Russia and the United States: No Longer Rivals, Not Yet Partners

RICHARD H. MATZKE

Abstract: Russia is the world's largest producer and exporter of energy and the United States is the world's largest consumer and importer of energy. As such, there are many reasons to seek better and more numerous associations at all levels. The Russian energy sector is relatively new, as are all economic sectors, having formed only after the collapse of the Soviet Union in 1991. Reform in the energy sector is moving rapidly now that political and economic stability have been achieved. The split between the state and private company control of the sector will probably develop with changes in energy economics just as it does in other producing countries. It is likely the beneficiaries of Russia's vast reserves of oil and gas will be those countries who choose to include Russia among their strategic partners.

Keywords: energy, energy cooperation, energy evolution, LUKOIL, oil and gas, Russia, United States

At the start of the twentieth century, consumer oil supplies were almost entirely controlled by Russia and the United States. Today, the market is much less monopolistic: there are major oil export centers in the Middle East, North and West Africa, South America, and the North Sea. But Russia remains a leading oil supplier to the global market. In 2006, it became the world leader in deliveries, surpassing Saudi Arabia. The United States, on the other hand, has, over the past century, become the world's largest oil importer. Half of the oil used in the United States is brought in from other countries.

Despite the changes that have taken place, the former rivals have not become strategic partners. In looking for alternatives to Persian Gulf oil supplies, the United States is inclined to West Africa. Seeking to reduce its dependence on the European market, Russia is increasing its cooperation with the countries of the Asia-Pacific region.

Although they need each other, Russia and the United States are nonetheless moving in opposite directions. This is regrettable, particularly if you consider that the world is on the threshold of creating a global natural gas market.

Richard Matzke is a member of the board of directors of OAO LUKOIL.

Beginning of the Twentieth Century: The Rise and Fall of Baku Oil

For Russia, the beginning of the twentieth century was marked by the active development of the Baku oil industry. In 1901 the area produced 220,000 barrels per day (bpd), more than half of the world's output. As in the United States, the main role in the development of the Russian oil production sector was played by private capital.

However, in the United States this capital came from within the country. The founder of the famous Standard Oil Trust was John Davison Rockefeller, the son of a doctor from New York. Investors in Russian oil production were not only domestic companies (the Nobel Brothers Petroleum Company and the Russian General Oil Corporation) but also French (the Rothschilds) and later Anglo-Dutch (Royal Dutch/Shell).

The 1917 revolution and subsequent nationalization changed the direction of development of the Russian oil industry.

For American and European companies, the 1920s and 1930s were a period of active international expansion. In 1928 the managers of Royal Dutch/Shell, Standard Oil of New Jersey (the future Exxon), and the Anglo-Persian Oil Company (the future BP) reached an agreement on joint measures to explore and develop deposits in the world's main oil-producing regions. They were later joined by Standard Oil of California (the future Chevron), Standard Oil of New York (the future Mobil), Texas Company (the future Texaco), and Gulf Oil. The informal association came to be called the "Seven Sisters." The consortium's coordinated actions allowed it to monopolize oil production and supply on the world markets for several decades.

At the same time, the Soviet Union was making efforts to restore production—which had decreased considerably because of the civil war and the nationalization of the oil industry—in the Baku region. This was achieved only on the eve of World War II. However, the successes were undermined by the striving of Hitler's Germany to obtain control over the Baku oil fields. Production capacity had to be evacuated to the central regions of the country, and as a result, Baku's oil production once again fell to 1901 levels.

The 1950s and 1960s: The USSR as the New Player on the World Market

The postwar years were marked by the increasing influence of the oil-producing states on the development of the global oil industry. The understanding that Enrico Mattei, head of the Italian concern ENI, reached with the Iranian authorities played an important role in this development. Attempting to break the monopoly of the Seven Sisters, Mattei offered new, more profitable cooperation terms to the host side. For the first time, in 1957, income was split between the investor (ENI) and the host country (Iran) in a 25:75 ratio (the "Mattei Formula").

