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RUSSIA

The focus of this chapter is on contemporary oil industry bargaining in Russia, and this is achieved by engaging in two case studies – one studying domestic oil industry bargaining in Russia, and the other examining Russian Far Eastern pipeline bargaining, involving Russia, China, and Japan. In both case studies, the bargaining outcome is primarily determined by political and not economic factors. If it was not for politics, Russia's oil sector would be increasingly privatised and not gradually nationalised; Yukos would be building the pipeline to Daqing; and Khodorkovsky would not be in prison. Putin's power consolidation vis-à-vis the oligarchs is a major political factor which influenced the outcome of domestic oil industry bargaining. Moreover, the Kremlin has been deeply reluctant to give up the political influence that controlling Russia's geopolitically important export flows affords. Thus, the rise of resource nationalism in Russia is clearly a political factor.

Economics played a secondary role in influencing the outcome of oil industry bargaining in Russia. The FDI in the oil sector, which would help Russia's long-term economic growth,[1] is now discouraged. The critical issue in final decision over pipeline routes is not the relative economic merits of alternative pipelines, but the decision-making process.[2] The cheaper pipeline option, to China, may be chosen primarily because of political reasons, and not because of the price of construction. High market prices of oil have very little influence on the outcome of bargaining. Since Russia's economy is not as reliant on income from oil exports as that of some other economies,[3] the change in oil price does not

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[1] "Russia will have to worry about how it gets foreign investment inside to make sure that its incomes from exploitation of hydrocarbon resources are held steady over time." Edward Morse quoted in "U.S.-Russia Energy Summit Executive Seminar," p. 7.

[2] Ahrend and Tompson, "Realising the Oil Supply Potential of the CIS," p. 43.

[3] "Gas, more than oil, is Russia's largest source of export earnings." Lo, *Vladimir Putin and the Evolution of Russian Foreign Policy*, p. 63. I am referring mainly to the economies of the Middle Eastern, African, and Latin American oil exporting countries. It is too early to know whether Russia will suffer from the "resource curse" or the "Dutch Disease." Russia is endowed with many human and cultural advantages not enjoyed by other resource-rich countries and, therefore, has better policy choices. Edward C. Chow ("U.S.-Russia Energy Dialogue: Policy, Projects, or Photo Op?" *Foreign Service Journal*, December 2003, p. 39) argues that President Putin's policy choices aim at developing other industries in order to prevent the "Dutch Disease" away from Russia's economy. Also, see William Tompson, "A Frozen Venezuela? The 'Resource Curse' and Russian Politics," in Michael Ellman (ed.), *Russia's Oil and Natural Gas: Bonanza or Curse?* (London,

have much effect on it.[4] Moreover, Putin's sound macroeconomic management, which has seen much of the oil windfall saved in the oil fund, will insulate Russian economy from a falling oil price.[5] Western governments, investors, and IOCs have acquiesced to the destruction of Yukos, finding it legal, and appeared ready to play by the Kremlin's rules.[6] Due to resource nationalism, in the near future, the IOCs are not likely to make large investments in Russian oil sector. Any international pressure by their home governments against Russia would do them more harm, and would further compromise their bargaining position, which is weakened after their defeat in Russia.

Introduction to Russia's Oil Industry

Historically, Russian oil industry has undergone cyclical phases of state and private control. The periods between 1829 and 1873, and 1930 and 1990 witnessed the state control of the industry, while the period between 1873 and 1921 was when the industry was in hand of foreign and private control, and when Russia saw "the rapid, large-scale industrialisation… of the oil industry in particular, fuelled by a vast infusion of foreign capital."[7] Periods between 1921 and 1930 and the late 1980s and 1990s were transitions, where foreign participation and private ownership were invited but the state was still involved. Between 1929 and 1990, during the Communist rule there were twelve five-year plans, with no private or foreign participation. Gorbachev's reforms to decentralise the economy beginning in 1987 did not have a salubrious effect on the oil industry as oil remained under centralised control. High costs, controlled prices, high gross profits taxes, and limited investment funds from the central government limited their profitability and ability to maintain production. Thus, production fell in 1989 and 1990.

Anthem, 2006). Russia has more than doubled the size of its stabilisation since its inception in early 2004, which stood at about $43 billion as of end-2005. In addition, its foreign reserves grew from $44.7 billion in 2002 to $162.3 billion in 2005, which is indicative of high rate of saving. McCown, Plantier and Weeks, "Petrodollars and Global Imbalances," p. 4.

4 Russia would suffer recession only if oil prices fall below $10 a barrel – highly unlikely in the long-run. See "U.S.-Russia Energy Summit Executive Seminar," p. 2.

5 "Dancing with the Bear," *The Economist*, February 3, 2007, p. 61,

6 Torbakov, "Yukos Bankruptcy."

7 Yergin, *The Prize*, p. 129. For more on history of Russia's oil, see Jennifer I. Considine and William A. Kerr, *The Russian Oil Economy* (Northampton, MA: Edward Elgar Publishing, 2002).

Since 1985, first under Mikhail Gorbachev and then under Boris Yeltsin, the recourse to foreign investment has seen one of the best means of financing a sector with considerable investment needs. Russia's aim of integrating itself into the world market contributed to significant IOC involvement in the country. Although joint ventures with western companies had been encouraged, the complexity of required procedures and high risk had discouraged all but two companies from investing in the Russian energy sector by 1989.[8]

Meanwhile, shortages and unrest plagued the economy. By the end of 1990, all 15 Soviet Republics had become politically independent or had gained legal sovereignty. Russian crude oil production continued to decline. The former oil ministry became Rosneft and the daunting task of converting from a planned to a market economy began, and the West helped with pious advice. In the early 1990s, there were notable difficulties in the transition from a centralised command to a competitive market economy. However, we could witness some early foreign investment in the form of working over and refurbishment of idle wells,[9] JVs,[10] and PSAs.[11] Overall, while the fall of the command economy and privatisation of the 1990s hinted at a future period of foreign and private domination of the industry, the events in this decade point to the contrary.

Russia is important to the oil markets because it holds the world's seventh largest oil reserves and it is the second largest oil producer and exporter.[12] According to BP, in 2005 Russia had proven oil reserves of 74.4 billion barrels,[13] most of which are located in

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8 Considine, *The Russian Oil Economy*.

9 Title to all oil produced remains with the Russian side; the Western oil company, which receives no equity stake, is paid with the proceeds of the enhanced oil production, which is exported for dollars. Having identified the repair of idle wells as the industry's top short-term priority, the Russian government has actively encouraged this type of investment. In January 1992, presidential decrees exempted such projects from the loathed export tax, and provided special export quotas so that oil produced could be sold abroad. James Watson, "Foreign Investment in Russia: The Case of the Oil Industry," *Europe-Asia Studies*, vol. 48, no. 3 (May 1996), p. 432.

10 Most of the first deals negotiated in Russia were of this type. For more details see ibid. p. 433; and Andreas Heinrich, Julia Kusznir and Heiko Pleines, "Foreign Investment and National Interests in the Russia Oil and Gas Industry," *Post-Communist Economies*, vol. 14, no. 4, 2002, pp. 496-8. Between 1992 and 2000 there was a total of 30-42 oil producing JVs registered in Russia, with their output constituting just 3-9 percent of the Russian total. "Joint Ventures Add to Russian Oil Production," *Oil and Gas Journal*, March 14, 1994, pp. 34-5; and Heinrich *et al*, p. 497.

11 The French company Elf Acquitaine became the first company to sign a production agreement with the Russian government in February 1992, when it contracted to develop fields in the Volgograd and Saratov regions. Helen Avati, "Elf Acquitaine Pioneers Production-Sharing Deals," *Petroleum Economist*, April 1993, p. 15. For a list of approved PSA projects in Russia see Heinrich *et al*, "Foreign Investment in Russian Oil and Gas," pp. 501-3.

12 For a relatively recent study of Russia's oil and its political economy, written on the eve of Yeltsin's rule see David Lane (ed.), *The Political Economy of Russian Oil* (London: Rowman & Littlefield, 2000); also see Falola and Genova, *The Politics of the Global Oil Industry*, chapter 14.

13 *BP Statistical Review of World Energy 2006*. According to a recent study by Dallas-based energy reserve auditors DeGolyer & NacNaughton, whose clients include leading Russian energy companies such as Gazprom and Yukos, Russia's true

Western Siberia, between the Ural Mountains and the Central Siberian Plateau, and on Sakhalin Island just north of Japan. In the 1980s, the Western Siberia region, also known as the 'Russian Core',[14] made the Soviet Union a major world oil producer, allowing for peak production of 12.5 million bpd in 1987 and 1988, all but 1 million bpd of which came from Russia (see Table 3.1). Following the collapse of the Soviet Union in 1991, oil production fell precipitously, reaching a low of roughly 6 million bpd between 1996 and 1999 (Table 3.1 and Figure 3.1). Several factors are thought to have caused the decline, including the depletion of the country's largest fields due to state-mandated production surges and the collapse of the Soviet central planning system that was exemplified in Soviet industrial ministry's enormous financing[15] and in the full control of the oil industry.[16]

Table 3.1: Russia's Crude Oil Production and Consumption (1985-2005)

Year	Production (mbpd)	Consumption (mbpd)	Balance (mbpd)
1985	10.904	4.910	5.994
1986	11.306	4.972	6.334
1987	11.484	5.017	6.467
1988	11.444	4.967	6.477
1989	11.135	5.077	6.058
1990	10.405	5.015	5.390
1991	9.326	4.888	4.438
1992	8.038	4.597	3.441
1993	7.173	3.875	3.298
1994	6.419	3.359	3.060
1995	6.288	3.025	3.263
1996	6.114	2.686	3.428
1997	6.227	2.689	3.538
1998	6.169	2.554	3.615
1999	6.178	2.625	3.553
2000	6.536	2.583	3.953
2001	7.056	2.566	4.490
2002	7.698	2.606	5.092
2003	8.544	2.645	5.899
2004	9.287	2.714	6.573

recoverable reserves are between 150 and 200 billion barrels. Jason Bush, "Oil: What's Russia Really Sitting On?" *Business Week*, November 22, 2004, p. 36.

14 "Russia Country Analysis Brief," Energy Information Administration, www.eia.doe.gov, February 2005 [May 30, 2005].

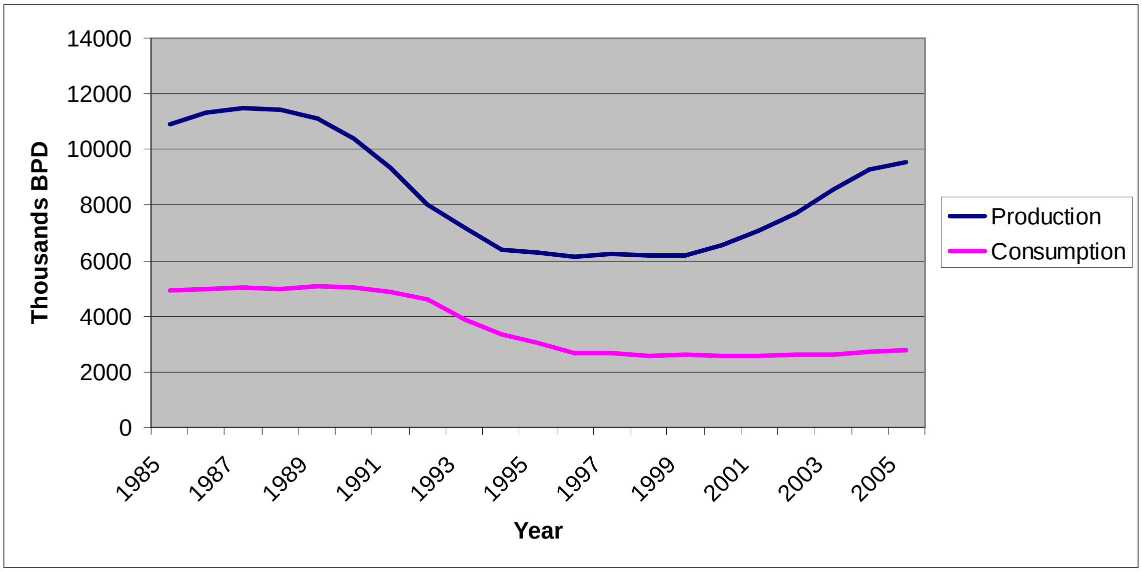
15 Watson, "Foreign Investment in Russia," p. 431.

16 Other factors in Russia's declining oil output were the dislocation caused by the more general economic and political transformation in the region, in particular the breakdown of inter-republic trade (the bulk of the Soviet Union's oilfield equipment was produced in Azerbaijan); the uncertainties of economic reform, battles over resource control, and the peculiar incentive structures faced by oil companies only partially independent from state control; low domestic oil prices, which both discouraged production and deprived the Russian oil companies of the money they needed to undertake investments; and the rapid contraction of the industrial sector, which reduced energy demand. Ibid, p. 452.

2005	9.551	2.753	6.798

Source: *BP Statistical Review of World Energy 2006*

Figure 3.1: Russia's Crude Oil Production and Consumption (1985-2005)



Source: *BP Statistical Review of World Energy 2006*

On November 17, 1992, President Yeltsin signed a decree establishing the first vertically integrated oil companies, and ordered the industry restructured.[17] In addition, framework for PSAs was laid out in another presidential decree in December 1993, and the PSA Law was adopted by the Duma in December 1995, terms of which were further improved in February 1999.[18] A turnaround in Russia's oil production, which can be attributed to the privatisation of the industry and opening it up for foreign investment following the collapse of the Soviet Union, began at the turn of the century.[19] In six years, between 1999 and 2005, Russian crude oil production grew by 3.4 million bpd (or 55 percent), but was still around 1.9 million bpd short of its 1987/88 peak. However, since average Russian oil consumption in the last ten years (approximately 2.6 million bpd) is slightly over half of what it was in the second half of 1980s (5 million bpd), as can be seen in Figure 3.1, Russian oil exports were larger in 2005 (6.8 million bpd) than during its peak production in 1987/88 (6.5 million bpd). Much of Russia's oil exports head to Europe, with low, albeit growing share heading to the United States and East Asia.

[17] David Hoffman, *The Oligarchs* (New York: Public Affairs, 2001), p. 299.

[18] Heinrich *et al*, "Foreign Investment in Russian Oil and Gas," p. 499; also see Jonathan H. Hines and Dmitri V. Nikiforov, "Russia Improves Its PSA Regime: a Thumbnail Analysis," *Journal of Energy and Natural Resources Law*, vol. 17, no. 2, 1999, pp. 178-85.

[19] Mainly thanks to the new technologies, such as horizontal wells and computerised reservoir management systems, the recovery rates are increased dramatically. Bush, "Oil: What's Russia Really Sitting On?".

