

Working paper

The East-West maneuvering in Russia's energy policy – Could oil and gas exports to China endanger Europe's energy security?

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Introduction

Much in Russia's relations with China, and Asia-Pacific more generally, is determined by the character and content of its relations with Europe, which for reasons of history and geography are of pivotal importance for the organization and identity of the Russian state. Russian-European interactions have always been loaded with much philosophical controversy and practical tension, and the post-Soviet period is no exception in this regard.¹ Without going into in-depth examination, which belongs to a different research project,² it appears useful to point out at the very outset of this one that since the middle of this decade, these relations have followed a rather paradox pattern as the intensity of economic interactions (both trade and mutual investment) has steadily and massively increased, while the political dialogue has stalled and the underlying perceptions of trust and respect have eroded. In parallel, and no less paradoxically, the friendliness of Russia's political relations with China has notably strengthened, while the scope of the economic ties has not expanded at all. Seeking to sustain the first part of this two-track trend, President Dmitri Medvedev paid a 'self-introductory' visit to China within the first month of his term, but the demonstrated devotion to 'strategic partnership' did not help break the apparent deadlock in energy cooperation.³

Energy has been the central element of Russia's economic relations with Europe but has not acquired the same prominence in trade with China (not to mention mutual investments, which are kept at a fairly low level), as Moscow has remained reluctant to deliver supplies that would satisfy 'China's hunger for natural resources'.⁴ At the same time, energy has become the main focus of Russia's foreign policy and a matter of personal priority for both former President Vladimir Putin and his successor Dmitri Medvedev, who has acquired extensive experience in these matters chairing *Gazprom's* Board of Directors for eight years; at this moment, it is unclear how this experimental 'duumvirate' would share control over energy policy as the division of responsibilities remains fluid.⁵

¹ One good source on this thoroughly researched problem is Iver B. Neumann, *Russia and the Idea of Europe: A Study of Identity and International Relations*. London: Routledge, 1996. The most fundamental Russian study is Aleksandr Yanov, *Rossiia i Evropa: 1462-1921* (Russia and Europe), Moscow: OGI, 2005. See also Yanov's interview 'The alternative to reunification with Europe is Chinese yoke', *Polit.ru*, 29 September 2005 (<http://www.polit.ru/analytics/2005/09/28/yanov.html>). A thoughtful current analysis is in Aleksei Makarkin, 'Modern Russia and the European factor', *Polit.ru*, 13 May 2008 (<http://www.polit.ru/institutes/2008/05/13/evrop.html>).

² I have devoted much attention to that in Pavel Baev, *Russian Energy Policy and Military Power: Putin's Quest for Greatness*. London: Routledge, 2008.

³ See Aleksandr Gabuev, Aleksandra Gritskova, Konstantin Lantratov, 'Strategic pretension', *Kommersant*, 23 May 2008; Fedor Lukyanov, 'Diversification of clubs', *Gazeta.ru*, 22 May 2008 (<http://www.gazeta.ru/column/lukyanov/2730757.shtml>).

⁴ See 'A Ravenous Dragon', Special Report on China's Quest for Resources, *The Economist*, 15 March 2008. This analysis emphasizes that 'Over the past few years, the volume of raw materials it consumes per unit of output has risen sharply. In particular, China has gone from miser to glutton in its use of energy, and is now struggling to diet.'

⁵ My recent comments on that are Pavel Baev, 'Russian energy policy remains under Putin's control', *Eurasia Daily Monitor*, 17 March 2008 (http://jamestown.org/edm/article.php?article_id=2372889), and 'The Putin-Medvedev duo get back to energy business', *Eurasia Daily Monitor*, 3 June 2008 (http://jamestown.org/edm/article.php?article_id=2373111).

This article aims at providing an explanation for the apparent contradictions in Russia's Europe/China energy and political relations and at exploring the prospects for their transformation. It starts with analyzing the impact of ambivalent ideological tenets on energy policy and proceeds to assess the limitations on this policy dictated by the problems in Russia's energy complex. Then the pattern of Russia-China cooperation/competition in Caspian energy developments is examined, and the last two sections look into the prospects of possible significant shifts in Russia's political course and energy partnerships at the start of the next decade.

Europeanism and Eurasianism in Russia's energy policy

From the very start of his unexpected presidency, Putin rejected the proposition of constructing an official ideology and presented himself as a 'pragmatist'. In the 2007 Address to the Federation Council, he even made a point of ridiculing the tradition of 'searching for a national idea' as Russians' 'favorite pastime'.⁶ In fact, however, there has always been a strong and essentially ideological desire to restore Russia's 'greatness' at the core of Putin's leadership, and by the end of his second term this motivation has become more pronounced despite the predominant concern about securing a smooth transition of power. President Medvedev has taken this ambition to the heart and stated at the St. Petersburg Economic Forum: 'Russia today is a global player. We must recognise its responsibility for the destiny of the world and we want to participate in shaping the new rules of the game, not because of any so-called imperial ambitions, but simply because we have both the requisite capacity and resources'.⁷ While some analysts argue that the dominant driver of Russia's external behavior is the greed of the ruling elite camouflaged by bombastic rhetoric, there is more explanatory value in the proposition about a 'mixture of mercantilism and messianism' in Russian foreign policy.⁸

Putin arrived to power with a strong conviction that Russia was a European state; this perspective was rooted both in his upbringing as a 'man from St. Petersburg' and in his formative experiences in the GDR (admittedly, not exactly an exemplary European state). He also had – and has not overcome – a strong obsession with the US typical of his generation of KGB officers. For that matter, his trusted aids did not miss the shift of strategic focus in the US political thinking towards China that was developing at the start of George W. Bush administration.⁹ That perspective informed Putin's attitude to the pattern of high-level contacts with the Chinese leadership that he had inherited from

⁶ Official translations of Putin's speeches are available at the archive of the presidential website; see (http://www.kremlin.ru/eng/speeches/2007/04/26/1209_type70029type82912_125670.shtml).

