

# RUSSIA'S OIL IN AMERICA'S FUTURE

## *Policy, Pipelines, and Prospects*

For most of the twentieth century United States relations with the Soviet Union ranged from suspicion and smoldering hostility to proxy warfare. The election of Boris Yeltsin as president and full demise of the Soviet Union in 1991 flowed from and led to dramatic domestic changes in Russia and a reorientation of the country's relations with the United States and the rest of the world. In an atmosphere of considerable hope, dynamism, despair, and sometimes chaos, Russia's new non-communist governments undertook or at least "enabled" democratic- and market-oriented reforms that were strongly promoted by American government and independent advisers. Undertaken under very difficult conditions, the reforms were unevenly successful. Yeltsin survived an economic crash in August 1998, but on the eve of the twenty-first century, turned the government over to his prime minister, Vladimir Putin. Putin was elected president in March 2000, and after taking office in May launched a more orderly, controlled transformation of Russian politics and economics that was critical in stabilizing the country and bringing unprecedented growth in the GDP.

U.S. President George W. Bush first met Putin in Slovenia in June 2001, and famously looked into his soul. Then and subsequently, the two pledged to reconstitute bilateral relations. A "Joint Statement" in

November 2001 looked at the future this way: “Our countries are embarked on a new relationship for the 21st century, founded on a commitment to the values of democracy, the free market, and the rule of law.” After their most recent meeting in St. Petersburg in June 2003, Putin said “What we want is to create a solid economic basis for continued political dialogue and cooperation.”<sup>1</sup> Their next summit is scheduled for the end of September 2003 in the United States.

In this paper I will review the objectives and challenges of U.S.-Russian relations under Bush and Putin, and future leaders, with a strong focus on Russia’s current oil industry, its prospects, and its importance to the United States. In May 2002, Bush and Putin launched what they called “an energy dialogue to strengthen the overall relationship between our countries, and to enhance global energy security, international strategic stability, and regional cooperation.” This dialogue, they said, was intended to develop bilateral cooperation in energy, reduce volatility, enhance predictability of global energy markets, facilitate commercial cooperation, encourage investment in the energy sector, and promote world markets for Russian energy. The U.S. ambassador in Moscow, Alexander Vershbow, said in mid-2003 that energy is “the bold new frontier of the 21st century for both America and Russia” and that “the energy sector represents perhaps the most promising area for economic cooperation.”<sup>2</sup> According to President Putin the emphasis at the Camp David meeting in the United States will be on economics, meaning energy and oil. Russian oil companies are aiming at taking as much as a 10 percent share of the U.S. oil market.<sup>3</sup>

## OIL AND U.S.-RUSSIAN RELATIONS

The challenges and prospects of U.S. energy relations with Russia depend on our bilateral relations more broadly, and these, in turn, will be influenced by a variety of developments that are beyond the scope of this study. These range from bilateral and global developments in the fields of terrorism, Iraq, non-proliferation and narcotics to the willing-

ness and abilities of individual leaders to work together and promote productive policies and responsive institutions in their own countries and bilaterally.<sup>4</sup>

The United States is deeply interested in Russia's oil for several reasons. While Europe will undoubtedly remain the major consumer of Russian oil, many Americans want a lot more of it to come here. The United States produces less than 10 percent of the world's petroleum, with production declining for the past three decades, but consumes more than one-quarter of the world total, that is about 20 million of the 75 million barrels used each day worldwide. America must import about 60 percent of the oil it uses, a major portion of that from Saudi Arabia, a country that seems to be on the verge of major political and related change. The cost of importing this oil is about \$120 billion annually, making it the largest single component of the country's \$435 billion trade deficit.<sup>5</sup> Americans are increasingly convinced that this country should not be as dependent on just a few sources of such a critical product as it is today. The reliability of the sources cannot be taken for granted, be they in the Middle East, Africa or Latin America. The danger of depending on too few sources became starkly obvious and urgent after the terrorist attacks of 11 September 2001. In the wake of that tragedy, U.S. relations became increasingly uneasy with our current main supplier, Saudi Arabia, the source of so much funding and personnel for Islamic terrorist groups and a country that has been instrumental in training radical Muslims around the world. In mid-August 2003 the United States announced its decision to put Iraqis in charge of restoring that country's major oil industry, and that could prove to be good news for Russia for at least two reasons. First, Russians are now more likely than before to regain the active role they had in the Iraq oil industry during Saddam Hussein's era, when they invested about \$9 billion there. Second, the United States, which seeks to reduce its dependence on Saudi Arabia, will not have so clear a guarantee of favored treatment in purchases from Iraq, so it will be all the more interested in developing Russia as an alternative source.<sup>6</sup>

