STRATFOR
GLOBAL INTELLIGENCE

The Past, Present and Future of Russian Energy Strategy

February 12, 2013 | 1001 GMT

By Lauren Goodrich and Marc Lanthemann

The future of Russia's ability to remain a global energy supplier and the strength the Russian energy sector gives the Kremlin are increasingly in question. After a decade of robust energy exports and revenues, Russia is cutting natural gas prices to Europe while revenue projections for its energy behemoth, Gazprom, are declining starting this year.

Russia holds the world's largest proven reserves of natural gas and continually alternates with Saudi Arabia as the top oil producer. The country supplies a third of Europe's oil and natural gas and is starting to export more to the energy-hungry East Asian markets. The energy sector is far more than a commercial asset for Moscow; it has been one of the pillars of Russia's stabilization and increasing strength for more than a century. The Kremlin has designated energy security as the primary issue for Russia's national security, especially since recent changes in global and domestic trends have cast doubts on the energy sector's continuing strength.

Throughout Russian history, the country's energy sector periodically has strengthened and weakened. Managing this cycle has been a centerpiece of Russia's domestic and foreign policy since czarist times. This historical burden now rests on Vladimir Putin's regime.

Russia's Imperatives and the Energy Factor

Russia is an inherently vulnerable country, surrounded by other great powers and possessing no easily defensible borders. In addition, Russia is a massive, mostly inhospitable territory populated by diverse ethnic groups that historically have been at odds with Moscow's centralized authority. This leaves Russia with a clear set of imperatives to hold together as a country and establish itself as a regional power. First, Russia must consolidate its society under one authority. Second, it must expand its power across its immediate neighborhood to create buffers against other powers. (The creation of the Soviet Union is the clearest example of this imperative in action.) Finally, it must leverage its natural resources to achieve a balance with the great powers beyond its periphery.

Russia has used a variety of tools throughout history to achieve these imperatives, ranging from agricultural exports to pure military conquest and intimidation. Starting in the late 1800s, Russia added energy to the list of vital commodities it could use to achieve its central strategic goals. By the 1950s, Russia's energy sector had become one of the major pillars of its economic and political strength.

The revenues from oil and natural gas exports show how the energy sector empowered the Kremlin to consolidate the country. Energy export revenues for the Russian Empire began flowing into government coffers in the late 1800s, with oil export revenues making up 7 percent of the export earnings. These revenues rose to 14 percent in the late 1920s during the early stages of the Soviet Union, and by the 1950s accounted for half of Soviet export earnings. Currently, energy revenues make up half of the government's budget. This capital influx was and continues to be instrumental in helping Russia build the military and industrial basis needed to maintain its status as a regional -- if not global -- power. However, as the Russian governments became dependent on energy, the revenues also became a large vulnerability.

Beyond export revenues, the energy sector has contributed to the creation of a domestically stable and industrialized state. Russia's domestic energy consumption is very high due to extremely cold weather for most of the year, but despite inefficiencies within the energy sector and the cost of producing energy, the country's domestic reserves have enabled Moscow to provide its citizens and the industries that employ them with low energy prices.

The energy sector also contributes to Russia's ability to expand its influence to its immediate neighbors. Moscow's use of energy as leverage in the buffer states differs from country to country and ranges from controlling regional energy production (as it previously did in the Azerbaijani and Kazakh oil fields) to subsidizing cheap energy supplies to the countries and controlling the energy transport infrastructure. Russia has used similar strategies to shape relationships beyond the former Soviet states. For instance, Russia is one of Europe's two main energy suppliers and is the only European supplier with large reserves of oil and natural gas and historically cheap prices. Russia's physical connectivity with Europe and ability to undercut any competitor have served as the basis of many of Moscow's relationships in Europe.

Evolution of Russian Energy Strategies

Energy's usefulness as a means of achieving Russia's three main imperatives has altered over time because Russia has had to change its strategies depending on shifts in domestic or international circumstances. Moscow's strength lies in its flexibility in managing its energy sector.

