



**Testimony before the
Committee on Foreign Relations
United States Senate**

“RUSSIAN ENERGY POLICY”

June 21, 2005

A Prepared Statement by

Robert E. Ebel
Chairman, Energy Program

Thank you, Mr. Chairman. My name is Robert Ebel and I chair the energy program of the Center for Strategic and International Studies. I welcome the opportunity to discuss with you and members of the Senate Foreign Relations Committee the current and likely future direction of Russian energy policy and how this policy is impacting its relationship with the United States and the rest of the world.

As background, I was a member of the first oil delegation the United States sent to the Soviet Union. The year was 1960. Since then I have visited every oil-producing region of the country. I must say that analysis of the Soviet oil and energy sector was much easier then than it is today. For then, one could write and say almost anything about the subject and few could argue with your findings, because we knew so very little about what was going on.

Today is very much different. We are overwhelmed with information and data, and the task to separate the good from the bad is a difficult one, from the spin offered by a government official to a spin offered by a company representative.

For the past 18 months or so, the attention of oil producers and consumers worldwide has been captured by just one simple word. And that word is “sustainability.” Is growth in oil production and exports by Russia, second only to Saudi Arabia, sustainable?

Russia is very much in the news today. The volumes of oil Russia has been able to place into the world oil market have helped keep world supply and demand in balance. Because of that, it very much matters to all of us whether Russia’s oil sector continues to expand as it has the past number of years, whether it cools off, as it has been since late summer of 2004, or whether the Russian oil boom truly is over. That is, should we anticipate a decline in production and in exports?

If Russian oil export growth cannot keep up with world oil demand growth, for whatever the reason, then the burden on OPEC to balance oil supply and demand becomes even greater. Is this a responsibility that OPEC can readily assume? No, it is not. Is this scenario in the best national interests of the United States? No, it is not.

We have witnessed the loss over time of spare producing capacity worldwide, capacity that can be called on to respond to an expected gain in oil demand. Other

than for Saudi Arabia, there is very little spare producing capacity available among OPEC member-countries. Russia, for example, has never developed spare producing capacity, and never will by choice. In their judgment, spare capacity is a frozen asset.

Adding to capacity takes time, and exporting countries always will want to be reassured that a market for that new capacity will be available. Today it is, but there can be no assurance for the future.

Russian Oil Collapse, Then Recovery

In mid-1988, Russia was producing at a rate of about 11.4 million barrels per day, well above Saudi Arabian production. Then the oil sector began an unprecedented collapse in production. Unprecedented because it was not caused by developments in the market place or by war, but rather by a lack of investment capital and mismanagement of the oil fields. The production collapse took the oil sector to a low of some 6 million barrels per day in 1998 before it began its slow recovery.

Last year, Russia produced about 9.2 million b/d, close to matching Saudi Arabia. Of that production, Russia was able to export around 70 percent, that is, both crude oil and petroleum products, because domestic requirements have held relatively stable. Indeed, virtually all of the increments in production the past years have been available for export.

Despite the successes of 2004, signs of trouble had begun to appear. Rates of growth in production began to slow, beginning in August 2004 and have continued through to today. The causes of this fall in growth rates—little investment in oil field exploration and overproduction of producing fields—match the causes behind the collapse that began in 1988.

Moreover, past successes in expanding oil output derived in large part from the massive application of advanced technology. This one-time gain is no longer available.

Yet, we are not anticipating an annual decline in production nor are we watching a decline in oil export levels. I would venture that oil production in 2005 will exceed the 2004 level by 3 to 4 percent, averaging about 9.5 million barrels per day, and matching the current Saudi level. Oil exports should also show a modest expansion.

But What About the Future?

It is the Russian oil future that is of concern. Before the collapse of the Soviet Union in December 1991, the Caspian Sea had been viewed as representing the oil future of the country. But the collapse took that future away and gave it to Azerbaijan and Kazakhstan.

Given that, where does Russia see its oil future today? In East Siberia and offshore. But three obstacles stand in the way of converting this future to reality. These obstacles are the lack of experience in exploiting offshore oil resources, a lack of investment capital, and a lack of the kinds of technology required.

Where to turn? To international oil companies, of course. For national oil companies, the name of the game is access, access to new oil reserves. Russia has unquestioned oil potential, and the national oil companies can bring the needed experience, technology, and investment capital to the table.

But, will they? We should add a fourth obstacle to foreign investment in Russian oil. That is the failure of the country to offer the potential investor what he needs and expects: transparency, rule of law, sanctity of contract, and equally important, opportunities where anticipated returns on investment reflect the risks that lie ahead. Or, do they need be only relatively better than alternatives? In sum, the rules of the game must be clear and secure.

In the words of Lord Browne, CEO of BP: “For many potential investors and for many commentators and observers, Russia remains a dark and hostile place, a source of risk rather than of opportunity.”

A portion of investment risk derives from perceptions of the Yukos affair. Was the Yukos affair really about eliminating Khodorkovsky as a factor in the economic and political life of the country? Yes, it was. But was it also part of an effort to restore control over the country’s oil resources? Yes, it was.

Oil Sector Constraints

Current Russian oil sector prospects are troubling.

- A rather high number of idle wells, possibly one out of every four wells.
- Inability to replace oil reserves produced.
- Almost all existing major fields are likely to be depleted by 2015.