The U.S.-Russian objective of stabilizing the global energy market is sure to prove more difficult than diversification. Two top analysts go so far as to conclude that, “The real measure of a Russian-American partnership [is] not the capacity to supplant America’s less savory suppliers but rather whether dialogue can have any influence on the world oil market.”<sup>7</sup> Many factors, ranging from transportation costs to the location of the oil fields, and the nature of the oil itself to the structure of the oil industry, affect the cost of oil on the world market and the stability of that market. For the past three decades, prices on the world oil market have been very strongly influenced by the Organization of Petroleum Exporting Countries (OPEC) whose “influence in setting oil prices is much greater than implied by market presence alone.” Oil production in OPEC countries is generally inexpensive (for example, Saudi production is usually on or near the sea while Russian production is a thousand or more miles inland), and its “member governments are generally able to exert strong control over production decisions.” Each OPEC country has just one “fully state-owned enterprise” while Russia, particularly after so much privatization and an increasing number of mergers, has many entities competing with each other in an effort to turn a profit, this making strictly “national interest” decisions by the government much more difficult.

Finally, U.S. leaders believe that helping Russia update and develop this critical natural resource and industry will contribute to the stability of the country during a difficult transition period and that this, in turn, will provide the foundation for its active and productive participation in the global economy, though at present to a very large extent this depends on a continuation of the high levels of oil prices. It is reasoned that economic stability and Russia’s forthcoming membership in the World Trade Organization will increase the chances that Russia will develop along democratic and market-oriented paths. Washington’s oil initiative with Moscow has involved both government agencies and private industry. The role of the latter, a central and innovative element in the bilateral relationship, was emphasized at the October 2002 U.S.-

## RUSSIA'S OIL IN AMERICA'S FUTURE

5

Russia Commercial Energy Summit in Houston, which in turn set up the Commercial Energy Working Group, which met again in mid-September 2003 in St. Petersburg. Though in 2002 U.S. economic ties with Russia were roughly comparable to ties with Costa Rica, Americans could soon play a critical role in funding development of the Russian oil industry, as well as providing technology and expertise. There is considerable U.S. government and business interest in doing so, and already there is some movement in that direction.

## OIL AND THE RUSSIAN ECONOMY

Russian oil exploration began in the 1840s near Baku on the Caspian Sea. Oil production did not take off under communism until after World War II when it became increasingly productive and efficient. During the late Soviet period Russia was the world's top exporter of oil, a distinction it may have recovered in the past year.<sup>8</sup> At its peak in the 1980s, Soviet production was about 10 million barrels per day, of which about half was used domestically. The production and use of energy declined after the fall of communism even as the economy also suffered from the virtual collapse of the second leg of the Soviet economic system, the defense industry. Restructuring of the state-controlled Russian oil sector began in the early 1990s, building on changes that had occurred under Mikhail Gorbachev, and surged in and after the mid-1990s when major portions of the state industry were sold to private buyers in auctions. Today the private companies (including Yukos, Tyumen Oil [TNK]) are more efficiently run than state companies, and this is one of the reasons the government reportedly intends to divest itself of its remaining minority holdings in oil companies by 2006.<sup>9</sup> This will, of course, further decrease central control over the vital industry.

After the 1998 financial crisis, and particularly since the beginning of Putin's presidency, energy has become the engine of Russian growth, for resources, mostly oil and natural gas, constitute more than 40 percent of Russia's exports and almost 15 percent of its GDP. During the first

seven months of 2003, oil output averaged 8.26 million barrels per day, and in August it rose to 8.6 million barrels per day,<sup>10</sup> of which about two-thirds is exported, in part because domestic prices for oil are very low. The recent increase in production is not due mainly to tapping new fields, though new reserves have been found, but to reviving and streamlining the Soviet period production, in large part through privatization, and exporting a higher percentage of the product. Still, major new investments in technological renovation will be required for Russia to maintain its high levels of production in the decades that follow and much of that must come via merger and acquisition, both within the Russian domestic market and with international industries. At the energy session in St. Petersburg in September 2003, Russia's energy minister Igor Yusufov said that in the next twenty years Russia will need about \$500 billion to develop its fuel and energy sector.<sup>11</sup>

During the Soviet period most exports went to Soviet-bloc countries, from Eastern Europe to Cuba, but those countries are less attractive today because most cannot pay their bills. With the revival of the oil industry, exports to the European Union (EU) have risen to 39 percent because the demand there is high, and payments are in cash. An energy summit with the EU in October 2000 brought a European pledge to help develop Russian reserves in return for a long-term energy commitment to the EU. Thus shipments to the EU are projected to rise to some 45 percent in the years ahead.<sup>12</sup> In mid-2003 the Russian government produced a study on energy strategy to 2020. It projected a 30–35 percent increase in the production of primary fuel and energy resources, the continued importance of the European market, an expansion of oil deliveries to Asia from the current 3 percent to 30 percent of sales, and greater attention to the Americas.<sup>13</sup>

