U.S.-Russia Relations and the Hydrocarbon Markets of Eurasia

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The Working Group on the Future of U.S.-Russia Relations convenes rising experts from leading American and Russian institutions to tackle the thorniest issues in the bilateral relationship. By engaging the latest generation of scholars in face-to-face discussion and debate, we aim to generate innovative analysis and policy recommendations that better reflect the common ground between the U.S. and Russia that is so often obscured by mistrust. We believe our unique, truly bilateral approach offers the best potential for breakthroughs in mutual understanding and reconciliation between our countries.

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Executive summary

U.S.-Russia relations exist across many issue areas and economic sectors. Yet there is virtually no meaningful relationship in one area of tremendous economic and geopolitical importance: oil and gas.

The lack of sustained and productive engagement has not meant that there is no tension between the United States and Russia when it comes to oil and gas markets. On the contrary, there are a number of explicit and implicit conflicts (Gazprom’s dominant position on the European gas market, and U.S. support for prospective oil and gas pipelines that circumvent Russian territory, are but two of the most visible illustrations of the way in which energy issues have been an irritant in U.S.-Russia relations). Points of tension between Russia and the United States in energy-related matters mostly involve third parties, as well as disagreements on the market principles and rules of international energy trade. From the point of view of domestic energy security, there are no real problems of survivability between the United States and Russia, as both countries are nearly self-sufficient. There is no imminent opposition between them, and in fact nothing over which they must struggle in order to provide a sustainable energy supply to their countries—indeed, these two countries face the lowest national energy security threats in the world.

The conflicting positions do not manifest themselves in open confrontation, but are expressed, rather, through rhetoric, symbolic action, and attempts at diplomatic persuasion in third countries or broad regions. A clash of words over control of resources in the Arctic is an example of competition declared over a highly theoretical energy-resource base. The open policy disagreement over the energy configuration in the so-called Southern Corridor, a broad region between the Black Sea and China, meanwhile, is a more tangible manifestation of tension.

This paper casts a critical eye on the way the Russian Federation and the United States have approached energy issues1 in the post–Cold War period, and on the assumptions underpinning each side’s perceptions of the other’s decisions. Most of the assumptions made by both countries reflect (a) short- and medium-term concerns, rather than long-term strategic thinking about energy markets; (b) a lack of appreciation for the critical role that commercial considerations can play in decision making on oil and gas; and (c) the remains of an obsolete Cold War mindset geared toward zero-sum outcomes rather than mutual benefit.

This paper opens with three fundamental realities often overlooked by U.S. and Russian policy makers:

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1 “Energy” is used herein to refer exclusively to oil and gas. Nuclear and alternative energy issues are beyond the scope of this paper.
1. Foreign direct investment decisions of firms are driven primarily by market forces, and not by political objectives.

2. The United States has little if anything at stake in the relationships between Gazprom and its European and Eurasian energy customers.

3. Europe’s position as Russia’s primary gas export market creates greater vulnerability for the exporter (Russia) than the importer (European customers).

In overlooking these realities, Russia and the United States have allowed energy issues to serve as an arena for conflict, even though neither country is directly threatened by the actions of the other. A more rational acceptance of international oil and gas realities could allow both sides to create an environment conducive to joint investments at best, and at the very least, prevent active undermining of the other’s activities. Accordingly, this paper proposes the following measures to facilitate positive-sum outcomes:

• Both sides acknowledge that the foreign direct investment decisions of firms are driven primarily by economic, and not political, objectives.

• Both sides recognize that there is little perspective for joint cooperation in oil and gas in Russia and the United States, and direct the focus of their state-level energy cooperation toward other energy sectors (energy efficiency, renewable, nuclear—those sectors emphasizing technological cooperation).

• Both sides seek opportunities to facilitate firms’ joint projects in the Caspian region instead of disrupting each other’s projects. Recent developments in Arctic cooperation provide a model of how these “conflicts” could be resolved for mutual benefit. Initially Russia and the United States employed very tough rhetoric over Arctic resources, but after several rounds of negotiations, in the summer of 2011 Rosneft set up a strategic alliance with ExxonMobil for the exploration and development of the Arctic shelf.