The creation in 1960 of the Organization of Petroleum Exporting Countries (OPEC) further strengthened the influence of the oil-producing states. One of the main goals of this organization was to review the principles for price formation on the oil market.

Until the end of the 1960s, international oil majors played the decisive role in setting world oil prices. And because of this prices remained low over a long period—from the formation of the Seven Sisters cartel until the 1973 oil crisis. Initially, companies made most of their profits at the refining and distribution stage. OPEC changed the situation: from then on, companies were forced to agree on export prices with the governments of the oil-producing states.

Into this difficult situation on the world oil market, an influential new player appeared: the Soviet Union. In 1960 the national oil exporter Soyuznefteexport negotiated a five-year contract to supply ENI with fifty thousand barrels of oil. The terms of the contracts were unusual for the time. The price of oil was substantially lower than the international reference price and the contract was to be paid partially in cash and partially in industrial goods, including large-diameter steel pipes.

The first supplies of Soviet oil to Italy were a major milestone in the evolution of the world oil market. They laid the foundation for a dialogue between oil-producing and oil-consuming states. Moreover, a major oil supplier appeared on the market that was not a member of OPEC.

In the 1960s, when the resources of the Middle East were still open to international companies—even if on less favorable terms than before—the start of oil deliveries from the USSR was seen by the West as a destabilizing factor. However, in just a few years the Soviet Union would turn into an important guarantor of Europe's energy security.

The 1970s: The Paths of the USSR and the United States Diverge for Good

The 1970s were a turning point in the history of the world oil market. For the first time OPEC demonstrated that it could dictate its terms to consumers. After the 1973 Arab-Israeli War the price of oil (in 2005 dollars) tripled from $15 to $45 per barrel. After the Iranian Revolution in 1979 the price again doubled to $88 per barrel (in 2005 dollars).

During this energy crisis, the USSR sharply increased its supplies to the world market. Between 1970 and 1980 exports of oil and oil products from the Soviet Union doubled while income from these exports rose tenfold. The development of deposits in Western Siberia, together with North Sea oil, made it possible to reduce Europe's dependence on supplies from the Middle East.

For the United States, the 1970s were a time of rapidly increasing oil imports. Whereas in 1970 imports made up about 22 percent of consumption, by 1977 they comprised 47 percent. At the same time, more than 70 percent of oil was imported from OPEC countries. By 1981 spending on energy accounted for 14 percent of GDP, compared with 8 percent ten years earlier.

It was in the 1970s that the direction of Soviet and American oil sector development diverged for good. The USSR embarked on a course of developing its own production capacity and increasing exports, while the United States aimed to obtain access to hydrocarbon resources outside its borders. The development of deposits in Alaska and the Gulf of Mexico allowed the United States to reduce its dependence on foreign oil for a certain period, but it could not fundamentally change the situation.

The 1980s and 1990s: The Collapse of the USSR

The decrease in the rates of economic growth in the Organization for Economic Cooperation and Development (OECD) countries, the energy conservation policy, and increased supplies from Western Siberia and the North Sea together led to a turnaround in world oil prices in the second half of the 1980s. A fifteen-year period of low prices began, which brought with it a liberalization of the world oil and gas sector and megamergers in the corporate sector.

The fall in prices led to signs of crisis in the economies of oil exporters. In the USSR the situation was exacerbated by a drop in production due to underinvestment in the oil industry. In the ten years starting from 1988, oil production in Western Siberia dropped by half, from eight million to four million bpd.

The economic crisis, in conjunction with a political crisis, led in the end to the collapse of the Soviet Union and a change in the economic development model in the post-Soviet area. For the first time in one hundred years, international capital gained access to the oil and gas resources of Siberia and the Caspian region.

Today, we can say that this change was by no means fully exploited. In dialogue with the authorities of "host countries," international companies were influenced to sign production-sharing agreements (PSAs). However, this approach was successful only in the Caspian region, which has significant reserves, though not comparable with Russian reserves.