The importance of Russian energy was established in the late 1800s, when the monarchy saw great potential for the Russian Empire if it could develop this sector on a large scale. However, the empire had neither the technology nor the capital to start up an indigenous energy industry. As a solution, the monarchy eased its foreign investment restrictions, inviting European and U.S. firms to develop the Baku and Volga oil fields. This brought about a brief period of warmer relations between the Russian Empire and many Western partners, particularly the United Kingdom, France and the United States. All parties soon realized that the only way to make the Russian oil business profitable despite the high costs associated with the country's harsh and vast geography was to transform Russia into a massive producer. By the turn of the century, the Russian Empire was producing 31 percent of global oil exports.

As the importance of the Russian Empire's energy sector grew, it became clear that Russia's internal stability greatly affected the sector. The Bolsheviks used the energy sector in their attempts to overthrow the monarchy in the early 1900s. The oil-producing regions were one of the primary hubs in which the Bolsheviks operated because energy was one of the few sectors with organized workers. In addition, the Bolsheviks used the oil rail networks to distribute propaganda across the country and abroad. In 1904, when the Russian Empire cracked down on an uprising in St. Petersburg, mostly Bolshevik protesters set the Baku oil fields on fire. This cut Russia's oil exports by two-thirds, forcing Moscow and the foreign markets to realize oil exports' great vulnerability to Russian domestic stability.

Russia's modern energy strategies began forming after World War II. With the Soviet Union left standing as one of two global hegemons towering over a divided Europe, Moscow saw no barriers to achieving dominance in the global energy field. Between the 1950s and 1960s, Soviet oil output had doubled, making the Soviet Union once again the second-largest oil producer in the world and primary supplier to both Eastern and Western Europe. Revenues from oil exports started to make up nearly half of Soviet export income.

Because the Soviet Union was producing oil en masse and the Soviet system kept labor costs low, Russia was able to sell its oil at prices almost 50 percent lower than oil from the Middle East. The subsidization of oil to the Soviet bloc and then to Western European countries helped Moscow undercut Western regimes and strengthen its position in its own periphery -- a strategy that the CIA dubbed the Soviet Economic Offensive. For the Soviets, this was not about making money (although they were making money) as much as it was about shaping a sphere of influence and undermining the West. This strategy came at a cost, since Moscow was not bringing in as much revenue as it could and was producing oil inefficiently, rapidly depleting its fields.

In the 1970s, the price of oil skyrocketed due to a series of crises mostly in the Middle East. At the same time, Russia was already feeling the strain of sustaining the massive Soviet Union. Soviet leader Leonid Brezhnev's regime was left with a choice: use the high global prices as a reason to raise prices in Eastern Europe and benefit the Soviet economy, or continue subsidizing the Eastern bloc in order to keep it beholden to Moscow and not push it to start thinking about other energy sources. It was a choice between two imperatives: Soviet national stability and holding the buffer zone. In the end, Moscow chose to protect its own interests and in 1975 raised the price of oil for its customers, allowing for further increases based on global market prices. By 1976, oil prices in the Eastern bloc had nearly doubled, remaining below global prices but rising high enough to force some countries in the bloc to take out loans.

The Soviet focus on maintaining high energy revenues continued through the mid-1980s, when these revenues accounted for nearly all of the Soviet Union's hard currency inflows. But the Soviets were dealt a double blow in the mid-1980s when the price of oil collapsed and the West imposed an embargo on Soviet oil, prompting Saudi Arabia to flood the oil markets. Moreover, the Soviet Union was falling far behind the West in technology, particularly in energy and agriculture. In response, starting in 1985, the Soviet Union moved closer to a market-based energy economy, raising prices for the Eastern bloc, requiring hard currencies for payment and allowing foreign firms to re-enter the energy sector.

But Russian strategy shifts were not deep and timely enough to prevent the collapse of the Soviet Union. In the decade following the fall of the Soviet bloc, the Russian energy industry was in disarray. The energy liberalization that started under Mikhail Gorbachev in the 1980s was taken to an extreme under Boris Yeltsin in the 1990s. As a result, production fell by half and the Russian energy sector was divided between foreign groups and the emerging Russian oligarch class.