• The U.S. government accepts that Gazprom’s dominance of European gas markets in the medium term is a reality that neither it nor any other government can change. At the same time, both governments recognize that Russia’s status as a monopoly supplier will wane in the long term.

• The United States stops pushing non-market-based initiatives that serve only to irritate the bilateral relationship (e.g., cheerleading for the increasingly implausible Nabucco pipeline).

• The U.S. government acknowledges in public pronouncements that it is natural for Russia to develop infrastructure to supply growing Eastern markets with oil and gas.

• As gas market pricing becomes global rather than regional, in part because of shale gas, Russia accepts that this does not in any way reflect a U.S. government plot to undermine its interests.

• Russia accepts that turmoil-linked gas contracts will no longer be attractive to European customers, and that this is due to market—rather than political—reasons.
Introduction

There is no meaningful U.S.-Russia oil and gas relationship. Although the United States and Russia are among the largest importers and exporters of energy resources respectively, for the most part they have not bought and sold from each other. Russia accounts for a mere 5% of the U.S. oil market, and the United States has never purchased a molecule of gas originating from underneath Russia’s territory or coastal waters.

At the same time, energy is an important aspect of a bilateral relationship that has vacillated between amity and discord. For the most part, energy issues have been a source of discord.

Some of that discord stems from conflicting national incentives that can be neither wished nor managed out of existence. However, most of the discord is rooted in misunderstandings—deliberate or otherwise—that should be subjected to mutual interrogation.

In this paper we begin by examining three ways in which energy plays into the U.S.–Russia bilateral relationship.

First, on both sides, confusion about the balance between public and private sectors has reigned. The profit motive plays a much larger role in policies and practices than either nation has acknowledged. U.S. leaders complain about the lack of solidarity in Europe’s energy relationship with Russia, but European policy makers have at best modest influence on a sector steered more by profit-driven firms than by governments. For their part, Russian leaders express concern that so little U.S. investment flows into the Russian energy sector, overlooking the fact that these flows are driven not by public policy, but by private firms’ estimates of potential returns on investment. U.S. and supermajor energy companies do not take their marching orders from the U.S. government; U.S. officials, therefore, cannot fully control the evolution of the energy aspect of the bilateral relationship. A recognition of this reality could limit the antagonism that emerges from complaints about practices that are actually beyond the control of policy makers.

Second, Russia’s relationships with oil and gas customers do not, and will not, have a major impact on U.S. national interests. The United States is very quickly changing its position from strongly dependent on hydrocarbon imports to much more self-sufficient (primarily due to the unconventional gas and shale oil production boom). The United States is not—and is unlikely to become—an important market for Russian energy exports. However, a number of European allies and key partners, as well as Russia’s neighbors in post-Soviet Eurasia, depend on imported gas and oil from Russia. As European and Eurasian policy makers and business executives have sought to manage this energy relationship, some U.S. policy makers have attempted to insert themselves, taking firm positions on the organization of a relationship in which the United States has no direct role.
energy exports are a critical source of revenue for the Russian government, though they are not (Russian bluster and U.S. alarmism notwithstanding) a significant source of geopolitical power. Taking the bluster at face value, U.S. policy makers have generally failed to recognize that Russia’s growing dependence on hydrocarbon exports is a sign of vulnerability, not strength. Moreover, this vulnerability runs deep; the Russian budget depends on the ability of Russian firms to export oil and gas.

Third, energy exports are a critical source of revenue for the Russian government, though they are not (Russian bluster and U.S. alarmism notwithstanding) a significant source of geopolitical power. Taking the bluster at face value, U.S. policy makers have generally failed to recognize that Russia’s growing dependence on hydrocarbon exports is a sign of vulnerability, not strength. Moreover, this vulnerability runs deep; the Russian budget depends on the ability of Russian firms to export oil and gas.
Who controls foreign direct investment decisions—governments or firms?

