The Effect of Energy on Russian Foreign Policy

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Abstract

The history of Russian energy politics is cyclical which consists of the invitation of foreigners to the sector if the technology is needed and the energy prices are low, and nationalization of energy companies and use of the energy weapon when the world energy prices are high. As Putin came to power in 2000 and the energy prices in the world markets were rising, he started to nationalize Russian energy industry gradually and used the energy as a foreign policy instrument by subsidizing friendly regimes and punishing the insurgents with supply interruptions or imposing higher prices. From 2008 onwards, dramatically declining energy prices have undermined Russian energy weapon and Putin's ability to use energy exports as a foreign policy tool. Besides, Kremlin's need to modernize its energy sector and to diversify Russian exports has become much more urgent as the energy prices is not expected to rise in near future. In addition, Russian economy and energy industry needs institutional reforms in order to attract foreign investments in times of low energy prices as well. Such reforms in Russian economy including development of rule of law, property rights protection, more transparency and liberal institutions, in turn mean the erosion of the state influence on the economy which is the case Putin never favors. Russia also has to make huge investments in order to extract oil in new and cheaper oil fields and for the construction of new gas pipelines to be able to diversify customers. Such concerns will shape future of Russian energy and foreign policy. This study aims to investigate the pattern of historical development of Russian energy sector and its effects on Russian foreign policy especially by focusing on current dilemma that Russia face in times of low energy prices. **Keywords:** Russian Foreign Policy, Russia's Energy Policy, Energy Prices, Energy Weapon, Oil, Natural Gas

Özet

Rusya'nın, sektörel teknoloji transferine ihtiyaç duyduğu ya da uluslararası enerji fiyatlarının düşük olduğu dönemlerde yabancı yatırımcıyı davet eden; enerji fiyatlarının yüksek olduğu dönemlerde ise Rus enerji şirketlerini millileştirme yoluna giden ve enerji silahını kullanıma sokan konjonktürel bir enerji politikası tarihi olduğu görülmektedir. Putin'in 2000 yılında enerji fiyatlarının yükseldiği bir dönemde iktidara gelmesiyle Rus enerji endüstrisini yavaş yavaş millileştirdiği, dost ülkelere uyguladığı sübvansiyonlar ve problem yaşadığı ülkelerin enerji arzında yaptığı kesintiler ya da yüksek fiyat uygulamaları ile enerjiyi bir dış politika aracı olarak kullandığı görülmektedir. Fakat 2008 yılıyla beraber enerji fiyatlarında yaşanan dramatik düşüş Rus enerji silahını zayıflatmış ve Putin'in enerji ihracatını bir dış politika enstrümanı olarak kullanabilmesini zorlaştırmıştır. Enerji fiyatlarında yakın gelecekte yükselme beklenmemesi sebebiyle, Kremlin'in Rus enerji sektörünü modernize etme ve ihracatını enerji sektörü dışındaki ürünlerle çeşitlendirme ihtiyacı daha da acil hale gelmiştir. Bunun yanında Rus ekonomisi ve enerji endüstrisi enerji fiyatlarının düşük olduğu dönemlerde de dış yatırım çekebilmek için kurumsal reform ihtiyacı duymaktadır. Hukukun üstünlüğünün sağlanması, mülkiyet hakkının korunması, şeffaflık ve liberal kurumların geliştirilmesi gibi reformlar aynı zamanda devletin ekonomi üzerindeki etkisini zayıflatan reformlar olması sebebiyle Putin'in sıcak bakması beklenmemektedir. Yeni petrol sahaları araştırmak, petrolü daha düşük maliyetle çıkarmak ve doğalgazını satabileceği bölgeleri çeşitlendirmek için inşa edeceği yeni boru hatları Rusya'yı büyük yatırımlar yapmak zorunda bırakmaktadır. Bu meseleler gelecekte Rusya'nın enerji ve dış politikasını şekillendirecektir. Bu çalışma Rus enerji endüstrisinin tarihsel gelişimini araştırmak ve enerjinin Rus dış politikası üzerindeki etkisini bugün olduğu gibi özellikle enerji fiyatlarının düşük seyrettiği dönemlerde Rusya'nın içinde bulunduğu açmaz özelinde incelemeyi amaçlamaktadır. **Anahtar Kelimeler:** Rus Dış Politikası, Rusya'nın Enerji Politikası, Enerji Fiyatları, Enerji Silahı, Petrol, Doğalgaz