In Russia, projects implemented on PSA terms are still uncommon. Over fifteen years a mere three agreements have been concluded on the Kharyaga, Sakhalin-1, and Sakhalin-2 projects. Total investment in these projects may now have reached $30 billion, while oil production in 2006 was only one hundred thousand bpd.

Structural Reforms in the Sector

In contrast to the majority of countries rich in natural resources, Russia at the end of the last century chose a liberal model for the development of its oil sector. The basis for this model was the creation of vertically integrated companies and the transfer of subsoil usage rights to them.

Initially, twelve companies were created: LUKOIL (1991); YUKOS and Surgutneftegaz (1993); Bashneft, TNK, Sibneft, and Rosneft (1993); and KomiTEK, ONAKO, Sidanko, Slavneft, and Tatneft (1994). In the process of privatization some of these came to be owned by major financial structures (YUKOS, Sidanko, TNK, and Sibneft), while some remained in the ownership of the federal authorities (Slavneft, Rosneft) or the regional authorities (ONAKO, Tatneft, Bashneft).

The exceptions were Surgutneftegaz, which came under the control of its own management, and LUKOIL, whose shares were being sold on the open market as early as 1997. At the end of the 1990s, the capital concentration process began in the Russian oil industry. This was due, first of all, to the insufficiently effective distribution of assets among companies when the sector was initially restructured and only secondarily to growing competition between these companies.

KomiTEK became part of LUKOIL, ONAKO and Sidanko part of TNK, TNK and Sibneft acquired 50 percent of Slavneft each, and Sibneft in turn was acquired by Gazprom. On the whole, over the past eight years the number of vertically integrated oil companies in Russia has contracted to eight: LUKOIL, Rosneft, TNK-BP, Surgutneftegas, Gazprom, Tatneft, Bashneft, and Russneft.

The events in Russia fit in with the general picture of the development of the global oil and gas market at the end of the twentieth and beginning of the twenty-first centuries. The decrease in world prices in conjunction with rising production costs required companies to improve their operating efficiencies. State shareholdings began to be transferred to private investors.

The British government gave up its share in BP in 1987. The French government sold its shares in Total and Elf Aquitaine in 1992–96. From 1995 to 1998 control over ENI was transferred to private investors. The shares of the Norwegian company Statoil were listed on the stock exchange in 2001.

The desire of companies to cut costs and pool resources led to the formation of mega-alliances. In 1999 the mergers of Exxon and Mobil, BP and Amoco, Repsol and YPF, and Total Fina and Elf Aquitaine took place; in 2000 BP Amoco and ARCO; in 2001 Chevron and Texaco; and in 2002 Conoco and Phillips Petroleum. The aggregate value of these transactions exceeded $200 billion.

Strategic Partnership

The specifics of the reform of the Russian oil industry forced foreign investors to search for new ways to gain access to Russian resources. One way was the creation of strategic alliances with large Russian companies. The first step in this direction was made by BP, which acquired 10 percent of Sidanco in 1997. Subsequently, after Sidanco joined TNK, the shareholders of BP and TNK decided to pool their assets in Russia and Ukraine under a joint venture, the equity shares in which were split 50-50.

A second example of successful investment was the purchase by ConocoPhillips of shares in the Russian LUKOIL. The partners had been developing a small joint venture for quite some time in Timano-Pechora, a large oil province in the north of European Russia. In 2004 they announced a strategic alliance that envisaged the purchase by ConocoPhillips of up to 20 percent of the shares in LUKOIL and joint projects in Russia and abroad.

New Form, Old Content

Despite the fact that the Russian oil industry's system of management has undergone fundamental changes over the last fifteen years, its development strategy remains the same. Investments were used primarily to reestablish raw materials production and to increase shipments to Europe. This objective was only truly achieved in 2005. Russia has nearly returned to the production and export levels it had previously achieved.

Why did this happen? Perhaps it is because until recently Russia did not have a national oil policy. Perhaps it is because throughout the 1990s most business owners were trying to generate maximum income for minimum cost. Or perhaps the roots lie in the Soviet past of the majority of industry managers.