Regardless of policy preferences in Moscow and Washington, firms have—largely on their own—been remaking Eurasia’s energy environment. Both nations should be more aware of how corporate decisions get made in the energy sector. These corporate decisions are generally the result of cold, calculating, profit-oriented decision-making processes. Thus the closeness of European firms to Gazprom and Russia is a function primarily of decades of profitable relationships. The indifference of Russian and U.S. firms toward each other’s energy sectors is not primarily due to political antagonisms, but rather stems from the inability of those firms to successfully navigate disparate business environments.

One might think that U.S. energy firms would see Russia as a highly attractive source of hydrocarbons. Or that Russian energy producers would be vying for a share of the lucrative U.S. energy market. But mutual corporate penetration has been marginal at best: U.S. international oil companies (IOCs) do not have significant access to Russian hydrocarbons, while Russian companies reach few U.S. consumers. The problem cannot be attributed solely to Russian intransigence—joint ventures between Russian companies and their British, German, Italian, and Japanese counterparts prove that inter-firm cooperation of major IOCs with Russian counterparts is both possible and recurring.

A limited record of engagement in oil

There are few examples of U.S. firms’ investment in the Russian energy sector, and most of them are disappointing. In 1996 ExxonMobil joined an international consortium running Sakhalin-1, an oil and gas project in Russia’s Far East. Since 2010, Sakhalin-1’s gas component has been frozen over disagreements about where the extracted gas is to be sold. Sakhalin-1 signed a deal to supply China with 8 billion cubic meters (bcm) per year, but Gazprom would prefer to supply China with gas from Eastern and Western Siberia. Gazprom claims it needs the gas produced at Sakhalin-1 to cover domestic needs.

More promisingly, Rosneft and ExxonMobil recently joined forces to explore and develop the Arctic shelf and part of the Black Sea. In August 2011, Prime Minister Putin proclaimed that “direct investments could total from $200 to $300 billion, if you speak of infrastructure development and the construction of necessary facilities, this figure could reach up to

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2 The Sakhalin-1 consortium was comprised of the following participants: Exxon Neftegas Limited, a subsidiary of ExxonMobil, was the operator, with a 30% interest; Rosneft held stakes via its affiliates RN-Astra (8.5%) and Sakhalinmorneftegaz-Shell’ (11.5%); the Japanese SODECO consortium held 30%; and 20% was owned by the Indian state-owned oil company ONGC Videsh Ltd.
$500 billion. The strategic agreement stipulates that $3.2 billion would be spent on joint explorations in Russia’s Arctic Kara Sea and the Tuapse license block in the Black Sea. The deal will enable Rosneft to expand its presence beyond Russia and become an international company. ExxonMobil in turn will strengthen its position in the Russian Federation and gain access to the Arctic shelf.

In addition, the two companies agreed to create an Arctic research and design center in St. Petersburg to support and develop technology for exploration and drilling in Russia’s icy northern seas. The two oil giants also pledged to conduct a joint study of oil resources in Western Siberia. For a Russian energy player looking to expand beyond Russia, ExxonMobil made Rosneft an offer it could not refuse.

In the retail sector, Lukoil has succeeded in establishing itself in the U.S. market. In 2000 it acquired Getty Petroleum Marketing and its 1,300 petrol stations in the United States. In 2004 the Russian company bought an additional 800 petrol stations, thereby supplying 5% of the U.S. retail market. Although the financial crisis of 2007–2009 led to the loss-making sale of some 160 petrol stations, the company has not reconsidered its presence on the U.S. market.

Gas: The U.S. shale revolution has upended Russian plans

U.S. companies have tried to join huge Russian gas projects, and were particularly interested in the Shtokman field and the Yamal Peninsula. In 2005 Gazprom began negotiations over developing Shtokman with eleven international oil and gas companies. The resulting short list had five potential partners: Norway’s Statoil and Norsk Hydro, the United States’ Chevron and ConocoPhillips, and the French company Total. In July 2007 Gazprom awarded Total a 25% stake in the project in exchange for development of the field; some months later StatoilHydro (now Statoil) also was awarded a 24% stake in an operating company responsible for planning, financing, and building the first stage. U.S. companies ultimately failed to acquire a stake in the project.