Introduction

Being the world's one of few global powers; Russia's historical and current foreign policy posture is one of the vital topics discussed in both academic and political grounds constantly. As being the world's largest energy exporter and gaining the half of the government's budget from these energy export revenues and energy related indirect earnings like mineral extraction tax, VAT and excise taxes, and export duties; wellbeing of Russian energy sector is important for Russian economy and internal politics on the one hand. On the other hand, it is also decisive for Russian foreign policy, because in retrospect it is revealed that Russian leaders did not hesitate in using Russian energy as a foreign policy tool.

History of Russian energy politics started with the invitation of the European and the US energy firms in the late 19th century, since the Russian technology was not capable of extracting oil at that time. In the early Cold War years, Russian energy export strategy became a tool for shaping a sphere of influence and undermining the West by the subsidization of oil to the Soviet bloc countries. However, in mid-1980s when the oil prices collapsed, the USSR's energy sector was turned to be much more market oriented, subsidizations for Eastern bloc were weakened and many oil companies were privatized. As Putin came to power in 2000, he started to nationalize Russian energy industry gradually and use its energy weapon as foreign policy instrument by subsidizing friendly regimes and punishing the insurgents with supply interruptions or imposing higher prices. From 2008 onwards, dramatically declining energy prices have undermined Russian energy weapon and Putin's ability to use energy exports as a foreign policy tool. Besides, Kremlin's need to modernize its energy sector and to diversify Russian exports is becoming much more urgent as a rise in energy prices is not expected in near future. In addition, Russian economy and oil industry needs institutional reforms in the long run in order to attract foreign investments in times of low energy prices as well. Such reforms in Russian economy including development of rule of law, property rights protection, more transparency and liberal institutions, in turn mean the erosion of state influence on the economy. Russia also has to make huge investments in order to extract oil in new and cheaper oil fields and for building new pipelines for the transportation of gas. This study aims to investigate the pattern of historical development of Russian energy sector and its effects on Russian foreign policy especially by focusing on current dilemma that Russia faces in times of low energy prices.

A Short History of Russian Energy Sector

The initiation of the importance of energy resources for Russian Empire goes back to 1800s. At that time the monarchy in Russia saw great potential for its energy resources. However, Russia did not have the necessary technology for extracting and processing the oil. So the monarchy, by easing foreign investment restrictions for the first time, invited foreign capital and technology for developing Baku and Volga oil fields. The foreigner investors mostly were comprised of British, French and Americans. At that time it was understood that because of the high costs of extracting and processing Russian oil due to Russia's vast territory, the only way to make Russian oil profitable is to make Russia a huge oil producer. This was the idea that made Russia the producer of 31% of world's total oil exports until the end of 19th century.[1]

The Russian energy sector began creating vulnerabilities for Russia even in those early days. The importance of energy sector for Russia's internal stability aroused when the Bolsheviks started to use the Russian energy sector for their ambitions to overthrow the monarchy in the beginning of 1900s. The Bolsheviks were primarily operating in oil fields, because organized labor was working in these industries. They used Russian oil rail networks

[1] Lauren Goodrich and Marc Lanthemann, "The Past, Present and Future of Russian Energy Strategy," *Geopolitical Weekly*, February 12, 2013, accessed on August 29, 2016, https://www.stratfor.com/weekly/past-present-and-future-russian-energy-strategy.

for distributing their propaganda. In 1904 St. Petersburg uprising, Bolsheviks set the Baku oil fields on fire and cut the two-thirds of Russian oil exports.[2]

During 1950s and 1960s, Soviet Union was the second largest (after Saudi Arabia) oil producer in the world and primary oil supplier for Eastern and Western Europe. Oil export revenues comprised half of Soviet export income. Oil also helped Soviets to strengthen its position in Cold War circumstance. Soviets were able to sell at a price 50% lower than Saudi Arabia, mostly because of low labor cost in Soviet system. This helped Soviets strengthen its position in Soviet bloc and vis a vis the Western Europe as well, because Soviets were subsidizing oil for Eastern bloc countries and became the major oil provider for western Europe as well, thanks to its low pricing policy. This strategy was called Soviet Economic Offensive.[3] By this strategy, Soviets were able to undermine the West and create a sphere of influence in its region. However, it also caused the depletion of its oil fields for much lesser revenues than they could gain in market prices.[4]

