

Russia and the Global Energy Arena

Basic Issues in the Geopolitics of Oil and Natural Gas



RESEARCH

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Three Energy Superpowers

Global markets are dominated by three energy superpowers

- Saudi Arabia: world's largest oil exporter with largest production capacity
 - All exports are waterborne and directed more or less equally globally to the three largest market areas – USA, European Union and Far East (largest supplier to China, Japan, Korea)
 - Directs sales to markets to maintain market position and to maximize revenues (minimize market risks)
 - Key to policy is holding spare capacity for political purposes
- USA: world's largest market (totally open to assure competition, lower prices)
 - Is #1, 2 or 3 in world as producer of oil, gas, coal, nuclear and refining
 - Most oil imports are waterborne, globally sourced; integrated with Canadian market and Canada is largest single foreign supplier of oil and natural gas
 - In the geopolitics of oil, all the main roads still lead to Washington
- Russia: world's largest hydrocarbon exporter
 - Globally insignificant in that most exports are to Europe and a significant share is by pipeline not waterborne -- and Russia is a large, lumpy European player and it's influence to the near abroad is also dominated by pipeline politics
- ***Geographical issues dominate their different orientations to the politics of hydrocarbons***

The Three Energy Superpowers and the rules of the game

Each of the three has a different approach to the status quo

- Saudi Arabia: *conservative* and wants to preserve the status quo
 - Keep oil prices reasonably low so as to preserve oil's role in the world economy (the country is very 'long' in oil)
 - Preserve influence in Washington, Brussels, Tokyo, Beijing through spare capacity to keep oil prices low
 - Use spare capacity as a 'weapon' in case of 'existential' threats
 - Make sure USA protects its regime and provides open access to global waterway
- USA: *ambivalent* about status quo
 - Wants to keep open access to supplies and prevent others from using oil as an instrument of policy (has used military force twice since 1991 to assure secure oil)
 - Wants to change status quo by ending oil monopolies (e.g. Saudi Arabia, Iraq) and radically reducing dependence on oil imports
 - Uses oil as a weapon or instrument of policy in discreet critical cases (Iran, Libya)
- Russia: unambiguously wants to *change the status quo/rules of game* (as does China for different reasons)
 - But has not yet figured out the rules it would prefer or how to attain them
 - Meanwhile has used hydrocarbons to consolidate power at home and to increase influence internationally

Structure: Three worlds of energy

The 'rules' of the world's most globalized market are not global

- ◆ OECD: Within, private firms dominate; open trade and investment based on reciprocity, retreat of the state as manager, legal commitment not to use oil as an instrument of foreign policy; trade/capital flows lead to bigger pie, and everyone better off (win/win relationships). Big change after 1970s
 - Yet in relations outside OECD, oil/gas are used as policy instruments
 - US, EU, Japan, in rivalry to gain favors with Moscow in 1990s misplayed their relations, squandered a unique opportunity to forge partnerships with Russia; pushed selfish commercial opportunities instead of higher goals
- ◆ OPEC: State firms dominate; suspicion of free trade and investment, dislike of markets, transparency; governments use energy as a direct instrument of foreign policy for financial and policy reasons;
 - objectives: offensively to create relative value win/lose results; defensively to push burden of adjustment on others'

Structure: The third world of energy

- ◆ Those in-between (3 big ones)
 - Russia: World's largest energy producer, exporter, superpower
 - Control over oil and gas critical for domestic revenue and power; international influence; power mostly based on pipeline links, near abroad
 - Inchoate sense that the rules of the game do not favor Russia and need to be changed; what happens as Russia goes global?
 - Energy sector a hybrid combination of private sector and state intervention with limited property rights protection
 - China: Rapidly globalizing, adopting property rights regime, but government retains command economy outlook on prices; growth momentum pushing toward globalization; urge to catch up pushes neo-mercantilist perspective on foreign investment; use instruments to 'talk down' prices
 - Mexico: An OECD country except for now self-defeating monopoly in hydrocarbons
 - Meanwhile, Brazil and India have moved toward the OECD model

