EUROPEAN AND EURASIAN ENERGY: DEVELOPING CAPABILITIES FOR SECURITY AND PROSPERITY

HEARING

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EUROPEAN AND EURASIAN ENERGY: DEVELOPING CAPABILITIES FOR SECURITY AND PROSPERITY

THURSDAY, JUNE 2, 2011

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON EUROPE AND EURASIA,
COMMITTEE ON FOREIGN AFFAIRS,
Washington, DC.

The subcommittee met, pursuant to notice, at 2:30 p.m., in room 2172, Rayburn House Office Building, Hon. Dan Burton (chairman of the subcommittee) presiding.

Mr. BURTON. The committee will come to order.

I apologize to you, Ambassador, as I said a moment ago, because my Democrat colleagues are at the White House discussing the debt limit and other things. We did that yesterday. So, hopefully, they will be coming back here pretty quickly.

Unfortunately, because of issues that are hot and moving right now, I will have to go to a meeting with our leadership in just a few minutes. So my staff and my colleagues will be here, and I will go through all of your testimony and come back as soon as I meet with them.

For decades, energy and energy security have been global concerns. All economies, developed and developing, need reliable, affordable, and secure sources of energy to drive economic growth. As more nations join the cadre of developed countries, demand for energy continues to rise and the search for reliable energy and stable sources grows further.

Everyone needs energy, but it has become rare for countries to develop domestic sources because of safety and environmental concerns. This "not in my backyard" mentality has allowed Russia, North Africa, and the Middle East to become primary providers of energy. And we are very concerned about this because we are not doing what we need to develop reliable energy sources real quickly and we are becoming more energy dependent on other countries. Reliance on such unstable foreign sources of energy puts U.S. and European economies at risk. As we have all witnessed in a very real way this year at the gas pump, any time there is a global security scare, real or predicted, including terrorist attacks and civil unrest, the cost of energy in global markets dramatically increases.

Under this administration, the United States exemplifies this unhelpful "not in my backyard" mentality. We refuse to drill offshore, we refuse to drill in Alaska, and we refuse to embrace new technology such as hydraulic fracturing to extract large deposits of

oil and gas from shale. Instead, the United States chooses to rely on unstable foreign sources of energy, including regimes dedicated to advancing the polar opposites of our democratic ideals. Hypocritically, we ask our foreign partners to increase production using the same technology and innovation we ourselves scorn.

This must change. We should not ask European and Central Asian countries to adopt policies and build infrastructure that we are not willing to put in place on our own soil. We cannot ask our partners to drill, build pipelines and operate nuclear power plants if we are unwilling to do so here at home. Furthermore, we should not support ventures that further enrich bad actors in Europe and around the globe; for example, plans to connect Iranian energy with Western consumers. Every dollar that we spend on energy from such sources is a dollar given to anti-Western and anti-democratic radicals.

Europe's energy future is uncertain. Germany and Switzerland appear to share our "not in my backyard" mentality. In the wake of the emergency at Fukushima, both countries have announced their intention to forego nuclear development. Germany alone has recently announced that they will shutter 17 reactors by 2022. As a result, these countries will be more reliant on energy from Polish coal plants, Russian gas, and Czech nuclear plants. Meanwhile, Russia uses Europe's dependence on Russian gas to hold the region hostage. Just this week, Ukraine again opened discussions with Russia to have natural gas prices lowered. These talks come less than 2 years after Russia cut supplies to Ukraine, bringing the country's economy to a halt.

For over 10 years, we have heard of the development of the Nabucco pipeline and its ability to connect Western Europe with diverse energy sources in Central Asia and the Middle East. However, continuous delays have pushed back the forecast completion date for this project to 2017. Negotiations over transit rights have hampered the project, while historic disputes between neighbors poison discussions and prevent resolution.

In addition to Nabucco, proposed projects, including the Trans-Caspian gas pipeline, the Trans-Adriatic pipeline, the Arab gas pipeline, and other pipelines connecting Central Asia with the Balkans, all have potential to provide Europe with diverse sources of energy. The North Stream and South Stream projects, which will connect Europe to Russia, are also in development. All of these proposals represent progress toward a Europe that relies on diverse sources of energy. However, we must be cautious and ensure that Europe and its partners enact these projects in a fair and transparent manner, open to all investors.

All of these projects are of interest to the United States, as they will stabilize global energy prices. And we really need that. These projects also present opportunities for American investors. The U.S. Government should work to guarantee that American companies can access these new markets and projects in a free and fair manner. The proposed European, Eurasian and Central Asian pipelines also provide exporting countries with new sources of revenue. This income must be used to develop infrastructure, support democratic governments and build strong civil societies.

Central Asia, the Caucasus and the Middle East are all experiencing instability as people seek basic human rights, economic reforms and true democracy. Accordingly, the United States must work with these partners to increase transparency, the rule of law, free and fair elections and good governance. We must be careful to ensure that European and American investment strengthens democracy instead of weakening it by filling the Swiss bank accounts of autocratic leaders with the money they use to prop up their regimes.

American energy policy should be seamless at home and abroad. Our goals overseas should be our goals here in the States. Instead of the "not in my backyard" mentality, the United States and Europe must develop an all-of-the-above policy that combines economically viable sources of renewable energy with environmentally responsible development of fossil fuels. Moreover, we should achieve understanding with our closest European partners that a diversified energy market will protect economies from unwanted political influence and increase connections between like-minded nations.

The United States and our European partners have made considerable investments in the energy sector. We must not allow our cooperation to fragment during critical negotiations. The United States and Europe must continue to cooperate with Eastern Europe and Central Asia to achieve a diversified energy market. Only a transparent and diversified energy market will perpetuate transatlantic security and prosperity.

Now, my minority colleague is here in spirit but he is not in body. He is down at the White House. I am sure when he gets back he will have an opening statement.

At this time I will recognize my colleague from the great State of Arkansas to chair the committee in my absence, and I will be back shortly.

[The prepared statement of Mr. Burton follows:]

Remarks of the Honorable Dan Burton, Chairman
Subcommittee on Europe and Eurasia
Committee on Foreign Affairs
U.S. House of Representatives

Hearing on: "European and Eurasian Energy: Developing Capabilities for Security and Prosperity"

June 2, 2011

For decades, energy and energy security have been global concerns. All economies, developed and developing, need reliable, affordable, and secure sources of energy to drive economic growth. As more nations join the cadre of developed countries, demand for energy continues to rise and the search for reliable energy and stable sources grows further.

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This must change. We should not ask European and Central Asian countries to adopt policies and build infrastructure that we are not willing to put in place on our own soil. We cannot ask our partners to drill, build pipelines, and operate nuclear power plants if we are unwilling to do so here at home. Furthermore, we should not support ventures that further enrich bad actors in Europe and around the globe; for example, plans to connect Iranian energy with Western consumers. Every dollar that we spend on energy from such sources is a dollar given to anti-western and anti-democratic radicals.

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All of these projects are of interest to the United States, as they will stabilize global energy prices. These projects also present opportunities for American investors. The U.S. government should work to guarantee that American companies can access these new markets and projects in a free and fair manner. The proposed European, Eurasia, and Central Asian pipelines will also provide exporting countries with new sources of revenue. This income must be used to develop infrastructure, support democratic governments, and build strong civil societies. Central Asia, the Caucuses, and the Middle East are all experiencing instability as people seek basic human rights, economic reforms and true democracy. Accordingly, the United States must work with these partners to increase transparency, the rule of law, free and fair elections and good governance. We must be careful to ensure that European and American investment strengthens democracy instead of weakening it by filling the Swiss bank accounts of autocratic leaders with the money they use to prop up their regimes.

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Mr. GRIFFIN [presiding]. I recognize the gentlelady for an opening statement.

Mrs. SCHMIDT. Thank you, Mr. Chairman, and thank you for holding this hearing on an issue that perhaps does not receive enough attention, but is extremely important, given the uncertain nature of the energy sector in today's global economy.

Mr. Chairman, I believe it is in our national security and economic interests to promote a stable environment in Europe and Eurasia, particularly with regard to the production, transportation and availability of oil and natural gas. With global oil consumption on the increase, particularly with the huge surge in demand from developing countries like China, India and Brazil, it is of utmost importance that we work with the European Union, Russia, Ukraine and other countries of Central and Eastern Europe to help them maximize their oil and natural gas production and distribution.

When one understands that approximately 85 percent of all oil exported from Russia is consumed by European countries, many of whom are our active NATO partners in the war on terror, it becomes very obvious as to why we need to be involved in helping this region of the world with development and security of its energy capabilities. While many of the Eurasian countries such as Azerbaijan and Kazakhstan hold the promise of increased oil and natural gas production, they are prevented from realizing this objective due to governmental and bureaucratic corruption, economic uncertainty and the lack of open and transparent decisionmaking.

Beyond production, however, is the matter of transportation. Oil and natural gas are no use to anyone if they cannot be transported to the market where they are needed so the people who need it can purchase it. Pipeline development is therefore essential to and a necessary component of the increased production of oil and natural gas in Eurasia.

Whether it is the development of the North Stream pipeline, the South Stream pipeline or the Turkey-Austria pipeline, increased and improved infrastructure is necessary if Eurasia is to increase its energy sector.

Mr. Chairman, I look forward to the testimony of our witnesses and to learn more about this important issue.

I yield back my time.

Mr. GRIFFIN. Would the gentleman wish to make an opening statement?

Mr. MARINO. Yes, sir. Thank you, Mr. Chairman, and I want to thank our witnesses for participating.

Emerging economic powers like China, India and Brazil consume more and more of the world's energy resources every day, which is steadily increasing international demand. This increased demand coupled with the continuing instability in North Africa and the Middle East has only put additional pressure on the world's energy supplies. As we look to secure our own energy and economic future, I believe it is essential that we reduce our dependency on energy resources imported from overseas by exploring all of our domestic energy capabilities, and that includes not only fossil fuels, but nuclear, solar, wind and other renewable energy sources as well.

Today, our counterparts in Western Europe find themselves in a similar position, dependent on relatively unstable and unpredictable partners for the energy resources needed to power their economies and largely unwilling to take advantage of domestic resources.

As Europe reevaluates its energy policy and security, there is increasing reluctance to increase drilling and to construct additional nuclear power plants. Recently, German Chancellor Angela Merkel backed proposals to shut down all of the country's 17 nuclear power plants within a decade.

Interesting, though, the United States has the capacity to be a large part of the energy solution for Western Europe. Increased interest in unconventional natural gas production on both sides of the Atlantic holds great promise, accounting for nearly 25 percent of our domestic natural gas production, and Western Europe nations which had been overly reliant on Russia for natural gas are evaluating whether to develop their own substantial shale gas resources.

In addition to enormous shale gas reservoirs in places like Poland and the Ukraine, my Congressional district, the 10th District of Pennsylvania, sits atop a large portion of the Marcellus Shale, where natural gas is being produced. I am already familiar with many of the positive benefits that the unconventional gas drilling industry can yield. To date, there has been a huge amount invested in and around my district to develop the industry and the accompanying infrastructure. This investment has brought good jobs to our area at a time when Pennsylvania needs them the most.

As Pennsylvania strives to develop the best practices and become the architect for the unconventional gas industry in America, I am particularly interested in how knowledge of gas development, the tools and techniques used to extract gas in the most environmentally accepted manner, as well as new uses for gas for transportation, fuel for example, can be shared on both sides of the Atlantic to ensure a more energy independent future in both the United States and our European allies.

If European nations move forward with exploration of their unconventional gas reserves as part of a greater plan for energy security and to reduce its reliance on imported oil from Russia and the Middle East, it will likely have a positive impact on the overall international price of natural gas and could yield economic benefits for the United States. Furthermore, as these nations develop the expertise and infrastructure necessary to grow and expand the unconventional gas industry, they will likely continue and increase their reliance on American firms that already have the knowledge and the capability to do so and further intertwine our common economic and energy interests going forward.

Finally, as the production of natural gas increases in the United States, and particularly in the 10th Congressional District of Pennsylvania, we can begin to export resources to Western Europe as a reliable and stable source to meet their energy needs.

Again, thank you, Chairman, for calling this hearing, and I look forward to hearing from our esteemed panel and witnesses about this issue.

Mr. Chairman, before yielding, I would like to ask unanimous consent to enter into the record a recent piece from the Foreign Af-

fairs Magazine that provides an interesting look at how unconventional gas development here at home could have major positive effects in Europe.

Thank you.

Mr. GRIFFIN. Without objection. Thank you.

I recognize myself for 5 minutes to give an opening statement, and then we will get to you, Mr. Ambassador.

I want to thank Chairman Burton for holding this hearing today. We have a lot of natural gas in the Second Congressional District of Arkansas and we are very concerned about domestic energy policy, but also what is going on in Europe and how it is going to impact us. Also I would like to thank in advance all the witnesses for coming and testifying today and look forward to hearing your testimony.

Everything we produce in this country requires energy, and any time energy costs go up, we are paying more—at the supermarket and the department store and at the pump. There are a lot of factors that determine the price we pay at the pump, but one thing is clear, that we could be doing more to lower the price of gas, lower the price of energy in this country.

The President has instituted a series of policies that I believe has reduced American-made energy production and the result has been higher prices and fewer jobs. The administration has systematically locked up the entire Atlantic Coast, the Pacific Coast and much of Alaska, preventing the creation of an estimated 1 million jobs. This administration imposed a real and then de facto moratorium on drilling in the Gulf of Mexico, which according to their own estimates cost approximately 12,000 jobs. According to the U.S. Energy Information Administration, production in the Gulf has declined by nearly 300,000 barrels of oil a day since last April.

This lack of a commitment to energy production in our own backyard is sending the wrong signal to our allies in Europe and Eurasia. According to an analyst from an energy market firm, for every penny the price of gasoline increases, it costs consumers an additional $4 million per day. That equals $1.4 billion over an entire year. Even the smallest increase in gasoline prices has a significant impact on our economy. That means that instability in Europe's energy security has a negative impact on global energy prices and in turn how much Americans pay at the pump. Worse, the United States chooses to rely on foreign sources of energy in unstable areas of the Middle East, including from regimes dedicated to advancing anti-democratic ideals.

Unfortunately nothing is happening fast, and in some cases European countries are going in the wrong direction. Nuclear plants in Germany and Switzerland are now set to be dismantled, and this will further strain markets for non-renewable energy sources. Eastern Europe is still heavily dependent on Russian energy, which disallows a full disconnect from Moscow's political pressures, as evident in the Russian showdown and continued moderation of gas loads to Ukraine from 2005 to 2009. Political pressure from Moscow is prevalent throughout the region. Regional reliance on a sole supplier makes countries vulnerable and subservient to that provider. In turn, this destabilizes the entire region and makes Western investment riskier.

Energy production in Europe and Eurasia presents opportunities for American investors. We should ensure that American companies can access these new markets and projects through free and transparent market systems. I agree with the chairman that the U.S. must institute and promote an all-of-the-above approach to energy, not only at home but also in expanding markets throughout the world.

Thank you. I will now introduce our first witness.

Richard L. Morningstar is the Secretary of State's Special Envoy for Eurasian Energy. Appointed by Secretary Clinton, he was sworn in on April 6, 2009. From June 1999 to September 2001, Ambassador Morningstar served as United States Ambassador to the European Union. Prior to this, Ambassador Morningstar served as Special Adviser to the President and Secretary of State for Caspian Basin Energy Diplomacy, where he was responsible for assuring maximum coordination within the executive branch and with other governments and international organizations to promote United States policies on Caspian Basin energy development and transportation.

Thank you very much for being with us today. Go right ahead, Ambassador.

STATEMENT OF THE HONORABLE RICHARD L. MORNINGSTAR, SPECIAL ENVOY FOR EURASIAN ENERGY, U.S. DEPARTMENT OF STATE

Ambassador MORNINGSTAR. Thank you very much, Mr. Chairman. It is a great pleasure to be here today. I appreciate it very much, hearing all of your comments, and I hope that between my written testimony and oral testimony and answering your questions, that I can respond to many of the points that you made.

I have submitted detailed written testimony that I would like to ask to be made part of the record. So I will lead off today with an overview of our strategy to leave time for your comments and questions. I am also happy that three good friends will be testifying in the second round after I finish. They will all have their own views. Some of them may be different, but I am sure that they will add very much to what you are trying to accomplish here today.

Let me start off by discussing first what is our Eurasian energy strategy. There are three main components.

First, we encourage the development of new sources of oil and gas and the adoption of clean and efficient energy technologies. As we have seen and as you have mentioned in the past few months from events in North Africa and the Middle East and the nuclear crisis in Japan, the global and regional energy security picture can change literally in a heartbeat. It is therefore critical that consumer countries have secure energy supplies from diverse sources, and that is really what the key focus is of my job.

Second, we do specifically work with Europe in its quest for energy security; that is, building the markets and architecture necessary to deliver a balanced and diverse energy supply from multiple sources through multiple routes.

Third, we work to build new routes to European markets for energy producers in the Caucasus and in Central Asia. This not only meets our goals in Europe, but it provides economic development

and political independence for these countries of the former Soviet Union. The main point is that we want these countries to be free to make their own choices as to how to best utilize their resources, and that is what we are striving towards.

So, how are we going to achieve our energy security goals? First, natural resources are produced, transported, bought and sold primarily in the private sector, but governments can play a role by creating the right economic climate for commercial activity to prosper. We can be facilitators.

At the heart of our policy is the belief that energy security is best achieved through diversity of suppliers, transportation routes and consumers, together with a focus on alternative and renewable energy technology and efficient energy usage. More specifically, we have talked a lot about the Southern Corridor, you have heard about that and about Nabucco.

In line with this approach that I just described, the Obama administration, and I might say every administration going back to the Clinton administration, strongly supports the southern energy corridor, which will be a pathway to bring natural gas to Europe via Turkey from the Caspian and potentially other sources beyond Europe's southeastern frontiers, including for example, Iraq and Turkmenistan. Gas from the Shah Deniz project in Azerbaijan will be the first gas to enter the Southern Corridor and is absolutely necessary for the development of the Southern Corridor.

Three separate pipeline consortia, Nabucco, ITGI, which is the Italy, Turkey, Greece Interconnector, and the Trans-Adriatic pipeline, are competing for the right to ship Shah Deniz gas. In the abstract, a large dedicated pipeline like Nabucco would be preferable, politically and strategically, but it must be commercially viable. And we expect that the Shah Deniz consortium will make a decision on a pipeline route by the end of this year, choosing among these three pipelines. I might also add that oil markets are also key to our strategy, and we certainly actively support Kazakhstan's new export routes to world markets.

With respect to Russia, we have had productive discussions with Russia on world market energy trends and possible bilateral investment with Russia through our Energy Working Group, which is part of the U.S.-Russian Bilateral Presidential Commission. Through the Department of Energy, we are developing pilot-smart grid projects with Russia and sharing technical information on new technologies. We want to engage with Russia in areas where we can cooperate and discuss areas where we disagree, and I think we are making at least progress in having those discussions.

I would be happy to talk further about whatever your concerns are or also talk about Russian strategic projects such as South Stream during the questioning period.

Regarding Ukraine, through the U.S.-Ukraine Commission on Strategic Partnership and the U.S.-Ukraine Energy Security Working Group, we continue to encourage Ukraine to make the necessary measures to attract foreign investment and to make the necessary reforms to qualify for international financing, which will allow it to modernize its gas transit system.

There is no reason why Ukraine can't become energy secure and energy dependent through the development of its own conventional

and unconventional resources. But to do that, if has to follow through on creating the proper investment climate for Western companies to offer financing and technology for these projects, and we think we are making some progress.

I might also add, partly in response to Mr. Marino's points, that in February 2011 we signed the U.S.-Ukraine memorandum of understanding on unconventional gas resources to help them in the process of developing shale, which we are also doing with other countries such as Poland and particularly other Eastern European countries and other countries in the rest of the world.

With respect to Central and Eastern Europe, we have worked very closely, I have probably spent more time with Central and Eastern European countries than anybody else, very closely with Central and Eastern European States in their efforts to come up with a balanced energy strategy and diverse energy sources and to encourage them to work toward a common energy market in Europe.

We have actively supported the Baltic Energy Market Interconnection Plan. We have encouraged increased regional energy coordination through the Visegrad Four, that is Poland, Czech Republic, Slovakia, Hungary, and other countries in the region. It is critical that these countries to become energy independent again have a balanced and diversified energy strategy.

I also want to emphasize that new pipelines alone will not make Europe energy secure. Europe is making progress in building a single market for energy, unbundling the distribution and supply functions of energy firms, building interconnectivity of networks, developing shale gas reserves, enhancing their LNG import capabilities, and I might, by the way, add that Poland just signed a memorandum of understanding with an American company, Cheniere, to supply LNG to—I am sorry, Lithuania has signed this agreement to supply LNG to Lithuania directly exported from the U.S. By liquefying shale gas into LNG, which I think could be an extremely important possibility for American companies.

Also, Europeans are making progress in increasing gas storage and improving energy efficiency and exploring alternative and renewable sources.

Finally, I might make some mention of the U.S.-EU Energy Council. This is one of our primary engagement mechanisms with the EU, and we work in three areas, global energy security, energy policy and standards, and technology and research cooperation. We coordinate our approaches with the European Union to Ukraine, Russia, the Southern Corridor, Iraq. We are also making strides toward harmonizing standards for such things as electric drive vehicles, software for smart grids, and we are working to increase cooperation and research and technology.

