RUSSIA'S ENERGY GEOPOLITICS

LAVAUX GLOBAL | QAMAR ENERGY

June 2018

1. INTRODUCTION

Russia is unique as a geographical power that spans from Eastern Europe, the Caucasus and Central Asia, to East Asia. It is also unique as the world's leading exporter of natural gas and one of the three largest producers of oil, as well as a significant player in nuclear power. Its state-capitalist economic model places it closer to China than to the US or EU. In recent years, Russia has been much more active than at any time since the Soviet collapse in political, diplomatic and sometimes military endeavours in both the Middle East and East Asia. It has also extended its energy reach in these regions via outbound investments, market agreements, new export connections, and attracting inward investments.

This report contrasts the Russian approach in the two regions, and examines its methods and objectives, focussing on the issue of energy.

The erratic and hostile US policies against some traditional partners as well as adversaries open room for Russia (and China) to assert themselves as reliable economic and diplomatic partners. Despite some problems over European gas supplies and sanctions, Russia does appear a more predictable trade partner than the current US. Given Russian weaknesses in demographics, economics and technology, energy is a key strength and tool.

> The erratic and hostile US policies against some traditional allies as well as adversaries open space for Russia to assert itself as a reliable economic and diplomatic partner.

Preserving Russia's energy advantages is also an important target for its policies. But not all Russian energy moves are driven by grand strategic goals. Some are straightforward commercial transactions, while others are propelled by personal ambitions or rivalries within Vladimir Putin's inner circle.

Oil and gas revenues account for almost 40% of Russia's fiscal budget, hence the leadership has adopted a prudent view on oil prices and based its 2018 budget on Urals crude of $53/bbl. Under this regime, the budget deficit was capped at -3.2% of GDP, a figure that the Kremlin was surprisingly comfortable with given its depleted fiscal reserves. If the Urals oil benchmark averages over $53/bbl, Russia may be pleasantly surprised to see its fiscal budget in surplus, which will enable Moscow to replenish its reserve fund. Understanding and predicting Russia's moves in these regions is important for regional and international policymakers. It is vital for any company considering partnering or competing with Russian firms. They need to know which Russian investments and deals have staying power and which are likely to be ephemeral, and which projects may align or collide with the Kremlin's goals. They also need to weigh such considerations against the likely reaction of powerful players in each region – Turkey, Iran, Saudi Arabia, China, India, Japan and others.

2. RUSSIA'S APPROACH

2.1 MIDDLE EAST

2.1.1 RUSSIA'S POLITICAL AND GEO-ECONOMIC APPROACH

It is natural that Russia, one of the world's three top oil producers, its largest gas producer and exporter, and largest or second-largest gas reserves holder, has growing Middle East interests. This region can be defined a little broadly, to include Egypt and Libya, Iran and Turkey.

Russia's interest in the Middle East represents a number of factors. Amongst these are:

- The reactivation of old Soviet ties (with Syria in particular);
- The search for Mediterranean naval bases (Syria again, at the port of Tartus);
- A natural southward extension of influence in its 'Near-Abroad' in the Caucasus and Central Asia;
- The fight against terrorism on Russian soil and the chance to export Chechen extremists;
- A desire to weaken or divert competition for its own oil and gas exports, as in Turkey;
- Commercial opportunities which benefit the Russian state (arms, nuclear power, oil and gas) or well-connected Russian businesspeople, often overlapping;
- The availability of capital and investment, particularly when Western sanctions constrain this from other sources;
- Empire-building by Russian state companies, Rosneft in particular[1];
- The demonstration of strength and resolve, which plays well to a domestic audience as well as to some international audiences.

A large part, though, reflects simple opportunism. Wide areas of the Middle East are beset by weak and failing states, civil wars and insurgencies. One regional power, Turkey, has drifted away from its Western alliance; another, Iran, is in heightened confrontation with the US; and the remaining two, Saudi Arabia and Egypt, are open to tactical cooperation with Moscow. The US's lack of a clear strategy for the region and its growing unreliability as a partner, and the EU's inability to exert diplomatic or military clout commensurate with its economy, has opened a path for Russia.

Russia is no stranger to dealing with such weak states and with instrumentalising its intervention and continuing presence in zones of 'frozen conflicts' such as Nagorno-Karabakh, Transdniestria, South Ossetia and Abkhazia, and now Crimea and eastern Ukraine. In these it can deploy its tools such as the use of deniable mercenaries, propaganda and diplomatic cover at the UN.

Russia's policy in the Middle East is presented as transactional and non-ideological[2]. It does not have a long history of entanglements[3], nor come with the lectures on human rights and democracy that, at least traditionally, Western engagement has. It is thus able to work with, at first sight, rather contradictory partners, such as Syria and Iran on the one hand, and Israel, Saudi Arabia and the UAE on the other. Its power means that it cannot be ignored, even by countries which dislike some of its policies.

Without necessarily having any well-defined long-term strategy, Russia can therefore accumulate bargaining chips which may be useful in future, perhaps trading off against Western sanctions or negotiations over Ukraine. But not every action Russia takes in the Middle East should be seen through the prism even of a tactical masterplan. Some represent the individual initiative of companies and government officials, and even if the more important ones are cleared by the Kremlin, this does not mean that they were planned there.

However, Russia's transactional approach is also a weakness. Russia can deal with almost all parties in the Middle East, but without being a natural ally of any one. Its deep involvement with the Assad regime and Iran limits its attractiveness in the

---

[1] Fak, A., Nesterov, V. and Kotelnikova, A. (October 2017) 'Russian Oil and Gas: Tomorrow is a Distant Memory' Sberbank
[2] https://www.rand.org/blog/2018/05/the-limits-of-russian-strategy-in-the-middle-east.html?adbsc=social_20180524_2346691&adbid=999757936858550272&adbpl=tw&adbpr=22545453
[3] Except in Syria and to a very limited extent Iraq

Gulf. Long-standing Western partners such as the Gulf Cooperation Council (GCC)[4], Egypt and even Turkey may use Russia to diversify and balance their relationships, but not elevate it to primacy – they are well-aware of the Western confrontation with Russia. And the Middle East ranks lower as a Kremlin policy priority than Eastern Europe, Central Asia or China.