A market like no other - globalization meets the oil map

- ◆ The oil market is superficially like all other traded markets; it is global and the largest sector in the world economy by value and volume of transactions
- ◆ But it is also a ‘contest’ between national/group politics and the world economy
- ◆ In the petroleum sector, the ‘market’ has superficially penetrated the globe
- ◆ Oil trade is based on 3 major benchmarks, with highly liquid markets, well-developed derivative instruments
- ◆ But as in no other sector, anti-market politics play a fundamental role

Geopolitics: one of the key drivers of oil prices

- Factors driving oil prices
 - Supply/demand fundamentals
 - Financial flows
 - Disruption risks: weather, infrastructure outages, geopolitics
- Up to last year tightening fundamentals eroded spare oil production and refining capacity, leaving the market without buffers in the event of disruption
 - This made oil markets much more vulnerable to price shocks
 - It also reinforced resource nationalism and enabled some countries to succeed in using oil or natural gas as instruments of policy (Russia, Venezuela, Iran, China)
 - Also led to targeting of oil facilities for attack
 - What does it mean for key world players if oil prices stay low for a while?
- Which countries matter to the geopolitics of oil?
 - Importers and economic heavyweights: US, Europe, China, Japan
 - Exporters: Saudi Arabia, OPEC producers, Russia, FSU, West Africa
- In 2009, perception is that market requires a lower geopolitical risk premium, maybe a negative risk premium
- What's oil's new geopolitical gloss?

We believe prices will not recover to previous heights any time soon, turning the geopolitics of oil on its head

Revenue losses create major challenges to the domestic and foreign policies of exporters, political opportunities for importers

- Budget requirements are unlikely to be met for key exporters even if prices rise to \$75 by 2010
 - Venezuela needs oil well over \$100/bbl; Iran's budget is negative at \$90/bbl.
 - Low revenues make it difficult to achieve domestic distributional/re-distributional goals
- For Iran and Venezuela, lower income impedes the achievement of fundamental foreign policy objectives that require use of funds.
- Most exporters will remain in a state of denial, thinking that global economic recovery is around the corner; others will be happy to keep a lid on prices for some time.
- For the US and others the low-price environment is also challenging, presenting opportunities that are difficult to recognize and achieve; will these opportunities be squandered as they focus on economic recovery and try to take advantage of exporters' current weaknesses?

OPEC net oil export revenue (billion USD)

Country	1998	2002	2005	2008*	2009**
Algeria	5.7	12.3	36.6	70.3	31.2
Angola	3.2	7.5	22.8	68.1	30.3
Ecuador	1	2	5.9	10.2	4.5
Iran	10.7	18.6	48.2	82.4	36.6
Iraq	6.8	12.7	23.9	59.8	26.6
Kuwait	8.1	15	40.4	80.5	35.8
Libya	6	10.3	27.9	56.5	25.1
Nigeria	8.8	16.6	47	69.9	31.1
Qatar	3.4	6.9	19.7	38	16.9
Saudi Arabia	34.8	57.8	157.5	287.6	127.8
UAE	9.8	17.8	44.2	89.1	39.6
Venezuela	9.7	16.3	37.4	59.4	26.4
OPEC	107.9	193.8	511.5	971.8	431.9

Source: US DOE, LCMC. *Est. **Projected

How long will this price decline last? What difference will it make?

If it lasts long, it will require major adjustments for exporters

- **Causes:** The economic decline and consequent drop in demand is only part of the problem; other structural factors were already at work softening oil markets and we expect markets to remain relatively soft for three to five years (the same length of time as the recent mini boom).
- **Venezuela is already feeling the squeeze:** Government more comfortable trying to get companies to reinvest; is in deep arrears with oil service firms needed to keep production steady, which has been a losing battle; government was already in debt, no longer has credit to finance foreign policy hand-outs
- **Iran's soft foreign policies may be less in danger than consumer/employment policies at home** yet its stalled output growth is continuing to confront rising consumption and lower revenues; will the rulers be able to make accommodations for western firms, find ways to accommodate neighboring and other governments?
- Will low prices make some countries more venturesome? (Israel striking Iran? Iran lashing out at Saudis?)
- What revolutionary changes are on the horizon in countries overly dependent on commodities?