⁷ He also emphasized the US responsibility for the crisis of the global financial system. See, Dmitri Medvedev, speech at the XII St. Petersburg Economic Forum, 7 June 2008 (http://president.kremlin.ru/eng/speeches/2008/06/07/1338_type82914type127286_202288.shtml).

⁸ For the former, see Andrei Piontkovsky, 'Two-headed Russian eagle', *Insight*, 8 January 2008 (http://www.hudson.org/index.cfm?fuseaction=publication_details&id=5366); for the latter, see Ivan Krastev, 'The Crisis of the Post-Cold War European Order', *Brussels Forum Paper Series*, March 2008 (<http://www.gmfus.org/publications/index.cfm>).

⁹ One characteristic example is John Mearsheimer, *The Tragedy of Great Power Politics*. New York: W.W.Norton, 2001.

President Boris Yeltsin, but he was far more concerned at that time with establishing his reputation in the West and building European networks.

Focusing on Europe, Russian foreign policy at the start of this decade also had a strong orientation towards security matters determined by the crucial importance of the Second Chechen War for domestic affairs and also by the radical transformation of international political agenda driven by the US 'war on terror' launched after the terrorist attack that is commonly defined by simple numerals '9/11'. Indeed the only goal in the Kremlin's energy policy was to restore direct control over the gas monopoly *Gazprom*, which took a couple of years to achieve.¹⁰ Two dissimilar events in 2003 prompted a transformation of Putin's priorities: The US invasion of Iraq, and the scandalous persecution of the oil company *Yukos* and its owned Mikhail Khodorkovsky. In a different way, both caused estrangement between Russia and the West, while at the same time increased the salience of energy in Russia's policy. As the rising world oil prices increased the revenues of the state budget, Moscow was less and less inclined to tolerate criticism from its 'partners' regarding the curtailing of democratic reforms.

The event that created a deep antagonism between Russia and Europe was the 'Orange Revolution' in Ukraine in late 2004, which was a painful personal defeat for President Putin and a direct challenge to the 'enlightened' authoritarian system of power in Russia. While the panic in the Moscow political elite about a looming 'color revolution' in Russia subsided during 2005, the deepening gap in fundamental values became only more apparent, so the productiveness of political dialogue diminished to insignificance.¹¹ It was the chairmanship in the G8 that constituted the central proposition for Russia's foreign policy in 2006, so Moscow was reluctant to escalate the tensions with the West and defended its 'right' to be a member of this exclusive club as both 'natural' and very particular since without Russia it could become a mere gathering of 'fat cats', in Putin's words.¹² At the same time, the emphasis on Russia's energy power increased to an unprecedented degree as the topic of 'energy security' was chosen as the main theme for the G8 deliberations.

In hindsight, it is possible to see through the self-compliments of official propaganda the disappointment in the net results of the G8 chairmanship that did not provide a boost to Russia's international standing that the Kremlin had been counting upon. So more sharp was the anti-Western turn signaled by President Putin's 'Munich speech' in February 2007 and translated into a new strong emphasis on 'hard' security problems that were seen as developing in Russia's favor for the first time in two decades.¹³ That turn was

¹⁰ Insightful account is in Valery Panyushkin & Mikhail Zygar, *Gazprom – Novoe Russkoe Oruzhie* (Gazprom – New Russian Weapon). Moscow: Zakharov, 2008.

¹¹ One argument for breaking that crystallizing deadlock was Arkady Moshes, 'Reaffirming the Benefits of Russia's European Choice', *Russia in Global Affairs*, July-September 2005 (<http://eng.globalaffairs.ru/numbers/12/942.html>).

¹² On that, see 'Putin deflects criticism on Russia's G8 role', *People's Daily Online*, 1 February 2006 (http://english.peopledaily.com.cn/200602/01/eng20060201_239560.html).

¹³ My recent analysis is in Pavel Baev, 'Russia's Security Policy Grows "Muscular": Should the West Be Worried?', *UPI Briefing Paper*, Helsinki: January 2008 (http://www.upi-fiia.fi/eng/publications/upi_briefing_papers/).

justified by a stream of quasi-geopolitical arguments that Russia was something 'greater' than merely a part of Europe, that it had its own historical path and singular state-society symbiosis, and that it was destined to play a unique role in the on-going transformation of the world system.¹⁴ This 'escape from Europe', sometimes conceptualized as revival of Eurasian orientation, involved a determined offensive against the Organization for Security and Cooperation in Europe (OSCE) and a demonstrated rapprochement with China, first of all in the framework of the Shanghai Cooperation Organization (SCO). President Medvedev has noticeably softened the tone of foreign policy rhetoric but this limited 'de-securitization' has been accompanied by invectives against NATO enlargement and OSCE bias, while his own Berlin initiative on a new all-European treaty fashioned after the Briand-Kellogg pact (1928) was strikingly irrelevant.¹⁵ He also confirmed the devotion to strengthening partnership with China, while the 'natural' affinity between the two political systems is well illustrated by the remarkably similar emphasis that is placed by the two regimes on organizing the Beijing 2008 and the Sochi 2014 Olympic games.

