

MOSCOW vs RIYADH OIL

Between partnership and cooperation on the energy market

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From the new alliance to an unlikely oil cartel, in a scenario of increasingly difficult political and economic situation for two among the major players in the world energy market

On September 2nd 2003, following an intense and diplomatic activity carried out for months, the Russian President Vladimir Putin and the Saudi Crown Prince Abdullah Ibn Abdul-Aziz Al Saud have signed in Moscow a bilateral cooperation agreement on energy.

This event is of extraordinary nature for many reasons, with its roots originating in history far back at the beginning of the last century.

Russia and Saudi Arabia almost completely broke up their diplomatic relations in 1926, following the stalemate due to the Bolshevik revolution which rapidly dethroned the Romanov royal family, founding and consolidating the Soviet Union. The bipolar balance of the Cold war and the escalation of the interventionist policy of the Soviet Union in Afghanistan had further diminished any chance of contact, moreover triggering the dangerous Saudi support, more or less concealed, of the higher ranks of the Afghan leadership.

Russia and Saudi Arabia were able to re-establish the framework of their bilateral relations only at the beginning of the nineties, after the disintegration of the USSR and of its policy of domination on the Islamic regions of Central Asia.

Moscow's interventionist policy in Chechnya and in other neighbouring areas between the Caspian Sea, the Black Sea and the southern Russian territories cannot be, and is not, perceived by Saudi Arabia and by the other regional players as the result of an expansive action, but as a necessary policy aimed at preserving national integrity. Notwithstanding the much announced contribution to the "war against terrorism", Russian policy is perceived in the near regions of the Persian Gulf and of Central Asia as necessary action to limit the still evident risks of fragmentation of the "ex-provinces of the empire".

The ideological element deriving from the clash with Islamic forces does set up another battle front with the region's countries, but this is of a different nature compared to the past. The Russian action is no longer inspired by a strategy or territorial expansion towards the Persian Gulf, and the clash with Islamic forces within Russian territory may be handled with low-profile effective support policies, rather than through broad alliances. Actions which are therefore aimed at triggering regional crises of limited intensity, but heavily exhausting for the Russian strategic system in the region.

Saudi Arabia, on the other hand, from the beginning of the seventies, revealed a gradual but steadily growing social, economic and political crisis originating from the balance of forces and the role of the royal family on the territory.

Specifically since 1995, when King Fahad transferred - even if in a gradual manner - his power to crown prince Abdullah because of his poor health, the power framework of the Saudi kingdom entered a stalemate caused by the clan disputes among its members.

The Crown Prince Abdullah Ibn Abdul-Aziz Al Saud, whose past achievements as mediator between Saudi tribes and sense of duty modelled on religious principles are well-known, has had to face from the very beginning the burdensome task of guiding the country through two imperative needs.

The first one has been to keep the clan framework of power united through a role of moderation and domestic diplomacy which, also due to the limited authority assigned to his mandate, has been almost entirely addressed to the settlement of

the mixed interests of the ruling class of the immense royal family.

The second need, on the contrary, has been a tighter religious conception as a founding base for the State, to face the potentially destructive role of an increasingly powerful clergy and of the many radical Islamic hotbeds on the Saudi territory. Hotbeds which are somehow imputable to the crown prince's activity of mediation on a national scale.

The tragic events of September 11th 2001 and the subsequent American campaign against the Taliban regime and Al Qaeda in Afghanistan, publicly highlight the fragile and dangerous balance within which domestic Saudi Arabian policy has been shaped in the Nineties, showing explicitly the fragile nature of the post-succession social and political order. Abdullah Ibn Abdul-Aziz Al Saud, realizing how Saudi Arabia would likely become the first undeclared target of the American "war against terrorism" and "rogue states", especially due to the critical position of the Saudi citizen Osama Bin Laden and of the group who is responsible for the attacks in New York and Washington, chooses to rapidly adopt a pragmatic strategy to handle the crisis. In the imminence of the American strike on Saddam Hussein's Iraq, Saudi Arabia chooses to carry out an energy policy of strong support of the international economy, increasing oil production and preventing OPEC from adopting an aggressive strategy in the most critical time from an economic point of view.