## RUSSIAN OIL FIELDS AND PRODUCTION

Russia is the largest country in the world, and most of it is undeveloped. That means it is often very difficult to explore, extract, process and

transport oil from a site.<sup>14</sup> The fields today can be divided into two categories. There are the older fields, mainly in western Siberia, that while they still produce the bulk of the product know that their years are numbered.<sup>15</sup> And there are the new or "green" fields on the fringes of the older ones, ranging geographically from the Antarctic to Russian territory on the eastern Pacific coast. There is much disagreement as to how extensive Russia's reserves are in these areas, due in part to a lack of accurate information and differing yardsticks. Estimates range from the eighth largest to perhaps the largest in the world.<sup>16</sup>

Russia's most important oil areas, both producing and potential, are the following.

- western Siberia, where most of the early and 70 percent of current production takes place, particularly in the Nizhnevartovsk/Surgut area;
- the western basins between the Caspian and Barents Seas;
- eastern Siberia, where the reserves are considered particularly rich but "green" and difficult to access;
- the Arctic domain; and
- the currently booming basin of Sakhalin on the Pacific margin.<sup>17</sup>

The Russians have strong interest also in the oil produced in neighboring countries, and in pipelines passing through other countries, most of which were part of the now defunct Soviet Union. For example, in late August 2003 TNK-BP shareholders expressed interest in the privatization of 66 percent in the Turkish oil company Tupras. Since 9/11 in particular, Russian leaders have promoted closer bilateral and multilateral relations in central Asia and the Caucasus and negotiated, as yet unsuccessfully, which of the five countries bordering on the Caspian Sea (Russia, Kazakhstan, Turkmenistan, Iran and Azerbaijan) own how much of its oil-rich bed. Private and state-owned energy companies have also become very active throughout the region.<sup>18</sup>

Two additional problems require comment here, and very substan-

tial government and private attention. First, the vulnerability of Russia's industry generally, and its thousands of miles of oil pipelines in particular, to sabotage. The impact of terrorist attacks on the oil industry, which was the subject of the 1999 James Bond film *The World Is Not Enough*, became reality in post-Saddam Hussein Iraq and could become enormously disruptive to the Russian system. Also, threats to the environment have resulted in destruction and promise more. Governments and environmental groups have responded, with reasonable and sometimes unreasonable demands. Nordic and Baltic states say Russian tankers in northern seas are a threat to the Arctic environment. Therefore, they will apply to the United Nations to get the Baltic Sea designated a "Particularly Sensitive Sea Area" so that the tankers will have to stick to narrow lanes and use pilots near the coasts. On the other side of the world, a Russian/Japanese team has charged that exploration and drilling in the Sakhalin region in Russian east Asia are threatening the sea eagle population and in violation of treaties to protect migratory birds. Some pressure groups have advanced environmental interests, while others have weakened them.<sup>19</sup>

## THE PROBLEM OF PIPELINES

A major portion of Russia's pipeline system dates back to the last decades of the Soviet era.<sup>20</sup> The pipelines have always been managed and serviced by the state-owned transport monopoly, Transneft. During the Soviet period, oil exports left Russia proper through what are now independent countries. The main Soviet export terminals were the Baltic seaports of Ventspils (in Latvia), Klaipeda (Lithuania), Tallinn (Estonia) and the Black Sea port of Odessa (Ukraine). The main export pipeline to eastern Europe was the Druzhba (Friendship), with a northern branch that passed through Belarus to Poland and eastern Germany and a southern branch that crossed northern Ukraine to Hungary and Czechoslovakia. Of course, the collapse of the Soviet Union led to the formation of independent countries in the Baltics, as well as in other

parts of the former Soviet empire, and Russia now finds itself having to pay transit fees to foreign businesses or states for continuing exports through ports from the Baltics to Ukraine. Considerable Russian oil still goes through Baltic ports in late 2003, the main exception being Ventspils, and most of it is transported to Western Europe. But for financial and security reasons, to “get even” with the Baltic countries for their independent actions and/or to apply pressures on Baltic businesses to accept Russian domination, Russia now is emphasizing the development of alternative routes within Russia's borders. European Russia now has two important seaport terminals of its own, Novorossiisk on the Black Sea and Primorsk, northwest of St. Petersburg on the Gulf of Finland, and others are planned.