The country is also economically weak. Its last ambitious push into the Middle East came to a halt in 2008 as the global financial crisis hit both Russia and one of its main prospective partners, Dubai[5]. Unlike the EU and (still) the US, it does not offer a very attractive civilisational model. Unlike China, it does not have large financial resources or a vision such as 'Belt and Road'. China is a far larger investor in oil, gas and particularly power in every significant country in the region, and it has cemented that position with recent contract wins in Iraq, Iran and Abu Dhabi[6]. Unlike East and South Asia in general, Russia does not present a large future market for Middle East energy exports. It does not export significant quantities of energy to the region either, with the exception of Turkey. Except for arms and, perhaps, nuclear power, it does not have much to offer in high-quality and high-technology exports.

2.1.2 RUSSIA'S METHODS

Russian energy-economic engagement in the Middle East has been carried out via a number of methods, which can be grouped under four headings. Firstly, it has **cooperated with parties which are opposed to the US** or seeking to diversify their relationships, and this cooperation has included energy.

Secondly, it has **worked with OPEC states**, notably Saudi Arabia, the UAE and Iran, to put together the deal on oil production cuts which included other leading non-OPEC producers. Its own large production, its influence over former Soviet states Azerbaijan and Kazakhstan[7], and its ability to mediate between Riyadh and Tehran, were crucial.

Thirdly, it has **invested in oil, gas, pipelines and nuclear power** in various countries. This is carried out through a variety of state companies (Rosneft, Gazprom / Gazprom Neft and Zarubezhneft), as well as private companies (mostly Lukoil) which may be acting on more commercial motives. Even with Rosneft, the corporate veil allows the Kremlin to retain some 'plausible deniability' over more politically controversial deals.

Fourthly, it has invited **investment in its own energy sector**. This is badly-needed given the restrictions on financing imposed by Western sanctions. Russian companies, Rosneft and Gazprom in particular, have been willing to sell stakes in domestic assets to finance overseas expansion. Middle Eastern investors also have the advantage of being weaker and less politically threatening than Chinese state investors.

Russia's involvement in **Syria** has been the most prominent of its regional activities, and has had profound consequences both for the conflict there, and for neighbouring states. The political, diplomatic and military aspects of this intervention will not be covered here. But, in energy terms, its involvement is limited.

> Russia would probably be happy for Syria to become a 'frozen conflict', where it could continue to exert influence.

Some Russian companies have been offered natural gas and phosphate resources essentially as war booty if they are able to recapture areas from opposition groups. Tatneft had some minor pre-war oil production in the country, Soyuzneftegaz signed for offshore exploration rights in 2013 but withdrew in 2015, while Stroytransgaz built pipelines. Theories linking the war to a supposed gas pipeline from Qatar to the Mediterranean, or a competing Iranian version through Iraq, are geographically, politically and financially absurd (in any case, neither would be to Russia's advantage).

The cooperation with **Iran** in Syria has built on other engagement with Tehran, including the Russian construction of the Bushehr nuclear power plant, its delivery of S-300 air defence missiles, and the involvement of Russia in the P5+1 negotiations which led to the Joint Comprehensive Plan of Action (JCPOA) over Iran's nuclear activities. Russia has also

[4] Consisting of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates
[5] https://www.thenational.ae/russia-looks-to-strengthen-its-links-with-the-gulf-1.504200
[6] Middle East Economic Survey Volume 61, Number 21 (25th May 2018)
[7] Although Kazakhstan has in practice largely ignored the agreement

verbally defended the deal following the US violation of it in May 2018, and has offered to settle transactions in roubles rather than dollars[8].

Russian oil companies, notably Lukoil and Gazprom Neft, have negotiated for opportunities in Iran but received no special favours. Rosneft signed a $30 billion 'strategic cooperation' agreement in November 2017, but this does not appear to have gone anywhere yet, and Iran is known for memoranda of understanding that do not lead to binding contracts. Smaller state firm Zarubezhneft signed a smaller deal to develop two fields in March.

During the previous period of stringent nuclear-related sanctions on Iran, during 2012-15, Russia discussed oil swaps with Iran. These could be revived, but appear logistically difficult. As a leading oil and gas exporter, Russia benefits from sanctions on Iran which limit its ability to export or to grow production in the longer term.

Russia, particularly **Gazprom**, has also been keen to divert Iranian gas exports to the south-east – towards India and Pakistan, which are not core markets for it – rather than to Europe. And the two have differing positions over the Caspian Sea: Russia considers it a sea and has delineated its borders with Kazakhstan and Azerbaijan; Iran maintains it to be a lake, of which all five littoral states should have an equal share, and has disputed Azerbaijan's right to drill in the adjacent area. As well as their competition in the energy sphere, there are also suspicions between the two countries over Iran's loss of territory to Russia in the early nineteenth century; over the chance that the Kremlin will fail to back Tehran over US sanctions because of a *quid pro quo* somewhere else; and over their different visions for Syria. Russia would probably be happy for Syria to become a 'frozen conflict' where it could continue to exert influence; Iran would prefer Assad to be in firm control but still reliant on Iranian support.

Russia's interaction with **Iraq** has been much more opportunistic. It was initially largely confined to investment by Gazprom Neft in the Kurdistan Region and in the Badra field in 'federal' (non-Kurdistan Region) Iraq; by Lukoil in the West Qurna-2 field and Block 10 exploration project, where it has made the large Eridu discovery; and by Bashneft, then acquired by Rosneft, in the Block 12 exploration project, which recently announced a possibly sizeable discovery[9]. Russia also reached a $4.2 billion arms deal in 2012 with the government of then-Prime Minister Nouri Al Maliki, which was scrapped over corruption allegations.

