Analysis

Russian Energy Power Abroad

By Jeronim Perovic, Zurich

Abstract

Energy lies at the heart of Russia's economic recovery. The wealth generated from energy exports has gone hand in hand with political stabilization and has contributed significantly to Russia's assertiveness in international politics. Energy has emerged as a key factor shaping Russian's foreign relations. But it is difficult for Russia to use energy as leverage in a market where buyers, sellers, and intermediaries are so inter-connected. The interdependencies in the energy market are complex, and changes in the system can easily lead to conflicts that might ultimately also affect Russia in a negative way. Russia thus has to maneuver carefully in its decision-making, since the stability of the system also depends on the choices that the EU, Russia's neighbors, and the US make.

Russia's Role for Eurasian Energy Flows

As a major supplier of fossil fuel, Russia plays an important role for global energy security. According to the most recent European Commission figures, 27 percent of the oil and 24 percent of the gas consumed in the EU are of Russian origin. Of EU imports, 30 percent of its oil and 44 percent of its gas come from Russia. Some of Russia's post-Soviet neighbors (e.g., Ukraine, Belarus, Armenia, Georgia, and Moldova) as well as other non-EU states (especially the western Balkan countries and Turkey) are likewise dependent on Russian energy.

Russia also represents the most important channel for Eurasian energy flows. The country is the main export outlet for Central Asian gas and oil and the most important consumer of gas from Kazakhstan, Uzbekistan, and Turkmenistan. Recent developments have only had a small impact on this picture. Some of the Caspian oil and gas exports sent westwards now circumvent Russian territory via newly constructed pipelines from Azerbaijan through Georgia to Turkey. Small amounts of Turkmen gas flow to Iran by pipeline, and some of Kazakhstan's oil is shipped to China via a new pipeline.

Furthermore, Russia is seeking to become a key player on the Asian oil and gas markets. While the Sakhalin fields already provide some energy to countries in the Asian-Pacific region, plans are underway to explore and develop East Siberian oil and gas fields and to build a network of oil and gas pipelines connecting this region to Asian consumers.

Concerns about Russia

Russia has received bad press for its foreign energy policy. The price dispute between Gazprom and Ukraine, for instance, which ultimately prompted Russia to cut off gas deliveries to Ukraine in January 2006, has sometimes been portrayed in Western media as a politically-motivated action and "punishment" from the Kremlin for the country's "Orange Revolution" of 2004. The construction of a pipeline from Russia to Germany under the Baltic Sea and the penetration of the European energy market by Gazprom and other Russian energy companies are often seen as part of a "divide and conquer" policy aimed at undermining efforts by European Union members to pursue a common European energy policy. Russia's declared goal of entering the Asian energy market is frequently depicted as an attempt to play off East against West.

Russians argue that their actions are driven purely by business interests as they seek to secure the highest possible return for their energy sales. While Russian motivations remain a matter of contention, many are beginning to fear that Russia is simply not investing enough in its production capacity to provide sufficient oil and gas to meet growing European demand while satisfying new Asian customers. Russia's ability to meet future world demand is becoming a question of increasing anxiety. Russian companies have been increasing their investment in upstream projects recently, but the question ultimately remains whether new fields will come online *before* existing production falls to a point where Russia will not be able to meet the projected output increase (see also Indra Øverland's article in this issue).

Nevertheless, Russia certainly has every interest in keeping a strong profile as an energy supplier to international markets. The energy sector is the motor of Russia's economic growth and the massive rents generated from oil and gas sales are highly important for Russia's state revenues. In 2006, the Russian budget received close to $50 billion from oil export duties. Almost half of Russia's total export earnings are oil-related.