Regardless, Russia continues to produce considerably more oil than it needs, Europe remains its main consumer, and income from oil exports are rarely used to purchase assets abroad.

This means that the changes that took place in Russia after 1991 did not have a major impact on the state of global energy security as a whole or the energy security of the United States in particular. Over the past fifteen years American dependence on imported oil has increased from 40 percent to 60 percent. In the process, the share of OPEC oil in total consumption has increased from 24 percent to 27 percent. Prior to the crisis in 1973 this figure was only 17 percent.

Russia could have become a reliable supplier of oil to the United States but did not do so—partly because of Washington's passivity. The United States actively supported the construction of the Baku-Tbilisi-Çeyhan oil pipeline purposely to bypass Russia, but shied away from participating in the Western Siberia–Murmansk oil pipeline project that might have allowed very large crude container (VLCC) exports of Russian oil to the United States. With rare exceptions, American financial institutions do not provide guarantees on construction of new infrastructure in Russia. The conditions necessary for refining and marketing Russian oil have not been created in the United States. This leads to a logical question: on which reasons—economic or political—was this position based?

The only Russian company that was able to develop and implement a fundamentally new development strategy was LUKOIL. From the start, this company's goal was to transform itself into a worldwide corporation such as ExxonMobil or ConocoPhillips. In recent years, LUKOIL acquired nearly three thousand retail outlets in the northeastern United States that formerly traded under the names Getty Oil and Mobil.

Today more than 50 percent of LUKOIL's shares circulate on the open market. This is the only Russian company with significant assets outside the country. LUKOIL's activity outside Russia includes production, 6 percent; refining, 22 percent; and retail fuel sales, 76 percent. Over the next ten years LUKOIL plans to increase the share of foreign production to 20 percent and foreign refining to 50 percent of the total volume.

LUKOIL was the initiator of the first—and so far only—project to supply Russian oil to the East Coast of the United States. Together with ConocoPhillips, the company is developing oil deposits and building an ice-resistant export terminal in the north of European Russia. By early 2008 it will be able to export up to 240,000 bpd to the United States from the terminal at Virandi.

Turn to the East

On the whole, the direction of development of the Russian oil industry is gradually turning toward the Asia-Pacific region. There are objective reasons for this. Oil consumption in Europe and the United States is growing at less than 1 percent per year, while in India and China this figure is 3–3.5 percent per year.

According to the estimates of the Ministry of Industry and Energy of Russia, over the next ten years shipments of Russian oil to Europe will fall from 4.7 to 4 million bpd. At the same time, shipments to the Asia-Pacific region will grow from 0.2 to 1.6 million bpd. Accordingly, the share of Russian oil in the consumption of European countries will fall from 25 percent to 21 percent, but the share of Russian oil in the consumption of the Asia-Pacific countries will increase from 1 percent to 6 percent. Oil will be transported along the Eastern Siberia–Pacific Ocean pipeline and the Sakhalin shelf.

In addition to LUKOIL's project, the prospects for increasing oil shipments to the United States are tied to the construction of the Kharyaga-Indiga oil pipeline, with a throughput capacity of 240,000 bpd. However, Transneft representatives admit that for the state this project takes a backseat to the construction of the Western Siberia–Pacific Ocean pipeline.

Investment Famine

In addition to the supply of hydrocarbons, the cooperation between Russia and the countries of the Asia-Pacific region also includes an investment component. Russia is in dire need of monetary support and technology to modernize its production and refining facilities, both of which suffer from insufficient investment in maintenance and upgrading. Moreover, it is interested in developing new regions of oil production: Timano-Pechora, Eastern Siberia, the Far East, and the continental shelf.

A sharp increase in energy consumption is being seen inside Russia, caused by the growth in car ownership, active housing construction, and the restoration of industrial capacity in a number of key sectors of the economy. To meet this demand while maintaining its position on the world hydrocarbon raw materials market, Russia needs annual investments of at least $20 billion.