At the same time, he obtains the withdrawal of American troops from Saudi soil with a low-profile ceremony attended by Secretary of State Colin Powell, where he presented the circumstance as an ordinary and absolutely positive development in their relationship with the United States. A relationship that, in the official statements, is jointly recognized as a stable priority for the security order of the entire Gulf region.

Nevertheless the relations between Washington and Riyadh are still the target of serious and circumstantial accusations from an increasingly broad political circle, where the actual effectiveness of the relationship between the two countries is openly disputed. In America there is a harsh debate on the need to renew an alliance with a partner of uncertain stability and, above all, frequently perceived as hostile, due to the growing anti-American sentiment of some radical Wahabite circles.

The Russian position on the American intervention in Iraq is just as pragmatic.

On one side President Putin disagrees on its necessity, highlighting the risks of such policy in such an unstable and troubled context. On the other hand he does not decide any tangible strategy to prevent or even only to make the American plan difficult to implement in political terms. The Russian economic interests, as relevant as the French ones in Iraq, become part of negotiations through a framework of relations with the United States. So essentially, Russia declares itself ready to reconsider its attitude in the area, in exchange for a greater openness of the West in considering Russian hydrocarbons as a privileged and safe source compared to the uncertain and unstable Middle Eastern option.

Not just that. Russia asked to take part in the "war against terrorism", underlining how it is a victim too in Chechnya and in other regions of Central Asia, not of autonomist and independentist groups, but of radical Islamic forces.

In such framework, it is therefore clear how Putin's Russia is willing to conquer a dual advantage in the complex and dynamic international relations system through the lever of energy sources. On one side Russia realizes that the energy production industry is the main and most promising warranty for economic development of the country. On the other hand a relations framework such as the one presented to the international community allows it to operate in a more radical and decisive way towards the protection of national integrity, reshaping the Chechen factor of instability as a mere terrorist problem.

The global oil market and the forecasts by consumers and producers

The global instability of the Nineties and the outbreak of the last three years have determined a general context of economic recession on a global scale, whose trend is still hard to predict.

The energy industry has obviously suffered, with a stagnant demand in the major industrialized territories, and with a policy by the producing countries which aims at keeping the price of oil close to the higher levels of the range. **This policy has allowed Russia and other minor producers, which have higher production costs, to play a greater role, eroding OPEC market share.**

We have also witnessed an early form of revision, specifically in the United States, of the global energy policies, with the introduction of the concept of long-term development criteria. It is therefore obvious how the diversification of energy sources and sourcing regions, together with the development of new forms of alternative energy is becoming an absolute priority for industrialized countries. To the detriment of the traditional group of producers, which are usually based on single-industry economic models. Models that are unable to react quickly to context changes.

Such condition therefore implies synergies among the weaker elements of the energy chain, the producers. This synergy can only be achieved by developing a new model which is not based on the control of global production amounts, which is impossible, but on oil price policies. A synergy among large producers, especially those which have higher operation margins on reserves, should not aim, as many fear, at forcing an energy crisis, but at levelling the price of oil at the lower end of the price range, targeting the 25 dollar per barrel limit. A strategy which is oriented towards the strengthening of the traditional players by preventing an unrestrained broadening of the market, and above all, capable of slowing down any technological effort for an alternative to hydrocarbons. A process, however, that will clearly become irreversible.

The Russian-Saudi deal on energy in the general framework of the national economies and on domestic politics of Russia and Saudi Arabia.

This is the general context in which the framework of the relations between Russia and Saudi Arabia has developed. A context where Russia's hydrocarbon production strategy is increasingly aggressive,

with volumes which are comparable and even in excess of the Persian Gulf's giant, with a freedom of action which Saudi Arabia, as a member of OPEC, cannot enjoy. There is an essential structural difference between the Saudi and the Russian energy systems. The former is clearly directly controlled and expressed by the royal political establishment, while the latter, after the Soviet disintegration, has moved out of the government's sphere of influence, turning into a private interest group controlled by few powerful oligarchs.