Russian-European Energy Relations

Europe is by far Russia's most important trading partner. Given the very strong mutual dependencies between Russia and Europe, it is at present hard to imagine that either side would see a benefit in applying sanctions against the other. Around two-thirds of Russian gas and oil exports go to EU member states, while the rest is sold to other European countries and the CIS states. According to European Commission figures, in 2005, the EU accounted for some 56 percent of Russia's exports and around 45 percent of its imports. In such numerical terms, the significance of Russia for Europe is relatively small. Russia is certainly important as a supplier of oil and gas to Europe, but its role is also confined to these two commodities. Overall, in 2005, the country accounted for only about 10 percent of EU overall imports and consumed a little more than 6 percent of EU exports.

Although in terms of overall trade volumes, Russia is clearly much more dependent on Europe than vice versa, it is the *quality* of the dependency that makes Russia equally important to Europe. Oil and gas are commodities of the highest strategic importance, and Europe at present cannot do without Russian supplies. A hypothetical stop of Russian oil deliveries would hurt Europe less than a disruption of gas supplies, however, simply because all of the gas that Europe imports from Russia arrives through pipelines and there are currently no alternative sources. The physical connection between consumers and producers is less immediate in the case of oil, where most imports arrive by tanker, and where shortfalls could theoretically be balanced via imports from other places.

Europe could gain leverage in dealing with Russia if the members of the EU decided to speak with one voice towards Russia. As long as European countries prefer to deal with Russia on the basis of individual bilateral relations, the EU cannot bring the full potential of its leverage to bear. This is why the EU has so far failed to achieve reciprocity in its energy relations. While Russian companies are allowed to enter the EU downstream market, EU and foreign companies still face obstacles when seeking similar access in Russia. The state-controlled Gazprom monopoly controls 85 percent of gas production and all major gas pipelines and the state monopoly Transneft operates Russia's oil transportation system.

The EU has made a series of efforts to increase the pressure on Russia, for instance by a EU Commission proposal in summer 2007 that aims to break up big utilities that control power supply, generation, and transmission. While this planned legislation is directed at some of Europe's own big energy utilities, it would also effectively bar foreign companies such as Gazprom from controlling European networks unless they play by the same rules as EU companies and their home country has an agreement with Brussels. While this plan faces opposition from within the EU itself, Russia has also reacted angrily, and it still very uncertain whether this plan will be implemented in the near future. For the time being, however, the disputes in European-Russian relations are not reflected at the general level of business cooperation or in day-to-day politics.

Energy Dependencies between Russia and its Post-Soviet Neighbors

Energy is also a major element in Russia's relations with its post-Soviet neighbors. Russia is important for the region in two ways: as a customer and transit country for Central Asian gas and oil, and as a supplier of oil, gas, and electricity to energy-poor countries like Georgia, Armenia, Moldova, Ukraine, and Belarus.

But Russia is also dependent on some of these states. Russia relies on Central Asian gas imports in order to offset declining production from its own major fields in Western Siberia. Ukraine and Belarus are important as transit countries for Russian gas and oil to Europe: About 80 percent of Russia's gas destined for Europe transits Ukraine. Russia's biggest oil pipeline, Druzhba, which accounts for about one third of Russia's crude exports to Europe, crosses Belarus. Even after the new oil and gas pipelines circumventing Ukraine and Belarus become operational, the bulk of Russian gas, and a significant share of Russian pipeline oil, will still pass through these two countries.

There have been two notable changes in Russia's approach towards its former Soviet neighbors in recent years: A first change is that Russia has stopped its policy of subsidizing other economies with cheap gas. Thus, from about 2005–2006 onwards, it started to raise prices to world market levels. It has occasionally done so in very bad style by abruptly shutting down energy supplies. But, even if Russia's price hikes should cause more friction in the years to come, this development would still be a healthy one, as it would end the subsidies to these economies of cheap Russian energy and would eventually help to stabilize relations between Russia and its neighbors based on market principles. In fact, Russia has been raising prices for its adversaries (e.g., Georgia) and allies (e.g., Belarus) alike, although at varying speeds. In some instances, Russia has even accepted that the price increase will result in a loss of influence. For example, Georgia, which until recently imported all of its gas from Russia, is increasingly turning to Azerbaijan and Iran as alternative sources for its imports. Azerbaijan has stopped importing Russian gas altogether and has tapped into its own domestic sources.