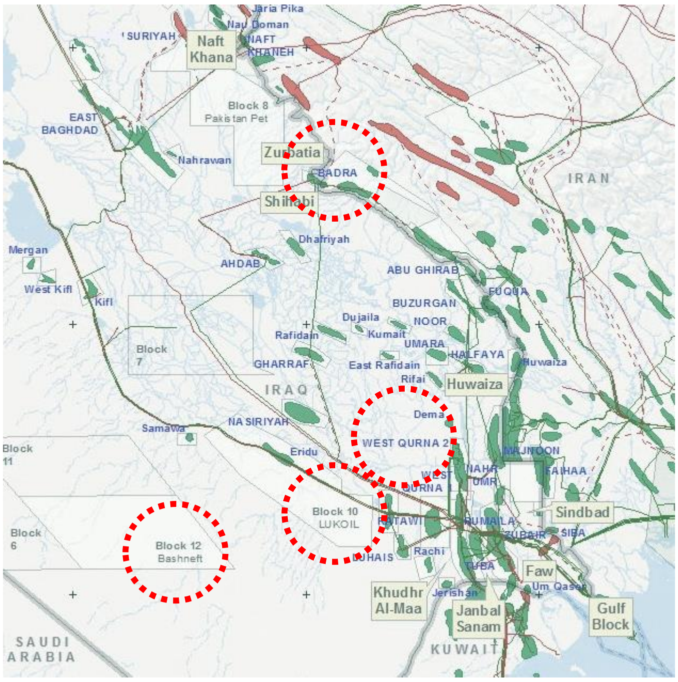

Figure 1: Russian oil assets in federal Iraq[11]

Rosneft's April 2017 deal to pre-pay for Kurdish oil exports (to feed its refineries in eastern Europe), its purchase of 60% of the main oil pipeline for $1.8 billion, acquisition of six oil exploration blocks for $400 million, and agreement to finance a gas pipeline to Turkey, appeared to put it in a strong position in the autonomous region[10]. The money it provided temporarily eased the region's dire financial situation and enabled it to pay down some debts to oil companies.

Russia opposed the Kurdish referendum on independence of September 2017, but rather ambiguously. But when in October 2017, federal Iraqi forces retook control of the disputed Kirkuk area and its major oil fields, Rosneft's gamble appeared miscalculated.

Not only had it angered Baghdad, but it has little prospect of being repaid soon given the region's loss of revenues from Kirkuk mean it cannot cover its operating budget.

[8] http://www.xinhuanet.com/english/2017-03/31/c_136172016.htm
[9] Middle East Economic Survey Volume 61, Number 21 (25th May 2018)
[10] http://www.iraqenergy.org/rocky-road-kurdish-oil-and-independence; https://www.reuters.com/article/us-rosneft-iraq-insight/the-great-russian-oil-game-in-iraqi-kurdistan-idUSKBN1HQ1R3
[11] Qamar Energy

Since this, Russia has scrambled to regain favour with Baghdad, and has largely succeeded in doing so. Its investments in the Kurdistan region may prove a loss, but still provide a useful bargaining chip. In May 2018, Rosneft signed a deal for design of a gas pipeline[12], though it will look for third-party financing which means this long-delayed project is still unlikely to move on quickly. It also may join BP in redeveloping the Kirkuk-area fields[13].

Rosneft's aims in joining the Kurdish gas pipeline are unclear. It could be supporting compatriot Gazprom by essentially ensuring the project does not move ahead, or does so only under heavy Russian influence. Turkey is a key market for Russian gas (as noted below) and it is in Russia's interest to limit competition. On the other hand, Rosneft has been developing its own gas business both at home and abroad, and competes for political power with its state-owned rival.

Energy has been an integral part of the developing Russian relationship with **Turkey**. Turkey began importing Russian gas in 1987 via the Balkans, and in 2003, the Blue Stream pipeline under the Black Sea expanded deliveries. In 2016, 51% of Turkey's gas imports came from Russia, 17% from Iran, 14% from Azerbaijan and the rest as liquefied natural gas (LNG). In 2015, it received 11% of its crude oil imports from Russia, 20% from Iran and 41% from Iraq. Russia's Rosatom is also building the 4456 MW Akkuyu nuclear power plant on the southern Mediterranean coast.

To replace gas deliveries via Ukraine, Gazprom is constructing the Turkish Stream pipeline (actually two, or even four, separate lines on the same route, each with 15.75 billion cubic metres annual capacity), which runs under the Black Sea. The first line will supply Turkey, and the second will supply south-eastern Europe, with the intention of pre-empting additional deliveries from Azerbaijan or even Iraqi Kurdistan or Iran. This will increase Turkish dependence on Russian gas, but Turkey is also increasing its LNG import capacity to reduce the chance of being held hostage. It has also sought to diversify its energy supplies with more domestic gas production, coal, nuclear power and renewable energy.

Figure 2: Turkish oil and gas pipelines[14]

Russia's relations with Turkey have not been smooth. The two are at odds in Syria. The Rosneft move into Iraqi Kurdistan may have partly had the aim of inserting Russia into Kurdish affairs, an implicit threat to Turkey given its long dispute with its own Kurdish population.

[12] https://www.reuters.com/article/us-rosneft-kurdistan/rosneft-boosts-clout-in-iraqi-kurdistan-with-gas-pipeline-deal-idUSKCN1IQ121
[13] https://www.ft.com/content/dd55468c-fc46-11e7-a492-2c9be7f3120a
[14] http://www.gatewayturkey.com/turkey-ready-to-be-energy-hub-of-eco-region/

However, Russia and Turkey should be forging a closer relationship. They have a common interest in Syria, and Turkey's relationship with the US and EU (and hence NATO) has sharply deteriorated under the leadership of President Erdoğan. Their authoritarian, religiously conservative and state-capitalist politico-economic models now look rather more similar.

In contrast to this direct involvement in the northern Middle East, Russia's engagement with the **GCC** has focussed mainly on international organisations and inbound investment. It does not have significant energy investments in any of the GCC states.