When the world oil prices incredibly increased in 1970s because of the crises in the Middle East, Soviets had to choose between continuing the oil subsidization for the Eastern bloc and keeping the Soviet Union intact, or rising the prices and benefiting the economy. Moscow chose to benefit the economy and rose the oil prices for Eastern bloc. In 1976, although it was lower than the global prices, the oil prices in Eastern bloc nearly doubled. While oil and gas exports earning of Moscow was 600 million dollars and accounted to 22% of Soviet hard-currency incomes in 1971, it became 15 billion dollars and 74% of Soviet hard-currency income until 1985. This high price strategy of Soviets continued until the mid-1980s when the oil prices collapsed and the west applied embargo to the Soviet oil. In 1985, the Soviet Union was obliged to sell the oil in world market prices to the Eastern bloc, requiring hard currencies for payment and again started to allow foreign firms to facilitate in Russian oil sector. Such precautions did not prevent the collapse of Soviet Union. Besides, the policy of privatization and approval of foreign firms to the sector continued. In these Russian energy sector liberalization years, the level of oil production decreased 50% and the sector was dominated by two groups, foreigners and Russian oligarchs. The oligarchs benefited from the privatization of oil industry and gained considerable power in 1990s. Even partially privatized Gazprom had an autonomous power.[5] The privatization of oil industry continued until the initiation of Putin's era in 2000.

Putin's policy was based on the consolidation of the energy sector by the state and Putin started to nationalize the Russian energy sector under Gazprom, Rosneft and Transneft and started to use energy as a foreign policy tool by trying to apply hard supply contracts or cutting energy supplies. It was not only because of Putin's choice, but also rising global energy prices has helped Moscow to be able to apply such policies.[6] In 2001, Putin started to appoint loyal high ranking officers to Gazprom like Alexey Miller and Dmitry Medvedev in order to reduce the autonomy of Gazprom's management. Then Rosneft bought the assets of Yukos. In October 2012, Rosneft bought the third largest oil producer in Russia, TNK-BP. By such strategies, Gazprom became a monopoly on gas exports and Rosneft strengthened its position in oil sector. Strengthening the state controlled energy companies enabled Moscow to use the energy as a foreign policy tool. Although, there are still existing some private companies like Lukoil and Novatek, because of their limited size and power, they are not practicing any political power

[2] Goodrich and Lanthemann, "The Past, Present and Future of Russian Energy Strategy."
[3] Willard L. Thorp, "American Policy and the Soviet Economic Offensive," *Foreign Affairs* 35, No. 2 (1957): 271.
[4] Goodrich and Lanthemann, "The Past, Present and Future of Russian Energy Strategy."
[5] Matteo Verda, "Russian Oil and Gas Sector: Politcal and Economic Prospects," *ISPI Analysis,* no. 147 (2012): 1-2; Goodrich and Lanthemann, "The Past, Present and Future of Russian Energy Strategy."
[6] Goodrich and Lanthemann, "The Past, Present and Future of Russian Energy Strategy."

on Russian energy sector.[7] Because of high prices, Moscow's hand became much stronger and energy gains became higher that enabled Moscow to use energy as a foreign policy tool.

Russian Energy Sector and the Challenges It Faces

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. Russia has huge energy reserves. Its 12 billion tonnes oil reserves represent 5% of the world's total proven reserves. Russia is one of the two largest oil producers in the world and largest oil exporter. The coal reserves in Russia amount to 157 billion tonnes that is 18% of the world's total and second biggest after United States. Russia is the first in the world in proven natural gas reserves amount to 48.000 billion cubic metres, 21% of world's total. As the top producer of natural gas, producing 20% of world's total, today Russia earns more than half of its energy gains from natural gas.[8] Russia supplies one third of Europe's oil and natural gas and East Asian countries receive fundamental amount of their energy needs from Russia.[9]

