U.S. Senate Committee on Foreign Relations

Subcommittee on International Economic Policy, Export and Trade Promotion

Hearing on "U.S. Energy Security: Russia and the Caspian"

April 30, 2003

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Thank you, Mr. Chairman. It is my honor to appear before you and Members of the Subcommittee to discuss the role for Russian and Caspian oil in U.S. energy security. I joined Carnegie Endowment for International Peace in Washington this year to focus on international energy policy. My views on this subject are informed by 25 years of experience in the international oil and gas industry, primarily with a major American oil company (Chevron). In recent years, I have also advised foreign governments and Western companies on strategy, investment policy and negotiations in the oil and gas sector, particularly in the former Soviet Union. I hope to bring some industry perspective from my work not only in this part of the world, but also Latin America, West Africa, Middle East, East Asia and Western Europe, to your Committee's discussion on the important subject of U.S. energy security.

No one can argue with the proposition that it is important for policymakers to have a realistic view of the policy environment. Otherwise political expectations are likely to be inflated and policy misguided. On the subject of oil & gas in the former Soviet Union, therefore, it is distressing to see the volume of misinformation and hyperbole not only from governments and industry in the region, which may have a vested interest in exaggerating the significance, but occasionally from our own government.

A number of years ago, most of us in industry were shocked to find a State Department report to Congress discussing the possibility of close to 200 billion barrels of crude oil reserves in the Caspian, at a time when industry estimates were at best 10% of that level. Today that industry estimate may be more generous, perhaps 30 billion barrels of oil reserves, but still barely 3% of total world proven reserves. The fact remains there has been only one significant discovery (Kashagan) in the Caspian since the fall of the Soviet Union. In a global context, the Caspian represents another North Sea or Alaska; it is significant, but even full development will not represent a fundamental shift in oil market dynamics or the world supply picture.

It is one thing for the President of Azerbaijan to talk about his country signing "the contract of the century," quite another for U.S. officials to repeat this claim. (After all, this is the same century, the 20th, that had King Abdul Asis of Saudi Arabia signing the original Aramco concession, which holds 25% of known world oil reserves.) It is worse still if U.S. policy is based on mistaken expectations and lack of understanding of petroleum industry realities. Even in his testimony before this Committee earlier this month, Under Secretary of State Al Larson, referred to Caspian Basin production of 1.6 million barrels per day in 2001 and the possibility of 5 million barrels per day in 2010. Most in industry would have a hard time finding Caspian production in 2001 to be much more than half of that level and believe that we will be doing well if production can be raised to 2 million barrels per day by 2010.

Industry expectations are moderated not only by geologic risks, but significant technical, economic and political risks in oil development in the region. Major finds are challenged by either being offshore; or in deep, high-pressure reservoirs; or with sulfur-laden associated gas that needs to be processed and the sulfur removed; or far away from market in a land-locked location – often times all of the above. Investments required are measured in billions or tens of billion dollars.

Peaceful political succession is unproven in the region. Political legitimacy of the governments in the region, as seen by their own population, has declined since independence from the Soviet Union. At the same time, the investment climate, which was largely welcoming a decade ago, has deteriorated with tougher contract terms, concerns over sanctity of contract, and greater appetite on the part of ruling elites for rent-seeking opportunities. Increased oil income has coincided with more autocratic rule, enhanced the ruler's ability to temporarily "pay off" parts of the elite by sharing some of this wealth, and allowed deferral of desperately needed fundamental economic and political reforms.

These unfortunate, but often repeated, developments associated with sudden oil income have in the past led to political instability, for example, in Latin America and West Africa. No wonder oil people around the world believe all the easy oil has been found and produced long time ago. More importantly, if uncorrected, this troubling trend in the Caspian region can give rise to longer-term threats to U.S. security interests, beyond energy.

Most of the commentary on the remarkable increase in Russian oil exports in the last two to three years has missed the fact that this has not been due to new discoveries or even development of new oil provinces or new fields. Russian oil production is around 8 million barrels per day today. It was over 10 million barrels per day (just in Russia) in the peak of Soviet oil production reached in the late 1980s. So the rise in exports, which has been dramatic, is driven by the revival of Russian production in the last three years and by the total collapse of Russian oil demand following a similar collapse in its economy since the fall of the Soviet Union. Russian oil consumption dropped from 5 million barrels per day in 1991 to 2½ million barrels per day today, accounting for almost all the export surge. This oil consumption level can be compared to the United States where we consume 20 million barrels of oil per day. This is in a country with approximately half our population and greater transportation distances with twice the number of time zones as we have.

The short-term causes of the recovery of Russian oil production are:

- Ruble devaluation after the 1998 financial collapse improving the cost structure of Russian petroleum industry;
- Return of domestic investment in the sector after owners of privatized oil companies believe their property rights will be largely honored by the Russian state; and
- Introduction of Western technology by using international service contractors in modern oilfield practices and reservoir management.