The most notable cooperation, as noted above, is in the OPEC/non-OPEC deal (the 'Vienna Group' or 'OPEC+'), in which Saudi Arabia and the UAE were key interlocutors. Previous offers by Russia to cut oil output in coordination with OPEC failed. This time, energy minister Alexander Novak put his own credibility on the line following the meeting of April 2016, which broke down in disagreement over Iran's participation. In November 2016, following conversations between Vladimir Putin and Iranian supreme leader Ali Khamenei, Iran did agree to limit its production.

In the longer term, Russia's prospects for a decisive role in the **GCC** are quite dim. Unless its political model changes dramatically, its demographic weakness, unattractive cultural model, inherently limited alliance potential, and slow-growing, monocultural economy will lead to it becoming gradually weaker relative to China and likely also to India, the US and EU. As in the longer term, non-hydrocarbon technologies become more competitive, and the market and geopolitical importance of oil and gas shrink, Russia will face many of the same socioeconomic problems as Middle Eastern petroleum exporters.

However, the **US's incoherent regional policy** – particularly under Trump but a consistent failing ever since Bill Clinton – still gives Moscow opportunities.

Russia probably also exerted influence to bring in Kazakhstan and Azerbaijan. The participation of these countries, along with Oman, Mexico and a few other non-OPEC states, gave OPEC confidence that it would not be giving up too much market share.

Unlike in previous deals, Russia did actually reduce production significantly (albeit after a time lag and with some manipulation of its figures) and the overall cut, along with collapsing output in Venezuela, impending sanctions on Iran and a robust global economy, pushed Brent crude above $80 per barrel by early 2018; it had been as low as $27 per barrel in 2016.

Unlike Saudi Arabia and several other OPEC states, Russia maintained budget discipline by continuing to plan around prices of $40 per barrel. Its flexible currency (unlike the dollar-pegged GCC currencies) allowed government spending to adjust while its domestic oil production costs fell in dollar terms.

OPEC cooperation has therefore been very beneficial to Russia, strengthening its economy while giving it an entirely new tool to wield on the international scene. Novak has formed a close working relationship with his Saudi opposite number Khalid Al Falih. However, with the tightening market of mid-2018, OPEC+ began talking of raising production again. A loose cooperation with Russia and perhaps Oman and a few other leading non-OPEC countries is likely, but as members begin to raise output in line with their disparate abilities, the close coordination will fade. In the longer term, both OPEC and Russia have to define how to meet the future market challenge. On the one hand, North American and perhaps worldwide shale oil output (both Russia and the Middle East have substantial shale resources of their own) will keep non-OPEC output growing robustly. On the other, world oil demand may flatten or go into decline by the 2030s due to environmental policies and the rise of electric vehicles. Major hydrocarbon resource holders would face the choice of ramping up production while demand is still available, but at the cost of low prices; or trying to defend prices but leaving much of their reserves unproduced.

The OPEC+ deal was not the first international energy organisation inspired by Russia. The Gas Exporting Countries Forum (GECF) was launched at a meeting in Tehran in 2001; its first and current (third) secretary-generals have been Russian[15], though the organisation is based in Doha. Significant members include Russia, Qatar, Iran, Algeria, Egypt, Libya, Nigeria, the

[15] The second was Iranian

UAE and Venezuela. The GECF has served as a basis for discussion and information exchange, though it has not developed into a gas OPEC (not really feasible given the realities of the market) nor for production quotas or price-setting.

Russia also competes with the GCC for oil sales to East Asia in particular, via its East Siberia-Pacific Ocean pipeline (ESPO), which carries a medium-sour crude grade similar to the main Middle East exports. Rosneft, with trading firm Trafigura and partners, paid $12.9 billion for India's Essar refining company, which had also interested Saudi Aramco. Instead, Aramco will now build a greenfield refinery in India.

Russia will also compete more with **Qatar** in gas if and when it starts the 'Power of Siberia' line to China, but it is already becoming a growing LNG exporter with Sakhalin Island (just north of Japan) and now Yamal LNG, which can access East Asia via the 'Northern Sea Route' through the Arctic.

But in investments, Russia has forged energy links with the three leading GCC countries, despite the stand-off between Qatar on the one side and Saudi Arabia, the UAE and allies on the other. The Qatar Investment Authority (QIA) stepped in to buy a stake in Rosneft, in partnership with trader Glencore, when this was required to help the Russian government avoid breaching budget targets. It initially planned to sell this on to China Energy (CEFC), a well-connected, ostensibly private conglomerate, but when CEFC defaulted and its leadership were jailed on corruption charges in May 2018, QIA agreed to hold on to the stake. Beyond any commercial rationale, this deal was intended to win some favours from Russia while Doha was under pressure (at the same time, Qatar also took measures to win back US support, while maintaining reasonably friendly relations with Iran despite the US abandonment of the JCPOA, and greatly strengthened its relations with Turkey). Russia's investment relations with Riyadh have centred on joint investments in the Russian energy sector itself, with the growing Saudi need for gas manifesting itself in the idea of Saudi Aramco's joining the Arctic-2 LNG project. This would be an odd choice given the lack of technical or operational synergies.

The UAE's investment relations, by contrast, are driven by commercial considerations along with the idea of some mild hedging and diversification of its diplomatic partners. In May 2018, Abu Dhabi state vehicle Mubadala agreed to take a share in a subsidiary of Gazprom Neft's which operates in Tomsk and Omsk in south-central Siberia. But bigger investment schemes have been in the drawing book for several years without proceeding very far. Russian companies were conspicuously absent from the renewal of the various large Abu Dhabi concessions, where Western, Chinese, Korean, Japanese and Indian firms all acquired large stakes. The higher cost of capital for Russian companies, and their moderate technical capabilities, make it hard for them to compete with leading Western and Chinese E&P firms.