The Kremlin's energy rhetoric has followed this ideologized Eurasianism by emphasizing diversification and new opportunities in the so-called 'BRIC group' (Brazil-Russia-India-China), but the practical energy policy has remained unequivocally Eurocentric and concerned primarily with securing new export routes to European markets. At the same time, the sustained transfer of wealth from the EU to Russia has made it possible for the latter to internalize and advertise its own experiences not as merely a lucky 'petro-state' but as a model – comparable to the much admired Chinese 'miracle' – of achieving growth and prosperity without importing Western democratic institutions.

Virtual diversification and surrealistic Energy Strategy

Russia, with its unique endowment of natural resources and inexhaustible energy reserves, and China, with its astoundingly dynamic economy and insatiable appetite for raw materials, appear to be natural partners that are destined to complement one another's economic strength. In the near future, this perfect compatibility could only increase as most of Russia's untapped energy reserves are in Eastern Siberia – and it certainly makes perfect economic sense to transport those to the Chinese consumers, who now struggle to secure the deliveries of coal from Australia, oil from Sudan and Angola, and natural gas from Iran and Qatar. Politics does not seem to stand in the way of this 'made-in-heaven' economic marriage as Moscow and Beijing recycle tirelessly pledges of friendship and partnership. Still, there are few reasons to believe that the trickle of oil from Russia to

¹⁴ Thus, the former Chief of the General Staff Yuri Baluevsky argued: 'I am against placing Russia in opposition to Europe and Asia (Eurasia), but I am also against the imposition of European civilization on Russia, since I am certain that if Russia wants to have a successful future, it must remain Russia. Russia is not Europe, not Asia, and not even Eurasia. I'd like to emphasize, it is Russia!' See, Yuri Baluevsky, 'Security Index of a Globalized World: The Russian Dimension', *Security Index*, Vol. 13, No. 1, 2007, pp. 27-38, on p. 30. More thoughtful views are in Vladimir Lukin, 'Russia's Global Role and European Identity', *Russia in Global Affairs*, January-March 2008 (<http://eng.globalaffairs.ru/numbers/22/1175.html>).

¹⁵ Judy Dempsey, 'Medvedev, in Germany, revisits Russia's tensions with the West', *International Herald Tribune*, 6 June 2008.

China would soon become an energy flow, and the main reasons for that can be found in the development deformities of the Russian energy complex.¹⁶

Serious problems in functioning of the energy industry started in the late 1980s and had become one of the main causes of the spectacular collapse of the Soviet Union.¹⁷ Setbacks continued throughout the 1990s and were seriously aggravated by the deep dive of the world oil prices at the end of that decade. Coming to power in the situation of dangerous economic instability, President Putin had every reason to see the energy sector as a source of possible new shocks that might bring the Russian state to the brink of failure – and so sought to provide stimuli and guidelines for its rehabilitation as means to ensure domestic ‘energy security’. The Energy Strategy was developed in 2002-2003 and envisaged three possible scenarios, in which the key variables were the oil prices and Russia’s ability to invest in modernizing infrastructure and developing new production capacity not only in the oil-&-gas sector but also in the coal and nuclear industries.¹⁸ The real development, however, followed an entirely different trajectory as Russia’s economic recovery acquired high dynamism, the world oil prices continued to climb – but the investments failed to materialize.¹⁹

The watershed in the recovery of the energy complex, which also became the major breakdown in the implementation of the Energy Strategy, was crossed in 2003 with the state-run attack on the oil giant *Yukos* and imprisonment of its owner Mikhail Khodorkovsky. There is no need in revisiting that ‘scam of the year’ (in the words of Putin’s ex-aid Andrei Illarionov), but some of its aspects have direct relevance for Russia’s energy relations with the West – and with China as well. One immediate consequence, for that matter, was the collapse of Russia-US energy dialogue as the *Yukos* project for building an export pipeline from West Siberia to Murmansk was abandoned. Another implication concerned *Yukos* business with China that after a protracted squabble was acquired by the state-owned *Rosneft*, which had to borrow from Chinese partners up to US\$ 6 billion for accomplishing that hostile takeover to be repaid by oil deliveries.²⁰ Yet another issue was the derailed *Yukos* plan for constructing an oil pipeline

¹⁶ One recent analysis argues convincingly that ‘the outlook for energy cooperation between Russia and China is not as positive as Russian policy-obsessed neo-cons suggest.’ See Vladimir Milov, ‘Neo-Cons Plans and Sober Reality’, *Russia in Global Affairs*, October-December 2006 (<http://eng.globalaffairs.ru/numbers/17/1071.html>).

¹⁷ Solid analysis of that causation is in Egor Gaidar, *Gibel Imperii: Uroki dlya Sovremennoi Rossii* (The death of the empire: Lessons for modern Russia), Moscow: ROSSPEN, 2007.

¹⁸ The text of the ‘Energy Strategy of Russia for the Period to 2020’ is still available at the website of the Ministry of Industry and Trade (<http://www.minprom.gov.ru/docs/strateg/1>).

