

7-1-2007

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Recommended Citation

Sabonis-Helf, Theresa (2007) "Fueling the Superpowers: Russia as a Player in World Energy," *New England Journal of Public Policy*. Vol. 21: Iss. 2, Article 20.

Available at: <https://scholarworks.umb.edu/nejpp/vol21/iss2/20>

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Fueling the Superpowers

Russia as a Player in World Energy

This article by Theresa Sabonis-Helf is taken from the proceedings of the EPIIC Symposium at Tufts University, February 2005

Many have lamented the lack of a coherent, strategic energy policy in the United States. The good news is that someone does have a coherent, relatively integrated approach to energy as a strategically significant commodity. Perhaps you will consider it bad news that the nation with such a strategy is Russia. In oil, gas, and even electricity, Russia is giving clear signals that it intends to become and remain a player in world energy politics. Nor is this the first era in which Russia has been an important player of “power politics.” Shortly before its collapse, the Soviet Union was the largest oil producer in the world, extracting 11 million barrels of oil a day in Russia alone, and 12 million overall.¹ In that era, the USSR played power politics in two ways. Moscow strove to be a reliable, nonpoliticized supplier to non-allies at world prices, while using heavily subsidized prices to discipline and reward allies. Hence, as a supplier to Europe, the Soviet Union earned a reputation for being a reliable, commercial supplier, following economic rather than political objectives when the two conflicted.² At the same time, however, the Soviet Union used variable quantities of subsidized energy exports to discipline its Eastern European allies.³ The strategic question for the future is; which pattern from its Soviet experience will Moscow follow?

The answer matters because, although Russia today is extracting less oil than it was in 1989, since its economy is less energy-intensive, it is exporting more — making Russia the second largest oil exporter after Saudi Arabia. Russia has been in the top two producers since shortly after September 11, 2001. At that time, Russia flooded world markets with cheap oil, for two main reasons. The first was to prove they could. Nearly a decade had been invested in revitalizing the infrastructure that Russia inherited in the wake of the Soviet Union’s collapse, and they were ready to compete for

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a larger share of the world market. The second reason they hit the world market hard after 9/11 was to demonstrate solidarity with the United States. They were signaling that, regardless of what response the United States crafted to 9/11, the Middle East didn't have the power to use the oil weapon with devastating effect at that moment. Russia was also hoping that this display of solidarity would win support from the United States for their taking a new role in world oil markets: before 9/11, U.S. foreign policy had focused more on shoring up the sovereignty of the non-Russian successor states with oil, Azerbaijan and Kazakhstan, than it had on encouraging Russia to arise again as a world oil power.

Russia has maintained the market share it captured in the post-9/11 world, producing 9.0 million bbl/day to Saudi Arabia's 9.5 million in September 2004.⁴ Currently, Russia is more limited by its ability to export — that is, by its lack of pipelines — than by any other factor, and Russia is negotiating to build a wide array of new pipelines. There are many problems with pipeline construction, including a persistent tension between market forces and state intervention, but in the current era of high prices and growing demand, Moscow is free to use the politics of scarcity in allocating room in its limited pipelines: oil companies in favor with Moscow have more access to pipelines. Oil companies out of favor are compelled to use rail transit, a much more expensive way to bring oil to market.

There has been much discussion about pipeline construction, but there is a question more fundamental than which lines to construct in which directions: Is Russian oil extraction really sustainable? Russian oil costs approximately \$15/bbl to get to market (for those with access to a pipeline), while Saudi oil costs a mere \$3/bbl. If Russia is not careful with its federal budgeting, it will also share Saudi Arabia's vulnerability to price swings — debt. Saudi Arabia currently counts on at least \$15 per barrel in debt service to remain solvent. When you factor this in, the breakeven price for Saudi Arabia (\$3 extraction plus \$15 debt service) was actually higher than it was for Russia back in fall 2001, since the Russian budget at that time did not assume high oil revenues. That is how Russia managed to force Saudi Arabia to the negotiating table, and how it won its place as the second largest exporter in the world. I concur with those analysts who doubt that oil prices will return to price bands below \$30, but Russia certainly remains vulnerable to drops in oil prices because its cost of extraction will remain high, and its budgetary reliance on oil has grown dramatically since 2001. The U.S. Department of Energy estimates that a \$1 change in oil prices causes a \$1.4 billion change (in the same direction) in Russian revenues at this time.⁵