This changed under Vladimir Putin in 2000. One of the first items on Putin's agenda to help stabilize the country was to consolidate the energy sector under state control. This meant radically reversing the liberal policies from the two decades before. The government effectively nationalized the majority of the energy sector under three state behemoths: Gazprom, Rosneft and Transneft. The Kremlin became more aggressive in negotiating supply contracts with the former Soviet states and Europe, locking them into large volumes at extraordinarily high prices because these customers had no alternative energy supplies. The Kremlin also began cutting energy supplies to certain markets -- blaming troublesome transit states such as Ukraine -- in order to shape other political negotiations.

Though Moscow's energy strategy became fairly aggressive, it helped bring about a stronger and more stable Russia. Russian energy revenues soared due to high global oil prices and the high natural gas prices it charged in Europe. Russia had excess funds to pump into its political, social, economic and military sectors. Energy politics also helped Russia leverage its influence in its former backyard and forced Europe to step back from countering Russia's resurgence. Of course, the financial crises that swept Europe and Russia in 2008 reminded Russia of its need for its biggest energy clients when oil prices dropped and demand began declining.

Challenges to Maintaining Russian Energy

Russia's top concern is its vulnerability to fluctuations in the price of energy. With half of the Russian budget coming from energy revenues (of that, 80 percent is from oil and 20 percent comes from natural gas), the government could be crippled should energy prices fall. The Kremlin has already decreased its budget projections for oil prices to $93 per barrel instead of $119 -- though even at that price, the government is playing a game of chance. Stratfor is not in the business of forecasting oil prices, but historical patterns show that major international crises and fluctuations in global consumption and production patterns repeatedly have had sufficient impact on oil prices and on Moscow's revenues to destabilize the country.

Natural gas export revenues are also currently in question. With alternative natural gas supplies coming online for Russia's largest consumer, Europe, the Kremlin has been forced to lower its prices in recent months. This year, Gazprom expects to give European consumers $4.7 billion -- approximately 10 percent of Gazprom's net revenues -- in rebates due to price cuts.

In its current configuration, Russia's energy sector is under strain. The consolidation of the sector mostly under two large state firms had many benefits for the Kremlin, but after a decade of consolidation the disadvantages are piling up. With little competition for Russia's natural gas giant, Gazprom, the firm is lagging in technology and is considered unfriendly to outside investment. Russia's oil giant, Rosneft, recently began evolving into a larger monopoly like Gazprom, which could lead it to fall into a similar trap. With future energy projects in Russia requiring more advanced technology (due to their location and environment) and more capital, both Gazprom and Rosneft need modernization and foreign investment.

Corruption is also a major factor, with varying estimates of 20 to 40 percent of Gazprom's revenues lost to either corrupt or inefficient practices. Rosneft has similar problems. This loss would be sustainable with Moscow's previous high energy revenues, but it will not be sustainable in the future should energy prices fall or the maintenance and expansion of the energy sector become more expensive. The Kremlin is probing Gazprom, although with a culture of corruption rampant throughout Russian history there is little the Kremlin will be able to do to eliminate wrongdoing within the natural gas firm.

Moreover, Europe's dependence on Russian energy is decreasing. The natural gas shortages experienced throughout Europe during the Russian-Ukrainian crises of 2006 and 2009 were a stark reminder of how vulnerable European nations were because of their dependence on Russian natural gas exports. Both unilaterally and through the European Union, European countries began developing strategies that would allow them to mitigate not only Europe's vulnerability to disputes between Moscow and intermediary transit states, but also its general dependence on energy from Russia.

The accelerated development of new and updated liquefied natural gas import facilities is one such effort. This will give certain countries -- Lithuania and Poland, most notably -- the ability to import natural gas from suppliers around the globe and bypass Russia's traditional lever: physical connectivity. This is particularly significant in light of the accelerated development of several unconventional natural gas plays in the world, particularly the shale reserves in the United States. The development of a pipeline project that would bring non-Russian Caspian natural gas to the European market is another attempt -- albeit less successful so far -- to decrease European dependence on Russian natural gas.

Additionally, a set of EU-wide policies, including the Third Energy Package, has begun giving EU member nations the political and legal tools to mitigate Gazprom's dominance in their respective natural gas supply chains. This common framework also allows European nations to present a more unified front in challenging certain business practices they believe are monopolistic -- the latest example being the EU Commission probe into Gazprom's pricing strategy in Central Europe. This, coupled with the EU-funded efforts to physically interconnect the natural gas grids of EU members in Central Europe, has made it increasingly difficult for Russia to use natural gas pricing as a foreign policy tool. This is a major change in the way Moscow has dealt with the region for the past decade, when it rewarded closer ties with Russia with low gas prices (as with Belarus) and increased rates for those who defied it (the Baltics).