¹⁹ As one keen analyst pointed out, ‘The statistical relationship between oil prices and industrial output is so close that it is tempting to ascribe virtually all of Russia’s post-August 1998 performance to oil’. See Clifford G. Gaddy, ‘Has Russia entered a period of sustainable economic growth?’, pp. 125-144 in Andrew Kuchins (ed.), *Russia After the Fall*. Washington: CEIP, 2002, on p. 131.

²⁰ The details of that deal remained murky but the overall *Rosneft* commitment amounted to 48.5 million tons of oil to be delivered until 2010, beyond which the prospect are still unclear; see Natalya Skorlygina, ‘Rosneft-China talks have stumbled over the pipe’, *Kommersant*, 6 March 2008.

to China; after much delay and reconfiguration, the project was entrusted to state-owned *Transneft*, but its costs have sky-rocketed to US\$ 12.5 billion.²¹

It was in early 2006, when the post-*Yukos* controversies had subsided, that the proposition for diverting a greater share of energy export to China was strongly advanced by the Russian leadership – and the main driver behind that ‘diversification’ was the fall-out from the ‘gas war’ with Ukraine in the first days of that year. Putin was convinced that his motives in that high-profile conflict were grossly and deliberately misinterpreted by the West, hence the blunt message to the alarmed Europeans that Moscow intended to channel to China not only oil but also the increasingly marketable natural gas. It was Minister for Industry and Energy Viktor Khristenko who first stated that the plan for the ‘strategic’ Eastern direction was to increase by 2020 its share in oil export from 3% to 30% (up to 100 million tons) and in gas export from 5% to 25% (up to 65 bcm).²² President Putin’s visit to China later the same month brought an agreement to start the export of gas in 2011 with the aim to increase it to 60-80 bcm.²³ Seeking to reinforce the message, *Gazprom*’s CEO Aleksei Miller warned the EU ambassadors against politicizing the supply problem: ‘It should not be forgotten we are actively seeking new markets such as North America and China’.²⁴

The essence of that warning was in the fact – well known to European experts – that gas production in Russia has been growing very slowly, and that the flat trajectory is set to continue well into the next decade. At the same time, domestic consumption has been increasing at a rate significantly higher than envisaged by the Energy Strategy and has little elasticity, so the painfully negotiated price increases (17% in 2007 and 25% in 2008) have not reversed this trend. In fact, the difference between the fixed prices on the domestic market and the ‘upward-mobile’ prices for the European consumers has never been greater than in mid-2008.²⁵ Even without any export to China, the prospect of a gas crunch at the end of this decade is very real, and there are few doubts about the main cause of this problem – *Gazprom*’s sustained underinvestment in new production. Responding to European concerns, *Gazprom* has revised its target figure for production in 2020 to 650-670 bcm from 620-640 bcm, but these manipulations cannot change the fact that the Shtokman project would come on-line only in the second half of the next decade and the ‘green’ gasfields of Yamal cannot begin deliveries before 2020, when production in old Urengoi and Yamburg would decline by 50% comparing with 1996.²⁶

²¹ The decision to build the 2700 km long East Siberia – Pacific (VSTO) pipeline from Taishet to Skovorodino was taken in 2004, but the launch date for the first line (30 million tons of oil) has been recently shifted to the end of 2009; see Denis Rebrov, Petr Netreba, Dmitri Butrin, ‘Pulling the pipeline’, *Kommersant*, 11 February 2008.

²² Viktor Khristenko, ‘Russia’s Energy Strategy: Breakthrough to the east’, *Vedomosti*, 6 February 2006.

²³ Good discussion is in Ivan Rubanov, ‘China is for a long time’, *Expert*, 27 March 2006.

²⁴ See Mark Milner, ‘Gazprom threatens Europe’s gas supply’, *The Guardian*, 21 April 2006.

²⁵ Aleksei Miller, *Gazprom*’s CEO, meekly admitted that the company had underestimated the price dynamics; see Sergei Kulikov, ‘Gazprom delivers a preventive strike’, *Nezavisimaya gazeta*, 11 June 2008.

²⁶ Detailed analysis can be found in Vladimir Milov’s presentation ‘*Gazprom*’s reform: design and failure’ (<http://www.milov.info/speech.php?id=682>); *Gazprom*’s plans are evaluated in Aleksei Sheglov, ‘Gazprom has returned to higher goals’, *Nezavisimaya gazeta*, 17 June 2008; for a European view, see Paillard C.-A., ‘Gazprom, the Fastest Way to Energy Suicide’, *Russie.Nei. Visions* No. 17, Paris: IFRI, March 2007.

Characteristically, after that 'gas offensive' in spring 2006, the Russian leadership made a turnaround in the second half of the year and downplayed the issue of 'diversification', while since mid-2007 the focus of political attention has shifted decisively to the energy bargaining in Central Asia.

Has Russia achieved the victory in the 'Great Caspian Energy Game'?