I also want to emphasize, we don't work just with the European Union in Brussels. We work very closely with member states. I have visited 20 of the 27 EU member states in the 2 years-plus since I have been in this job.

So, in summary, the key to achieving our Eurasian energy strategy is engagement. We will continue to work with the EU, engage with the EU and individual European states, with Turkey, with Russia, with Caucasus and Central Asian countries, and, very im-

portantly, with the private sector. And our job is to listen, identify common interests and priorities, and play a facilitating role where we can.

We appreciate your interest in these matters and look forward very much to working with you to build stronger relationships throughout Europe and the world so that we can all enjoy an energy secure future.

I will stop at this point to answer whatever questions you may have. Thank you.

[The prepared statement of Ambassador Morningstar follows:]

Testimony of Ambassador Richard L. Morningstar
Special Envoy for Eurasian Energy
House Foreign Affairs Committee
Subcommittee on Europe and Eurasia

June 2, 2011

Chairman Burton, Ranking Member Meeks, Members of the Committee:

It is a great pleasure to be here today to talk about one of the important pillars of U.S. diplomacy, energy security. I'd like to thank the Committee for inviting me to talk to you about what the U.S. is doing with regard to energy security. We'll examine the overall U.S. Eurasian energy strategy and then discuss the specific areas where we are implementing it.

What is the U.S. strategy?

There are three main components of our Eurasian energy strategy. **First**, we want to encourage the development of new oil and gas resources and also promote efficiency and conservation in the use of all energy resources. Because there is a world market for oil, new production contributes to meeting growing demand anywhere in the world, including in the United States. When we are talking about new natural gas production in the Caspian region, it is unlikely that any of that gas will reach the U.S., but it is still important because it will add to international gas supply. Additional supply in one place naturally frees up supply in another. As the market for liquefied natural gas continues to grow, we can start to think about gas moving around markets in much the same way oil does.

Second, we want to assist Europe in its quest for energy security. With the combination of goods and services, the EU27 and the U.S. account for the largest bilateral trade and investment relationship in the world. Europe is our partner on any number of global issues from Afghanistan to Libya to the Middle East, from human rights to free trade. We have an interest in an economically strong Europe. Of course, Europe is composed of many different states and energy security is a more pressing issue to some than to others. Some countries in Europe do not have a diverse energy mix and depend largely on a single supplier and transport route. When that route is disrupted, as we witnessed in January 2009, the consequences can be severe.

The populations of Bulgaria and Serbia and others who suffered in the cold can attest to that. So our aim is to encourage the development of a balanced and diverse energy strategy with multiple energy sources with multiple routes to market. This approach furthers competitive, efficient markets and the best prices for consumers.

Third, we want to help Caspian and Central Asian countries find new routes to market. We want to help foster economic growth and prosperity in these countries. By expanding export routes, they can increase competition for their resources, demand a fair price, and create strong links to the global economy. These countries should also be able to make their own independent choices regarding how they deal with energy resources.

How will we achieve our energy security goals?

Energy markets work best when free market forces drive decisions on how oil and gas are produced, transported, and purchased.
This is normally the case for private firms and can even be the case for state-owned oil and gas companies. But governments can and should play a facilitating role. Governments should put in place the right business climate to attract investment and should work with neighboring states to expand the market and increase interconnectivities. We can encourage these efforts, and work with our partners to create the political framework in which businesses and commercial projects can thrive.

At the heart of our policy is the belief that energy security is best achieved through diversity – diversity of suppliers, diversity of transportation routes and diversity of consumers, together with a focus on alternative technologies, and renewable and other clean energy technologies, and increased energy efficiency.

The Southern Corridor

In line with this approach, the Obama Administration strongly supports the establishment of a new pathway, the so-called Southern Corridor, to bring natural gas to Europe, via Turkey, from the Caspian and potentially other sources beyond Europe's south-eastern frontiers. Gas from Azerbaijan's offshore fields will be the first significant volumes available to supply the Southern Corridor. Development of a major field is well underway by the international Shah Deniz consortium. Three separate pipeline consortia --

the Nabucco, ITGI and TAP groups – are meanwhile laying the financial, technical and organizational groundwork to compete for the right to ship Shah Deniz gas. From the standpoint of U.S. policy goals, the best outcome is one that brings the most gas, soonest and most reliably, to those parts of Europe that need it most. But at the end of the day, any solution for bringing Azeri or other gas to European customers must make commercial sense. In light of the momentum achieved over the past 18 months, we are confident that a commercially viable Southern Corridor will be realized. The investment decisions to make that possible should occur by the end of this year.

While gas from the Shah Deniz field will be the first gas available and is necessary to the development of the Southern Corridor, there is good reason to believe other sources can ultimately contribute additional volumes to the Southern Corridor. Azerbaijan has promising potential in other Caspian fields. Turkmenistan is investing in infrastructure to keep open a western gas export option. And there are increasing indications that, once it finds the means to satisfy pressing domestic demands for electricity, Iraq will have significant gas export capacity. We have an active dialogue with these countries, with key partners like Turkey, and with relevant members of the international business community, to explore and encourage development of the broadest possible basis for a robust Southern Corridor that will ultimately be a critical element in the global energy architecture.

Oil markets and oil production are also keys to our strategy. We actively support further production of oil in Kazakhstan and new export routes for that oil to world markets, since Kazakhstan is one of the few non-OPEC countries with the potential to substantially increase production over the next 10 years.

Russia

Some people have portrayed our energy policy and Russia's as the next round in the Great Game in Central Asia. I reject this analogy. Energy security and energy investment are topics for serious two-way discussions with Russia. The importance of these issues is reflected by the inclusion of a Working Group on Energy, chaired by Energy Secretary Chu and Russian Energy Minister Shmatko, under our U.S.-Russia Bilateral Presidential Commission. The Energy Working Group also includes sub-groups on Energy Security, Energy Efficiency, and Clean Energy Technologies.

Discussions held in the context of the Presidential Commission, and other venues, will help us find areas where the United States and Russia can mutually benefit from cooperation in the energy field.

Russian Deputy Minister of Energy Kudryashov and I chaired two meetings of the EWG's Energy Security Sub-Group, in which we have had productive discussion on issues such as world market energy trends, proposed projects to bring new oil and gas to market and bilateral investment in Russian and U.S. energy markets. Russia is an important supplier of oil and gas, and we welcome market-driven expansion of its production capacity.
We are considering a Russian proposal to hold an energy investment conference in Moscow in the fall.

The Energy Efficiency Sub-Group, co-chaired by the Department of Energy (DOE), is developing a pilot smart grid project that will match Russian and U.S. cities and facilitate the sharing of experiential data, technical information and best practices. The Clean Energy Sub-Group, also chaired by DOE, has focused on facilitating exchanges and sharing best practices with regard to biofuels, solar, new materials, smart grids, hydrogen economy, and clean energy forecasting. The Energy Efficiency and Clean Energy Sub-Groups have also agreed to cooperate on federal energy management programs and financing mechanisms, and to conduct joint research on clean energy technologies.

Ukraine

The United States and Ukraine are heavily engaged on energy issues. We discuss energy on a regular basis through the U.S.-Ukraine Commission on Strategic Partnership as well as the U.S.-Ukraine Energy Security Working Group. We continue to encourage Ukraine to take the necessary measures to attract foreign investors to its energy sector, including transparency, good governance and effective legal and regulatory frameworks. Ukraine has recently taken steps to reinforce its energy security, including plans to increase domestic supply of both conventional and unconventional gas sources. The February 2011 signing of the U.S.-Ukraine Memorandum of Understanding on Unconventional Gas Resources marks a deepening of our bilateral cooperation in the energy sphere. The next step will be cooperation between the U.S. Geological Survey and Ukraine on assessing Ukraine's unconventional gas potential, and providing advice on related environmental and regulatory issues

Central and Eastern Europe

We support Central and Eastern European states efforts to more effectively diversify energy sources. We are encouraging them to coordinate work toward a common energy market and to increase gas and electricity connections with each other and with the larger, better-supplied economies of Europe. To this end, the U.S. is actively cooperating with the Baltic States in implementing the Baltic Energy Market Interconnection Plan (BEMIP), which strives for full integration of the Baltic States into the European energy market. The U.S. also encourages increased regional efforts in the energy sphere by the Visegrad Four (V4); Poland, Czech Republic, Slovakia, Hungary, and other countries in the region. New gas import infrastructure is underway in Poland and elsewhere in the region.

Existing Infrastructures, EU Law and Unconventional Sources

It is important to emphasize that new pipelines alone will not full assure Europe's energy security. The U.S. supports the other initiatives that Europe is undertaking to increase its own energy security, including through a major set of decisions in energy that the European Council recently adopted. Those initiatives focus on building a single market for energy, unbundling the distribution and supply functions of energy firms, building interconnectivity of European gas and electricity networks, environmentally sound development of shale gas reserves, enhancing LNG import capabilities, increasing gas storage, improving energy efficiency, and exploring alternative and renewable sources. All of these are pieces of the puzzle to ensure European energy security.

While some of that appears highly technical, these measures move toward a future where every country in Europe can access regional and global markets for energy resources. We are already seeing this today, as the United Kingdom is becoming an important transit country for LNG supplies to reach continental Europe. Some of this included LNG that has become available to global markets as U.S. domestic gas supplies have increased. Interconnector pipelines are being expanded or built to move gas across borders in multiple directions within Europe. Such developments should greatly improve Europe's ability to respond to supply shocks and to adapt to changes in global supplies and markets.

The U.S. - EU Energy Council

The U.S.-EU Energy Council was launched in November 2009, formalizing our ongoing engagement with the EU and member states on energy issues in three areas: Global Energy Security and Markets, Energy Policy and Standards, and Technology and Research Cooperation. We have developed coordinated approaches to Ukraine, Russia, the Southern Corridor and Iraq. We are coordinating with the EU to encourage Ukraine to implement international financial institutions' pre-conditions for financing. The Energy Council played a key role in encouraging Turkey and Azerbaijan to reach an agreement on gas transit and supply conditions, which will ultimately help secure Caspian basin supplies via the Southern Corridor. We are also exploring options to foster development of Iraq's gas resources.

In coordination with the Trans-Atlantic Economic Council, the Energy Council is making strides toward harmonizing battery and plug-in charging standards for Electric-drive Vehicles (EVs) and software for Smart Grids. Finally, we are working to facilitate an unprecedented level of researcher exchanges in key areas of clean and renewable technologies research.

Given current global financial and economic conditions, it is more important than ever for countries to have reliable and consistent access to affordable energy supplies. Greater energy interconnectivity, competitiveness, and transparency will increase energy security and propel economic development and prosperity.

In sum, the key to achieving our Eurasian energy strategy is engagement. We need to continue to engage with the private sector, with the EU, and also with Turkey, Russia, and Caucasus and Central Asian countries. Our job is to listen, identify common interests and priorities and play a facilitating role where we can. We appreciate your interest in these matters and look forward to working with you to build stronger relationships with our partners around the world to ensure that we all enjoy an energy secure future.

Thank you.

Mr. GRIFFIN. Thank you, Mr. Ambassador. I recognize myself for 5 minutes.

First I would like to ask you just as a general matter what your reaction is to the recent announcement from Germany that they are going to move away completely from nuclear energy, and if you would talk about what you think the impact it will have on other sorts of energy that they are going to have to consume to replace their reliance on nuclear. If you would comment on that generally, I think a lot of us are really interested in this move. And I know there are some politics at work there, at least that is my understanding. But do you have any comment on that as a general matter?

Ambassador MORNINGSTAR. Yes. As luck would have it, I was in Berlin I guess 12 days ago. I feel like I am a time zoneless person, so it all blurs. I think it was 2 weeks ago, maybe it was last week. But, in any event, I was in Berlin and talked to many members of their government up to very high levels. They have clearly made the political decision, as you put it, to get out of nuclear, and I think that is a done deal. That is what they are going to do, and they intend to be out by 2022. That is their right as a sovereign country.

I think it is going to have an impact, as you suggest. It is going to have an impact in Germany because it is going to cost a lot of money to come up with the alternative sources of energy that are necessary. I think it could have, in part, along with other situations like what is going on in North Africa, the overall nuclear situation, it is going to have an impact on gas. It is going to I think actually help the promotion of gas as a bridge fuel toward a cleaner economy. It is going to have an effect on coal in Germany, which could have an effect at least in the short to midterm on their carbon emissions. They recognize this, and it is a high-risk bet they are taking but they think they can accomplish what they are setting out to do during that 10-year period, and we will see.

I would make one other comment. We are strongly supporting those countries in Europe that want to continue their nuclear ambitions. While on the trip to Europe when I visited Berlin, I also spent time in Warsaw. Poland is continuing, along with shale and other policies, a very strong pro-nuclear policy.

Lithuania is doing the same. We have worked with them, and they have just received two bids from American companies to build a nuclear reactor at Visaginas. We have a very detailed strategy to work with the Czech Republic with respect to their proposed nuclear reactor in Temelin. We are working in other countries as well.

So I want to assure you that we are working closely with American companies, and this is on an interagency basis, to help further the goal of those companies winning transparent bids on new nuclear reactors. So as much as what is happening in Germany, Switzerland, maybe some other countries as well, there are still some real opportunities in Europe and opportunities for American companies.

Mr. GRIFFIN. What are the chances of a political reversal 2, 3, 4, 5, 6, 7 years down the road in Germany, for example? I mean, this obviously is a political decision that could be reversed when they find that it may not be as easy as they expect. What sort of

coalition has been behind this in Germany and is there a possibility of this coalition weakening and it reversing?

Ambassador MORNINGSTAR. Well, it is interesting, because I asked that very question.

Mr. GRIFFIN. It is a good question.

Ambassador MORNINGSTAR. It is an excellent question. I did ask that question to at least three or four people while I was in Berlin, and the feeling, at least right now, is that that is unlikely. I have learned in life never to say never, because, as you have said, facts change. They will see what the effects of this are. We will see if it has any effect on their economic competitiveness and so on. Those are questions that will have to be answered over time.

But right now there is a very strong coalition in support of eliminating nuclear power. Part of it relates to the fact that the Green Party did so well in the local elections after the Fukushima tragedy. Chancellor Merkel has taken a very strong position. So right now there is a very strong coalition. Again, you know, the view in Germany is that that won't change, but, again, I would say never say never.

Mr. GRIFFIN. Do you think—I see my time has expired, I just want to get this last question in. Do you think that this shift would have occurred absent the Japanese tragedy?

Ambassador MORNINGSTAR. It is hard to say, but my educated guess is that it would not have occurred, because Chancellor Merkel had made the decision prior to the Japanese tragedy that she would extend—that lives of existing nuclear plants would be extended until 2036, and so that has obviously changed dramatically after Fukushima.

Mr. GRIFFIN. Sure, sure.

I see my time has expired. I recognize the gentleman from Pennsylvania for 5 minutes.

Mr. MARINO. Thank you, Chairman.

Ambassador, I was pleased to hear you say that the development in these respective countries is ultimately up to the country and the people in those countries themselves. We cannot and must not force an upper hand in any of these situations. But with that said, what is the likelihood of Russia, China, stepping in and trying to get ahead of the United States with regard to assisting in development in these countries and actually trying to keep the United States removed from it?

Ambassador MORNINGSTAR. Again, another very good question. You know, we try to think of it in terms of it not being a zero sum game, but at the same time there is no question that China, with its growing demand for energy resources, is going to play a very, very aggressive role with respect to finding sources for its energy; that Russia, the Russian natural resource sector is its most successful and profitable economic sector. So I think that both countries are going to do everything that they can do to develop their sources of energy and to take advantage of whatever comparative advantages they may have, which means, it seems to me, that it is all the more important that we continually focus, and it is not simply to compete with Russia or to compete with China—I don't know that that is the point—we want to cooperate as much as we can. But at the same time, we have to ensure that we and our al-

lies have adequate sources, have adequate sources of energy. We have to mobilize our own private sector to work in developing resources in many of these areas and do the best we can.

When I testified a couple of years ago I guess at this point before the Senate Foreign Relations Committee, I made the statement that has been quoted many times that, hey, when China comes into Turkmenistan and offers $11 billion and says here it is, build a pipeline, that that is a deal easy to accept. But what is also interesting is you never get something for nothing, so now countries like Turkmenistan are recognizing that they have to pay back that debt, that a lot of the jobs are not Turkmen jobs, but become Chinese jobs, Chinese technology. So, there are pluses and minuses.

I think that we can have answers to that. We have companies that can go into some of these countries who can help to finance projects and provide help to these countries with respect to their own development. We have financing agencies that can help projects, whether it be OPIC or Ex-Im Bank, and we have to continue to keep that on the radar screens of all countries and maybe do a better job sometimes in explaining what we can do and what our companies can do in various parts of the world. That is what we are trying to do with the nuclear industry in Central and Eastern Europe, and I think it is beginning to work.

Mr. MARINO. Do you see us in a situation where China, or Russia for that matter, would come in and fund a project outside their country trying to work a deal out with being an exclusive purchaser and reduce pricing, whereas in the United States do you think that it is going to take investment from private industry as opposed to the United States?

Ambassador MORNINGSTAR. Just to make sure I understand the question, that, for example, if China were to come in and deal with Turkmenistan, for example, where they would be saying we will provide this money, we will give you reduced prices, but you can't sell to anybody else, that hasn't happened yet, and hopefully would not happen.

In a country like Turkmenistan, there is so much gas that there is enough to go around. I think that leaders in most countries understand that they need—as a supplier, just as consumers need diversity, that suppliers need diversity as well. And I know that—I don't mean to continually use Turkmenistan as an example, but given the question, they recognize that they are selling to Russia, they are selling to China. We hope that they will sell across the Caspian and on into Europe. We are talking with Turkmenistan about the so-called TAPI pipeline that would go through Afghanistan, Pakistan and India. So they are looking for diversity, too.

The message we keep sending to all countries is whether you are a supplying country or a consuming country, in this global market where there are so many potential sources of energy, that it is critically important that everybody, whether a supplier or consumer, have balanced and diversified policies. And, frankly, it is in Russia's interest, for example, to have a diversified supply strategy, not just to Europe, but they are selling to China, they are selling to Japan, they are selling to South Korea. They should.

Mr. MARINO. I see my time has run out.

Ambassador MORNINGSTAR. Sorry for the long answer.

Mr. MARINO. It is a good answer.

Mr. GRIFFIN. We will give you more time in a minute.

I want to ask a few questions about energy in the countries where we have been at war. First of all, Afghanistan and in Iraq.

With regard to Afghanistan, what potential is there for significant energy exploration that might help Afghanistan economically and could be a resource for Europe and Eurasia? I just got back from Afghanistan last weekend, and there was a discussion of some of the gas reserves there and the difficulty, not too much unlike the difficulty we have had in certain parts of the United States, in extracting the gas. I was wondering if you have any comments on Afghanistan and what the potential is there?

Ambassador MORNINGSTAR. It is certainly at the beginning stages in Afghanistan. There are potential gas fields. I think my colleague sitting behind me will confirm that Sheberghan is one potential gas field, but we really don't know. We really don't know the extent that it can be. But it needs to be explored.

There is some oil in Afghanistan. I know that some companies have looked, for example, at exporting—it is not large amounts—but exporting oil to Turkmenistan or Uzbekistan to be refined and then to be sent back into Afghanistan. I think it is too early to say that Afghanistan would be a major source for the Southern Corridor, although you never know. It certainly would be a transit country for the TAPI pipeline, and I could get into a separate discussion on that with all of its inherent risks and so forth. But it is something that we are looking at.

One of the other things in Afghanistan that is very important that needs to be explored is rare earth, and there is apparently some real potential there.

Mr. GRIFFIN. With regard to Iraq, what is the status of the oil and gas business in Iraq in terms of their ability to export it and ultimately to be a source for Europe?

Ambassador MORNINGSTAR. Again, another very good question that we have spent a lot of time thinking about. I can guarantee you that the EU and Turkey have also spent a lot of time thinking about.

First of all, just with respect to oil, of course, you know there are various bid runs that have taken place. They have very ambitious goals as to increasing the production of oil. The production of oil is in fact going up, but one of the problems is infrastructure and getting that oil out. We are working hard with them to see that that happens, and I know that the companies are as well.

Gas is a very, I think, incredibly fascinating issue with respect to Iraq. First of all, as I am sure you well know, their biggest concern right now is increasing the amount of electricity to their own consumers. That is a real problem. So from a political and substantive standpoint, they are very concerned about as much gas as possible going to power plants and to provide electricity to consumers. There are issues, again, on infrastructure and getting the gas from fields to a power plant, building power plants, and it all gets very complicated.

We have been talking with companies. I know companies have been looking at how can you come up with projects that meet the Iraqi need to increase the supply of electricity to its citizens, but

at the same time allow for exports and allow for a revenue stream that will actually help create funding to improve the infrastructure. I think that is the key, to create some win-win situations that will help the electricity sector and at the same time allow for exports to give incentive to companies to go forward.

There are also issues, as you know, relating to Baghdad and Arbil reaching agreements as to how oil and gas may be exported. There has been some progress in the oil sector, but there still is work to be done as far as hydrocarbon and revenue sharing laws to be enacted. It is something that we are watching every day. We think that some day, hopefully soon, there will be gas going north to Europe, but the question is when.

