

## Russia's ability to use its energy might

By Jyrki Terva

In the end of 2005, Russian president Vladimir Putin introduced the concept of Russia as an energy superpower to the public. In January 2006, the gas crisis happened in Ukraine. The decision made by Gazprom to close the gas valve resulted in a drastic weakening of Russia's image in Europe and elsewhere in the world as a reliable energy producer. Also recently during the war in Georgia in August 2008, there were renewed fears that Russia might cut its energy exports to the West.

What would be the possible effects of this kind of energy embargo on Russia itself? At the moment over 50% of Russian government tax revenue is generated by energy exports. Russian markets and the stock exchange are built on the foundation of wealth generated by the oil and gas industry. Thereby it is clear that in the event of disturbances to energy exports, negative impacts would be felt in the very foundation of the Russian economy. The stock market would collapse and the effects of capital flight would be felt in the real economy as well.

It is safe to state, that disturbing energy exports is not in Russia's interests. Instead, the ability of Russia to use its energy might revolves around three basic factors: the ability to control energy transit routes and distribution channels, the ability to make deals on energy supplies and the ability to control and finance energy production.

### New transit routes to bypass old ones

Control of the energy transit routes would guarantee Russia the independence required by its proposed energy superpower status. In the current situation this is not the case. Russian energy exports are currently dependent on Soviet era oil and gas pipeline infrastructure that resides in Ukraine, Belarus and Central-Asia.

To change the situation Russia has started to build new transit routes. The new routes bypass the old routes through the sea areas in the North and in the South of Europe. The routes in the North are the Nord Stream gas pipeline crossing the Baltic Sea and the new oil terminals in Primorsk and Ust-Luga in the Gulf of Finland. In the South the routes are the Blue Stream and South Stream gas pipelines crossing the Black Sea, and the Novorossiysk oil terminal on the Black Sea coast.

Russia has also repeatedly announced that it will not ratify the European Energy Charter Treaty. The treaty would require Russia to open up its pipelines to non-native companies. In contradiction to the treaty, Russia wants to retain its monopoly of the Central-Asian energy transit routes. All current pipelines from Central Asia, especially from gas rich Turkmenistan, go through Russian territory.

### The goal to control the value chain in European energy markets

Out of the Russia's energy companies, Gazprom and Lukoil have stated that they aim at controlling the whole value chain of their energy products starting from energy production in the fields to delivery to the end consumer. Russian companies often accuse the European Union for protectionism in its energy markets. A special target for criticism has been the energy market reform of the EU, which aims at separating production, transport and retail to be owned by different companies. The reform effectively prevents the control of the value chain.

Contracts on energy deliveries are a central instrument for Russia to influence relations with certain importing countries. Oil is sold through traders with short term contracts whereas gas is sold with long term contracts of 25-30 years. Russian oil is mainly being traded in the London raw materials exchange. Russia's own oil exchange was established on Putin's initiative in Saint Petersburg, but so far the traded volumes have not reach considerable levels.

Gazprom is the market leader of gas trade in Europe. The most important long term contracts were renewed with the main European customers in 2006. Gazprom has been very successful in making deals in recent years. Export revenue of the company has seen steady growth.

### Old technology prevents adjustments in energy production

As with the transport infrastructure, the production infrastructure in Russia is also inherited from the Soviet era. Technology has been upgraded to make production in the old oil fields more efficient, but the fundamental technological solutions are still out of date. Therefore, the ability of Russian energy companies to adjust their production is weak, in comparison to Saudi Arabia's ability to adjust its production according to the market situation.

The bulk of Russia's oil production originates from the fields of West-Siberia. Production from the old fields is static at its current levels. New investments are starting to be realised in East-Siberia, but the long term results of the new investments are highly dependent on oil price developments. The primary market of East-Siberian oil is in China.

Current gas production as well as new investments are located in Yamal Peninsula in the West-Siberia. The Shtokman field is also prepared for production, but Yamal is the first priority of Gazprom for the simple reason that the current transport infrastructure is starting from Yamal. Investment decisions concerning Shtokman are supposed to be made in September 2009.

The lack of available gas storages is affecting the ability of Russia to adjust its gas production. Therefore the gas reserves that are used during the winter heating season are being spent often too quickly. Similarly during the summer, gas production can often not be kept on-stream due to this lack of storage. Gazprom is addressing the issue by building new storages for the gas in Austria and in Saint Petersburg.

### Risks to the Russian energy might

Choices made by Russia which have been reflected in its energy policy in recent years appear contradictory. Russian energy companies have successfully increased their income generation and renewed contracts with their main European partners. At the same time Gazprom's efforts to control its distribution channels in Europe have been mostly unsuccessful.

Russia has also not succeeded in its goal to increase independence from the traditional transit countries for its energy transportation. New transport projects, including Nord Stream still entail many factors of uncertainty. At the same time relations to the old transit states of Ukraine and Belarus have been strained.

In gas production the most challenging years for Gazprom will be 2010-2015, when it is likely that domestic production will start to decrease at the same time when domestic consumption will continue to grow.

In the current situation, Russia's ability to use its energy might depends heavily on the continuation of high energy prices. The new projects which are planned demand huge investments, which are possible only if energy prices stay at their current high levels.

Lower energy prices due, for example, to the global economic slowdown could drive Russia's current energy policy into a dead end. However, if energy prices will continue at their present high levels, the situation might change to be more favourable for Russia in 5-10 years. This will require that the new proposed investment projects for energy production and for transit routes start to bring results.

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