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Vershbow "Cautiously Optimistic" about Russian Energy Policy, June 17, 2003

(Remarks at U.S.-Russia Energy Summit Executive Seminar)

In the energy sector "there is a real commonality of interests" between the United States and Russia, Ambassador Alexander Vershbow told participants in the U.S.-Russia Energy Summit Executive Seminar in Moscow June 17.

"The United States is the world's largest energy consumer and is trying to diversify its sources. Russia has some of the world's largest deposits of energy resources. The goal is to make sure Russian oil companies can develop their resources and get their products to market," said Vershbow, the U.S. ambassador to the Russian Federation.

American companies can play a role by "providing the technical capability, the access to capital, and the international expertise that Russian companies need to become truly global companies, helping to advance and solidify Russia's integration into the international economy."

"There are good reasons to be 'cautiously optimistic' about the direction of Russia's energy policy," Vershbow said. "Electricity reform is underway and gas reform, while currently stalled at the starting gate, has at least been recognized as a priority by opinion-makers, business, and Russian policymakers."

Among other positive developments he cited "encouraging signs that the Russian Government will permit private companies to play a larger role in determining when and where pipelines are built. While this will not likely include private ownership of major export pipelines, private financing in exchange for preferred pipeline access or lower tariffs may be possible."

He said the United States welcomes Russian government support for a pipeline to Murmansk and is "pleased that companies, analysts and government officials are beginning to look at prospects for Russian exports of liquefied natural gas" through that Arctic port.

However, Vershbow also discussed some reasons to temper his optimism about Russian energy policy:

- The Caspian Pipeline Consortium (CPC): "There has been no decision to move forward to Phase 2 ... We also are concerned about past threats to declare CPC a natural monopoly, despite the guarantees written into its founding agreements. To ensure an attractive investment climate, federal regional and local authorities must respect the sanctity of agreements and contracts."
- Production-sharing Agreements: "PSA tax amendments passed by the Duma last month don't do enough to inspire international confidence in the stability and predictability of Russia's investment climate."
- Sakhalin Island Travel Restrictions: "New travel restrictions recently imposed on all non-residents on Sakhalin Island represent another example of a very mixed message being sent to investors in the Russian energy sector. ... In a spirit of cooperation and partnership, and for its own sake, Russia should rescind or modify these restrictions - and soon."

Among the items of good news mentioned by Vershbow in conclusion were last year's Houston Commercial Energy Summit and the establishment of a Commercial Energy Dialogue consisting of five "sub-groups" comprised of representatives of Russian and U.S. companies who have been working on various issues. They will present a report in September at the Commercial Energy Summit

in St. Petersburg containing policy recommendations for the two governments.

Following is Vershbow's speech as prepared for delivery:
(begin text)

U.S.-RUSSIA ENERGY COOPERATION - IN OUR MUTUAL INTEREST

Remarks by Alexander Vershbow U.S. Ambassador to the Russian Federation At the "U.S.-Russia Energy Summit Executive Seminar" Carnegie Institute Moscow Center June 17, 2003

Thank you very much for that kind introduction and thank you for giving me the opportunity to speak at this seminar on the important, and timely, subject of U.S.-Russian energy relations.

Energy is truly the bold new frontier of the 21st century for both America and Russia. Both of our peoples expanded the frontiers of their nations across whole continents - the Americans heading west across the Great Plains in the 1800s, and the Russians moving east. Both of our nations have brought forth great scientists and innovators: Edison and Mendeleev, Ford and Lomonosov, Franklin and Sakharov. Today, our astronauts and cosmonauts are working side by side, along with other nations, on the International Space Station.

And over the past few years we've seen Americans and Russians make bold advances in the field of energy development as well, working together to tap the natural resources that lie beneath the earth in Siberia and on the seafloor off the coast of Sakhalin. Our scientists are also leading the world in developing the next generation of energy technologies. This leadership was recognized on Sunday night, when President Putin presented the first annual "Global Energy" prize to three scientists, one from Russia and two from the United States, who are pushing the technological envelope.