How will Europe, the US and others respond?

Softer prices will provide complex new opportunities

- **European Union leaders are already taking steps to ensure the reliability of supply**
 - The latest disruption of natural gas flows to Europe has prompted policy-makers to place new emphasis on *diversifying its sources of imports*.
 - Governments are moving to establish public/private partnerships to promote the development of the continent's vast *unconventional shale gas resources* as well as to boost storage capacity and integrate the pipeline grid.

- **The US challenge is broader and more systemic: to develop non-zero sum energy relationships regionally (Venezuela, Mexico), globally (China, Russia) and in individual cases (Iran).**
 - This might best unfold in an Obama administration set to *reduce dependence on imports* and to move to a “post-hydrocarbon” economy, but the vision to do so might be difficult to foster.
 - The US is increasingly viewing European energy security as a vital policy goal, perhaps *promoting technology transfers* that would expedite the development of unconventional European gas reserves.

- **One obstacle will be the temptation to use sticks rather than carrots, to rely in sanctions and uses of energy as a policy instrument** instead of finding ways to set aside the use of oil/gas as instruments of policy.

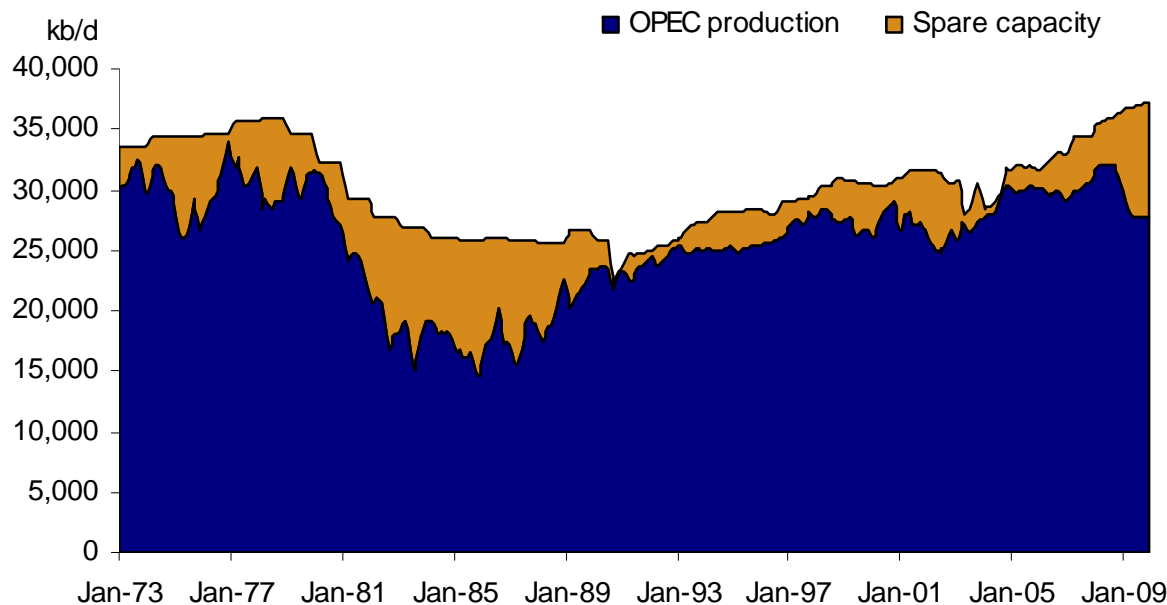
- **Another problem might be the unintended consequences of lower oil prices in producer countries significantly weakened by adjusting to lower prices,**
 - Bear in mind that the roots of *Saddam's taking of Kuwait and the rise of Hugo Chavez* lay in a low oil price environment.
 - *The burden of adjustment* to sustained lower oil prices in resource-rich countries is heavy and requires more than a sympathetic ear from governments of consuming nations.