There is an oil export duty to be paid, a Russian version of a “windfall profits tax” that in effect discourages exploration and production. This tax, at present, is \$18.66 per barrel when the selling price is above \$25 per barrel.

Given that it usually takes 5 to 7 years or so from field discovery to development means that time is not on Russia’s side if it is to avoid a production decline.

Pipeline Constraints

Then, there is the more obvious constraint, that of pipeline capacity limitations.

Russian oil exporters complain that pipeline capacity limitations have in turn limited volumes that could be exported. That means a considerable share of exports must move by more expensive rail and water. All oil pipelines are currently under the control of Transneft. There are no privately-owned pipelines. Khodorkovsky wanted to build a private line to China and there were plans to build a private line to the port of Murmansk, to facilitate oil exports to the United States. Both plans, for now at least, have been consigned to the trash can.

Shifting Pipeline Directions

Russian oil pipelines face the west. But that is not where the growth markets are. Oil demand growth is found to the east, in Southeast Asia and the Far East. How to respond to this market? Build a pipeline to the Pacific Ocean port of Nakhodka, in the Russian Far East, with a branch line going to China, a line that eventually would have a carrying capacity of 1.8 million barrels per day.

One small problem, though. Where would sufficient oil be found to fill this projected pipeline? Some volumes could be made available from West Siberian fields, but large new sources of supply would have to be discovered and developed in East Siberia, geologically attractive but completely lacking in supporting infrastructure, inhospitable terrain and weather conditions.

Nonetheless, when a thirsty China looks north, it sees Russia and its tremendous oil and gas reserve base. Just as when a thirsty United States looks north, we see Canada, our leading supplier of foreign oil who also provides one-sixth of the gas we consume.

Russia-China is a natural linkage, especially in terms of geography. Current plans now anticipate construction of an oil pipeline eastward from a point near Irkutsk, in East Siberia, to a point some 1,700 kilometers eastward, and just 70 kilometers from the Russian-Chinese border. Then by rail to the border. And beyond by rail to the port of Nakhodka, assuming available oil. When available volumes permit, the pipeline will then be extended to the Pacific.

Until this planned pipeline to China becomes a reality, oil will move to China by rail, some 200,000 barrels per day this year, rising to 300,000 barrels per day next year. Rail shipments can expand to a limit of 600,000 barrels per day, at which point pipelines are more financially viable.

But East Siberia is more than oil, it is also a storehouse of natural gas. The largest known gas field is Kovykta, and TNK-BP holds an interest in this field. Indeed, Lord Brown of BP has called Kovykta “the tomorrow” for TNK-BP. But that tomorrow has been stalled by the efforts of Gazprom to see to it that development and planned export pipeline construction to China and South Korea do not proceed without their involvement.

Russia is very jealous of its prerogative as a transit country. That is, it would like to see all oil and gas exported from Central Asia, Azerbaijan and Kazakhstan to be channeled through Russia. The recent completion of the oil pipeline from Baku through Georgia to the Turkish port of Ceyhan, on the Mediterranean, bypasses Russia, much to their displeasure.

Near Term

Russian officials, public and private, have been comparatively open as to how they view the oil sector’s future. Their forecasts portray a Russia that, at least in oil, will essentially be marking time within the next several years.

Economic Development and Trade Minister German Gref recently outlined the near-term future of the Russian oil sector, and his views generally reflect a consensus.

- Oil production growth should be around 3.5 percent this year, declining further to 2 or 3 percent in 2006. That compares with an average growth of 8.5 percent during 2000-2004.

- In his opinion, oil exports would increase by 5 percent in 2005 and by 3 percent in 2006, down from an average of 14 percent during 2000-2004.

Again, it is important to note that production and exports are not expected to decline. Rather, it is the rates of growth that decline. Moreover, export increments continue to match production increments.

That approach is very much in line with Russian marketing philosophy. Oil is not withheld from the market as a way of supporting price. Any and all volumes surplus to domestic needs are exported, regardless of the current market price.

Nonetheless, as Russian oil growth rates fall while world oil demand increases, the market will increasingly look to OPEC to fill the gap. That of course brings increasing concentration on a select few, geographically separated countries. That in turn gives rise to inherent logistical, infrastructure and security concerns.

Longer Term

A somewhat different picture emerges for the longer term, a picture that very much depends upon the timely discovery and development of new oil fields.

The most recent evaluation comes from the Ministry of Industry and Energy. An oil and gas sector development strategy reportedly was drawn up in 2004, and covers the ten-year period between 2005 and 2015. According to an official of the Ministry, “in 2015 Russia will be able to produce 10.6 million barrels per day...” To reach that level, he noted, would require up to \$270 billion investment in the sector.

He added later that in 2015 Russia may export 6.2 million barrels per day of crude oil alone. If so, crude oil exports will jump by 1 million barrels per day in 2015, compared to about 5.1 million barrels per day last year. Not much, considering the prospective growth in world oil demand.

A Final Comment

The head of LUKoil, the largest oil company in Russia, recently was asked about the prospects for foreign investment in Russia’s petroleum sector. His answer was

forthright: “You are doomed to invest in Russia.” But that can work both ways. Russia is “doomed” to seek that investment.

But, what if that investment is not forthcoming? Then consumers could well be faced not only with high prices but as well with physical constraints on volumes available for purchase.