Since the middle of the 1990s, business plans for developing hydrocarbon resources in the Caspian littoral have been subsumed and overwhelmed by intense political competition driven to a no small degree by misperceptions and miscalculations spun by lobbyists posing as 'experts'. Russia, for that matter, has since the start of this decade been primarily preoccupied with the geopolitical rivalry with the United States, perceiving the limited US military presence in Kyrgyzstan and Uzbekistan as a 'bridgehead' for an advance to the Caspian, despite the plain geographic fact that the Kharshi-Khanabad airbase (closed by the end of 2005) was nearly 1000 km away from the Tengiz and Kashagan oilfields.²⁷

The Chinese economic penetration into Central Asia was perceived in Moscow quite indifferently, and the completion of the Atasu-Alashankou pipeline that delivered oil from Kazakhstan to Xinjiang in early 2006 attracted little attention.²⁸ What Russia was mostly concerned about was finding the optimal pattern of security cooperation with China in the framework of the Shanghai Cooperation Organization (SCO) that would have consolidated its own role as the main 'security provider' without making a corresponding military effort. These efforts culminated in the joint Russian-Chinese military exercises 'Peace Mission' in mid-2007,²⁹ but by that time the Caspian energy theme had acquired top urgency in Moscow due to the unexpected opportunity to advance new project proposals created by the sudden death of Turkmenistan's President Saparmurat Niyazov in the last days of 2006. For several years up to that date, President Putin had been the only leader who saw the mercurial Turkmenbashi as a partner he could do business with – but his departure meant that all the cordial deals on Russia's exclusive import rights had to be re-negotiated anew.³⁰

Putin wasted no time with pressing his proposals to the new Turkmen leadership, and already in early May 2007, much to the surprise of US and European suitors, he succeeded in striking a new deal on importing greater volumes of gas from Turkmenistan through the new pipeline along the eastern shore of the Caspian Sea. Kazakhstan was a

²⁷ My more elaborate examination is in Pavel Baev, 'Virtual Geopolitics in Central Asia: US-Russian Cooperation vs Conflict of Interests', *Security Index*, No. 1, Spring 2008, pp. 29-36.

²⁸ See 'Kazakhstan oil piped into China', *China Daily*, 25 May 2006 (http://www.chinadaily.com.cn/china/2006-05/25/content_600060.htm); Marat Yermukanov, 'Kazakh-Chinese pipeline: A bond of strategic partnership or a source of tension?', *CACI Analyst*, 11 January 2006 (<http://www.cacianalyst.org/files/20060111Analyst.pdf>).

²⁹ One balanced evaluation is Marcel de Haas, 'The Peace Mission 2007 Exercises: The Shanghai Cooperation Organization Advances', Defence Academy of the UK, ARAG, September 2007; see also Marcel de Haas, 'The SCO armies are useful for NATO, the issue is Beijing's consent', *Nezavisimoe voennoe obozrenie*, 22 February 2008.

³⁰ Anxiety in Moscow is reflected in 'The end of the life term', *Expert*, 25 December 2006.

key partner for Moscow in this arrangement (Uzbekistan was the significant fourth party), and it also agreed to export most of its oil through Russian territory.³¹ The deal was almost too good to be true, and indeed the bargaining on volumes and prices continued until December 2007, when the follow-up technical agreement was signed. As of mid-2008, the project still has not advanced to the construction phase and quite possibly would experience more delays as the stakes appreciate.

In the meanwhile, Moscow has spared no effort seeking to torpedo the 'hostile' Trans-Caspian pipeline project linked to the much-advertised but poorly-organized *Nabucco* project.³² In fact it should have been more worried about the agreement that Turkmenistan's new President Gurbanguly Berdymuhammedov signed with China just a few weeks after striking the deal with Putin. The agreement involved a project for constructing an extraordinary long pipeline from Eastern Turkmenistan via Uzbekistan and Kazakhstan to China that would make it possible to export up to 30 bcm of natural gas a year perhaps already since the start of the next decade. Moscow did not raise any objections since the subject of the agreement was 'new gas' that was yet to be produced from 'green fields' at the right bank of Amy-Darya River in Eastern Turkmenistan (Bagtyarlyk).³³ It was, nevertheless, greatly worried about further steps in the implementation of Turkmenistan's new 'multi-vector' policy, which included also re-opening of the far-fetched project for transporting Turkmen gas via Afghanistan to Pakistan and India.³⁴

Russia's concerns are driven not by the prospects of losing influence in Central Asia but by entirely practical calculations of the gas balance, where import from Turkmenistan (45 bcm), Kazakhstan (7-8 bcm) and Uzbekistan (8-10 bcm) currently amounts to just about 8% of the grand total, but is set to increase to about 10% by the end of this decade and to 15% by the middle of the next one.³⁵ The drop in *Gazprom's* production in 2007 to the level of 2003 (548 bcm) is a clear evidence of aggravation of the structural problems in the company that has to increase the acquisitions in Central Asia in order to deliver on its domestic and export commitments. If in the last few years, and particularly in 2006, the main issue of contention were the prices, as *Gazprom* sought to maximize its profits on re-selling the imported gas, now the key issue is the volume, so *Gazprom* has taken many experts by surprise agreeing to purchase gas from the three Caspian producers on the

³¹ A sober assessment is Ivan Rubanov, 'Not by the right of might', *Expert*, 21 May 2007; my current comment is in Pavel Baev, 'Putin's double triumph not yet in the bag', *Eurasia Daily Monitor*, 14 May 2007 (http://jamestown.org/edm/article.php?article_id=2372161).

³² See Guy Chazan, 'Russia outflanks EU's pipeline plan', *Wall Street Journal*, 16 June 2008.