Accordingly, in 2005, Russia was the world's second largest producer and exporter of crude oil, behind only Saudi Arabia, and in the early years since the break-up of Soviet Union it became very important for the IOCs, as access to resources in the major OPEC countries remained closed. In 2004, oil and gas accounted for roughly 20 percent of Russia's economy, 55 percent of its export earnings, and 40 percent of its total tax revenues.[20] According to Moises Naim, "in the future, Russia's oil (and gas) industry will become even more important, as no other sector can be as internationally competitive, grow as rapidly, or be as profitable."[21] In May 2003, the Russian government released its energy strategy to 2020, which designates the energy sector as the engine of economic growth. Both the Russian government and outside observers agree that production should continue to grow, at least in the short term, as oil companies in Russia are applying new upstream techniques to older oilfields and therefore improving current production.[22]

It is uncertain however, that sustained improvements to exploration and development will continue in the medium and long term as the state is nationalising the private firms previously owned by the so-called oligarchs, such as Vladimir Potanin (who privatised Norilsk Nickel and SIDANCO), Mikhail Khodorkovsky (Yukos), Mikhail Fridman (Tyumen Oil), and Boris Berezovsky and Roman Abramovich (Sibneft).[23] These and other men acquired the abovementioned firms in just four months through rigged auctions. These auctions were made possible by them bailing out Boris Yeltsin in the 1996 'loans for shares' scheme, which allowed a destitute Russian state to pay back salaries and pensions,[24]

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[20] Moises Naim, "Russia's Oily Future: Overcoming Geology, not Ideology, will become Moscow's Greatest Challenge," *Foreign Policy*, no. 140, January-February 2004, p. 96; Gawdat Bahgat, "Russia's Oil Potential: Prospects and Implications," *OPEC Review*, vol. 28, no. 2, June 2004, p. 135.

[21] Ibid. Naim goes on to suggest that Russia risks becoming a "petro-state." This is highly debatable, as natural gas is as important in its exports earnings as oil is, so if oil prices drop, Russia is not as vulnerable as other oil exporters, which do not export natural gas at the same time.

[22] "Russia Country Analysis Brief;" For estimates of future Russian oil production and exports see Sadek Boussena and Catherine Locatelli, "Towards a More Coherent Oil Policy in Russia?" *OPEC Review*, vol. 29, no. 2, June 2005, pp. 89-90.

[23] For details see Hoffman, *The Oligarchs*; Joseph R. Blasi, Maya Douglas, and Kruse Kroumova, *Kremlin Capitalism: Privatizing the Russian Economy* (Ithaca: Cornell University Press, 1997); Chrystia Freeland, *Sale of the Century: Russia's Wild Ride from Communism to Capitalism* (New York: Crown Business, 2000).

[24] The loans for shares program began in 1994. Under this program, the government would allow private businesses (oligarch-owned banks) to manage the state stake in a group of key companies in exchange for loans. The government listed the loans as additional budget revenues, thereby appearing to reduce its budget deficit. Not able to pay back the loans, the state would auction off the right to manage its shares. This was supposed to be an open and competitive process, but in reality, it was dominated by insider deals and lobbying of the future oligarchs. This was how Khodorkovsky got a 78 percent share of ownership in Yukos, worth about $5 billion, for a mere $310 million, and how Boris Berezovsky got Sibneft, another oil giant, worth $3 billion, for about $100 million. The loans for shares scheme

and which bought Yeltsin the political, financial, and strategic support of the future oligarchs in the upcoming presidential elections.[25] When it came to dealing with the oligarchs, the government was generally unable to exercise much control, especially during Yeltsin's rule.[26] Since the state was very weak, the oligarchs who now owned and managed Russia's most precious raw material assets, which were previously owned exclusively by the state, paid little or no taxes. This "gigantic scam" or "crooked giveaway"[27] made Khodorkovsky and other new executives "dazzlingly wealthy almost overnight," with no legal action taken against them despite some "inevitable shady dealings."[28] The oligarchs became owners of some of Russia's most attractive assets, and big political actors in their own right.[29] In 2000, Chrystia Freeland called the loans-for-shares scheme "so brazen and so bizarre that five years later it's still hard to understand why the Russian government actually did it."[30] Most importantly, Vladimir Putin viewed it as a costly mistake that must be reversed.[31]

CASE STUDY 1: Vladimir Putin and the Oil Industry – From 'Bandit Capitalism' to 'Statist Capitalism'[32]

Table 3.2: Goals of Main Actors in Russian Oil Industry Bargaining

Actor	Bargaining Goals
Vladimir Putin and the Russian government	Consolidation and government control of the industry in order to strengthen domestic power and Russia's international position
Oligarchs	Challenging Putin politically; maintenance of control over their oil companies; low taxes
IOCs	Easy and secure entry into Russia; low taxes

operated until September 1996. Hoffman, *The Oligarchs*, pp. 127-149; and Marshall I. Goldman, "Putin and the Oligarchs," *Foreign Affairs*, vol. 83, no. 6 (November-December 2004), p. 35. An IMF report in 1998 estimated that 17 Russian oil and gas companies, with a fair market value of at least $17 billion, had been sold for a total of $1.4 billion. Engdahl, *A Century of War*, p. 237.

25 Freeland, *Sale of the Century*, p. 170.

26 Goldman, "Putin and the Oligarchs," p. 35.

27 "The Tycoon and the President," *The Economist*, May 19, 2005.

28 Goldman, "Putin and the Oligarchs," pp. 33-4. In May 2004, the Russian edition of Forbes identified 36 oligarchs as being worth at least $1 billion. Khodorkovsky topped the list with an estimated net worth of $15 billion.

29 Andrew Jack, *Inside Putin's Russia* (Oxford: Oxford University Press, 2004), p. 181.

30 Freeland, *Sale of the Century*, p. 170.

31 Vladimir Putin, "Mineral Raw Materials in the Strategy for Development of the Russian Economy," *Notes of the Mining Institute*, January 1999. For a detailed look at the privatisation of the Russian oil sector, see Lane, *The Political Economy of Russian Oil*.

32 Transition coined by Peter Truscott, *Putin's Progress* (London: Pocket Books, 2005), p. 343.

By the time Vladimir Putin succeeded Yeltsin in 2000, there was much to remedy. Putin does not believe the oligarchs are acting in Russia's best interests, since he does not want the Russian economy to be dependent on the sale of raw materials, and therefore to fall prey to the 'Dutch Disease', or the 'resource curse' as some have suggested.[33] Instead, Putin believes that "the stable development of the Russian economy … needs to be based on the planned growth of its component parts, including in first place, the potential of its mineral resources …, which will serve as a guarantee of the country's economic security." Russia cannot simply be an exporter of raw materials but rather, "the development of the domestic processing industry … is the main source to turn Russia into a leading economic power with a high standard of living for the majority of the population in a relatively short period."[34] Putin notes that this is not possible without the support of the state or without the development of "large financial-industrial corporations" that cut across economic sectors and "are able to compete on an equal basis with the West's transnational corporations."[35]

One of Putin's first steps as Russia's President was to declare a change in the rules of the game, where oligarchs were no longer able to count on 'special access' to the Kremlin as during Yeltsin's rule.[36] In July 2000, Putin told the oligarchs that he would not interfere with their businesses or re-nationalise their possessions as long as they "stayed out of politics."[37] Limiting the oligarchs' political involvement proved difficult, as many of them were tempted to expand their activities beyond business – for example to media,[38] and more importantly to politics,[39] which Putin saw as "a danger and threat to the Russian

[33] Birdsall, "Saving Iraq From Its Oil," p. 77.
[34] Putin, "Mineral Raw Materials in the Strategy for Development of the Russian Economy."
[35] Ibid.
[36] Goldman, "Putin and the Oligarchs," p. 36.
[37] Ibid.
[38] Several, including Vladimir Gusinsky and Berezovsky, created media empires of television stations, newspapers, and magazines and used these outlets to attack not only each other, but also Putin, particularly for his policies in Chechnya and his inept response to the 2000 sinking of Kursk in the Barents Sea. Ibid.
[39] Khodorkovsky was reported to have offered Russia's two liberal parties, Yabloko and SPS, $100 million to unite and campaign together in opposition to Putin and his United Russia Party. Moreover, he broadly hinted that he would run for president in 2008 when Putin's term is due to expire. Khodorkovsky also actively promoted legislation that would benefit Yukos. It was said that, to ensure such support, he bought control of as many as 100 seats in the Duma, including several held by members of the Communist Party. Whether the rumours were true or not, he was able to head off attempts by the Duma to increase taxes on petroleum producers in 2001 and 2002. Finally, after being outbid by it in an attempt to buy a smaller company due to an inflated price, Khodorkovsky denounced Rosneft, what was an open challenge to Putin, because Rosneft's head, Sergei Bogdanchikov, was closely associated with the *siloviki*. Ibid, p. 37.

state."[40] Eager to export more oil, Mikhail Khodorkovsky, the CEO of Yukos, called for the building of new pipelines: one to the Arctic port of Murmansk (a base for exports to the United States), another through Siberia (toward Asian markets).[41] For the latter, he favoured a pipeline to Daqing, China, despite the government's preference for a route to the Russian Pacific port of Nakhodka, which would primarily serve Japan. Although both proposals were a direct challenge to Transneft, the state pipeline monopoly that owned and operated all of Russia's pipelines,[42] Khodorkovsky announced that he was prepared to build his own pipelines if necessary.[43]

The fact that Putin appeared to have personally blessed the Tyumen Oil's (TNK's) merger with BP,[44] led some to hope that Putin's rule would lead to new opportunities for Western oil investment in Russia.[45] President Putin was supportive of Western investment in the Russian oil industry and actively encouraged Western investment in technologically challenging projects. He was also not against Western investment in Russian oil firms.[46] Before Putin came to power, both the Russian oligarchs and the state favoured the idea that foreign companies invest in Russia,[47] and the legislation on PSAs was entered into force in June 1996, after the Duma passed a PSA law in December 1995. The PSA law discussed license holders negotiating special terms without reference to whether they were Russian or foreign.[48] While the 1995 PSA Law did not insulate foreign investors from frequent changes in legislation and from an unpredictable state bureaucracy, the 1999 improvement in legislation made PSAs the most attractive form of foreign investment in the Russian oil and gas industry. From 1999 to 2001, altogether 22 projects were made PSA-eligible with another 18 projects awaiting a vote in the Duma.[49] It is important to note that Washington spent a great deal of time and effort pressing Moscow to grant broad

40 Ibid, p. 38.
41 Ibid.
42 For a good study of issues surrounding Transneft see Komori Goichi, "Issues Involved in the Russian Crude Oil Transportation System and the Role of the State-Owned Pipeline Company, Transneft," *The Institute of Energy Economics, Japan*, August 2005.
43 Goldman, "Putin and the Oligarchs," p. 38.
44 "Price-fixing Row Over BP's Russian Oil Deal," *The Guardian*, June 25, 2003.
45 Martha Brill Olcott, "The Energy Dimension in Russian Global Strategy: Vladimir Putin and the Geopolitics of Oil," The James A. Baker III Institute for Public Policy or Rice University, 2004, p. 1.
46 Ibid, p. 14.
47 Ibid, p. 8.
48 Ibid.
49 Heinrich *et al*, "Foreign Investment in Russian Oil and Gas," p. 500.

scope for PSAs with IOCs, [50] and based on Russia's PSA legislation improvements in the late 1990s, its pressure clearly contributed to better terms for its IOCs. Russia's relatively close relationship with the U.S. at the time helped the U.S. voice to be heard in the Kremlin.

However, the honeymoon between the Western oil industry and Putin ended in 2003, when PSA legislation was changed. Putin's clear preference was for Russia's policy on partnership with Western firms to evolve over time, setting the limits of what was, or was not, possible on a case-by-case basis through consultation rather than through the decisions of Russia's oil magnates.[51] For example, Putin argued in 1999 that there must be a fusion of the state and private sectors, which can be achieved by the creation of vertically integrated financial industrial groups established with the assistance of the state. These industrial groups were to operate within the framework provided by the state, and have the explicit goal of developing Russian firms that are capable of competing on equal terms with Western multinationals.[52] Therefore, in early 2003, the Duma adopted a law, which effectively scraped PSAs. According to the Russian government, PSA Law caused a reduction in tax receipts from oil projects.[53] Under the 2003 legislation, oil, gas or other natural resources must be offered, first in open tenders and only then, if no purchasers are found, re-bid on PSA terms.[54] In other words, the government would treat PSAs as a special regime to be applied selectively on a case-by-case basis, and they are likely to be limited to complex and capital-intensive offshore projects.[55]

Moreover, in mid-2003, the Russian procurator's office began arresting Yukos executives, and although it could have been taken against any of the Russian oligarchs, Putin's October 2003 action against Khodorkovsky and Yukos occurred due to Khodorkovsky's direct involvement and interference in politics.[56] The Kremlin's seemingly sudden attack

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50 Barnes, "NOCs and U.S. Foreign Policy," p. 23.
51 Olcott, "The Energy Dimension in Russian Global Strategy," p. 14.
52 Putin, "Mineral Raw Materials in the Strategy for Development of the Russian Economy."
53 Sam Fletcher, "CERA: Yukos CEO Claims BP Deal Proves PSAs not Necessary for Russian Investments," *Oil and Gas Journal*, vol. 101, no. 7, February 17, 2003, pp. 34-6.
54 "Market Overview," *Energy Economist*, no. 260, June 2003, pp. 25-9.
55 Joseph McAllen, "Making Sense of Merger Mania," *Petroleum Economist*, vol. 70, no. 6, June 2003, pp. 32-3.
56 Khodorkovsky was arrested on October 25, 2003 and was charged with violating seven articles of the Russian Federation Criminal Code, including personal income tax evasion, overseeing corporate tax evasion, non-compliance with a court judgment, falsifying documents, and theft. *Russian Petroleum Investor*, January 2004. For more on Putin's

on private industry surprised the international business community that was expecting investment-friendly and cooperative behaviour from the Russian leadership. The publicly approved and supported arrest of Mikhail Khodorkovsky, however, triggered speculation that conditions in Putin's second term may be even less advantageous to foreign investors. Khodorkovsky's arrest came at a time when Yukos' owners and managers were engaged in possible merger talks with senior executives from Chevron and Exxon Mobil,[57] which alarmed *siloviki* and other hard-liners in the government.[58] They feared that Putin would wake up one morning and discover that Russia's most strategic and valuable energy companies had been taken over by Western corporations.[59]

Khodorkovsky's arrest accurately foretold a dramatic shift in how Russia planned to do business in the energy sector.[60] "The demise of Russia's most westernised oligarch"[61] was widely viewed as a blow to outside investment, given his role as a major proponent of foreign involvement in the country's energy industry.[62] The confrontation between Khodorkovsky and Putin served as a defining event in the future development of Russia's oil, effectively setting the terms and conditions of future Western investment.[63] Signs of this shift were visible even before the March 2004 presidential elections. In January 2004, the Russian government announced that it wanted over $1 billion for a license to explore and develop one of the three Sakhalin-3 parcels, Kirinsky block, the rights to which would be won through a tender process. This decision effectively annulled the results of a 1993 tender, in which Exxon Mobil, Chevron and Rosneft received the same exploration

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crackdown of the oligarchs, see Anders Aslund, "The Hunt for Russia's Riches," *Foreign Policy*, vol. 152, January-February 2006, pp. 43-48.

57 David Black, "Kremlin Threat to U.S.-Yukos Deal," *The Guardian*, August 4, 2003; Gregory White, "Yukos' Legal Woes Continue Despite a Possible Exxon Deal," *Wall Street Journal*, October 7, 2003; Susan Warren, Gregory White and Anita Raghavan, "Exxon Signals Interest in a Deal with Yukos," *Wall Street Journal*, December 12, 2003. The Wall Street Journal reported that both Chevron and Exxon Mobil were preparing preliminary bids for a one-quarter stake in the company that will be formed after two Russian firms, Yukos and Sibneft, complete a merger around the end of 2003. "Promising Whispers," *The Economist*, September 20, 2003, p. 68.

58 *Siloviki*: "power people;" Russian politicians from the old security or military services, often the KGB and military officers or other security services.