Only two Russian gas companies have penetrated the U.S. market: Itera and Gazprom. Itera USA Inc., an offshoot of an independent gas intermediary, was registered as early as 1992. The company bought Grayson Hill Energy and, through it, began producing gas in the United States in 2002. In 2004 Itera acquired 78% of shares in Dune Energy, which held licenses for hydrocarbon production in Texas. In 2005 Dune Energy bought 95% of Dallas-

4 An earlier version of this cooperative project was to be carried out by BP and Rosneft. Describing that deal in January 2011, Putin estimated that the 126,000-km² Arctic area to be jointly explored contained 36 billion barrels of crude, or enough to meet global demand at current levels for about five months. The Tuapse block in the Black Sea covers an area of 11,200 km² and is estimated to hold 9 billion barrels of oil reserves. In the first phase of the project, ExxonMobil will finance 100% of the geological exploration work (at a cost of some $2 billion) and carry all prospecting risk. The partners will then share the remaining costs 70/30, with Rosneft paying the larger share. Rosneft will hold a 67% stake in the projects in Russian territory. In return for granting unprecedented access to Russia’s hydrocarbon reserves, Rosneft will receive equity stakes in at least six ExxonMobil projects, including tight oil in Texas and offshore in the Gulf of Mexico. Rosneft wants to acquire deep sea drilling experience, and Putin mentioned ExxonMobil’s offshore work in Canadian waters as one attraction of the company.
based Voyager Partners Ltd., which has a license covering 1.3 bcm of confirmed gas reserves and oil reserves (in gas equivalent). In early 2008, Itera Ethanol finished building an ethanol plant in Clearfield, Pennsylvania; construction of a similar plant in Louisiana is next.

From 2002 to 2008 Russia made plans to aggressively conquer the U.S. gas market with liquefied natural gas (LNG) supplies from Shtokman gas field. At the time, the United States had an insufficient supply of natural gas, and high prices. The discovery of exploitable shale gas in the United States has changed all that. The inflow of gas from local unconventional sources means that the North American market has at least temporarily “dropped out” of the cross-continental natural gas trade. Rising domestic gas production and market oversupply have halved natural gas prices in the United States, and have contributed to lower coal and electricity prices. (Ironically, traditionally cheap and subsidized domestic gas prices in Russia are now higher than U.S. prices.) The U.S. administration has of course embraced the possibility of reducing dependence on oil imports, encouraging power generating companies to switch from coal- to gas generation plants, and calling for gas to be used more actively in the transportation sector.

The “shale revolution” has also influenced the global gas market: LNG, primarily from Qatar, that was intended for the North American market instead entered the global market as uncontracted LNG from 2008 to 2011. This created a gas glut that exerted downward pressure on prices in all regional markets. First and foremost, the downward pressure affected spot prices at European hubs, leading to many disputes around oil-indexed long-term contracts. The Asia Pacific market was also affected when LNG spot cargoes appeared on the market for nearly the first time. Therefore, in addition to driving down domestic gas prices, the shale gas revolution in the United States has contributed to the formation of prices in the LNG spot market.

The emergence of global, rather than regional, gas markets will have a tremendous impact on Gazprom’s negotiating power in markets where it has exploited its position as a dominant supplier. When and if the United States and Canada become net LNG exporters, they will for the first time directly compete with Russian gas exports in Europe and Asia. Given the dependence of Russia’s economy on these gas exports, Russian leaders are understandably alarmed at the prospect of such competition.

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5 According to Head of Gazprom Export Alexander Medvedev, the Russian gas monopolist planned to take up to 10% of the U.S. gas market by 2015. The United States was mentioned as a target market in the Energy Strategy of the Russian Federation through 2030. In 2006, the Gazprom Marketing and Trading USA Company was established to help the Gazprom Group penetrate the U.S. market; perform trades, lease transmission, and regasification capacities; and purchase LNG. In October 2009 GM&T USA began commercial operations in North America based on the volume of pipeline gas obtained in swaps between Russian pipeline gas and LNG from other producers. The company also operates in conjunction with Gazprom Global LNG for the implementation of LNG to the U.S. market, but the current conditions on the U.S. market do not favor these activities.

6 In 2009–2010, gas prices did not move above $140/1000 m³ at the Henry Hub, and experts estimate they will remain at this level in the near future.