The call on OPEC rose faster than OPEC capacity – until this year

Resurgent spare capacities establish a different geopolitics of oil as the oil weapon turns inward

- After a period of complacency regarding new investment, Saudi Arabia and others were surprised by production elsewhere (Venezuela, Nigeria, Iraq, Iran) that fell well short of expectations.
- As spare capacity fell, risk premiums in oil markets rose dramatically, but the Saudis launched an aggressive campaign to expand production capacity, as have the international majors.
- With demand now in decline and recent investments bearing fruit, spare capacity has mushroomed.
- **Saudi Arabia's can now wield its spare capacity to keep prices down** and maintain financial pressure on other exporting countries, curbing their influence in the market and in the geopolitical arena.

OPEC Production and Spare Capacity (1973-2009)



Source: EIG; LCMC Estimates.

Geopolitics point to lower prices

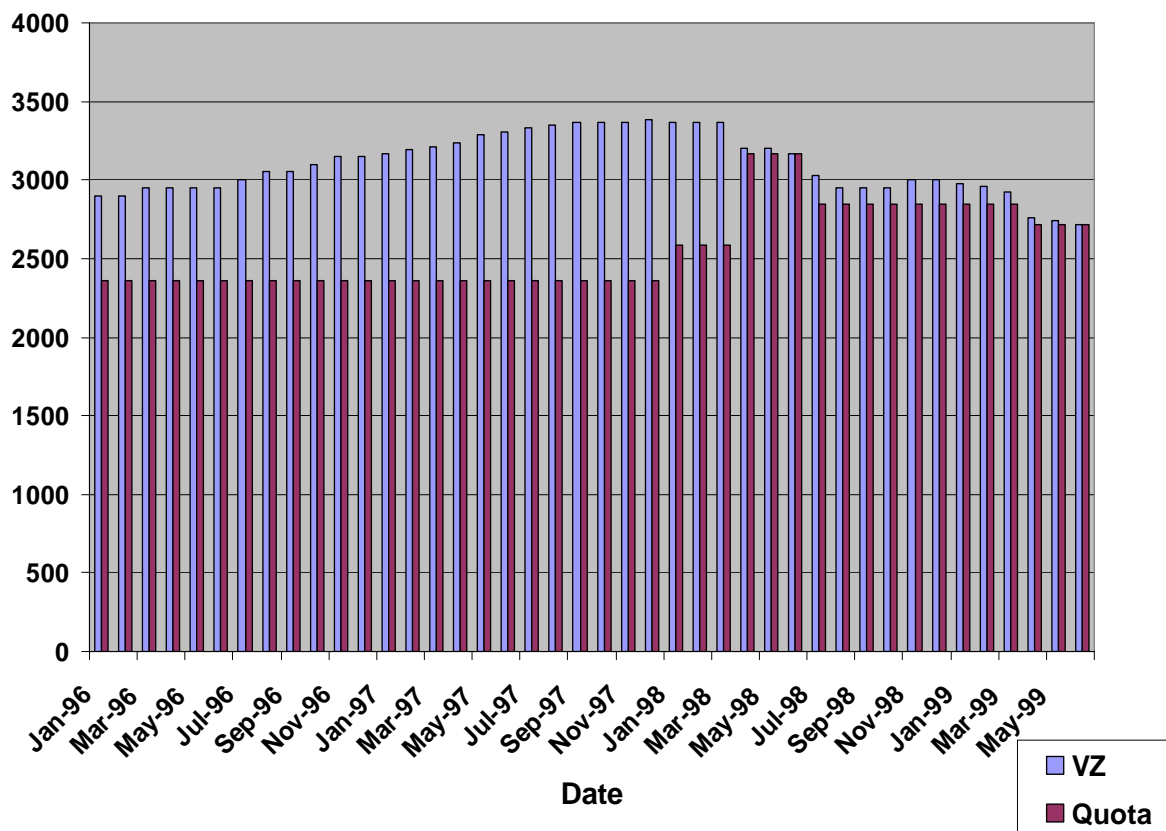
Despite OPEC's cuts, Saudi Arabia is content with lower prices