The last point I will make is there was a declaration signed by the EU and by the Deputy Prime Minister Shahristani, who is responsible for energy in the Iraqi Government, at least in principle, stating that Iraq should ultimately transit gas to Europe, or supply gas to Europe, but again a question of when given all the complicating difficulties.

Mr. GRIFFIN. Thank you for that. I am see that I am out of time.

I want to have, if I could have one more question before I go to you. I want you to comment generally on rule of law in Russia and whether some of the problems with rule of law are impacting commercial agreements vis-à-vis Russia and whether some of the rule of law and corruption problems that we have seen in Russia, whether they have impacted willingness of Western investors to go in and do business in Russia, American investors included. Could you comment on that?

Ambassador MORNINGSTAR. Sure. I would say a couple of things. One, rule of law is an issue clearly in Russia still. Two, that corruption, there have been obviously corruption issues, and that that does have an effect on investors.

Having said that, I think that there are two other areas that have actually had even a greater effect on larger, particularly on larger energy projects. One is the Russian fiscal regime, in which once you get above—if you are producing oil and you get above some level, I heard the figure yesterday, something like $27 a barrel or some number such as that, then a huge, huge percentage of the revenues are taxed by the government, which does have an effect on incentives.

Second, there is a strategic sectors law which potentially has a problem with respect to some investments in which a field which has been explored can be in effect taken over by the government for basically national security reasons once the exploration has taken place. So nobody wants to go in and spend the money on exploration and then basically lose the field.

Russia understands that both of these are problems. They are working on them. They have made deals in the last several months with both Exxon and Chevron and are addressing those issues.

But I think at least in the energy area, those types of issues are actually even more significant, whereas the issues that you talk about in terms of rule of law and corruption is a more overarching issue that does have a general effect.

Mr. GRIFFIN. All right. Thank you. I recognize the gentleman from Pennsylvania for 5 minutes.

Mr. MARINO. Thank you.

Concerning Russia, I have got a large concern over what is taking place in Russia right now, given the fact that Medvedev and Putin do not see eye to eye. Putin wants to be President again. They may be running against one another, if that is the right term to use. But Medvedev seems to be more orderly, more structured, more concerned about rule of law relationships with foreign countries, particularly the United States. Putin, on the other hand, is just quite the opposite.

Can you tell me what the administration's position is in dealing with one or both of these individuals if there is a change in the presidency, if Putin gets back in to be President.

Ambassador MORNINGSTAR. I am a little bit hesitant to get into any detail on that because I am really not the person who is responsible for our U.S.-Russia relations on the political level, so it might be a mistake for me to say too much about it.

I will say this, that if you ask anybody in the administration, for that matter if you ask anybody in Russia, and I have had this discussion in fact in the last couple of days, who will be the next President of Russia, almost anybody would say "I don't know." They don't know. It really is still very much up in the air. I mean, I have heard discussions essentially saying that, you know, maybe Mr. Putin would be happy the way things are right now. But we don't know. We really have no idea.

If Putin becomes President, I can assure you we would do everything we can to work with him, and the devil would be in the details as to what would happen if such were to be the case. So I don't think—certainly I am not the person to hypothecate as to what would happen if Putin becomes President. Obviously there are people thinking about it and I am sure the answer would be, well, you know, we will see how he reacts if he does become President.

Mr. MARINO. I am a supporter of the Nabucco pipeline. However, I am unequivocally opposed to having anything to do with Iran, whether it is on a joint venture or assistance of somehow, or development in the least way of doing anything concerning Iran, if a terrorist regime is involved in it. Can you address that issue?

Ambassador MORNINGSTAR. Yes, I can. Are you referring specifically to new sanctions issues in the Shah Deniz project?

Mr. MARINO. Yes, sir.

Ambassador MORNINGSTAR. I just wanted to make sure that is where you were going. Look, you know, it is a very difficult policy issue when it comes to Nabucco, the Southern Corridor and the question on Iran. We have been, certainly in the time I have been in office and before, we have been very, very direct and straightforward that there is no way in our view that Iranian gas should be part of the Southern Corridor. And there are, by the way, many Europeans and European companies that have advocated that Iranian gas be part of it.

But we do have I think what is a very difficult policy issue potentially with respect to the Shah Deniz project and the Southern Corridor. There is an Iranian subsidiary of the Iranian National Oil Company that owns 10 percent of the Shah Deniz project. This goes back to I think as far as 1996. They are a passive investor. They

have absolutely nothing to do with the operation of the project. So that raises a question and a serious policy question. And I speak of somebody, and the administration as well, as a strong supporter of Iran sanctions. The question becomes whether 15 or 20 years of the bipartisan Southern Corridor policy should be in effect eliminated as a result of that passive Iranian interest.

The other thing I think that needs to be considered, and, you know, when I raise these issues, I am not necessarily saying what is right and what is wrong, but just what needs to be considered is the unintended consequences if the Shah Deniz project ended up being sanctioned. Because what would probably happen is that the Western companies would have to pull out of the project, and the unintended consequence would be that the resources, which are absolutely necessary for the Southern Corridor, wouldn't go to Europe.

But there are three possibilities of where they could go to—Russia, China, or Iran. And I could make the argument that Iran would in fact benefit by that project being sanctioned because it could end up that they ended up being the recipient of much of that gas if the project continued in some form. And Iran needs gas, which may be surprising to some.

In any event, I would leave it at that. It is a serious policy issue, and I just think that before any final decision is made with respect to that policy question, that at least all of the ramifications on both sides be considered.

Mr. MARINO. Thank you, Ambassador.

Mr. GRIFFIN. I want to thank you, Mr. Ambassador, for being here today. I think we are going to move on to the second panel. Again, I apologize for the President taking this entire side down to the White House today. They would otherwise be here. But I think we are going to make a transition and the gentleman from Pennsylvania is going to take the chair.

Thank you.

Ambassador MORNINGSTAR. Thank you very much.

Mr. MARINO [presiding]. If the witnesses can come up to the table, please. Thank you, gentlemen, for being here. I would like to introduce the witnesses.

Ambassador Keith Smith is currently a senior associate at the Center for Strategic and International Studies. Ambassador Smith retired from the U.S. Department of State in 2000, where his career focused primarily on European affairs. From 1997 to 2000, he served as U.S. Ambassador to Lithuania. Ambassador Smith's earlier postings in Europe include Hungary, Norway, and Estonia. Ambassador Smith also served the State Department as Director of Policy for European and Senior Advisor to the Deputy Secretary of State for Support of East European Democracies.

Dr. Cohen is a senior research fellow for Russia and Eurasian Studies and International Energy Policy at the Kathryn and Shelby Cullom Davis Institute for International Studies of The Heritage Foundation. Dr. Cohen brings firsthand knowledge of the former Soviet Union and the Middle East. In addition to energy policy, Dr. Cohen's studies covers issue such as economic development and political reform in the former Soviet Republics, the global war on ter-

rorism, and the continuing conflict and unrest in the Middle East. Welcome.

Ambassador Wilson is director of the Dinu Patriciu Eurasia Center at the Atlantic Council of the United States and a lecturer on international affairs at George Washington University. In December 2008, Ambassador Wilson completed nearly three decades of U.S. foreign service. From 2005 to 2008, he served as United States Ambassador to Turkey. From 2000 to 2003, he served as United States Ambassador to Azerbaijan. Prior to these postings, Ambassador Wilson served at the U.S. Embassies in Moscow and Prague and as Consul General in Melbourne, Australia. Ambassador Wilson's colleague at the Atlantic Council, Mr. Boyko Nitzov, had agreed to provide testimony for this hearing at its earlier date, but was unable to do so when the hearing rescheduled for today.

Without objection, I would like to include Mr. Nitzov's statement in the record.

[The information referred to follows:]

Statement for the Record before the House Committee on Foreign Affairs' Subcommittee on Europe and Eurasia on

"European and Eurasian Energy: Developing Capabilities for Security and Prosperity"

By
Boyko Nitzov
Director of Programs, Dinu Patriciu Eurasia Center of the Atlantic Council of the United States
2:30 PM, Thursday, June 2nd, 2011

Mr. Chairman, Ranking Member Meeks, Members of the Subcommittee:

The dichotomy of the title of the hearing – European and Eurasian – is probably a fair way to describe today's status of the energy industry across the Eurasian continent: a western part with the European Union (EU) at its heart, and an eastern part in which Russia carries the greatest weight. The main points of difference between these two parts are not in industry itself, but in policies, particularly policies related to access to markets for investors and operators, competition, market structure, and private participation across the energy chain.

The basic rift in energy policies across Eurasia is in the degree to which two distinct market structures are preferred in the two parts of Eurasia: vertically integrated, often monopolistic, government-controlled markets (mostly outside the European Union - EU), or liberalized, competitive, private markets (mostly within EU). There are exceptions in both instances. Besides, various countries within the two groups pursue policies that are not necessarily coherent with those of their immediate neighbors. Such divergent policies result in great fragmentation of markets and barriers for investors and operators, and also create an environment wherein price and contract discrimination and other noncompetitive behavior can flourish. It does not help at all that in many countries lack of transparency, good governance, and stability in the legal framework and regulations are still the norm rather than an exception. In many instances important energy sector decisions are made on the basis of political goals, i.e. the energy sector is seen as a tool for achieving given political objectives, including in foreign policy.

In this statement for the record, the focus is on cross-border energy policy issues related to the two sectors which have the greatest weight on national and international scale: oil and gas.

Oil

Since the beginning of the modern petroleum industry around 1850, oil exports from Russia and other countries in the North Caspian have flown almost exclusively one way: west. Up to this day almost all the oil exports originating in the former Soviet Union end up on European markets which are part of the larger Atlantic Basin oil markets. Europe is *the* export market for Russia's oil: about 7/8 of Russia's oil exports end up on European markets, with U.S. and Asian markets taking about 1/16 each. By value, oil (crude and refined products) constitutes 55-60% of Russia's

exports and 22-25% of GDP and tax revenues. For other major oil producers in Eurasia, the reliance on oil exports and the European market is similar to that of Russia, or even greater. For these countries, access to the European energy market is literally a matter of economic life or death.

Transportation and its terms remain fundamental constraints on Eurasia's oil development. The growth of oil production in Eurasia requires the expansion of the existing transportation infrastructure and the construction of new facilities needed to bring oil to ports. International trade in oil is conducted almost exclusively by sea, with tankers carrying about 90% of exports. Oil fields in the eastern parts of Eurasia are inland, hundreds and thousands of miles from suitable ports. The availability, control, and terms of access to major oil transportation infrastructure is seen by the main producing countries in Eurasia as a national security issue. The few countries that heavily depend on oil imports, but do not have access to seaports or face difficulties in tanker shipping similarly see oil supply via pipelines as a national security concern. Outside the EU, the prevailing response in Eurasia to the challenge of oil transportation has been to keep the facilities in the hands of tightly regulated, government-owned monopolies, of which Russia's Transneft is the largest one. Similar attitudes exist in some other countries.

In an environment of tight government control over pipelines, cross-border projects require the establishment of a special legal regime in each case. Outside EU, this is often done by entering into intergovernmental agreements (IGA), ratified and having the power of treaties, complemented by other covenants as the case may be (host government agreements for investors, commercial contracts for oil shippers and users of other services). This is the road taken by the Baku-Tbilisi-Ceyhan, the Bourgas-Alexandroupolis, and the Caspian Pipeline Consortium, among others. Cross-border pipeline regulatory frameworks can be quite market-friendly or, to the contrary, very restrictive. An example of restrictive legal basis is Article 5 of the IGA for the Bourgas-Alexandroupolis pipeline. In other instances (Baku-Tbilisi-Ceyhan, the Caspian Pipeline Consortium), the IGA is far more balanced and business-friendly, providing a reasonable platform for upstream investors and operators, governments, and the public.

Commercial contracts tend to be written in a way that reflects the facts on the ground, including any applicable legal and regulatory base in place and the structure of the market at hand. Market structure, on the other hand, is more elusive, even though its gravity shapes the essence of commercial relationships. It is also very important that each type of market structure is supported by a relevant physical, services, and information infrastructure.

Oil transportation in inland Eurasia is a chokepoint that may force some governments into strange relationships and promote instability. The best solutions provide access to global markets via seaborne trade without attempting vertical foreclosure or otherwise limiting competition, be it by insisting on exclusivity, discriminating on the basis of national origin or ownership (private

or public), limiting information, or other means. For the U.S., it would be beneficial to work with Russia to alleviate its concerns regarding overdependence on a single export market, a circumstance which makes it sensitive to projects that "circumvent" Transneft's system of pipelines. However, it is indispensible for the U.S. to focus on solutions that provide to Caspian oil producers and inland oil importers in Eurasia outlets to free markets, rather than lock them up in a long-term relationship with state-controlled entities.

Gas

Over three-quarters of international gas trade is effected by moving gas via pipelines. Europe is the largest global export market for natural gas. Most of the hydrocarbon resources of both Russia and the Caspian are natural gas, not oil, and the largest upstream and transportation projects that are being mulled are almost invariably related to natural gas. So far, however, only one modest pipeline links the gas resources of the Caspian directly to competitive markets: the South Caucasus Pipeline (SCP) from Azerbaijan across Georgia to Turkey.

Central Eurasian gas exporters remain vulnerable to serious constraints limiting their negotiating power. The main export route is the Central Asia-Center pipeline, which ends up in Russia. Gazprom's strategy views Central Asian gas as a part of its own resource base. For years now, Russia has been trying to consolidate its control of the gas chain from the well to the retailer, acquiring exclusive rights over existing pipeline capacity in several countries, touting asset swaps, and making downstream acquisitions in Europe. Gazprom plans to enhance its positions in the region in order to preserve and expand its posture on the European market, match supply and demand in the former Soviet space, minimize investment expenditures, and optimize gas flows and financials across its system. To achieve these goals, Gazprom plans to participate in regional gas exploration and production and related infrastructure undertakings, including within EU. Gazprom also intends to keep the format of reselling Central Asian gas in Europe through the use of affiliated "transit" companies based outside of Russia. This practice allows them to avoid paying certain charges, but is opaque and prone to fostering corruption and inefficiency across the Eurasian gas supply chain.

The opening up of export routes to the east is seen by Russia as diversification of markets that enhances its bargaining position in Europe. Similar is the thinking of Central Eurasian gas producers, who now have the option of selling piped gas to China: they see the outlet as a bargaining chip in the relationship with Russia, in addition of course to the benefits of development, attracting foreign investment, and diversification.

The advent of the "unconventional gas revolution" in North America is a major factor that impacts the rethinking of national energy policies and the repositioning of national and international oil companies in Central Eurasia. The tapping of the major shale gas reserves in the United States occurred in parallel with the development of global liquefied natural gas (LNG)

infrastructure that would have also serviced North American markets at a time of global economic downturn. The resulting LNG glut transposed lower North American gas prices to Europe, which is still for all practical purposes the market for Russian and Central Eurasian gas. The result is that Eurasia is experiencing a period of economic uncertainty as far as its natural gas sector is concerned, which makes geopolitical considerations even more prominent in decisions about terms offered to foreign investors, pricing of gas, duration of contracts, and major gas pipeline projects.

Falling prices in Europe spelled lost market share and revenue for Gazprom, which in several instances bowed to requests for lower prices and contract renegotiation. However, attempts by countries which depend entirely on Russian gas to renegotiate contracts, particularly pricing and volume terms, have been rebuffed. The outcome is a strange disequilibrium, whereby prices for countries farther from Russia along the same gas pipeline are lower than for those who are "first in line": in Turkey gas sells for less than in Bulgaria, in Germany for less than in some East European countries. These mismatches in pricing underscore the fact that without supply diversity the door is open for discrimination and vertical foreclosure. It also clearly points out that, without actually having alternatives for supply not just by route, but also by supplier and origin, internal market liberalization within EU can only yield limited benefits for those countries that continue to depend on a single foreign supplier.

A consequence of the lack of integration and diversification of supply on large tracts of the EU internal gas market is the potential or perceived divergence among EU member states regarding the development of a common EU external energy policy and key infrastructure projects. Countries in the Baltic Sea region, Southeast Europe, and Central European countries still do not have options in gas supply, but in many instances transit very large volumes of gas to other EU members under long term exclusive contracts. These divergent market situations may lead to policies and projects that cement the dominant market position of an external supplier and undermine the gas market liberalization effort currently underway in EU.

LNG gas exports from Eurasia are in their infancy, with only one plant operating in Russia's Far East. In the Far East, Russia has prioritized the "gasification" of major cities and is completing the construction of main gas pipelines. Nevertheless, access to Asian gas markets continues to be an important factor for all major gas producing countries in Central Eurasia, including Russia.

Dealing with Uncertainty

Probably the greatest uncertainty of Eurasian energy lies in the future of its gas markets. Uncertainties permeate the dialogue between the EU and Russia and it is yet to be seen whether reasonable accommodation can be reached on open markets, level playing field, the future of long-term contracts, gas pricing principles and other elements that would allow for a degree of market convergence. Climate change policy goals and the role of gas in reaching these goals

make gas demand and power generation fuel mix forecasts in Eurasia more difficult. Demand forecasts are also difficult because of the uncertain future use of natural gas in transportation, where it could be a substitute for petroleum-based fuels.

The approximation of market structure between EU and Russia is a challenging task now on the agenda of the EU-Russia dialogue. EU's keystone is the third liberalization package, which is not a goal in itself, but a tool for creating single electricity and natural gas markets. Not even within EU are the tasks of the package's legal and regulatory implementation complete. Besides, regulatory harmonization and legal implementation of competition and access rules are empty words without interconnected infrastructure and the actual ability to move oil and gas between markets. Several countries in the Baltic Sea region are all but isolated from the power grid of other EU countries. So far, only very modest advances have been made in interconnecting national gas markets in most of the EU's eastern parts.

Low-carbon economy is a priority for the EU. Whether natural gas, because of its lower carbon emissions compared to other fossil fuels, will be a bridge fuel to green energy or the green fuel of choice, is debatable. Lowering emissions and improving energy efficiency are fields where collaboration with producers outside EU is welcome by all parties.

Russia's preferred answer to market uncertainties and the challenge of market structure approximation across Eurasia is to stress stability over competition and try to keep the status quo. In the natural gas business, this translates into preference for long-term contracts (LTC) for sale-purchase of gas and use of gas pipeline capacity. At this time, Gazprom's European exports LTC portfolio is for 1.4 trillion cubic meters over a horizon reaching to 2040 and beyond. About 570 billion cubic meters are LTCs with a leading German company. These LTC contracts continue to use take-or-pay clauses, albeit thresholds for the clause to kick in have been lowered. Pricing is still formula-based by reference to oil, but the formulas may now contain references to other fuels or to spot gas prices at certain European hubs. There are no plans to phase out the policy of a single gas export point in Russia, and transit to market of other producers' gas across Russia is not even being discussed, although netbacking to European markets is now in use when gas is sold to Gazprom by producers around the Caspian Sea.

Successful development of shale gas in Europe may be a great challenge to restrictive practices on Eurasian energy markets. However, real benefits to consumers and energy importing nations can only accrue if the current rigid structures are transformed into free, competitive, liberalized markets. The key stakeholders have yet to agree that such transformation should be the prevalent policy across Eurasia, and not just in EU.

The fears that market liberalization, improved market access for all producers and consumers, and competition will dilute the value of assets, contracts, and market positions of incumbents in

Europe are greatly exaggerated. In fact, no one wishes to lose Russian businesses as long-term suppliers of energy to Europe, and few scenarios see the share of Russian oil and gas on European energy markets as declining. Europe and Russia have relied on each other in energy for many decades now, and will continue to do so. The real issue is *not* eliminating "dependence on Russia", but eliminating lack of choice and establishing level playing field for all. It is very difficult to push anyone out of the market, as long as the market itself is open and competitive for all. One thing that will likely be lost or diminished with the success of open energy markets in Eurasia, however, is the ability to use energy as a general policy tool and wield influence by selective application of the tool. In fact, approximating Eurasian energy markets on the basis of openness and competition can be a boon for Russia's effort to modernize and be globally competitive.

In triangulating security of supply, competitiveness, and sustainability in its dialogue with Russia, the EU has so far avoided bringing to the table other producers and prefers to deal with them separately, for example via the Southern Corridor initiative with Caspian producers. Also notably missing from the table are transit countries. Multilateral platforms like the Organization for Security and Cooperation in Europe, the Energy Charter Treaty and the United Nations Economic Commission for Europe where Eurasia is represented across its expanse, generally do not have a mandate to negotiate new substantive agreements in energy, but do conduct useful energy dialogues.

Many leading businesses in EU sometimes have views regarding LTCs, pricing, and the implementation of the third liberalization package which dovetail with the views of their main trading partner, Gazprom. The Russian counterparties, on the other hand, speak with one voice and the government is always helpful by negotiating special supranational terms for major infrastructure projects. This is the case of the South Stream project, where IGAs have been signed and ratified with each country along the route, creating a legal framework which is different from the one for the internal EU market. EU's position, which does not see direct involvement in negotiations as really needed, may not be the best answer.

The factors trying to preserve the status quo in Eurasian energy are strong. A collateral is the nagging existence of potential "flash points" in parts of Eurasia where energy markets are particularly fragmented, vertically foreclosed by a single supplier, and dependent on access to export or import infrastructure, often by a single route. A meaningful answer to these challenges would require action on the ground to resolve the two key issues: open access to markets and competitive market structure.