Can Russian oil production increases be sustained without more fundamental structural changes in the sector, including those reforms required to attract investment not only from domestic sources but internationally? With the sole exception in Sakhalin Island, neither the Russian government nor Russian industry has been particularly welcoming to direct foreign investment in the oil & gas sector in spite of the public rhetoric. Government fears loss of control and industry naturally wants to avoid competition. This is clearly demonstrated by recent events such as the rigged auction of Slavneft in December. From this perspective, the recently announced BP-TNK merger should be seen as BP deciding that, if you can't join the Russian oil party directly, then you must partner with a strong domestic player. It should not be seen as a sign that the Russian oil patch is now completely open to direct foreign investment.

Having achieved production and export growth by encouraging domestic investment, the Russian government seems to be hesitant to pursue further restructuring in the oil & gas sector. Reform of Gazprom, the natural gas monopoly, and Transneft, the state pipeline monopoly, is hardly even mentioned anymore. Both are significant obstacles to investment, even by Russian oil companies. Production Sharing Agreement (PSA) legislation, called for by international oil companies wishing to invest in Russia, has been rejected for almost all projects other than frontier exploration. It remains to be seen whether this trend of stalled reform will be maintained after the coming round of Duma and presidential elections.

Before further reform can take place, there needs to be a healthy political debate in Russia on the role the oil & gas sector should play in its overall economy and the impact on its politics, domestic and foreign policy. Given its population of 130 million people, industrial base, and agricultural potential, it is questionable whether its economy should be based on maximizing oil and gas exports, potentially crowding out all other economic activity. The oil industry is capital not labor intensive. It demands centralization of decision making both politically and economically in a few hands. Of course, this suits the interests of current political and business leaders. It is less clear whether this benefits the Russian people overall.

With 5% of the world's know oil reserves and a reserve/production ratio of around 20 years, Russia will always be a price taker in an oil market dominated by OPEC, not a price setter. Our own view of the role Russia can play in U.S. energy security should also be informed by this reality. Nothing that is happening or might happen in Russian or Caspian oil development, as prospective and lucrative as they may be to individual countries or oil companies, will change the fact that two-thirds of known oil reserves are in the Persian Gulf.

Certainly, diversity of supply is important to the world oil market and benefits the United States as the largest oil importer in the world. So new supplies from Russia and the Caspian are significant. Just as new supplies from deep water Gulf of Mexico, deep water West Africa, synthetic crude oils from Canadian tar sands and the Venezuelan Orinoco belt, under-explored acreage in Alaska, bringing Alaskan and Canadian Arctic gas to the lower 48s, new liquefied natural gas (LNG) projects, gas-to-liquids conversion technology – not to mention conservation and energy efficiency improvement – are all important, because they stretch the time when the last incremental barrel of oil demand must be satisfied by the Persian Gulf.

However, we should be under no illusion that a major supply disruption of prolonged duration in the Middle East can be replaced by such sources. Given their position as the world's swing producers with the most abundant and cheapest oil to produce, sitting between major oil markets in Europe and the United States and rapidly rising demand in Asia, Persian Gulf countries have a unique and irreplaceable position in the oil supply chain.

Until a technological leap allows us to move beyond oil's dominance in world energy consumption, a major supply disruption of prolonged duration in the Middle East will have a direct impact on U.S. energy supply and pricing, whether or not we are importing a drop of Persian Gulf oil ourselves. Oil is a largely fungible commodity in a fast-moving global market and supply will shift according to market signals, i.e., pricing. We and other members of the International Energy Agency (IEA) are also under obligation to not only hold strategic stockpiles (SPR in our case), but also share these strategic stockpiles in times of supply crisis. Any policy on international energy security based on bilateral oil relationships with other countries is, therefore, unlikely to be effective.

U.S. policy must be based on a realistic assessment of the global energy situation and the potential role these countries can play, not based on unrealistic expectations or as a substitute for a well-balanced foreign policy in the region. By focusing too much on energy relationships, we give these countries the impression that this is all we care about. By explicitly discussing specific projects (like individual pipelines) or laws that we favor (like PSA legislation) in bilateral meetings, we give the impression that we care less about improvement in fundamental conditions – like the rule of law, transparency, more political openness – that will lead to a better investment climate for domestic as well as foreign investors, not just in the export oriented natural resource sector, but in the larger real economy where the population lives.

They hear our rhetoric but do not believe us when our government keeps pushing projects. Leave that to industry and companies. Government officials should focus on what they know and can impact – how to foster a business climate conducive to investment and to avoid market distortions. Better that U.S. officials discuss lessons we learned in sectoral reform from our own deregulation of the oil and natural gas industries, including removal of price controls and import restrictions, in the 1980s that can be usefully applied than to lecture the Russian Duma on what laws they should pass.

I am very sympathetic to the extremely difficult jobs U.S. officials have to perform in this part of the world, having traveled there on a regular basis since 1992. However, we cannot reinforce the rulers and the general population's belief that the U.S. cares only about oil and the war against terrorism, without having to face long term the unintended consequences of such a policy. Russia, Central Asia and the Caucasus are important to U.S. foreign policy interests whether these countries have any oil or not. We should not allow exaggerated expectations in one area, for them and for us, to detract from sound overall policy.

Thank you.

[Prepared to discuss Iran in Q&A]