

How Russia's Energy "Weapon" Turned into an Oil Pillow and Gas Rattle

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The transformation of the global energy market has been so swift that strategic thinkers have had difficulty internalizing the consequences of a massive expansion of supply. In the United States, the long-aspired epitome of energy independence arrived so unexpectedly that policy planners now appear lost in defining exactly what the country's national interests are in the Persian Gulf. In Russia, the path from ambition to become an "energy superpower" to suspicion of having been reduced to a "raw material appendage" has been so swift that the two perceptions have blended into an unhealthy obsession with the energy business. There is no intention here to add to this obsession, but it appears useful to examine Russia's residual capacity for instrumentalizing energy exports to achieve its political goals and to investigate the intrigue around control of this uncertain capacity.

Desperate Denial of Decline

It is remarkable, even ironic, that the material basis for Russia's energy ambitions and worries has not changed all that much since the shocking turmoil of the first year of Dmitry Medvedev's disappointing presidency. The production of both crude oil and natural gas increased slightly in 2012 compared with the pre-crisis level of 2007 and is expected to remain stable. The big news in Russia's energy sector over the last couple of years really has concerned the completion of "midstream" developments—the Nord Stream gas pipeline and the East Siberia-Pacific Ocean (ESPO) oil pipeline. In practical terms, the first of these export channels has only had a minor impact on Russia's ongoing transit and export travails vis-à-vis Ukraine (which are currently centered on its intention to sign the trade agreement with the EU), while the second has secured Russia a position as one of China's smaller suppliers of oil.

Newly-declassified Russian data on hydrocarbon reserves confirm that Russia is an overachiever in oil, producing nearly as much as Saudi Arabia while hanging on to the sixth or at worst eighth place in terms of global volume of potentially recoverable

crude. Even in a period of market tightness, Moscow was never able to exert influence on the fluctuation of prices; now it is even more anxious due to fear of its imminent decline. Russian companies, including state-owned Rosneft, which became the dominant player after its 2013 acquisition of conflict-ridden TNK-BP, effectively sabotage orders to develop underexplored fields in East Siberia because of uncertain tax breaks and poor cost-effectiveness. The most attractive proposition in the oil industry is to conclude partnerships with Western majors in order to rehabilitate older brownfields in Western Siberia and the Volga region, where new technologies make it possible to expand production from various tight sources.

The picture in the gas industry is strikingly different. The badly mismanaged Gazprom has begun production at the giant Bovanenkovo field on the Yamal peninsula, but it can neither secure the profit volume needed to sustain its investment nor increase its efficiency by introducing new know-how. Strictly speaking, Gazprom does not need to develop non-traditional sources. However, it cannot adjust to the fast-moving shale gas revolution and, paradoxically, is set to become a giant loser in the dawning “golden age” of gas. Gazprom has failed to secure useful entry eastward to Chinese demand and is trapped westward in the depressed European market, where its activities are investigated by the relentless European Commission. Gazprom’s stubborn denial of the need to change its business strategy and culture does not impress investors or political masters, and its market value (as of August 2013) has dropped to barely a third of what it was in mid-2008.

The profit-maximization model in the Russian oil industry is not compatible with the political aims of weaponization, while the more politicized gas sector is dejected. While Gazprom is desperate for more political support, President Vladimir Putin is reluctant to waste his leadership capital on a succession of defensive skirmishes.

False Premises of Two Modernizations

Medvedev’s vision of modernization should not be dismissed outright as a failed discourse, if only because it strongly advanced the proposition that Russia should overcome “oil dependency” by becoming a major producer of modern technologies. While Medvedev’s claim for leadership can only be described as pathetic, a remarkably broad consensus on the urgent need for modernization did emerge. This meant that when Putin returned to the presidency, he could not recycle the “energy superpower” posture. However, Putin dislikes the word modernization and the gadgets associated with it, and he committed to a different version of this course, one centered on restoring Russia’s traditional industrial strength, first of all by rehabilitating the military-industrial complex. There is a common premise in the two strategies-of-sorts: modernization requires a redistribution of resources from the energy sector to the chosen direction of strategic advances.

In real terms, Putin’s “re-industrialization” makes no more economic sense than Medvedev’s “innovations,” but in either case the damage to the oil and gas industry is massive. There is no space here to elaborate on the unaffordable costs of Russia’s colossal rearmament program (see PONARS Eurasia Memo No. 254 by Brian Taylor,

[“Kudrin’s Complaint: Does Russia Face a Guns vs. Butter Dilemma?”](#)). However, it can be safely asserted that the company UralVagonZavod, which has become the model enterprise among dozens of aging defense super-plants, makes a far deeper “black hole” for disappearing budget allocations than the “high-tech village” Skolkovo could ever be.

The point is that the only realistic avenue for Russia’s modernization lies in exploiting its rich natural advantage in the energy sector, which is in fact a cluster of extraordinary modern industries in which fundamental science meets applied technologies producing a menu of innovative byproducts, including “know-how” in environmental protection. Extraction of raw materials is certainly the central part of this industry, but value-added chains go in many directions – unless they are curtailed, which is exactly what happens in Russia due to over-taxation, political misdirection, and corruption.

The political need to confiscate revenues from energy companies—even Gazprom—clashes with the need to invest in key core businesses, with the net result being neither here nor there.

A Battle of Tweedledee and Tweedledum?