However, what will limit Russia regardless of its fiscal behavior is its reserves. While the Middle East enjoys some 56.5 percent of proven world reserves in oil, the entire former Soviet space has but 6.4 percent, a significant portion of which is located in Azerbaijan and Kazakhstan. So if Russia has such limited reserves, why is it playing such a tough game in oil? The

answer may well lie in the gas sector. Although Russia's proven oil reserves are meager compared to the Middle East, its gas reserves are quite competitive. In fact, 35.5 percent of proven gas reserves in the world are in the former USSR, much of it in Russia. The Middle East has only 35.9 percent. Russia has approached Turkmenistan, Kazakhstan, and Azerbaijan in an effort to engage them in a gas suppliers' cartel. Although this cartel is currently very poorly defined (and all three post-Soviet states may opt out of such a cartel), Russia is clearly learning how cartels work through its negotiations with OPEC. Russia need not establish a global cartel in order to have some success. Unlike oil, which is a global commodity, natural gas is a regional commodity. Oil is supply driven — meaning that, wherever it is found, it will be extracted and sent to a waiting market. Gas, by contrast, is demand driven. Reserves are not exploited until an end-user is found, and long-term agreements are established, because gas is more difficult to store and transport than oil. This may change in the longer-term future, if LNG is developed on a larger scale, but for now exploitation of gas depends on a proven market. So who is the buyer for Russia's gas? Europe. Demand for gas, as Europe retires nuclear power plants and also pursues lower greenhouse gas emissions, is growing dramatically. Russia is well aware that Europe needs Russian gas to make its transition to lower emissions without damaging productivity, and so far European states have been willing to sign long-term contracts with the Russian state gas company, Gazprom, in spite of the fact that it has a reputation for being very nontransparent and closely linked to Kremlin politics. Europe has no reason to believe that Gazprom's style of business is changing any time soon. Putin told Schroeder directly in 2003, "We are not going to break up Gazprom. The European Commission should have no illusion: they are going to be dealing with the state in the natural gas industry."⁶

The Khodorkovsky trial suggests that oil in Russia will, over time, become more like gas, rather than the reverse. Russia is increasingly taking a heavy state hand in the energy sector. The government's stabilization fund, established in January 2004 for windfall oil profits, now holds an estimated \$16.7 billion,⁷ and is likely to be spent at least in part on buying up additional energy infrastructure.

Putin has long held reconsolidation of the state's power in Russia as a key goal of his administration. From a Western perspective, this reconsolidation is cause for concern, but consider for a moment Putin's position. By 2000, according to a well-known Russia analyst, "Collectively, the economic power of Russia's twenty-five richest men far outstripped that of the Russian state."⁸ The majority of these so-called oligarchs have their fortunes in the energy sector. Putin's goal has been to return the state to a position of primacy, and energy is a key component in his strategy.

Perhaps the most significant outlier in energy is electricity — a sector in which the Russian state also has strong interest, but which is managed somewhat differently. Russian electricity, specifically the Russian Joint-

Stock Company — Unified Energy Systems of Russia (RAO-UES), is a corporation in which the government has a majority share. But it has a reputation for being the most transparent of the energy sectors, and the energy sector in which Russian state interests are not always closely reflected in the parastatal's business behavior. Anatoly Chubais, an architect of the privatization program in the early 1990s and one of the energy oligarchs, is CEO of RAO-UES. He is openly proud of the fact that, under his leadership, all of the former Soviet republics began operating on a parallel grid in fall 2003. Parallel grid operation for the entire former Soviet space is particularly notable because it was never achieved during the Soviet era.⁹ RAO-UES completed significant purchases in the Caucasus in 2003 and in Central Asia in 2004, largely through debt-for-equity swaps. Although nations like Georgia had reservations about portions of their systems being bought up by a Russian parastatal, there are some clear advantages. An integrated grid increases the quality and reliability of electricity, by ensuring that shortfall in one area can be supplied by another area, and that surplus electricity in one area can be exported rather than wasted.

