

“Energy Supplies in Eurasia and Implications for U.S. Energy Security”

**The United States Senate Foreign Relations Committee
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Thank you, Mr. Chairman and Members of the Committee, for the opportunity to appear before you to share with you my views on Eurasian energy dynamics and implications for U.S. energy security. I have closely followed Eurasian energy developments and U.S. policy towards the Caspian Sea Basin since the mid 1990s, and I am delighted to be part of this hearing today.

With its significant oil and gas reserves, especially in Russia and Kazakhstan, the Eurasian region is vitally important to the U.S. strategic effort to diversify energy supplies away from sources in the Middle East. The U.S. has a clear need to ensure that these supplies reach world markets cheaply and safely; however, it has an equal need to ensure internal reforms in the countries of the region. If it fails to do so, its effort to end its energy dependence on oil and gas from Saudi Arabia and the Persian Gulf will only result in the creation of a “second Middle East,” with equally damaging consequences for U.S. interests.

A Review of U.S. Caspian Energy Strategy

In the 1990s, the U.S. developed a multiple pipeline policy to the oil and gas reserves of the Caspian Sea. The intention of this policy was to allow the production of the region’s newly independent countries to reach Western markets without having to rely solely on Russia’s transportation infrastructure. The U.S. strategy was founded on four major objectives. The first was to strengthen the independence and prosperity of the Caspian states through the revenues obtained from energy production. The second was to bolster the security of worldwide energy markets by ensuring the free flow of supplies unfettered by the policies of regional competitors and by geographic chokepoints such as the Bosphorus. Third was to reestablish close economic linkages among the new states of the region in order to prevent or mitigate regional conflicts, while the final goal was to enhance overall business opportunities.

The U.S. extended its support to five major pipeline projects intended to achieve the above-mentioned goals. The most significant projects backed by the United States were the two pipelines along the so-called East-West Energy Corridor. First was the Baku-Tbilisi-Ceyhan (BTC) oil pipeline, which later this year will begin transporting Azerbaijani (and, in the future, Kazakhstani) oil through Georgia to Turkey’s Mediterranean port of Ceyhan, and second was the South Caspian Gas Pipeline, which

after its completion next year will transport Azerbaijani gas via Georgia into Turkey and onward to Western Europe.

U.S. support for these two projects did not reflect any anti-Russian agenda; it was instead intended to break the Russian monopoly on economic and political relations with Azerbaijan and Georgia so that these newly emerging states could freely develop their economic and foreign policies without fear of reprisal. The breaking of the Russian monopoly over the region's transportation system also helped Western companies operating in Azerbaijan and Kazakhstan. Once they were able to use the east-west pipelines and railroads to get their oil to markets, the companies were in a much stronger negotiating position vis-à-vis Russian corporations, who had become accustomed to charging high transport tariffs and gave preferential treatment to Russian companies. The availability of alternative routes provided security for Western companies operating in this region.

Despite the strong support of the U.S. government, the east-west pipelines would never have materialized were it not for their commercial attractiveness. American involvement was certainly important to the oil companies and other investors, as it substantially reduced the political risk of these projects. However, U.S. support was not sufficient by itself to make the projects a reality; the international consortium responsible for the development of Azerbaijani oil and gas did not make the final decision on either pipeline until each state signed the internationally-binding agreements offering the investors the right incentives and the necessary legal protection.

Ultimately, U.S. Caspian policy envisioned these pipeline projects acting as engines of economic growth, providing an impetus for political and economic reform in both the producing and transit states. Indeed, to avoid the so-called "resource curse" experienced by many energy-rich countries in the developing world, Azerbaijan and Kazakhstan have created Oil Funds that are transparently managed and monitored by international financial institutions and NGOs. While the governments have used part of the money to improve the living conditions of the countries' poorest citizens, the bulk of the energy revenues have been set aside in investments for the future. Although the implementation of democratic and political reforms have been slow, both countries are heading toward critically important elections this fall, and both leaderships seem committed to conducting elections that would meet international standards.