Presidents Bush and Putin have placed energy high on the U.S.-Russian agenda. Since their first summit meetings in 2001, energy issues have figured prominently both in high-level discussions and in my Embassy's day-to-day engagement with representatives of the Russian Government and Russian energy companies. As we approach the next Commercial Energy Summit, which Russia will host in St. Petersburg toward the end of September, I'd like to give you the view from my desk in the Embassy of what has been achieved so far, what we still hope to accomplish, and the prospects for reaching our final destination.

The energy sector is clearly an area where there is a real commonality of interests between our two countries. The United States is the world's largest energy consumer, and is trying to diversify its sources. Russia has some of the world's largest deposits of energy resources. The goal is to make sure Russian oil companies can develop their resources and get their products to market. U.S. companies can definitely play a role here, providing the technical capability, the access to capital, and the international expertise that Russian companies need to become truly global companies, helping to advance and solidify Russia's integration into the international economy.

Stronger energy ties, and stronger economic ties more generally, can also strengthen the overall bilateral relationship. From time to time, the United States and Russia will continue to have differences on important issues. But if we can give each side a stronger stake in the relationship through expanded trade and investment, it can help keep the overall relationship on track through good times and bad. Despite all of the recent frictions between the United States and some of its European Allies over Iraq, for example, the network of interlocking relationships and interdependencies between the United States and Europe is so extensive, and runs so deep, that it makes it much less likely that political disagreements will affect the basic foundations of our relations.

I can't say the United States and Russia have reached the point where our energy cooperation is strong enough to play this role single-handedly, but we have made great progress. Several large and medium-sized U.S. oil and gas and oilfield service companies are either working in Russia, or actively

seeking to participate in projects here. In turn, several Russian companies either have or are pursuing downstream assets or marketing arrangements in the United States.

Meanwhile, representatives of U.S. and Russian companies are working together within the framework of the Commercial Energy Dialogue, identifying existing obstacles to bilateral energy trade and investment, and proposing ways of eliminating those obstacles. At the same time, officials from the U.S. Department of Energy and Russia's Ministry of Energy are pushing forward on our government-to-government dialogue on energy and are cooperating on a range of technical and policy issues, ranging from power sector regulation to oil spill prevention and response, to coordination in gathering and analyzing energy statistics.

How will we know when we have succeeded? I think one sign will be when U.S. and Russian companies have equal access to each other's markets - when U.S. companies can compete for Russian projects on an equal footing with Russian companies, and when the term "Russian oil company" no longer implies a company whose shares are less highly valued than those of its western competitors.

To use a well-worn diplomatic cliché, there are good reasons to be "cautiously optimistic" about the direction of Russia's energy policy. The policy battles continue, but electricity reform is underway and gas reform, while currently stalled at the starting gate, has at least been recognized as a priority by opinion-makers, business, and Russian policymakers.

Meanwhile, there are signs that Russian Government officials are beginning to recognize that it is in the national interest to address the shortage of oil export pipeline capacity. Expansion of the Baltic Pipeline System and construction of the Angarsk-Daqing and Western Siberia-Murmansk pipelines are the most prominent of a number of planned expansions of the trunk pipeline system. And there are encouraging signs that the Russian Government will permit private companies to play a larger role in determining when and where pipelines are built. While this will not likely include private ownership of major export pipelines, private financing in exchange for preferred pipeline access or lower tariffs may be possible.

A word about the Western Siberia-Murmansk project. In their joint statement last November, President Putin and President Bush welcomed the prospect of constructing a deepwater port for energy exports. Consequently, we welcomed the fact that, in its new long-term energy strategy, the Russian Government supports the concept of a pipeline to Murmansk - an ice-free, deepwater port. Construction of the pipeline and terminal will fulfill the promise of this initiative. A Murmansk oil terminal would be ideally located to facilitate direct exports to the United States, as well as to European markets, 12 months a year. Shippers could also avoid the delays and heightened safety and environmental hazards that attend shipping through the Bosphorus or the Danish Straits.