- The sharp drop in oil prices has pitted Saudi Arabia and core GCC countries against the rest
- OPEC hawks have high “break-even” budget prices, with Venezuela needing oil at \$120 and Iran requiring \$100 oil.
- GCC countries have much lower break evens prices, ranging from <\$20 (Qatar) to \$40 or so (Saudi Arabia).
- It's in the GCC's long-term economic interest to see lower prices to spur economic growth and petroleum demand
- It's convenient as well to see the “hawkish” countries in a revenue squeeze that could impair their use of oil as an instrument of foreign policy in ways that are inimical to the GCC.
- The Saudis have a history of fostering lower oil prices at existential moments (1985/86, 1989/90, 1997).
- ***The Saudis seem willing to protect \$40 and to limit price increases to \$50-55 in the short term, aiming ultimately for ~\$75***
- One question is whether there will be a serious “re-evaluation” of ties to US in light of recent Israeli attacks on Gaza; overall recent Saudi threats do not seem to be worrisome.
- Other threats have not disappeared, particularly concerning Iran and the Strait of Hormuz, major bottleneck for oil transit (>17 mb/d).

The Saudis have often used their oil weapon (Venezuela's Challenge in 1997, the Soviet case of the 1980s) for 'existential' reasons

- After the Gulf War, Venezuela embarked on an independent strategy
- The decision was geopolitical and was a turning away from OPEC
 - Goal: raise output from 2.3- to 5.5-mmb/d
 - Tactic: Ignore Quotas
- Impact: Stole market share from Saudi Arabia, causing the Kingdom to lose #1 position in US market
- There's also evidence Riyadh targeted USSR after invasion of Afghanistan, probably together with Reagan White House

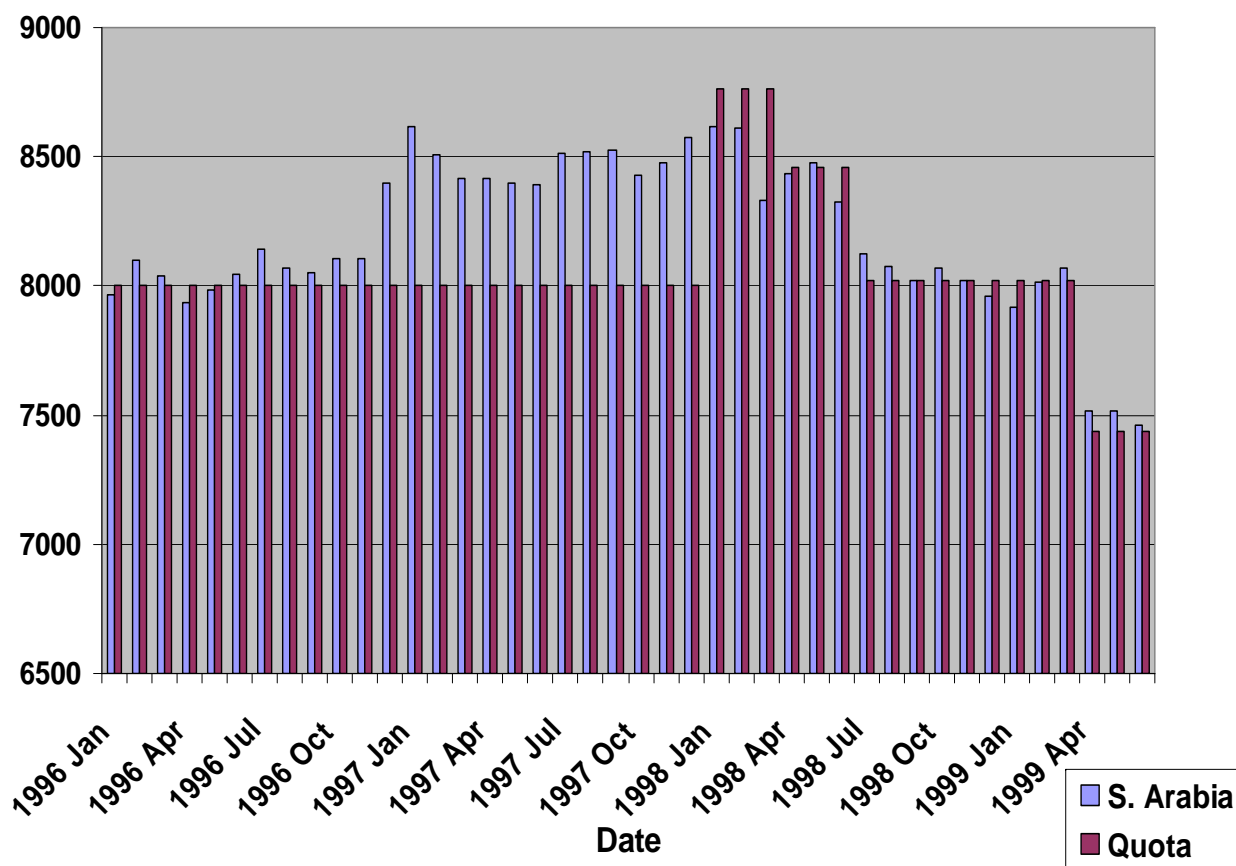
Venezuela Production vs Quota (000 bbl/day)



