

Russia's great transit game

Russia is trying desperately to maintain a monopoly on the transport of all oil and gas produced in the former Soviet Union. The country would do better to create an open, competitive market and invest in developing its own resources, argues Vladislav Inozemtsev.

| by Vladislav Inozemtsev

Russia leads the world in gas extraction and is second in oil extraction. Unlike the Persian Gulf countries, Russia exports the majority of its energy resources via pipelines: 58% of oil and nearly 100% of gas. This factor restricts the Russian authorities' room for manoeuvring, the result often being irrational and unpredictable decisions.

Supplying oil and gas to Europe – the main market for Gazprom and the leading Russian oil companies – leaves Russia critically dependent on Ukraine and Belarus for transit. Until 2005, the Kremlin preferred to negotiate with the Ukrainian and Belorussian authorities using discounts to form 'strategic partnerships' on political issues. Viktor Yushchenko's victory in the Ukrainian presidential elections in 2004, and Belarus's increasingly firm position on pricing and control of the main transit gas pipeline of Beltransgaz, have led the Russians to a distaste for using the services of transit countries. As a result, from 2004 to 2008 the Nord Stream and South Stream projects were initiated (the Blue Stream gas pipeline to Turkey started a little earlier), groundwork was laid for the Burgas-Alexandroupolis oil pipeline, and a number of other projects are being developed.

The main problem with all these projects is that they were primarily set up with political interests in mind. As a consequence, their economic advisability is dubious. The cost of Nord Stream has been determined as \$7.4 billion, but if Russian infrastructure projects are a guide, this might easily end up twice as much. If the same transport tariffs are used as in Ukraine now, the project's

pay-back period could be 17-20 years. If the price of gas and of transit go down, the pay-back period may stretch to 30 years. Even if Nord and South Streams reach full capacity in 2014, Russia's dependence on transit countries will be reduced by no more than half, based on current gas export volumes.

The transit problem became political after the interruptions to the European gas supply in January 2006 and the crisis in relations with Belarus in the winter of 2006-07. While Ukraine and Belarus have made Moscow nervous as unreliable transit countries, Russia herself is an even less cooperative negotiating partner when it is

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the transit country. After the collapse of the Soviet Union, the Central Asian republics of the former USSR and Azerbaijan found themselves without direct access to foreign markets. Gazprom, the Russian gas monopoly, began dictating terms to producers of gas extracted in Kazakhstan, Turkmenistan and Uzbekistan. And



Gas processing facility in Yamburg, Russia. Photo: Taco Anema/Hollandse Hoogte

while Russia initially tolerated direct trading agreements between Turkmenistan and Ukraine, for instance, and imposed a tariff on the transportation of gas, the situation changed radically after 2006. Gazprom began buying up Central Asian gas first through the dubious company RosUkEnerg, and after its liquidation, directly. True, the prices Russia pays for importing gas are rising: from \$65 per 1,000 cubic metres in early 2006 to \$100 in 2007, and from \$130 in the first half of 2008 to \$150 currently. From January 1, 2009, the parties have agreed to shift to market prices (with the initial price agreed at \$225-295 per 1000 cubic metres). Gazprom had to compromise on the price but still insists on purchasing all the gas exported by Turkmenistan (currently about 45 billion m³ per annum). Another approximate 14 bcm of gas is supplied to Russia by Uzbekistan. So while supplying Europe with 114 bcm of gas a year through Ukraine and Belarus, Russia itself acts as a transit country for 60-65 bcm of Central Asian gas.

The same applies to oil: the pipeline system and railways transport 40 million tons per annum (mtpa) of Uzbek, Kazakh and Azerbaijani oil across Russia. Today, only Azerbaijan has an alternative – transit across Georgia to Turkey.

So Russia is playing a colossal transit game. Its credo is to release itself from dependence on other transit countries while maintaining transporter status to extracting countries. So far, Russia's strength and possibilities have allowed it to preserve the status quo to its advantage.