7 U.S. firms plan to expand LNG exports by reequipping unused regasification terminals into LNG production plants. In 2010 shal gas production leader Chesapeake signed a preliminary agreement on supplying 14 bcm of LNG to Cheniere Energy within the planned LNG project in Louisiana (to start in 2015). This project has already been granted a relevant agreement from the authorities. Agreements on a number of other projects are currently pending. In particular, discussions are underway on five production projects that will deliver LNG to Europe and Asia, with overall projected capacity of 55 bcm/year, and with possible commissioning of the first capacities as soon as 2015. Despite their high cost, the economics of these projects appears quite reasonable if one takes into account the high gas prices in the Asia Pacific region (primarily in Japan and South Korea).
What role should the United States play in Russia’s relationship with its oil and gas customers?

Russian energy strategy is built on special relationships with buyers in post-Soviet Eurasia and in Europe. Although the United States and the European Union have at times encouraged states in post-Soviet Eurasia to “move away” from Russia, the West, broadly conceived, has not been prepared to foot the bill for the subsidized Russian gas these countries depend upon for economic survival.

East European countries—former members of the Warsaw Pact, now new NATO/EU members—which in the past enjoyed the privilege of lower energy prices, face significant economic challenges because of skyrocketing energy bills over the last two decades. Historical overdependence on Russian energy supplies associated with high oil-linked gas prices for these countries in recent years has created grounds for price disputes.

The Caspian as irritant in U.S.-Russia relations

The Caspian region is part of a broader area of pivotal geopolitical significance to all global players, and more so to Russia, given its proximity and history of domination—indeed, for Russia, the Caspian region has always been an area of vital interests. The United States too has a multitude of interests in this region that transcend issues of energy security into realms of political and strategic importance, stemming from a desire to maintain global preeminence. Competition between the United States and Russia for influence in this region of post-Soviet Eurasia may be understandable, but it need not be inevitable.8

U.S. policy makers believe the Caspian holds the potential to diversify world hydrocarbon markets in the first half of the twenty-first century. Energy production in the region is seen as one means of reducing the dependence of the United States and other developed countries on oil exports from the Persian Gulf countries. The United States has also been interested in supporting projects that build new gas transportation routes in regions outside Russia’s jurisdiction. In particular, U.S. officials have repeatedly articulated their support for the Nabucco gas pipeline (which would run from the South Caucasus to Europe, bypassing Russian territory) and for a Trans-Caspian gas pipeline (which would transport Turkmen gas to Turkey via Azerbaijan and Georgia, linking Central Asia with the South Caucasus).

Russia does not explicitly oppose Nabucco but has hindered it indirectly; as for the Trans-Caspian pipeline, Russia expressed its irritation with the EU for trying to negotiate directly with Turkmenistan and Azerbaijan, warning that the EU policy of ignoring other countries of the Caspian Sea region would lead to tension.9

This opposition provoked so-called “paper wars”: information campaigns pro- and anti-Nabucco held the public’s attention, while no real movement occurred in the pipeline’s implementation. The enormous information campaigns surrounding Nabucco are unique in global history: never has any energy project received so much attention for such a long time. Meanwhile, real threats (radicalization of the region, drug trafficking, and the strong penetration of China, for example) have not received sufficient attention from either global player.

The Nabucco Gas Pipeline International GmbH (NIC) was formed by energy companies from Austria (OMV), Bulgaria (Bulgargaz), Hungary (MOL), Romania (Transgaz), and Turkey (Botaş) in 2004 for the construction and operation of a natural gas pipeline from Turkey to Austria with a capacity of a 31 bcm/year. The backers planned to transport gas flowing into Turkey from various sources, but the most feasible source in the short term was to be Azerbaijan. According to the company, “Nabucco was also the most viable transport route from the Caspian basin, both logistically and economically, making it more attractive than other alternatives being discussed.”10

In 2007, energy companies from Italy (Eni) and Russia (Gazprom) signed a memorandum of understanding on the construction of a natural gas pipeline from Russia to Italy via the Black Sea and several European countries. Both Nabucco and South Stream were presented as indispensable for the energy security of Europe: Nabucco as both a new pipeline route and a source of gas away from Russian and Ukrainian transit, and South Stream as an alternative to Ukrainian transit.11 12