The Transneft monopoly survived into 2003 when its pipelines were carrying up to 75 percent of Russia's crude oil exports. But most of the pipelines are several decades old and often, as one Russian commentator says, “on their last legs” and a critical constraint on the expansion of the oil industry.<sup>21</sup> Russian companies have been forced to transport about a quarter of their product by rail, at three times the price, or rail/tanker.<sup>22</sup> The only operational exception to the Transneft monopoly in 2003 is the Caspian Pipeline Consortium's line. Central Asian countries that ship oil by Russian pipelines include Kazakhstan, Azerbaijan and Turkmenistan, and discussions or pledges of cooperation in joint programs, investments, etc. have been held with and in such diverse countries as Iran, Poland, Turkey, Venezuela, Japan and China. Faced by the reality of inadequate pipelines, and under heavy pressure from private oil companies and foreign businessmen/governments, in early 2003 Russian Energy Minister Igor Yusufov said private oil companies could now build pipelines but still under government supervision and regulation.<sup>23</sup> If the government follows through on its decision, this will make an enormous difference for the oil industry and Russian economy.

Another infrastructure problem is that nowhere do tankers have access to a deepwater port where crude oil can be transported long distances in an economically sound and environmentally safe way.

Novorossiisk, the Baltic ports and Primorsk have constraints on the size of tankers that can transit the neighboring waterways and straits. Thus long-distance markets such as America, China and the Asia-Pacific are still mainly targets for the future. These markets require access to deep water ports, or new, long-distance pipelines, or some combination of the two.<sup>24</sup> These ports/pipelines will be expensive to develop.

Russia has many pipelines within its national boundaries and into neighboring countries. The main ones aimed at Russian ports today are:

- Baltic Pipeline System (BPS), which began operations in December 2001 from the northern port of Primorsk, is fully owned and operated by Transneft. When completed it will serve northern Russian and western Siberian oilfields on the east and west of the Urals and some fields in Kazakhstan. One problem with Primorsk is that it is not ice-free year-round.
- The Caspian Pipeline Consortium (CPC), which sent its first oil out of the port of Novorossiisk in October 2001, is the first pipeline run by an international consortium rather than Transneft, though Russia is the largest stockholder with 24 percent. It is mainly intended to carry oil from Kazakhstan and Russia to Black Sea ports. In time, it will send out up to one million barrels of oil per day.

The main pipeline/port projections currently in planning or early stages, which will help meet the challenges of the future in important degrees by breaking free from the Transneft monopoly, are:

- The Murmansk Oil Pipeline and Terminal. This is by far the most important pipeline for getting Russian oil to the United States. This was a major topic of discussion in St. Petersburg in mid-September, and it will be a key issue discussed by Bush and Putin at the Camp David summit. When completed it will link western Siberia with the Atlantic coast of the United States via a deep-water, year-round ice-free oil terminal in the Arctic port in Mur-

mansk on the Barents Sea. The project was first proposed by LUKoil and is now strongly supported also by Yukos, TNK and other Russian companies. It is estimated that exportations can begin in 2007, and shipments will come to 1.6 or 2 million barrels per day. Oil should reach the east coast of the United States in half the time it takes shipments from the Middle East.<sup>25</sup>

- Pipelines to China and/or Japan. Two major new pipelines are under consideration linking eastern Siberia with east Asia, but only one probably will be built in the foreseeable future. This has led to intense competition between China and Japan, each a primary beneficiary of a different pipeline. Yukos has been exporting oil to China by rail since 1999 and proposing a 1,500-mile pipeline from Russia's Angarsk, just north of central Mongolia, to Daqing in China's Heilongjiang province. It could begin operation in three years. Beijing has offered to contribute to the building of the pipeline and some in Russia think this project would curry favor in China, a rapidly growing country that is of increasing economic interest to Russia but considered strategically unpredictable.<sup>26</sup> Chinese President Hu Jintao visited Russia, and on 27 May 2003, he and Putin signed a "Joint Declaration" stating that "big scale oil and natural gas projects should serve as the basis for strengthening energy cooperation between the two countries." At that time, with Putin's blessing, Yukos and the Chinese National Oil Corporation signed an agreement that would ship 20–30 million tons of oil annually to China over a twenty-five-year period. But Japan has pushed hard for a more expensive (in part overlapping) 2,500-mile pipeline from Angarsk to Nakhodka, near Vladivostok. Japanese Prime Minister Junichiro Koizumi visited Russia in January and May of 2003 and expects to go again before the end of the year. Japan has pledged to purchase 50 million tons annually, though some geologists warn that at this time the region can not guarantee that much oil. Japan has offered even more financial

support than China, not only for the pipeline but also for oil exploration and social programs in eastern Siberia. The United States tends to prefer the Nakhodka terminal that could serve many countries, including America, instead of just China. In mid-September both projects received negative environmental assessments, and their prospects remain uncertain.<sup>27</sup>

