

# Russia's Energy Security Dilemmas in Northeast Asia

## CONTENDING WITH THE DIFFERENT FACES OF RESOURCE NATIONALISM

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### **Introduction**

Northeast Asia is widely regarded as “ground zero” for global energy activity, with mounting demand and anxiety about over-reliance on vulnerable sea-lines from traditional but unstable Middle Eastern and African suppliers. Accordingly, emerging Chinese, Japanese, and Korean markets have become a conspicuous fixation for Russian suppliers, given their proximity for overland transit, changing geological bases of domestic production, and drive to diversify outlets to break the “co-dependency” on established European importers and post-Soviet transit states. For many observers, mutual and converging commercial energy interests among the world’s fastest growing supplier and customer regions constitute the basis for spurring development in the Russian Far East while bolstering integration within the Asia-Pacific region and transforming Russian-East Asian cooperation. Others, however, are not as sanguine, seeing in complementary supply-demand interests and the strengthening of interdependence a recipe for deeper Russian-East Asian engagement that has negative strategic consequences for Europe and the United States. Still others see the assertion of resource nationalism – marked by (re)statization of the energy sector, a resort to pipeline politics, and competition for equity oil stakes – as a harbinger for strategic rivalry across Eurasia and between Russia and the heavily import-dependent Northeast Asian states – and not to Moscow’s advantage.

Yet for all the political handwringing over Russia’s “Eastern vector” of diplomacy, the debate typically overlooks the mixed record of Russian-Northeast Asian energy relations. It also conflates commercial with non-commercial energy competition and fails to appreciate the dynamics (and dilemmas) of strategic energy interaction.

This memo addresses these oversights by recasting the Russian-Northeast Asian energy tangle in terms of a security dilemma. It begins by exposing prominent myths that color an assessment of this relationship. It then explicates market and institutional

factors that shape the intensity of security dilemmas in Russia's oil versus gas relations with China and Japan. This entails focus on dimensions of cooperation and inadvertent escalation of tensions. The conclusion illuminates practical guidelines for advancing Eurasian-Northeast Asian energy projects and strategic reassurances.

### **Myths vs. Realities**

Moscow's prevailing energy strategy projects that new oil development will constitute 50 percent of national production, and that output from gas fields in East Siberia and the Russian Far East will exceed that from European Russia by 2030. This "Eastern" energy wealth represents the brightest light amid rising depletion rates (60-75 percent) of existing large fields in West Siberia. Coupled with the Kremlin's determination to spur development in the Far East, mounting activism of state-owned energy companies at tapping these new reserves, and a push to diversify Russia's international customer base to enhance "security of demand," the Kremlin is primed to engage China with energy at the core. Russian officials and policy insiders also eye the promise of energy cooperation with Japan and South Korea for diversifying regional energy exports, securing a springboard into new markets in Southeast Asia and the United States, and embracing the dynamic Asian-Pacific "face" of globalization.

Not surprisingly, Russia's commitment to strengthening its foothold in the rapidly growing East Asian energy markets raises the specter of a resurgence of aggressive resource nationalism. This conventional wisdom, however, is premised on at least four prominent myths.

#### *1. Russia as an Energy Superpower?*

Its emergence as the world's largest oil and gas producer notwithstanding, Russia is a price-taker in the integrated global oil market and faces significant fiscal and infrastructure constraints on employing gas as a sustainable strategic weapon. Although capable of disrupting short-term supply to gas customers in Europe, Russia's stature in emerging Northeast Asian markets is circumscribed by steep start-up costs and preoccupation with "returns on investment" with new pipelines, as well as by the prominence of increasingly integrated LNG markets and the rising potential of unconventional gas offered by more established Southeast Asian, Australian, and Middle Eastern suppliers. The country's eastern hydrocarbon resources are situated under permafrost and complicated geological conditions that elevate already high exploration, production, and export costs. The competitive disadvantages of these fields are compounded by the fragile ecosystem and general under-development of the surrounding provinces, as well as Moscow's dependence on foreign investment, capital, technical knowledge, and managerial experience for unlocking these new and especially difficult-to-access reserves.

#### *2. Russia's Aggressive Resource Nationalism?*

A second misconception is that Russia embraces a concerted and coherent strategy of resource nationalism. Yet resource nationalism comes in different forms, including

deliberate strategies to bolster energy cooperation and foreign investment. Under Vladimir Putin's presidency, the emphasis was on redressing the insecurity prompted by dramatically declining socioeconomic trends and general degradation of the inhospitable Far East, its creeping dependency on China, and appreciation of the region's energy potential for strengthening Russia's position in Asia. This fostered an autarchic, if not paranoid, approach to building up the region's energy infrastructure as a bulwark for accelerating protectionist political and economic development in the Far East and asserting Moscow's strategic interests in the Asia-Pacific region. In the face of steadily declining socioeconomic trends in the Far East, disappointing performance of successive government-sponsored regional development projects, and the threat of Russia's further marginalization in Asia, President Dmitry Medvedev retreated from offensive energy plays in favor of diversifying and modernizing the economy. So in contrast to the strategically competitive orientation of the earlier Russian posture, since 2009 the state-directed strategy has placed emphasis on bartering commercial energy deals in the Far East for increased trade and investment links with China, Japan, and South Korea, both directly and via participation in APEC (Asia-Pacific Economic Cooperation) and other international organizations.