59 It was one thing for the foreign companies to be minority investors, such as Conoco Phillips in Lukoil, but quite another for them to buy operational control, especially when some of their payments to the oligarchs were being diverted abroad (Abramovich's $400 million into Chelsea Football Club for example). Goldman, "Putin and the Oligarchs," p. 40.

60 Ibid. p. 2.

61 "The Tycoon and the President," *The Economist.*

62 Mark Berniker, "Khodorkovsky Arrest Clouds Russia Investment Outlook," *Oil and Gas Journal*, vol. 101, no. 42, November 3, 2003, pp. 38-39.

63 Olcott, "Vladimir Putin and the Geopolitics of Oil," p. 14.

rights.[64] It was a particular blow to Exxon Mobil, which had already invested over $80 million in the project,[65] and had been withholding further investment in the project in the hopes of being able to develop it through a PSA.[66]

After the presidential elections of 2004, signs began to emerge that the events of 2003 and early 2004 were no aberration but rather the calculated implementation of a plan and vision for the future of the Russian oil sector.[67] President Putin was not going to use his increased political power simply to 'open the door' for foreign investment in the Russian oil and gas industry. Rather, he intended to reorganise the Russian oil and gas industry to enhance the power of the Russian state, as "privatisation and competition" made "it increasingly difficult for Russia's oil industry to identify a singe national interest or to behave, like OPEC's members, as a coherent unit."[68] It thus came as no surprise when in April 2004 the Duma passed new oil taxes that raised revenues when crude prices were high. The new export duties, which took effect in August 2004, work on a sliding scale that hands the state the lion's share of any gains in the oil price over $25 a barrel. These changes indicated the state's willingness to take aggressive steps to increase its share of oil profits at the expense of oil companies and to expand its control over the oil sector.[69] Moreover, Russian government's February 2005 decision to ban majority foreign participation in new natural resource concessions removed the welcome mat to the outsiders and to any new PSAs. Thus, currently, while Russia does allow foreign investment, the legal and tax structure *strongly* favour ownership by domestic firms.

It remains questionable if BP would now be able to conclude the deal in which it bought half of TNK, and what to date has been the largest foreign oil presence in Russia. This is particularly so when one considers that in April 2005 Russian government presented

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64 Ibid, p. 2.
65 Sakhalin-3's Kirinsky block, the largest of the project's three blocks with estimated reserves of 3.32 billion barrels of extractable oil and 700 billion cubic meters of gas. Valeria Korchagina, "Energy Minister Says State is Seeking $1 Billion for Exxon Sakhalin-3 License," *St. Petersburg Times*, February 6, 2004.
66 A 1993 tender for development on Sakhalin Island by an Exxon Mobil-led consortium was suddenly revoked after the consortium was accused of failing to invest as much as it had promised. Goldman, "Putin and the Oligarchs," p. 43. When Exxon Mobil realised that this project would not be added to the list of those eligible for production-sharing agreements by the Duma, they were prepared to develop it under ordinary licensing terms. However, by then ten years had elapsed since the initial agreement, providing the loophole for the Russian government to annul the agreement. Olcott, "Vladimir Putin and the Geopolitics of Oil," p. 2.
67 Olcott, "Vladimir Putin and the Geopolitics of Oil," p. 2.
68 David G. Victor and Nadejda M. Victor, "Axis of Oil?" *Foreign Affairs*, vol. 82, no. 2 (March-April 2003), p. 50.
69 Gawdat Bahgat, "Energy Partnerships: China and the Gulf States," *OPEC Review*, vol. 29, no. 2, June 2005, pp. 120-1.

TNK-BP with an arbitrary $936 million tax bill,[70] which TNK-BP's vice president Peter Henshaw believes "can be negotiated down,"[71] by going "through it with the tax authorities."[72] The belated tax bill was all too reminiscent of the tactics used to dismember Yukos, whose key production assets were confiscated by the state in order to settle old tax claims.[73] Finally, the Duma has been considering legislation that would make it much harder for non-Russian companies to explore new oilfields and that makes Conoco Phillips's $2 billion investment in Lukoil extremely risky,[74] although it has been touted as an "example of a good partnership between the private sector and the state."[75]

Thus, following legislative changes, Exxon Mobil is on the verge of losing its license to explore a fresh area around Sakhalin Island off Siberia ($17 billion Sakhalin-1 field), with Russian bidders angling to take over. Moreover, Russia's Academy of Natural Science recommended that the state takes majority control of Royal Dutch/Shell's, 55 percent owned and $22 billion worth, Sakhalin-2 field, the Kharyaga license held by Total, together with Exxon's abovementioned Sakhalin-1, because they were all behind schedule.[76] In September 2006, Russia's Natural Resources Ministry withdrew its approval of Royal Dutch/Shell's Sakhalin-2 permit, and revoked the license on environmental grounds, although the construction work on the development of the field was 75 percent complete and due to come fully on stream by 2008. Moreover, in December 2006, Russia suspended vital permits for Sakhalin-2 venture, and Royal Dutch/Shell had to give up its controlling stake in the project, [77] handing Gazprom 50 percent plus one share interest.[78] "The doors

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70 "A Survey of Oil," *The Economist*, April 30, 2005, p. 10. Tax bill was for back taxes dating from 2001, when the Russian partner in the venture, Tyumen Oil, took advantage of tax havens that were then widely assumed to be legal. Jason Bush, "Mixed Messages from the Kremlin," *Business Week*, May 2, 2005, p. 28.

71 Ibid, p. 29. Under the 2003 deal, when BP purchased 50 percent of Tyumen Oil for $7.7 billion, according to John Browne the British energy giant has been indemnified for any tax claims from the pre-BP era. Schwartz, "Putin Gives Big Oil the Cold Shoulder."

72 Ibid.

73 Bush, "Mixed Messages from the Kremlin," p. 28.

74 Schwartz, "Putin Gives Big Oil the Cold Shoulder," p. 26.

75 Olcott, "Vladimir Putin and the Geopolitics of Oil," p. 28.

76 "Russia Looks as Oil Control Move," *BBC News*, May 26, 2006, http://news.bbc.co.uk/go/pr/fr/-/1/hi/business/5018664.htm, [May 27, 2006].

77 The concerns raised by environmentalists included fears that pipelines could threaten salmon-filled rivers. However, industry insiders argue that Russia might be hitting Shell on the environment to force concessions elsewhere – Shell would give Gazprom 25 percent of Sakhalin-2 in return for 50 percent of a Siberian gas field. This is particularly so, since under the 1994 agreement, the Russian government has to foot most of the doubling in costs ($20 billion) that Shell announced in 2005. See "The World This Week," *The Economist*, September 23, 2006, p. 9; and "Yukos Revisited?" *The Economist*, September 23, 2006, p. 13; Also, see Owen Matthews and Anna Nemtsova, "Grasping Hands," *Newsweek*, October 2, 2006, p. 6; Stanley Reed and Jason Bush, "A Gusher for Big Oil is Drying Up," *Business Week*, October 2, 2006, p. 44; "Russia Ups Pressure on Sakhalin," *BBC News*, December 7, 2006,

are definitely closing," according to Sanford Bernstein, an analyst from Neil McMahon.[79] That is a particularly painful loss for majors, such as BP, Royal Dutch/Shell, Exxon Mobil and Chevron,[80] who are desperate to increase their production but are already shut out of state-dominated oil industries in countries such as Kuwait and Mexico.

Initially, IOCs did not appear as the only oil companies discouraged from participating in the Russian oil industry, as in 2002 Moscow blocked a Chinese attempt to take a 75 percent stake in Slavneft, a state-controlled energy firm.[81] However, signs of this changing emerged in November 2006, when Rosneft and Sinopec signed a deal to buy Udmurtneft, a Russian oil company.[82] In addition, in late 2006, a partnership between Rosneft and Sinopec has resulted in a first exploration well on the Sakhalin-3 block, offshore Sakhalin Island. This is the first time the two countries have cooperated in an upstream oil project on Russian territory.[83]

Ever since Putin launched his crackdown against Yukos, the Russian state has been steadily reasserting its control over the country's vast oil reserves. As of February 2006, state-owned companies produced about 30 percent of Russia's oil,[84] and of late 2005 Kremlin directly owned 57.4 percent of Russia energy sector.[85] Putin's oil industry consolidation is evident in the fact that Gazprom and Rosneft,[86] Yukos,[87] and Sibneft[88] are

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http://news.bbc.co.uk/2/hi/business/6218908.stm, [December 12, 2006]; Richard Galpin, "Shell Deal Over Russia Oil Field," *BBC News*, December 11, 2006, http://news.bbc.co.uk/2/hi/business/6169927.stm, [December 12, 2006]; and "After Sakhalin," *The Economist*, December 16, 2006, pp. 67-8.

78 Shell is also facing court action and fines for alleged environmental infractions and has lost a $300 million second bank loan for the project. *Oil & Gas Journal*, January 2, 2007, p. 29.

79 Schwartz, "Putin Gives Big Oil the Cold Shoulder," p. 26.

80 Chevron's boss, David O'Reilly, has talked about Russia as one of the firm's key growth areas. "Promising Whispers," *The Economist*.

81 Alexander Koliandre, "Russia Keeps China Energy Options Open," *BBC News*, March 21, 2006, http://news.bbc.co.uk/go/pr/fr/-/2/hi/business/4830768.stm, [March 23, 2006].

82 "Rosneft, China's Sinopec Sign Deal to Buy Russian Oil Company," *RIA Novosti*, November 17, 2006.

83 "News in Brief," *Petroleum Economist*, no. 2, 2006, p. 11.

84 "Russia: Energy Overview," *BBC News*, http://news.bbc.co.uk/go/pr/fr/-/2/hi/europe/4699942.stm, February 13, 2006 [February 15, 2006].

85 According to figures released by the Moscow-based Novosti agency.

86 Kremlin paid $6 billion through Rosneft in June 2005 to achieve majority stake. Meanwhile, a proposed merger between Gazprom and Rosneft has been cancelled by the Russian government. The Russian government has announced its intention to increase its stake in Gazprom. Under the new deal, Rosneft will buy a stake in Gazprom but its stake will be reduced and will allow the Russian government to obtain majority control of Gazprom. The Russian government currently holds a 100 percent interest in Rosneft. "Russia Cancels Rosneft, Gazprom Merger," *Oil and Gas Journal*, vol. 103, no. 20, May 23, 2005, pp. 36-7. For more on Gazprom, see "Energy Tsar," *Forbes Asia*, July 24, 2006, pp. 55-60. For more on Rosneft, see Nina Poussenkova, "Lord of the Rigs: Rosneft as a Mirror of Russia's Evolution," paper prepared in conjunction with an energy study sponsored by Japan Petroleum Energy Center and the James A. Baker III Institute for Public Policy, Rice University, March 2007.

now *de facto* controlled by the Russian government (see Table 3.3). In addition, Lukoil, the largest Russian oil group, and Surgutneftegaz, the fourth largest crude oil producer in Russia are both Kremlin-friendly private operators, with "close ties to the state."[89] Lukoil has always acted in close coordination with Kremlin, often presenting itself as a faithful servant of state, and, even if it maintains its private ownership in future, it will increasingly act at the behest of the government.[90]

Table 3.3: Main Russian Oil Companies and Their Ownership, Reserves and Production (2005)

Company	State Ownership	Private Ownership	Reserves (billion barrels)	Production (mbpd)
Lukoil	Very close to Kremlin	Conoco Phillips 19%	16.0 (crude oil) 20.1 (incl. n. gas)	1.79 1.88 (incl. n. gas)
Gazprom	73%; including Yukos' gas assets		18.4 (crude oil) 195.9 (incl. n. gas)	0.91 10.38 (incl. n. gas)
Rosneft	100%; including Yukos' oil assets		15.0 (crude oil) 19.4 (incl. n. gas)	1.99 2.15 (incl. n. gas)
TNK-BP		Fridman 50%; BP 50%	4.3	1.55 1.69 (incl. n. gas)
Surgutneftegas	1.0%; Very close to Kremlin		6.6 8.7 (incl. n. gas)	1.28 1.53 (incl. n. gas)
Tatneft	Local government		4.1 (crude oil) 4.4 (incl. n. gas)	0.49 0.51 (incl. n. gas)
Slavneft	76%		n.a.	0.49 0.51 (incl. n. gas)
Bashneft	Local government		n.a.	0.362 0.368 (incl. n. gas)

Sources: http://www.lukoil.com, http://www.gazprom.com, http://www.rosneft.ru, http://www.tnk-bp.com, http://www.surgutneftegas.ru, http://www.tatneft.ru.

87 On December 19, 2004, Yuganskneftegaz, which accounted for 60 percent of Yukos's oil production capacity, was sold by the government for $9.35 billion, ostensibly to pay some of Yukos's huge tax bill (of $21 billion). The sale was to Baikal Finance Group, a hitherto unknown firm, which was three days later bought by Rosneft, a state-owned oil company for an undisclosed sum. Thus, the state took back Khodorkovsky's prime asset in a way not unlike that in which he acquired his wealth in the first place. Rosneft, a fully stste-owned company, unlike Gazprom, which was initially expected to buy Yuganskneftegaz, should enjoy sovereign immunity against any court rulings based on Yukos's protection of firm's assets while filing for bankruptcy. "Method and Madness," *The Economist,* January 1, 2005, p. 53; "The Bell Tolls," *The Economist*, November 27, 2004, p. 74.

88 72.7 percent of Sibneft was bought by Gazprom in late September 2005 for $13.7 billion; since, Sibneft changed its name to Gazprom Neft. There were indications that Abramovich's Sibneft will be taken by the government-controlled companies ahead of September 2005, especially since Yukos owned 34.5 percent of Sibneft. Moreover, in 2003, "Sibneft has paid taxes on only 7 percent of its profits, less than a third of the statutory rate and half of what Yukos paid" (Goldman, "Putin and the Oligarchs," p. 43). It was also argued, "Sibneft may yet face a back-tax bill of its own" ("Method and Madness," *The Economist*), and that "Gazprom is lining up more than $10 billion in financing to try to get control of Sibneft." (Heather Timmons, "Gazprom Preparing Battle for Oil Producer," *The New York Times*, August 18, 2005).

89 "Luk Warm," *The Economist*, September 30, 2004; "Russia: Energy Overview."

90 Isabel Gorst, "Lukoil: Russia's Largest Oil Company," paper prepared in conjunction with an energy study sponsored by Japan Petroleum Energy Center and the James A. Baker III Institute for Public Policy, Rice University, March 2007, pp. 1-2.

Signs of government's oil industry consolidation came in early 2005, when Deutsche Bank advised Gazprom, Russia's state-controlled gas monopoly, to buy several of the largest private domestic oil companies.[91] Deutsche Bank, hired by Gazprom to advise it on the strategic development of its oil business, suggested that the state monopoly in effect, should renationalise the Russian oil industry by swallowing the main production asset of Yukos, the embattled oil company, as well as Sibneft and Surgutneftegas, two privately owned groups.[92] Valery Draganov, head of the parliamentary committee for economic policy and a member of the pro-Kremlin United Russia party, said the recommendations reflected the general strategy of the Russian government: "Today there is consensus that natural resources must be controlled by the state and managed for the good of the whole country."[93]

Thus, experts predict that in the future, Rosneft, lead by Igor Sechin, Putin's deputy chief of staff as the chair of the board, and Gazprom, headed by Putin's St. Petersburg cronies Alexei Miller and Dmitri Medvedev, the First Deputy Prime Minister, as the chair of the board, would seek to expand further by acquiring other companies in future.[94] Thus, the future of TNK-BP consortium is far from certain,[95] as "Yukos would not be the last company to find itself under attack."[96] There is intense speculation that in 2007 a deal will be brokered allowing Gazprom to replace Russian shareholders that own 50 percent of TNK-BP, and that Surgutneftegaz may also soon be victim of state incursion.[97] The government, according to an industry expert, "has set its sights on Slavneft, Surgutneftegaz, at least half of TNK-BP and whatever is left of Yukos," thus enabling it to gain control up to 60 percent of crude oil production in near future.[98] A further indication

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91 "Gazprom Urged to Buy Russian Oil Companies," *Pipeline & Gas Journal*, vol. 232, no. 1, January 2005, p. 16

92 Ibid.

93 Ibid.

94 "Russia: Energy Overview."