Energy sovereignty |

What do the Russians want? Official sources say that Russia's aim is to minimise its dependence on transit countries to ensure full and timely fulfilment of its oil and gas supply contracts to the EU countries. Particular attention is focused on gas, although Russia receives considerably lower export revenues from gas than oil (less than a third of aggregate hydrocarbon export revenues). Among experts, however, it is being stated increasingly openly that the Kremlin is, in fact, quietly trying to establish Russia's energy sovereignty over the entire former Soviet bloc.

Overall, Moscow is striving to fulfil three objectives. The first is to maintain a steady share of energy resource exports – especially gas – to the EU at the current level of 26% or to increase it to 34% by 2030, as is the hope of Alexei Miller, Gazprom's chief. The second is to achieve greater independence from the transit countries (this is partially the goal of organising supplies of oil and gas to China and Japan along the oil pipeline currently under construction from Eastern Siberia to the Pacific Ocean and the planned Trans-Altai pipeline). And thirdly, not to allow energy resources not controlled by Russia to be supplied from the landlocked regions of Central Asia to Europe and Mediterranean sea ports.

In other words, Russia wants to expand the monopoly enjoyed internally by its state energy companies to neighbouring and more remote countries. All this rightly causes concern in Europe and the western world. There are doubts, however, whether Russia's plans are realistic.

Russia faces two problems. The first is the weakness of the country's own oil and gas sector. Russian oil and gas extraction is unlikely to rise in 2008-2009 and may even fall, considering the recent financial crisis. It may turn out to be quite difficult to fill the ambitious Nord and South Stream projects as well as the Eastern Siberia-Pacific Ocean pipeline with sufficient oil and gas. The Blue Stream pipeline is actually not yet operating at capacity. Second, Russia's neighbouring producing countries are becoming increasingly dissatisfied with the transit dictates imposed by Russian authorities. In recent years, a powerful energy production centre has taken shape in the Caspian basin and in Central Asia. Although it is not yet as big as the Middle East or Russia, it is of critical importance to world markets.

Caspian countries are landlocked and do not share borders with their consumers. The current wave of geo-political rivalry in the region, in which Russia plays a very active role, revolves precisely around access to world markets.

Russian policy tries to achieve three main goals: to prevent the direct sale of trans-Caucasus and Central Asian energy resources to European consumers; to prevent construction of major transit routes from the region to Europe; and to limit the regional influence of China, which is increasingly being drawn into the oil and gas game.

In the first matter, Russia has already suffered defeat. The Baku-Tbilisi-Ceyhan and Baku-Supsa oil pipelines and the Baku-Erzurum gas pipeline are already in operation. At a convention



In contrast to Russia, oil and gas extraction is growing in the region by 10-20% or more per annum. Azerbaijan was the fastest growing producer in 2007 with an increase of 31.7% in oil production and a 63.2% rise in gas extraction. The states of Central Asia and Azerbaijan are not short of investments or resources, but they are faced with one common problem: ensuring reliable and safe ways for exporting their energy resources. In all these countries (except Uzbekistan), domestic consumption of oil and gas is closer to Middle Eastern figures (15-20%) than Russian (33% of oil and 66% of gas). This raises the significance of export corridors, since the

held in September in Baku, the first direct contract was signed for the supply of Azerbaijan gas (1 bcm per year) to Greece. In the summer of 2008, the EU reached agreement on the construction of a Turkey-Greece-Italy gas pipeline with a capacity of 7 bcm per annum, to be commissioned in 2012.

Russia is now trying to offer Azerbaijan beneficial terms for transportation along the Baku-Novorossiysk pipeline, but so far Baku is not keen on the idea. During the recent conflict in Georgia, the Russian military did not make any strikes against the pipeline route across Georgian territory or the port structures

in Supsa. This may be regarded as confirmation that Azerbaijan's status as an "independent exporter" is recognised by Moscow and that the struggle is for other Central Asian producers. Russia insists its partners in the Caspian Pipeline Consortium (including Chevron, British Gas and ENI) use the pipeline for oil transport to Novorossiysk, but Moscow strategists are unable to decide whether they want to maximise this transit, eliminating capacity shortage, or to retain it to exert pricing pressure on producers.