Conclusions

In Eurasia, U.S. energy policy faces challenges from non-competitive practices that are not in the West's long-term interests. Balancing bilateral and multilateral approaches, U.S. policies should focus on solutions that provide market convergence on the basis of openness, competition and liberalization. The U.S. should promote a dialogue based on these principles between the EU and key energy producing and transiting countries in Eurasia, and seek to involve other Eurasian stakeholders in the energy dialogues with Russia. The U.S. should seek to promote greater access for energy producers in Eurasia to free markets, including in the United States and the European Union.

Washington should work together with Moscow, Brussels, and Central Eurasian producers to alleviate legitimate concerns in Russia about secure access to its main export market in Europe, in other producing countries about fair terms of natural gas trade and transit, and in Europe about the Russian energy sector and its relationship with the government. The United States should seek ways to demonstrate the importance of participating in open markets for achieving overall economic modernization and competitiveness in the global marketplace by energy producers and exporters like Russia and other Eurasian nations. Appropriate platforms for such effort could be the Organization for Security and Cooperation, the United Nation's Economic Commission for Europe, and the Energy Charter Treaty.

Restructuring and establishing transparent regulatory systems are particularly important for the downstream parts of the gas industry, but are not sufficient in themselves to create competitive markets if supply is vertically foreclosed from beyond the reach of the regulating authority. It is very important to understand that commercial contracts, such as long-term contracts for supply of gas, are heavily influenced by the market structure, not just by regulatory requirements. Diversification of supply by source, route, and supplier, and integration of isolated markets by providing the physical ability to move energy are therefore a must. The United States should not back down from explicitly supporting particular infrastructure projects that link energy producing countries to free markets and energy importing countries to each other since, without such infrastructure, free trade and competitive markets will have a hard time emerging and restrictive commercial practices will continue to exist. For oil, there is a history of success, for example the Baku-Tbilisi-Ceyhan line. For natural gas, precious little has been brought to fruition.

Improved access to free markets for both producers and consumers will not lead automatically to sustainable growth and prosperity. Major risks in Eurasian energy exporting countries include poor governance, failure to manage resources for the greater good, improper rule of law, an unfavorable investment environment, and unstable terms offered to foreign investors. Risks in energy importing countries include divergent views about national energy mix policies,

modalities of promoting green energy, and finding a balance between security of supply, competitiveness, and sustainability goals. Policy should focus on alleviating the worst features and most serious concerns of gas markets in the region: the extremely high concentration of natural gas trade flows, many of which follow a single route; gas monopolies epitomized by a single sales point for all exports from Russia, including resale of gas originating in Turkmenistan, Uzbekistan, and Kazakhstan; complete domination of the transit natural gas pipeline systems by a single customer; and a lack of negotiating leverage.

The United States should support national oil companies based in Eurasia as they seek to become fully integrated in the global petroleum industry. However, a reciprocal approach to improving terms of access for investors and to markets also requires government actions. The establishment in Eurasia of transparent and cooperative relationships between international oil companies and the "market-friendly" nationals is likely to enhance energy security and promote stability. Exporting U.S. technology, know-how and experience in shale gas could help develop indigenous resources across Eurasia, help alleviate concerns about security of supply, and promote competition. Washington should support shale gas development in Eurasia by private businesses and a public-private undertaking, by also supporting environmentally responsible effort in shale gas.

The eastern part of Eurasia has considerable potential in renewable energy resources and energy efficiency, but does not possess the capital and technical wherewithal to tap it. Moreover, a focus on hydrocarbons tends to crowd out alternative energy efforts. Governments should eliminate barriers and work with donors to structure initiatives that promote investment in renewable energy and energy efficiency. The United States and the European Union should support technical aid programs and demonstration projects in Russia and Central Eurasia via established channels and cooperation with multilateral institutions.

Few countries in Eurasia outside EU's core boast competitive energy markets. In the gas industry, regional integration and cohesion across Eurasia is in its infancy; the electricity sector is hardly different. Beyond EU's core, both are strictly compartmentalized on the national level. Opportunities for improving cross-border investment and market access do exist, and should be supported. One way to promote market efficiency is to reduce existing national fragmentation by eliminating restrictions and entering into investment, trade, and transit agreements based on open market principles.

Thank you.

Mr. GRIFFIN. Again, thank you all for being with us today. We will begin with Ambassador Smith, sir.

STATEMENT OF AMBASSADOR KEITH C. SMITH, SENIOR ASSOCIATE, NEW EUROPEAN DEMOCRACIES PROJECT, CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES

Ambassador SMITH. Thank you, Mr. Chairman. It is a pleasure to be here. I have been at various committees before talking mainly about the issue of the supply of gas and oil from Russia to Central Europe. But my concern nowadays has refocused to some extent on the question of corruption and transparency, because I believe that while diversity of supply is important, part of the problem and a big part of the problem, quite frankly, in Central Europe and especially in east Central Europe, but not exclusively in east Central Europe, is a question of transparency and corruption in the energy trade.

It takes you back to—I am old enough to remember when the U.S. bank robber Willie Sutton, they kept asking him why he kept robbing banks and get caught. His answer was, Well, that is where the money is. Quite frankly, the corruption around the world is generally, in large measure, in the energy trade. And that is where the money is.

Quite frankly, in the East-West energy corridors, particularly those running from Russia into Central Europe and Western Europe, that is where you have had a lack of transparency because you have companies which are state-owned companies that are the suppliers in Western Europe and Eastern Europe, particularly in Russia, and then you also have Central Europeans. I think this is the major challenge really in Europe, this whole question of transparency. There has been a problem that I think goes back a ways in the European Union to the fact that the new member states of the European Union—these are countries that I feel very close to—have been treated as second-class citizens, quite frankly, by the larger, more powerful countries in Western Europe, and you have had up until 2009 the January cutoff of gas to Ukraine and it affected for the first time Western Europe. And that suddenly brought the Western Europeans I think to the conclusion that they needed to do something to help the more energy island states, the Baltic states, Poland, Bulgaria, Romania.

But at the same time as that has gone on you still have a question in Western Europe of the large energy companies. Each country, of course, wants to put its own companies in a position of influence within Russia, and the competition for favor by the Russian Government, particularly by Mr. Putin, who really runs the energy policy of Russia, has really resulted in a divide-and-conquer policy within the European Union where the large countries, their energy companies can kind of determine what the energy policy is within the European Union. And there isn't really a coordinated energy policy. Although the EU was started as a coal and steel community, there is no energy community within the European Union. This puts the weaker states to the East—the Baltic States, Poland, Bulgaria, Romania, to some extent Hungary—in a very disadvantaged position because they have been, the way the Soviet Union was set up and the Warsaw Pact, the energy pipelines all went from east

to west and they were coordinated out of Moscow. A lot of this hasn't changed until very recently. It is just beginning to change to some extent.

Another thing which I think influenced the situation in Eastern Europe was the fact that when they became members the European Union required these countries to do certain things which, quite frankly, in the long run increased their dependency on Russia. The Lithuanians were required to close down their nuclear power plant. And that was a power plant which our experts thought could safely operate for another 15 years. But the anti-nuclear lobby within the EU I think was responsible for the Lithuanians having to close that down, and that made Lithuania more dependent on Russian energy.

I think there are a whole series of elite groups within Russia, Ukraine, and Central Asia, which have benefited from this lack of transparency.

The European Union in another area has refused up until now to enforce its own antitrust and competition policies. And I think that is—for instance, they have made it illegal for Microsoft to bundle its music program with its Windows program. That seems to be a real threat. But at the same time, the monopoly position of Transneft, which is a state monopoly for all the export of oil from Russia to Europe, and of Gazprom, which is the monopoly exporter of gas, remains and has not been challenged as monopolies in violation of the competition laws.

I could go on, and I have long papers which I could submit on this issue, but I think that there has to be some stronger enforcement within the European Union. It is beginning a little bit, but I think the lack of transparency even in the pipeline area hurts the Central Europeans, the people who populate your district to some extent and I have a strong tie to myself. These people are—for instance, there is no policy which says that if a country has secret negotiations going on with Russia regarding a pipeline issue that it has to first let its member state—the other member states know about it or that they have to let the EU Commission know about it. They don't have rules, for instance, like we have, which require—for instance, the Foreign Agents Registration Act. So Russia can put a lot of money into trying to influence the energy policies in Brussels, in Berlin, in Paris, in Vienna. And they do. They don't have to report that. And so nobody knows.

Now there are a lot of universities and NGOs in Europe that are taking money from Gazprom. In the U.S. we know that just down the street from CSIS, where I work, there is a company that takes $250,000 a month from Gazprom. But in Europe you wouldn't find that information because it is not public knowledge.

Anyway, these things have to be done. I think there needs to be much greater coordination. We are limited in what we can do. But I think by putting out a lot of information, I think that we can help the Central Europeans in their attempts to become more energy secure.

I had the occasion to give a talk to the Business Club in Poland, in Warsaw, and I arrived in Poland the day that President Medvedev left, and he said that he wanted his company, the Rosneft, the state company, to buy Poland's most modern oil com-

pany and the refinery. Well, fortunately that day I was able to get hold of some information which showed that one of the 10 sleeper agents that we had expelled from the United States had just been hired by Rosneft that day. It was announced that this person would assume responsibilities for international projects, which fit very well.

If you look at the whole scheme of things, part of the problem is in Russia most of your energy companies are dominated by former KGB or GRU officers and they are negotiating with people in Western Europe who don't have the experience or the intelligence background or the intelligence information on how to negotiate these kinds of deals.

I think I have taken more than my time, and I will yield and try to answer any questions later on.

Thank you, Mr. Chairman.

[The prepared statement of Ambassador Smith follows:]

CSIS | CENTER FOR STRATEGIC & INTERNATIONAL STUDIES | New European Democracies Project

EUROPEAN ENERGY SECURITY:
TRANSPARENCY AND ENFORCEMENT OF EU RULES

June 2, 2011
House Committee on Foreign Affairs

Keith C. Smith

Summary

A major challenge to the new democracies of Central Europe is the corruption and lack of transparency in importing oil and natural gas from Russia and other energy producing states once part of the Soviet Union. This situation threatens to undermine good governance and ethical business practices throughout the European Union. It is a mistake to believe that there will be a major shift in the near term toward more openness in Russian foreign economic and political relations. Change will have to come through stricter EU enforcement policies and the adoption of stronger anti-corruption measures within the importing states. Unconventional gas production in Europe can help provide greater energy security in the medium term, but will not by itself reduce corruption or bring greater transparency.

EU membership provides only limited energy security to the EU's newest member states. The European Union lacks a common energy market and needs strong enforceable transparency and competition policies regarding energy imports. Nor does it have a common energy strategy concerning accountability by large importers, such as the Russian state monopolies Gazprom and Transneft.

Wealth accumulation from the energy trade is often used by powerful groups in the East to buy support in Western countries for Russian economic and security policies. This situation is facilitated by the lack of legal reporting requirements in Europe, including within the EU, concerning outside funding of political and business groups. Major Russian energy firms are busy financing large public relations efforts, university research and "independent" think tanks in Europe. This is one area where Europe could adopt laws to increase transparency, such as the U.S. Foreign Agents Registration Act.

The most serious threats come from the danger of intervention at any point in the commercial process on the part of elite cartels that dominate the energy trade, particularly in Russia, Ukraine, and Central Asia. These cartels are composed of governmental leaders, intelligence officials, and favored business oligarchs. Lawsuits by these elites designed to silence Western critics have been a standard tactic up to now, including some oligarchs with close ties to Russian organized crime.

Courageous steps are needed by EU and Central European political leaders in order to bring about greater transparency and competition. Reformers too often pay for making the tough decisions by being turned out at the next election. After adopting badly needed improvements in legal and judicial systems they face well-funded opponents who are backed by nebulous firms representing energy importers. Real reformers would benefit from increased business transparency and from faster implementation of EU law concerning monopolies and accounting standards. The energy security concerns of the newer and more

vulnerable member states have taken a back seat to the interests of the wealthier, but more energy secure countries in Western Europe.

Corruption and Non-transparency

Western energy firms too often confront demands from governmental officials and Eastern energy companies to engage in shady business practices when considering investment decisions, long-term sales contracts, and accounting procedures. Lack of a common energy policy and of strong antimonopoly enforcement regarding energy importers, have over the past 20 years increased opportunities for non-transparent state companies to secure influence among Western governments and with political and economic elites in Europe.

Dubious or outright corrupt business practices are distorting the energy decision making processes in both consumer and supplier countries. According to Russian economists, the business climate within the Russian energy sector has become less transparent and more corrupt in recent years. Why should one assume that this increase in Russian corruption has not spilled over into Europe, particularly into countries heavily dependent on oil and gas imports from, or through, Russia?

Many businessmen in former Communist states engage in what people in the West refer to as corrupt practices as a result of having grown up in a culture that considers bribery and coercion to be normal methods of conducting business. Some other influential individuals have close economic and personal ties that go back to the Soviet period. In addition, Western leaders are often at a significant disadvantage in negotiations with a highly trained former Soviet or Warsaw Pact intelligence officer. It is worth noting that both Rosneft and Transneft have hired "sleeper agents" recently expelled from the U.S. for spying.

Elite Beneficiaries

Corruption and tight Kremlin control of Russia's energy companies have weakened the bargaining position of Western firms that normally use "best practices" when engaging in East-West energy trading. The domestic monopoly power and designated export privileges of Russia's state-controlled energy companies have led to a marked reduction of alternative investment possibilities for Western companies. This further intensifies the pressure on Western firms to agree to demands by Eastern energy suppliers that they engage in behavior not acceptable when dealing with other Western firms. In addition, this fuels the temptation for Western governments to ignore questionable business practices by their own domestic energy firms engaged in trade with Russian suppliers.

Western firms are already at a disadvantage when making business decisions in the former Soviet area. The absence of a win-win business concept in the East, combined with the absence of impartial judicial systems to enforce internationally recognized contracts between business firms, gives nontransparent firms an advantage in negotiations. Western businesses are usually compelled to work with partners favored by elite cartels. The existing systems appear to be designed to enrich networks of higher-level elites and/or their political parties, making it even more difficult for reform elements in some EU member states to bring about political and economic change.

Weak Western Reaction

The ineffective reaction of Western governments and the European Union to non-transparent business practices by Moscow only encourages the Kremlin to believe in the effectiveness of its aggressive energy policies and in its own ability to circumvent the "unbundling" and "third party access" rules of the EU.

The EU's blessing of the Nord Stream gas pipeline and what now appears to be its acceptance of South Stream, only facilitates continuation of monopoly and antitrust practices on the part of Russian companies. These antitrust and anti-competition practices are a clear violation of the original EC Treaty, the Energy Charter Treaty and now of the Lisbon Treaty. The EU's granting of "opt-outs" from its own rules only further encourages Russian firms to demand exemption from EU anti-monopoly rules.

Western governments continue to be reluctant to investigate and enforce the anti-bribery laws and regulations of the European Union and the Organization for Economic Co-operation and Development (OECD). The lack of a common EU approach to Russian and Central European energy policies allows Moscow to carry out a "divide-and-conquer" strategy that plays to the particular vulnerabilities of each European state.

Most EU member countries do not require their national firms that accept payments from foreign governments or that companies report this information to official government agencies and make the details concerning such payments available to the public. This makes it virtually impossible for governments, the media, or private researchers to know who is behind foreign-directed public relations campaigns or political influence peddling.

The problem is particularly pronounced in countries where the media is either unable or unwilling to engage in aggressive investigative reporting. Many newspapers and television stations in the new democracies are in precarious financial positions and are vulnerable to offers of help from well-financed foreign companies or their intelligence services.

The EU organizations in Brussels are particular targets of Eastern intelligence services that in many cases are charged with promoting the interests of their country's energy companies. Lobbying and public relations firms in Brussels are frequently hired directly and indirectly to further the interests of Gazprom and other Russian companies. Russian nationals are regularly employed by the European Union, some of whom then go on to lobby EU bodies on behalf of their country's energy firms.

Competition and Transparency

The new democratic states of Central and Southeastern Europe have too often been relatively passive in dealing with transparency and anticorruption issues. One reason for this could be that there are large numbers of political and economic leaders in the region who are holdovers from the Communist period. In the chaos resulting from the collapse of the Soviet Union and the Warsaw Pact, many former officials were able to gain control of the Communist Parties' assets and/or purchase large domestic industries cheaply. Not surprisingly, the business ethics of most former Communist officials did not significantly change with the fall of the old system.

Of course, the leaders of the new democracies are already faced with many problems, not the least of which is implementing the multitude of laws and regulations required for EU membership. Reformers find it difficult to curb the activities of the old-new business elite, particularly when these people already possess much of the countries' wealth and influence and often control large parts of the media.

Murky Alliances

The weak state of transparency in Central Europe aids the formation of new alliances between East European elites and former Communist Party and intelligence officers in Russia who dominate the major energy companies. This again puts Western firms at a clear disadvantage when negotiating for facilities acquisition or pipeline construction. With the renationalization of Russian energy assets, negotiations with the West are often carried out by top Kremlin officials. Fewer agreements are carefully negotiated at

the company level. It is fair to ask whether there are many Western political leaders who can negotiate effectively with the seasoned intelligence officers in the Kremlin who determine Russia's energy policies.

Western leaders rarely have the skills or the ability to fully mobilize the state's resources in order to negotiate on an equal basis, and they often lack good intelligence regarding the tactics of the other side. Russia's top leadership is directly involved in energy sector deals with other countries. Prime Minister Putin devotes more time and attention to promoting his country's energy interests than does any leader from a Western country. Putin knows how to effectively use the Russian intelligence services to promote pipeline projects and downstream acquisitions.

In sum, corruption in the East-West energy trade will only end or diminish significantly when the large import countries decide that it is in their collective interests to abandon the practice of looking past non-transparent practices. They must be persuaded to stop attempting to give their own countries' energy firms a competitive edge at any cost. If they demand "best practices" by their own commercial interests and closely monitor the activities of government officials engaged in energy transactions, the more vulnerable "new democracies" will be more inclined to follow. When the large and more prosperous countries of Europe ignore corruption in the energy trade, they indirectly facilitate coercion of the new and smaller states of the region by more nontransparent, state-directed energy importers and foreign investors.

Saved by Unconventional Gas?

No doubt, the unconventional gas "revolution" that started in the U.S. is already having an effect on the natural gas market in Europe. The U.S. no longer needs LNG imports. This frees up LNG supplies to compete with piped gas from Russia. Prospects are good that significant quantities of shale and methane gas will be produced in Poland and the UK. Gazprom, however, is actively attempting to dampen enthusiasm for this new technology, and the company's export head, Alexander Medvedev, has warned Europeans of the alleged environmental dangers of unconventional gas production. Of course, Gazprom's leverage will be weakened by larger domestic gas production in Europe. However, the nuclear disaster in Japan will likely slow or stop the construction of new nuclear plants, thereby preserving the market for Gazprom exports to Europe over the medium term.

Environmental opposition to halt unconventional gas exploration, however, has sprung up in France and Germany. In many cases, it is difficult to trace the funding sources of these groups. A stop has been imposed on "fracking" efforts in those two countries, and a moratorium may be imposed on other countries, possibly by the EU's own environmental directorate. An official at DG Environment has even claimed that unconventional gas is "dirtier" than Arctic gas that will go through Nord Stream. This could be an attempt to dampen enthusiasm for increased exploration efforts within the EU. Europeans and Americans should carefully study the relative risks posed by the various forms of energy production. Unfortunately, too often frightening media headlines and poor science are utilized by various groups for their own political agenda. These scare tactics are encouraged by domestic coal producers and by foreign business interests, including Alexander Medvedev, the Director of Gazprom Export.

The views expressed above are solely those of the author and do not necessarily represent those of the Center for Strategic and International Studies.

Mr. MARINO [presiding]. Thank you, Ambassador Smith. Gentlemen, if you don't mind, I would like to get your statements in. Don't worry so much about the 5 minutes. We are a captive audience here today, just you and me and the people in the room.

Dr. Cohen, please.

STATEMENT OF ARIEL COHEN, PH.D., SENIOR RESEARCH FELLOW, THE KATHRYN AND SHELBY CULLOM DAVIS INSTITUTE FOR INTERNATIONAL STUDIES, THE HERITAGE FOUNDATION

Mr. COHEN. Thank you, Mr. Chairman. It is a pleasure. The views expressed here are my own and should not be construed as representing any official position of The Heritage Foundation.

With that, I would like the full text to be included in the Congressional Record.

Mr. MARINO. Without objection.

Mr. COHEN. Thank you.

Russia is indeed the 3,000-pound elephant in the room when it comes to energy in Eurasia. It has the largest reserves of natural gas in the world. It has giant reserves of oil. And it competes with Saudi Arabia, the largest producer and exporter of oil in the world. Despite this vast resource base and its formal assurance of reliability as a partner, Moscow has already proved that it is willing to hike up oil prices to match the general trend of higher energy prices, engage in anti-free-market practices, especially at home and in Europe, and use energy as a foreign policy tool.

Russian energy strategy, adopted in 2003, amended in 2009 to last through the year 2030, says that Russia is building its energy security on protection of the country, its citizens, its economy, from external and domestic threats to the reliable energy supply, including geopolitical and energy market risk factors. President Medvedev added that the wars in the future may be fought over natural resources and that Russia will be willing to protect its interests, including through the use of force.

