



**U.S.-Russia Relations:
Energy and Strategy**

**Joseph Ferguson
National Council for Eurasian and East European Research**

Casual observers of U.S.-Russia relations over the past three years understand that the two nations have navigated rocky paths in their search for common understanding and shared strategic goals. This quarter started off well enough for the two nations as Presidents George W. Bush and Vladimir Putin met amiably at the G-8 Summit, for which Russia was the host this year. But as the quarter wound down, familiar themes of distrust and misunderstanding pervaded the relationship once again. It is not that Moscow and Washington have strategic interests that are directly opposed to one another. In fact, leaders in both capitals see eye-to-eye on the pressing issues of nuclear proliferation and terrorism, and on more long-term goals, such as managing a peaceful rise of China. The problems seem to lie more in the tactics of achieving these strategic aims. Russian leaders have a hard time conceding global leadership to Washington; likewise many in the United States still harbor engrained prejudices against the longtime adversary in Moscow.

Additionally, energy issues have become more and more the cause for disagreement between Russia and its neighbors and partners. The Russian government does seem determined – for right or for wrong – to control the access to and management of the resources lying beneath its soil and waters. This has become an acute problem in the Russian Far East for Washington and its two closest allies, Britain and Japan. Meanwhile, elsewhere in the Asia-Pacific region, relations between Japan and Russia have become downright contentious, due to a series of events, including the untimely death of a Japan national at the hands of Russian border authorities.

The G-8 Summit

The July G-8 Summit in St. Petersburg was a showcase for Vladimir Putin and Russia's reemergence on the international stage. The summit took place at a beautifully restored palace, in sumptuous style, and Putin was hailed by many as a decisive and informed leader. The international press gave the summit middling marks – nothing of great consequence was achieved – however, many observers came away impressed with Putin's confidence and his determination to bring Russia back to its accustomed position as a global power. As is often the case with big summits, international events came to dominate the discussions of the day. Headlining the summit was a resumption of hostilities in Lebanon. The leaders of the member nations spent much time discussing this issue, as well as the nuclear crises in Iran and on the Korean Peninsula. Although G-8

leaders agreed to return the Iran nuclear question to the UN Security Council, North Korea got off somewhat easier, with the G-8 expressing support for the UNSC resolution condemning the missile launches. There was speculation that Moscow (with Beijing's concurrence) agreed to swap action on the Iran crisis for continued inaction toward North Korea. Some wonder whether Beijing called on Moscow to back the DPRK on this issue.

Putin and his team were able to control the G-8 agenda and avoid public lectures from Western leaders about the state of democracy in Russia, or Russian diplomacy in the Middle East and Central Asia. It is also interesting that Putin's first meetings at the conclusion of the summit were with Chinese President Hu Jintao and Indian Prime Minister Manmohan Singh, both of whom had been invited as observers. Putin hopes that Russia can serve as a bridge between the West and Asia. Many in Russia favor Chinese and Indian inclusion in the G-8.

The G-8 issued an "Energy Statement." The statement read: "Energy is essential to improving the quality of life and opportunities in developed and developing nations. Therefore, ensuring sufficient, reliable and environmentally responsible supplies of energy at prices reflecting market fundamentals is a challenge for our countries and for mankind as a whole." Although the communiqué said all the right things, it probably did little to assuage fears in continental Europe and elsewhere about Russia's domination of gas and energy markets across Eurasia.

At the summit Putin and other Russian leaders scoffed at the idea that Russia would use its energy as leverage against its neighbors. On the sidelines of the public discussions, however, Russian leaders made it clear that they would like a share in Europe's downstream energy sectors, hinting darkly about what might happen if they didn't. Later it would become clear that no energy agreements between Russia and Western multinationals are immune from Russian government pressure – not even the sacred Production Sharing Agreements (PSAs) signed by several of the oil majors in the 1990s. Nowhere is this more evident than with the Sakhalin oil and gas projects.

