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Hearing on U.S. Energy Security: Russia and the Caspian

Testimony of

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President

American Chamber of Commerce in Russia

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Senator Hagel, on behalf of the 700 member companies of the American Chamber of Commerce in Russia operating in the Russian market, I would like to express our appreciation for this opportunity to testify on U.S. Energy Security: Russia and the Caspian.

A brief word about the American Chamber, known in Russia by the acronym "AmCham". We are an independent, self-funded business advocacy organization with offices in Moscow and St. Petersburg. Our mission is to promote trade and investment between the U.S. and Russia in order to maximize sustainable penetration of the Russian market by our member firms. To achieve this objective we are engaged in an on-going, and we believe, effective dialogue with all relevant organs and levels of the Russian government and the most influential representatives of the Russian private sector. We benefit greatly from the new U.S.-Russia strategic relationship which has emerged under the leadership of President Bush. In this regard I should acknowledge in particular the vital support of AmCham by U.S. Commerce Secretary Donald Evans and the U.S. Ambassador to the Russian Federation Alexander Vershbow.

It is in the interests of American business for Russia to continue its re-emergence as a major oil producer and to gain a significant share of the U.S. oil import market. As the U.S. Department of Commerce held last June after an extensive public inquiry, Russia has succeeded in making the difficult transition to a market economy. Moreover, this fundamental change in the character of the Russian economy has occurred within a new democracy, an historic transformation in itself. American business prospers best in democratic market economies. By allowing such an important sector of the Russian economy to contribute with other oil-producing nations to meeting U.S. energy needs, the U.S. would help to globalize the Russian economy and stabilize these positive developments.

For the U.S. to make such a commitment requires, of course, a judgment that Russian oil is a viable option for diversifying foreign-sourced energy supply to the U.S. In our view 3 factors should be considered when making this determination:

1). Transportation infrastructure.

2). Production and reserves.

3). The investment climate.

1. <u>Transportation Infrastructure</u>:

a) <u>Current export constraints</u>.

It is an incontrovertible fact acknowledged by all parties operating in the Russian oil sector that Russian oil is export constrained. Current production far exceeds both local demand and the capacity of the

Russian state oil transport system, Transneft. As a result local oil prices are depressed and the volume of crude available at export points is significantly compromised. An additional negative effect is the decline in profitability of small independent oil companies who must sell at low prices and lack the refinery facilities common to the majors for the production and sale of secondary oil products at a reasonable markup. With Duma elections ahead in the fall and the Presidential elections looming in the spring of 2004 it is perhaps not surprising that no vigorous steps have been taken to relieve the pipeline clog and risk an increase in domestic oil prices. However, for Russia to be a viable import option, substantial improvement of the current oil transport infrastructure is imperative.

b) Future export constraint relief.

Two important features of the current Russian oil environment suggest that relief for Russia's export constant problem could be on the way in the relative near term. I have in mind the existing Caspian Pipeline and the proposed Murmansk Pipeline project.

b(i) Caspian Pipeline. Russia has already taken a significant step toward the enhancement of its oil export capability. A 24 % majority shareholder in the Caspian Pipeline Consortium ("CPC"), in which U.S.-owned Chevron Caspian Pipeline holds the largest private sector stake of 15 % and Mobil Caspian Pipeline owns 7.5%, Russia can use the pipeline to quickly increase its oil exports. Operational since late 2002, the initial stage of the Caspian Pipeline delivery system involves shipment from the Tengiz oil field in Kazakhstan on the north-east shore of the Caspian through almost 1000 miles of Russian territory to the Black Sea port of Novorossisk. If the Russian state oil transport system Transneft builds a 40-mile trunk line connecting its network to the Caspian Pipeline at the Russian city of Kropotkin, where CPC has already constructed the necessary pumping facilities, Russia's export capacity on the Caspian Pipeline could be increased by 150,000 barrels of oil per day in 6 months and by 300,000 barrels of oil per day within 2 years. As yet Transneft has given no indication it plans to build this trunk line.

b(ii) Murmansk Pipeline Project. Due to Transneft's failure over the past several years to add capacity to Russia's oil transport infrastructure, substantial private investment is needed. Several Russian oil majors recently proposed the construction of a pipeline from Western Siberia to the northern city of Murmansk, a deep-water, ice-free port. Private Russian capital would cover the cost of this several billion dollar investment, which would include renovation of the port. Proponents of the project see it as the gateway to the U.S. market, estimating that the cost of transport to the American east coast would be comparable with that from the Middle East. Initially the Russian government balked at the concept of private ownership of the pipeline but more recently indications of a compromise solution have emerged. Some Western analysts estimate that Murmank export capacity could reach one million barrels of oil per day. Given the commitment and resources of the Russian majors and the lack of a governmental plan for substantially increasing infrastructure, the Murmansk Pipeline project may well be the long term solution to export constraint.

2. <u>Production and Reserves:</u>

Russia's primary source of oil production is Western Siberia, with a volume of 7.4 million barrels of oil per day, of which about 1/3 is exported by pipeline, and another 1/3 exported as fuel oil by rail, a very costly method of transportation. Western estimates see this level of output from Western Siberia continuing for the next several years and then declining. For this reason a number of Western experts urge that Russia start developing major new reserves on both the Eastern and Arctic Continental Shelf and Eastern Siberia. Several such projects with foreign investment are already underway off the coast of Russia's Sakhalin Island. The Sakhalin projects are beneficiaries of so-called Production Sharing Agreements ("PSAs"). PSAs are intended to provide investors in long-term projects, remote from infrastructure, with a certain degree of predictability concerning taxes and fees over the 20-30 year period required to make the project fully operational. PSA legislation to cover some projects but exclude others is now pending in the Duma and probably will pass into law this spring.

Some Russian private sector sources are more optimistic about Russia's reserves and see little need for PSAs. Yukos, now the world's fourth largest oil company recently asserted that reserves are sufficient to assure the extraction of oil in Russia over the next 30 years at levels of 9-10 million barrels per day, with an export capacity of 6-7 million barrels per day. A strong proponent of the Murmansk project to resolve the export constraint problem discussed above, Yukos claims that Russia can supply 15 % of U.S. oil imports with an estimated range of 1-2 million barrels of oil per day.

A word on the Russian Caspian: estimates put Russian Caspian recoverable oil at about 3 billion barrels, or less than one 10th of the resource base of Kazakhstan. The geology of the Russian Caspian is very different from the Kazakhstan Caspian. The Russian Caspian eventually may provide 400,000-500,000 barrels per day, a not insignificant volume.

3. <u>The Investment Climate:</u>

There can be little doubt that the investment climate in Russia has significantly improved during the Putin years. Political stability, fiscal discipline, 3 successive years of constant GDP growth, including a stunning 6.4% GDP growth for the first quarter of 2003 testify to Russia's emergence as a strong investment candidate. American companies operating in the Russian marketplace are experiencing strong annual growth in revenues, market share and profit margins, with the Russian operations of some U.S. global companies outperforming all other units worldwide. In the energy sector the enormous potential for fruitful cooperation between the two counties is reflected by the creation of the government-to-government U.S.-

Russia Energy Dialogue, which had its first summit in Houston October 2002 and has scheduled the second summit for St. Petersburg in September. Of equal significance is the private sector Russian American Commercial Energy Dialogue. Comprised of 5 working groups of American and Russian energy company executives, the Commercial Energy Dialogue will identify barriers to trade and investment and make concrete recommendations to both governments to facilitate commerce in the energy sector.