Moreover, what is "good" for Russia's state energy companies, let alone private firms, is not necessarily "good" for advancing Russia's national strategy. True, the interests of the political leadership and national energy companies can converge. This was the case with the Kremlin's discretionary enforcement of environmental protection and pressure on foreign majors to sell shares to Gazprom in the potentially productive Sakhalin-2 project in 2006. However, they also can conspicuously conflict, as evidenced by Gazprom's arbitrary intervention in the development of the Kovytkha gas field, the gas giant's decision to buy Central Asian gas at the expense of exploring the Chayandinsk field in Sakha, and the Russian railroad monopoly's efforts to undermine the Eastern Siberia-Pacific Ocean (ESPO) pipeline in favor of expanding regional rail exports. In each episode, the state company directly undermined the negotiating credibility of federal and regional authorities, as well as the appeal of prospective field development, pipeline deals, and commercial contracting for potential Northeast Asian energy investors and customers. Accordingly, it is not so much that Russia's energy firms serve as proxies for state power as that distinct commercial and strategic motivations converge or diverge under different conditions.

### 3. *An Asian Redux?*

It is often asserted that Russia's offensive energy diplomacy toward Europe and post-Soviet transit states will be revisited in relations with import-dependent Northeast Asian customers. But Asia is not tantamount to Europe in Russia's energy strategy or portfolio. The Kremlin is deeply concerned about becoming a "resource appendage" to Northeast Asia and reluctant to play an "Asian energy card" that would jeopardize "modernization alliances" with more advanced and stable economies in Europe and the United States. Moreover, Russia's projected energy trade with Northeast Asia constitutes a residual opportunity, even under the most optimistic scenarios. The

national energy strategy officially calls for only gradually increasing Russia's deliveries to East Asia from 4 percent to nearly 30 percent of the country's overall energy exports by 2030. That Russia has both experienced delays in developing its eastern fields and related pipelines and faces stiff competition from Central Asian oil and gas suppliers only frustrates these optimistic plans.

#### *4. Russia's Energy Unilateralism?*

Russia's resource nationalist strategy is typically treated as a product of concerted policy, legacy infrastructure, and resource endowments. Yet the Kremlin does not operate in a strategic vacuum, and it is constrained by the respective interests and behavior of its Northeast Asian partners. With China, Moscow must manage not only the opportunities to diversify supply and its own fears of over-dependence, but the impact of Beijing's activist and state-controlled "going out" approach to foreign equity acquisition and pipeline building across Eurasia. With Japan, Moscow can benefit from complementary interests derived from Tokyo's commitments to diversifying both the geographic and sectoral sources of energy imports, but there are limits imposed by peaking Japanese demand for energy; preferences among Japanese energy firms for investing in downstream activities amid the poor investment climate in the Far East; and the profitability to Japanese refineries of importing "lower quality" crude from the Middle East. These tensions are inflamed by the longstanding political row over the status of the Kurile Islands/Northern Territories.

#### **Strategic Energy Opportunities and Risks**

A state's ability to advance its energy security and related cross-border engagement depends, in part, on what it expects other states and firms to do and how these actors indeed behave. The calculations and related energy outcomes, therefore, are shaped by a confluence of market dynamics and domestic politics that constrain the range of possible outcomes, stakeholder interests, capacity to formulate and implement coherent policies, and international signaling among states and firms. Moreover, because extra-commercial energy conflict is costly (in terms of lost revenue, failure to bring resources on line, deprivation of strategic supply, costs of disruption and diversion, and so on), there exists a range of negotiated outcomes that will leave all involved better off than if they arbitrarily turn off the spigot or terminate an existing contractual arrangement. Yet amid bargaining and technical uncertainties, states are entwined in an energy security dilemma, whereby what one does to enhance its security and commercial capacity can fuel the fears of another, inadvertently generating spirals of mutual suspicion and political rivalry to the detriment of both states' energy security. The intensity of this dilemma varies directly with asymmetries in market power and opacity of domestic regulatory systems.