95 BP should be worried about the $7 billion it has already invested in a partnership with Tyumen Oil, a company that has been accused of misbehaviour similar to Yukos', including abuse of the legal system, unfair payment for state resources, and tax delinquency. The partnership itself has also been charged with violating the official state secrets act by disclosing the extent of the country's petroleum reserves. Goldman, "Putin and the Oligarchs," p. 43. Konstantin Simonov, General Director of the Center for Current Politics in Russia, argues, "The destiny of the joint stock of BP and TNK in its current form seems doomed… and this promises nothing good to the transnational companies." Konstantin Simonov, "Problems of Energy Security and Russian Energy Policy," paper presented at the 2006 Global Dialogue on Energy Security, Beijing, China, October 16, 2006. Also, see "Dancing with the Bear;" and Jason Bush, "The Kremlin's Big Squeeze," *Business Week*, April 30, 2007, pp. 42-3.

96 Goldman, "Putin and the Oligarchs," p. 43.

97 Gorst, "Lukoil: Russia's Largest Oil Company," p. 3.

98 Bonita Nightingale, "Russian Roulette," *Lloyd's Shipping Economist*, vol. 28, March 2006, p. 11.

of this came when on 1 August 2006, amid almost record-high oil prices, the Moscow Arbitration Court declared bankruptcy and liquidation of Yukos, assets of which were in late March 2007 auctioned at well below market rates to Kremlin-controlled companies, Rosneft and Gazprom, first of which then became Russia's biggest oil producer (Table 3.2).[99]

Some have suggested that the government aims to create one big state-controlled conglomerate ("Gosneftegaz"), composed of Gazprom, Rosneft, Surgutneftegaz, Lukoil, Yukos, Sibneft, and possibly TNK-BP. According to this view, the mega-company would emerge by 2008, before the next Russian presidential election, with Putin as its head.[100] This company, rivalling Saudi Aramco in size, would be an even stronger foreign-policy instrument for the government than Gazprom and Rosneft are now. As of early 2007, we are not too far from this suggestion becoming a reality, as Gazprom and Rosneft are on the way to becoming the world's top energy suppliers, and a dominant force in oil and gas.

After Yukos affair, other private companies "suddenly started to like paying taxes," as the government is paying closer attention to company activities at times of increased tax burden on the energy industry triggered by high energy prices. For example, Sibneft's share of profit paid in taxes to the state grew from 7 percent in 2003 to 25 percent in 2004, Lukoil's from 24 to 25.2 percent, TNK-BP's from 7.5 to 16.5 percent, and Surguneftegaz's from 19 to 22 percent respectively.[101] Another lesson from the Yukos case is that "oil companies must 'make friends' with the state and demonstrate their loyalty to the government." This concerns large mergers and acquisitions, entry into new regions, extending guarantees for future government transportation and export routes and many other issue areas where the paths of oil companies and government cross.[102]

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[99] Igor Torbakov, "Yukos Bankruptcy: The Big Picture," *Eurasia Daily Monitor*, vol. 3, no. 151, August 4, 2006, p. 1.
[100] Glada Lahn and Keun-Wook Paik, "Russia's Oil and Gas Exports to North-East Asia," *Energy Politics*, no. 7, Fall 2005, p. 75.
[101] Inna Gaiduk and Raisa Vasilenko, "Year 2004 – Records and Anti-Records," *Russian Petroleum Investor*, March 2005, p. 5.
[102] Ibid, p. 6.

Russia's oil and gas reserves serve as a source of income for reinvestment in the country's economy and provide an attractive lever for use in Russia's foreign relations,[103] and thus, foreign control of Russia's oil is a step that the Kremlin will not allow. However, since Russia will be unable "to provide additional significant financial revenue from the country's budget for large state investment in its own processing industry" in the immediate future, Putin supports the idea of *state-sponsored* foreign investment in Russia's extractive industries. These, properly managed large-scale investments, including foreign capital, allow the state to earn hard currency from the export of its natural resources.[104] This may be the only way into Russia for IOCs. It is virtually inconceivable that the Western energy firms will be welcome bidders for any of the Russia's strategic energy assets.[105] Even if they enter, for each dollar of price above $25 a barrel, since 2005 Russia took 89 percent in taxes, up from 68 percent in 2003. These levies deter costly, risky investments.[106]

Only after the reorganisation of oil industry is complete and the state's capacity to protect national interests in this strategic sector is affirmed, will Western companies be 'invited' in to participate, albeit in a very limited way, in the Russian oil industry.[107] It is clear then that the primacy of the Russian state in the country's energy sector is non-negotiable. While Putin recognises the importance of market forces and the need to protect private property, he believes that both must be managed to ensure that neither takes precedence over the interests of the state, which exercises its control in the name of the Russian people, a vast majority of whom support Putin's re-nationalisation of the oil industry.[108]

Even if they were to re-enter Russia's oil industry, IOCs would most likely find some staunch competition. Andrey Kokoshin, the head of the committee on the Commonwealth of Independent States (CIS) affairs at the Russian parliaments, argues, "Russia can accept the offers coming in from London, Frankfurt or New York – or from Beijing, Hong Kong

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103 Olcott, "Vladimir Putin and the Geopolitics of Oil," p. 3.
104 Putin, "Mineral Raw Materials in the Strategy for Development of the Russian Economy."
105 "Luk Warm," *The Economist.*
106 "Open Season on Big Oil," *Business Week*, p. 42.
107 Olcott, "Vladimir Putin and the Geopolitics of Oil," p. 2.
108 A World Public Opinion June 2006 survey found that 85 percent of Russians favoured the re-nationalisation of Russia's oil and gas industries. See "Russians Support Putin's Re-Nationalization of Oil, Control of Media, But See Democratic Future," *World Public Opinion*, June 2006, http://www.worldpublicopinion.org/incl/printable_version.php?pnt=224, [March 3, 2007].

or New Delhi."[109] Energy reserves, and options of where to direct them, give Russia considerable bargaining power in its relations with other actors in the oil industry.

Outcome

For Putin, the oil industry bargaining aim was to reassert state control over 'strategic resources' and gain primacy over the main pipelines and market channels through which it ships its hydrocarbons to international markets.[110] Vladimir Putin is therefore methodologically consolidating state control over Russia's energy resources and deploying them as a tool of international statecraft, and the vehicle for his aspiration that Russia re-emerges as a global superpower.[111] Bargaining between Putin and Russian oligarchs resulted in Putin's triumph and in consolidation of the oil industry. The oligarchs and IOCs are on the losing end of the bargain.

Analyses and Conclusions

Boris Yeltsin's rule in the 1990s indicated that the oligarchs and IOCs would have it their way. Their bargaining victory was evident in oligarchs' cheap acquisition of most of Russia's oil industry. Further, it was evident in the legislation on production sharing agreements, which was entered into force in June 1996, and which discussed license holders negotiating special terms without reference to whether they were Russian or foreign.[112] This 'national treatment' legislation opened Russia's oil industry to IOCs. However, the initial bargain slowly obsolesced after Putin became president, and consolidated his rule. Under Putin, the relationship between Russian business and the state swung between the two extremes. In 1998/99, during Yeltsin's presidency, both federal and regional authorities were under the control of 'oligarchic capital', and the relation between business and the state was characterised by the so-called 'privatisation of the state' (or 'state capture'). By 2003/04 Russia under Putin had made a rapid shift to the

109 Emma Simpson, "Russia Wields the Energy Weapon," *BBC News*, February 14, 2006, http://news.bbc.co.uk/go/pr/fr/-/2/hi/europe/4708256.stm, [February 15, 2006].
110 Yergin, "Ensuring Energy Security," p. 69.
111 Daniel Twining, "Putin's Power Politics," *Weekly Standard*, vol. 11, no. 17, January 16, 2006.
112 Olcott, "Vladimir Putin and the Geopolitics of Oil," p. 8.

dominance of the state over big business.[113] In addition, Khodorkovsky's arrest was a blow to outside investment, given his role as a major proponent of foreign involvement in the country's energy industry, and Russian government's February 2005 decision to ban majority foreign participation in new natural resource concessions removed the welcome mat to IOCs.

Why did Putin decide to control and consolidate Russia's oil industry? He did not believe the oligarchs were acting in Russia's best interests, and wanted to control the industry, which was to become a driving force to Russian economic recovery and an important bargaining asset internationally. Russian ownership of Russia's resource base was deemed critical to Russia's economic recovery and to the country's re-emergence as an important international actor. Putin's following statements support my argument that energy security equals Russian national security, and that Kremlin will not shy away from making energy a significant tool of its foreign policy:

> The state has the right to regulate the process of the acquisition and the use of natural resources, and particularly mineral resources, independent of on whose property they are located.[114]
>
> [Russia] must aspire to claim world leadership in the realm of energy.[115]

Additionally, Putin made a tacit bargain with the oligarchs when in July 2000 he told them that he would not interfere with their businesses or re-nationalise their possessions as long as they "stayed out of politics."[116] Khodorkovsky, who is in prison, and others, who are in exile,[117] interfered in politics and by openly challenging Putin violated the bargain he had offered them. Hence, in order to consolidate his rule, Putin arrested Khodorkovsky, the one who challenged him the most, in order to discipline and reduce the power of the other oligarchs. Therefore, this factor is also an important one in determining the outcome of oil bargaining between Putin, the oligarchs and IOCs, who were Khodorkovsky's main allies.

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113 Andrei Yakovlev, "The Evolution of Business-State Interaction in Russia: From State Capture to Business Capture?" *Europe-Asia Studies*, vol. 58, no. 7, November 2006, pp. 1033-4.
114 Putin, "Mineral Raw Materials in the Strategy for Development of the Russian Economy."
115 Vladimir Putin's speech to Russia's Security Council in December 2005, quoted in Peter Gumbel, "Crude Power," *Time*, July 10, 2006, p. 23.
116 Goldman, "Putin and the Oligarchs," p. 36.
117 Berezovsky and Gusinsky.

While IOCs showed considerable interest in Russia following privatisation, their opportunity for entry has been reduced by recent developments in the Russian oil industry. At present, the primary mechanism through which IOCs can get involved in the Russian oil industry is through the creation of JVs; the other forms of entry, such as shareholding or PSAs encounter serious obstacles. For example, under Russian PSA law only 30 percent of Russian oil reserves can be developed under the PSA regime. However, already in 2000, the 21 projects eligible for a PSA accounted for 28 percent of Russian oil resources.[118] Although at the time there was hope among IOCs that this will be changed to allow larger share of Russian reserves to be developed under the PSA regime, this is nowadays nigh on impossible, and the use of the PSA is slowly becoming an exception.[119] To be sure, PSAs were never intended to form the basis for the fiscal regime in Russia's oil sector, and were seen as a transitional arrangement to facilitate early investment while the country developed its tax code and regulatory framework.[120] Illegitimate privatisation of Russian oil industry and the State's wish to regain the control of oil industry in order to use it to fulfil its economic and foreign policy objectives restricts the IOC entry to Russia. Besides government's attempt at controlling and consolidating the oil industry, the remaining Russian private oil companies, such as Lukoil or Surgutneftegaz, do not see interest in new arrival of IOCs. They believe that they can reach the very optimistic production targets that they have fixed themselves for 2010 from existing deposits, with limited investment in improvement of techniques used.[121] Ergo, the conditions of access to resources for IOCs are becoming harder, and since the Russian government must approve any major international investment, it is unlikely that the Russian state will favour any significant penetration by IOCs into Russian oil industry.

The February 2005 decision to ban majority foreign participation in new natural resource concessions weakened the bargaining position of IOCs. The Russian government's

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[118] "High-level Backing for PSAs," *Petroleum Economist*, October 2000, p. 30; and "One Step Forward Two Back For PSAs in Russia," *Petroleum Intelligence Weekly*, March 20, 2000, p. 4.
[119] Catherine Locatelli, "The Russian Oil Industry between Public and Private: Obstacles to International Oil Companies' Investment Strategies," paper submitted to *Energy Policy*, July 2004, p. 11.
[120] Rudiger Ahrend and William Tompson, "Realising the Oil Supply Potential of the CIS: The Impact of Institutions and Policies," OECD, Economics Department Working Paper, no. 484, May 12, 2006, p. 20.
[121] Ibid, p. 12.

decision is legitimate and does not violate any international rules, norms, or principles,[122] and, as such, no actions can or should be taken against Russia. Foreign investment in Russia's oil industry, although limited, is still welcomed, and desperate foreign IOCs,[123] just as Russia's remaining oligarchs, should play the Kremlin's game if they wish to maintain their possessions and limited presence in Russia. The Western governments and IOCs acquiesced to the destruction of Yukos, and now appear ready to play by the Kremlin's rules.[124] However, IOCs are not likely to make large investments in the Russian oil sector. Although Washington was successful in pressing Moscow to grant broad scope for PSAs with IOCs during Yeltsin years, any international and particularly American pressure against Putin's government would have caused IOCs more harm, and would have further compromised their bargaining position, which is weakened after defeat in Russia.

Relationship with Hypotheses

The case study of contemporary bargaining in Russia's oil industry has direct relevance to three of the hypotheses set in Chapter 2. Evidence presented in this case study is supportive of hypothesis one. Due to their weak bargaining power, the IOCs have been on the losing side of their bargain with Russia in the current decade and we are witnessing the obsolescing bargain in Russia. Moreover, although this case study is not the main determinant of the validity of the third hypothesis, when considering that in November 2006 Rosneft and Sinopec jointly purchased a Russian oil company and their partnership also resulted in a first exploration well on the Sakhalin-3 block, one can suggest that in Russia, the Chinese NOCs are gaining bargaining power at the IOCs' expense. Finally, this case study has relevance to hypothesis four. Although the interests of American IOCs and the U.S. Government are aligned, the U.S. Government supported American IOCs in

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122 "Every State has and shall freely exercise full permanent sovereignty, including possession, use and disposal, over its wealth, natural resources and economic activities." Each State has the right: (a) To regulate and exercise authority over foreign investment within its national jurisdiction in accordance with its laws and regulations and in conformity with its national objectives and priorities… (b) To regulate and supervise the activities of transnational corporations within its national jurisdiction and take measures to ensure that such activities comply with its laws, rules and regulations and conform with its economic and social policies. Transnational corporations shall not intervene in the internal affairs of a host State… (c) To nationalise, expropriate or transfer ownership of foreign property…" *Charter of Economic Rights and Duties of States*, UN General Assembly Resolution 3281 (XXIX), December 12, 1974.

123 The moves by western oil companies to collaborate with Russian firms have been driven by the buyers' interest in gaining the "booked" discoveries of the purchased company without the expense or risk of actual exploration. Roberts, *The End of Oil*, p. 172.