- Druzhba-Adria Pipeline Integration, a project launched by Russia's largest independent oil company, Yukos, is intended to integrate the southern Druzhba pipeline with the Adria pipeline that goes from the Croatian Adriatic port of Omisalj to Hungary. This integrated line will take Urals' blend crude nearly 2,000 miles through Ukraine to the Adriatic port with its direct access to the Mediterranean Sea, thus bypassing the increasingly crowded and otherwise problematic Bosphorus exit from the Black Sea.
- The Sakhalin Island region north of Japan has been the scene of high activity in recent years. The Sakhalin 1 project, operated by ExxonMobil, plans to export to Asia via the Russian mainland port of DeKastri which will, however, be closed several months of the year by ice. Oil will be shipped to the mainland port by a 150-mile underwater pipeline. The Sakhalin 2 project, a consortium led by Royal Dutch/Shell (Netherlands/U.K.), plans to export to Japan, South Korea and Taiwan. It will require a 450-mile pipeline the length of Sakhalin Island to the ice-free, year-round port of Prigorodnoye. This project currently produces oil for about half of the year, that is, when weather permits. Several other largely projected Sakhalin projects involve British Petroleum and other Russian and foreign companies.

## CHALLENGES TO U.S. INVOLVEMENT IN RUSSIA

Though U.S. and other foreign companies have become players in Russia, and prospects for further ties in general seem good in many

respects, there are specific cultural, political, economic and other challenges that complicate foreign involvement in or dependence on Russian oil. Some relate to broad international developments that are largely or entirely out of the control of companies and sometimes even governments. These play out in the sometimes tense (or worse) relations between and among countries or regions that either were or are under Moscow's sway, from Estonia to Chechnya to Kazakhstan. Or in reactions to such issues as terrorists emanating from Afghanistan, radical Islamic teachings fostered by Saudi Arabia, Pakistan or other countries, the increasing U.S. presence throughout central Asia since 9/11, and China's longer-term strategic objectives in Asia.<sup>28</sup> Besides differences over the ownership of the Caspian basin, there are political tensions over transporting oil from the region. The U.S. has long opposed sending oil through Iran, a natural route, with which relations have been strained, promoting instead the proposed Baku-Tbilisi-Ceyhan line from Azerbaijan through Georgia to the Mediterranean coast of Turkey, a NATO ally. The fallout of political conflict in and over Iraq both threatened the loss of Russian investments there and prompted a record growth in the sale of Russian oil to the United States as a result of the shutting down of Iraqi sources.<sup>29</sup> In the longer term, disruptions in the Persian Gulf area will raise the value of Russian oil if the latter can be efficiently and reliably provided. Russia's relationship to the Organization of Petroleum Exporting Countries could become an issue. While not a member of OPEC, Russia attended a meeting for the first time as an observer in June 2003. Two months later Russia and Saudi Arabia signed a cooperation agreement in the oil and gas sectors, and on 2 September, Crown Prince Abdullah met Putin in Moscow, the highest level visit since diplomatic relations were established in 1926. Officials from the two governments signed an agreement on cooperation in the oil and gas industries which called for joint ventures in exploration and efforts to "maintain stability in the global oil market," suggesting joint efforts on production and pricing, according to a statement released by the Russian Cabinet.<sup>30</sup> In the past Russia sometimes pledged to coop-

erate with OPEC production guidelines, but did not in fact do so. Close cooperation will be difficult because, as noted earlier, Russia's industry is largely in the hands of private companies and cannot easily be manipulated by the Kremlin.

Hoover Institution scholar Michael McFaul gave an overview of the problem in mid-2003 when commenting on the harassment of oil oligarch Mikhail Khodorkovsky, Russia's richest man and primary owner of Yukos oil. "A state that isn't constrained by checks and balances, the rule of law, the scrutiny of an independent media, or the will of the voters is unpredictable at best, predatory at worst." Directly to the point, he concludes that "It's bad for business."<sup>31</sup>

Here are some of what the U.S. ambassador in Moscow calls the "problem areas" American businesses may encounter in Russia. In an address to the New Economic School in Moscow in May 2003, Ambassador Vershbow said Russia needs to:

- support the "sanctity" of commercial contracts and agreements;
- create a "transparent, stable and enforceable" tax and license regime;
- improve and enforce intellectual property rights protection;
- act decisively on "pervasive bureaucratic red tape and over-regulation";
- bring corruption under control;
- reverse the "worrying trend" in Russia towards control over the mass media.<sup>32</sup>