As to the second goal, Russia categorically opposes the construction of the Nabucco pipeline from Central Asia to Europe. Estimated at \$12-12.5 billion, it could supply the EU with up to 31 bcm a year and, considering Turkmenistan's obligation to sell up to 30 bcm of gas a year to China from 2011 onwards, is capable of completely drying up the Central Asia gas stream currently flowing to Russia. This worries Moscow because, if implemented, Europe will not only obtain an alternative source of gas, but will deprive Russia of an important source of replenishment of its own gas balance. Its continued attempts to persuade East European countries (above all Hungary) and Greece not to participate in Nabucco have been somewhat successful, as the EU still has not decided to build the pipeline despite the established need for it.

Sturgeon at risk |

Russia is equally concerned about Kazakhstan's plans to expand oil transit across Azerbaijan and Georgia. The only response Russia has come up with is to increase transit capacity of the Central Asia-Centre pipeline and expand capacity of the Caspian Pipeline Consortium. Russia has also been devising many restrictions on hydrocarbon extraction in the Caspian Basin (even resorting to the argument that the reproduction of sturgeon is at risk).

The third problem for Russia is increasing Chinese influence in Central Asia. Despite growing cooperation with Russia, China is actively pursuing its own interests in the region, which it sees as key for future energy supplies. Relations between China and the Russian Federation in the energy sphere can hardly be called benign. Moscow has repeatedly blocked Chinese state-owned companies from participating in the purchase of large interests in Russian oil corporations, such as Slavneft; the Chinese, in turn, have been hard bargainers over the price of gas – contributing to the indefinite postponement of the Trans-Altai gas pipeline. As a result, China turned to Central Asia and began constructing an oil and gas pipeline from Turkmenistan, Uzbekistan and Kazakhstan to China. From 2006-2008, the Chinese invested about \$3.4 billion in these projects. As a result, at the end of 2006, the first oil pipeline from Kazakhstan to China began operations (by 2010, it will extend to the Caspian shore, where the region's biggest oil deposits are being developed). At the beginning of 2008, a smaller oil pipeline from Uzbekistan was commissioned and, from 2009, gas supplies should be initiated from Turkmenistan (planned volume of 30 bcm of gas a year after two to three years). These projects make China a real competitor in the struggle for regional resources. And Russia, still not having completed construction of the Eastern Siberia-Pacific Ocean pipeline, will have to become a customer of the

Kazakh transit system. Rosneft has been using this channel to supply China with oil since the end of 2007.

Political friction |

Russia remains virtually the only major energy resource exporter facing an acute transit problem. This is its legacy from the former USSR, and Moscow perceives the need to seek a compromise with the now independent republics with considerable discomfort. Russia is treating its Central Asian partners far more harshly than Ukraine and Belarus are treating Russia. The contradictions accumulating around the transit problem appear insoluble; the only option for Russia is moving away from strict 'linkage' to transit pipelines and stepping up its efforts to develop a network of flexible supplies – primarily by sea, as most energy resource exporters do today.

This reorientation programme could involve construction of major new oil-loading terminals on the White and Black Seas and in the St Petersburg area, the creation of gas liquefaction plants in the Archangelsk Region and on the Black Sea coast, and initiation of a serious state programme for building up a tanker fleet and vessels for transporting liquefied natural gas (LNG). Russia lacks a single suitable LNG-vessel at a time when LNG accounts for 27% of the global cross-border supplies of gas. The International Energy Agency predicts that the total market for LNG will double between 2008 and 2016, approaching 393 bcm per year. Even today, LNG terminals in advanced industrial countries can take in 617 bcm of gas – almost all of Russia's annual production – and new facilities are under construction.

Despite all the political friction with the West, Russia is a far more natural ally of Europe and the US than, for example, the Persian Gulf states. Russia could overcome conflicts with its neighbours if it were to cease acting as a party dictating its own conditions. No matter how difficult for the Russian ruling elite to admit, the country's oil and gas complex would benefit if it were to stop trying to monopolise oil and gas from Central Asia and concentrate instead on stepping up development of new deposits in Russia.

Economic development is bolstered by competition. By contrast Russia's transit policy is intended to ensure and consolidate its monopolistic position. This is precisely what might undermine Russia's position as an energy superpower. In the end this would be equally disadvantageous for both Russia and the West. ■

Who is Vladislav Inozemtsev?

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