Putin as the CEO of Russian Oil and Gas

The U.S. vision in its Caspian energy strategy was the correct one, and many of its policy goals are still valid objectives. However, important developments require a new framework for the broader Eurasian region. Today the biggest policy challenge for the U.S. is Russia, which may well become a second Saudi Arabia in more than one sense. Indeed, Russia is already the world's largest gas exporter, and is the second-largest oil producer after Saudi Arabia. According to the Department of Energy, Russia has more than twice the gas reserves of the next country on the list—Iran. The report further states that the Russian gas monopoly Gazprom "holds nearly one-third of the world's natural gas reserves, produces nearly 90% of Russia's natural gas, and operates the country's

natural gas pipeline network....Because exported Russian natural gas accounts for approximately 25% of Europe's demand for natural gas, Gazprom is also one of Moscow's main foreign policy tools." This is the key point I would like to focus on in the remainder of my testimony.

As you know, Presidents Bush and Putin concluded a Strategic Energy Partnership in 2002. While it is not clear at all what the U.S. and American companies got out of this partnership, it has been a rather lucrative one for the Russians. With little interference from the United States, Russia has constructed monopolistic oil and gas networks that now threaten the energy security of the entire region. Over the past several years we have seen Putin dismantle Yukos, once the largest Russian oil company, and through the state firm Rosneft gradually consolidate its assets under the Kremlin's control. Yuganskneftegas, the main production unit of Yukos, was effectively nationalized in December 2004; through the acquisition of other assets, Rosneft plans to overtake Lukoil as Russia's leading oil company by 2008. Gazprom is also planning to enter the oil sector and will soon be joined by the privately held Sibneft, Russia's fifth-largest oil producer. Soon Putin will be in direct control of the world's largest integrated oil and gas enterprise.

It is not as if their intention to do so had been kept secret; in September 2003, Anatoly Chubais declared that "Russian business ought to be allowed to expand...with the aim of creating a liberal empire" in the former Soviet sphere. This sentiment was echoed at the highest levels of government; in 2004, then-energy minister (and later prime minister) Viktor Khristenko declared that Russia would act "more confident in pursuing its interests, while relying on [the] common resources" of the former Soviet states.

Adding to the strength of its monopolistic base at home and in its "near abroad" has been the increase in world oil prices. As I mentioned earlier, Russia is the world's second largest oil exporter after Saudi Arabia, and earned \$34 billion from oil exports in the first half of 2005—almost 50% more than the same time last year. Over the last five years, Russian economic growth has been primarily fueled by energy exports, and the economy has become dangerously dependent on the energy sector. And as long as oil prices remain high, there is little incentive for the Russian government to improve the investment climate and attract the billions of dollars worth capital necessary to increase oil and gas production.

Instead, Russia can afford to focus on its long-term interests in the energy sector: strengthening Gazprom, both as a gas monopoly and soon as an oil giant; building up Rosneft through former Yukos assets; and maintaining the monopoly power of the state-owned pipeline operator Transneft. All these long-term goals dovetail perfectly with Russia's long-term geopolitical interests.

But it is in America's and world energy security's interest for Russia to produce more oil and gas, and it is important to act fast. Easy oil is running out and huge investment and new technologies are needed to exploit the more remote and difficult fields such as those in the West and East Siberia. Therefore now is a good time to discuss a set of new

initiatives and conditions, especially as Russia moves to head the G-8. Russia has already stated that energy security will be its major theme; the U.S. needs to have its own energy security strategy as well.

Given that Russia wants to accede to the World Trade Organization (WTO) by end of the year, the U.S. has some leverage over Russia, but it is limited, especially given that there are other pressing issues in the bilateral agenda ranging from North Korea to Iran. Moreover, the U.S. needs to engage with Russia on energy and ensure that it can purchase Russian oil and gas, including liquidified natural gas (LNG) on a commercial basis. For the purchase to be on a commercial basis, the U.S. and Russia need to work together to channel Gazprom and other oil and gas industry operators toward operations on commercial basis and mitigate monopolistic power. The U.S. and the EU share similar interests in this area, and in fact, their common position should be to try to break up the monopolies that control the oil, natural gas and electricity industries across Europe and Eurasia as monopolies are clearly bad for consumers, because they charge higher prices than in a more competitive situation, while offering geo-strategists in the Russian Government an irresistible temptation to use energy supplies as leverage over Russia's neighbors.