Energy coercion

In late September a decision was made by the Russian high court system to temporarily suspend operations on the Sakhalin-2 oil and gas development project due to environmental considerations. The Russian court order was issued in response to a complaint filed by the Russian Ministry of Natural Resources that the project is violating environmental regulations. The Sakhalin-2 energy consortium – run by the Sakhalin Energy Investment Company – is 55 percent controlled by the European energy giant Royal Dutch-Shell. The Japanese trading firms Mitsui and Mitsubishi control 25 percent and 20 percent respectively. Thus far the project is experiencing massive cost overruns (thus depriving the Russian government of profits at a time of soaring energy prices). It should also be noted that the state-controlled Russian energy giant Gazprom is hoping to become involved with this project, and with other projects on Sakhalin.

The Russian Ministry of Natural Resources is also asking that the Sakhalin Energy Investment Co. review its planned gas pipeline routes, suggesting that certain portions be rerouted to avoid sensitive ecological areas. For months Gazprom has been in negotiations to acquire a 25 percent stake in Sakhalin-2 in an asset swap with Shell. Shell has been hesitant to take Gazprom management up on their offer, but the pressure from the Russian government has been intense of late, and Shell will more than likely come to some sort of agreement. Gazprom is also pressuring the Japanese to sell shares in the project. The pressure seems to have paid off as it was reported that both Mitsubishi and Mitsui plan to sell a small portion of their share, so that the project can run “more efficiently” with Russian participation.

Gazprom is very eager to get in on the Sakhalin action to meet growing energy demands across East Asia. Vladimir Putin announced recently to a group of foreign experts that Russia wishes to increase the level of its energy exports to the Asia-Pacific region from the current 3 percent of total Russian energy exports, to 30 percent over the next decade. Eastern Siberian development is still in its infant stages, so the Sakhalin projects would appear to be the best sources to meet that goal.

Leaders in Japan and Europe have expressed dismay about the court decision. Japan’s new prime minister, Abe Shinzo, voiced his dissatisfaction: “A significant hold-up in this [Sakhalin-2] project, which is a symbol of Japanese-Russian cooperation, will have...negative repercussions on the whole of our relations with Russia,” he said.

The other Sakhalin energy projects – including the Exxon-Mobil controlled Sakhalin-1 project – also appear to be under pressure. In August the Russian government announced that it wants to review the three major Production Sharing Agreements (PSAs) that it signed with Western and Japanese energy firms in the early 1990s, when it was desperately trying to attract outside investment in the energy field.

These three PSAs were negotiated when the price of oil was hovering around \$15 a barrel in the mid-1990s. At the time, the Russian government was eager to attract investment, and agreed to terms that were far less than they would have been able to negotiate today. According to the terms of the PSAs, the Russian government can only see profits once the projects themselves begin to recoup their cost outlays. Because the costs overruns have been so massive – particularly for Sakhalin-2, whose costs have risen from \$10 to \$20 billion – the Russian government is unlikely to see any profits in the near future. This must be particularly galling to the Kremlin, given the high price of oil. People in Russia might be inclined to ask: how could Russia not be gaining profit from resources taken from its own soil? Meanwhile the costs of the Exxon-led consortium Sakhalin-1 development project could rise from an initial estimate of \$12 to \$17 billion. The Russian government has strongly warned Exxon-Mobil that it would forbid any further spending on the Sakhalin-1 project.

Exxon-Mobil is also facing problems with environmental issues. The firm has been told that it cannot begin regular shipments of oil to the Asia-Pacific region from the Sakhalin-1 project until mid-November when terminal inspections have been completed. Of

course, there is no telling what these inspections might come up with. Exxon-Mobil is also under fire for a proposed gas pipeline to China from Sakhalin. In China, Exxon can get market rates for gas. In Russia, the rates are below market value. Gazprom, however, has its own plans for a gas pipeline to China through the Altai highlands near the Kazakh-Russian-Mongolian border. Any Exxon-Mobil pipeline to China would be in direct competition with Gazprom's strategy for supplying gas to China.

Putin has remained relatively quiet about these issues. Natural Resources Minister Yuri Trutnev, whose ministry is behind the proposed suspensions, met with Putin recently, and he denied that the Sakhalin projects were even discussed. Some within the Russian government are reportedly concerned that Russia's image as a place for investment could be dealt a serious blow now that the highest profile investment projects seem under fire. However, Putin did issue a veiled warning to multinationals "unconscientiously" operating within Russia; i.e., firms that have huge cost overruns and who are not overly concerned about the local ecology. His suggestion was that these firms could not expect to enjoy privileges forever.