124 Torbakov, "Yukos Bankruptcy."

bargaining with Russia only in the 1990s, and not after Putin came to power. In the 1990s, U.S. government's support resulted in improved investment legislation in Russia. However, since there has been no government support for American IOCs after Putin came to power and after the overall Russo-American relationship deteriorated (see analyses in the next case study), American IOCs lost bargaining power vis-à-vis the Russian government. This will be elaborated on in Chapter 7, when I discuss my findings.

CASE STUDY 2: Pipeline Bargaining – 'The Scramble for Siberia'

Until recently, Russia had little or no access to East Asia's lucrative energy markets due to the lack of infrastructure in East Siberia and the Russian Far East. However, with rapid growth of China, and perceptions there of a potential hostage situation, in which the U.S. would block supply routes from the Middle East to East Asia, the diversification of energy sources has become one of the priorities of China's energy policy. In Japan, it has been high on agenda for decades, albeit for different reasons. Russia's East Siberia and Far East have ample oil and gas reserves, which could replace a share of Chinese and Japanese Middle Eastern oil and gas exports, and the three-way 'game' for prioritised construction of pipelines has emerged.

Table 3.4: Goals of Main Actors in Russian Pipeline Bargaining

Actor	Bargaining Goals
Putin and the Russian government	Government controlled construction of pipelines; seeking to serve both Japan and China, yet relationship with China more important
The government of the People's Republic of China (PRC)	Importance of diversifying oil sources from the Middle East; in order to maintain high economic growth and therefore domestic stability, need for more imported oil to fuel the economy; Russia seen as a crucial source
The Japanese government	Attempt to diversify sources of oil; Russia an obvious choice
Russian private oil companies	Constructing pipelines in private deals with foreign governments, NOCs and/or IOCs without government intervention

In May 2003, when Yukos' head, Mikhail Khodorkovsky, signed an agreement with CNPC, China thought it had struck a deal with Russia to build a 2,260 km oil pipeline from Angarsk in eastern Siberia to the Chinese oil city of Daqing, where Russian oil would then be refined. The $2.5 to 4.0 billion project would help to feed China's "growing hunger for energy that only foreign supplies can satisfy,"[125] reduce its dependency on Middle Eastern oil and the vulnerability to American disruption of supply lines,[126] and be a symbol of the new friendship established between the former enemies.[127]

In 2002, China overtook Japan as the world's second largest oil consumer, and in the following years, its oil imports surged by 30 percent in 2003, and 37 percent in 2004.[128] Given that Russia is the world's second largest oil exporter, the idea of a pipeline linking the two seems logical, even more so given the strategic partnership that Boris Yeltsin and Jiang Zemin affirmed in April 1996.[129] In February 1999, after two countries almost completely settled their border issues, Prime Ministers Yevgenii Primakov and Zhu Rongyi signed a framework agreement to investigate the export of oil and gas, and Yukos, Transneft and Sinopec signed a trilateral agreement to build a Siberian pipeline to China. Moreover, in July 2001, President Jiang Zemin signed an agreement in Moscow for a feasibility study of a pipeline from Angarsk to Daqing,[130] which was finished in July 2002, and in May 2003 Khodorkovsky and CNPC signed an agreement that seemed to have sealed the deal. China was also interested in building a 4,000 km line to import natural gas from the Kovykta fields, being developed by the TNK-BP consortium.[131] In short, according to Anders Aslund, "relations between China and Russia have never been better

125 "In the Pipeline," *The Economist*, May 1, 2004, p. 29.

126 "China imports about 60 percent of its oil from the Middle East. … Tankers carrying oil to China from the Middle East must pass through chokepoints that leave China vulnerable to blockade by the U.S." Clay Chandler, "Can China Keep the Lights On?" *Fortune*, February 23, 2004, p. 50; the objective of China's energy security activities is to reduce the vulnerability of China's oil supply in the face of American power, as the U.S. controls the sea routes leading from the Persian Gulf to the East Asian ports, particularly the Strait of Hormuz and the Malacca Straits. For more on China's energy security see David M. Lampton and Richard Daniel Ewing, *The US-China Relationship Facing International Security Crises* (Washington D.C.: The Nixon Center, 2003); and Strecker Downs, *China's Quest for Energy Security*.

127 "Your Pipe or Mine?" *The Economist*, September 27, 2003, p. 26.

128 "The World This Week," *The Economist*, September 25, 2004, p. 9.

129 Peter Rutland, "Pipeline Pirouette in Northeast Asia," *Eurasia Daily Monitor*, vol. 1, no. 53, July 16, 2004; Leszek Buszynski, "Oil and Territory in Putin's Relations with China and Japan," *The Pacific Review*, vol. 19, no. 3, September 2006, p. 288.

130 Bernard D. Cole, "'Oil for the Lamps of China' – Beijing's 21st-Century Search for Energy," *McNair Paper*, No. 67, Washington, D.C.: Institute for National Strategic Studies, National Defense University, 2003, p. 73.

131 Rutland, "Pipeline Pirouette in Northeast Asia."

since the time of Mao and Stalin, from 1949-1953."[132] Similarly, Alexander Lukin argues that relations between the two states were at an all-time high.[133]

However, in September 2003, China became worried that its newly found 'friend' was seduced by a rival scheme proposed by Japan. This became evident in Russia's Prime Minister Mikhail Kasyanov's statement after talks with his Chinese counterpart, Wen Jiabao, in Beijing, where he said, "Russia would uphold its commitments to supply oil to China," by delaying consideration of the pipeline to Daqing for three to four months to "assess the environmental impact."[134] He offered no assurance that Russia would reject the proposal that Japan has been lobbying for: to make the pipeline bypass China and terminate in Nakhodka, the nearest Russian port to Japan. This pipeline, to be the world's longest and most expensive, would be almost as twice as long (3,700 km – 4,180 km), would cost more than twice as much as China's ($5-15 billion according to various estimates), but it could also deliver more oil (1-1.6 million bpd versus 0.6-1.0 million bpd for Daqing route).[135] The pipeline to the Pacific would also give Russia access to a wide range of markets – Japan, South Korea, USA, and China (See Figure 3.2 for pipeline proposals).[136] Meanwhile, China's proposal would provide quicker returns: the pipeline would be operational three to five years earlier than the Nakhodka route.[137] Both China and Japan have suggested that branch lines could be attached to their proposed pipelines to satisfy the needs of each country, providing that Russia had enough oil to service them,

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132 Quoted in Esther Pan, "Sino-Russian Energy Ties," *Council on Foreign Relations*, April 5, 2006, http://www.cfr.org, [April 21, 2006]. There are enormous complementarities between Russia, which has commodities, and China, which has cheap labor and manufacturing. In addition, the two countries share a common political objective of containing the United States, according to Ted Galen Carpenter, of Cato Institute, quoted in ibid.
133 Quoted in "When Dragons Dance with Bears," *The Economist*, December 2, 2006, p. 67.
134 "Your Pipe or Mine?" *The Economist.*
135 The Angarsk-Nakhodka pipeline would be the longest in the world. "U.S.-Russia Energy Summit Executive Seminar: The Strategic and Geopolitical Implications of Russian Energy Supply, Security, and Pricing," Baker Institute Study, no. 23, published by the James A. Baker III Institute for Public Policy of Rice University In conjunction with Carnegie Endowment for International Peace, October 2003, p. 5. For estimates of cost and capacity for both proposed pipeline see Barry Naughten, "Impact of the New Asia-Pacific Energy Competition on Russia and the Central Asian States," conference paper, Energy Security in the Asia Pacific, Griffith Asia Institute, Brisbane, August 31 – September 2, 2005, pp. 7-8.
136 "Your Pipe or Mine?" *The Economist*. By using the Chinese route, Russia would be gambling on a single market. The Nakhodka scheme is also seen as a potential boost to the development of the Russian Far East, especially since Japan "promised some $12 billion in business investment in Russia." "The Great Oil Hunt," *Business Week*, November 15, 2004, p. 30. Also see Sergei Blagov, "Russia Walks Thin Line between Japan and China," *Asia Times*, August 1, 2005. For more on Russia's vulnerability on single export market for a particular oil pipeline, see Isabel Gorst, "Russian Pipeline Strategies: Business versus Politics," James A. Baker III Institute for Public Policy of Rice University, October 2004.
137 "Your Pipe or Mine?" *The Economist.*

which is doubtful.[138] Nevertheless, whichever country gets the preferential deal would put its own needs first.[139]

Figure 3.2: Chinese and Japanese Pipeline Proposals

Source: *The Economist*

Peter Rutland argued that two forces derailed the China plan, one domestic and one international.[140] CNPC's partner in the Daqing pipeline was none other than Khodorkovsky's Yukos. As shown in the previous case study, late in 2003 the Kremlin launched an assault on the company that led to the arrest of its top owners and its near-bankruptcy. Yukos' Daqing project stimulated a powerful counter-proposal from a coalition of rival energy companies. Keun Wook Paik explained how state-owned Transneft, whose monopoly on oil export pipelines was threatened by the Yukos project, first raised the idea of a pipeline to Nakhodka in August 2002.[141] In February 2003 Gazprom and Rosneft joined forces to propose building parallel oil and gas pipelines to Nakhodka. Gazprom planned to tap their Chayandinskoe oil field in the republic of Sakha – and not the BP Kovykta field.[142]

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138 "In the Pipeline," *The Economist*. Promising though eastern Siberia's oil resources appear to be, they have yet to be tapped commercially. Even to be sure of filling the original proposed pipeline to Daqing, Russia would have to depend initially at least on supplies from the better-developed fields of western Siberia; also see Bahgat, "Russia's Oil Potential: Prospects and Implications," p. 144.
139 "Your Pipe or Mine?" *The Economist.*
140 Rutland, "Pipeline Pirouette in Northeast Asia."
141 Cited in ibid.
142 Ibid.

Second, Japan entered the game. During his visit to Moscow in January 2003, Prime Minister Junichiro Koizumi promised $5 billion in Japanese financial support for the Nakhodka pipeline. Bargaining continued through the spring. Citing that the Angarsk oil reserve was not large enough to sell oil to both China and Japan, then-Russian deputy Foreign Minister Alexander Losyukov said in mid-April 2003 that Russia had rejected a Japanese proposal to construct a trans-Siberian pipeline to provide Japan with oil, and would instead build a shorter pipeline to Daqing.[143] In May 2003, Japan dropped its request for Russian government's financial guarantees and agreed to contribute another $7 billion to help develop the oilfields. In June 2003, Putin said that the Pacific pipeline "looks preferable because it allows broad access to markets."[144] In July 2003, Japan dispatched a delegation, led by Iwao Okamoto, director-general of the Natural Resources and Energy Agency, to Moscow. The Japanese energy officials discussed with their Russian counterparts about providing financial and technical assistance to the construction of the Pacific pipeline and the development of oilfields in eastern Siberia. The Japan Bank for International Cooperation was said to be willing to finance the construction project even without any loan guarantees from the Russian government.[145] Following a year of heavy Japanese lobbying, on 14 May 2004, the heads of Gazprom, Rosneft and Surgutneftegaz reaffirmed their commitment to common routes for oil and gas pipelines to Nakhodka.[146]

In September 2004, in what at the time seemed to be the final decision, when Wen Jiabao visited Moscow with the intention of pressing Russians to keep to the Yukos deal, Russian government withdrew its support for the Daqing route. Instead, Russia expressed interest in an even longer and more expensive pipeline from Taishet, and not Angarsk, to Nakhodka, from which oil could be shipped to Japan and other Asian customers.[147] As a concession to China, Moscow suggested that a branch line could be built from the Nakhodka route down to Daqing,[148] and Russia's oil majors promised to double rail

143 Lee, "China's Quest for Oil Security," p. 276.
144 *Oil and Gas Journal*, July 7, 2003, p. 9.
145 Lee, "China's Quest for Oil Security," pp. 276-7.
146 Rutland, "Pipeline Pirouette in Northeast Asia."
147 Taishet-Nakhodka pipeline would be some 250 km longer than Angarsk-Nakhodka and would cost between $11 and $16.5 billion. See Xu, "China's Energy Security," p. 25; Sergei Blagov, "Russia Tangles with Japan and China," *Asia Times*, September 1, 2004; and "Russia Snubs China over Pipeline Route," *Times*, September 24, 2004.
148 Rutland, "Pipeline Pirouette in Northeast Asia."

shipment of oil to China in 2005 to around 165,000 bpd,[149] although that route was at full capacity and struggling to meet demand.[150] Although unofficially "Beijing was very unhappy,"[151] the Chinese government refrained from public criticism of Russian dithering, and meanwhile stepped up its interest in securing alternative supplies from Kazakhstan.[152] Only on 31 December 2004, did Prime Minister Mikhail Fradkov formally announce the decision to go with Japan,[153] although this was implicit from earlier events.

However, with Yukos out of the way, Moscow shifted its attention back to the Daqing route. In April 2005, Moscow repeatedly announced that the pipeline will head south from Skovorodino first,[154] and that the Japanese fears that they would not be prioritised may be realised. A mysterious $6 billion transfer from China for future oil deliveries that were used to help Rosneft buy Yuganskneftegaz in December 2004, may have influenced Moscow's decision.[155] When the government's instructions to Transneft, the pipeline monopoly, were released in late April 2005, some of the details were missing. An oil port was supposed to be constructed at Perevoznaya (near Nakhodka), which was an odd choice, given the disruption it would cause to the habitat of a rare leopard. However, the schedule for pipeline construction, to be completed by the end of 2008, refers only to an initial section

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149 Frank Brown, "Looking to the East," *Newsweek*, January 17, 2005, p. 28.

150 Mihailescu, "U.S. Watches China's Oil Demand, Deals."

151 Brown, "Looking to the East," p. 28.

152 Uncertainties over the Daqing scheme and worries about the Middle East have made China all the keener to explore other options. Hence, a long-standing proposal for an oil pipeline from Central Asia to China, which had previously made little headway because of cost concerns, became an attractive option. On May 17, 2004, agreement was signed between President Nursultan Nazarbayev of Kazakhstan and Chinese President Hu Jintao on the construction of the Atasu-Alashankou oil pipeline. This pipeline now connects western Kazakhstan with China, as a part of very expensive - $3 billion - 1,200 km cross-border section of the pipeline from Atasu in Kazakhstan to Dushanzi in China's Xinjiang region. This part of the pipeline, which took a couple of years to complete, and was opened in May 2006, will supply China with about 150,000 bpd in 2007. Once the pipeline is constructed all the way to Dushanzi, it is expected to supply China with up to 400,000 bpd. The pipeline links up with Kazakhstani pipelines connecting to the Caspian Sea region. John C. Daly, "Kazakhstan Inks Oil Pipeline Agreement with China," *Eurasia Daily Monitor*, vol. 1, no. 13, May 19, 2004; and "Kazakh Oil Begins Flowing Into China," *Houston Chronicle*, May 25, 2006. Further, on May 25, 2005, China and Uzbekistan signed an oil deal worth $600m. The joint venture between China National Petroleum Corp and Uzbekneftegaz lay at the heart of an agreement to establish a "friendly, co-operative partnership". "The Dragon and the Tyrant," *The Economist*.