How the Saudis Responded

- Saudi overproduction in 1997 was explicitly designed to punish Venezuela.
- The price collapse of 1998 was a consequence of the kingdom's use of the deterrent.
- Saudi Arabia appears ready to use its weapon again, having just undergone several 'fat' years following two 'lean' years.
- Saudi Arabia's imposing spare capacity promotes compliance among OPEC members during the latest round of production cuts.

Saudi Arabia Production vs Quota (000 bbl/day)

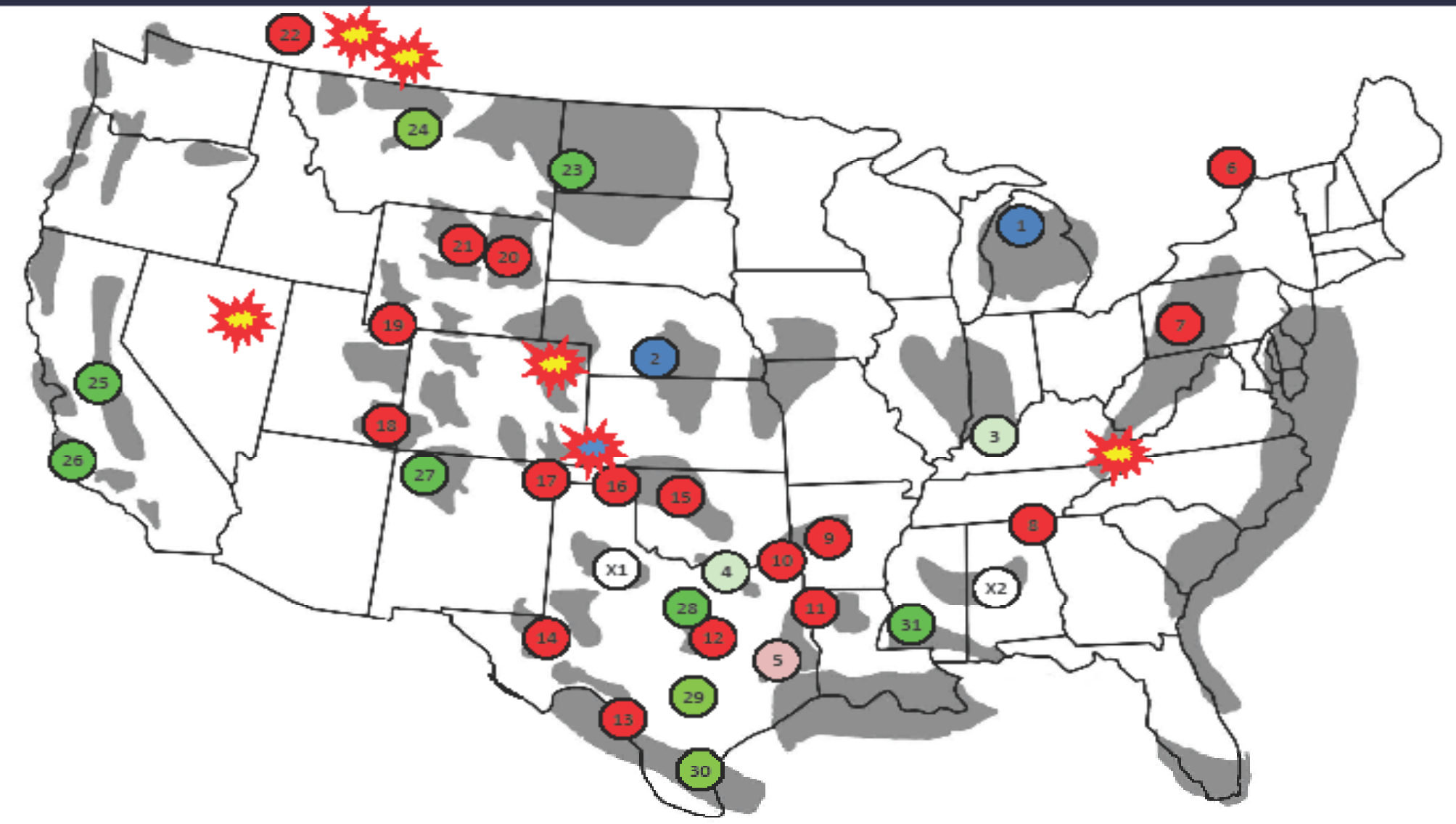


Issues for Russia in the new low priced environment

- If the low price, more competitive environment will last 5 years or longer, what are the implications for Russia's foreign policies? (In retrospect the last five years of high prices might prove to be a period of missed/wasted opportunities for Russia)
 - In what ways will Russian authority/respect be enhanced (opportunity to re-knit the FSU)? In what ways will it be impaired?
 - What will be the limits of using energy as an instrument of policy – With other producers of oil and gas? With other groups of producers (e.g. OPEC/GOPEC)? With key markets (EU, China)? Within the G-8?
- What will others be doing to impair Russian authority?
 - What's the Saudi/GCC position on Russia?
 - Biggest challenge may be Europe, where Russian financial weakness can lead to: new conditionality on credit when credit markets re-open; immediate new pressures on competition within the European gas market; new pressures on reciprocity of investments
 - Longer term European challenge in unconventional natural gas in Europe that will eventually (ten years?) curtail Russian natural gas to Europe
- Dealing with critical Russian energy weakness: companies are giants at home, midgets abroad (except for Gazprom in EU context and Transneft in the Caspian/ Asian context)