Confusion in setting guidelines for energy strategy and the general downgrading of energy interests translates into an escalation of tensions between the Gazprom/Rosneft/Novatek lobbies and the government, as well as quarrels among the masters of the energy empires. In some analyses, these conflicts are presented as fierce corporate wars involving larger-than-life characters, like Igor Sechin, or mysterious operators, like Gennady Timchenko; in others, these confrontations are reduced to petty squabbles between pathetic personalities resembling Tweedledee and Tweedledum who agree to have a battle but are ready to abandon it the moment Putin issues a croak of displeasure. (This author is inclined to take these matters seriously, if only because the financial stakes concerned often exceed the annual budget of his institute by three orders of magnitude.)

It stands to reason that the government’s pressure to extract more revenues from the energy sector in order to cover ever-expanding budget expenditures produces a modicum of solidarity among the oil and gas companies, who consent to make Igor Sechin the champion of their resistance. The main vehicle for this lobby is a presidential Commission on the Issues of Strategy for Developing the Fuel-Energy Complex, which works in parallel (and in most cases, at cross purposes with) a governmental Commission on the Issues of the Fuel-Energy Complex, chaired by Deputy Prime Minister Arkady Dvorkovich. Sabotaging the government’s initiatives as a matter of principle Sechin has few reservations about abusing his position as secretary of the presidential commission for advancing his own agenda, for instance derailing the plan to privatize Rosneft. He is nonetheless unable to prevent the confiscation of dividends earned by Rosneftegaz (the state-owned umbrella company that holds a 75 percent stake in Rosneft and 11 percent of Gazprom) into the federal budget as Putin becomes concerned about shrinking revenues.

Sechin's privileged position has turned the formerly competitive oil sector into a nearly monopolized domain. Some oligarchs, such as Mikhail Fridman and other owners of the Russian half of TNK-BP, have preferred to cash out their stakes and move to different pastures. Others, like Lukoil owner Vagit Alekperov, opt to keep a low profile. Tensions are rising with Gazprom's boss Aleksei Miller (who is envious of Sechin's access to the "decider") and multiple owners of energy-grid companies, who suspect that Sechin neglects their needs in maintaining profitability as domestic tariffs on gas and electricity are increased only by about a half of their demand. While Gazprom and Rosneft stand together to protect their monopoly in developing hydrocarbon resources on the continental shelf, Sechin is moving incrementally toward curtailing Gazprom's monopoly control over gas pipelines and encouraging legislation on liberalizing LNG exports. In so doing, he is preparing the ground for a long-overdue reform of this over-stretched super-corporation which has become a political liability.

It is remarkable that the energy oligarchs are managing to keep themselves out of the squabbles among and reshuffling of the political clans caused by the evolving crisis of Putin's regime. For that matter, neither of the two major cadre dramas—the replacement of Minister of Defense Anatoly Serdyukov with Sergei Shoigu, and the replacement of Vladislav Surkov by the new "manager of democracy" Vyacheslav Volodin—has any direct relevance for the energy complex. Also, none of the three most visible politicians—Dmitry Rogozin, who champions the interests of the defense industry, Vladimir Yakunin, who is enmeshed in a nasty corruption scandal, and Sergei Sobyenin, who is fighting a difficult election campaign for the post of Moscow mayor, has any explicit connection to the oil and gas lobbies. Sechin is often portrayed as belonging to the clan (or rather alliance of hawkish clans) known as the *siloviki*, but there is in fact no hard evidence of any financial flows from Rosneft coffers to any so-called "power structure." The only business-political intrigue in which Sechin had a prominent role was the hostile takeover of Yukos back in 2003-2004.

So What Energy Weapon?

The oil and, to a remarkably lesser extent, gas industry are set to remain the major producers of revenue for Russia's economy, but the petro-oligarchs are keeping a low profile in Russia's unfolding domestic political crisis and are experiencing a diminishing influence in foreign policy-making. In the oil sector, the looming shadow of falling prices discourages investments in newer greenfields in East Siberia, so the immediate interest of focus is on untapped unconventional resources around and under the brownfields, which necessitates partnership with Western majors and service companies.

In the gas sector, the disreputable Gazprom is losing position in the crucial European market. Every attempt to mobilize Kremlin support against the probe launched by the European Commission or securing exemptions from the EU's "third energy package" backfires by inviting firm political countermeasures. Recurrent gas quarrels with Ukraine bring frustrated "not again!" signals from regular customers, who wearily observe how Gazprom is balancing on the brink of a major blunder with the

start of construction of the hugely expensive South Stream pipeline across the Black Sea, which could not possibly make economic sense but is part of Putin's pet mega-project portfolio.

The record of Russian energy diplomacy is informative: its offers to partake in oil developments in Venezuela are fruitless; contracts in Libya are annulled; attempts to turn the Forum of Gas Exporting Countries into an operational cartel have come to naught. The culmination of the financial crisis in Cyprus last spring saw a flurry of baseless speculation about Gazprom seizing control over Aphrodite and other gasfields. The only place where Russia is making an impact is Northern Iraq; Gazprom Neft has signed three production-sharing agreements with the government of Kurdistan while paying scant attention to Baghdad's reservations.

The unusual stability of oil prices camouflages the depth of changes in the global energy market. Fears focused on a probable price drop prevent Russian policymakers from internalizing these changes. The underlying proposition behind the newly-established dominance of Sechin's Rosneft appears to be the added value of political control, which may turn out to be nonexistent. Gazprom constitutes proof positive of the maxim that political interference is bad for business, but it transpires that instrumentalizing gas export is bad for politics as well. Wielding an imaginary "energy weapon," Russia suddenly discovers itself armed with a rattle.

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