Meeting Summary
Russian Hydrocarbons: Economic Driver and Foreign Policy Tool?
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Presenters:
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This was the third of six meetings in the series, "Economic Change in Russia and its Implications for U.S. Policy," a CSIS project sponsored by the Carnegie Corporation of New York.

Russia's oil and gas sector – the primary driver of the country's current growth – will play a central role in the future of its economy. The two presenters offered different perspectives on the nexus between economic policy and natural resources in Russia. Chow's presentation focused on two main themes: the current state of the sector and the role of the sector in Russia's economic development.

In terms of production, the oil sector is in worse condition than gas. The reserve/production ratio in oil is slightly above 22 years, whereas the world average is approximately 40 years. The ratio for gas is about 74 years versus a world average of 60 years; however, for gas larger investments are necessary and there are longer lead times. There has been a significant increase in oil production in recent years (although it still is not as high as the Soviet-era peak); gas production increases have been minimal in comparison and mostly a function of Soviet-era projects. There is a major need for replacement of reserves and development of greenfield projects, such as Shtokman and Yamal.

In terms of policy, the Russian government's actions have allowed the state to reap most of the benefits of the high prices for hydrocarbons and to centralize authority over the sector generally. At prices of over $26 per barrel, the state – not private companies or shareholders – receives 90% of the proceeds, thus creating disincentives for production

increases and limiting cash flow for investment. Further, the government's policy of greater centralization has worsened the investment climate for both foreign and domestic producers. For example, Gazprom and Rosneft have *de facto* right of first refusal over all new auctions for offshore fields. Through such practices, the government has fostered short-term thinking and behavior, since firms have no confidence in the rules of the game.

Therefore Russia faces a condition that it need not find itself in: there are no new investments at a time of the most favorable oil and gas prices in a generation. In this sense, Russia finds itself in a league with Venezuela, Iran, Nigeria and Mexico. Why does this matter? In a cyclical industry, while prices are high, governments should be attracting high levels of investment. Several countries, such as Angola, Libya, Indonesia and Colombia, which previously had poor investment environments as a result of bad policy, are now using policy instruments to do just that.

The question is thus whether Russia will use its policy tools in the sector to bring more openness to the market and improve the investment climate, fostering greater economic development, or continue to centralize the sector, which is likely to retard production volumes. Chow pointed out that centralization can be appealing to all participants in the sector. For private firms, it means that there is only one relevant entity to which they need to be accountable; centralization mitigates political risks. Centralization is even more appealing to politicians and policy-makers. They find extracting revenue from the oil and gas sector more appealing than taxing the population, from which they might need to garner a political mandate. Windfalls from the sector can also be used to reward friends and punish enemies. Chow expressed doubt that a policy of continual centralization would deliver optimum economic performance in the sector in the long term.

Stulberg's presentation focused on the effectiveness of energy as a tool of statecraft and the relationship between energy wealth and great power politics. Russia's recent attack on Georgia has reignited this debate. US policy-makers, including Secretary of State Condoleezza Rice, have reacted by questioning whether Russia wishes to be a 19th century power or to play by 21st century rules. Stulberg argued that this frame is distorted, for several reasons: first, globalization does in fact create opportunities for great power politics; second, the frame ignores the variation in the degree of success of statecraft; and finally, the issue of continuity and change in tactics is not taken into account.

Stulberg went on to describe five common myths about Russia as an energy player in global markets. First, there is a notion that Europe's energy dependency on Russia is a one-way street. In fact, Russia receives the lion's share of its energy export revenues from Europe and has no near-term alternative to this market. The second myth is that Russia is an energy superpower. Stulberg contends that Russia is a *gas* superpower, given its massive reserves and high production levels. However, in the oil sector, Russia is a price-taker and a much smaller player —"it's no Saudi Arabia," as Stulberg put it. The third myth is that what is good for Gazprom is good for the state. In reality, there is a major divergence of interests between Gazprom and the state; after all, Gazprom is a profit-making (if not profit-maximizing) entity. Gazprom executives and policy-makers have differed on domestic prices, corporate governance, access to pipelines and investments. The fourth myth is that Russia has a grand strategy in energy diplomacy. The record suggests that multiple strategic objectives have been pursued at different times and that tactics have also varied and were often contradictory. The fifth myth is that Russia has had uniform success in its hydrocarbon diplomacy. In fact, it has had mixed success; in the gas sector, it has been very effective,

whereas in oil it has had less success. Further, it is unclear how to define "success" —is it the capacity to affect prices or demand, or to effect political outcomes such as regime change?