 - One step would be to encourage global energy partnerships, providing direct access of Russian firms (private, state-owned and mixed) to global/international projects
 - But this would re-open the Russian energy space to more foreign investment

Russia needs to get into the shale gas/oil
play now

North American Shale Resource Plays



Global Potential Shale Resource Plays



Issues for Russia (continued)

- Is the European shale gas play a natural for Gazprom or for Russian oil companies?
- Does Russia need to re-assess the stark choice between emphasizing a G-8/OECD road ahead, a partnership with China, or alignment with other producers
 - Do OPEC countries really want a Russian association? (Russian alignment with Iran/Venezuela poses internal OPEC difficulties; would the GCC countries remain in OPEC if Russia wanted to join?)
- Is there a third path for Russia?
 - Is maintaining a series of bilateral ties the best way to achieve influence through energy markets?
 - Do bilateral ties limit revenue maximization? Bilateral ties emphasize pipeline rather than waterborne exports of oil and natural gas; but pipeline exports over time prove in weak markets to impair revenues and to provide leverage to buyers at the other end of the pipeline
 - If Russia is to become a truly global player and energy magnet what will be required?
 - Waterborne exports to both the Pacific and Atlantic Basins
 - Fostering new global pricing benchmarks based on Russian crude (which will be problematic unless there is a property rights regime in Russia to support a financial market for oil and gas)
- Is the best way to become a global player to forget a partnership with the EU or the US or China?