153 Buszynski, "Oil and Territory in Putin's Relations with China and Japan," p. 291.

154 On April 6, 2005, Russian presidential adviser Viktor Ivanov said the government plans to construct a pipeline to transport oil to China from eastern Siberia. This was the first time that a key Russian official has clearly given China priority. "Russia to Build Branch of Oil Pipeline to China," *Alexander's Gas & Oil Connections*, vol. 10, no. 8, April 20, 2005. On April 19, Russia's Industry and Energy Minister Viktor Khristenko told Japanese journalists that the Chinese branch would be constructed first. In addition, Igor Rogochov, Russian ambassador to Beijing, reiterated that the Chinese branch line would get first priority. Kanako Takahara and Mayumi Negishi, "Russian Minister Tight-lipped on Oil Pipeline Plans," *Japan Times*, April 24, 2005; Kanako Takahara and Mayumi Negishi, "China to Get Oil Before Japan: Russian Envoy," *Japan Times*, May 21, 2005.

155 "Chinese Lend Rosneft $6 bn for Yugansk," *The Moscow Times*, January 2, 2005.

from Taishet, in eastern Siberia, to Skovorodino, in the Amur region, which is a 'stone's throw' from the Chinese border.[156]

In support of prioritising China, in July 2005, Putin said that China would get two-thirds of 600,000 bpd of oil that Russia plans to export to Asia within four years.[157] In September 2005, he said that Russia would first build a pipeline from eastern Siberia to China and then a smaller line to the Pacific coast near Japan.[158] In early November 2005, Russian Prime Minister Mikhail Fradkov assured his Chinese counterpart Wen Jiabao that the construction of a key cross-border crude oil pipeline will go ahead as per 2001 agreement.[159] Meanwhile, the Japanese counter-lobbied and argued that they would be content for the Chinese to get a spur from the main pipeline, but insisted that their branch be built first. They fear that without priority commitment to their route, the largely untapped east Siberian oil reserves will remain just that. In short, if their branch is not built first, it may never be built at all.[160]

Hence, after Japanese pressure was applied, in a document on the pipeline project, which was the main focus of the Russo-Japanese summit in Tokyo in late November 2005 just weeks after Fradkov's meeting with Wen Jiabao, Russia promised Japan that it will build a Pacific-bound oil pipeline linking eastern Siberia with the Russian Far East.[161] However, Russia fell short of setting a date for constructing it, and some have suggested that despite public statements to the contrary, Russia is set to have the eastern Siberian pipeline serve China before Japan.[162] As of December 2005, Russia started implementing a project to build the Taishet-Skovorodino pipeline, and Transneft and CNPC became engaged in talks to build a pipeline segment from Skovorodino to China, resulting in CNPC's pledge to provide $400 million grant to finance a feasibility study and construction.[163] On 22 March 2006, Putin said that this line would "ensure a dramatic increase in crude supplies from

156 "King Solomon's Pipes," *The Economist*, May 7, 2005, p. 60.
157 Hector Forster, "Japan, in Contest with China, Will Pressure Putin for Oil, Gas," *Bloomberg.com*, October 17, 2005.
158 Ibid.
159 "China, Russia Pledge to Build Cross-Border Oil Pipeline," *The Financial Express*, November 4, 2005.
160 "King Solomon's Pipes," *The Economist.*
161 "Putin Reassures Japan on Pipeline," *BBC News*, November 21, 2005, http://news.bbc.co.uk/2/hi/asia-pacific/4455542.stm, [November 25, 2005].
162 "Russian Oil Pipeline Takes a Tentative Step Forward," *Petroleum Economist*, December 2005.
163 Eurasia Group, "China's Overseas Investments in Oil and Gas Production," p. 14.

Russia to China."[164] Environmental concerns about prospecting near Lake Baikal, which is one of UNESCO's World Heritage sites,[165] were tackled by Putin, on whose initiative a decision was made to route the pipeline over 400 kilometers to the north of Lake Baikal.[166] Finally, the construction of the Taishet-Skovorodino was launched in April 2006.

Outcome

It is now certain that Russian Government's state pipeline monopoly, Transneft, will be in charge of Far Eastern pipeline construction, as "the government intends to maintain control over Russian oil company exports."[167] According to analysts, Putin appears to have assured the Chinese that the question now is not if the pipeline will serve China, but whether it will serve China before Japan,[168] and therefore, the decision who is going to be a primary customer, China or Japan, is still uncertain. As of early 2007, a 2,000 km pipeline from Taishet to Skovorodino is under construction, and is due for completion late in 2008. What happens after that has been at the centre of a diplomatic battle between Tokyo and Beijing in 2006 and 2007. The Russians are taking a "short-term tactical approach to an issue that both its potential partners view as strategic." Therefore, it seems that oil-thirsty Asian countries, similar to ambitious IOCs, have little choice but to court the Kremlin.[169] Japan has lobbied heavily for the next phase to consist of transporting crude another 2,000 km by rail, and eventually by pipeline, to a new export terminal off the Pacific coast in Perevoznaya Bay, although environmentalists would prefer it to be sited at the port of Nakhodka. The oil would then be shipped to Japan and other East Asian countries. Skovorodino, however, is only 70 km from the Chinese border, so Beijing has pressed for Russia to build a spur from that point to the Chinese border, where it would connect to a pipeline the Chinese would build from the ageing oilfields around Daqing, in Heilongjiang province. Below, I argue that China will most likely win this prolonged battle.

Analyses

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164 Ibid.
165 "Russia, China to Sign Joint Oil Pipeline Agreement," *Novosti: Russian News and Information Agency*, November 3, 2005.
166 Nodari Simonia, "Russian East Siberia and the Far East: A Basis for Co-operation with Northeast Asia," *Global Asia*, vol. 1, no. 1, September 2006, p. 72.
167 Boussena and Locatelli, "Towards a more Coherent Oil Policy in Russia?" p. 96.
168 "China Unfulfilled."
169 "King Solomon's Pipes," *The Economist*.

Russia

> Putin believes that Russian ownership of Russia's resource base is critical to Russia's economic recovery and to the country's re-emergence as an important international actor.[170] Russia's natural resource base will not only secure the country's economic development but will also serve as the guarantor of the country's international position.[171]

Russia is trying to use its role as a major oil and gas exporter as a means, or as a bargaining chip, in securing influence or pursuing its own goals in neighbouring countries. Russia's position as an energy-exporting nation is a 'power resource' that enhances its status in foreign negotiations.[172] Major economies, increasingly dependent on Russian gas and oil exports, are rendering themselves vulnerable to the ambitions of a country that has not refrained from using energy as a geopolitical weapon and has been ruthless in its treatment of both internal political opponents (oligarchs) and neighbouring states. In future, Russia will be well positioned to marshal its oil and gas reserves to support domestic and foreign policy objectives.[173]

In early 2006, Russia flexed its political muscle when it turned off the gas to Ukraine, and therefore stopped subsidising the Ukrainian government, as Ukrainian political elite decided to go with the West and not to integrate in the post-Soviet space. Similar scenarios followed suite with Belarus and Moldova in March 2006, with Georgia later that year, and Poland and Germany in January 2007.[174] Russian government officials have talked tough with West European leaders, raising the prospect that they might divert energy supplies to China and the U.S. if the Europeans do not meet their demands for better market access,

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170 Olcott, "Vladimir Putin and the Geopolitics of Oil," p. 16.

171 Putin, "Mineral Raw Materials in the Strategy for Development of the Russian Economy."

172 Sugino, "The Energy Dimension in Russian Global Strategy," p. 1.

173 For example, some have suggested competition between Europe and China for Russian gas. See Roland Götz, "Europe and China Competing for Russian Gas?" German Institute for International and Security Affairs, SWP Comments, no. 14, May 2006.

174 In January 2006, Russia stopped exporting gas to Ukraine, after Ukraine refused to accept a massive price hike from \$50 to \$230 for 1,000 cubic meters. Moldova was cut off after refusing to accept a price doubling, to \$160 per cubic meter. Belarus' fivefold price increase was due to come into effect at the start of 2007. "Belarus Hit by Russian Gas Hike," *BBC News*, March 30, 2006, http://news.bbc.co.uk.go/pr/fr/-/2/hi/business/4862158.stm, [March 31, 2006]. For more on Russia's recent oil and gas politics with Europe, see Owen Matthews, "No More Mr. Nice Guy," *Newsweek*, January 22, 2007, pp. 16-8; "Don't Mess with Russia," *The Economist*, December 16, 2006, p. 11; Andrew Purvis, "Trouble in the Pipeline," *Time*, January 22, 2007, p. 9; Andreas Heinrich, "Gazprom – A Reliable Partner for Europe's Energy Supply?" *Russian Analytical Digest*, no. 1, June 6, 2006, pp. 2-6; "A Bear at the Throat," *The Economist*, April 14, 2007, pp. 53-5; and David Wood, "Russia Seeks Global Influence by Exploiting Energy Geopolitics," *Oil & Gas Journal*, February 12, 2007, pp. 20-4.

including ownership of some refining and distribution operations.[175] As investigated in this case study, Russia is playing the energy card in a similar way in its Far East with Japan and China, where it is deliberately using its indecisiveness about the priority choice of pipeline route to secure influence in its relationship with Japan and China. Putin is aware of the fact that both Japan and China need oil and that considering current market conditions they would offer a lot for priority rights to Russian oil. This is similar to Russia's exports of gas. If Russia does not accept gas offers from Ukraine or Western European governments, it can choose to accept those from China, Japan or India, and this choice gives it bargaining advantage against its customers.

The bottom line is that senior Russian leaders believe that their country can ultimately punch far above its weight internationally by systematically increasing both its allies' and its adversaries' dependence on Russian energy supplies and distribution networks.[176] After all, in 2006 Russia was presiding the Group of Eight (G8), a forum for rich democracies, despite being neither rich nor democracy. Western and Asian states, including all current and future great powers, are rendering themselves increasingly, and in many cases dangerously, dependent on Russian energy. As Russia's neighbours have already learned, such dependence comes at a price.[177]

The official Russian position in negotiations regarding the Far East pipeline construction reflects the importance of issue linkage. From a strategic security standpoint, the growing energy requirements of a rapidly modernising China and the desire of other Asian economies (i.e. Japan) to diversify their sources of supply create opportunities for Russia to become an important strategic player in the Asia-Pacific region.[178] However, in becoming a strategic player in the region, in building a major branch of its Far Eastern oil pipeline, Russia has to choose between China and Japan. Why should Russia choose one over the other?

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175 "Crude Power," p. 23.
176 Twining, "Putin's Power Politics," pp. 3-4.
177 Ibid, p. 9.
178 Bobo Lo, *Vladimir Putin and the Evolution of Russian Foreign Policy* (London: The Royal Institute of International Affairs, 2003), p. 67.

General Sino-Russian relations seem to be much better than during the Soviet times.[179] Moreover, they are also perceived as 'friendly' by majority of the Russian public.[180] Close Sino-Russian relations are evident in large-scale Russian arms sales to China, leading the latter to become the largest recipient of Russia's arms receiving more than a quarter of its total arms deliveries,[181] with average annual purchases of well over $1 billion.[182] Besides arms sales, Russia is also the largest nuclear technology supplier to China, thus helping China to quadruple its nuclear power capacity by 2020. Close Sino-Russian relations are also evident in the final resolution of long-standing border issues in 2004; in unprecedented level of cooperation, as in 2005 presidents Vladimir Putin and Hu Jintao met four times and issued a joint declaration on the 21st century world order; in the fact that in 2005, the two countries carried out their first joint military exercises on Chinese soil and in the East China Sea involving around 10,000 troops; and in the fact that their bilateral trade in 2005 increased by more than 30 percent to $29-30 billion.[183] One could therefore argue that Sino-Russian new 'strategic partnership' or 'axis of oil' is a sign of collaboration in order to balance the hegemon – the United States – and supports the realist assumption that in unipolar world, hegemonic challengers tend to get in some sort of formal or informal alliance to counterbalance the overwhelming power of the hegemon.

Russia's earlier security and other collaboration with the United States, in which it unilaterally offered numerous concessions to the Americans,[184] pointed towards Russian

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179 For a history of Sino-Soviet and later Sino-Russian relationship, see Elizabeth Wishnik, *Mending Fences: The Evolution of Moscow's China Policy from Brezhnev to Yeltsin* (Seattle: University of Washington Press, 2001).

180 In a survey conducted by Russian Department of State, Office of Research, between January 29 and February 11, 2000, Russia's relations with China were considered friendly by 52% of respondents, while only 9% considered Sino-Russian relations as difficult. Meanwhile, while 20% considered Russo-American relations as friendly, 48% percent considered them difficult. Department of State, Office of Research, "Opinion Analysis," March 14, 2000, p. 4.

181 *World Military Expenditures and Arms Transfers* (Washington, D.C.: US Arms Control and Disarmament Agency, 1995).

182 See Sergei Blagov, "More Russian Weapons Go to China," *Asia Times*, January 30, 2003.

183 Roderic Lyne, Strobe Talbott and Koji Watanabe, "Engaging with Russia: The Next Phase," The Trilateral Commission, Washington, Paris, Tokyo, 2006, p. 124.

184 Putin has consistently pursued a policy of cooperation with the United States, without pressure from domestic constituencies, making a stream of hitherto unimaginable concessions by allowing the U.S. to - extend NATO to include the Baltics, station its troops in Central Asia to wage war in Afghanistan, unilaterally withdraw from the Anti-Ballistic Missile Defense (ABM) Treaty, and to have special forces in Georgia. For details, see Dale Herspring and Peter Rutland, "Foreign Policy Under Putin," in Dale Herspring and Jacob Kipp (eds.), *Putin's Russia* (Rowman and Littlefield, 2002), ch. 11. Further, the 800,000 - 1 million bpd, 1,767 km Baku-Tbilisi-Ceyhan (Azerbaijan-Georgia-Turkey) pipeline, which is the lynchpin of U.S. policy towards the Central Asia, was explicitly designed so as to provide an alternative export route for Caspian oil that did not involve transiting Russia. Peter Rutland, "Russia's Response to U.S. Regional Influence," *National Bureau of Asian Research Journal Analysis*, vol. 14, no. 4 (November 2003), p. 5. See also "Oil Over Trouble Waters," *The Economist*, May 26, 2005.

bandwagoning, rather than balancing the hegemon.[185] However, this has changed in recent years, and following negative developments in the U.S.-Russian relationship, the U.S. Council on Foreign Relations (CFR) concluded that Russia was "headed in the wrong direction."[186] Besides other bilateral developments with China, mentioned in the previous paragraph and in this case study, since 2003 Moscow has worked assiduously to establish a new sphere of influence in Central Asia and Former Soviet Union in general, using regional autocrats' interest in resisting U.S. pressure to democratise. Meanwhile, China has been trying to avoid 'encirclement' by U.S. forces and limiting its reliance on maritime supplies, to maximise pressure on America.[187] Therefore, Russia and China have found a common cause in limiting U.S. influence in Central Asia,[188] and their 2001 establishment of Shanghai Cooperation Organization (SCO) together with three (now four) Central Asian states may serve to achieve that goal. In addition, together with Beijing, and against Washington, Moscow has been opposed to the 1999 NATO's Kosovo campaign, the 2003 U.S.-led invasion of Iraq, and to any comprehensive sanctions or other cause of action to be carried out against Tehran for its alleged non-compliance with the Nuclear Non-proliferation Treaty (NPT). It is also important to keep in mind that Iran has been an SCO observer, with the possibility of joining the organisation in future.[189] Western analysts are increasingly alarmed that the economic and political endgame of the SCO is to limit the U.S. influence in Central Asia.[190] In addition to opposing U.S. interventionism, and its influence in Central Asia, Moscow and Beijing held common views in opposing both Washington's alliance systems and its plans for national missile defence.[191] Finally, both countries resent foreign criticism of their domestic human rights records, and outside meddling in what they see as illegitimate separatism in Chechnya and Taiwan.[192] Clearly, Russia and China share an interest in ensuring a multipolar world as opposed to a unipolar

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185 Rutland, "Russia's Response to U.S. Regional Influence."
186 John Edwards, Jack Kemp, and Stephen Sestanovich, "Russia's Wrong Direction: What the United States Can and Should Do," Council on Foreign Relations (CFR), Independent Task Force Report, no. 57, 2006.
187 Leverett and Noël, "The New Axis of Oil," p. 65. Also see Dmitri Trenin, "Russia Leaves the West," *Foreign Affairs*, vol. 85, no. 4, July/August 2006, pp. 87-96.
188 Wesley, "The Geopolitics of Energy Security in Asia," p. 10. For more on Russia's policy in Central Asia, see Dmitri Trenin, "Southern Watch: Russia's Policy in Central Asia," *Journal of International Affairs*, vol. 56, no. 2, Spring 2003, pp. 119-31.
189 For more on SCO and Iranian role there, see Douglas, Nelson and Schwartz, "Fueling the Dragon's Flame," pp. 10-14.
190 Jehangir Pocha, "Summit Forges Military Ties in Central Asia," *The Boston Globe*, June 18, 2006.
191 Lyle Goldstein and Vitaly Kozyrev, "China, Japan and the Scramble for Siberia," *Survival*, vol. 48, no. 1, Spring 2006, pp. 168-9.
192 "When Dragons Dance with Bears," p. 67.

world dominated by the United States.[193] Developing further energy links would certainly help cement these growing ties.