Russia's involvement with **other Middle Eastern countries** is far more opportunistic and *ad hoc*. Energy investments, either inbound or outbound, have been sparser since large opportunities are scarcer and the other countries lack large financial resources. The involvement of Novatek in exploration offshore Lebanon might be seen in political terms, but more likely is just an early-stage bet on establishing an international gas presence. Russian companies have not acquired a role in Israel's offshore gas, which they could have done easily and cheaply. Similarly Rosneft's acquisition from ENI of 20% of the giant Zohr gas-field offshore Egypt has some strategic potential but seems mostly driven by corporate empire-building. President Sisi has built relations with Russia to allow him to play them off against the US, which still remains the key partner. As with Turkey, Rosatom has sought to lock itself early into nascent nuclear power plants in Egypt and Jordan, and so block off likely competition, but financing these large projects is challenging. As with Egypt, Russian backing for General Haftar in Libya represents opportunism, another way to pick up influence that might be traded with the Europeans, and a possible entrée into oil projects. (Haftar conversely is seeking to diversify his own backers).

2.1.3 FUTURE OUTLOOK

Russia's energy footprint across the region therefore remains patchy. Unlike the swelling role of the Chinese, it could quickly be reversed if Russian companies were instructed or needed to sell out. The Sino-Gulf relationship of mutual dependency in energy trade does not apply. Apart from in nuclear power, and in the possible Kurdistan-Turkey gas pipeline, Russia is not involved in strategic energy infrastructure in the Middle East in the way that Western companies and China are. Russia's reputation for using pipelines and gas trade as a weapon has made some regional countries wary of inviting it in.

Moscow has not yet had to make hard choices between its regional partners, but worsening tensions between the Saudi-led, Iran-led and Turkey-led camps means that may not endure. In the event of an open US-Iran conflict drawing in various regional American allies, Russia would have to decide. It could follow the risky and confrontational policy of practically supporting Iran. Or, it could take a more passive approach (as with the 2003 invasion of Iraq) of decrying the US action and seeking to delegitimise it and oppose it diplomatically, without taking very practical steps. Either case would damage its relations with most Gulf Arab states, but the second approach would be in likely alignment with Europe.

In the longer term, Russia's prospects for a decisive role in the region are quite dim. Unless its political model changes dramatically, its demographic weakness, unattractive cultural model, inherently limited alliance potential, and slow-growing, monocultural economy will lead to it becoming gradually weaker relative to China and likely also to India, the US and EU. As in the longer term, non-hydrocarbon technologies become more competitive, and the market and geopolitical importance of oil and gas shrink, Russia will face many of the same socioeconomic problems as Middle Eastern petroleum exporters.

However, the US's incoherent regional policy – particularly under Trump but a consistent failing ever since Bill Clinton – still gives it opportunities. It still may acquire other Middle Eastern military bases alongside that in Syria. That would allow it to exert influence and play spoiler in various regional conflicts. The US's hegemonic position is eroding and Russia could well be one of a number of powers that will take a more active role beyond their own borders – local ones including Turkey, Iran, Saudi Arabia, the UAE, and international ones including the UK and France and likely at some point India and China. That creates more potential for great-power contestation and proxy conflicts. Russia's position as a major oil and gas exporter places it in quite a different role from most other outside actors – it is not concerned about securing a free flow of energy exports from the Middle East.

2.2 CENTRAL & EAST ASIA

Every country builds and defines its "*geopolitical spaces"* in a manner that is congruent and aligns with its national interests. For Russia, its geopolitical influence is largely determined by its role in the global energy markets. Russia's transactional approach to regional relations in Asia has been non-uniform at best. In this section of the paper we will differentiate between Russia's sui generis relations with China and those with ASEAN and Japan.

Unlike in the Middle East, Russia does not find many weak and failing states in East Asia, where it borders China, Japan and Korea. This region is also much further from the centres of Russian power, with the Russian Far Eastern Federal District being the largest of Russia's eight districts but having a population of only 6.3 million. Its engagement here is therefore quite different.

In the attractive, fast-growing Asian energy markets, Russia also faces strong competition from other exporters – notably Qatar, Saudi Arabia, Iran, Iraq, as well as increasingly the US. As developed country oil use is set to dwindle, major Middle Eastern producers realise how essential it is for them to secure Asian market share.

Key Russian interests in East Asia include:

- Securing oil and gas markets and building key export infrastructure, against competition from the Middle East and other suppliers;
- Building a new gas market that can enable it to monetise its vast reserves and diversify from near-total dependence on the problematic (though still very profitable) European market;
- Competition for influence in Central Asia against China;
- Developing East Siberia and the Russian Far East, and strengthening it against potential Chinese encroachment;
- Attract Chinese, Indian and other investment into its domestic energy sector;
- Sell nuclear power, for instance to Vietnam;
- Benefit from China's 'Belt and Road' programme.

2.2.1 RUSSIA-CHINA

The main geo-economic instrument at the core of Russia-China relations is, of course, energy. China's middle-class expansion from 430 million people today to 780 million in the mid-2020s will place enormous pressure on the country's security of energy supply, in particular for oil and gas. In terms of oil, the Eastern Siberia-Pacific Ocean (ESPO) pipeline has now been expanded to provide close to 30 million mt/yr (0.6 MBPD) which is double the capacity initially intended. The ESPO is a feat of engineering: a 4,800 km long pipeline in two stages plus an additional 1,000 km parallel route from Mohe to Daqing, this is a piece of infrastructure that was strategically sanctioned at the highest level. With ESPO firmly in place, China is planning an additional 1.4 MBPD of new refinery capacity by the end of 2019.

In 2017, Russia was the largest exporter of crude to China, totalling 1.2MBPD which represented just over 14% of China's total imports. This trend continued in 2018, with Russia sending just over 1.3MBPD to China in January 2018. For a country that currently represents close to 13% of oil world consumption, the security of supply that Russia can provide is paramount. The increase in oil exports to China comes in concert with Russia's willingness to join OPEC in reducing crude output as an avenue for stabilising oil prices. In this respect, we need to highlight that Russia is the main non-OPEC member who decided to join OPEC's cuts strategy[16].

