



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

“RUSSIAN ENERGY POLICY”

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An Oral Statement by

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Mr. Chairman, members of the committee, I appreciate the opportunity to appear before you today to discuss Russian Energy Policy and its implications for the US and the rest of the world. My name is Frank Verrastro and I serve as Senior Fellow and Energy program Director at the Center for Strategic and International Studies (CSIS). I am here this morning pinch hitting for Bob Ebel, who was suddenly taken ill and hospitalized over the weekend and consequently is unable to appear before you today. You have before you the written statement which Bob submitted for the committee's consideration, so in his absence let me just briefly review some of the highlights of that statement and put those highlights in context with respect to global oil markets and shifting geopolitics and then I'd be pleased to answer your questions.

With the current tightness in global oil markets and the acceleration in energy demand, ALL producers are important to world oil supply. But given Russia's enormous potential in terms of total energy resources – the largest proven resources of natural gas, the second largest coal reserves and the world's eighth largest proven reserves (60 bb, most of which are located in Western Siberia) of oil – Russia's global energy role is particularly significant.

In 2004, Russia was the world's largest non-OPEC oil producer and exporter with production of approximately 9.2 mmb/d and exports of 6.7 mmb/d – ranking second behind only Saudi Arabia. Sustaining or increasing that production is critical to oil market stability, but given the enormous challenges facing Russia, the sustainability of recent performance is by no means a certainty.

In 1988, Russian oil production peaked at around 11 mmb/d. Following the dissolution of the Soviet Union, production plummeted to around 6 mmb/d less than 10 year later – in part the result of depletion of several of the largest fields due to state mandated production practices, but also due to the collapse of the Soviet central planning system.

Recovery from that decline has been extraordinary as production has rebounded to present levels as a result of the introduction of new technologies, improved field practices, new investment and step out drilling – contributions that are unlikely to be repeated on a continuing basis. With internal demand fairly stable, incremental increases in output have resulted in increased volumes of exports.

But what about the future?

Beginning last August, the rate of growth for Russian production had begun to slow down, revealing some of the same symptoms that preceded earlier declines – namely a decided lack of investment in new oil field exploration and the over production of fields currently on line (in order to take advantage of prevailing high prices). 2005 production levels are expected to be 3-4% above 2004 output (averaging around 9.5 mmb/d), but probably not much more than that.

An additional 2-3 percent growth rate is projected for 2006; an increment which is helpful, but only a fraction of the average growth experienced between 2000 and 2004 of 8.5% per year, and insignificant when compared against projections for rising demand.

And prospects for further improvements face a series of formidable challenges, including the need for new investment capital; improvements in infrastructure, including pipelines; the expertise and technology to develop the offshore fields; and a regulatory regime that provides potential investors with adequate incentives and predictability in terms of transparency, rule of law, contract sanctity and the opportunity to achieve returns on investment commensurate with the risks taken.

Sir John Browne, CEO of BP has aptly characterized Russian risk, noting that for many potential investors, "...Russia remains a dark and hostile place, a source of risk rather than opportunity."

In recent months, Russia has done little to allay such concerns. The Yukos affair has been characterized on the one hand as a thinly disguised effort to silence a well heeled political rival but at the same time is clearly recognized as a part of a broader effort to restore and solidify greater state control over Russia's energy assets.

The problem, in terms of global oil/energy supplies, is that at precisely the time when the world appears to need incremental new production from virtually all sources, Russian policy and field practices are headed in just the opposite direction. The adoption of Russia's oil export duty, the equivalent of a "windfall profits" tax captures roughly 90% of the current upside value in oil prices above \$25 per barrel.

And the proposal to require 51% Russian company ownership in new projects only further discourages new investment and stakeholders. When coupled with the increasing number of idle wells (possibly as high as 1 in 4), the inability to replace reserves, and projections for significant depletion in ALL existing major fields by 2015, the 5-7 year lead times required to bring on new fields only reinforces the significance of the challenges facing Russian production in the years ahead.

When taken in context, the decline of a major non-OPEC producer in the current market only serves to further concentrate future supply availability in the hands of a select few OPEC nations.

A somewhat more optimistic picture emerges for the longer term, but it is a picture that very much depends on the timely discovery and development of new fields. The most recent projections prepared by the Russian Ministry of Industry and Energy covering the ten-year period between 2005 and 2015 estimates that Russia will be able to produce some 10.6 mmb/d in 2015. But that same analysis suggests that reaching that level of production will require some \$270 billion of new investment.

Analysis prepared by CSIS and others projects a shift in global oil markets within the next 10 years with a decided increase in concentration for both producing and

consuming regions alike. Main producing areas are projected to be in the Middle East, Africa, Russia and the Caspian (along with non-conventional production coming from Canada and Venezuela) while principal consumers look to be located in North America, Europe and Asia – areas geographically separate from the producing regions – requiring increased investments in shipping and infrastructure to facilitate inter-regional movements and placing additional pressure on shipping choke points, ports, pipeline and terminal facilities, security and the environment.

In particular, the projected rise of Asian demand, especially in China and India will place increased logistical burdens on interregional movements of both oil and natural gas. Russia and the Caspian are counted on to play a significant role in that developing system and failure to realize that potential would have serious consequences for consumers everywhere.