Building a pipeline towards Japan or China would most probably bring in additional 0.6 – 1.6 million bpd of export capacity and it would play an important role in increasing Russian oil export volumes and revenues, which are needed in order to maintain Russia's steady economic growth. If there were sufficient amounts of oil reserves in Eastern Siberia, Japan would be a better option when considering future export volumes. However, most likely, there are insufficient oil reserves to justify the at least 1 million bpd Nakhodka pipeline, particularly given uncertainties about extraction costs in the new and geologically difficult fields of East Siberia. Thus, it is also highly unlikely that Eastern Siberia contains sufficient oil reserves to satisfy the needs of both Japan and China. Eastern Siberia and Russia's Far East have a small share of the country's total reserves - 7 percent, compared with 72 percent in Western Siberia.[194] In addition, Edward Chow argues that "everyone, even the [Russian] government, agrees there are not enough resources in the eastern half of Russia to commercially guarantee throughput for the line to Nakhodka," and many other analysts concur with this prediction.[195] Indicative of this was Putin's statement from July 2006, when he said that he could not give Japan guarantees that a planned Far Eastern pipeline would eventually reach the Pacific coast, citing uncertainty about oil supplies.[196]

Naturally, if there was enough oil in Russia's Far East and East Siberia, the 'Japan' route would give Russia access to more markets rather than just Chinese market if it chooses the 'China' route and Russia could therefore have a large number of potential customers. Some have argued that the Nakhodka project would not lock Russia into a single buyer, China. Hence, the Pacific destination of the pipeline would possess self-evident marketing

193 Lyne, Talbott and Watanabe, "Engaging with Russia: The Next Phase," p. 125.
194 Quoted in "Russian Oil Pipeline Takes a Tentative Step Forward."
195 Edward C. Chow, "Russian Pipelines: Back to the Future?" *Georgetown Journal of International Affairs*, vol. 5, no. 1, Winter 2004, p. 30. Eugene Khartukov and Ellen Starostina ("Ex-Soviet Oil Exports: Constraints, Outlook, and Global Impact," *Energy Politics*, no. 7, Fall 2005, p. 44), James Dorian and Joseph Ferguson (in F. Joseph Dresen (ed.), "Russia in Asia-Asia in Russia: Energy, Economic, and Regional Relations," conference proceedings, Woodrow Wilson International Center for Scholars, Washington, D.C., July 22-23, 2004, pp. 58 and 63), and Leon Aron, ("Russia's Oil: Natural Abundance and Political Shortages," American Enterprise Institute for Public Policy Research, Spring 2006, p. 3.) agree with this assumption.
196 "Putin Says Can't Give Japan Guarantees on Planned Oil Pipeline," *People's Daily Online*, July 16, 2006, http://english.people.com.cn, [July 20, 2006].

advantages over the Chinese route.[197] In such scenario, Russia's international bargaining position would be strengthened. However, Russia should prioritise the 'China' route in order to make China more dependent on Russian oil, and therefore gain more bargaining power vis-à-vis China *per se*. While it has been suggested that exporting to China and not any other market in East Asia would be dangerous for Russia, as it would rely just on one market,[198] this assumption is incorrect. Russia has plenty of other markets in the west – Western and Eastern Europe, the United States – which would certainly welcome more Russian oil, in case China decides to stop purchasing it. Russia has a complex system of pipelines stretching from Western Siberia to Europe, and it would not be a large obstacle for Russia to link Western and Eastern Siberian pipelines. It would be unwise not to do so. Hence, a common perception that in case the Far Eastern pipeline is not built to the Pacific, Russia would be relying solely on Chinese market is false. Moreover, China and Russia had reached a mutually acceptable agreement on pricing as part of the deal,[199] and this further supports my argument that Russia should prioritise the China route.

Furthermore, Russia's security objectives could be put in danger if it prioritises the 'Japan' route, as this could cause serious deterioration in Sino-Russian relations and it may trigger Chinese assertiveness in its pretensions against the Russian Far East, which was once a part of China.[200] If Russia dropped the China pipeline, its Far East would transform from a region of economic potential to a source of strategic vulnerability.[201]According to some sources, Beijing poses a threat to Russia, and "this is especially true in Siberia and the Far East region, where economic development is lagging and population decreasing."[202] There

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197 See, for example, Buszynski, "Oil and Territory in Putin's Relations with China and Japan."
198 Ibid.
199 Viktor Kalashnikov, an economist from Khabarovsk, cited in Rutland, "Pipeline Pirouette in Northeast Asia."
200 These territories (Khabarovsk, Primorye, Amur, Birobidzhan regions) were acquired controversially through 'unequal' treaties, such as the 1860 Treaty of Peking. Lo, *Vladimir Putin and the Evolution of Russian Foreign Policy*, p. 91. China's educational system continues to present the Russian seizure of formerly Chinese lands in the Amur and Ussuri river basins as unjust and, perhaps, temporary. Even Russians in the Far Eastern region admit that this area was seized by force or coerced by the Chinese in unfair negotiations over a century ago. James Clay Moltz, "Russo-Chinese Normalization from an International Perspective," in Tsuneo Akaha (ed.), *Politics and Economics in the Russian Far East: Changing Ties with Asia-Pacific* (New York: Routledge, 1997), pp. 189 and 191.
201 See Brown, "Looking to the East," pp. 28-9: "the *siloviki* are against providing energy to China for fear of building up an already formidable rival;" and Yergin, "Over a Barrel": "the wrangle over a proposed pipeline for Siberian oil to Asia is not just a commercial matter – it reflects all the rivalries and suspicions among China, Russia, and Japan."
202 Sugino, "The Energy Dimension in Russian Global Strategy," p. 14. Also, see Alexander Lukin, "Russian Perceptions of the China Threat," in Herbert Yee and Ian Storey (eds.), *The China Threat: Perceptions, Myths and Reality* (London: Routledge, 2002), chapter 4; and Owen Matthews and Anna Nemtsova, "Fear and Loathing in Siberia," *Newsweek*, March 27, 2006, pp. 16-9. Russia is sensitive about the security of the eastern borders it shares with China, with its growing economic and military power and uncertain future. The population of Russian Far East decreased from 7.9 million in

is concern amongst Russians that Chinese immigration and settlement in Russia's Far East would naturally follow. According to Mikhail Khodorkovsky, "a rapid Sinification of the Asian part of Russia is already taking place, and represents the main strategic threat to the country's security."[203] This attitude contrasts the general Sino-Russian relations, which, as shown above, seem to be much better than compared to the Soviet times. This issue is an important one for Russia, as it is axiomatic in Russian conceptions of security to assert the primacy of defending the nation's 'territorial integrity.'[204]

Russia's territorial integrity is at stake in its relations with Japan too. However, unlike in Moscow's relationship with Beijing, they are a dominating factor in its relationship with Tokyo. If Russia decides to build the pipeline to prioritise it, Japan, unlike China, would not put aside the Kuril Islands issue, which has been on Japan's agenda ever since the end of the World War II, and which has consistently been the major obstacle in its relations with Russia. The Russian government may be in for a rude awakening, since the Japanese government might raise the return of the 'Northern Territories' (the southernmost Kuril Islands) as a precondition for concluding the deal. Moscow assumes that Tokyo has given up on getting the islands back, but that is erroneous.[205] The two countries have not signed a peace treaty formally ending hostilities of World War II, and longstanding territorial issues are far from solved.[206] Alternatively, if Russia prioritises the 'China' route, Japan could decide to push the Kuril Islands issue up to the top of its foreign policy agenda, and we would witness further deterioration of Russo-Japanese relations. However, Russia does not share a land border with Japan, and Japan is far from a military and demographic threat to Russia's Far East. Therefore, Russia needs not fear any threat to its territorial integrity from Japan.

1989 and 8 million in 1992, to 7.6 million in 1995, 6.7 million in 2002, 6.6 million in 2004, and further to 6.5 million in 2006, yet it also attracts large number of illegal Chinese immigrants about whom there are no official data. At the same time, 107 million people live in three neighbouring provinces of China. See Chikahito Harada, *Russia and North-east Asia*, International Institute for Strategic Studies, Adelphi Paper, no. 310, 1997, p. 19; Buszynski, "Oil and Territory in Putin's Relations with China and Japan," p. 289; "Russia in Asia-Asia in Russia: Energy, Economic, and Regional Relations," pp. 36-40; and "When Dragons Dance with Bears," p. 67.

203 Mikhail Khodorkovsky, "Letter from Siberia," *The Economist, The World in 2007*, 2006, p. 90.

204 Lo, *Vladimir Putin and the Evolution of Russian Foreign Policy*, p. 90.

205 Japanese political scientist Hiroshi Kimura, cited in ibid.

206 Ayako Sugino, "The Energy Dimension in Russian Global Strategy," The James A. Baker III Institute for Public Policy of Rice University, October 2004, p. 14.

On one hand, if Russia decides against China's priority route, Beijing will continue to establish its presence in Central Asia in order to get that extra 0.6 million bpd it would not get from Russia. In addition, China's structural power in the Far East clearly points towards a large power asymmetry, as "China has a superior position to Russia in the region both politically and economically."[207] Hence, as already stated, Russia's strategic security objectives could be in danger as power asymmetry increases. In such situation, we could witness Chinese assertiveness against Russia's Far East, and hence "alienating Beijing is simply not an option for Moscow."[208] On the other hand, if Russia chooses the 'China' route, this would most likely mean that China would not actively pursue its ambitions against Russian Far East in the short or the long run. As the bilateral relationship between Russia and China would be further improved, this would be a further sign of the two countries' attempt to balance the hegemon. Goldstein and Kozyrev have argued, "The formation of the Sino-Russian energy nexus would represent a strong consolidation of an emergent bipolar structure in East Asia, with one pole led by China (and including Russia) and one led by the United States (and including Japan)."[209]

While domestic reasons affect Russia's official position in pipeline bargaining with China and Japan, they fail to influence Russia's final decision. Was it not for 2003 crackdown on Yukos, and the prevalence of *siloviki* in the Kremlin, the private pipeline to Daqing would have already been under construction. However, influenced by the international power objectives Putin resumed state control over the country's oil industry and decided to go against Yukos' original plan, with the plan supported by the *siloviki*, the 'Japan' route. For a while, Putin played to *siloviki* wishes but has since changed his decision likely to settle with the 'China' route.[210] Domestic factors did not influence Putin's, and therefore Russia's, final decision, since Putin centralised decision making in Moscow, demonstrated his own personal management of foreign policy, and reduced the role of domestic actors.[211]

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207 Harada, *Russia and North-east Asia*, p. 46.
208 Goldstein and Kozyrev, "China, Japan and the Scramble for Siberia," p. 175.
209 Ibid, p. 163. On bipolarity in East Asia, see Robert S. Ross, "The Geography of Peace," *International Security*, vol. 23, Spring 1999, pp. 81-118.
210 The role of *siloviki* in Russian politics has been more modest than commonly asserted. See Bettina Renz, "Putin's Militocracy? An Alternative Interpretation of *Siloviki* in Contemporary Russian Politics," *Europe-Asia Studies*, vol. 58, no. 6, September 2006, pp. 903-24; and Edwin Bacon and Bettina Renz, *Securitising Russia: The Domestic Politics of Putin* (Manchester: Manchester University Press, 2006).
211 Buszynski, "Oil and Territory in Putin's Relations with China and Japan," p. 287.

It can be argued that one of the reasons behind Russia's *potentially* final decision could lie in its receipt of multi-billion dollar transfers from China and Japan. Both China and Japan are willing to offer considerable amounts of money to gain Russia's preference. Elsewhere, in what clearly portrays its financial superiority vis-à-vis Japan, China has been outbidding other competitors in the energy field by sometimes offering even "twice as much as its closest competitors" ever since its emergence as a net oil importer in 1993.[212] $6 billion provided by China in December 2004 for future oil deliveries, that were used to help Rosneft, a state-owned oil company, buy Yuganskneftegaz, may have influenced Moscow's decision, as Putin used this money to consolidate government's control over the oil industry in Russia, as this is a crucial element in enabling Russia to rise to its historical power status. Government-controlled oil pipelines permit the government to control supply and direct investment flows not only into the pipeline sector, but also in the economy as a whole. It also maintains a system of differential pricing and preferential access to resources, allowing the government to hand out rewards and punishments for both economic and political reasons.[213] In addition, state control of the oil industry adds considerable bargaining power in Russia's foreign policy, as compared to the situation in which the pipelines were owned and operated by private owners. However, although this money was important for Putin, China's $6 billion transfer did not influence Russia's final decision, since in the same month (December 2004) Prime Minister Mikhail Fradkov formally announced Russia's decision to go with Japan.

Unsurprisingly, Russia's international position is strengthened by its indecisiveness over the primary route of Far Eastern oil pipeline. Continuous interest shown by China and Japan gives Russia the sense of importance in the international affairs. Friendly relations with China would be more important to Russia than increased bargaining power against Japan or any other oil importer. Due to its rapid growth, China is increasingly seen as a strategic security threat against Russia's Far East, and prioritising the 'China' route would reduce this threat and bring Russia and China even closer together in attempting to balance American hegemony. Although if Russia prioritises the 'Japan' route, it would get a wider export market, and therefore more bargaining power against a variety of East and

[212] Strecker Downs, *China's Quest for Energy Security*, pp. 16-7.
[213] Chow, "Russian Pipelines," p. 32.

Southeast Asian actors, Russia has access to many markets in its west, so reliance solely on China in the Far East would not leave it hostage to China's oil purchases. It could play a strategic 'game' with China by threatening to divert its exports westwards. Although the Pacific route would enable Russia to export more oil and therefore possibly receive more revenues, it is highly likely that East Siberia cannot reach a production capacity of 1 million bpd, what is the minimum required to feed this pipeline.