Finally, Russia faces the simple yet grave possibility that the escalating financial and political crisis in Europe will continue to reduce the Continent's energy consumption, or at least preclude any growth in consumption in the next decade.

Russia's Next Move

The Putin administration is well aware of the challenges facing the Russian energy sector. Russia's attempts in the past decade to shift away from dependence on energy exports by focusing on industrial development have not been particularly successful and keep the country tied to the fate of its energy sector. Russia's strategy of using its energy exports as both a foreign policy tool and a revenue generator is contradictory at times: To use energy in foreign policy, Moscow must be able to lower or raise prices and threaten to cut off supplies, which is anathema to the revenue-generating aspect.

Global and regional circumstances have changed to the point that Moscow has had to prioritize one of the two uses of its energy industry -- and it has unequivocally decided to maintain its revenue-generating capability. The Kremlin has begun crafting a set of policies designed to adjust the country to the changes that will come in the next two decades.

First, Russia is addressing the very damaging uncertainty surrounding its relationship with key transit states that traditionally allowed it to export energy to Europe. The construction of the Ust-Luga oil terminal on the Baltic Sea allows Russia to largely bypass the Belarus pipeline system and ship crude and oil products directly to its consumers. Similarly, the construction of the Nord Stream natural gas pipeline under the Baltic Sea -- and eventually its southern counterpart, South Stream, through the Black Sea -- will allow Russian natural gas to bypass the Ukrainian and Belarusian transit systems if necessary. These two pipelines primarily will ensure natural gas deliveries to the major European consumer markets in Germany and Italy, with which Russia seeks to maintain long-term strategic partnerships.

By allowing Russia to guarantee deliveries to its major European customers, the bypass systems ensure Moscow's vital energy revenues. This strategy of future energy export flexibility will also progressively reduce the leverage Minsk and Kiev can exert in warding off Moscow's attempts at consolidating Belarus and Kiev as vassal buffer states -- one of the few foreign policy goals Moscow is still intent on pursuing through energy strategy.

Moreover, Moscow has adapted its energy strategy with European customers amid growing diversification and liberalization efforts. Gazprom has begun expanding the natural gas discounts formerly reserved for strategic partners such as Germany or Italy. The Kremlin knows that its only hope of maintaining natural gas revenues in the face of a potential global shale boom is to lock its customers into price-competitive, long-term contracts. Moscow will continue showing that it can offer European consumers guaranteed high volumes and low-cost deliveries that producers relying on liquefied natural gas shipping for transport can seldom afford.

Finally, Russia is focusing significant attention and funds on developing connections to the growing East Asian energy markets, diversifying its export portfolio should challenges in the European market continue intensifying. One aspect common to all the strategies Russia is set to pursue for the next decade is the high capital needed to complete them; the Eastern Siberia-Pacific Ocean oil pipeline alone is set to cost nearly $15 billion. Despite the effects of the financial crisis in 2009, Russia still has vast capital reserves earmarked for these large-scale projects, but these funds are not infinite.

The Kremlin appears keenly aware of the challenges that Russia will face in the next two decades as another energy cycle draws to an end. Unlike Brezhnev and Gorbachev, Putin has proven capable of enacting effective policy and strategy changes in the Russian energy sphere. While Russia's dependence on high oil prices continues to worry Moscow, Putin has so far managed to respond proactively to the other external shifts in energy consumption and production patterns -- particularly those affecting the European natural gas market. However, the long-term sustainability of the model Russia is moving toward remains doubtful.

Send us your thoughts on this report.

— — — — — — —

About Stratfor
Stratfor is a privately owned publisher of geopolitical analysis. Our analysts use a unique, intel-based approach to study world affairs.

The Past, Present and Future of Russian Energy Strategy is republished with permission of **Stratfor**.

STRATFOR
Stratfor Forecasting, Inc.
221 W. 6th Street, Suite 400
Austin, TX 78701, USA
www.Stratfor.com