The security dilemmas confronting the Russian government in its energy dealings with Northeast Asia account in part for its mixed success at forging partnerships. On the one hand, the combination of weak market standing and opaque regulatory systems in both Russia and China ironically augur well for cementing joint

oil development and pipeline deals. Although the strategic context has been ripe for competitive posturing over contract terms and the stoking of mutual misperceptions, not to mention frustration, the opportunities for modest gains from cooperation generally outweigh the risks. For Russia, emphasis was placed on keeping options open and wooing preferred financing arrangements for construction of the ESPO up to Skorovodino, as well as securing multiple commitments for throughput from emerging Northeast Asian customers. Similarly, the drop in oil prices and tight global credit conditions enhanced China's leverage in bilateral negotiations over construction of a direct ESPO connector. This not only strengthened the appeal of Beijing's 2009 "loans-for-oil" offers but enabled China to hedge its bet with Moscow and other foreign suppliers, diversifying the commercial and political risks of the country's growing oil import dependence. Although muddled regulatory authority in both national systems shake confidence in negotiations, the opportunistic circumstances reduce the stakes of bilateral confrontation and contain the potential adverse strategic consequences of commercial rows, as evidenced by China's recent decision to pay off its debt for initial deliveries in the face of a Russian threat of legal action.

On the other hand, the market vulnerability associated with piped gas from Russia, and interaction of clearly delineated responsibilities within the Russian gas sector with opaque authority relations among government offices and state-centered energy firms in China have conspired against sealing long-term deals since 2004. This constellation of factors is conducive to accentuating mistrust and converting competitive commercial plays into punctuated political rivalry, notwithstanding otherwise common interests in unlocking reserves and diversifying the energy trade. For example, irrespective of Moscow's claims of innocence in a 2009 pipeline explosion in Turkmenistan, the fear exacerbated by the strategic context had a boomerang effect on Russia's gas diplomacy. It increased the prospective payoffs to Ashgabat and Beijing of taking risks on diversification, while obfuscating China's motives and escalating the costs to Moscow of exerting its significant market power. However, because Japan is not dependent upon imports of piped gas and possesses more transparent regulatory institutions, its gas trade with Russia lacks the same intensity and instability. This creates opportunities for modest commercial cooperation, as evidenced by preliminary cooperation with Gazprom on the construction of the LNG plant linked to the Sakhalin-II and III fields.

### **Guidelines for Policy**

A focus on energy security dilemmas illuminates several practical considerations for future Russian-Northeast Asian energy relations.

#### *Focus on the Strategic Context*

The strategic context rather than energy endowments and scarcity, relative power, or discrete national policies can be decisive for determining both the trajectory of commercial energy interaction and the dimensions of political conflict. Russia's success at landing deals with Northeast Asian customers and brandishing the energy weapon

vary across sectors and states. Unlike on gas issues, the pervasive market and institutional weakness of the parties in the oil sector lessens both the risks and costs of being exploited by the other. Accordingly, the sides' burgeoning confidence in the other as negotiating partners in the ESPO is not likely either to unlock or restrict opportunities in the gas sector. Rather, the risks and uncertainty of a Sino-Russian deal are sizeable in their own right due to imbalanced market and regulatory factors that require more than narrow commercial concessions on price to be assuaged.

#### *Embrace the Dynamic Landscape*

With the growing promise of shale and unconventional gas exploration across the globe, the industry stands at the precipice of transformation. Should trends hold, the gas sector may reflect the dynamics of the integrated oil trade, reducing the significance of overland pipelines and, thus, Russia's regional market power. This opening of the gas market, ironically, can reduce the risks of commercial cooperation with Russia that, with viable financing arrangements, can both facilitate LNG transactions and break the logjam over prices, thereby enabling Moscow and Beijing to realize ambitious commercial plans.

#### *Promote Domestic Regulatory Reform*

Institutions matter for unlocking the prospects of Russia's energy trade with Northeast Asia. However, unlike Russia's relations with Europe, less attention needs to be devoted to forging international norms to protect supply, demand, and transit security. Rather, the focal point for reform should be enhancing the transparency of respective national regulatory systems. Relative market power and bargaining strength matter so much in shaping bilateral Russo-Sino deals and the risks of inadvertent escalation of commercial gas rows are so great because the capacity and credibility engendered by opaque regulatory systems in both countries are so weak. Over time, policymakers should devote more attention to clarifying authority and oversight mechanisms – such as easing restrictions on foreign direct investment, creating new and transparent PSA arrangements, reforming tax structures to stimulate investment in refining and greenfield projects in East Siberia and Sakhalin, distinguishing between state and private authority – in order to allow commercially viable, self-enforcing, and strategically reassuring agreements to take shape. While this may not root out the possibility of future energy conflicts, it will help to expose commercial from strategically offensive intentions, avert costly blunders, and ease the flow of financing and technologies, thus enabling Russian and Northeast Asian partners to realize common energy security interests while strengthening regional and global stability.