The ESPO's strategic importance to Russia's ability to export into Asia as a whole cannot easily be overstated. Via ESPO, Russia has the ability to provide volumes up to 0.6MBPD into the Korean[17] peninsula as well as into SE Asia via its port at Kazmino. The pipeline aligns strategically with China's Belt and Road (BRI)[18] initiative that aims at addressing regional economic disparities, of which energy is one. But Russia faces a tension here. It needs Chinese investment to develop its infrastructure, and potentially benefits from spillovers from Beijing's BRI spending in Central Asia. But, at the same time, its sparsely-populated and resource-rich Far East is vulnerable to eventual Chinese encroachment. Chinese investments in the Russian 'Near Abroad' also provide countries such as Turkmenistan and Kazakhstan with an alternative to Moscow for money, markets, and military and diplomatic support.

In an effort to deepen the ties with the Russian oil sector, China's CEFC made an unsuccessful attempt to purchase a $9bn stake in Rosneft last year from Qatar Investment Authority (QIA) and its partner Glencore, as discussed above. Unexpectedly though, QIA cancelled the sale which dealt a blow to China's ambition to become a significant shareholder in Russia's largest oil producer. QIA will now own 19% of Rosneft, cementing its position as the second largest shareholder in Rosneft after the Russian state. We believe that the ties between Qatar and Russia are the result of an asymmetric foreign policy strategy by the GCC country, which continues to be diplomatically at odds with Saudi Arabia, UAE and others over its role in backing radical Islamist groups like the Muslim Brotherhood.

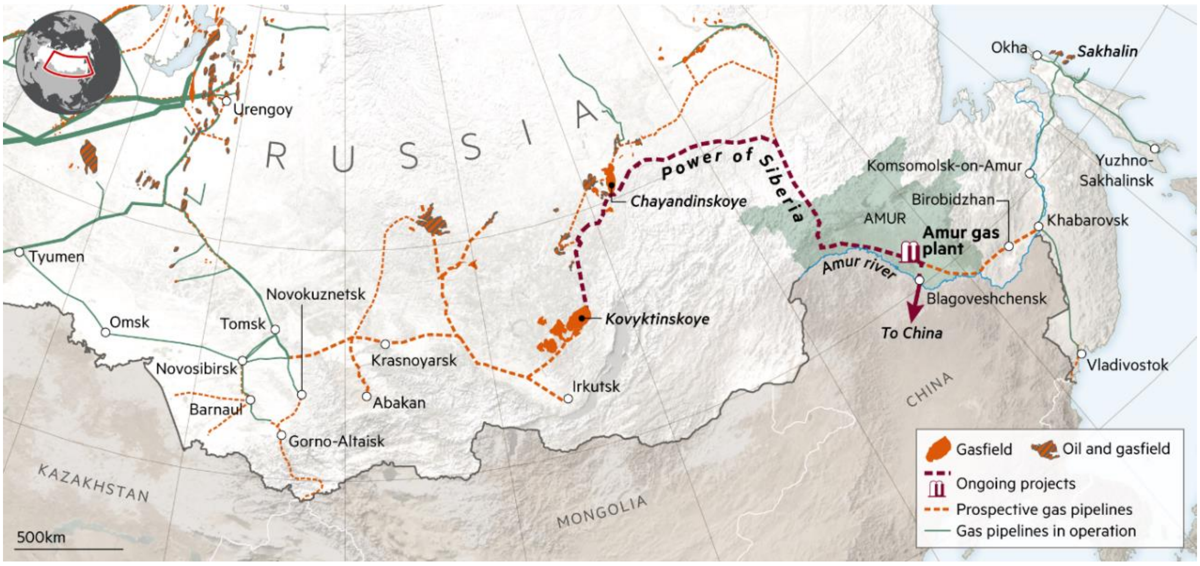

Figure 3: Power of Siberia pipeline

[16] It is by far the largest non-OPEC producer in the deal; most of the others did not cut output or merely volunteered their natural decline.
[17] Eurasiareview: "Russia Energy profile" February, 2018
[18] Or 'One Belt One Road' (OBOR)

But when it comes to China, oil is not the only card that Russia has in its arsenal. The largest natural gas reserves holder in the world (estimated at 1,700 Tcf) is keen to assert its power on the global gas and LNG markets, in particular in the Asia and SE Asia regions.

Between now and 2025, China will double its consumption of natural gas to around 480-500 Bcm annually in a quest to increase gas's share in the energy mix to 8-10%, by various government accounts. Peeking further into the future, the gap between the domestic gas supply and consumption in 2040 will reach around 160 Bcm, a staggering amount.

Russia is very much aware of China's dilemma. With a total cost estimated to be over $55bn, the Power of Siberia (PoS) gas pipeline is a testament to what the leadership of Russia and China can achieve when they get directly involved in the process. The project was sanctioned in 2014 at the height of gas and LNG prices and stipulates that 38 Bcm of natural gas will be exported into China annually under a 30-year contract between Gazprom and CNPC. The pipeline is close to 85% complete as of May 2018 but concerns remain over Gazprom's ability to recover its investment. After supplying over 210 Bcm of gas to Europe in 2017, Russia saw its gas revenues slide partly due to the collapse of natural gas and LNG prices but also in the face of fierce competition from new LNG volumes coming into Europe. With Europe's move toward sustainability, renewables and circular economies, it is expected that the oil and natural gas consumption in the EU-27 will remain flat or decline for the foreseeable future, though the continent will remain heavily dependent on gas imports as its own production falls.

But PoS is not just any project: as it stands at the moment, it represents close to 10% of Gazprom's market capitalization, hence its success is paramount not only to Gazprom but also to Russia's economic influence toward China. The pipeline is the bedrock of Russia's gas exports to China and critical in the decision-making process of sanctioning PoS2. The benefits of the PoS extend also to the Russia's Far East where a new gas plant at Svobodny will contribute to the much-needed economic uplift in the region. Dependent on developments in the Korean peninsula, Russia could even end up building a long-heralded gas pipeline to South Korea via the North.

