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Can Russia Use Its Energy Endowment and the World Oil System To Its Advantage?

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Russia was hit hard by the drop in oil prices in the second half of 2008 and also by the financial turmoil that has since spread around the world. While in 2008 the Organization for Economic Cooperation and Development (OECD) estimated the growth of Russia's gross domestic product to be 5.6 percent, it predicts a decline of 6.8 percent for 2009. The rebound in oil prices in the first half of 2009 has mitigated some of Russia's problems, as has the relatively small role of Russia's banking sector in its overall economy, but recovery may still be a long way off.

Regardless of how its economy performs, however, Russia's endowments as an oil producer and transporter continue to give it potential power in the world petroleum system. Russia, still the second largest oil producer in the world (behind Saudi Arabia), lifts almost 10 million barrels a day. Similarly, although exports have declined as world demand has contracted, Russia still exports nearly 5 million barrels a day to customers around the world, mostly in Europe, but increasingly to China as well. Russia also continues to be a dominant force in the regional pipeline system, despite the efforts of others to develop alternative routes.

What can Russia do with these potential levers of power? This memo explores actions that Russia could take to influence its neighbors, reshape the world oil system more broadly, or both. The possibilities are many, but few are easy and none is without cost. The memo concludes by cautioning against seeing Russian actions only in terms of the damage they might do.

Physical Levers

Export

The most obvious source of leverage for an oil producer is the threat of supply cutoffs. The West has feared such a move since the 1973 embargo, and it is a strategy Russia has employed with natural gas, most famously in its relations with Ukraine. With oil, Russia seems to have taken a similar approach in its negotiations with China in recent years. In accordance with an agreement from late 2004, Russia exported about 10 million tons of oil to China in 2005 and 15 million tons in 2006. In 2007, however, exports were much lower, as Russia sought to pressure China into paying for a pipeline spur from Skovorodino to Daqing and to increase the price it paid for Russian oil. China eventually agreed to both.

China, of course, is not helpless in this relationship. Its dependence on Russia is limited. Even the 15 million tons China imported from Russia in 2006 represent only a fraction of its total oil consumption. China is also famously pursuing oil sources in other areas of the world, from Central Asia to Africa and beyond. China, therefore, has been able to moderate Russia's demands for a higher oil price. Still, Russia appears to be at least on even footing with China in matters related to oil.

Russia supplies much more oil to Europe than to China, but its leverage vis-à-vis the former has been more limited, as the limitations of the cut-off threat are more apparent in the European context. An oil embargo may be painful to the target in the short run, but in the medium and long run supplies can be replaced, if at a higher price. Target countries can also prepare for an embargo by accumulating strategic reserves, thereby mitigating even short-run problems. Meanwhile, the embargoing country itself loses revenues. With regard to all three of these issues, Europe is in a better position than China.

Transit

It is thus the oil exporters in Russia's vicinity, rather than the oil importers, that may be the most vulnerable. Russia can block pipelines that carry their oil across or near its territory. The Western-financed Caspian Pipeline Corporation (CPC) pipeline runs from Kazakhstan around the northern edge of the Caspian Sea to the Russian port of Novorossiysk, while a Soviet-era pipeline carries oil from Turkmenistan and Kazakhstan to central Russia and into the main export lines to Europe. These exporting countries are in a relatively weak position when negotiating transit tariffs or volume quotas.

Russia can still affect transit routes that do not cross its territory. In certain strategic areas, most notably the Caucasus and Central Asia, Russia can cause uncertainty and instability at a fairly low cost to itself. Gains, too, might not be large, but they would probably include a short-term jump in oil prices. Disrupting trade beyond its own neighborhood is also theoretically possible, but options like blocking maritime trade in a particular region are extremely risky and produce uncertain gains.

Production

While oil power is generally thought to derive from the ability to cut off supplies,

another source of influence lies in the capacity to increase supplies or refuse to do so. Swing producers (Saudi Arabia today, but Kuwait, Iraq, and others in the past) are treated differently than other states. Being in a position to ease world oil shocks grants a state potential leverage in international affairs.

For now, Russia does not appear to have the ability to increase short-term production, and, therefore, it cannot function as a swing producer. Russia's undeveloped oil regions are inhospitable and expensive to work; with today's lower oil prices and scarcer investment capital, developing excess production capacity would seem to be a very tall order. It is, however, at least a theoretical possibility, especially if it becomes a priority for the Russian government.

Furthermore, Russia can enhance its role in export, transit, and production by expanding its presence in oil sectors beyond its borders. It has already begun to do this, most prominently in Central Asia. Lukoil, with the support of the Russian state, has ownership stakes in Kazakh oil deposits, the CPC pipeline, and the westbound pipeline from central Kazakhstan to China. In addition, much of the oil flowing through the Kazakhstan-China pipeline comes from Russia for now. Such a foreign presence does leave Russia more exposed to certain dangers; its deposits, pipelines, and transit oil are all at the mercy of Kazakhstan's government. At the same time, it gives Russia a more direct say in Kazakh affairs and provides it with more oil and global connections.