RAO-UES made the purchases, hoping to export power through the former Soviet space into desirable markets including Turkey, Iran, and Afghanistan. It has already begun such exports. It has also reduced disputes over debt and theft of power. Most importantly, however, RAO-UES has, through these purchases in the CIS, positioned itself better for links to a larger European grid by way of Turkey, and to markets in Pakistan and China.

Electricity is more value-added than export of raw materials such as oil or gas and may prove to be an increasingly attractive energy export for Russia. Interestingly, if Russia seeks to play a larger role in electricity markets, the energy security of the southern tier near abroad may be enhanced, since these states are rapidly being transformed from end-of-the-grid consumers to strategically important transit states. This enhanced security of former Soviet states may come at the expense of Europe's energy security. The key question in electricity is whether Putin will continue to tolerate Chubais's relative independence in such a strategic sector.¹⁰ If he moves against RAO-UES, he risks losing access to European electricity markets, as electricity in Europe is more transparent than the oil or gas sectors.

In short, Russia has oil, gas, and electricity, and is using oil windfalls to increase the state's holdings in all three sectors. The sectors are not being developed along Western lines, but rather in a manner that enhances Russian state political power, and potentially increases Russia's strategic significance to Europe, and its leverage with Europe. Russia has a vision of providing power in various forms to Europe, and thereby remaining a power in Europe. It remains to be seen if economic rationality will dominate or be subordinate to political logic in Russia's energy export strategy.

Notes

The views expressed in this article are those of the author and do not reflect the official policy or position of the National Defense University, the Department of Defense, or the U.S. Government.

1. See Edward Chow, "Russian Pipelines: Back to the Future?" *Georgetown Journal of International Affairs* (Winter/Spring 2004): 27–33.
2. See Chapter 8 of Thane Gustafson, *Crisis Amid Plenty: The Politics of Soviet Energy Under Brezhnev and Gorbachev*, (Princeton: Princeton University Press, 1989).
3. See William Reisinger, *Energy and the Soviet Bloc: Alliance Politics After Stalin* (Ithaca: Cornell University Press, 1992).
4. Data from U.S. Dept. of Energy Energy Information Administration, November 2004 report.
5. EIA, "Russia:Country Analysis Brief," Energy Information Administration of the U.S. Dept. of Energy, February 2005, accessible at: www.eia.doe.gov/emeu/cabs/russia.html.
6. Quoted in Chow, p. 32, from ITAR-TASS, October 9, 2003, online.
7. EIA, "Russia: Country Analysis Brief," Energy Information Administration of the U.S. Dept. of Energy, February 2005, accessible at: www.eia.doe.gov/emeu/cabs/russia.html.
8. Martha Brill Olcott, "The Energy Dimension in Russian Global Strategy: Vladimir Putin and the Geopolitics of Oil," James A. Baker III Institute for Public Policy of Rice University occasional paper, October 2004 (prepared in conjunction with an energy study sponsored by the Petroleum Energy Center of Japan).
9. Unified Energy System of Russia, 2003 "RAO UES of Russia Preparing Energy Projects in NIS," RAO-UES Public Relations office [online], September 17, 2003. http://www.rao-ees.ru/en/news/pr_depart/show.cgi?170903nis.htm.
10. As of May 2005, Putin called for criminal charges to be brought against Chubais in connection with a major failure of the electricity grid in five oblasts. See Anatoly Medetsky, "Power Goes off in Moscow, Four Regions," *Moscow Times*, Thursday May 26, 2005,1.