Russia will need a lot of investment to develop new infrastructure needed to develop its major oil and gas fields. The U.S., together with the EU, could put together a large package—with the involvement of international financial and lending institutions, as well as the private sector (Western and Russian)—but make it conditional to Russia improving the investment climate—such as rule of law, transparency and governance, which will be required to make the major investment to happen.

The Russians have responded to competition, especially from the Caspian, and the U.S. therefore needs to maintain its focus on the Caspian. The monopoly control of Transneft over the oil pipelines is one of the major hindrances on Russian oil export. Transneft is creating massive bottleneck as it keeps pipelines under its control and does not let any other company develop pipelines. Russians provided good terms for the early oil pipeline from Baku to Novorrossiyk, mainly after the companies built another early oil pipeline from Baku to Supsa, the Georgian port on the Black Sea—concerned about the competition, the Russians then gave good terms to the companies for their route. Similarly, only after the Baku-Tbilisi-Ceyhan oil pipeline from the Caspian Sea to Turkish Mediterranean port of Ceyhan became real, the Russians became more constructive on the Caspian Pipeline Consortium to transport oil from Kazakhstan to Russian Black Sea port of Novorrossiyk. And now we have seen once Kazakhstan and China began work on their oil pipeline, Russia announced it would be building East Siberia with a spur to the Pacific.

Transatlantic Initiative Needed on Gas Diversification

The main leverage the U.S. would have is by working with the Europeans, and when they are talking about expanding Russian energy partnership, having them understand that increasing oil and gas supplies from Russia does not necessarily increase their energy security. What the Europeans need to do, given that they are the major market for

Russian gas, is to say to Russia they will continue to purchase their gas only after Russia signs on to the Energy Charter Treaty, conducts competitive business, and offers the Central Asian oil and gas transiting Russian infrastructure the same terms.

The U.S. therefore needs to hold a transatlantic discussion to urge the Europeans not to cut any long term deals with Russian monopoly companies without any pressure to change—otherwise, they will be hurting Russian energy development and Europe’s own long-term security. For example having Gazprom grow without any checks is not good for Europe’s long term security; and in this context, the pipeline agreement between Russia and Germany that would cut out Poland and Ukraine is not a positive development as these two transit countries would not be able to pressure Gazprom to behave in a commercial manner.

Western and Central European countries are dependent on the Russian gas monopoly Gazprom as their sole or primary supplier of natural gas. Consequently, European energy utilities have vested commercial interests in maintaining cordial relations with Gazprom. For example, Germany’s Ruhrgas is a major investor in Gazprom. Such relationships create a disincentive for European countries to take a firm line with Russia, even as Russia’s policies undercut democracy at home and undermine the sovereignty and independence of its neighbors.

Gazprom has over the last years systematically increased its leverage over European energy markets by bolstering its monopolistic control of regional pipelines. Last December the International Energy Agency already expressed concern that the EU as a whole was becoming too reliant on Gazprom, which could use its power as a monopoly supplier to push up gas prices. Russia in the past withheld oil and gas supplies to pressure the Baltic States and has done the same in the South Caucasus. The fact that Russia has in the past been a reliable gas supplier to Western Europe is meaningless; Russia has never had the kind of power it has recently acquired and we simply have no precedent to help us determine how it will use this power

Gazprom is not without vulnerability. It is burdened with its obligation to supply Russian consumers with gas at below-market prices. Gazprom needs to undertake significant corporate restructuring and reinvest into technology to increase its domestic production. Otherwise, to meet its supply demand, it will continue to try to acquire as much cheap gas in Central Asia as possible, and sell that gas more expensively to Western markets. In other words, Gazprom will need to rely on its monopoly control of regional pipelines to compel Turkmenistan, Uzbekistan, and Kazakhstan to continue to sell their gas at below-world prices. This has already made gas into a major geopolitical issue.