The recent history of the Russian oil market is that of a daring political manoeuvre which has, back in 1995, handed huge power on the national economic system to a small circle of young and wealthy entrepreneurs. With the "shares for debt" plan, the State had openly declared its economic fragility and would refer to the newborn Russian private entrepreneurship to raise on the market the much needed resources for the economic recovery. It is in this context that the privatizations took place and that a group of oligarchs no longer under direct control by the central authority gradually built up political ambitions conflicting with the President's.

This is the main reason for the long and harsh war between the Kremlin and the oligarchs. A war that has ended up in exile or bankruptcy of all the power centers openly or mildly inclined towards political interests and ambitions not perfectly compatible with President Putin's authority.

Many people today predict a political path that will bring back under public control those companies that were handed to the market at meagre prices in very difficult

times for the Russian economic system. A strategy which could contrast with the public image Russia wants to show of transparency and consistency, if carried out with sudden moves such as nationalizations.

Many analysts believe that the arrest of Yukos' Mikhail Chodorkovskij on November 25th 2003 is President Putin's last attempt to block the rise of leaders and political parties which may be financed by the Russian oligarchs. Not all oligarchs should however be treated indistinctly.

A part of this complex economic system does not show personal ambitions but only the will to preserve the status-quo, in order to limit the role of politics on the whole power system. A system which today will not allow the pre-eminence of the economic leadership over the political one, despite declaring itself liberalist, and that will not tolerate other strategies colliding with its own. The actions against the oligarchs are carried out using traditional means. The charge against Chodorovskij followed by his arrest for tax offences, which reminds of the one the United States implemented against the great gangsters, is carried out by the judiciary branch which President Putin describes as an independent authority of the State. A circumstance which rapidly produces negative counter-effects for the President himself, accused of acting against those who represent the main and most significant Russian economic entities.

Russia does not however focus only on domestic issues. President Putin in fact favours a very ambitious and innovative international policy. The main problem nowadays is to limit the effects of the clash with the national economic system, preventing if possible the flight of capital and instead encouraging foreign investment.

This is the framework around Russia's proposal to create an "energy common space" in Europe, together with the offer of listing the price of Russian oil in Euros, and the partially unexpected opening to Saudi Arabia through the definition of a cooperation agreement in the energy industry.

The September 2nd 2003 agreement

The one signed by President Putin and Prince Abdullah Ibn Abdul-Aziz Al Saud is a broad five-year agreement aiming at bi-lateral cooperation and development, in order to strengthen the relationship between Saudi Arabia and Russia in almost every field of the energy system. The real nature of the agreement, apart from the operational protocols which should generate short-term results such as the creation of joint-ventures, resides in the will of the two partners to build a cooperation hub in order to define common criteria in the production system and in the delivery of hydrocarbons. This fully addresses the market structure pursued by both players, through a system of synergies which, overlooking the critical relations of the past, may allow to join forces in particularly tense times for the two entities.

What has been described as "exchange of information on the global hydrocarbon market" is in fact an operational framework for the joint management of a strategy to limit and overcome the present negative energy market trend. A situation which is mainly due to the independent policies carried out in the past by both parties, which now results in a possible massive reduction of their production volumes in absence of some form of effective cooperation.

The wording "definition of mutual strategies in the joint interest of producing countries and the definition of more effective criteria of international stability in the energy market" has worried many Western analysts.

The threat of a new giant oil cartel – which could extend to gas – between Russia and Saudi Arabia reminds them of a new super-OPEC which may potentially display aggressive intentions and be unbound from the rigid model of the present organization.

What Russians and Saudis have actually agreed upon is presumably a joint rational cooperation which aims at preventing unnecessary and potentially damaging

conditions of competition on the market, in order to avoid frictions between producers which would benefit consuming countries alone.