Russia's Far Eastern gas strategy encompasses both pipeline gas and LNG. It has raised some concerns of a diversion of European gas towards the Far East, but in fact the gas is primarily from new fields (and Russia's vast resource base means it can serve both markets). Allowing for the vast capital costs in these remote and inhospitable regions, and China's strong bargaining position, Gazprom's sales east earn at best half the margin of its European volumes. Piped gas is however certainly not the only avenue to meet China's thirst for gas. In 2017, China overtook South Korea as the second largest LNG importer behind Japan, while Australia provided half of China's LNG under some advantageous old contract terms. By 2025 however, we could see a scenario in which Russia will have the potential to cover more than half of China's LNG needs estimated to be close to 70 million tonnes per annum (MTPA) and challenge Australia as the number one LNG exporter to China. Since it is expected that close to 50% of LNG volumes in 2020 will be traded as spot or short term contracts, China will have other options for securing LNG supply but we have no doubt that Russian LNG will flow into China at higher than expected volumes. Banking on this, Yamal LNG was a landmark of Russian achievement on the LNG front and an important step toward fulfilling Mr Putin's views that his country can capture close to 20% of the global LNG market by 2025. At the time of writing this article, Total has already signalled its willingness to join the Artic-LNG2 project.

It appears that Russia and China's long-term energy destinies are intertwined. In the words of Russian president: "essentially, we seek ultimately to reach a new level of partnership that will create a common economic space across the entire Eurasian continent".

2.2.2 RUSSIA-ASEAN, JAPAN

If China's growth and progress are viewed as global mega trends, ASEAN's story is not far behind. For many at the Kremlin, it simply can no longer be ignored, albeit the implications on the political front are complex to say the least. The ten countries that form ASEAN are on an aggressive journey of growth that is challenging but filled with hope. Currently close to 10% of ASEAN's 640 million people are without access to electricity and 40% depend on biomass for their daily cooking needs. Contrary to other regions of the world, coal will overtake gas in the electricity mix but the demand for gas grows by 50-60% by 2040, even though its share in power generation will fall from the current levels.

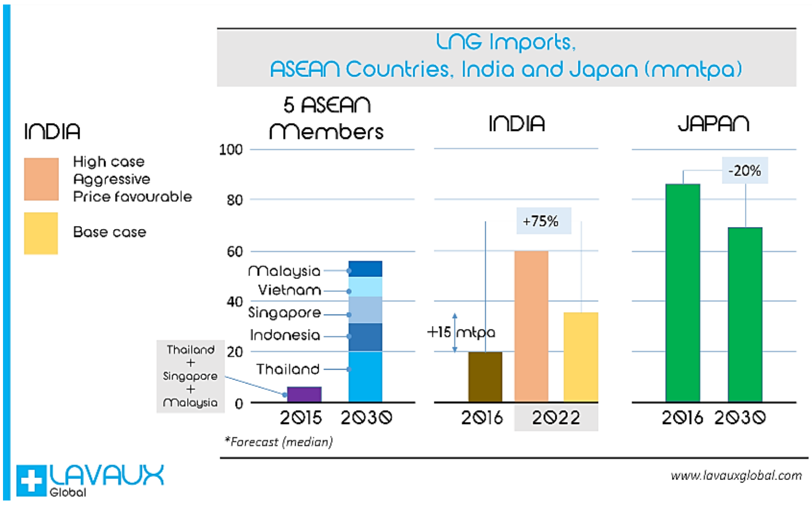

Figure 4: Future LNG demand forecast for ASEAN, India and Japan

> The West's view that Russia simply would do anything to preserve its status quo ante may be quite antiquated. Russia's foreign policy approach to "strategic spaces" and regional spheres of influence is more pragmatic and sophisticated than many think, and its energy might acts as a catalyst as well as an enabler.

On the oil front, the dependency on imports exacerbates as the region's domestic production slows down to around 1.7MBPD by 2040 while its demand accelerates to 6.7MBPD. The differential is a staggering 5MBPD, equivalent to half of Saudi Arabia's production in 2017.

Given ASEAN's challenges to sustain such growth levels and Russia's close proximity to the region, it is peculiar that the Russian-ASEAN relations are still in their infancy, perhaps with the exception of Vietnam. Traditionally, Russia's lack of strong and meaningful relations with ASEAN can be viewed as the by-product of the Cold War. However, most recently, Russia noted that energy should be viewed as "a promising area for cooperation" between them and the pan-Asian bloc. But actions speak louder than words: the bilateral ties with ASEAN are still very weak. Last year, the ASEAN economies exported just under 1% of their goods and services to Russia while, in return Russia sent just under 3% of their goods to the 10 countries in the region.

We believe that in the short term the nature and intensity of these relations are unlikely to change though some steps are made on the nuclear power front with Myanmar and Thailand. We do believe however that Russia will take an active interest in the increasing LNG demand in SE Asia which aligns well with Russia's LNG ambitions to develop long term sustainable markets and grow its LNG market share.

The caveat: Russia's recent reticence in engaging in a meaningful way with ASEAN can be understood in the context of China-ASEAN foreign relations. We believe that ASEAN would be willing to accept Russia as an honest broker in their regional disputes with China, but the question remains: can Russia indeed fulfil that role?

If the answer is *no*, then we believe that Russia will sacrifice its energy trade potential with ASEAN in the interest of keeping China happy.

If the answer is *yes*, then to what extend will Russia be willing to contribute to the heated dialogue on the subject of the South China Sea?

Russia will need to weigh its options as far as the ASEAN bloc is concerned – and these options pose further questions – but with the current US administration following an inward policy of protectionism, we see opportunities for Russia to take a more active role in the region. We do however view these opportunities as transactional rather than systemic.

In contrast, Russia's relations with Japan are progressing at the highest level. In May 2018, Japan's PM Shinzo Abe visited Russia and spoke at St. Petersburg International Economic Forum (SPIEF). Despite the fact that we expect a reduction in Japan's LNG imports over the next ten years, the country's close proximity to Russia leaves room for joint developments and cooperation. Technip and the Japanese company JGC have already been involved as EPC contractors in the Yamal LNG project while Chiyoda and Toyo Engineering of Japan were involved in the Sakhalin-2 project where the consortium is already studying the possibility of adding additional LNG capacity to the existing 9.6 MTPA. The joint agreements signed at SPIEF 2018 were not enormous, but that leaves room for further collaboration.