A particularly unsettling issue for some major investors is the availability (or unavailability) of production-sharing agreements (PSAs) in particularly risky investment areas. One high U.S. official described these agreements in congressional testimony. "PSAs are attractive to foreign investors in relatively unstable economies because they state in one negotiated document how much a company will have to pay to the government for the right to exploit the resource, how costs will be

recovered, which legal regime will be used in the event of disputes and many other rights and obligations.”<sup>33</sup> PSAs were easier to secure in the mid-1990s than today. In particular, with oil prices high, business booming and seeming adequate resources available, some private companies like Yukos see little need for PSAs, while less efficient and less resource-endowed, state-controlled or state-oriented companies are more receptive. The former prefer to sell substantial degrees of stock to foreign investors, as TNK did during 2003 when it sold 50 percent of its stock to British Petroleum, and to adopt more nearly international accounting standards and business practices and management structures, though even here the adaptation to Western practices is less than complete.<sup>34</sup> Some analysts, however, argue that not even the PSA “really provides an enclave of stability [because] investors know that they are always vulnerable to ‘renegotiation’ where the law is weak and once their investments are entrenched.”<sup>35</sup>

#### THE YUKOS AFFAIR: THE SILOVIKI CHALLENGE THE FAMILY

The events of the Yukos affair that began in mid-2003 warrant special attention because they dramatically raised many questions about the state of the legal system, the security of property rights, the roles and strength of squabbling factions within the Kremlin, the population more broadly, the prospects for improving U.S. ties and the foreign investment climate.<sup>36</sup>

On 2 July 2003 the prosecutor general’s office arrested one of Mikhail Khodorkovsky’s main business partners and charged him and several other Yukos leaders with crimes ranging from swindling the state to murder. Putin refused to become openly involved in what seemed to be a showdown between two factions within the government until the end of September when he said what distinguished the Yukos case was murder.<sup>37</sup> The first is the “Petersburgers,” siloviki or chekists, usually with security backgrounds like Putin’s, who launched the attack on the

Yukos oligarch and favor turning the institutional clock back to a state-dominated society. In opposition was the “Family,” top officials in the Kremlin who usually were closely tied to the government of former president Boris Yeltsin and benefited politically and financially from that relationship. These officials, including current prime minister Mikhail Kasyanov and Putin’s chief-of-staff Aleksandr Voloshin, and most of the major oligarchs, want to build on the reforms that have already been undertaken, whatever their shortcomings may seem to the siloviki and majority of the Russian people.

A key issue is whether the government should “revisit” the privatizations of the Yeltsin era, which gave a score of very clever and well-connected individuals ownership of extensive Soviet-period state property in the mid-1990s at bargain basement prices.<sup>38</sup> After those privatizations, as one analyst put it with evident understatement, the oligarchs have been “very resourceful in seeking further enrichment and influence.”<sup>39</sup> They have created business empires that reach into many countries, including the United States, and acquired private fortunes of billions of dollars. Their incomes and lifestyles contrast sharply with the modest means of most Russians, the vast majority of whom see the oligarchs as crooks.<sup>40</sup> At the same time, in varying ways these businessmen have contributed substantially to the development of the nation, and on taking office, Putin decided he had to work out an accommodation with them for the sake of the economy. So a deal was struck whereby the president would leave the oligarchs alone if the latter minded their businesses, helped develop the country and stayed out of politics. Two prominent media oligarchs (Vladimir Gusinsky and Boris Berezovsky) were driven into exile before 2003 in part because they became involved in politics. Khodorkovsky also became politically active, giving money to opposition political parties and seeming to develop a base for possible political power for himself. In mid-September chief-of-staff Voloshin spread a wider net when he said that though “there has been no revision of privatization results” still “There are just certain cases that are being investigated.” One analyst speculated that

“the Kremlin wants to take back control of the commanding heights of the economy that right now are dominated by the oligarchs.” If this happens, the Kremlin would regain control of much or most of the oil industry and be able to make it an arm of Russia’s foreign policy in its dealings with OPEC and the world.<sup>41</sup>

But why a legal attack on Khodorkovsky, who more than any other oligarch has in recent years made his business transparent according to Western standards, at this particular time?<sup>42</sup> There are strong elements of economic statism and “don’t sell the Fatherland” nationalism. “Written all over the Yukos affair,” says Russian analyst Sergei Markov, “is the bureaucracy’s desire not to allow other big Russian corporations to follow in the footsteps of the Tyumen Oil Co. [TNK], which in essence sold its business to BP.”<sup>43</sup> Many in the Kremlin and around the country are concerned with increasing foreign investments in Russia, in part reflecting a traditional Russian concern over outside influences.<sup>44</sup> But even this is closely related to politics. Attacking the oligarchs may help Putin’s often lackluster United Russia Party win votes in the December Duma (parliamentary) elections. Many Russians also worry about U.S. intentions in Russia and the world, and Khodorkovsky has cultivated ties to Americans. He has adopted pro-American positions on international affairs at a time when America’s standing among the Russian people is very low.<sup>45</sup> He is a key mover in plans to increase Russian oil shipments to the United States through Murmansk and has even discussed the sale of part of Yukos to Chevron, a possibility that resurfaced in mid-September when George Bush Sr. visited Russia.<sup>46</sup> Lilia Shevtsova, a senior associate of the Carnegie Endowment for International Peace, writes that “Yukos was the first Russian company that started to look for legitimacy not through maintaining cozy relations with the apparatus but by making the switch to transparency and legality. It was a challenge to the bureaucracy, which reacted immediately. The Yukos affair has proven that Russia’s stability is not sustainable.”<sup>47</sup> Some analysts note that almost all of the oligarchs under attack are Jews.