³³ The total length of the pipeline from Amu-Darya to China's Eastern seaboard is about 7,000 km; Turkmen's estimates for Bagtyarlyk are in the range of 1.3 billion m³; see 'CNPC starts building Turkmenistan-China gas pipeline', *News Central Asia*, 30 August 2007 (<http://www.newscentralasia.net/Regional-News/160.html>); Aleksandr Koksharov, 'Gurbanguly's blue dream', *Expert*, 20 July 2007 (<http://expert.ru/articles/2007/07/20/gaz/>).

³⁴ One typical example of such worries is Andrei Serenko, 'Gas attack in the South: Washington seeks to win over the Taliban securing delivery of blue fuel', *Nezavisimoe voennoe obozrenie*, 7 March 2008.

³⁵ Good source of data is the US Energy Information Administration, see 'Central Asia' (<http://www.eia.doe.gov/cabs/Centasia/NaturalGas.html>). On Russia's growing dependency upon Central Asia, see Vladimir Milov's presentation 'Global Energy Security: The Role of Russia and Central Asia', February 2008 (<http://www.energypolicy.ru/files/uzbekistan%20presentation1.ppt#1>).

basis of 'European' prices, which presumably means that they would be calculated already in 2009 on the basis of a formula where the main variable is the world oil price. That allows *Gazprom* not only to out-price China (which has reportedly agreed to pay US\$ 195 per 1000 m³ on the border) but also to put new pressure on Ukraine and Belarus, who would have to adjust to prices twice higher than in 2007 (presumably, above US\$ 300 per 1000m³) – which would necessitate cuts in consumption.³⁶

Overall, Russia's energy interests in Central Asia have sharply intensified and are now perceived in Moscow as both vital and highly vulnerable, primarily because *Gazprom* needs to secure a significant increase in imports having only limited access to production (in Kazakhstan and Uzbekistan) – and even without having reliable information on reserves in Turkmenistan. China, which is seen as a 'friendly competitor' for the transit of oil from Kazakhstan, objectively becomes a grave challenge to these vital gas interests, particularly since it has secured a useful access to a particular gas 'province' and could expand from this foothold.

Bracketing politics out of energy business

It is clear that Russia's energy trade has been politicized and even 'securitized' to a very high degree during Putin's second presidential term, and President Medvedev has shown no inclination to reverse this trend. It still might be useful to isolate the interference of competing political agendas and assess the economic fundamentals of this business, artificial as this exercise – perfected by the International Energy Agency – inevitably is.³⁷ Politics remains the art of the possible, as Otto von Bismarck famously observed in the pre-oil era, so establishing realistic parameters for Moscow's energy ambitions and fears regarding China is a sensible analytical task.

The most significant shift in the immediate future is certain to be the launch of the East Siberia – Pacific Ocean (VSTO) pipeline, most probably by the end of 2009, despite the joint demands from Medvedev and Putin to keep the schedule of completing the project in 2008.³⁸ The first line of this pipeline has the capacity of 30 million tons of oil a year, half of which is designated for China, and the other half of which is going to be transported by rail to the yet-to-be built tanker terminal at Kozmino. Russian oil companies that currently export oil to China by rail and also through the Atasu-Alashankou pipeline will easily find 15 million tons to deliver to Skovorodino, but might

³⁶ See Sergei Kulikov, 'Gazprom is stuck in Turkmenistan', *Nezavisimaya gazeta*, 19 June 2008; Lionel Barber, Catherine Belton and Neil Buckley, 'Gazprom chief casts doubt on Kiev gas deal', *Financial times*, 27 March 2008.

³⁷ In the Reference Scenario developed in the *World Energy Outlook 2007* (Paris: OECD/IEA, 2007), China's demand in natural gas grows from 51 bcm in 2005 to 131 bcm in 2015 and production goes up from 51 bcm to 103 bcm, while Russia's production increases from 639 bcm to 702 bcm and internal demand – from 431 bcm to 516 bcm (pp. 85-87). The prime concern in this forecast is about the fundamentals of supply/demand of oil.

³⁸ Semen Vainshtok, former CEO of state-owned *Transneft*, claimed that the VSTO project was on track as of mid-2007; see his interview with *Kommersant*, 14 February 2008; see also Vladimir Dorofeev, 'Emperor's finger', *Business guide in Kommersant*, 24 March 2008; Elena Boldyreva, 'VSTO is promised to Dmitri Medvedev', *RBC Daily*, 17 June 2008.

think twice about the efficiency of transporting oil to the Pacific shore.³⁹ The prospects for the second phase of this project, which includes the Skovorodino-Kozmino pipeline (30 million tons) and the second trunk of the pipeline to Skovorodino are far more problematic, firstly due to fast-rising costs, and secondly due to delays with developing the oilfields in East Siberia, so the 'strategic' aim for channeling up to 80 million tons of oil a year in the Eastern direction (of which at least 30 million directly to China) by 2025 looks far from realistic.⁴⁰ The project for the north-south *Altai* pipeline that – as Putin announced during his March 2006 visit to Beijing – would bring the Yamal gas to Xinjian already in 2011, has been quietly shelved.