Murmansk could also be a hub for Russia gas exports, given the sizeable gas reserves in the Arctic, both onshore and offshore. We are pleased that companies, analysts and government officials are beginning to look at prospects for Russian exports of liquefied natural gas (LNG). We see a growing demand for LNG worldwide and, in particular, in the United States. It is no longer a "pipe dream" - pun intended - to imagine a world market for LNG, with multiple buyers and sellers. Russia - particularly a Russia with a restructured gas industry featuring many producers and sellers - would be well placed to thrive in such an environment. We can easily envision sizeable LNG exports from Murmansk and Sakhalin being sold on both U.S. coasts and in both Asia and Europe.

What makes both concepts attractive - the Western-Siberia-Murmansk oil pipeline and the idea of Murmansk as an LNG hub - is that they both are stories of diversity of supply and, therefore, of strengthening energy security. We are accustomed to the arguments from the perspective of large energy-consuming countries like the United States. It is prudent policy to avoid excessive reliance upon a single oil supplier or on several suppliers in a particular region. Likewise, relying on a mix of energy sources - oil, gas, coal, renewables - provides some protection against a possible disruption in supplies of one of those sources.

But diversification is equally important for major energy exporters like Russia. Most of Russia's current energy exports run either south, through the Bosphorus (which is increasingly congested), or west. Shipping oil and gas north can open up new markets and provide alternatives in the event of constraints or disruptions on Russia's traditional routes. Similarly, adding LNG exports to exports of crude oil and exports of gas via pipeline would give Russia added security as an energy provider. A three-legged stool is much more stable than a two-legged stool.

Let me also note that, as President Bush has said, we welcome cooperation with Russia in Caspian energy, yet another non-traditional area that could show real promise in expanding the horizons for our energy partnership.

So energy security and energy diversity are important both to net energy-exporting countries and to net energy-importing countries. And Russia and the United States can directly address each other's energy security needs. But we don't see energy security as simply a bilateral issue. Nor does Russia. I think this accounts for Russia's enhanced cooperation with the International Energy Agency (IEA), an organization whose core mission is to promote world energy security. Both Russia and the members of the IEA recognize the critical role that Russia can play in strengthening world energy security. That is why IEA members welcomed the participation of Russian Energy Minister Yusufov at their recent meeting in Paris.

We don't delude ourselves into thinking that all of those involved in energy are making grand calculations about strengthening national or world energy security. The companies, particularly the private companies, are calculating what moves will increase their profits and enhance shareholder value. This year, we have welcomed the successful partnerships between Russian oil companies and U.S. oilfield service companies, Marathon Oil's reentry into Russia with its purchase of KMOC and its holdings in western Siberia, and the launch of the next phase of the Sakhalin-1 project. We hope these successes presage deeper cooperation between U.S. and Russian companies.

Over the past few months we also have witnessed two large mergers in Russia. We hope that the creation of TNK-BP and YukosSibneft will help break down the barriers that have separated Russian oil and gas companies from their international counterparts. We also hope that the same dynamism, the same entrepreneurial spirit that prompted these deals will help foster an open, competitive environment in which small and mid-sized oil companies and new entrants to the market can flourish as well. We have a similar view of the gas market. The more competition the better.

However, in looking at Russian energy developments, I note that we see reasons to be "cautious" as well as "optimistic." To date, there has been no decision to move forward to Phase 2 of the Caspian Pipeline Consortium (CPC), which would expand the capacity of the pipeline to accommodate an expected increase in oil exports from Kazakhstan, plus oil from Russia, too. We also are concerned about past threats to declare CPC a natural monopoly, despite the guarantees written into its founding agreements. To ensure an attractive investment climate, federal, regional and local authorities must respect the sanctity of agreements and contracts.

Indeed, investors prefer stability or, at least, predictability. For some time now, the U.S. Government has promoted production-sharing agreements (PSAs) as a means of promoting development of certain difficult fields. So we are concerned that the PSA tax amendments passed by the Duma last month don't do enough to inspire international confidence in the stability and predictability of Russia's investment climate. Much is at stake. The unique economic and technological challenges of developing many large projects - projects that are needed to ensure that Russia can sustain its role as a growing and reliable supplier of energy to world markets - require a new approach from the Russian side that is more inviting to the potential investor.