Gazprom’s diplomacy is to press the countries around the Black and Caspian Seas to agree to gas supply and transit arrangements which satisfy the company’s goals, specifically: keeping Central Asian gas prices at below-world-market rates; channeling such Central Asian gas to low-paying Russian customers; and protecting its lucrative European markets by freezing out Central Asian suppliers. In short, Gazprom is trying to

strengthen its monopoly power, which in turn will strengthen its leverage (and that of the Russian government) over European gas consumers.

The Central Asian states must therefore settle for barter deals with lower-paying Russian customers, as Gazprom reserves for itself more lucrative deals with Western European consumers. And the West's challenge then is to prevent Gazprom from further strengthening its leverage over European markets by reducing its monopoly power and channeling it toward more market-based behavior.

The Bosphorus Chokepoint and New Cooperation Possibility

The bulk of Russian oil is transported to the Black Sea and from there via tankers to world markets. The increasing amount of oil being transported to the Black Sea has caused the dangerously narrow and overcrowded Bosphorus to become a chokepoint, stalling traffic in and out of this closed body of water. In severe weather conditions, delays can be up to 30 days, which is hugely costly for the oil companies. Once Russian oil companies reach their production targets, and once the Caspian Pipeline Consortium (CPC) begins to transport oil from Kazakhstan to the Black Sea at full capacity, traffic through the Straits will simply become paralyzed. Any incident that caused delays above and beyond those caused by traffic and weather would shut down the passageway for a considerable period, with devastating effects for all countries in the region, which rely on the Bosphorus for transportation of imported goods and exported commodities.

The occurrence of such an incident, whether it is a major oil spill or a terrorist attack, is a serious possibility; the consequences of the latter are nearly unimaginable. If an LGP tanker is attacked while traversing the narrow Bosphorus through a city of 14 million, over a million people could be killed. After all, Istanbul was already hit twice by terrorists in November 2003 and is a front-line state in the war against terror.

One way to make the Straits safer is to divert some of the oil traffic to bypass pipelines. Once the BTC pipeline opens later in the year, the bulk of Azerbaijani oil will reach world markets via Ceyhan. Other Caspian countries could also use this pipeline, but there still will be significant amount of Russian oil transported via tankers. Given the importance of uninterrupted oil exports to its economy, Russians are now actively looking for a second Bosphorus bypass pipeline.

A win-win project the U.S. can work on with Russia and Turkey is to encourage Turkey to provide incentives for companies to construct of a new oil pipeline across Turkey to Ceyhan with capacity of 1 million barrels per day, which would also increase Russian government tax revenues by \$5bn to \$6bn a year. The U.S. could then focus oil exports into Mediterranean at Ceyhan, and thereby create a sort of oil "supermarket" where traders buy Iraq, Azeri or Urals oil.

Implications of Russian-Chinese Energy Partnership

Ending months of speculation, Putin has confirmed earlier this month that Russia will build a multi-billion dollar oil pipeline across Siberia to first go to China's Daqing oil terminal and then be extended to Nahodka, the Pacific port from which oil can be shipped

to Japan and to the U.S. In addition, Gazprom is in talks with CNPC to lay two pipelines to China. One would carry Russian gas west to join China's internal West-East pipeline and the other would head to the country's northwest direction; for each pipeline, the figures are 20-30 bcm per year.

The Russian-Chinese energy cooperation is extremely significant in light of the developments in and around Central Asia over the last several years. While it is difficult to fathom a long-lasting Russian-Chinese strategic partnership, at least for now both seem to have decided to cooperate to reduce the U.S. influence and presence in Central Asia. Benefiting from the growing concern over perceived U.S. support for the revolutions in Georgia, Ukraine and Kyrgyzstan, Russia and China used the July summit of the Shanghai Cooperation Organization (SCO) to make the first declaration against the presence of the U.S. military bases in the region. The SCO has been a weak regional alliance consisting of co-chairs Russia and China, and the Central Asian countries of Kazakhstan, Kyrgyzstan, Tajikistan and Uzbekistan, with Mongolia as the observer. In July, India, Iran and Pakistan joined as observers as well.