Some people have been willing to give the Russian government the benefit of the doubt. After all, Putin himself ordered a significant northward shift of the planned East Asian oil pipeline earlier this year, so as to avoid the sensitive watershed of Lake Baikal. Perhaps the primary concern in Sakhalin is indeed the protection of the ecology of what is a beautiful island. But it is curious to see the government-owned energy giant Gazprom lurking behind some of the court decisions and government actions that are affecting the Sakhalin energy projects.

Off northern Russia in the depths of the Barents Sea, the Russian government announced that it plans to divert up to half the gas from its vast Shtokman field to Europe and away from the United States. This is bad news for U.S. companies Chevron and ConocoPhillips, which had been hoping to be the major developers of this deepwater field. Some analysts suggested that this move was in response to the U.S. State Department's August decision to introduce sanctions against the Russian arms firms Rosoboroneksport and Sukhoi for violating the Iran Nonproliferation Act.

Conflicting agendas in Moscow and Washington

There is no shortage of contentious issues between Moscow and Washington these days, even besides the energy differences listed above. Iran and the general situation in the Mideast have been sticking points for months, if not years. And if the two sides seemed in agreement at the G-8 summit over the idea of keeping Iran from acquiring nuclear weapons, the leaders of both countries cannot agree on how to go about ensuring this. Washington wants strong sanctions, if not outright military action. Moscow prefers working on an international consensus through the United Nations. Moscow may win out on this, as it seems several U.S. allies in Europe are not thrilled with the idea of sanctioning Iran.

Another issue that is indicative of the worsening tone of bilateral relations between Moscow and Washington is the state of nonproliferation efforts within Russia, which have been largely funded and run by the U.S. government. The Nunn-Lugar efforts have always had opponents in both countries, but now many of the major programs within this initiative are dying a quiet death. One of the benchmark programs, the Nuclear Cities Initiative (NCI), expired Sept. 22 with little fanfare. At its height NCI employed 13,000 Russians and helped 1,600 nuclear scientists transition into the civilian economy. Now NCI simply has run out of time and support.

Another source of concern for the relationship is the development of ABM systems. When the United States unilaterally abrogated the ABM treaty in 2001, Moscow was obviously upset. Washington's professed rationale for doing so was to respond to the nuclear ambitions of North Korea, Iraq, and Iran. Russian press reports recently suggested that now Washington aims to deploy elements of an ABM system in Poland and the Czech Republic. Should this come to pass, expect a furor to emanate from the Kremlin. The Kremlin has also made known its discomfort with the state of the START I treaty which is due to expire in 2009. Russia wants to renew the treaty, but Washington remains noncommittal, no surprise given the fact that Congress has not ratified the START II from the 1990s. Russia's non-membership in the World Trade Organization is also a sticking point. Bilateral talks on this issue collapsed prior to the G-8 summit.

Washington has its own list of grievances. These include Russia's emboldened energy policies, as well as Russia's obstreperous diplomacy in the Middle East, Latin America, and across Asia. Washington has gotten used to Russia's dalliance with Iran, Syria, North Korea, and elsewhere. But Moscow's warm reception of Venezuelan President Hugo Chavez had to have been particularly difficult for U.S. leaders. In Moscow Chavez and Putin signed a series of arms deals worth up to \$3 billion. The shopping list includes submarines, anti-aircraft *Tor-M1* missile systems, and 24 *Sukhoi Su-30* jets. Chavez also visited Belarus (home of "Europe's last dictator") and Iran. The fact that Chavez called Bush "Satan" at the UN several weeks after his historic visit certainly did not put his weapons-buying spree in a positive light in Washington.

Russia and Japan

Relations between Moscow and Tokyo are as cold as they have been in decades. The Sakhalin energy issue is making leaders in Tokyo nervous, as mentioned. But perhaps even more distressing for Japan was the shooting death of a Japanese fisherman in the waters off northern Hokkaido, adjacent to one of the disputed islands (Habomai). The Russian government has taken a hard stance on the issue, and is in no way conciliatory toward the Japanese about the plight of fisherman (or "poachers" in Russian parlance). Although the two remaining crewmembers have been released and the boat's captain appears to be set for release, the tone between the two governments has been decidedly chilly on this and other topics.