China and Japan

China's foreign policy is almost completely dominated by energy concerns, as it is trying hard to gain control of any overseas oil at the source, and it is attempting to diversify its sources of imported energy.[214] Hence, to an extent, China's strategic security concerns explain the most likely outcome of pipeline bargaining between Russia, China and Japan. Since it became a net oil importer in 1993, China violated the Maoist doctrine of self-reliance.[215] For example, in 2005, China imported 48 percent of the crude oil it consumed (see Table 3.5). Applied to the energy sector, self-reliance implies the ultimate control by the government over the domestic energy sector.[216] In order to achieve long-term security 'independence', China seeks to reduce its short-term energy dependence and vulnerability away from cooperation with the United States. The U.S. controls the sea routes leading from the Persian Gulf to the East Asian ports, particularly the Strait of Hormuz and the Malacca Straits. Therefore, the U.S. is seen by some Chinese analysts as the major threat to China's energy security.[217] Diversification of import sources, to Central Asia and Russia among others, is therefore, the main objective of Chinese energy policy, evident in its effort to construct a "pan-Asian continental oil bridge."[218] Diversification is a sound strategy for energy security that both the United States and Japan have pursued.[219]

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214 For implications of China's growing energy hunger, see Xiaojie Xu, *Petro-Dragon Rise: What it Means for China and the World* (Fucecchio, Italy: European Academic Press, 2002).

215 From a theoretical perspective, reliance on imported oil arguably violates the Maoist doctrine of self-reliance (*zili gengsheng*), the guiding principle for economic development in the 1960s and 1970s. Strecker Downs, *China's Quest for Energy Security*, p. 11

216 Kim Woodward, *The International Energy Relations of China* (Stanford: Stanford University Press, 1980), p. 33

217 For example, Xiao Feng, "Views on Some Hot-Stop Issues in International Situation," *Contemporary International Relations*, vol. 9, no. 12, December 1999, pp. 1-5; and Chu Shulong, "Sino-US Relations: The Necessity for Change and a New Strategy," *Contemporary International Relations*, vol. 6, no. 11, November 1996, p. 8.

218 "Experts Call for a Pan-Asian Oil Bridge," *Xinhua*, June 16, 1996. In order to accomplish this goal, China has already established energy ties with Iran, Kazakhstan, Turkmenistan and Uzbekistan.

219 Strecker Downs, *China's Quest for Energy Security*, p. 19. One (the U.S.) more successfully than the other (Japan).

Table 3.5: China's Crude Oil Production and Consumption (1992-2005)

Year	Production (mbpd)	Consumption (mbpd)	Balance (mbpd)
1992	2.841	2.740	0.101
1993	2.888	3.051	-0.163
1994	2.930	3.116	-0.186
1995	2.989	3.395	-0.406
1996	3.170	3.702	-0.532
1997	3.211	4.179	-0.968
1998	3.212	4.228	-1.016
1999	3.213	4.477	-1.264
2000	3.252	4.772	-1.520
2001	3.306	4.872	-1.566
2002	3.346	5.288	-1.942
2003	3.401	5.803	-2.402
2004	3.481	6.772	-3.291
2005	3.627	6.988	-3.361

Source: *BP Statistical Review of World Energy 2006*

In accordance with its strategic security goals, China is ready to pay any price to secure that Russia prioritises the Daqing route. China's oil imports from Russia amounted to barely 80,000 bpd in 2004, rising to 320,000 bpd in 2006,[220] and if pipeline were built, this could be raised to at least 600,000 bpd. China depends on the U.S. for security of sea-lanes between the Middle East and East Asia, and is vulnerable to embargoes or blockades of Middle Eastern oil supplies. Thus, higher reliance on Russian oil would result in lower demand for oil from the Middle East, which is a region that supplied China with 40.2 percent of its crude oil imports in 2005 (see Table 3.6).

Table 3.6: Chinese, Japanese and American Oil Imports by Region of Origin (2005)

	China		Japan		United States	
	kbpd	*Of total*	*kbpd*	*Of total*	*kbpd*	*Of total*
Unidentified	6	0.2%	44	0.8%	214	1.6%
Europe	12	0.4%	6	0.1%	1100	8.1%
Former Soviet Union	398	11.8%	47	0.9%	473	3.5%
Middle East	1360	40.2%	4269	81.7%	2345	17.3%
N. Africa	64	1.9%	2	0.0%	547	4.0%
W. Africa	574	17.0%	60	1.1%	1943	14.4%
E. and S. Africa	135	4.0%	80	1.5%	-	-
S. and C. America	107	3.2%	2	0.0%	2868	21.2%
N. America	8	0.2%	90	1.7%	3819	28.2%
Australasia	25	0.7%	65	1.2%	14	0.1%
Other Asia Pacific	626	18.5%	511	9.8%	202	1.5%

[220] "China's Oil Imports from Russia Up," *United Press International*, March 1, 2007.

Total	3384	100.0%	5225	100.0%	13525	100.0%

Source: *BP Statistical Review of World Energy 2006*

There has been some opposition to increasing energy cooperation with Russia on national security grounds coming from Chinese domestic actors. A number of China's leaders and People's Liberation Army (PLA) officers are reportedly opposed to increasing energy cooperation with Russia, as they are concerned that in the event of a Sino-Russian crisis, Russia would stop the flow of energy resources to China.[221] However, despite these worries, the overall security objectives still favour the construction of a pipeline from Russia amidst the potential future risk, which unavoidably also exists in other projects.

Domestic factors are crucial in determining Chinese policy choice. Beijing's external affairs are closely intertwined with its domestic policy, and the watchword that drives both is stability. Beijing seeks continued economic growth, because rising living standards provide the party's only claim to legitimacy: "Economic growth has become the central justification for continued CCP rule since Mao's death … it determines the future of the entire political system."[222] Moreover, since rapid economic growth is crucial for maintaining the domestic regime stability, domestic interests are more important than foreign policy interests.[223] For example, Ng argues that "holding on to state power has been and continues to be the main objective of the CCP."[224] In recent years, according to Xu Yi-Chong, "continuing economic growth has been threatened by the shortage of energy supplies," and this issue has thus drawn much political attention in Beijing, especially since "energy shortages in China can choke its economy and lead to a serious economic slowdown."[225] In order to continue fuelling its economic growth, it is paramount for China to secure access to increasing amounts of imported oil every year. Thus, in future, bringing more Russian oil to China will be crucial for satisfying its mounting energy demand. Moreover, the pipeline to Daqing would serve one of China's national development goals – "Revitalising the

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221 Mehmet Ögütçü, "China's Energy Future and Global Implications," in Werner Draguhn and Robert Ash (eds.), *China's Economic Security* (New York: St. Martin's Press, 1999), p. 137.
222 Bruce Gilley, *China's Democratic Future: How It Will Happen and Where It Will Lead* (New York: Columbia University Press, 2004), p. 37. Also, see Bill Powell, "The New Power in the Persian Gulf," *Time*, January 30, 2006, p. 56.
223 Swaine, "Chinese Crisis Management," p. 23.
224 Ng Ka Po, "Critical Developments in Chinese Politics," in Czeslaw Tubilewicz (ed.), *Critical Issues in Contemporary China* (London: Routledge, 2006), p. 44.
225 Xu, "China's Energy Security," pp. 268 and 271.

Northeast" – because, if built, it could provide jobs for this economically suffering region, China's 'rust belt' of sunset manufacturing enterprises.[226]

Japan is currently the second largest importer and the third largest consumer of crude oil in the world. Its ambition to get Russian oil via the construction of a pipeline which would primarily serve Japan's oil needs, reflects its efforts to diversify the sources of imported oil, as "Japanese officials claim that diversification of supplies is paramount for the future of the Japanese economy."[227] It is commonly argued, "Energy development in the Russian Far East can be instrumental in helping diversify energy supplies and thus enhance energy security."[228] However, as it is a strategic ally of the United States, it does not feel as vulnerable in having to rely on the U.S. for protection of supply lines from the Middle East, where most of its oil comes from. Moreover, as it relies on the U.S. for protection, although it has been a net oil importer for decades, unlike China and the U.S., it completely failed to pursue its diversification policy, since its imports from the Middle East in 2005 constituted 81.7 percent of total oil imports (see Table 3.6). Thus, since the U.S. is its major ally, the strategic motivation behind Japan's diversification policy is far less pronounced than in the case of China.

In addition, the importance of securing extra crude oil for imports is less important for Japan than for China, since Japan's crude oil consumption has been on a downward slope since its peak in 1996, and has dropped by 8 percent between then and 2005 (see Table 3.7). Unlike China, where oil consumption almost doubled, and oil imports grew six-fold in the same period (see Table 3.5), Japan is becoming less reliant on imported oil and price volatility and political instabilities associated with it, because it is investing large sums of money in alternative sources of energy and is promoting energy conservation.[229] Hence, Russia's Far East, which is also rich in natural gas, could "contribute to Japan's efforts of

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226 Lewis, "Chinese NOCs and World Energy Markets," p. 35.

227 Chow, "Russian Pipelines," p. 30. The major pillars of Japanese energy strategy are: (1) the security of supply; (2) reasonable prices; (3) the diversification of energy sources (away from oil to non-oil resources); (4) geographical diversification of the supply of energy; and (5) energy conservation. Takamichi Mito, "Japan's Energy Strategy, Russian Economic Security, and Opportunities for Russian Energy Development: Major Issues and Policy Recommendations," The James A. Baker III Institute for Public Policy of Rice University, May 2000, p. 8.

228 Takamichi, "Japan's Energy Strategy," p. 8.

229 For interesting insight into this issue, see Roberts, *The End of Oil*, pp. 188-212.

diversifying its sources away from oil to natural gas."[230] Further, investing, for example, $5 billion into Nakhodka pipeline would add about $2 per barrel to every imported barrel Japan consumes for the next 40 years. Put another way, if it does not invest $5 billion in Nakhodka, Japan could afford to pay a $2 per barrel premium for every barrel to give it a competitive edge against every other oil consumer on the market, and still come out even.[231] Hence, Japanese strategic security factors are less pronounced than those of China in determining the possible outcome of pipeline bargaining between the two countries and Russia.

Table 3.7: Japan's Crude Oil Consumption (1996 – 2005)

Year	Consumption (mbpd)
1996	5.813
1997	5.762
1998	5.525
1999	5.618
2000	5.577
2001	5.435
2002	5.359
2003	5.455
2004	5.286
2005	5.360

Source: *BP Statistical Review of World Energy 2006*

In contrast to Sino-Russian relations, Russo-Japanese relations have undergone no significant improvement since the collapse of the Soviet Union, and this is despite the October 1993 Tokyo Declaration, which promised some improvements in the relations between the two countries.[232] The territorial dispute over the four islands between the Sea of Okhotsk and the North Pacific remains a persistent source of tension between the two countries, which negatively affects the possibility of Russia prioritising the 'Japan' pipeline. Japan's long-standing approach to the territorial dispute had been to adopt the "principle of inseparability of political and economic relations" (*seikei fukabun*). Hence, without progress on the territorial issue, which will remain a major cause of tension between Russia

230 Takamichi, "Japan's Energy Strategy," p. 8.
231 Chow, "Russian Pipelines," p. 30.
232 Harada, *Russia and North-east Asia*, p. 49. For the geopolitical and historical context of Russo-Japanese relations see Takamichi, "Japan's Energy Strategy," pp. 3-5.

and Japan, there can be no progress in other areas.[233] The persistent 'Northern Territories' question continues to be the foundation of Japan's Russia policy and therefore continues to cast a deadly shadow on bilateral relations.[234] As an illustration, after the Russo-Japanese summit in Tokyo in November 2005, Japanese Prime Minister Koizumi said, "We [Japan] recognised the need to resolve the island ownership issue and conclude a peace treaty. But frankly speaking, there are considerable gaps between the two countries."[235] This became particularly evident when in late 2005 Moscow backed away from positions favouring a limited territorial deal with Japan that it had maintained for more than a decade.[236]

Conclusion

Regardless whether the pipeline route prioritises China or Japan, Russia will improve its international standing by directly controlling new oil export pipelines through Transneft. If it prioritises the 'China' route, it will improve the strategic security situation in its Far East by reducing China's threat potential against territorial integrity of its demographically weak regions. In opposition to what many have argued, Russia would actually increase its bargaining power over China, what is much more important an objective than increased bargaining power against Japan, as it could threaten China with diverting its oil exports to Europe or the United States. China seeks access to Russian oil for its own strategic security reasons – energy security by meeting rising oil imports and by oil import diversification – and domestic reasons – sufficient energy supply to keep the economic growth at high levels – all in order to maintain regime stability. Due to domestic pressure, Japan seems unwilling to improve its economic or political relationship with Russia until the issue of Kuril Islands is resolved. While the overall factors point to Russia prioritising the 'China' route (see Table 3.8),[237] as of early 2007 this issue is not resolved. However, according to

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233 Ibid. pp. 51 and 58. Also see Nobuo Arai and Tsuyoshi Hasegawa, "The Russian Far East in Russo-Japanese Relations," in Tsuneo Akaha (ed.), *Politics and Economics in the Russian Far East: Changing Ties with Asia-Pacific* (New York: Routledge, 1997), pp. 157-86.

234 Arai, "The Russian Far East in Russo-Japanese Relations," p. 176.

235 May Masangkay, "Koizumi, Putin Fail to Make Any Progress on Isle Issue," *Japan Today*, November 22, 2005, www.japantoday.com (November 24, 2005).

236 Kent E. Calder, "Stabilizing the US-Japan-China Strategic Triangle," Asia-Pacific Policy Papers Series, no. 4, Edwin O. Reischauer Center for East Asian Studies, Johns Hopkins University-SAIS, 2006, p. 17.

237 Previously, I already argued that China was likely to succeed in Russia's Far Eastern pipeline bargaining. See Vlado Vivoda, "Russia and China: A Bear Hug for a Dragon," *Transitions Online*, July 18, 2005, www.tol.cz [July 19, 2005]. In a seprate account, Gabe Collins also suggested that China is likely to succeed, see "Fueling the Dragon: China-bound Pipelines are Russia's Most Realistic Asian Energy Options," *Geopolitics of Energy*, vol. 28, no. 9, 2006, pp. 12-20.

memoranda signed during President Putin's visit to China in March 2006, over the next 15 years Russia will most likely become the largest energy supplier to China.[238] This will only be possible if numerous oil and natural gas pipelines link the two countries.

Table 3.8: Factors Favouring "China" and "Japan" Pipeline Route

Factor	Favouring "China" Route	Favouring "Japan" Route
Overall relationship with Russia	+	
Route's revenue potential		+
Market access		+
Strategic importance for China/Japan	+	
Domestic opposition in China/Japan	+	
Route's feasibility	+	
Route's cost	+	
Route's construction time	+	
Financial capability of China/Japan	+	
China/Japan as a strategic threat to Russia if not prioritised	+	
Overall in favour	8	2

Relationship with Hypotheses

This case study has direct relevance to two hypotheses set in Chapter 2. Evidence presented is partially supportive of hypothesis four, which states that if a major oil-importing government's oil supply security is perceived as threatened when bargaining with other actors, then this government will emerge victorious from bargaining. Based on the evidence presented above, while this certainly seems to be the case in China, it does not apply for Japan. In addition, this case study also appears partially supportive of hypothesis five, as Russia uses oil (or construction of an oil pipeline), both explicitly and tacitly, in bargaining with China and Japan, and by doing so, it gains concessions from China (funds; no pretensions against Russia's Far East), but not from Japan (the Kuril Islands are not put aside). For discussion of these findings, please refer to Chapter 7.

[238] Simonia, "Russian East Siberia and the Far East," p. 73.