Stulberg's research has shown that the conventional wisdom that success or failure of energy diplomacy depends on demonstrations of crude, hard power, such as pipeline shutoffs, is also a myth. Instead, the salient factor has been shaping the opportunity costs and risks to prospective partners; or, in other words, setting the upside and the downside of different policy decisions. The challenge for Russia in dealing with a state that is in a risk-prone mode is to make gambling on deference the most attractive option; when dealing with a risk-averse state, the goal is to make deference the safe bet. Despite conventional wisdom, a mark of success of energy diplomacy can be the lack of showdowns —proactive actions that take cards off the table or create incentives are the key.

In the case of Turkmenistan, the challenge for Russian policy-makers was to increase the downside of alternative options and increase the upside of dealing with Russia. On the one hand, Russia cornered the Caspian gas market and beat Turkmenistan to the punch in Europe. It thus reduced the prospective positive payoff of Turkmenistan's pursuit of other options. On the other hand, policy-makers increased the magnitude of difference between prospective positive and negative payoffs of working with Russia. They did so in three ways. First, they increased the price paid for Turkmen gas. Second, they upgraded pipelines linking Turkmenistan and Russia. Finally, in the 1990s they used the state's centralized regulatory authority (in this case, the power to set domestic prices) to induce Gazprom to buy Turkmen gas regardless of international market prices. When gas prices were high internationally, the state would lower the price that Gazprom could charge domestic consumers; this made it incumbent on Gazprom to buy Turkmen gas to service the domestic market. When prices were low, policy-makers increased domestic gas tariffs; Gazprom therefore had the incentive

to buy Turkmen gas for export. Using these three measures, they made dealing with Russia the most attractive risk for Turkmenistan.

In the case of the oil trade with Azerbaijan, Russia "failed miserably." In contrast to the situation with gas in Turkmenistan, in oil the Russians do not have strong market control. Further, the domestic regulatory environment is fragmented, which sent mixed signals to Russia's Azeri counterparts. In short, although Azerbaijan was prone to "gambling," Russia was unable to make itself the most attractive risk. In the oil sector, there were other players that could increase the potential payoff in ways that Russia could not.

Stulberg concluded that Russia is far more effective at diplomatic maneuvering in the gas sector than it is in the oil sector, but due to the structural constraints noted by Chow even the former may be circumscribed in the future. He also argued that there are some opportunities for Western engagement with Russia on these issues. The two sides can collaborate to "let the market in" —a development that would be mutually beneficial in the oil sector. For example, Russia and the West both seem to be interested in removing opaque intermediaries. Also, both sides can work together on diversifying oil pipeline routes, which, despite conventional wisdom, is mutually beneficial because Russia is not a dominant player in the sector. In gas, the Western strategy should primarily be damage limitation – increasing storage capacity and strategic forecasting – but also cooperation in emerging markets when possible. Western firms may also have the opportunity to engage as service providers.

The discussion centered around two main themes. First, several participants suggested other ways to engage Russia effectively on these issues. The US-Russia Energy Dialogue needs a major upgrade; it has become a forum for the promotion of US companies' interests, and, as a result of backlash in Moscow, often to the detriment of those interests. Instead of promoting US companies, the Dialogue should focus on fundamental

policy options that the Russians face, such as reform of access to pipelines and tariffs for their usage. The West also must be upfront with Russia about the cost to them of bad policies. Rather than using bi- and multi-lateral forums to promote the interests of private companies and projects, the West needs to talk to the Russians about policy.

The role of personal interests in determining policy outcomes was the second major issue in the discussion. Several participants suggested that both Gazprom and the state have acted in the interests of powerful individuals within the Russian political and economic elite. Further, these individuals often perceive policy "success" and benefit to the state as relating directly to their own personal interests; the Western and Russian definitions of success might diverge significantly. The feedback mechanism of policy outcome to future policy-making thus must be considered in the context of both personal interests and perception.