While there has been hope over the last decade within Japan that the territorial dispute with Russia might be solved to Japan's satisfaction, the last few years have witnessed fruitless and exasperating bilateral negotiations. President Vladimir Putin may have once been amenable to a settlement (in which Japan would receive two of the smallest disputed islands) but it appears that he is no longer in the mood to cooperate, especially given Russia's expanding economy and its rising international status. Meanwhile Japanese Prime Minister Koizumi Junichiro has ineptly played the history issue with China and Korea; resolving this historical and territorial issue with Russia has become even more difficult.

Moscow has moved boldly forward in advancing the economic development of the Kuril Islands, which have been among Russia's most backward and economically depressed regions. In August, the Russian government approved a draft program to aid the Kuril Islands over the next nine years by disbursing roughly \$670 million to help develop the islands' infrastructure and social programs. This in effect eliminates Tokyo's one trump card: the promise of economic development. It has been clear since before Putin's visit to Tokyo last year that Japanese-Russian relations were stalled. But the latest incidents threaten to send relations into the deep freeze.

Moscow and Washington understand that cooperation is vital in the emerging strategic environment. But achieving this cooperation is like trying to make two magnets stick to one another.

Chronology of U.S.-Russia Relations July-September 2006

July 6, 2006: It is announced that Russian government regulators have forced more than 60 regional radio stations to stop broadcasting news reports produced by Voice of America and Radio Free Europe/Radio Liberty.

July 15-17, 2006: G-8 Summit convened in Strelina, a restored Petrine palace outside of St. Petersburg, Russia. Discussions focus on the Middle East, nuclear proliferation issues, and democracy.

July 25, 2006: Venezuelan President Hugo Chavez arrives in Moscow, meets with Vladimir Putin, and signs a series of weapons deals with the Russian government.

Aug. 4, 2006: Russian Foreign Ministry publishes a statement condemning the decision of the State Department to introduce sanctions against the Russian arms firms Rosoboroneksport and Sukhoi for violating the Iran Nonproliferation Act.

Aug. 16, 2006: Russian coast guard forces fire on a Japanese fishing boat operating in disputed waters, killing one Japanese crewmember. The three other crewmembers are arrested and detained on Sakhalin.

Aug. 28, 2006: Secretary of Defense Donald Rumsfeld and Russian Defense Minister Sergei Ivanov meet in Alaska at a ceremony commemorating the WWII Lend Lease program.

Aug. 28, 2006: Japanese Prime Minister Koizumi Junichiro arrives in Central Asia for a three-day visit to Kazakhstan and Uzbekistan. This is Koizumi's last official overseas visit as prime minister.

Sept. 4, 2006: Japan External Trade Organization (JETRO) Chairman Osamu Watanabe arrives in Moscow for talks with the Russian business community.

Sept. 5, 2006: U.S.-Russia bilateral military exercise is canceled at the last minute due to technicalities concerning the extra-territoriality of U.S. soldiers in Russia.

Sept. 11, 2006: Japan and Russia sign a contract for more than \$700 million for the dismantling of several Russian nuclear submarines in the Russian Far East.

Sept. 16, 2006: Vladimir Putin addresses a group of 50 foreign experts (mainly U.S. and European) on Russia's politics and foreign policy. This meeting – held for the third year in a row – is known as the Valdai Discussion Club.

Sept. 18, 2006: A Russian high court orders the temporary suspension of operations on the Sakhalin-2 oil and gas development project due to environmental concerns.

Sept. 22, 2006: The U.S.-Russian Nuclear Cities Initiative (NCI), part of the Nunn-Lugar nonproliferation program, expires.

Sept. 26, 2006: In a speech in Los Angeles, Russian Foreign Minister Sergei Lavrov tells his audience that the United States will have to get used to a strong Russia.

Sept. 27, 2006: A delegation from the Russian government arrives in Washington, D.C. to discuss Russia's remaining obstacles to joining the WTO.