Russia is seeking to maximize its economic and geostrategic advantages as a major energy producer, and it becomes even more poignant as the Middle East supplies are now suffering from the repercussions of the so-called "Arab Spring," and the future of nuclear power has become more uncertain as a result of nuclear power station disasters triggered by the recent tsunami and earthquake in Japan. We heard from Ambassador Morningstar how they affected Germany in the nuclear sector.

Russia may be controlling up to 20-plus percent of the global energy reserves because it has the largest, longest coastline in the Arctic. The Arctic is a particularly interesting case because there are competing claims on the water, subsoil and on the sea shelf in the Arctic, including from Russia, Canada, Denmark, and other countries, but Russia specifically went the security route by announcing that special forces will be created to be deployed in the Arctic. However, Russia does not have sufficient technology or funds to develop the Arctic on its own. Nevertheless, when it came to a large natural gas field named Shtokman in the Barents Sea, Russia did not invite American companies, despite earlier promises, to include Chevron and possibly ConocoPhillips. They went

with Statoil Hydro from Norway without giving them any equity stakes in that field.

What Ambassador Smith already referred to, I could not stress enough. It is the control of these natural resources through the closest people to Prime Minister Putin, such as President Medvedev; Victor Zubkov, his former mentor; Alexei Miller, the CEO of Gazprom; and First Deputy Prime Minister Igor Sechin, who until recently was chairman of the board of Rosneft, the largest Russian state-owned oil company. Through control of state companies and through appointing of the senior officials, Russia indeed controls its oil and gas wealth and uses it as tools of foreign policy.

Now when you have former KGB and other security apparatchiks in charge, it is not surprising that some of the tools they use in order to gain that control came from the security services practices. And I am specifically talking about the Yukos case and the former owners of Yukos such as Mikhail Khodorkovsky and his partner Platon Lebedev. These two people were prosecuted for the first time in 2003. They were arrested in 2003, and then sentenced to 13 years of jail time, and then prosecuted again, just changing the charges, last year. And currently they appealed for parole. The U.S. Government, the British courts, and other European courts, as well as Amnesty International repeatedly said that Khodorkovsky, Lebedev and others connected to Yukos were prosecuted for political reasons. And as a result of nationalization and expropriation of Yukos, many shareholders, including Americans, lost billions of dollars in their investment without recourse to the Russian Government.

To summarize, the Obama administration, while focusing on improvement of relations with Russia, the so-called "reset" policy, neglected its involvement in the non-Russian countries of the former Soviet Union, which Ambassador Wilson will talk more; specifically Azerbaijan, Georgia, Turkmenistan, to certain extent, Kazakhstan; countries that are strategic if we want to encourage independence of Europe of Russian oil and gas.

Secondly, we are not emphasizing the issues of the rule of law enough. Congress is considering S. 1039, the Sergey Magnitskiy Rule of Law Accountability Act, that talks about revoking of visas and prohibiting financial transactions for Russian officials who engage in "extrajudicial killings, torture, and other gross violations of human rights committed against individuals seeking to expose illegal activity carried out by the officials of the Government of the Russian Federation or to obtain, exercise, or defend or promote internationally recognized human rights and freedoms." At the same time, President Obama meets President Medvedev in Deauville, France, and they talk about expanding the visa regime between our two countries.

Now freedom of travel is a good thing overall, but the U.S. Congress is seeking to limit travel to the U.S. on the part of clearly corrupt Russian officials, of those engaged in human rights violations or property expropriation. Why did the Obama administration not mention that in the Deauville declaration? In that respect I think the administration is defying Congress and going in the wrong direction.

To conclude, Congress has an important role to play in changing the relations with Russia in the energy field for the benefit of Russian and American peoples and our European allies, but that can be only done if the Russians open their oil and gas industry to foreign investment, improve the rule of law, make the courts independent, and fight corruption. Otherwise, just as my colleague said, they will treat our European allies in accordance to the Roman principle of divide et impera. We need to get the message across that curbing the use of energy as a geopolitical tool is a top American priority.

[The prepared statement of Mr. Cohen follows:]

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CONGRESSIONAL TESTIMONY

The Russian and Eurasian Energy Outlook and US National Interests

Testimony before the Europe and Eurasia Subcommittee, House International Relations Committee

June 2, 2011

Ariel Cohen, Ph.D.
Senior Research Fellow for Russian and Eurasian Studies and International Energy Policy,
The Heritage Foundation

The Russian and Eurasian Energy Outlook and US National Interests

Testimony by Ariel Cohen, Ph.D., Senior Research Fellow for Russian and Eurasian Studies, The Heritage Foundation

June 2, 2011, Washington, D.C.

My name is Ariel Cohen. I am Senior Research Fellow for Russian and Eurasian Studies and International Energy Policy at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

As a giant energy producer and major energy transit country, Russia is an important player in the field of global energy production. Russia has the largest reserves of natural gas in the world, and possesses some 79.4 billion barrels of oil, approximately 6.4% of the world's total.[1] In 2009 oil production, Russia accounted for 9.9 million barrels per day (mbd), competing only with Saudi Arabia for the title of number one oil producer.[2] Total Russian net oil exports reached 7 mbd the same year.[3] Russia produced 527.5 billion cubic meters of natural gas during the recession in 2009, second only to the United States.[4] In addition, large areas of Eastern Siberia and the Arctic are still unexplored and, according to experts, are expected to yield up to a quarter of the world's energy supply.

Despite its vast resource base and its formal assurances of its reliability as a partner, Moscow has already proved that it is willing to hike up oil and gas prices to match the general trend of higher energy prices, engage in anti-free market practices, especially at home and in Europe, and use energy as a foreign policy tool.

Russia is willing to use force to achieve its geo-economic goals as well. Control of energy corridors from the Caspian Sea to the Black Sea and beyond was an objective of the Russian military operation against Georgia in August 2008. This has been clearly confirmed by other incidents involving delays in energy supplies to Ukraine, Azerbaijan, Belarus, Georgia and the Baltic states. Many argue that Moscow's international energy behavior leaves its partners insecure and makes observers doubt that Russia is a responsible player, especially when unconstrained by competition and powerful investment sources.

To this day, Moscow is dependent upon the massive pipelines built during the Soviet era. Russia's energy policy is facilitated by the Soviet-era oil and gas infrastructure that ties Central Asian producers to Russia for their access to external markets. As part of its strategy, Russia

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[1] BP 2007 Energy Survey, June 2008, p. 6, http://www.bp.com/liveassets/bp_internet/globalbp/globalbp_uk_english/reports_and_publications/statistical_energy_review_2008/STAGING/local_assets/downloads/pdf/statistical_review_of_world_energy_full_review_2008.pdf

[2] EIA, *Russia Gas*, Country Analysis Briefs, Department of Energy, Energy Information Agency, November 2010, http://www.eia.doe.gov/emeu/cabs/Russia/Oil_exports.html (Accessed February 28, 2011)

[3] *Ibid.*

[4] BP 2009 Energy Survey, June 2010, p. 22, http://www.bp.com/liveassets/bp_internet/globalbp/globalbp_uk_english/reports_and_publications/statistical_energy_review_2008/STAGING/local_assets/2010_downloads/statistical_review_of_world_energy_full_report_2010.pdf

works to maintain control over energy transportation routes and opposes any projects that could provide Europe with alternative supply lines. European demand was very high before the recent economic crisis, and is projected to grow further provided the current geopolitical instability does not cause another global recession. Eastern Europe consumes even higher percentages of Russian energy, with several countries entirely dependent on Russian gas. However, US and Europe should have serious reservations concerning Russian practices that limit access to the market, tend to promote corruption, and expand Moscow's energy transport agenda.

Russian Energy Policy Overview:
Energy Nationalism and Abuse of State Ownership

Russia has criticized Europe's approach to international energy security as limited to the interests of energy importers. Under Russia's presidency in the Group of Eight (G8), then-President Vladimir Putin made energy relations a central theme at the 2006 summit in St. Petersburg, presenting his own vision for "global energy security".[5] While talking of interdependence and dialogue, Russia insisted on demand guarantees for the producers, and sharing responsibilities and risks among energy suppliers, consumers, and transit states. Putin spoke of joint commitments to work on the energy arena with coordination and distribution of profits and risks to prevent energy conflicts.[6] This would not be a problem if Russia allowed international oil companies (IOCs) minimally restricted access to its energy resources. Unfortunately, since 2003 this hardly has been the case, as the state has pursued a policy of monopolizing gas production and oil and gas pipeline transportation, and has tightened its grip on the quickly growing oil production sector by effectively expropriating YUKOS and buying the Sibneft and Russneft oil companies.

The trend toward marginalizing and even actively persecuting independent Russian energy businesses has continued, with the controversial re-sentencing of Russian oil magnate Mikhail Khodorkovsky in December of 2010, resulting in six more years in prison for the former businessman.[7] His appeal to the Moscow City Court was rejected on May 24th, 2011, despite the fact that President Medvedev publicly announced that Khodorkovsky does not represent a danger to public order. Moreover, after a seven-year delay, Amnesty International finally declared Khodorovsky a prisoner of conscience.[8]

The Khodorkovsky case is particularly symbolic. In 2003, the former oil tycoon went from being one of Russia's leading energy capitalists, owner of the YUKOS Oil Company and a promoter of economic and political liberalization, to a political prisoner. Of course, YUKOS was subsumed into Igor Sechin's Rosneft, a major state-owned oil company until recently. Before he was imprisoned, Khodorkovsky's opposition to then-President Vladimir Putin's authoritarian administration and the spread of corruption resulted in a long list of absurd charges

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[5] Nina Kulikova, "*Voprosy Energeticheskoy bezopasnosti pozitsiya Rossii* [The Issues of Energy Security – Russia's Position]," *RIA Novosti*, September 1, 2006, http://www.rian.ru/analytics/20060901/53406077.html

[6] *Global Energy Security Fact Sheet*: Official Website of G8 Summit in St. Petersburg, 2006, http://www.en.g8russia.ru/press/facts/global_energy/ (Accessed March 5, 2011)

[7] Vasilyeva, Nataliya, Russian Tycoon Khodorkovsky gets 6 more years, *Washington Times*, World News section, December 30, 2010, http://www.washingtontimes.com/news/2010/dec/30/russian-tycoon-khodorkovsky-gets-6-more-years/ (Accessed March 1, 2011)

[8] "Amnesty International declares Khodorkovsky 'prisoner of conscience'", *RIA Novosti*, http://en.rian.ru/russia/20110524/164210044.html (May 28, 2011)

of tax evasion and fraud. Somehow, even the fact that YUKOS was making a profit under his leadership became a chargeable offense.

The last conviction was handed down on December 29, 2010, after Khodorkovsky was accused of stealing 350 million tons of oil from his own company, a claim made all the more unbelievable given that the Russia state accounted for – and taxed – all the oil YUKOS sold, and that the total alleged production figures were higher than YUKOS' reported output.[9]

The tainted nature of this case became even more evident after lawyer and blogger Alexei Navalny's exposé of corruption in the construction of Transneft's massive East Siberian pipeline. Some four billion U.S. dollars have been stolen or defrauded by individuals close to the Kremlin with no redress.[10] Instead of thanking the whistle blower, the authorities paid Navalny back by launching a criminal investigation against him.

The non-transparent, unfair nature of the Khodorkovsky cases has received a great deal of criticism from Western leadership, including a statement from President Obama as well as European governments.[11] The matter highlights not only the "vendetta" politics of contemporary Russia,[12] but also that fact that the Russian government, not energy companies or international markets, sets policy on the nation's economy, and particularly its energy sector.

Energy Superpower?

Russia's Energy Strategy, adopted in 2003, sets the framework for the country's energy policy. Thus, Russian energy security builds upon "protection of the country, its citizens, and economy from [external and domestic] threats to the reliable energy supply," including geopolitical and energy market risk factors.[13] Moscow claims to promote a non-discriminative regime for the Russian companies to access foreign energy markets and advance their participation in large international oil and gas projects. Energy factors are placed in the center of Russian diplomacy. As then-President Putin noted in one of his speeches, "the place Russia takes in global energy cooperation directly impacts its current and future wellbeing."[14] Russia's energy strategy through 2030, formulated in 2009, predicted even greater increases in Russia's oil and gas production sector, despite issues with property rights, an impractical and unevenly enforced tax code, the huge scope of needed investments, and concerns about the obsolescent infrastructure.[15] With ample energy resources and a dominant position in the European market, Russia's hydrocarbon power will remain impressive into 2020 and beyond. Russia's decision

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[9] Simon Shuster; Khodorkovsky Case: Russia's Courtroom of the Absurd; *Time*, Dec. 27, 2010, http://www.time.com/time/world/article/0,8599,2039824,00.html

[10] Volchok, Dmitry; Юрист Алексей Навальный – о коррупции в компании "Транснефть" [Jurist Aleksei Navalny – on corruption in Transneft]; *Радио Свобода [Radio Liberty, Russian language]*, November 20, 2010, http://www.svobodanews.ru/content/article/2225552.html

[11] Ariel Cohen; "Free Khodorkovsky"; *Heritage Commentary,March 10, 2010, http://www.heritage.org/research/commentary/2010/03/free-khodorkovsky*

[12] Tisdall, Simon. "Mikhail Khodorkovsky: The latest victim of Vladimir Putin's vendetta politics"; *The Guardian*, December 27. 2010, http://www.guardian.co.uk/world/2010/dec/27/mikhail-khodorkovsky-vladimir-putin

[13] "Energy Strategy of the Russian Federation for the Period till 2020," http://www.minprom.gov.ru/docs/strateg/1.

[14] V. Salgin, "Globalnaya energeticheskaya bezopasnost' I vneshnyaya energeticheskaya politika Rossii [Global Energy Security and Russia's Foreign Energy Policy]."., *Neftegaz,* June 28, 2007, http://www.neftegaz.ru/analit/reviews.php?id=548

[15] Blagov, Sergei, Reality Check for Russian Oil, *Asia Times Online*, Central Asia section, January 5, 2011, http://www.atimes.com/atimes/Central_Asia/MA05Ag01.html (Accessed March 1, 2011)

makers sense that consumer governments and companies, anxious to gain access to coveted barrels and cubic meters, do not want to challenge the supplier's assertive foreign policy.

In the remaining years until 2020, Russia seeks to maximize its economic and geostrategic advantages as a major energy producer with vast hydrocarbon reserves. This becomes even more poignant as Middle East supplies are now suffering from the repercussions of the "Arab spring" and the future of the nuclear power has become more uncertain as a result of the nuclear power station disaster triggered by the recent tsunami that struck Japan.

The Kremlin has advanced Russia's energy strategy through an array of security and economic policies, all of which aim at a common strategic goal. The aggregate effect is to create customer country dependency by locking in demand with energy importers and consolidating oil and gas supplies by signing long-term contracts with Russian and Central Asian state-owned or state-controlled energy producers and Russian state-owned pipeline monopolists.

Europe is mainly concerned about potential supply disruptions resulting from government actions or policies that impact gas supply sources and transit. In recent years, the issue of gas corridor diversification has become increasingly important for Europe as EU officials try to reduce the region's dependence on Russian gas.

Arctic Energy Strategy

When the Russian flag was planted on the Arctic seabed under the North Pole in 2007, this was no pretense at subtlety. The act was overt and audacious. Moscow claims a sector of the energy-rich Arctic continental shelf along the Lomonosov Ridge, an underwater structure protruding from the northern coast of Eurasia towards the North Pole and abutting the Canadian and Danish sectors. Vladimir Putin weighed in during a speech on a Russian nuclear-powered icebreaker in early 2007, urging greater efforts to secure Russia's "strategic, economic, scientific and defense interests" in the Arctic.[16] Moscow's moves are dictated by energy-driven geopolitics and geo-economics. Geologists believe the Arctic Ocean's seabed may contain nearly 25 percent of the world's remaining hydrocarbon deposits. It is also rich in diamonds, and precious ferrous and non-ferrous metals.[17] As the ice cap melts and shrinks, these resources will become more accessible and a new sea passage along the northern coast of Eurasia may provide a cheaper transportation route.

From a geopolitical perspective, the exploration of polar petroleum reserves may be the kind of opportunity that allows Russia to become what then-President Putin termed "an energy superpower." Russia seeks to expand its continental shelf beyond the 200-mile economic zone through a mechanism provided by the UN Commission on the Limits of the Continental Shelf under the 1982 U.N. Law of the Sea Convention (UNCLOS), to which Russia is a party. Moscow claims that two underwater mountain ridges jutting into the Arctic Ocean from the Russian continental shelf—the Lomonosov Ridge and the Mendeleev Ridge—are extensions of

[16] Ariel Cohen, "Russia's Race for the Arctic," Heritage Foundation *WebMemo* No. 1582, August 6, 2007, http://www.heritage.org/Research/RussiaandEurasia/upload/wm_1582.pdf

[17] Alexander Gabuev, "Print – Cold War Goes North: Russia and the West begin the race for the Arctic Region," *Kommersant,* August 4, 2007

the Eurasian landmass[18] . The span of this area of seabed approximates the size of France, Germany and Italy combined. Russia's first claim with the UN, submitted in 2001, failed due to insufficient evidence.

In recent years, Russia has aggressively moved forward with the expansion its presence in the Arctic region, while the US has been less active in advancing its interests in this strategically important region endowed with vast natural resources. [19] As Arctic sea-lanes are becoming more navigable due to climate change, the competition for the vast natural resources of the Arctic is more likely to intensify. In February 2011, Russia's state-controlled Rosneft and British petroleum giant BP entered into an agreement to develop Arctic oil fields with estimated reserves of 5 billion tons of oil and 10 trillion cubic meters of gas. However, Russian Arctic energy development is likely to face difficulties because of the significant risks and costs associated with Arctic offshore drilling.

Great challenges also abound for the Arctic and East Siberian/Far East gas fields. These reserves lack functioning gas fields and pipelines, and require hundreds of billions of dollars in investments. Many hopes were hung on the Shtokman gas field, located over 300 miles offshore in the Barents Sea, where local sea depths exceeding 300 meters.[20] After many delays, Gazprom reconsidered its earlier decision to develop the field alone. In July 2007, Gazprom signed an agreement with France's Total, followed by a deal with Norway's Statoil Hydro in October 2007 covering the first phase of Shtokman development.[21] , U.S. companies were kept out despite earlier promises to include Chevron and possibly Conoco Phillips. However, the agreement gives Total and Statoil Hydro no ownership rights to the gas. Gazprom, through its 100 percent-owned subsidiary Sevmorneftegaz, remains the full owner of the Shtokman development license and will be the full owner and sole exporter of products.[22]

While Norway's Statoil Hydro has vast experience drilling off shore in the northern longitude, Total is cash-rich but has no experience working in Arctic conditions.[23]The completion of the Shtokman field in the Arctic has now been pushed back to 2016. Other fields under development in the Arctic and polar regions are often even more challenging than Shtokman. Only in the case of the Kovykta field in East Siberia is production assured: this field was essentially expropriated away from BP by the GOR and handed over to Gazprom, which the GOR controls, so that Gazprom could develop it and build a pipeline to China. Likewise, there is substantial additional gas in Eastern Siberia, including in Yakutia, which could be developed for the Chinese market.

China, Japan, and other destinations in East Asia are also attractive markets for East Siberian and Sakhalin Island gas, but it remains to be seen if Russia develops massive new fields

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[18] "Russia: Polar Expedition Means 'Very Little' For Territorial Claims," RFE/RL, August 3, 2007

[19] Ariel Cohen. "From Russian Competition to Natural Resources Access: Recasting U.S. Arctic Policy," Heritage Foundation. Backgrounder #2421, June 15, 2010, at http://www.heritage.org/Research/Reports/2010/06/From-Russian-Competition-to-Natural-Resources-Access-Recasting-US-Arctic-Policy#_fn62 (March 16, 2011)

[20] Shtokman Field, Gazprom Project – Field website, http://www.gazprom.com/production/projects/deposits/shp/

[21] "Statoil Hydro to develop Shtokman field," *New Europe*, Issue 753, October 25 2007, http://www.neurope.eu/articles/Statoil-Hydro-to-develop-Shtokman-field-/79155.php, and "Total signs on Shtokman dotted line," Upstream Online, July 13, 2007, http://www.upstreamonline.com/incoming/article137232.ece

[22] "New owner of Shtokman license", *Barents Observer*, Energy, February 18, 2009, http://www.barentsobserver.com/new-owner-of-shtokman-license.4559032-16178.html

[23] "Shtokman Watchers: Statoil Demonstrates Arctic Capability", *Oil & Gas Eurasia*, July 25, 2007, http://www.oilandgaseurasia.com/news/p/0/news/835

in the Arctic, as the difficulties with the recent Rosneft-BP deal may suggest. There, BP's Russian billionaire partners in the TNK-BP joint venture derailed an asset swap and Arctic field development by BP and Rosneft.

Recoverable gas and oil reserves around Sakhalin Island, one of the world's largest natural gas fields, are estimated at almost 7 billion barrels and 80 trillion cubic feet respectively, one of the largest in the world.

The Russian government announced a number of costly programs to explore and develop the East Siberian oil and gas fields and to build a network of oil and gas pipelines in the 2020-2030 timeframe, which will cost tens of billions of dollars.[24] In addition, the Russian leadership realizes the need to open up to foreign investment in its energy sector, since Russia needs Western capital and technology to successfully develop its climatically and geologically challenging oil and gas reserves. Furthermore, Russia, unlike any of the other major energy exporting countries, is also one of the world's leading industrial energy consumers, primarily because of the country's inefficient, aging infrastructure and utilities.