According to the Russian Energy Secretary Igor Yusufov, the nature of the agreement would not be only corporative, in terms of the joint interests of the two countries, but aims instead at increasing the overall market stability in a particularly critical time for the system of international relations in the Gulf area.

The analysts' worries are certainly legitimate, but not to the point of fearing the setup of a maxi-cartel.

Russia accounts for about 60 billion barrels in proven oil reserves, with an average production volume of about 7.65 million barrels per day. Saudi Arabia has in stock proven oil reserves of about 260 billion barrels, with an average production of about 8.25 million barrels per day (according to OPEC quotas). The aggregate reserves and production for the two countries, in relation to the global figure, sets the share under their potential control at 30.5% and 21.7% respectively. On the gas side, Russia accounts for proven reserves of 1.680 Tcf and its production of about 555 Bcf. Saudi Arabia's proven reserves are about 225 Tcf and its production about 55 Bcf. In this case their aggregate shares on the global market are 31% for reserves and 24% for production volume.

The value in terms of market share of a Russian-Saudi joint-venture could therefore be assessed as a little less than a third of the global amount. Certainly a large share, but not enough to determine the development of an irreplaceable strategic hub.

If the strategy were to pursue a controlling policy aiming at fixing the oil price at the medium-high level of the range, a Russian-Saudi cartel could in fact trigger a chain reaction on the market where new regional players could enter and traditional ones could improve their competitiveness. With demand levels currently depressed, in a relatively short period of time this would result in the erosion of their market shares. In many occasions, the Saudi Oil Secretary Ali al-Nuaimi has reaffirmed the fact that the two countries speak the same language, being the optimal price range for Saudi Arabia between 20 and 28 dollars per barrel and 20 to 25 for Russia.

Saudi Arabia is therefore at least apparently tending towards the reestablishment of its role in the international political and energy context, shaped, even if obtorto collo on the prevalent security interests of the United States and of the West.

This is also true for Russia, which certainly is not in a position to start an “oil war” when its domestic political and economic conditions seem uncertain.

It can be however subject to further analysis whether the Russians and Saudis, jointly or individually, may have developed long-term plans based on their forecasts.

It's not unlikely that the two players may pursue different interests on the short term. Being aware that a cartel aimed at increasing the price of oil would be risky and ultimately fail, they could instead choose a low-price strategy – in perfectly traditional five-year OPEC style – which would defuse the risk of “out-of-area” investments in other countries which would result in a reduction of their sphere of influence.

On the other hand, a gradual and fine-tuned price decrease would encourage the strengthening of their respective positions, with the expectation to play a greater role in a near, less uncertain future, in absence of new competitors.

If the strategy of Russia and of Saudi Arabia is the one we have anticipated, their goals may only be achieved through sound and reliable control of their energy corporations and policies. If this is not a problem for Saudi Arabia, it definitely is for Russia where the power and independence of the oligarchs is an extremely risky variable.

It seems also very unlikely that any such plan may be adopted without the United States knowing and even approving.

The American vision in terms of sourcing security, in spite of all the imaginative conspiracy theories that have accompanied the unfolding of American politics in the

last few months, **is to guarantee freedom of access to the market, preventing the rise of virtual or real monopolies.** The United States want to prevent any form of critical disruption in resource access in order to preserve economic stability and encourage growth. Growth and stability which, despite the opposite beliefs of many critics of American policy, is the foundation and the main requirement for the growth and stability of the United States themselves.

Until the interests of Russia and Saudi Arabia will correspond to the American vision of guaranteed sources, the cooperation agreement between the two large players will be supported and facilitated by the USA.

It's in fact likely that the United States may have played an active role in the process of defining the historic deal, in the direction of a clear - but honourable – “surrender” of Saudi Arabia to the principle of cooperation with the West. A principle that in the Saudi context needs to be imposed cautiously through a gradual implementation process, in order not to upset the fragile balance of the undeferrable political, social and economic renewal of the country.

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