Support for either of these natural gas pipelines signified an adherence to a broader system of values and alliances. South Stream had to contend with substantial opposition in the United States and Europe, particularly in prospective transit countries. Cooperation with Russia had turned into a divisive issue in the domestic politics of potential member-countries of the South Stream route. Supporters accepted Russia’s pragmatic language of economic benefits and energy security. Opponents employed more dramatic language, evoking fear and the not-so-distant memory of the domination of Central and Eastern Europe by the Soviet Union. Support for Nabucco implied a pro-U.S. orientation and defense of the foreign policy preferences of the United States. Moreover, South Stream and Nabucco were cast as mutually exclusive. Consequently, a strong correlation emerged between taking Ukraine’s side in the 2006 and 2009 gas disputes, supporting Nabucco,

opposing South Stream, and resisting Russia. Some of Nabucco’s supporters underscored the project’s political aspects. Joschka Fischer, former German minister of foreign affairs, said that Nabucco’s strategic value was in creating a linkage between the Caspian region and Europe. The politician predicted that “[i]f Europe says no to Nabucco, the Chinese will take over Turkmenistan,” and it would be geopolitical disaster.\textsuperscript{13}

Russian President Vladimir Putin in 2008 underscored that in contrast to the competing Nabucco pipeline, gas supplies would be guaranteed for South Stream. “It is absolutely obvious that the project we are offering can with certainty be realized,” he said, adding: “If someone wants to peck the ground and put iron in it in the form of pipes, please, we don’t mind. The task of our partners is extremely simple: to take a calculator and count what is more profitable.”\textsuperscript{14}

The EU, in turn, tried to devise a balanced policy toward Russia. Brussels considered the Southern Corridor, with access to new resources from Central Asia, the Caspian, and Middle East regions, as complementary to the EU’s traditional supplies from Algeria, Norway, and Russia. Cabinet member at the EU Commission Roland Kobia stressed that geography made close relations between Europe and Russia inevitable: “The topography between Russia and Europe is naturally conducive to easy flows,” which is a “truly win-win situation between two neighbors.” Alternatives could not substitute for Russia, Kobia noted.\textsuperscript{15}

U.S. policy changed its tone over time. In the immediate aftermath of the Russian-Ukrainian crisis in 2006, U.S. politicians and analysts were overwhelmingly critical of Russia. U.S. Vice President Dick Cheney argued, “No legitimate interest is served when oil and gas become tools of intimidation or blackmail.”\textsuperscript{16} A Council on Foreign Relations task force report severely criticized Russia’s behavior, particularly its use of energy exports as a “policy weapon” and “tool of political intimidation,” with Ukraine being its most “shocking and coercive application.”\textsuperscript{17} Matthew Bryza, a senior State Department official, offered diversification of sources as a potential solution: “Our approach is to help Europe and help our European allies achieve their goals in diversification and to put them in the strongest possible negotiating position with a Gazprom partner who will be around for a long time. Strength in negotiations comes from diversification.”\textsuperscript{18}

Since the Obama administration took power in January 2009, the U.S. government softened its rhetoric and in many aspects endorsed Brussels’ positions, a reflection of an improved climate in U.S.-Russia relations. Richard Morningstar, special envoy for Eurasian energy at the U.S. Department of State, said that the government had re-examined the

\textsuperscript{13} Joschka Fischer, interview by Rawi Abdelal, Berlin, Germany, June 18, 2010.
\textsuperscript{15} Roland Kobia, interview by Rawi Abdelal, Brussels, Belgium, October 13, 2009; Faouzi Bensarsa, interview by Rawi Abdelal, Brussels, Belgium, October 12, 2009.
\textsuperscript{18} See http://iipdigital.usembassy.gov/st/english/article/2008/05/200805300170946diameutoyo09f9903.html#zzz2DMt9Hv4aK
issue and had made some shifts in emphasis. “Our Nabucco policy is not an anti-Russian policy,” Morningstar said. "Russia will be a major player for the foreseeable future in any circumstance.”