"The mood that exists now in Russian-Japanese relations gives me every reason to express hope that the volume of investments, and it is rather modest — some $2 billion by Japan into the Russian economy, and the volume of trade — it is also modest, about $18 billion in the past year — all this can be multiplied manifold," Putin said during the "Business Dialogue: Russia-Japan" session at the St. Petersburg International Economic Forum (SPIEF).

It is perhaps worth mentioning that the Japanese sanctions imposed in 2014 after Russia's intervention in Ukraine have had limited negative effect on Russia's economy. Moreover, Japan was one of the few countries that refrained from admonishing Russia following the incident in the UK where a former Russian spy was poisoned allegedly by Kremlin orders. Under these circumstances, we see signs that Russia and Japan are interested in strengthening their cooperation for mutual benefit and taking a pragmatic view on their northern islands (Kuriles) dispute which seems to have been put on the backburner for the moment.

3. RECOMMENDATIONS

Our major conclusion is that Russia's non-uniform and somewhat erratic oil- and gas-oriented behaviour in the regions analysed will most likely prevail over the **short term** with perhaps some notable exceptions stated below.

The West's view that Russia simply would do anything to preserve its status quo ante may be quite antiquated. Russia's foreign policy approach to "strategic spaces" and regional spheres of influence is more pragmatic and sophisticated than many think, and its energy might acts as a catalyst as well as an enabler.

Over the **medium to long term**, Russia's approach to geopolitical spaces will be adjusted to include more stringent cost-benefit analyses of the impact of megatrends (such as the rise of non-hydrocarbon technologies) on the Kremlin's ability to move away from its energy-based economy and state finances. Saudi Arabia recognizes the clash of running a petrodollar-based budget while societies at large move toward a greener future, hence the emergence of Vision 2030. Russia is not yet in that frame of mind. Nevertheless, a new approach toward opening foreign markets such as ASEAN and Japan is required. Absent a major regional conflict, we do not believe that over medium to long term, Russia's foreign policy (which includes energy) toward the GCC will change; therefore, ceteris paribus, its behaviour on the energy front will continue to be opportunistic, collaborative and transactional. Via its discipline in the OPEC production cuts, Russia cemented its position as a **reliable partner to Saudi Arabia** which may serve Kremlin well into the future, while the imminent listing of Aramco will provide an opportunity for Russian oligarchs with ties to the government to take significant equity positions.

In Eurasia, **Russia and China** will continue to be joined at the hip in terms of future energy transactions and financing arrangements for mutual benefit. The failure of the CEFC deal discussed above will only motivate China to be more prudent and ensure that the "next big deal" will not fail.

Russia's **Far East strategy** is just starting to take contours. Gazprom's embarrassing failures to develop a string of gas projects (Shtokman, Baltic LNG, Vladivostok) showed Kremlin the importance (or lack thereof) of meaningful collaboration with Western companies. At the request of the West, we see Russia liberalising portions of its energy markets by allowing credible partners such as Total to take increasing shares in gas and LNG projects.

However, in the Middle East, Russia's and China's interests diverge, and they can be commercial competitors as well as potential diplomatic rivals, as the US inattention opens spaces for other players.

We expect that Russia's involvement in **Iraq** will continue to proceed despite its lack of a coherent strategy of dealing with the Kurdish side of diplomacy. Opportunities for strengthening relationships with Baghdad will come from Lukoil's commitment to increase the capacity of West Qurna 2 to 0.8MBPD by 2025. We see **Lukoil** as a major and reliable investor in Iraq's oil production. Rosneft could play a larger and more state-centric role around Kirkuk and in Kurdistan.

Iran will remain a hot spot for diplomacy given the current US administration's inability to understand that improving a long-standing compliant deal is easier than rebuilding one from scratch. This seems already to create opportunities for Russia, which advanced to the West the idea of creating new financial instruments that will enable the West to remain engaged and avoid possible US sanctions. Russian companies are possible investors in oil-field projects if European firms are prevented by sanctions, though Chinese are always likely to be the main investors.

In the **GCC**, Russia's approach will remain non-ideological and pragmatic while its interests in Syria (albeit military-driven) will always limit options with the Sunni countries. One step that Russia could follow is to invite reliable Middle Eastern investors or state-led entities to take equity positions in mega LNG projects in Russia. Saudi Arabia has already signalled its interest in getting involved in funding projects, some of which are still under US sanctions.

The ability to finance further projects, in particular LNG, will remain front and centre on Kremlin's agenda. The once tiny Novatek, which holds over 50% in the Yamal LNG project, is now a worthy LNG player; the company has been upgraded to BBB/Stable by Fitch, which helps with the company's ambitions to become a mega player - in particular via Arctic LNG-2. The success of Yamal LNG and the reliability of Gazprom's supply to Europe over the years, combined with Washington's political ebbing from the European stage (and its protectionist tendencies), will reshape the world's view on how to collaborate with Russia in a meaningful way for mutual benefit.

CONTACT INFORMATION

Robin Mills
CEO, Qamar Energy
robin@qamarenergy.com

Dr Dorel Iosif
CEO, LAVAUX Global
diosif@LAVAUXGLOBAL.COM

About Qamar Energy | www.qamarenergy.com
Qamar Energy provides leading-edge consulting and advisory services across the spectrum of energy companies, in strategy, economics and business development. We work with every segment of the industry: upstream, midstream and downstream.

About Lavaux Global | www.lavauxglobal.com
LAVAUX Global, headquartered in Australia, is a leading strategy, operations consulting and organizational transformation firm. The company has over 135 years of cumulative experience in energy and management consulting, in particular in the areas of organization design, corporate level strategy and strategic planning, dynamic capabilities and operational excellence.