Internal Consolidation

The Russian oil and gas sector is notorious for easing domestic and foreign corporations out of majority equity stakes in Russian mega-projects and for consolidating domestic ownership in the hands of government-controlled entities. The two Russian energy national champions—vertically integrated state-owned or controlled global companies capable of competing with foreign corporations—are headed by senior officials close to Vladimir Putin. Putin's former Chief of Staff and later successor as president, Dmitry Medvedev, was the ex-officio chairperson of Gazprom. Today, Putin's one-time mentor, former Prime Minister Victor Zubkov, occupies this position. Putin ally Alexei Miller is the long-serving CEO of Gazprom. Putin confidante and First Deputy Prime Minister Igor Sechin, who is in charge of energy and heavy industry, until recently chaired the board of Rosneft, Russia's largest state-run oil company, which expropriated the bulk of YUKOS assets. This management scheme ensures that Gazprom and Rosneft are reliable foreign policy arms for the Kremlin. Since the early 2000s Moscow limited access by major international energy corporations to giant Russian fields and forced them to give up their majority stakes in lucrative projects.

The Natural Resources Law limited foreign participation in energy exploration projects to minority stakes—25 percent in 'strategic' oil and gas fields, and 49 percent in other energy projects. Limited in their rights to own exploration licenses, the transnational corporations are reduced in many cases to operator or technical service provider roles. In June 2007, then-First Deputy Prime Minister Sergey Ivanov said that foreign companies "will never operate" Russia's major fields again.[25]

Although leading officials, including Mr. Medvedev, have explicitly rejected state capitalism as a model for Russia, the Kremlin is actively consolidating its ownership in the energy sector. Putin envisages the state not as the great re-nationalizer, but as the biggest shareholder in a privatized economy.[26] The return of strategic assets under state control is often

[24] U.S. Energy Information Administration, Independent Statistics and Analysis, Russia: Country Analysis Brief, November 11, 2010, accessed at: < http://www.eia.doe.gov/cabs/Sakhalin/Background.html>.
[25] Torrey Clark and Lucian Kim. "Gazprom Gains BP Gas Field as Putin tightens control," *Bloomberg*, June 22, 2007, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=afwFHAGtof3Y&refer=uk
[26] Nick Paton Walsh, "Meet the Chief Exec of Kremlin Inc.," *The Guardian*, July 6, 2005

presented to the public as the restoration of national property illicitly acquired in the mid-1990s by corrupt and politically manipulative oligarchs at deeply discounted prices.
This certainly was the case with state-owned Rosneft's 2004 murky acquisition of Yuganskneftegaz, the key production unit of forcibly bankrupted YUKOS. Despite the company's having received a clean bill of health from the Russian tax authorities, the State, through trumped-up bankruptcy proceedings, sold YUKOS to a straw company in a no-bid sale, which in turn sold it to Rosneft at a grossly undervalued price. Rosneft then amalgamated the YUKOS oil-producing company into its operations. The two principal YUKOS principal owners, Mikhail Khodorkovsky, discussed in detail earlier, and his business partner Platon Lebedev, received 13.5 year sentences in two highly flawed court proceedings; and the YUKOS affair became a byword for Russian-style judicial arbitrariness and politically motivated justice.

Western companies were also the subject of heavy-handed state interventionin the energy sector. Royal Dutch Shell was evicted from the Sakahlin project. British Petroleum was evicted from the lucrative Kovykta gas field in eastern Siberia after the forced sale of its 62.9 percent stake to Gazprom in June 2007. The TNK-BP joint venture was unable to meet production quotas prescribed by the Kremlin because pipeline monopolist Gazprom refused to develop any export pipelines. After officials threatened to cancel the license, and the courts refused to intervene, BP-TNK agreed to sell its Kovykta stake to Gazprom at a fraction of its market value.[27] Later on, in 2007–2008, the TNK-BP joint venture, with its unique 50–50 control between the Russian and British partners almost fell apart. This was due to pressure from the Russian partners, known as Alfa Access Renova (AAR) to oust the BP-appointed CEO and gain more control of the company. Many experts suspected that the ultimate goal was to force the British company to sell to AAR or to a Russian state-owned oil company; however, falling oil prices and the precipitous Russian stock market slide of 40 percent from May to August 2008 may have put pressure on the Russian partners to settle. A compromise, rare in the Russian oil sector, was achieved in early September 2008, and for now, the joint venture is continuing.

BP, however, signed what its chief executive, Bob Dudley, termed a "milestone" a joint-venture contract with Russia's Rosneft oil giant to develop the oil reserves in Russia's Arctic regions in January 2011.[28] However, relations between AAR and BP remain problematic, as the oligarchs sued BP in Great Britain and prevented its agreement with Rosneft from being executed. At this point, BP is trying to buy out AAR from the TNK-BP joint venture. While BP's leadership may envision a new strategy in Russia aimed at overcoming its troubles in the Gulf of Mexico, Russia's past relationship with foreign oil companies and with BP in particular raises many risk management questions.

Due to the resumption of global economic growth, and even before the current instability in the Middle East, oil prices have been increasing since January 2011, and consequently, Russian oil companies been enjoying higher oil revenues.

Sloviki in Charge

The Kremlin-affiliated structures are squeezing independent energy companies to get hold of their assets. In a ground-breaking interview to *Kommersant*, Oleg Shvartsman, then the

[27] "Russian Arm Twisting: Another Energy Firm Backs Down." *The Economist, June 22, 2007.*
[28] ABC Staff; *BP signs deal with Russian oil giant*; Australian Broadcasting Corporation, News, Jan 15, 2011, http://www.abc.net.au/news/stories/2011/01/15/3113634.htm (Accessed March 1, 2011)

head of the Finansgroup financial-industrial group close to the *siloviki* ("men of force", primarily the leaders around Putin who have security services backgrounds) revealed a scheme intended to pressure private companies that the Kremlin finds insufficiently accountable to the state.[29] Among the group's key assets is the Russian Oil Group that cooperates with Rosneft, TNK, and Lukoil. After an initial push for trading alliances, Finansgroup began to acquire small and medium-sized oil-refineries, using illicit activities to bring down corporate values prior to the acquisition.[30] Finansgroup also manages the so-called Social Investments Corporation, exercising what Shvartsman called the "velvet re-privatization" of strategic assets based on various voluntary and coercive market instruments of asset absorption. Shvartsman said the group enjoys the full support of the Russian "power" ministries, including the Interior Ministry, FSB, and the tax and environmental authorities.[31]

Simultaneously, Russia is seeking to develop its energy services industry. Only recently, the Eurasian Drilling Company, the largest provider of onshore drilling services in Russia, signed a substantive contract with world-famous hydrocarbon oil and gas services firm Schlumberger. According to the strategic contract, a vast exchange of assets will occur between the two industry leaders, but most importantly, Schlumberger will become a subcontractor for Eurasia's drilling operations for "up to 200 rigs for a 5-year period."[32]

Domestic consolidation of the Russian oil and gas industry under the Kremlin's direct ownership or control increases Moscow's options in the continued use of energy as a foreign policy tool. These major takeovers and expropriations further limit opportunities for foreign investment and technology transfer to the Russian energy sector and beyond. They signal the return of statist economic policies, and widespread corruption, while allowing the state to interrupt the flow of oil or gas for political reasons far more easily than a private-sector owned company would be able to do.

Russian Energy Geopolitics to 2020: The American Perspective

Russia's energy nationalism has been a source of frustration in Washington. From an American perspective, growing European energy imports on monopolistic Russian oil and gas exporters is a negative long-term geopolitical trend. However, there are other issues. Despite being the world's largest energy consumer, the United States has limited energy relations with Russia. In 2002–2003 Russia refused to construct projects dedicated to oil exports to the United States, such as the Murmansk pipeline, suggested by the then-privately held YUKOS, LUKoil and Sibneft oil companies. Moscow has also derailed attempts by U.S. oil supermajors to buy

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[29] "*Partiyu dlya nas olitsetvoryaet silovoy blok, kotoryy vozglavlyaet Igor Ivanovich Sechin* [The Party is embodied for us in the power bloc led by Igor I. Sechin]." *Kommersant*, November 30, 2007, http://www.kommersant.ru/daily.aspx?date=20071130.

[30] Jonas Bernstein, "Finansgroup: How Russia's Siloviki Do Business," Jamestown Foundation *Eurasia Daily Monitor*, November 30, 2007, www.jamestown.org.

[31] *Partiyu dlya nas olitsetvoryaet silovoy blok, kotoryy vozglavlyaet Igor Ivanovich Sechin* [The Party is embodied for us in the power bloc led by Igor I. Sechin]." *Kommersant*, November 30, 2007, http://www.kommersant.ru/daily.aspx?date=20071130

[32] *Eurasia Drilling Company and Schlumberger Enter Strategic Alliance, Sell and Purchase Assets*, Schlumberger, Press Release, October 5, 2010, http://www.slb.com/news/press_releases/2010/2010_1005_edc_slb_alliance.aspx (Accessed on March 1, 2011)

significant non-controlling stakes in large private Russian companies such as YUKOS. On the other hand, Gazprom considered and abandoned plans to export LNG to the US West Coast.

If Moscow is serious about the "reset", it needs to address a number of fundamental issues, first and foremost the issues of market access and the rule of law. First, US companies should gain access to oil and gas fields and pipeline projects, not limited by the obsolescent Natural Resources Law and the state-owned pipeline monopolies.

Second, for Russia to develop its Arctic and East Siberian reserves, it needs to put an end to corruption; completely revamp the rule of law, including assuring independence of the courts from the executive branch regardless of the scope of disputes and the powerful personas involved. The Russian government should provide Western companies enforceable guarantees that foreign investment will not be jeopardized by moving goalposts; revising the terms and conditions of prior investments. Ideally, it should also significantly disinvest the state from the natural resources sector. Finally, prior violations of the rule of law need to be redressed.

Energy issues spill over into the realm of the geopolitical balance-of-power. When energy prices skyrocketed in 2007-2008, Russia quickly evolved into an assertive anti-status quo power that challenged the U.S. and its allies on many fronts, especially in the territory of the former Soviet Union, as the 2008 Russian-Georgian Five Day War demonstrated. There are also ongoing frictions in the Balkans and the Middle East, where Russia has opposed Western policies. This happens both because of the ample funding available to finance a more ambitious foreign policy due to energy revenues and the self-assurance which comes with general economic prosperity, as well as from Moscow's tendency to use energy as a foreign policy tool. As oil prices rise, it is safe to expect Russia's cockiness to return.

Russia's strategic goals include preventing countries around its borders from becoming pro-American as well as increasing control over the transportation of Russia hydrocarbons through the territory of its neighbors. Furthermore, the Kremlin aims to control the export of oil and gas from neighboring countries by directing their flow via the Russian pipeline system. By locating pipelines and gas storage facilities in Austria, Hungary, Bulgaria, Greece and Turkey, Russia connects them to Moscow with ties that bind. Sometimes, these ties also include lucrative personal economic deals, as demonstrated by the employment of Gerhardt Schroeder as Chairman of the North Stream gas pipeline consortium, and similar arrangements for other prominent European politicians.

Russia also attempted to push the United States out of Central Asia, and successfully limited US participation in new Caspian energy projects, excluding it from the SCO's Energy Club. The United States, for its part, supports diversification of energy transportation routes in Eurasia. From the Russian perspective, the U.S. and EU-backed pursuit of diversified energy sources and transportation routes is unfriendly towards Russia, politically motivated, economically unfeasible and environmentally damaging. The Kremlin is likely to use Europe's dependence on Eurasian energy to exacerbate differences in transatlantic relations and use its influence to minimize the pro-American foreign policy agenda. In the current decade, America's allies in Europe may face tough choices between the cost and stability of their energy supply, on one hand, and siding with the United States on key issues, on the other hand.

In sum, the developed world economies and energy net importers in general will benefit from greater stability, security, transparency, and the rule of law in energy-exporting states, to ensure that oil and gas remain readily available, ample, affordable, and safe. However, the Kremlin views energy as a tool of assertive foreign policy and uses it broadly, often without much concern for diplomatic niceties. If current trends prevail, this decade may see the Kremlin

might translating energy monopoly into increasing foreign and security policy influence in Europe. In particular, Russia is seeking recognition of its predominant role in the post-Soviet space and Eastern Europe. This has already affected geopolitical issues important to the West, such as NATO expansion, ballistic missile defense, the tension around the status of Kosovo, and Moscow's increasing influence in the post-Soviet space.

Furthermore, before the current instability erupted, Moscow was seeking to re-engage in a centuries-old balance-of-power game in the Middle East, from Algeria, where it attempted a gas condominium, to Syria, where it is rebuilding naval bases in Tartus and Ladakiye and supplying modern weapons, to Iran and India.[33] Though in the end it voted in the UN Security Council with the U.S. and Europe during diplomatic crises over the Iranian nuclear enrichment program, Moscow has continually provided Teheran ample diplomatic cover in the United Nations and elsewhere, as well as expanded arms supplies. Moscow also abstained in the UNSC vote on Libya – together with China and Germany. Premier Putin harshly criticized the Libya war as a "new crusade", clearly trying to score points for Russia in the Middle East.
The Obama Administration seems to be less concerned about European energy dependence on Russia than its predecessor was. Just recently, Russian President Dmitry Medvedev and the American president announced plans to liberalize visa restrictions for businessmen and tourists travelling between the two countries in a joint statement at the G8 summit in Deauville. "We have instructed our officials to concentrate on visa liberalization on a reciprocal basis for the largest segments of our traveling nationals," the statement said. Under the new agreement, eligible business travelers and tourists would be issued visas valid for 36 months at a unified and reciprocal fee. Government officials would also be eligible to receive 12-month multi-entry visas.[34] While freedom of travel is a good thing overall, the US Congress is seeking to limit travel to the US on the part of clearly corrupt Russian officials or those engaged in human rights violations or property expropriation, as will be discussed *infra*. In this respect, the Administration is defying Congress and going in a wrong direction.

There are a number of steps the Obama Administration and Congress can take to address Russian state graft and corruption. Some of these measures were outlined by The Heritage Foundation.[35] Specifically, the Administration should increase cooperation among U.S. and allied intelligence services, law enforcement agencies, and independent experts to track Russian state and oligarch money laundering activities, corruption, and unfair competition practices. The White House should encourage U.S. and other multinational companies to compete in economically viable energy and infrastructure projects overseas through free-trade, diplomatic and security support, and regulatory and tax policies that will enhance free competition without government-directed investment decisions. U.S. companies should be encouraged to compete for

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[33] "Top Russian arms clients: India, Algeria, China, Venezuela, Syria", *World Tribune*, News, January 29, 2010, http://www.worldtribune.com/worldtribune/WTARC/2010/eu_russia0069_01_29.asp

[34] "Medvedev, Obama vow to liberalize bilateral visas", http://en.rian.ru/russia/20110526/164249981.html

[35] Ariel Cohen, Ph.D. *and* Lajos Szaszdi, Ph.D. "Russia's Drive for Global Economic Power: A Challenge for the Obama Administration", Backgrounder #2235, *January 30, 2009* http://www.heritage.org/Research/Reports/2009/01/Russias-Drive-for-Global-Economic-Power-A-Challenge-for-the-Obama-Administration

participation in the development of Turkmenistan's gas fields as well as in other geopolitically significant ventures, which Russia is targeting in India, Southeast Asia, Africa, and Latin America. The US should promote market-viable alternative energy sources and unconventional sources of fuels worldwide to counter the West's strategic dependency on Russian, Iranian, and Venezuelan oil. This should be accomplished through deregulation and trade and tax policies that encourage innovation and investment to develop, and through commercializing new sources of energy that best meet the needs of individual regions and nations. Western economies will be better off by expanding the supply of transportation fuels and reducing their Russian energy imports, thus reducing the influx of revenue into Kremlin coffers. Last but not least, the US should expand security cooperation with Russia's energy-exporting neighbors and other countries that Russia is targeting for energy cooperation, including train-and-equip programs for military and security forces protecting pipelines, and officer corps education in U.S. military colleges, and should make better use of NATO's Partnership for Peace program.

Washington should encourage Europe's energy diversification, providing political and diplomatic support to major consumers of Russian oil and gas to develop alternative energy pipelines throughout Europe and Eurasia. It is vital for EU members to come up with a joint position on energy geopolitics instead of lucrative bilateral deals, which only increase the region's dependence on Russian oil and gas. It is also necessary to insist that Russia live up to its commitments to uphold and implement the rule of law, without which its economic development, property rights, and civil liberties will remain in limbo. Otherwise, Russia will be positioned to apply the ancient Roman principle—*divide et impera*—to 21st century energy geopolitics.Finally, Congress should pass – and the president should sign – S. 1039, the Sergei Magnitsky Rule of Law Accountability Act of 2011. This bill, dedicated to the memory of a Moscow whistleblower lawyer who died in jail under torture in November of 2009, revokes visas and prohibits financial transactions for Russian officials who engage in

> extrajudicial killings, torture, or other gross violations of human rights committed against individuals seeking … to expose illegal activity carried out by officials of the Government of the Russian Federation; or … to obtain, exercise, defend, or promote internationally recognized human rights and freedoms, such as the freedoms of religion, expression, association, and assembly and the rights to a fair trial and democratic elections (Section 4, Paragraph 2).

Congress has an important role to play in changing the relations with Russia in the energy field for the better, for the benefit of the Russian and American peoples and our European allies. It is time to make the Russian oil and gas sector more transparent and open to foreign investment while curbing the use of energy as a geopolitical tool, which endangers Russia's neighbors.

# # #

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Mr. MARINO. Thank you, Dr. Cohen.
Ambassador Wilson.

STATEMENT OF THE HONORABLE ROSS WILSON, DIRECTOR, DINU PATRICIU EURASIA CENTER, ATLANTIC COUNCIL

Mr. WILSON. Thank you very much, Mr. Chairman. Let me join my colleagues in thanking you and the committee for the opportunity to be here. With your permission, I will summarize a longer statement that I would ask be entered into the record.

Mr. MARINO. Surely.

Mr. WILSON. For nearly 20 years, the United States has pursued a Eurasian energy strategy that is based on four sets of interests that I think remain valid.

First, given our dependence and that of most of our allies on imported energy, we have attached importance, as Ambassador Morningstar noted, to the development of new sources of oil and gas. The political changes that came after the Cold War ended made available to world markets resources in Eurasia that were previously inaccessible. American leaders have strongly supported the region's energy development. And I am proud to have been part of that effort as an American Ambassador in Azerbaijan and Turkey.

Second, we have regarded the success of the former Soviet states to be in America's interest. For over four decades, the principal threat to our way of life came from a Eurasian land mass dominated by a hostile Kremlin. More recently, new threats came from al-Qaeda that has offshoots in Central Asia. These countries' ability to govern themselves effectively, to secure their borders, and to foster prosperity for their people matters to American national security. Energy is an asset that they have to build a better future.

Third, we have supported multiple pipelines. Our policy has recognized that economies depending on a single set of transit routes through Russia will be neither strong nor independent, and their relationships with Russia won't be very healthy either. Multiple pipelines are the deliverers of energy security for Caspian producers and for our European allies alike.

A fourth set of U.S. interests can be ungrammatically summed up as: Not Iran. From your questions, Mr. Chairman, I think this is particularly pertinent for you. It has long been U.S. policy, reflected in legislation that this committee has been associated with, to oppose the development of Iran's oil and gas industries. Caspian energy, especially gas, has been a positive complement to the threat of sanctions, an alternative source for Iran for U.S. allies who are desperate to diversify their energy supplies. By helping to develop pipelines to the Black and Mediterranean Seas we have assured Iran could not become a principal export route for Caspian energy.

The next phase of Caspian energy development is natural gas, and it needs American support. The operator of Azerbaijan's offshore Shah Deniz project expects to decide, as Ambassador Morningstar indicated, soon on fully developing this giant gas field and an export route to Europe for that gas. The realization of the so-called southern gas corridor and the exploitation of Shah Deniz as a supplier for Europe will advance American interests. However,

I believe there is a possibility that well-intentioned new Iran sanctions legislation under discussion may imperil this future. Surely, this is not intentional.

In the mid-1990s, Azerbaijan's President and a friend of the United States, Heydar Aliyev, decided on Western firms, U.S. and Western firms, to lead his country's energy development. He made sure that the pipelines to take those resources to market would avoid Russia and Iran. He thought it politic to give modest and non-controlling shares in key projects, including Shah Deniz, to Russia and Iran. One could argue from the vantage point of hindsight whether this was wise policy. At the time, Azerbaijan felt its security was directly threatened by both those countries and so needed to placate them at a time when there was really no other option available for doing so.

As I understand it, Iran's sanctions language now under discussion might require Western firms with a stake in Shah Deniz to divest themselves of their investments and walk away. As Ambassador Morningstar indicated, the effect of this is that Shah Deniz will stall. Other Caspian gas will not get developed for Europe. No new East-West gas pipelines will be built. That will deprive our European friends and allies of gas that they need and increase pressure on them to turn to Russia and Iran for alternative supplies. I urge Congress and the administration to work together on Iran sanctions legislation that will be strong and effective to be sure, but that will also not sacrifice longstanding U.S. objectives and interests with respect to Shah Deniz and Eurasian energy.