It is informative in this respect to reflect on the assessments at the start of this decade, when Russia's prospects for increasing its share on the Asia-Pacific energy markets were connected primarily with the development of off-shore oil-&-gas fields near the Sakhalin Island (the *Sakhalin-1* project started commercial production in 2005) and the Kovykta gasfield just north of Lake Baikal in the Irkutsk oblast. Now, however, these prospects look problematic as the promising projects have been deformed or derailed in the course of the struggle for restoring state's control over energy reserves, initiated by the Kremlin. *Gazprom* has made itself the main partner in the international consortium implementing the *Sakhalin-2* project, which seriously affected its work; it also lobbied the decision that all natural gas produced by the *Sakhalin-1* project would be sold at the domestic market and not exported to China.⁴¹ Besides discouraging foreign partners, who now report poor results from new drilling on the Sakhalin shelf, these exercises in state *dirigisme* also brought quarrels between *Gazprom* and *Rosneft* for controlling the energy infrastructure in the Far East.⁴² As for Kovykta, after the protracted struggle for saving the project, the TNK-BP agreed to sell *Gazprom* the controlling stake, but as of mid-2008, this deal has not yet been finalized on the nice round target figure of \$US 1 billion.⁴³ *Gazprom*, apparently satisfied with shutting down a competitor, has not presented even a first draft plan for developing Kovykta as well as the Chayanda gasfield in Yakutiya, which it received in April 2008 from the federal inventory without any formal contest, presumably keeping them in 'reserve' for the long-term.⁴⁴

Overall, the near-term prospects for exporting oil to China remain moderately positive, but the mid-term expansion appears questionable, and longer-term figures are entirely unreliable since the current stagnation in the oil industry can only be overcome by a

³⁹ See Vera Surzhenko, 'Eastern discount', *Vedomosti*, 4 March 2008; Ekaterina Kapustina, 'Plenty of reserves, little oil', *Expert-Siberia*, 3 December 2007.

⁴⁰ The costs of implementing the first phase of the project increased from US\$ 6.6 billion in 2005 to US\$ 12.5 billion, and the second phase is very preliminary estimated at US\$ 15 billion. The optimistic forecast for oil production in East Siberia in the second half of the next decade is about 40 million tons a year. See Mikhail Sergeev, 'Eastern pipeline will be the most expensive in Russia', *Nezavisimaya gazeta*, 6 March 2008; 'Transneft will bring VSTO to full capacity only by 2025', RBC, 3 March 2008 (<http://top.rbc.ru/economics/03/03/2008/146817.shtml>).

⁴¹ See Ali Aliev, 'Blue cubic kilometers', *Expert*, 7 February 2008.

⁴² On the unpromising drilling, see Aleksandr Tutushkin & Irina Malkova, 'Drilling bill for US\$ 103 million', *Vedomosti*, 6 March 2008; on the Gazprom-Rosneft squabbles, see Ali Aliev, 'Contested pipe', *Expert*, 20 March 2008.

⁴³ See 'The closure on Kovykta', *Expert*, 17 June 2008..

⁴⁴ See Natalya Grib, 'Gazprom has found gas for future generations', *Kommersant*, 24 April 2008.

significant increase in investment, which remains a function of too many independent variables.⁴⁵ As for natural gas, the traditional and still unresolved issue here is the price, and China's reluctant readiness to take the European formula-based price for a reference point is now perceived by *Gazprom* as not good enough, since the huge investments in developing Kovykta and building an export pipeline would require prices nearly twice higher.⁴⁶ Fast as the oil prices have been climbing up in 2006-2008, *Gazprom's* operational expenditures and construction costs have been rising even faster. In order to compensate for the sustained underinvestment in its main upstream assets, and particularly in exploration, *Gazprom* has to undertake a dramatic increase in its investment program, far beyond the current guidelines, and the feasibility of such an effort remains doubtful.⁴⁷ Political demands on the Russian energy complex are hardly going to diminish.

Energy business as a continuation of politics

Russian official rhetoric about strengthening hydrocarbon ties with China and increasing the share of the Asian markets in energy exports to 30% in 10-15 years is so detached from the reality of production and domestic demand that no discrepancy in strategic plans or deviation in calculations could provide a sufficient explanation.⁴⁸ The quality of planning for the oil and gas sector is indeed far from the old GOSPLAN standards for the sector (which, in hindsight, were not that poor despite all the 'ideological' goal-setting); it is sufficiently clear, nevertheless, that an optimistic figure that would cover both the Sakhalin projects and the development of Kovykta plus the feasible flow through the VSTO, would be about 15%.⁴⁹ Everything beyond that could only mean that the energy export to Europe would be reduced – and that is something that Moscow is in real fact not prepared to contemplate seriously; the irrefutable evidence for that can be found in the massive efforts that are currently directed to building three new pipelines in the Western direction: the *Nord Stream* across the Baltic Sea to Germany; the *South Stream* across the Black Sea to Bulgaria; and the second trunk of the Baltic Pipeline System to the new terminal at Ust-Luga.

While imagining itself as a 'rising power' on par with China and India and increasingly discovering the compatibility of the respective political platforms, Moscow still cannot relate in any consistent manner to the Chinese economic model.⁵⁰ What remains

⁴⁵ See Kirill Martynov, 'Planned stagnation', *Business Guide in Kommersant*, 24 March 2008.

⁴⁶ See Ekaterina Tsyrlina, 'Gazprom has led the Chinese to a dead-end', *RBC Daily*, 31 January 2008.

⁴⁷ See Klavdiya Shur, 'Valve for the country', *Business Guide in Kommersant*, 24 March 2008.