Critics of the campaign against Yukos range from the Family, Rus-

sian businessmen and Communist Party leader Gennady Zyuganov to American politicians, foreign analysts and international human rights activists. They warn that “arbitrariness and intimidation” threaten national security and must end quickly. Khodorkovsky believes that the attack could not have been made without Putin’s OK and says Russia is in danger of sinking back into the “swamp” of its totalitarian past.<sup>48</sup> Putin himself might like to “revisit” the privatizations, but is undoubtedly concerned that to do so openly might torpedo the substantial if uneven economic growth of recent years, discourage foreign investments, and make it very difficult to reach his goal of doubling the GDP by 2010. He knows that attacking Yukos is already spooking current and potential foreign investors. Still he may be gambling that the world’s hunger for Russian oil is so insatiable that in the end, foreigners will accommodate themselves to almost any Russian domestic policies.

## CONCLUSIONS

The whole world has a stake in the emerging bilateral relationship between the United States and Russia. In addition to non-energy issues like terrorism and the U.S. role in the world, there are the matters of Russian reforms and how the United States might constructively influence and benefit from them. Russia is vast and its circumstances are complex, but these are some of the conclusions that seem to follow from the above analysis.<sup>49</sup>

- One fundamental challenge the Russian reformers of the 1990s had to face was the degree to which they wanted to and/or could move beyond certain aspects of traditional culture and institutions ranging from attitudes toward paternalistic and autocratic government to acceptance of corruption as inevitable.<sup>50</sup> In the end, the Russian people may be unwilling or unable to undertake the political and economic changes that will be necessary for their countries to “modernize” (not just become “like America”) in the adoption

of lasting free markets and some form of seriously participatory government. To take one practical example, Jurgis Vilemas notes that "Russia's urgent need for huge investments . . . exceeds any realistic internal possibility even if oil prices stay high." But is Russia willing to accept the level of foreign involvement it will need? If some reformers in the 1990s were wide open to foreign involvement, like Peter the Great some three centuries earlier, many today are equally slow to change their ideas, as many Russians were during and after Peter's time. The magnitude of the problem of changing culture and institutions can be measured by how modernization proceeded in Western Europe during the three centuries since Peter, and what happened in Russia during that same period. A top analyst from London's *Economist Intelligence Unit*, speaking in Moscow in mid-2003, said he was "somewhat pessimistic about whether Russia will really bite the bullet on foreign direct investment (FDI)." Unlike China, which has opened its doors and developed impressively, he said, Russia has been "sort of nibbling" at FDI.<sup>51</sup> The Russian peoples' willingness to open up to the West, as Peter did, will substantially affect the levels of foreign involvement which will, in turn, have an important impact on reforms, the nature of U.S.-Russian relations, and the future availability of Russian oil in the United States.

- One reason many Russians are concerned about the spread of U.S. influence through FDI is their fear that the United States intends to rule a "uni-polar" world, as the Russians and Chinese (who have the same concern) have said in several presidential-level bilateral joint statements. These statements have come from two generations of presidents in both countries, that is from Boris Yeltsin/Jiang Zemin and from Vladimir Putin/Hu Jintao. Russians, Chinese and others with this concern see the current American incarnation of this mission to remake the world in our image dating to Bill Clinton's U.S.-led NATO bombing of Yugoslavia in 1999.

Bush administration policies have merely expanded that drive to bomb sovereign countries using a different rationale for doing so. The Russians (and Chinese) are fully in agreement with an international move against terrorism, and indeed have been pressing united opposition to terrorism for longer than the come-lately, post-9/11 Americans. But many in Russia, as in China, fear that Washington will take its internationally supported, newfound aggressive stance against terrorism as an occasion for spreading its influence more broadly. To the degree that the world's foremost free-market democracy and advocate of the rule of law behaves in this way, by-passing the U.N., even if its leaders feel doing so is necessary, suspicions will underlie U.S. international relations and often reinforce some of the less progressive, traditional views and institutions in reforming countries. This fear will persist under the surface even if deals are struck off and on, and it will explode to the surface when more "evidence" of "real U.S. intentions" suddenly emerges. On the other hand, if we can cooperate with Russia in central Asia and the Transcaucasus, for example, we can both stabilize those vulnerable governments and make much more oil available to ourselves, in part by reducing foreign fears as to our global objectives. The deals we strike with Russia must be clearly in Russia's interest as well as our own.<sup>52</sup>

