BP in setting up TNK-BP, BP could not form other joint ventures in Russia without working through TNK-BP. In blocking the deal, BP's oligarch partners gave up a chance to sell their interest in TNK-BP for \$32 billion, a move that they thought was not in their interest since the company pays several billion in dividends a year (*Kommersant*, June 23, 2011). In the wake of the conflict, the future of TNK-BP remains in doubt. Rosneft is currently negotiating with Shell, Chevron, ExxonMobil, Petrobras, Petronas, and others to be its main partner for future work in the Arctic.

So far all the sides say that they want to continue talks. At the same time, everyone seems to have lost from the conflict. BP has yet again seen its plans collapse in Russia, though it still benefits from its on-going lucrative venture in TNK-BP. Sechin looks weak since he was not able to bring the deal that he supported to fruition. TNK-BP and AAR have made powerful enemies in Sechin and Rosneft. Rosneft would have benefitted from BP's vast off-shore experience and its strong desire to sign a deal with Rosneft as it sought out new opportunities after the fiasco in the Gulf of Mexico (*Kommersant Oil and Gas*, June 16, 2011).

Domestic Politics

Plans to develop Russia's Arctic hydrocarbon resources put the region at the center of Russia's political system.

About the Author

Robert Ortung is assistant director of the Institute for European, Russian, and Eurasian Studies at The George Washington University's Elliott School of International Affairs, and a visiting fellow at the Center for Security Studies of the Swiss Federal Institute of Technology Zurich.

Further Reading

- Baev, P. K. (2010). Russian Policy in the Arctic: A Reality Check. In D. Trenin & P. K. Baev (Eds.), *The Arctic: A View from Moscow* (pp. 13–32). Washington: Carnegie Endowment for International Peace.

(continued overleaf)

Russia's political economy is based largely on exploiting oil and natural gas resources and some of the key conflicts that take place in Russian politics pivot around determining who controls these resources.

A central player in such battles is Sechin, the informal leader of the siloviki. His rise in Russian politics is closely associated with that of Vladimir Putin's and they have been close since their days working together in Leningrad. Sechin played a key role in the decision to prosecute Mikhail Khodorkovsky in the Yukos case and then managed the transfer of Yukos's most valuable assets to Rosneft. Sechin's continuing influence over Russian politics makes it unlikely that Russia will be able to modernize its political and economic systems (Sakwa, 2011).

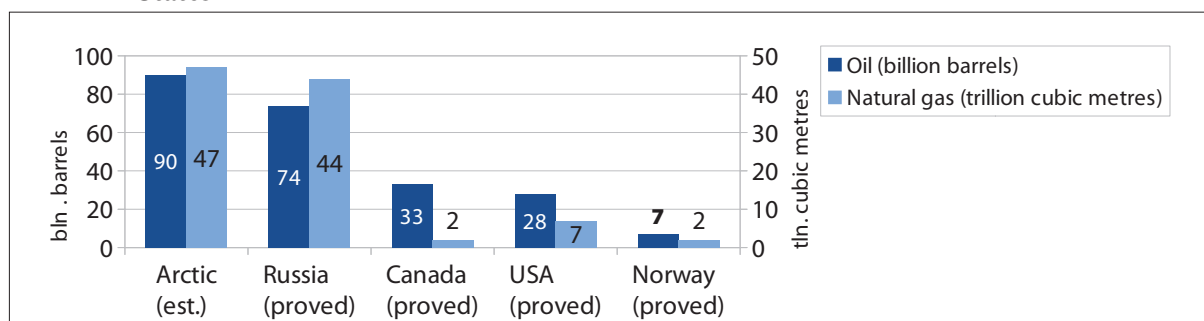
Sechin uses the opaque connections between the state and business to maximize his control. On 30 March 2011, Medvedev seemed to strike a blow against this system when he announced that he wanted all government ministers to give up their seats on corporate boards. This move forced Sechin formally to step down as the chairman of Rosneft, apparently reducing his control over Russia's energy assets. But, as usual with Medvedev's initiatives, the content did not live up to the form. Even as Sechin quickly resigned from Rosneft, his associates made it clear that he would still exercise control over the company through informal means. Accordingly, the factions inside the Russian government supporting and opposing reform will continue to do battle.

Conclusion

The unstable nature of the Russian political system, which is characterized by clan conflict rather than far-sighted planning, means that the country is unlikely to develop a coherent strategy to develop its Arctic resources. While violent inter-state conflict over the use of Russia's Arctic resources is unlikely, the increasingly intense struggles among the advocates of maintaining Russia's status quo political and economic system and those who want to pursue a path of reform means that the politics and corporate struggles surrounding Arctic policy will remain unsettled.

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Figure 1: Undiscovered Oil and Gas Resources of the Arctic and Proved Reserves of the Littoral States



Source: United States Geological Survey, July 2008, <http://pubs.usgs.gov/fs/2008/3049/fs2008-3049.pdf> (undiscovered resources of the Arctic); BP Statistical Review of World Energy June 2010 <http://www.bp.com/statisticalreview> (proved reserves of littoral states)

ANALYSIS

Liberalisation Heralds Change in the Gas Market

By Simon Pirani, Oxford

Abstract

The Russian government's efforts to liberalise the domestic gas market, and specifically to raise gas prices to levels comparable to those in Europe, will be a decisive factor in the country's energy sector over the next 5–10 years. Already, Ukrainian prices are close to "European netback" (i.e. European border prices minus export duties and transport costs)—and although Russian prices lag behind, sales across the former Soviet Union have become much more important to Gazprom, Russia's dominant, state-controlled gas company, than they were during the oil boom of 2002–08. In the domestic market, Novatek (Russia's no. 2 gas company after Gazprom) and the oil producers now account for one quarter of sales, and are giving weighty political support to liberalisation.

The European Netback Principle

The Russian government finally decided on gradual gas market liberalisation in 2006, as a corollary of liberalisation of power and heat markets (which account for more than half of domestic gas consumption). The key decree, no. 333 of May 2007, provides for domestic gas prices to move up in stages according to the principle of

"equal profitability of gas supply to domestic and foreign markets" (i.e. European netback), and for other steps to end Gazprom's quasi-monopoly of domestic sales and control of the pipeline network through which gas is transported to customers.

In ruble terms, Russian consumers pay roughly nine times more for gas than they did in the late 1990s. But