Nor was it the policy of the United States to oppose South Stream, despite “lingering issues with regard both to its cost and the availability of gas.” The diplomat stressed that the United States had tried to depoliticize these pipeline projects, and the latter would not be sufficient to ensure energy security of Europe. The Southern Corridor, according to Morningstar, should be complemented by interconnections within Europe, new gas storage facilities, and alternative technologies.

The U.S. government, Morningstar said, could not preach to the Europeans: “We cannot be more European than the Europeans in thinking about the region’s energy security.” At the same time, Morningstar highlighted the direct connection between the interests of the United States and continued strength of its European allies and partners. The United States’ interests also were present in the Caucasus and Central Asia, where the U.S. government promoted greater independence in their commercial and foreign policies. The envoy added: “Nabucco can help promote behavioral changes elsewhere, too. It would be good for countries in Central Asia to have more choices about how to deliver their energy resources and to whom to sell.” As such, despite changes in rhetoric, the United States continued to make its opinions known on the issue of Russia’s energy relationships in the Eurasian region.

**Russian pipelines and U.S. policy**

While the United States has expressed support for the transport of non-Russian gas to Europe via non-Ukrainian transit routes, the United States has not encouraged northern and southern pipeline routes—the so-called Nord Stream and South Stream projects—that would disintermediate Ukraine for Russian gas imports. U.S. policy has been based on the assumption that European countries that depend on Russia for vital energy imports may be unable to formulate foreign policy independent of Russian preferences. (Please see the Appendix for maps of existing and proposed natural gas pipelines in Eurasia.)

U.S. policy has been based on two misconceptions. First, that Europe depends on Russian gas more than Russia depends on European markets. Second, that political maneuvering can have a major impact on corporate profit-motivated decision making in Europe—and ultimately, on the way Caspian oil and gas is developed. It is worth noting that for all its pro-Nabucco cheerleading, the United States has been unwilling to bear the burden of paying for this project and others that attempt to push Gazprom and Russia out of

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20 Ibid.
21 Ibid.
European natural gas markets. Meanwhile, private companies—German, Italian, and French firms including E.ON, Wintershall, Eni, Enel, GDF Suez, and EDF—are cultivating closer relationships to Gazprom and the Russian state with numerous joint ventures.22

On the question of Nabucco and South Stream, great progress in the bilateral relationship could be achieved if the United States were—simply, and plausibly—to acknowledge that the Southern Corridor and the decisions made about it are being driven more by local economic logics than by global political agendas. Yet the persistence with which some U.S. policy makers have clung to contrary notions only reinforces the view that the United States will stand in the way of Russian goals with the slightest provocation and based on the shakiest of logics.

The role of energy in Russian state-building

The U.S. approach to Russia’s external energy policy is based on a misunderstanding of the European-Russian energy relationship. It is not that U.S. allies are dependent on an unreliable partner regarded by some U.S. officials with suspicion. Rather, it is Russia that is more deeply dependent on energy exports—first of all to Europe. Although the Russian economy has stabilized since 1998, in 2010 more than 80% of the nation’s export earnings derived from oil, fuel, natural gas, and minerals. Russia is now an exporter of raw materials, just as it was in the last few decades of the Soviet Union—it produces roughly 12% of global primary energy, about half of which it is exporting. Russia is the biggest energy-exporting country in the world, exporting two-thirds of the oil it produces, one-third of the coal it mines, and one-third of the gas it extracts, in addition to considerable implicit energy exports (e.g., aluminum, fertilizers, and other high-value-added goods exports).

This means that Russia is dependent on global commodities markets, and more specifically, on unpredictably fluctuating prices. A prolonged global downturn or systematically anemic growth rates during a halting recovery will likely keep demand for oil and gas below levels that would sustain the dizzying prices of just a few years ago. Weakening global prices and corporate profits threaten the very security of the Russian state. The vast majority of Russia’s energy resources export earnings—and nearly all of its revenues from natural gas sales—derive from European customers.