⁴⁸ Vladislav Inozemtsev, one of respected Russian experts, argued that the real question about President Putin's 30% guideline was 'Why promising the impossible?'; see 'It is all words, words, words', 12 September 2006 (<http://inozemtsev.net/index.php?m=vert&menu=sub2&pr=110&id=705>).

⁴⁹ On the gaps in various plans for developing the energy sector, with the most conservative estimates provided by *Gazprom*, see Sergei Kulikov, 'The mess in the forecasts is scary for the West', *Nezavisimaya gazeta*, 28 February 2008.

⁵⁰ As one astute commentator argued, 'Russia and China have separately arrived at very similar political doctrines', so they 'once again pose an ideological challenge to the West'; see Gideon Rachman, 'Russia and China challenge the West', *Financial Times*, 22 October 2007. See also Robert Kagan, 'League of Dictators?', *Washington Post*, 30 April 2006.

particularly puzzling for the Russian adherents of a 'new multipolarity' is the fact that China is not only producing colossal amount of consumer goods for the US market but is also to a large degree financing that consumption through investment in the increasingly unbalanced US financial system. The intensity of US-Chinese interdependency dwarfs the economic dimension of Russia-China 'strategic partnership'; it also has a far more complex character than the asymmetric 'energy-for-cash' Russia-Europe interdependency.

Positioning itself as one of the top 'emerging economies' rather than as a Kuwait-type 'petro-state', Russia cannot fail to see that its lopsided economy based on the export of hydrocarbons and metals is very different from the others in the so-called 'BRIC Group' (Brazil, Russia, India, China) with their fast expanding export-oriented manufacturing sectors.⁵¹ At the same time, seeking to add an emphasis on 'innovations' (such as nanotechnologies) to its core status of 'energy super-power', Russia cannot quite comprehend the plain fact that China (which does not claim such status) increased its electricity production in 2006 by 100 GWt, while its own very ambitious program aims at increasing the current production of about 220 GWt by some 33-35 GWt towards the year 2012.⁵² Worries about the dynamics and implications of China's growth reinforce the exaggerated perceptions about the 'unstoppable' flow of Chinese migrants into the underpopulated Far East, further magnified by the fears of Chinese organized crime.⁵³

These contradictory risk assessments and confusing aspirations boil down to the conclusion that China's breathtakingly efficient modernization would inevitably transform into expansionism. It is plain clear that Russia cannot deter this trend, so it should do everything possible to channel this ominous expansionism elsewhere by cultivating a 'strategic partnership' with China; at the same time, however, Russia 'should not let itself be used for strengthening of a global competitor', as some experts argue against the prevalent tone of 'political correctness'.⁵⁴ This pronounced reluctance to become a 'raw materials appendage' to the self-confident and hard-driven China translates into the preference to export to this difficult neighbor as little energy resources as possible without antagonizing it. Hence the barriers for China's investment in Russian energy complex that are perceived as 'political investments' and so, as one geopolitically-minded author argued, 'should be treated as a power-political factor'.⁵⁵ Much the same perceptions apply in Central Asia, where Moscow is quietly but persistently warning the leaders of Kazakhstan, Turkmenistan and Uzbekistan against

⁵¹ One sharp commentator suggested that the structural differences were so vast that Russia should take itself out of the BRIC Group; see Dmitri Butrin, 'On the way from BRIC to the world economy', *Kommersant*, 6 June 2008.

⁵² See Vasily Kashin, 'China's energy power', *Vedomosti*, 13 February 2007.

⁵³ On the latter, see Vladimir Ovchinsky, 'The 21st Century Mafia: Made in China', *Russia in Global Affairs*, January-March 2007 (<http://eng.globalaffairs.ru/numbers/18/1089.html>).

⁵⁴ See Olga Vlasova, Vladimir Popov, Aleksei Hazbiev, 'The great march', *Expert*, 4 July 2005.

⁵⁵ See Aleksandr Dugin, 'Chinese investments require a geopolitical examination', *Opec.ru*, 30 October 2006 (http://old-opec.hse.ru/comment_doc.asp?d_no=61811).

accepting Chinese investments and seeks to exploit the proposition of an 'energy club' in the SCO to gain better insight if not a stake in China's energy projects.⁵⁶

This well-camouflaged resistance to China's attempts to secure access to energy sources differs only marginally from the readiness to allow only a few carefully selected European companies to acquire minority stakes in some oil and gas projects. What makes a more significant difference is *Gazprom's* persistent penetration into the European downstream, which is emotionally condemned in many EU political quarters but in fact makes the best possible guarantee for Russia's priority delivery. Controlling a uniquely high share of the world's energy resources, Russia is hardly feeling any responsibility for supplying the growing global demand, and particularly China's needs, despite the pledges to act as an 'energy security' provider. Current Russia's energy strategy, to the degree that one exists, emphasizes the construction of pipelines and opening new export channels over the development of production base, which basically amounts to the intention to acquire flexibility in delivering energy to under-supplied markets in Europe and Asia-Pacific that would have to compete for over-valued oil and gas. This risky plan involves the prospect of many energy 'wars' in the short- and mid-term and assumes that the divided neighbors would never be able to put pressure on Russia.

⁵⁶ See Andrei Korzhubaev, 'To tame the dragon', *Expert Siberia*, 12 November 2007; an informed US view is Stephen Blank, 'China's recent energy gains in Central Asia: What do they portend', *CACI Analyst*, 31 October 2007 (<http://www.cacianalyst.org/?q=node/4726>).