Last month Russia and China held a joint military exercise, Russia and India will hold their first ever joint army drill next month, and in 2006 all of the SCO members and observers are expected to participate in such military exercises. While Russia, China and India have expressed interest in "maintaining stability in Central Asia and ensuring the stability of oil supplies" it makes one wonder if an anti-American alliance is in the making. Given the participation of Iran, and its new president's preparedness for confrontation with the U.S., it would be prudent for the U.S. to pay close attention to these developments in Central Asia.

Moreover, a realist approach to the region's hydrocarbon-rich but democracy-poor countries, such as Turkmenistan and Uzbekistan, is needed in order for the West to make full use of the alternative sources and transport routes in the region. The United States needs to develop new policies that better address the new challenges, so that U.S. energy security can be strengthened and influence maintained and deepened across Eurasia.

Conclusions and Recommendations

I hope I was able to draw a picture in which the Kremlin knows that control over the Eurasian energy infrastructure, especially its gas pipelines, is its most effective foreign policy tool today. Given that Gazprom will for the foreseeable future be the leading gas supply provider to the EU, the U.S. needs to urge the European gas consumers, as well as transit states, to form a transparent, market-based, commercial relationship with Gazprom. Forging such a relationship requires all these states to strive for increased competition in gas supply and transit arrangements, and to circumscribe Gazprom's monopoly power.

The U.S. can also work with the countries of the former Soviet Union for them to pay upfront for the gas they take from Gazprom and charge Russia for transit services, thus bringing full transparency to the gas relationship. They also need to make sure to not collect any further debt to Russian companies that could force them to each debt-for-

equity deals. The South Caucasus countries can already work with the EU and the Energy Charter to adopt European standards in these dealings; Russia needs to join the Energy Charter as well.

The U.S. needs to recognize that there is a new alliance taking place that brings countries of the SCO closer in cooperating on political, military and economic areas. Russia, China, Iran and India have also been increasing their energy cooperation—given that all have state-owned and monopoly companies, their business practices are different than those of the West. Moreover, they are able to offer government backing and non-transparent incentives Western companies are not able to offer. These developments are neither in the interest of American companies nor in line with U.S. stated Caspian Sea region policies I discussed earlier.

Moreover, U.S. democracy and freedom agenda is in direct opposition to what the major SCO countries are preaching today. While the U.S. may be limited in its ability to influence the region's developments, it nonetheless needs to be consistent in its promotion of internal reform and democratic change. While criticizing Uzbekistan or Turkmenistan for their democratic short-falls, the U.S. and the EU cannot turn a blind eye to developments in Russia in the name of "energy security". At the same time, it is important to be realistic about the implications of pushing the freedom and democracy agenda in a region where other major powers are vying for influence by promising stability instead.

In this context, I would like to express my strong disagreement with the State Department's reported decision to move Central Asia out of the European Bureau and into the South Asian Bureau. The U.S. has been able to help the Caspian Sea region's energy projects and internal reform process by offering the region an East-West perspective. If the Central Asian countries are put together with Afghanistan, Pakistan and India, the chances of them coming under the SCO's influence will be significantly increased.

If this decision is not reversible, then it would be important to assess the signals the U.S. would be sending to the leaderships and the people of Central Asia. Such major reorganization would also require a new Eurasian energy strategy, as the strategy of the 1990s looking East-West would effectively come to an end. A new Central Asian energy strategy would then be devised to integrate the infrastructures of Central Asia and countries like Afghanistan, Pakistan and India. For example the U.S. would then need to strongly support the proposal to get Central Asian gas to India to block Iranian gas. On the negative side, Kazakhstan, which has long made clear its long-term vision to be closely engaged with Euro-Atlantic institutions, will be left with little option but to increase cooperation with its giant neighbors Russia and China, and such cooperation may come at the expense of energy cooperation with the U.S. I therefore would like to conclude my presentation by urging you Mr. Chairman and Members of the Committee to carefully consider this pending reorganization of the U.S. government as you deliberate on ways to increase U.S. energy security.