Mr. Chairman, Eurasia is part of a vast region of instabilities whose evolution I think will have a lot to do with whether the 21st century is reasonably peaceful or not. Recent events in the Middle East and North Africa remind us that no energy strategy can ignore regional politics and economics. Eurasia faces many challenges. We need more intense, sustained and broadened American and Western diplomacy on energy and the full range of issues that affect these countries and Western interests there. This is not just my view, but it is also what I hear from leaders in Uzbekistan, Azerbaijan, Kazakhstan, Georgia and other countries.

The administration has taken some steps. I know that there are members of this committee who visited this region, too. This effort should be sustained, it should be strengthened. Building cooperation, drawing these countries more toward the West and toward more prosperous, peaceful, and free futures will be better for all of us.

Mr. Chairman, thank you. I look forward to responding to your questions.

[The prepared statement of Mr. Wilson follows:]

As prepared
for delivery

U.S. Strategy on Eurasia and Eurasian Energy

Ambassador Ross Wilson
Director, Dinu Patriciu Eurasia Center
Atlantic Council of the United States

House Committee on Foreign Affairs
hearing on
European and Eurasian Energy: Developing Capabilities for Security and Prosperity

June 2, 2011
Washington, D.C.

Mr. Chairman, thank you for this opportunity to be part of today's discussion about energy, Europe and Eurasia. Eurasia is part of a vast region of instabilities whose evolution will have a lot to do with whether the 21st century is reasonably peaceful or not, and energy issues are crucial for the global economy. It is wise that you focus on how these items come together and what should be American strategy going forward.

For nearly twenty years, the United States has pursued a Eurasian energy strategy based on four sets of interests and objectives.

First, given the dependence of our economy and the economies of most of our allies on imported energy, we have attached importance to the development of new sources of oil and gas. The political changes that came after the Cold War made available to world markets Caspian and Central Asian resources that were previously inaccessible. Beginning with talks that Secretary of State James Baker and U.S. Ambassador to the Soviet Union Robert Strauss had in Almaty with Kazakhstani leader Nursultan Nazarbayev even before the collapse of the USSR, American officials and business leaders have engaged intensively to support Eurasian energy development.

Second, we have regarded the success of the new independent states of the former Soviet Union to be in America's interests. For over four decades, the principal threat to our way of life came from a Eurasian landmass dominated by a hostile Kremlin. More recently, new threats came from al-Qaeda, a network based in Afghanistan, but with offshoots in Central Asia. These post-Soviet countries' ability to govern effectively, secure their borders and provide better lives for their citizens matters to U.S. national security. Energy is a potential "get out of poverty" card – an asset that resource and transit countries can use on behalf of a better future.

Third, we have supported multiple pipelines. This was summed up in bumper stickers an American ambassador to Kazakhstan, Beth Jones, had printed up years ago that read, "Happiness is Multiple Pipelines." Our policy recognized that economies depending on a single set of pipelines that go through one country, Russia, will be neither strong nor independent, and their

relationships with Russia won't be healthy either. To express this positively, multiple routes, especially those like Baku-Tbilisi-Ceyhan (BTC) that lead directly to international markets, are the deliverers of real economic independence. They represent greater energy security for our European allies, too, and multiple pipelines are themselves spurs for further exploration and development.

A fourth set of U.S. interests in Caspian energy could be ungrammatically summed up as "not Iran." It has long been U.S. policy, reflected in legislation that this committee has been associated with, to oppose the development of Iran's oil and gas industries. Caspian energy, especially gas, has been a positive complement to the threat of sanctions – an alternative to Iran for U.S. friends and allies desperate to augment and diversify their energy supplies. By helping develop pipelines to the Black and Mediterranean Seas, we have ensured that Iran could not become a principal export route for Caspian energy. Energy development and effective market-democratic policies in Eurasia have been and are ways to counter Iranian influence in Eurasia.

The next phase of Caspian energy development is natural gas, and it needs American support. The operator of Azerbaijan's offshore Shah Deniz project expects to decide in coming months on fully developing this giant gas field and on an export route to Europe for its gas. Negotiations among producers, potential consumers and transit countries on the details – and bickering over how to divide the spoils – have made progress slow. Patient U.S. diplomacy led by Ambassador Richard Morningstar has proven very helpful.

The realization of a major new Southern Corridor gas export route and the successful exploitation of Shah Deniz as a supplier to Europe will significantly advance American interests. Among other things, this progress opens the door to further progress on Eurasian energy, including to connect Turkmen and northern Iraqi gas with European and other markets. However, there is a serious possibility that well-intentioned new Iran sanctions legislation now under discussion may imperil this future. We risk undermining, if not standing on its head, a remarkably successful energy strategy that has helped our friends and allies and hurt Iran. Surely this is unintentional.

In the mid-1990s, Azerbaijan's president and a friend of the United States, Heydar Aliyev, decided on Western firms to lead the development of his country's large, offshore oil deposits at Azeri-Chirag-Guneshli (ACG), the BTC main oil pipeline, and Shah Deniz and its associated gas pipeline infrastructure. He made sure the planned pipeline routes would avoid Russia and Iran. He also thought it politic to give modest and non-controlling shares in ACG and Shah Deniz to Russia and Iran. One can argue from the vantage point of hindsight about whether this was wise policy. At the time, Azerbaijan felt its security interests could be directly threatened by both and so needed to placate them at a time when no other option for doing so was available. As I understand it, Iran sanctions language now under discussion might require BP and other Western firms with a stake in Shah Deniz to divest themselves of their investments and walk away from the project.

What will be the effect of this? Shah Deniz might not get developed. That will deprive our European friends and allies of needed gas and increase pressure on them to turn to Russia and Iran for alternative supplies. Or Azerbaijan might go ahead with the project, but to make money

it would likely have to export the gas to Russia or to Iran – unhelpful for U.S. policy on Eurasian energy or for punishing Iran. Without Shah Deniz, other Caspian gas will not get developed. No new, larger volume gas pipelines from the Caspian to Europe will be built. No Turkmen gas will flow west, little or no gas from Iraq will flow north, and the energy security of America's allies in Europe will remain more uncertain than is wise or necessary. U.S. relations with Azerbaijan, a close partner on regional energy issues for nearly two decades, will suffer, with ill effects for that country's cooperation with us on Northern Distribution Network supplies for Coalition forces in Afghanistan.

I urge Congress and the Administration to work with interested parties on Iranian sanctions legislation that will be strong and effective, to be sure, but that also will not sacrifice important and longstanding U.S. objectives and interests with respect to Shah Deniz and Eurasian energy.

Mr. Chairman, recent events in the Middle East and North Africa remind us that no energy strategy in any part of the world can ignore domestic politics or economics. In the 1990s, I and others argued that these new countries were on democratizing and market liberalizing trend lines, even if on many specific issues there were serious failings. The United States had a rich and frequent conversation at senior levels with leaders from all across Eurasia. There was buy-in on issues of interest to them *and* on issues of interest to us, including on economic and political liberalization. Virtually nowhere can one say these things now.

To ensure a reasonable level of success in these still fragile and ill-developed countries in a region marked by instabilities, we need more intense, sustained and broadened American and Western diplomacy on energy and the full range of issues that affect these countries and Western interests there. In Tashkent two months ago, I heard plenty of comments about the deterioration of U.S.-Uzbek relations after the terrible events in Andijan in 2005, but no one talked about wanting the United States less engaged. On the contrary, those I spoke with wanted us to be more present and more involved, including domestic reform. In Azerbaijan last June, I heard complaints, too, but Azeris wanted more United States, not less. The same can be said of Kazakhstan, Kyrgyzstan, Georgia, Armenia and most, if not all of the countries in the region.

It was helpful that Secretary of State Hillary Clinton and Secretary of Defense Robert Gates visited the Caucasus last summer. Assistant Secretary of State for South and Central Asia Robert Blake and others have started to redevelop U.S. dialogue with Central Asia. I would urge members of Congress and other senior officials in the Executive Branch to get us back in the game in this important region and to do so in a personal and sustained way. Go and hear out the region's complaints and concerns. Try to understand where the leaders and peoples of these countries are really coming from. Resist the temptation to judge in black versus white, good versus bad terms. Work to identify common interests and ways to advance them together. Building cooperation, drawing these countries more toward the West and toward more prosperous, peaceful and free futures will be better for all of us.

Mr. Chairman, thank you for holding this hearing. I look forward to what I am sure will be an interesting and useful discussion.

Mr. MARINO. Thank you, Ambassador Wilson.

Gentlemen, just for the record, your full written statements will be made part of the complete record. I have a myriad of questions here for you. One of my great interests is the country of Russia, one I studied in college; the Soviet Union. So you are going to have to actually cut me off.

I am going to ask a specific question to each of you, but if the others have comments on it, please relay those comments to us as well.

I am going to start off with Ambassador Smith, please. You mentioned indifference of Europe and the U.S. toward Russia's business mentality. Would you suggest that the West is too eager to oppose Moscow to get to its resources and is this adverse to the U.S. and European national security interests?

Ambassador SMITH. Yes. Mr. Chairman, I certainly agree with that. There has been a big rush by companies, particularly European countries, to try to get into Russia, at a point where even—take BP. BP has been in and pushed out three times. Shell has been in and pushed out three times. There is a very good book by a professor at Harvard called "Petrostate," which documents the eagerness of companies to go in thinking they are going to make enough money. The Russians get the technology and then boot them out. This has gone on and on and on.

I think that there has been too much competition. They have not followed a lot of the companies in Europe. I think the American companies on the whole have been pretty good; pretty open and transparent in their operations in Europe. I think a lot of the Europeans have scrambled hard to get an advantage.

You will notice that of all the companies that have had trouble in Russia—and most of the European and American companies have had trouble since Mr. Putin came in—have had problems with their contracts. Germany has not. Quite frankly, one has to ask oneself: Why have the German companies been able to operate without retaliation on the part of the Russians or having their assets taken away?

I think it is plain that the German Government has been very friendly to the Russians, and I think that has had an effect. But I think the whole area of transparency and corruption is one that we have been too lax, and I think we, being the Europeans mainly, but I think the United States—I think, quite frankly, Russia—and I will just end this. I am not a Russian specialist, although I have been following this for a long time. But I think that Russia is somewhat in a corner right now, and partly because of the United States. And what has happened is the big revolution in unconventional gas that is taking place in Europe and in the other parts of the United States is really having an enormous influence on the price of gas in Europe and on Russia's ability to squeeze these countries for higher and higher prices.

I think that now, with the kind of a new revolution in the United States of unconventional oil and the refracking for oil, that in the long run this is going to have an effect. Because the Chinese are picking this up, the Australians are picking this up. Poland of course is getting very much into unconventional gas. And I suspect there may be some unconventional oil there, too.

So all this is going to have an effect. I think the politics, we can do what we want, what we think is best in trying to help our European friends on energy security, but I think quite frankly that the facts on the ground, particularly in the United States, with the unconventional gas and oil, is going to have a big effect. What we have to do I think is fight back against a lot of absolutely insane propaganda in the United States, which is being quoted all over Europe by the Russians about the dangers of unconventional gas.

This movie "Gasland" I think had a bad effect. Also, I think Cornell University did a study which was very flawed. We have to kind of explain to our European friends over and over again this is not—these are not factual; that there are problems and we have to be careful. But this is really the direction they should be moving.

Mr. MARINO. Ambassador, that movie was based on the heart of my district. I am very, very familiar with it, and I do have to state this: 35 or 40 years ago, when I was going to my uncle's cabin, he would entertain us by turning on the spigot and lighting a lighter or match and there would be a poof of the methane. So it is nothing new.

Ambassador SMITH. No, sir. But that wasn't the unconventional fracking that caused that.

Mr. MARINO. Right.

Dr. Cohen, do you have any response to my question?

Mr. COHEN. Yes, sir. I think it is an excellent question because there is a linkage between interest of Europeans in investment in Russian oil and gas and getting a steady supply, or interest, for example, of the Obama administration to accomplish unrealistic goals of getting to zero, meaning to get the world rid of nuclear weapons in the time, which it is absolutely unrealistic when Pakistan, Iran, China, are all building nuclear arsenals. To entice the Russians to sign arms treaty agreements, we put our energy interests on the back burner. We did not promote independence of non-Russian post-Soviet states as vigorously as we did under the Clinton and Bush administrations. I would say that there is a break between the bipartisan policy of engagement in Eurasia in the Bush and Clinton administrations and what the Obama administration did in the Caspian and the Caucasus.

Additionally, other countries, like the Europeans, took steps that were appeasing to the Russians and probably from a business perspective provided jobs. I am talking specifically about the sale of helicopter carriers, the Mistral class ships, by France to Russia. They agreed to sell two French ships and then to build two more in Russia. At the same time, the Russians stuck to their guns.

The former First Deputy Prime Minister Sergey Ivanov, said, "No Western companies will have access to Russian strategic energy fields." The laws—the natural resources law and other laws that control Western investment in the energy field are Draconian. They discriminate against Western companies. And as I mentioned with the Yukos case, the Russian Government went after private companies and destroyed them and expropriated them, because they wanted to consolidate all these resources under the control of the selected few who run the state-owned energy companies.

So, you have a situation not unfamiliar from other places: An extreme case of resource nationalism that is against the interests of

the consumers in Europe and around the world and against the interests of the Russian taxpayers because of the opacity of the state sector, opacities and violations that were documented by brave whistleblowers like the lawyer Alexei Navalny who now, instead of a thank you, has a criminal investigation against himself. Navalny documented $4.5 billion disappearing, stolen, or defrauded from the state in the construction of the East Siberian oil pipeline.

So these are examples where we need more transparency, and the Obama administration should not be shy bringing these issues up in their meetings with President Medvedev, and if they manage to meet with Putin, which is a tough call, a tough job to get these meetings, but I understand Vice President Biden was successful in that back in April, bringing it up with Mr. Putin without shying away from these tough questions.

Mr. MARINO. Point well taken, Doctor.

Ambassador, do you have any response to that question?

Mr. WILSON. The only thing I would add to what my colleagues have said is the energy companies have worked very vigorously in Russia for the obvious reason: Russia has a lot of energy. Conditions are difficult. Many of the same issues referred to arise in lots of our countries where they operate, and they have concluded properly, more or less correctly, that they just have to try to work their way through those matters.

I can't speak in a lot of detail to the Obama administration's approach on these things. I know that previous administrations worked hard on issues of energy sector transparency and rule of law in that sector. Our leverage is limited. This sector is the crown jewel or one of the crown jewels of the Russian economy, and the leaders there have been very protective of it.

Mr. MARINO. A specific question for Dr. Cohen. Russia likes to bend the rules and at times makes new ones and forgets old ones in the middle of the game. U.S. investors are out $12 billion, as was stated just several minutes ago, after Moscow pursued Yukos into a nonexistence through manipulation of its legal system. First, how can the U.S. Government work to recover lost investment from Russia? And second, this is a repeating theme, as we have seen Russia's legal system file claims against international investors. Why would this change?

Mr. COHEN. I didn't hear the last part of the last sentence, sir.

Mr. MARINO. Why would this change?

Mr. COHEN. Sir, the only way Russia may modify its behavior is when there are assets or policy priorities at stake that they value more than the current practice. With the Yukos case, yes, there were vast numbers of American investors. There were vast numbers of non-American investors—Russians, Brits, and others, including pension funds, including firefighter retirement funds, including the former National Security Adviser to President Reagan—who were all investors in Yukos. As the company was expropriated and its owners were either put in jail or turned into fugitives, these American investors lost their assets by the acts of state that were found illegal in a number of courts in arbitration procedures. And Yukos' previous owners were found persecuted as political opponents and recognized, including by Amnesty International, as political prisoners.

The path, which is open for American investors, is what is called the espousal. And in that procedure U.S. Government adopts the claims of U.S. nationals as the claims of its own because of the lack of the bilateral investment treaty between us and the Russians. When it adopts these claims, it can pursue a monetary settlement of these claims in government-to-government negotiations. And the most common manner of the espousal is an attempt to negotiate a lump sum settlement.

At the current moment, the State Department met with the investors, I understand, took under advisory their position, and in a 2011 interview with the Russian President, Ambassador Bill Burns, our Under Secretary of State, said,

> "Trade and investment, as I mentioned before, are increasing between the United States and Russia, and I hope very much that continues. But it is also important to us—both of us—to address the obstacles in the path on expansion and questions that arise.
>
> "The case of Yukos, for example, there is another very practical reason that Americans are concerned; that there is a number of Americans in Yukos with several billions of dollars of investment at stake."

So we see that the U.S. Government is aware of the situation. The question is why the espousal procedures have not started. And that is not a question to me, sir. That is a question for the representatives of our Government.

Mr. MARINO. Anyone care to respond to that?

Ambassador SMITH. I don't know what I can add. I knew Mr. Khodorkovsky personally and used to meet with him on some investment issues. But I think that the one thing that will influence the Russian Government is if we made investment—we don't allow them to invest in the United States in the same manner—for instance, Lukoil has 3,000 gasoline stations around the United States. The idea that an American company could have 3,000 gasoline stations in Russia is inconceivable. This idea of reciprocity I think is one thing that we have because they do want to invest in the United States. There are big steel mills in the United States that are now under Russian ownership. That is not necessarily bad, but I think that we should demand, quite frankly, total reciprocity in investment in major industrial plants and also in raw materials.

Russia has become a big investor in raw materials in the United States and Canada, and I think that they should be limited to the 20 percent that they limit Americans to in Russia. So I think reciprocity is the only language they understand, quite frankly.

Mr. MARINO. Doctor?

Mr. COHEN. If I may add, in 2009 we published a backgrounder at The Heritage Foundation in which we are focusing on what is Russia doing worldwide economically; who are the actors, what industries do they target, and how they behave. While we at The Heritage Foundation clearly are the supporters of free markets, we also are supporters of the rule of law. And what we suggested in this 2009 backgrounder that I will be happy to share with the committee is that the U.S. will take a lead on focusing on illegal activities by Russian officials or, for that matter, some Russian business

people, if they launder money, if they deal in illicit activities—there were Russian banks that were identified in criminal investigations as funding child pornography. This is unacceptable.

So we should send a strong signal that we are looking at what you are doing, we know what you are doing. A good example is this arms dealer Viktor Bout. Viktor Bout was, through legal proceedings, apprehended in the country of Thailand. The Russian Government went full court press to prevent him from being extradited to the United States. They used every trick in the book. But Viktor Bout was extradited from Thailand and is facing justice in New York. This should be one of the models of what we can do with our allies in Europe and elsewhere.

Another example, I mentioned, is the Magnitskiy legislation. A tax official who was involved in fraud that the late Sergey Magnitskiy exposed, was found to own with her colleagues and relatives real estate and other assets in the tens of millions of dollars around the world. The Swiss froze those accounts. At least part of these assets are now frozen in Switzerland. That is another example how illicit Russian behavior can be countered. Very little of that happens so far. I do believe we can and should be using, as Ambassador Smith suggested, reciprocity. But that reciprocity can be asymmetrical, as the Russians like to say. So if they want to play chess, we can play chess.

Mr. MARINO. Thank you. Ambassador Wilson, you characterized oil as a potential get-out-of-poverty card that could be played by both source and transit countries. However, in places such as Nigeria, the world has seen the negative effect the oil can have on developing countries.

What can the United States and its European allies do to ensure that oil-related revenues actually benefit the people of the region?

Mr. WILSON. Mr. Chairman, the problem you identify is one that exists all over the world among countries that have large-scale natural resources to export and to trade in. One of the things that we worked on when I was in Azerbaijan, and I believe this has also been a theme in our diplomacy with Kazakhstan, has been to encourage the establishment of an oil fund, of a sovereign oil fund, operated in a reasonably transparent way with publicly available information about where the money is, how the proceeds are being spent, and so forth. Definitely not perfect and not an answer to—ultimately an answer to the question that you pose. Smart or cleaver leaders, clever oilmen, can find ways to make money even outside of—to make money that operates outside of that particular oil fund. But it has been helpful.

The Azeri oil fund I think is now hundreds and hundreds of millions—billions of dollars—that have effectively been parked for use by future generations of Azerbaijan. Parking them has helped to curb inflationary and other domestic pressures. As I said, I know that in the Azerbaijan case that particular fund got very high marks from organizations that look at transparency and transparent use of resources.

I think a second thing that we have to do and that we have done not with as much success as we would like is to encourage more effective economic strategies and more effective economic integration with the world economy and with the region. Many of the

countries in Eurasia, including Azerbaijan and Turkmenistan, Uzbekistan, Kazakhstan, are not members of the World Trade Organization. Their trading relationship with others are quite limited. Their economies are in some respects closed and in most respects what I would call adversarial or predatory. Incoming traders have a difficult time and all too often I think lose their shirts.

To the extent that these countries become more integrated into the world economy, they will have to adopt rules and rule of law standards more in line with those that are common in the West. There can still be plenty of problems. Corruption is an issue in lots of countries and not just in energy resource-rich ones. But I think developing more effective strategies to promote market economic reform and real open and transparent investment regimes, real open and transparent monetary flows, particularly when you are talking about these huge sums of money, that has got to be a big part of it.

I think the third element is work to promote democratic institutions, work to promote civil society, and to ensure that free media can operate in these countries to identify shortcomings locally, to talk about those shortcomings and issues locally, and to be some kind of a pressure for change. At the end of the day, a lot of these countries don't necessarily respond to what the United States or what others tell them to do. At the end of the day they don't always respond to their own people either. But I think over the long term that is probably the most important step that the United States can take to promote effective use of oil revenues as well as of course to promote long-term stability and effective governance.