- A specific reform that in the shorter and longer terms will be essential to expanding productive Russian relations with Americans and other foreigners (as well as among themselves) is the adoption of a society based on laws that safeguard all equally. This was one of the specific goals mentioned by Bush and Putin in the 2001 "Joint Statement." The implementation of a legal system based on rights, not privileges, corruption and/or politics is not easy in a society never accustomed to such relationships. It is made all the more difficult because when "rule of law" means defending the rights of oligarchs who often became rich by bilking others,

the population as a whole is likely to doubt that that is better than the arbitrary "law" of the past. The jury is still long out on whether this reform will be undertaken successfully and serve as a foundation for other political and economic change that the people can accept as legitimate.<sup>53</sup> In the end Putin may be right in his probable conclusion that American companies and the American government are so desperate to get alternative sources of oil that they will be willing to strike deals almost no matter what the legal system is, crossing their fingers and putting the need for energy and business above the legal security of investments. If that is Putin's gamble, it is a dangerous one, particularly for Russia, and he must know it. If the rule of law remains insecure and far from in place, an economic or political crisis precipitated from outside or within or both, could lead to a restoration of a full-fledged authoritarian government, precisely a danger Lenin warned of, and then occurred, a century ago.

- At the end of 2003 the United States is moving to distance itself from Saudi Arabia, its politics as much as its oil, and our eagerness to do so could easily drive us to expect too much from Russian oil. Thus while we should help Russia to develop its oil industry now to serve our needs, and to make Russia a more viable player in the modern world, our thirst for oil must be balanced with a recognition of Russia's longer term stability, also of critical importance to the United States. We must carefully balance our needs with the potential harm to Russia of pushing too hard and fast for an expansion of oil production and exportation, particularly to the neglect of other areas of development. The World Bank, IMF and others, including Russia's own 2020 report, have warned of the dangers of relying too much on oil, and not only because prices could fall and cripple the country's economy. As Peter Rutland has said, "Oil wealth may not lead to prosperity and democracy, but to corruption, tyranny and even interstate conflict." It is clearly not in

America's interest to press Russia too hard if doing so could result in what another analyst calls "death by oil." The chance of unreasonable expectations from, and perhaps counterproductive pressures on, Russian producers may increase still more if oil does not soon flow in significant amounts from Iraq, which by some calculations has the second largest proved reserves in the world.

- Hardly noticed abroad, in mid-September 2003, Putin met in Moscow with Saudi Crown Prince Abdullah, signaling a major shift in international relations. Officials signed several agreements and Russia received a reported Saudi promise of \$200 billion development aid and pledges to "maintain stability in the global oil market" through closer cooperation with OPEC. The question is whether Russian concern over American unilateralism, dating in particular from Bill Clinton's bombing of Yugoslavia in 1999, will in time turn an always-suspicious Russia increasingly away from the United States. Recent attacks on Yukos, the country's most successful and pro-American private oil company, and the Saudi rapprochement, are not encouraging.<sup>54</sup>
- U.S.-Russian relations cannot be relations between individual leaders, as important as those may be in the process. One of the most difficult challenges in American politics will be to get politicians (and the voters they appeal to) to understand that our relationship with Russia is a critically important bipartisan matter for the decades and not a political football that can be kicked around to win a few votes in the next election. American and Russian leaders must seek bilateral relations that transcend themselves, and this will, in many respects, require the spread of laws and institutions that support such a relationship. Specifically, this means U.S. negotiators must not focus only on striking investment deals, either at the energy conference that precedes the summit or the summit itself, which would just benefit oil companies and meet people's short-term energy demands. The U.S. government, and

companies as well, must see that the long-term interests of the American nation and world, and the long-term security of investments, demand that we simultaneously and actively support the development of the rule of law, infrastructure, and a more diversified and thus more stable economic system in Russia in general. This should include cooperation with Europe in the development of Russia itself and such essential links to Europe as Ukraine. Doing so will nurture Russian growth and respect for, rather than fear of, the United States and foreign involvement in their nation.

- Finally, we must recognize and act upon the fact that oil supplies from the Middle East, Russia, Africa, Venezuela and some other areas and countries are not only finite, but in the shorter term coming from locations that are inherently unpredictable. Even if we reduce our consumption of oil somewhat, which is not likely in the foreseeable future as Americans turn to ever larger cars and vans, and barring catastrophic developments, we will continue to use enormous amounts of energy. Thus in the end, the critical long-term lesson from 9/11, as well as the Saudi's unreliability as an ally and the Yukos affair among others, is that even as we cultivate Russia as an ally and major source of oil, we must actively develop alternative sources of energy. We cannot allow ourselves to forever be held hostage in an unstable world by other nations with their often very different cultures, institutions and interests.<sup>55</sup>