The major players in Russian energy sector can be classified into three. These are the state, the leading oil producers and the pipeline monopoly. Russian state effects its energy system in two active and one passive ways. One of active way is the regulation. The state in Russia has the ability to regulate the energy system by legislations, inspections or taxes. The second way that the state effects the system by directly controlling it through ownership of Rosneft and Gazprom Neft, two of the five largest energy firms in Russia. The Russian state owns the most of the assets of these two energy firms in Russia. By that these firms pursue policies coherent with the Russian state. The passive way that the state affects the system is as receiver of lobby activities of domestic and foreign energy firms in Russia. Since the state has such a power on its energy system, the firms operating in this system need to affect the state apparatus for their operations. In such a system, the Russian state is the receiver of these lobbying activities and has the power to influence the operations of the firms indirectly. The other two actors, energy firms and pipeline monopoly are also mostly in state's control. Most of the assets of the biggest oil company Rosneft are owned by the state. The other private oil companies do not have the power to apply policies incompatible with the state. Although some of the assets of the Russian pipeline company Transneft is in private hands, the state has the dominance in voting shares.[10]

During the twentieth century, energy resources were limited. That is why it was expected that its price could only go upwards. Because of inefficient production and consumption behaviors, easily accessible oil was gradually exhausted. People had to extract oil from more distant areas expensively and this also rose the energy prices as well. In times of high prices, the countries with oil reserves gained much more from energy exports. However, because of high prices, people tried to find alternatives to that limited commodity. So the energy industry has seen technological breakthroughs by the production of cheap and renewable energy and the

[7] Verda, "Russian Oil and Gas Sector: Politcal and Economic Prospects," 1-2.

[8] Leon Aron, "The Political Economy of Russian Oil and Gas," Russian Outlook, Spring, (2013): 1; Edward Chow, "The Power and Peril of Russian Oil and Gas," *CSIS*, March 23, 2016, https://csis-prod.s3.amazonaws.com/s3fs-public/publication/160323_Chow_PowerPerilRussianOilGas_Commentary_0.pdf

[9] Goodrich and Lanthemann, "The Past, Present and Future of Russian Energy Strategy."

[10] Andrew Barnes, "The Political Economy of Oil in Russia," *PONARS Eurasia Policy*, no. 168, (2011): 1-5, https://www2.gwu.edu/~ieresgwu/assets/docs/ponars/pepm_168.pdf

shale-oil revolution in the United States.[11] Such developments caused energy prices to go downwards especially after 2008.

Hydrocarbons are not as valuable as before in these days because of new technologies are making natural resources cheaper and more abundant. Besides, to maintain the current level of production, Russia has to make huge investments in exploring and recovering oil from virgin deposits of the east Siberian region and the Arctic shelf.[12] Although Russia is not running out of oil, it may be running out of cheap oil. Oil have to be pumped from places that are colder, deeper and more remote such as the continental shelf in Arctic, the ever more remote regions of eastern Siberia, the deeper horizons of the western Siberia, or the Black Sea.[13]

The challenges that Russian energy sector faces are not seen or given importance when the world's energy prices are high, they become much more prominent when the energy prices decline. Prices are declining because of supply and demand effect. Today there is excess supply of energy in the world. Because of developed technology, it is easier to extract the energy that cause the excess of supply. On the other hand, developed technology helps to consume less hydrocarbon resources for the same amount of energy need, and alternative green energy resources or new types of energies like shale gas decrease the demand for oil and natural gas in the world. This came up with the result of declining energy prices. Europe's dependence on Russian energy is decreasing as well. European consumption is shrinking and the increasing offer of liquefied natural gas is enhancing competition and reducing prices on the European markets as well. Natural gas can only be transported by pipelines. Thus the receiver state most of the time is significantly dependent to the seller state. However, the development of new liquefied natural gas import facilities diminishes this dependency. Although developing such facilities is very expensive; in order to overcome such dependencies, the natural gas buyers try to build such facilities. This will give the buyer countries the ability to import natural gas from suppliers around the globe and bypass the pipeline country's traditional lever. Lithuania and Poland are among these countries that try to cut their dependency to Russian natural gas.[14] The drop in US natural gas imports has decreased the demand for natural gas. This decreased the price of natural gas in world market. In addition, LNG transported by tankers from the Middle East has decreased Europe's dependency to Russian natural gas.[15]