Russia sees companies in India and China as promising partners in the development of oil and gas deposits. In the summer of 2006 the joint venture of Rosneft and the Chinese company Sinopec acquired the production company Udmurtneft from TNK-BP. In early 2007 Rosneft and the Indian company ONGC, which already owns 20 percent of the Sakhalin-1 project, signed a memorandum of understanding stipulating joint work in Russia, India, and other countries.

Asian companies are currently following the same path that ENI took a half-century ago. They are offering producing countries, including Russia, cooperation terms that are more favorable than those currently in place. At the same time, large global service companies have become the primary provider of state-of-the-art technology to most Russian companies. This does not mean that Russia is turning its back on cooperation with the leading private international companies. However, the latter will probably have to agree to play by new rules. This is exactly what happened after Iran first used the famous “Mattei Formula” in 1957.

New Rules of the Game

The new conditions in which foreign investors may have to work in the Russian oil industry have already been determined. They will be allowed to own shares in Russian companies, but the size of the shareholding belonging to one investor will be strictly limited. This formula was tried out first during the Rosneft IPO, which took place in the summer of 2006. This state-owned company placed 15 percent of its shares on the stock exchanges in Moscow and London and prohibited any one investor from consolidating more than 2 percent of share capital. The major foreign companies that invested in the shares of Rosneft included BP, the Malaysian company Petronas, and the Chinese company CNPC.

Foreign investors can also work together with Russian companies in major production projects, but foreign ownership will be limited to a minority interest. If a Russian state company is involved, it will own at least 51 percent. ConocoPhillips is restricted to a maximum ownership of 20 percent of LUKOIL shares. Under these conditions, Russia may become unattractive for foreign “independent” producers. But at the same time, new opportunities may open for major international oil companies and possibly national oil companies.

Gas Diplomacy

Russian gas projects are the most interesting for investors. Natural gas is considered the fuel of the twenty-first century. According to the estimates of the International Energy Agency, Russian consumption will increase by 70 percent over the next twenty-five years. The share of natural gas in the global energy balance will reach 23 percent.

In this regard, three countries have 56 percent of proven gas reserves: Russia, Iran, and Qatar. Iran is currently closed to U.S. companies and investment in the Qatar gas industry is restricted to liquefied gas projects and shipments of liquefied natural gas (LNG) to the markets of consumer countries. Russia, which is only beginning the reform of its gas industry, can expect to receive heightened attention from investors, as it will be able to pipe its gas westward to Europe or eastward to Asia.

Russian gas reform includes liberalizing the market of Gazprom shares, an end to subsidizing domestic and near abroad consumers, and the attraction of strategic investors to the development of geographically and geologically remote gas fields. This reform only became possible after Gazprom concentrated in its hands the management of the majority of gas assets in the country, and the state recovered its controlling interest in Gazprom.

Many owners of associated and nonassociated gas reserves would like to have equal access to gas transportation systems. Today "independent" producers can only deliver their gas on the domestic market with Gazprom's permission. However, their ability to deliver gas to Russian consumers will grow as the shortage of gas within the country grows. At the same time, the state (via Gazprom) will retain stringent controls over gas exports.

In time, one might expect to see gas industry reform yield wellhead netback pricing of gas based on market-related transportation tariffs to export markets. It will take time and patience for a countrywide gas price clearing system to be developed. But there is such strong economic motivation to do so that it should be anticipated.

The direction of the export of Russian gas from new fields has still not been determined once and for all. Only one LNG plant, on south Sakhalin Island, is in the construction stage. However, Gazprom representatives have announced their intention to build three more plants—on the coasts of the Baltic and Barents Seas and on the Yamal Peninsula.

Potential new gas pipelines such as the second phase of the Blue Stream, which crosses the Black Sea to Turkey, and the Nord Stream, which is on the Baltic Sea floor, will be promoted and justified by both economic and geopolitical factors of importance to Russia. The greater the level of East-West energy cooperation, the greater will be the emphasis placed on economic versus geopolitical factors.

Whether these projects are implemented and where Russian gas will be exported depends not only on the negotiating positions of investor companies but also on the political will of the consumer countries.