A second change has occurred in the way Russia handles the Central Asian gas producers. Russia is still the major outlet for the gas (and oil) extracted in the region, but given the competition from the EU, the US, and China for Central Asian energy, Russia has decided to become a more attractive customer by offering higher prices. While Turkmenistan sold its gas to Russia for $44 per thousand cubic meters of gas in 2005 (with only half of it paid in cash), the price was $100 in 2007. In the meantime, the two sides have agreed to raise the price to $150 by July–December 2008. Russia is also paying much higher prices for gas purchased from Kazakhstan and Uzbekistan.

In addition to price increases, Russia has also offered the Caspian states the opportunity to expand their direct outlets to the lucrative Western European market by using its transportation system. In December 2007, for example, Russia finally agreed to expand the capacity of the pipeline operated by the Caspian Pipeline Consortium, which transports mainly Kazakhstan's oil westwards. Moscow decided to expand the capacity after Kazakhstan consented to ship oil through the planned Burgas-Alexandroupolis pipeline, a trans-Balkan pipeline designed to take Russian and Central Asian oil from Bulgaria to Greece.

In the case of Caspian gas, Europe is now competing with China for supplies. Currently, Russia buys up Central Asian gas and uses it to supply its own domestic market and the markets of Ukraine and other CIS states, thus freeing Russian gas for export to Europe at a higher price than Russia paid for it in Central Asia. Should China manage to divert substantial parts of Central Asia's gas eastwards, however, the balance between the CIS and Russia will suffer, thus potentially leaving less gas for Europe. While both Turkmenistan and Uzbekistan have already concluded agreements with China on gas supply via new pipelines, Kazakhstan is also contemplating the construction of a gas pipeline eastward along the route of the existing oil pipeline.

Russian-Asian Energy Relations

The concern that Russia might divert increasing volumes of already scarce energy to Asia, mostly to China, thus leaving less for Europe, is a distorted view insofar as it leaves a key element of Russia's Asia strategy out of the picture: namely, that Russia intends to develop new fields in East Siberia and the Far East for the purpose of making additional oil and gas available for the Asian market (see also Nina Poussenkova's article in this issue).

However, Russia's diversification efforts towards Asia are not going as smoothly as planned. Apart from the Sakhalin oil and gas projects, other major projects – like the Kovytka gas field in Eastern Siberia – are still in the early stage of development. If the fields of Eastern Siberia are to be developed, the building of an extensive pipeline infrastructure to East Asia is of paramount importance. This, however, has also proved to be more complicated than anticipated. Negotiations with Japan and China have been going on since the early 1990s, but it is still uncertain when the pipelines will be built and become operational. Even the routes are still under discussion.

There are multiple reasons for Russia's failure to make much progress on the Asian energy front. In the area of gas, a major obstacle is certainly that Russia and China have not yet been able to agree on a price that will guarantee that Russia's large planned up-front investments will pay off within a foreseeable time span. Yet another, potentially more important issue is that Russia's policy towards China still seems to suffer from a psychological blockade fueled by decades of mutual mistrust. Russia understands that it has to engage with China for economic reasons, but it feels uneasy providing the fuel for China's modernization, which will inevitably accelerate the rise of a neighbor that could, from the Russian point of view, not only surpass Russia economically, but also pose a military threat in the future.

Even if pipelines are constructed that tie Asia to the fields in Western Siberia (a region that has traditionally supplied the European market), the key issue would likely not be politics, but the price that Russia's customers in West and East are ready to pay. As of now, Europe remains by far the most lucrative market for Russian gas and oil, and the most important source for generating Russian export revenues. Under normal political and economic circumstances, Russia is unlikely to redirect gas destined for its traditional costumers in Europe to Asia unless it can achieve similar or better conditions.