Russia’s current capacity to supply the global economy with oil and gas was built in the 1960s by the Soviet Union. The state invested money in research, exploration, drilling, and pipeline construction; the state collected revenues from sales of oil and gas domestically and abroad. When the Soviet Union collapsed in the early 1990s, the state divested itself of most of its oil-producing assets by privatizing regional companies that soon coalesced into national firms. Gazprom, the gas-exporting monopoly, was privatized more slowly, and the state retained a controlling stake. In the tumultuous 1990s, as the Russian economy plunged dramatically, export revenue maximization became critical.

Today, Russia’s energy policies are typical for an energy exporter for which export revenues provide a large share of GDP, employment, and tax receipts. Energy exports underpin state authority domestically and afford some degree of influence externally.

Russia is thus a global supplier, but one with a very challenging domestic agenda: it must modernize the Soviet-built energy and non-energy sectors if the country is to curb oil rent dependence in the long run. Aware of this, Russia currently invests 4–4.5% of its GDP in the energy sector versus the world average of 1–1.5%. But to remain competitive over the next decade, Russia needs to replace the majority of its old producing assets to reduce its energy intensity by 40%; this process alone could cost $211–282 billion. Satisfying domestic energy demand and export obligations from 2008 to 2030 is estimated to require total
capital investments of $2.3–2.7 trillion in the development of the energy sector. In addition, to protect its positions on the global energy markets, Russia has launched huge new upstream and midstream projects designed to replace depleting production in the old Soviet fields and create transportation infrastructure for new markets. This development of the energy sector will require enormous investments, making the country even more exposed to the conditions of the external energy markets.
Policy Recommendations

We recommend only a few specific policy changes. For what is most needed is not a change in the minutiae of energy policy, but rather a more fundamental change in attitudes and worldviews. Successfully recasting the relationship will require a deeper understanding of the vulnerabilities and motivations of both governments and firms.

The key priority of the United States is for its officials to let European and Russian policy makers and European and Gazprom executives work out their energy relationship without unhelpful, sometimes antagonistic pronouncements and policies. Russia is deeply dependent on energy exports to Europe, and U.S. policy makers should recognize that their counterparts in Europe have their relationship with Russia quite under control. There is no good reason to lobby against the Nord and South Stream projects. Nor is there any sense in continuing to antagonize Russia by promoting Nabucco. Worse, U.S. cheerleading for Nabucco undermines the nation’s credibility among European energy executives, who are mystified by the persistence of the approach.

Russia, for its part, should refrain from overreacting to these same U.S. missteps. Even if the U.S. approach to European energy markets has so far failed to change, its consequences are not sufficient to justify the political difficulties resulting between the two nations. Moreover, Russian policy makers and energy executives will have to recognize that the unconventional gas revolution in the United States and a worldwide economic slump will change the organization of gas markets. This is most likely inevitable, and Russia will have to adjust. These trends do not reflect any sort of U.S. conspiracy to undermine Russian interests. It is nothing personal—just business.

On this very point: the broadest necessary transformation is for U.S. and Russian policy makers to understand the role of business interests in these geopolitics. Profit-seeking firms are, for the most part, driving real investments. While political considerations are part of the reality that energy firms always face, their motivations are overwhelmingly focused on economic returns.

Russia and the United States do not have any really strong reasons for opposition in the energy sphere, nor any significant projects for cooperation. But this vacuum might be easily filled by real conflicts unless both sides find points of joint interest and advantage. Identifying these points need not require difficult reassessment in the United States. Some reassessment is required in Russia in terms of granting U.S. capital more access to Russian energy assets. In the right investment climate, U.S. firms could play a role in developing energy resources in Siberia and the Far East. Moscow has begun to understand that economic development of these regions can happen only through their integration into a “rising Asia,” including through energy links. Developing new greenfield oil and gas projects in these remote and challenging areas will require not only enormous capital investments, however, but also completely new technologies and managerial skills lacking in Russian firms.

The broadest necessary transformation is for U.S. and Russian policy makers to understand the role of business interests in these geopolitics.
Appendix

Maps of existing and proposed natural gas pipelines in Eurasia
Figure 1. Natural Gas Pipelines in Eurasia: An Overview

Figure 2. Nord Stream Natural Gas Pipeline

Figure 3. Nabucco and South Stream Proposed Natural Gas Pipelines

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