Mr. MARINO. Thank you, Ambassador. I am reaching back into my college days when I was studying political science and I took a course on Russia. And my professor wrote the book. I remember he had a quote in there. I think he referred to it as actum dictum, which was: Power corrupts. Absolute power corrupts absolutely. And I have a little twist on that. Money is power. But money and guns are absolute power.

So how do we get over that hurdle when we are dealing with Russia, Putin, and other KGB members who we know are attempting to pursue what they think is a legitimate career? You have testified brilliantly as to what actually has been going on in Russia and Europe. How do we get over that hurdle with these individuals?

Ambassador Smith.

Ambassador SMITH. Well, I can't say that I have the answer. There are a couple of things that I think are more important than guns in this case, and that is transparency. I hate to harp on that, but I think that greater transparency in the energy sector, particularly between Russia and Europe and Central Asia and Europe, would defeat a lot of, and is defeating to some extent, some of the actions of the intelligence people. In fact, these are facts on the ground. The countries that require greater transparency don't have the same problems of the others.

I think the other issue is the science and technology cooperation of the United States and what is happening in the U.S. I think quite frankly the unconventional gas revolution is to some extent defeating the interests of the elites in Russia that benefit from the

illicit profits that are made out of oil and gas. The studies show that 50 percent of all the investment by Gazprom in pipeline projects is frittered away in corruption. Fifty percent. That is an enormous amount of money. We pretty well know where it goes, quite frankly.

But I think that yes, guns and power or guns and money can be a deadly combination. But quite frankly, I think that I have a little more faith in democracy and transparency and the ability of some of these countries. I think little countries like Lithuania standing up to Russia and taking them to court. They are doing other things to take away some of their assets that they developed through I will say nontransparent means; companies they were able to acquire by paying people under the table. When you have got that kind of a system where you can rely on your connections during the Cold War, you have still got connections in Europe. You have got people who are very democratic. They believe that—they are free-market people. As the President of a European country—I named him in my writings, but I don't particularly want to do it here—who in fact just allowed the Russians to pay for his trip to Russia to publish a book that he wrote. Why does a President of a free democratic country do that? Once that became known and freely available to the press in that country, there was a lot of backing off.

So I think I still believe in transparency. You have got people in Russia—I have been a target of a lawsuit by one of the oligarchs who is involved in the Russian energy trade. And there have been some other people here in town. But their ability to do that in the future has now been curbed because President Obama signed legislation saying that U.S. courts are not required to carry out libel judgments of a London court, which is where these guys take you because they can't do it here because of the First Amendment. So they try to intimidate you. This kind of intimidation is weakened. It has been weakened over the last couple of years.

So I think there are some positive things happening. The unconventional gas revolution in the United States has affected the thing that Dr. Cohen mentioned, the Shtokman field up in the Barents Sea. It is not working. Yes, they brought in the French and the Norwegians to help work in the field. But it is dead. It is a dead project for a long time because of what has happened in America.

The science and technology cooperation that we are developing now with the Central Europeans I think is very important and we should continue that, and I hope that the Congress funds that adequately.

Thank you.

Mr. MARINO. Thank you.

Dr. Cohen.

Mr. COHEN. You were raising very tough questions but these are very good legitimate questions. I think that without changing the mindset of the Russian people we may not be able to affect the outcomes of the change that you are talking about. But at the end of the day, it is freedom that defeated Communism, and it was defeated in the Soviet Union through, among other things, the brave lives and brave work of people like Alexander Solzhenitsyn and Andrei Sakharov and Lech Walensa.

So the issue is, what the new generation of Russian people—not ethnic Russians, because Russia is a multiethnic, multireligious country—but new generation of Russian citizens, of Ukrainians and Belorussians and others, what they will value, what they will seek. And the Russian state is hard at work to make them nationalists, to make them supportive of their government through the Internet, through television.

We just had a panel yesterday at Heritage on Internet freedom in Russia. We heard from experts that the Russian Government is hiring armies of pro-government bloggers to be a presence on the Internet. But we in the United States now are stepping back in launching the struggle for hearts and minds. We are not as involved in the struggle through tools of public diplomacy as we used to be during the Cold War. We won the Cold War among other things through public diplomacy, through Radio Liberty, Voice of America, et cetera. We are not doing a good job, and this applies to the previous administration and to this administration, in terms of fighting radical Islam and their proponents. Al-Qaeda has a huge online presence.

We are not doing a good job supporting those in Russia who are willing to fight against corruption, to fight for freedom, to fight for democracy and an open political system.

But in any case, as we saw in the Middle East, the harsh state policies can last only as long as people are willing to accept them. And once they don't, once they protest, once they demand free elections, open media, stopping state control of television, these things may change.

Mr. MARINO. Thank you.

Mr. COHEN. And we need to do more to reach out to Russians, Belorussians, to people in Central Asia and other places who want freedom and work with them and support them.

Mr. MARINO. Doctor, you brought up a point earlier concerning you are amazed at the pornography that was budgeted for and comes out of Russia.

Mr. COHEN. Facilitated by Russia.

Mr. MARINO. When I was U.S. Attorney, that was one of my main projects, prosecuting pornographers, and it was just unbelievable, under the guise of legitimate businessmen, the pornography that was coming out of Russia. It is extraordinary.

Ambassador Wilson?

Ambassador WILSON. Mr. Chairman, it is always great to be last because all the good things have been said. I agree more or less with what my colleagues have said. I am a realist when it comes to foreign policy in a lot of respects. We have to deal with the world as it is, maybe not as we would like it to be. And I think as we calibrate the United States relations with Russia, we want and need to distinguish between the things that are essential in our national interest that we have to work with Russia, whatever its flaws may be, and other issues that may not be so important to us and we draw some appropriate conclusions from that.

The second thing I would say, I had the privilege of serving in our Embassy in Moscow for 5 years in the 1980s and I had the impression then and even more so now that one of the drivers that influenced the developments that happened in the late 1980s, and

ultimately the breakup of the Soviet Union, was a strong desire among citizens of the Soviet Union to live in a civilized country, to live in a European country, and to be seen as a real place and not something that was operating on different standards and that was removed from the rest of the world. I think that desire to be in a civilized country and in a European country remains a strong and powerful thing.

So to echo what some of my colleagues have said, stated in a different way, the more that we can draw Russia and Russians into the international system, the more the Russian citizens get out and travel and express politically in their own country this desire to be in a civilized country and to act on the things that flow from that, the more likely there will be internal pressures that will lead Russia in the right direction.

It is not going to change in the ways we would like it to because we say so; it will change because of what people there do. And I think everything we can do, and it is limited, but what we can do that encourages that kind of thinking among Russian citizens, the more likely we will see the sort of country we would like to see.

Mr. MARINO. Gentlemen, in conclusion, if you could just answer this last question briefly, and we will start with you, Ambassador Wilson, so you have an opportunity to take this on without hearing anybody else talk about it.

What should the U.S. be doing to convince Russia to end its occupancy in Georgia?

Ambassador WILSON. I will say two things, Mr. Chairman. Russia needs to understand and see that there are costs in its relations with a whole range of countries that it cares about that follow from its occupation of Georgia. The United States I think has been reasonably clear in the objections that it has to the events of August 2008 and to the ongoing state of affairs in Abkhazia and South Ossetia. I would not say the same of our European allies, including allies that the United States gave extremely strong, vigorous and costly support to throughout the Cold War.

So I think some stiffening of European spines is probably going to have a greater impact on Russian policy toward Georgia than almost anything that I can imagine the United States directly can do. And there I think Members of Congress in particular can play a role, through the NATO Parliamentary Assembly, through the OSCE Parliamentary Assembly and others, in engaging with your colleagues and talking to them about this, because Europeans I talk to have Georgia number 998 on their of list of 1,000 priorities.

The second thing I would say is my own personal perspective, and nothing I have said here reflects the Atlantic Council's views, but my own personal perspective is that in the absence of some significant change, including new pressure from Europeans that Russia cares about, the situation in Georgia is likely to be a long-lasting one. I think if that is going to be the case, some strategic patience on the part of the United States that we exercised over the 40 years that Germany was divided is probably going to be a necessary approach.

Work with the Russians in areas where it is in our interest to work with them where we have to; try to ensure that there is some cost to their relationship for us in what is going on in Georgia;

stand up for what we believe and keep saying it about Georgia, but also be prepared for a long game.

Thank you.

Mr. MARINO. Thank you, Ambassador.

Dr. Cohen?

Mr. COHEN. I generally agree with Ambassador Wilson's analysis. Russia also points out that despite the 2008 war, they won the bids to be the host of Winter Olympics of 2014 right on the border of Abkhazia, which is part of Georgia that you refer to as occupied. I believe they won the 2018 world soccer championship, which is huge. And I am not sure what the year is, maybe 2020, the world hockey championship. So these are the achievements that are real achievements for the Russian people that the leadership there points out and says, you see, we did what we did; we are not paying the price.

So if this is the mindset, the question to the policymakers is, is it possible to reverse the mindset? Otherwise we are, what Ambassador Wilson described, the strategic patience. Sometimes strategic patience does work. Not only Germany was divided, the Baltic States were occupied since 1939, first by the Soviet Union, from 1940 by the Soviet Union, then by Nazi Germany, and then again by the Soviet Union. We recognized the governments in exile, and in the end the Soviet Union collapsed and the Balts regained their independence.

Steps by the Europeans like the sale of the Mistral helicopter carriers that I mentioned already, do not help. They are sending the wrong message.

Any kind of recognition or integration of the representatives of these two enclaves, Abkhazia and South Ossetia, in Russian diplomatic delegations and any attempts to keep them as separate entities should not be recognized by American diplomats.

And there is a sensitive issue of supply of U.S. defensive weapons to Georgia. Since the Obama administration came to power, my understanding is that no defense weapons were sold to Georgia, including no spare parts for something as simple as M–4 rifles. While there are many meetings and discussions, including the recent meeting of Vice President Biden with President Saakashvili, the administration has not changed its position.

But this is clearly an executive branch decision. They are looking at the big picture and this is something that they decided. Whether it is sending the right signal to the Russians and whether it is enhancing the security of the Georgia and people is an open question.

Mr. MARINO. Thank you, Dr. Cohen.

Ambassador Smith.

Ambassador SMITH. It is hard to add much to that, except there are two things, and I better stress especially at this point that I don't speak for anybody else at CSIS but myself. But from my experience in that part of the world, I think, quite frankly, we are deficient in intelligence assets.

There are a lot of things going on. Whether or not it is who is responsible for a lot of the demonstrations going on in Georgia, there are charges that the Russians have been behind it. We do know there have been several attempts by Russian intelligence offi-

cers to carry out certain disruptive events in Georgia, including possibly trying to replace the President.

I think that we need to be sure that we are funding and we have adequate assets, because I know that in that part of the world we have drained down a lot of our intelligence assets to put them in the Middle East, and I think that is one of the things we need to work on. And we need to publicize, when we can back up the charges of interference in the internal affairs of these countries, not just Georgia but others, Ukraine for instance, that we do it.

The second leverage , the big leverage we have with Georgia I think is WTO membership. The Georgians actually have to agree with it, and we told the Russians that they have to reach a deal with the Georgians. And I think that is a little bit of leverage, a lot of leverage, that we need to use and use fairly openly.

The third thing, and I would agree with Dr. Cohen on this issue, and that is military assistance to Georgia. I believe that really we should be giving them equipment that is purely defensive, but giving them the ability to ratchet up their defense, particularly now that the French have agreed, as he mentioned earlier, agreed to sell these Mistral ships and missiles to the Russians, because the first thing that came out of Russia when the French made that announcement was some Russian general said, well, gee, we could have taken Georgia in just a few minutes rather than several days. So I think that is something that is important.

The fourth and last thing is, just to repeat again, I think we need to put some heat on our European allies who are showing a lack of courage in that. The agreement between Georgia and Russia was brokered by the French, and the OSCE was supposed to play a very strong role in that, and when the Russians after the agreement was signed said no, we are not going to allow that, the Europeans did not complain. They were a little spineless in that, I think.

Anyway, I will believe it at that.

Mr. MARINO. Doctor?

Mr. COHEN. Real quick, the problem we are facing in Europe is that Russian modus operandi, the way they deal is directly with either heads of state or former heads of state. When I say deal, I mean deal in sometimes billions of dollars.

The acting Prime Minister of a major European ally is known to be involved personally. The Prime Minister of Turkey deals directly with Mr. Putin on oil and gas transactions. And the former Chancellor of Germany chairs the consortium that built the Nord Stream pipeline and is a great friend of Russia, which is his right, but we also know it is a matter of public record that he receives a fat salary from Gazprom and he called Mr. Putin "a great democrat."

So when you have personal diplomacy of that kind on that level, we need to devise our diplomacy and our responses very, very carefully.

Mr. MARINO. Gentleman, I can't thank you enough for your testimony today. Your expertise and your intellect was clearly demonstrated today. I learned a great deal. As a matter of fact, I rather enjoy being the only one up here asking the questions, because this is the first time—I have been here 5 months, I am a new legislator,

but I actually had the opportunity to ask all my questions and your answers precipitated further questions.

Thank you so much. I am going to invite you back because my colleagues, they really missed a lesson today. It was extraordinary, and I thank you so very much.

The meeting is adjourned.

[Whereupon, at 4:45 p.m., the subcommittee was adjourned.]

APPENDIX

Material Submitted for the Hearing Record

SUBCOMMITTEE HEARING NOTICE
COMMITTEE ON FOREIGN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES
WASHINGTON, D.C. 20515-0128

Subcommittee on Europe and Eurasia
Dan Burton (R-IN), Chairman

May 31, 2011

You are respectfully requested to attend an OPEN hearing of the Committee on Foreign Affairs' Subcommittee on Europe and Eurasia, to be held in **Room 2172 of the Rayburn House Office Building (and available live, via the WEBCAST link on the Committee website at http://www.hcfa.house.gov):**

DATE: Thursday, June 2, 2011

TIME: 2:30 p.m.

SUBJECT: European and Eurasian Energy: Developing Capabilities for Security and Prosperity

WITNESSES: **Panel I**

The Honorable Richard L. Morningstar
Special Envoy for Eurasian Energy
U.S. Department of State

Panel II

Ariel Cohen, Ph.D.
Senior Research Fellow
The Kathryn and Shelby Cullom Davis Institute for International Studies
The Heritage Foundation

Ambassador Keith C. Smith
Senior Associate
New European Democracies Project
Center for Strategic and International Studies

Ambassador Ross Wilson
Director
Dinu Patriciu Eurasia Center
Atlantic Council

By Direction of the Chairman

The Committee on Foreign Affairs seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202/225-5021 at least four business days in advance of the event, whenever practicable. Questions with regard to special accommodations in general (including availability of Committee materials in alternative formats and assistive listening devices) may be directed to the Committee.

COMMITTEE ON FOREIGN AFFAIRS

MINUTES OF SUBCOMMITTEE ON *Europe and Eurasia* HEARING

Day *Thursday* **Date** *June 2, 2011* **Room** *2172*

Starting Time *2:30* **Ending Time** *4:44*

Recesses [ ] (____ to ____) (____ to ____) (____ to ____) (____ to ____) (____ to ____) (____ to ____)

Presiding Member(s)

Dan Burton, Tim Griffin, Tom Marino

Check all of the following that apply:

Open Session [✓]
Executive (closed) Session [ ]
Televised [✓]
Electronically Recorded (taped) [ ]
Stenographic Record [✓]

TITLE OF HEARING:

"European and Eurasian Energy: Developing Capabilities for Security and Prosperity"

SUBCOMMITTEE MEMBERS PRESENT:

Dan Burton, Tim Griffin, Tom Marino, Jean Schmidt.

NON-SUBCOMMITTEE MEMBERS PRESENT: *(Mark with an * if they are not members of full committee.)*

None

HEARING WITNESSES: Same as meeting notice attached? Yes [✓] **No** [ ]
(If "no", please list below and include title, agency, department, or organization.)

STATEMENTS FOR THE RECORD: *(List any statements submitted for the record.)*

Chairman Burton's opening remarks
Rep. Meeks' opening remarks
Witness statement of the Honorable Richard L. Morningstar, Special Envoy for Eurasian Energy at the U.S. Department of State
Witness statement of Ariel Cohen, Ph.D., Senior Research Fellow at the Kathryn and Shelby Cullom Davis Institute for International Studies, the Heritage Foundation
Witness statement of Ambassador Keith C. Smith, Senior Associate at the New European Democracies Project, Center for Strategic and International Studies
Witness statement of Ambassador Ross Wilson, Director at the Dinu Patriciu Eurasia Center, Atlantic Council
Statement for the Record, Mr. Boyko Nizov, Director of Programs at the Dinu Patriciu Eurasia Center, Atlantic Council
Essay, Foreign Affairs, January/February 2011, "The Good News About Gas." by John Deutch.

TIME SCHEDULED TO RECONVENE _____
or
TIME ADJOURNED *4:44 PM*

Mark J. Walker
Subcommittee Staff Director

OPENING STATEMENT
RANKING MEMBER GREGORY W. MEEKS
SUBCOMMITTEE ON EUROPE AND EURASIA HEARING
"EUROPEAN AND EURASIAN ENERGY:
DEVELOPING CAPABILITIES FOR SECURITY AND PROSPERITY"

JUNE 2, 2011

Thank you Chairman Burton for calling this hearing on European and Eurasian energy issues.

Energy security issues in Europe and Eurasia are directly connected to prosperity, economic growth, regional integration, stability and peace, and therefore of importance to the entire region as well as to the United States.

Europe and Eurasia's energy situation presents a complex picture of unevenly distributed energy scenarios. Collectively, EU member states import over half their energy supply, including approximately 84% of their oil and 62% of their natural gas. Some EU countries are almost entirely reliant on outside providers of energy, while others are largely self-sufficient or even net energy exporters.

The EU's neighbor, Russia, possesses the largest natural gas reserves in the world and also large oil reserves. The Central Asia, Caspian and Black Sea regions offer opportunities for much needed diversification strategies, if successfully connected to European markets, but uncertainties surround the various pipeline projects currently under discussion. The Middle East and North Africa also provide substantial oil and gas resources to Europe, and has the potential to increase these amounts if a more stable and open investment climate can be achieved. Energy exploration is increasing in the Arctic and could potentially provide vast amounts of untapped resources for both European and global markets.

Overall, Europeans are pursuing a number of strategies to address their future energy needs, including development of alternative energy sources, market liberalization, research and investment in renewable energy, increased efficiency, and ambitious policy goals.

Generally, Europeans are ahead of the curve in two ways: utilizing renewable energy and reducing energy consumption. The United States can learn from both strategies. Consider, for example, that according to the World Bank, Americans use almost twice as much energy per capita as many of the European countries that we would normally compare ourselves with. Simultaneously, the European Union has a target of achieving 20% of their energy supply from renewables by 2020. Several countries are already far ahead of this goal, utilizing hydro, solar, and wind power aggressively to diversify their national energy markets. The percentage of renewables in the U.S. energy mix is around 11%, for comparison.

The EU has also led cooperation to create interconnectedness across the European continent, in order to ensure energy security, prevent dependency on single suppliers and prevent supply disruptions. Despite all these efforts, geography cannot easily be changed, and in many ways, Europe's destiny is to have Russia as an "indispensable partner for European energy security", in the words of EU Commissioner for Energy, Günter Oettinger. I look forward to carefully examining this relationship today.

Russia's relationship with Europe – and with the United States – is truly multi-faceted. On one hand, Russia has used its dominant role as energy supplier towards political leverage in Central and Eastern Europe, the Baltics and the Balkans. On the other, Russia has proven a valuable partner in bringing peace and stability to Afghanistan by facilitating the Northern Distribution Network supply route, engaged with the United States to reduce our nuclear arsenals and joined the US and EU in approving UN sanctions towards Iran's nuclear weapons program.

This leads me to wonder whether the European dependence on Russian oil and gas is sometimes exaggerated. The increased availability of shale gas and liquefied natural gas resources combined with increased use of renewable and efficiency gains, tougher implementation of EU competition and anti-monopoly laws and the prospects of Caspian, North African and Arctic energy resources suggest that Europe may be in better shape over the long term than we give them credit for. I would be interested in our witnesses' assessments of whether this is the case, and whether the

recent announcement by Germany's Chancellor Angela Merkel to phase out nuclear power in Germany by 2022 will change the overall scenario.

These developments are taking place as the Middle East, North Africa and potentially parts of Central Asia are changing before our eyes. I know that Ambassador Morningstar has worked tirelessly to pursue U.S. diplomatic goals with the European Union, Turkey, Iraq, Azerbaijan and a host of Central Asian countries to fulfill American goals of developing new resources, assisting European energy security and helping Caspian and Central Asian countries connect their resources to global markets. This engagement is particularly important, as Central Asia sometimes finds itself beyond the reach of the traditional transatlantic and European institutions, although they certainly play a key role in any discussion relating to European and Eurasian energy security issues.

Again, I want to thank Chairman Burton for holding this hearing, and I look forward to hearing the testimony from our witnesses.

[NOTE: An article submitted for the record by the Honorable Tom Marino from Foreign Affairs Magazine entitled "The Good News About Gas," by John Deutch, is not reprinted here but is available in committee records or may be accessed on the Web at: http://www.foreignaffairs.com/articles/67039/john-deutch/the-good-news-about-gas (accessed 8/18/11).]