Along the same lines, from time to time, we hear of investigations or threats to withdraw development licenses held by companies - often foreign companies. It isn't clear what objective standards are being

used. Companies need to see greater transparency in the system, as well as a fair and even application of rules and regulations at the local and federal level.

Sometimes problems arise that surprise us. New travel restrictions recently imposed on all non-residents on Sakhalin Island represent another example of a very mixed message being sent to investors in the Russian energy sector. Sakhalin is one of the most promising areas for oil and gas development in Russia, and could become the home to 15,000 or more expatriate workers and their families in the coming years. Yet the Governor of Sakhalin issued a decree imposing onerous restrictions on travel outside the capital by non-residents, especially foreign visitors. The restrictions and delays are particularly burdensome for foreign oil and gas companies that employ many short-term, expatriate workers (as well as local residents) in developing their projects - projects that will enable Russia to become a major exporter of energy to Pacific markets. In a spirit of cooperation and partnership, and for its own sake, Russia should rescind or modify these restrictions - and soon.

The fact that domestic gas prices in Russia are set well below their economic level has become an issue in Russia's accession to the World Trade Organization (WTO). We welcome the Russian Government's recently announced plans to take certain steps, such as raising the regulated tariffs for natural gas on the domestic market. However, across the board, Russia should strive to create a level playing field of competition in the production of gas by independent producers selling gas at market-determined prices.

Back to the good news and the theme of this seminar, the "U.S.-Russian Energy Summit." Last year's Houston Commercial Energy Summit brought together two U.S. Cabinet Secretaries, two Russian Ministers, and hundreds of U.S. and Russian business leaders. It was a spectacular event, in which some of the most significant discussions took place, informally, among the private sector participants. Some even took place while pitching horseshoes and cowpies. That part may not be easily repeated, but we don't view Houston as a one-time event. It was meant to be a catalyst for enhancing the dialogue between U.S. and Russian companies.

With this in mind, the two Governments committed to establish a framework for this dialogue - the Commercial Energy Dialogue, which was established last December. Since then, as with the Russian-American Business Dialogue, the private sector has been in the driver's seat of this new initiative, with governments largely in the background. Five "sub-groups" comprised of representatives of Russian and U.S. companies, each with both Russian and U.S. co-chairs, have been working steadily since December. With the help of a Steering Committee, ably co-chaired by Andrew Somers of the American Chamber of Commerce and Arkadiy Volskiy of the Russian Union of Industrialists and Entrepreneurs, the participants are developing a report containing policy recommendations for the two Governments. They hope to present this to U.S. and Russian government representatives at the St. Petersburg Commercial Energy Summit in September. The Governments will then have clear guidance from the companies on what is needed to enhance bilateral cooperation and energy trade and investment.

I've spoken of energy cooperation so far primarily in commercial terms and primarily in terms of oil, gas, and electricity, but there is a broader framework. Opportunities for bilateral cooperation exist in the production, trade and use of other energy resources, such as coal and renewables. President Bush has announced a new initiative, inviting other countries to join the United States in developing hydrogen as an energy source. In response to the President's call, we are beginning to engage with our Russian counterparts on ways to make this clean fuel source widely available and commercially viable. We also hope to strengthen our cooperation on energy-related environmental issues, such as clean coal technology and carbon sequestration.

Energy is not the only area of expanding U.S.-Russia cooperation. Our common interests extend to the war against international terrorism, preventing or countering the proliferation of weapons of mass destruction to countries like Iran and North Korea, combating other transnational threats like narcotics trafficking and organized crime, and joining forces to fight infectious diseases like HIV/AIDS and to

promote sustainable development in the third world. If in the past we sought to manage a confrontational relationship through arms control, today we are discussing ways to meet common threats together - by cooperating on missile defense, building a real partnership between NATO and Russia, or forging close links between our intelligence services and law enforcement agencies.

The bilateral agenda will naturally change and evolve over time. But given the mutual interests of Russia and the United States, we can expect to continue to explore opportunities for closer cooperation on energy and countless other subjects for many more years to come.

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