Contrary to what is often written in the Western media, the main point for Russia is not to balance Europe against Asia, but to establish a diversity of customers among the individual Asian countries (mainly China and Japan) and, in the case of Sakhalin, among Asia and the US. Russia seeks a diversity to reduce its dependence on any particular customer.

Energy and Russia's Future

The international markets are dependent on Russian energy, but Russia is also dependent on these markets. The real worry for Europe and Russia's neighbors is not so much with regard to Russia's foreign energy policy, but the role that energy plays for Russian domestic trajectories.

Energy has provided the fuel for Russia's economic growth and has helped to stabilize Russia after the political chaos and economic turmoil of the 1990s. But this stabilization has come at the expense of democracy and uneven economic development in favor of the raw materials' sector. The massive new wealth from oil and gas sales has also helped spur an increase in corruption and authoritarian tendencies. Russia's stability is very much linked to the ability of the ruling elite to redistribute rents in a way so as to accommodate the various conflicting interests in Russian society. At least indirectly, Russia's stability is thus tied to a well-functioning domestic and international energy market and stable prices. It also depends on Russia's ability to continue playing a significant role as a supplier of energy to international markets. Major disruptions would ultimately test Russia's precarious political stability.

The challenge for Russia's new president will be to manage Russia's energy wealth in the way that is best for the country's long-term political, economic, and social development. Such efforts can best succeed if Russia manages to develop a thriving liberal market that is at least to some extent dependent on an open society.

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Analysis

Russia's New Political Leadership and its Implication for East Siberian Development and Energy Cooperation with North East Asian States

By Yoshinori Takeda, Moscow

Abstract
The transition from Putin to Medvedev marks an important new beginning for the future of East Siberian energy resources and their impact on Russia's Asian neighbors. East Siberian resources have not been developed, but could have great impact on Russia's relations with Asia. China currently has the best relations with Russia, while Japan has made little progress, and Korea has secured one major deal. The Korean arrangements with Russia could serve as a model for future ties because they strongly favor the Russian side, which maintains a 60 percent share of the project while taking on little risk. In the future, Russia's energy decisions will continue to have strong political motivations, but they will be based on better defined rules of the game. Essentially, Russia will use its energy resources to develop the Russian state and only allow foreign companies to participate in projects that meet Russia's national interest.

From Putin to Medvedev
The process of political and economic modernization in Russia entered a new phase on December 10, 2007, when President Vladimir Putin chose First Deputy Prime-Minister Dmitri Medvedev as Russia's next president. Medvedev's nomination clearly demonstrates that over the next four years Russia will seek further economic growth and the social welfare benefits that derive from such growth. Medvedev has been a close ally of Putin's for the last decade, but he is not a former secret service officer. In addition, Medvedev is less hawkish than others surrounding Putin.

Meanwhile, the Russian government is moving extremely slowly in diversifying the economy, a move seen as necessary to ensure continuing economic prosperity regardless of the cost of raw materials. Since almost 70 percent of Russia's budget revenues and export value derive from primary commodities, Medvedev will have to take serious measures towards economic diversification while Russia remains dependent upon oil and gas. Against a backdrop of historically high oil prices, this economic course would help Russia pursue its geopolitical strategy in the foreseeable future and lead the nation to a position of global influence and power with its oil and gas reserves.

Among Russia's oil deposits, East Siberia is the most underdeveloped region. In 2006, its total crude oil production amounted to only 0.7 million tons, or 0.1 percent of the national total. Although East Siberia's oil reserve is estimated to be approximately 75 billion barrels (10.2 billion tons), proven crude amounts are only 7 billion barrels. In addition, exploration has barely begun beyond two fields – the Verkhnechon field in the Irkutsk region and the Talakan field in the Sakha re-