The issue of energy prices is not something that easily be underestimated. It caused many vital developments in the history. For some, the decline of oil prices in 1986 has precipitated the collapse of the USSR. Declining oil prices have shrinked Soviet budget which led the pullback from Afghanistan and Russia could not afford to subsidize the Soviet bloc's energy needs any more. This caused the destabilization of Soviet bloc. At the time when energy prices were high and Russia was using its energy weapon against the states that defies Kremlin for political concessions and in favor of the states in Russia's backyards as granting oil and gas at subsidized prices, it was expected that the energy prices would be higher and the influence of the states with energy weapon like Russia would increase. However, it did not appear as expected and the energy prices have declined. Russia can use its petro power confidently when the energy prices are high in world markets, however, it is not the case when the prices are low.

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[11] Vitaly Kazakov, "Russia and the Post-Oil Economy," Project Syndicate, Jun 10, 2016, https://www.project-syndicate.org/commentary/oil-prices-russia-political-implications-by-vitaly-kazakov-2016-06?barrier=true.

[12] Aron, "The Political Economy of Russian Oil and Gas," 1.

[13] Thane Gustafson, "Russian Oil Industry at a Crossroads as Infrastructure Ages," *International Herald Tribune*, December 4, 2012; Thane Gustafson, "Putin's Petroleum Problem," *Foreign Affairs*, November/December 2012; Aron, "The Political Economy of Russian Oil and Gas," 1.

[14] Chow, "The Power and Peril of Russian Oil and Gas"

[15] Aron, "The Political Economy of Russian Oil and Gas," 1.

Russia can use its energy weapon in two effective ways as long as the prices are high. One is the subsidization of its allies and gaining political power over those allies and second, selling the energy at world market prices and gaining huge profits. Both ways serve for Russia.[16] Expensive new oil and gas transportation infrastructure, mainly pipelines, for diversifying export markets and routes becomes less affordable at a time of low prices. The temptation to use oil and gas as a political and foreign policy tool can no longer be indulged at a time of much lower prices without significant economic costs.

In order to prevent any interruptions by the pipeline transit states like Ukraine and Belarus, Gazprom completed the Nord Stream twin pipeline system under the Baltic Sea in October 2012 and launched the South Stream project, which includes a stretch under the Black Sea, in December 2012. The construction of the UstLuga 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. The construction of the Nord Stream natural gas pipeline under the Baltic Sea and the 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. [17]

Solutions for the Russian energy sector and Russian economy's dependency to its energy revenues can only be provided by reform in governance that removes corruption and promotes economic efficiency. Russia has to liberalize and diversify its economic system. However, diversification requires working institutions like rule of law, civil rights, and independent judiciary that probably causes an environment where Putin loses some of his political power.[18]

An effective reform in Russian economy and energy sector needs huge domestic investments and foreign direct investments (FDIs) as well. An environment where FDI favors to come can only be provided by making some political reforms in Russia which will diminish Putin's political power. The investments made by Russian state would lead a decline in state expenditures such as welfare-state or direct and fiscal support to the State-owned companies.[19]

Conclusion

It seems that Russia has lost the chance of making modernizations and investments in its energy sector during the times of high energy prices. The cost of extracting Russian oil is becoming much more expensive because the cheaper oil fields have been exploited. Russia needs to construct new gas pipelines to be able to diversify its customers. It would be difficult to do these when the energy prices are low and the rise is not expected because of the declining demand caused by technological developments and the alternative energy resources like shale gas. Besides, Russian economy needs institutional reforms which may diminish the central power of Kremlin. Russian decision makers will probably face such dilemmas and Russian foreign policy will be shaped around these issues in following decades.

[16] Randall Newnham, "Oil, Carrots, and Sticks: Russia's Energy Resources as a Foreign Policy Tool," *Journal of Eurasian Studies* 2, 2011: 136.
[17] Aron, "The Political Economy of Russian Oil and Gas," 3.
[18] Aron, "The Political Economy of Russian Oil and Gas," 6.
[19] Verda, "Russian Oil and Gas Sector: Politcal and Economic Prospects," 3-5; Olga Oliker, "The Past is a Sobering Prologue for Russian Economic Policy," *CSIS*, March 23, 2016, https://csis-prod.s3.amazonaws.com/s3fs-public/publication/160323_Oliker_RussianEconomicPolicy_Commentary_0.pdf