Financial and Political Levers

The world of oil goes beyond the physical extraction and transportation of petroleum. Futures contracts – promises to buy or sell a certain amount of oil at a certain price on a certain date – are traded in volumes far greater than the total oil produced in the world each day. The prices that result from trading on the two biggest markets, the New York market for West Texas Intermediate (WTI) and the London market for Brent, play a central role in determining the prices companies pay for physical oil. Russia has at its disposal at least two strategies for using the futures market to gain some advantages. One is short-term, disruptive to the market, and difficult; the other is long-term, potentially constructive, and also difficult.

Driving the Futures Price

Futures markets are promoted as mechanisms that allow buyers and sellers of commodities to hedge prices, but they also provide financial investors with opportunities to profit on changes in price. There is nothing nefarious about this arrangement, but it does mean that the price of futures may respond to forces other than supply and demand of the physical product. For example, investors may buy oil futures to hedge against inflation or a declining dollar, diversify their investment portfolios, or reap the rewards of riding a trend. In this context, buying can beget more buying, which benefits oil producers (while selling can beget more selling, which harms them).

One strategy available to Russia, therefore, is to try to foment another sustained rally in the futures markets. Any of the negative tactics discussed earlier – cutting exports, blocking pipelines, causing instability – might create an environment in which

speculators return to oil as an attractive asset. Conceivably, Russia could funnel assets into the futures markets directly, again hoping to prompt an upward trend in prices. Such activities are illegal, however, and today's constrained financial environment would make it very hard to attract a large enough wave of investment into the market to make the strategy work.

Reshaping the Futures Market

A second approach to oil futures markets involves reshaping them in a way that could benefit Russia. As noted earlier, futures contracts allow both buyers and sellers of physical oil to hedge prices. Most blends of crude oil do not have futures contracts that are traded widely; instead, buyers and sellers have to hedge their trades of, for example, Bonny Light oil (Nigeria) with futures deals in WTI (U.S.) or Brent blend (Europe).

From the perspective of both buyers and sellers, this is an imperfect arrangement. Futures contracts do not actually lock in the price of the oil being sold (in this example, Bonny Light) but instead the price of an oil that is usually of similar worth. At least the three types of oil just mentioned, however, are relatively "light" and "sweet." For crude oils that are relatively "heavy" and "sour" – like most crudes, including Russia's – deciding how many futures contracts of WTI or Brent to buy or sell in order to hedge the physical deal becomes even more complicated.

The current system is also imperfect from the perspective of the Russian government. Buyers and sellers of many different types of oil have to hedge with WTI and Brent, potentially driving up their prices more than the price of Russian oil. Russian leaders consistently express their frustration with what they believe to be an unjustifiably high spread between, on the one hand, the price for the world's two "marker crudes" (especially Brent) and, on the other, Russian exports.

There is thus reason to believe that the world could use another widely traded futures contract, one for heavier and sourer crude than WTI or Brent. Russia, however, is not the only country that wants to create one. In fact, Dubai's futures contract is the most established in the region right now. The New York Mercantile Exchange (NYMEX), the Intercontinental Exchange (ICE), and Russia itself have all tried to launch a futures contract for Russian oil, but so far their efforts have failed. Informal forward deals are conducted, but the formal futures market is moribund. Efforts in this direction, however, are likely to continue.

Final Thoughts

Russia has the natural endowment to be a significant oil power, and there are a number of ways it could capitalize on that endowment. To be sure, the list can seem long and worrisome, especially because some of the strategies discussed could be more effective if Russia were to join forces with other countries. It would be difficult for Russia to significantly affect world oil supplies by itself or to mold futures markets on its own, but it might be able to do so by cooperating with other producers, including those in the Organization of the Petroleum Exporting Countries (OPEC). Russian firms resisted such cooperation in the early 2000s, but domestic and international conditions are different today. Collaboration would not guarantee success, but it is one more tool Russia has at

its disposal for making political and economic use of its oil.

Still, it is important to recognize that not every move Russia makes is aimed at coercing another state. Furthermore, not everything that benefits Russia hurts others. Successful development of its oil resources is not pursued simply to entrap the West or force China's hand. It also brings direct benefits to Russia and, in some cases, can be good for the rest of the world as well. Having an additional swing producer in the system, for instance, or a widely traded futures contract for heavy and sour oil would have positive implications well beyond Russia.

Finally, it is important to recognize that the world oil system will evolve, whether the United States likes it or not. Some changes will result from Russian efforts, some will come from other international actors, and some will be entirely unplanned. The question is how the system will develop and with what consequences. This memo can be read as a frightening list of aggressive policies Russia might pursue, but it can also be read as a discussion of some of the parts of the system that are most likely to change: new consumers are on the rise; major producers are growing even less beholden to the United States; transit routes will link American allies to unfriendly governments; and new marker crudes may eventually take the place of WTI or Brent. For Russia, the West, and the world, being alert to such possibilities will be crucial to adapting successfully.

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