

The Russian and Georgian Conflict: Lessons Learned

The West, but particularly the European Union (EU), seems not to know just how to handle Russia, how to respond to its increasing sense of greatness, or how to respond to the rhetoric, and now military moves from the Kremlin that reminds one of the Cold Wars that came to an end years ago. Neither does the West have a confident measure of Russia's true military, financial, and economic strengths.

Then President and now Prime Minister Vladimir Putin had sensed this uncertainty and sought to use it to divide the members of the EU and to separate the EU and the United States. Success has been secured in playing to those individual EU members more concerned with adequate supplies of oil and natural gas and less about the good of the EU as a whole.

And, the matter of a U.S. missile defense shield to be set up in Poland and radar support in the Czech Republic to protect Europe against missile attack from the Middle East rogue states (read Iran) has raised the hackles of the Kremlin to the point where re-targeting Russian missiles towards Europe was threatened. Will Russia find it necessary, against the background of the Georgia-Russia conflict, to respond not with rhetoric but with actions that carry more meaningful implications?

This kind of one-upmanship is too dangerous to be allowed to continue, and means must be found to cool the tempers and control the tongues of participants. The United States reportedly would like to sign a long term agreement with Russia covering relations between the two countries, noting that it will be much more difficult to reach such an agreement when the new occupant of the White House arrives. Unfortunately Russia has a number of objections to current U.S. proposals and there can be no assurance an agreement of substance will be signed.

The EU, for one, finally recognizing perhaps that Russia has become a power to be recognized, and with hopes buoyed by prospects of a “new look” in the Kremlin, will try to once again enter into a positive relationship with that country. That is not to say that obstacles are no longer there, because they are, in particular deriving from the August 2008 Georgia-Russia confrontation that led to a brief shooting war. It will take considerable give by both sides if hopes are to become a reality.

Will newly-elected President Dmitry Medvedev be able to calm the political waters or could his attention be consumed by developments elsewhere, for example, in the Caucasus, Ukraine or Central Asia, or by former president and now Prime Minister Vladimir Putin, reluctant to share power and decision-making? There are more than ample scenarios, now and in the future, to occupy the minds of Russian watchers everywhere.

The West was recently reminded of constraints in its ability to respond to crises in the making or at hand. Georgia’s incursion into South Ossetia on August 8, 2008, in response to a bombardment of Georgian villages by Ossetian separatists, was followed almost immediately by the appearance of Russian troops purportedly “to protect Russian citizens.” That triggered thankfully limited warfare, all against the background of Western strongly worded demands for a truce.

Russia’s offensive theoretically ended on the fifth day, declaring that the aggressor (Georgia) had been punished. Georgian military capabilities had been severely damaged but withdrawal of Russian troops did not move as fast as had been predicated for reasons unclear but probably because some of Georgia’s diminished military strength still remained. Indeed, Russia had no intention of withdrawals to positions held before its invasion of Georgia.

Two surprises followed: first, the carving out of two security or buffer zones inside Georgia (one around Abkhazia and another around South Ossetia); and second, President Dmitry Medvedev recognizing the independence of Abkhazia and South Ossetia. It was this latter action that drew the anger of most Western observers.

Against this background, it should be kept in mind that the Russian military had crossed the borders of an independent and sovereign nation, although the full story may not be known for some time. What if Georgia had already succeeded to NATO membership and had called for support, would NATO have immediately responded?

Independent of that, had U.S. officials made promises to Georgia that aid would be forthcoming? No, the United States had clearly signaled to Georgia not to fall into a Russian trap and, if they did, little help should be expected, so the U.S. side continued to stress after bullets began to fly.

Georgian President Mikheil Saakashvili apparently set his own trap by a military incursion into South Ossetia, bringing about an almost an immediate Russian response, utilizing forces that had been building just north of the Russian border with South Ossetia.

What is the message the West should read into Russian actions and reactions? Is this the beginning of an effort to reassert control over certain former Soviet republics? Georgia's value lies in its position as a transit country and the movement of oil and gas to customers without transiting Russia.

But what about the Crimea (part of Ukraine), Chechnya (part of Russia), Nagorno-Karabakh (part of Azerbaijan), or other territories—all lumped under the common term of “frozen conflicts”—that may now see their opportunity for independence?

The Russian naval base in Sevastopol, in Crimea, is particularly important and would likely be protected by force against loss.

President Medvedev has let it be known that Russia has “regions of privileged interests” and the West should understand that Russia will do whatever it takes to defend its citizens abroad.

Are these territories perhaps next, or are speculators over-reaching? Will NATO move ahead and extend a membership invitation both to Georgia and Ukraine, knowing full well that Russia will respond in some fashion? If so, how might Russia respond -- by placing missiles

in Cuba, or perhaps by fostering among the “frozen conflicts” a renewed struggle for independence?

There is another reminder to be recognized. Geopolitics is perhaps another word defining the circumstances under which a nation will always act to protect its national interests, whatever those interests may be. That is exactly what Russia has done, but those interests are not yet fully satisfied.

Yet, there is some comfort to be found in the aftermath of the Russian military offensive against Georgia. It has served to bring the West together in a way and at a time when unity was badly needed. Now, that unity—a unity that undoubtedly caught Russia by surprise-- has to be put to work to keep political temperatures from rising to a boiling point.

But a particular advantage has also accrued to Russia. The conflict revealed serious weaknesses in the Russian military readiness. The Russian air force lost 6 planes to enemy fire, and this lack of air cover meant losses on the ground. President Medvedev responded by outlining a broad upgrading of Russian military forces to put them into a state of permanent combat readiness.

Looking Back, Looking Forward

The Russian oil and gas sector can be seen as “living off the past,” that is, living off the natural wealth it had inherited when the Soviet Union broke up in December 1991. This wealth is of enormous scope, although the infrastructure—pipelines, refineries, and the distribution network—was found to be in a sadly neglected state.

As were the oil fields themselves, many of which had been produced at levels well above those called for by good reservoir management practices. While overproduction allowed annual goals to be exceeded and bonuses paid to workers, the life of the field was shortened.

It is likely that oil field depletion rates may average at least 8 percent per year and that means some 700,000 b/d in new producing capacity must be added annually just to hold output at the same level, let alone allowing for increases. Others accept a much higher decline rate of 15

percent, up, they say, from 12 percent in 2006.ⁱ Application of a 15 percent decline rate implies that the Russian oil sector faces a yearly decline approaching 1.5 million b/d before any new oil is taken into account.

Media headlines point to a current shortage of crude oil for delivery to domestic refiners. Is it because of the slight decline in crude oil production? More likely, it is because of a growth in domestic demand, the very high crude oil export duties that take from 70 percent to 80 percent of income received, leaving very little for the oil producer. Although it would seem that it is those independent refiners who may be running short.

Cutting taxes will help but it may not be enough. The sector must be reoriented towards exploration and development and away from maximizing output through overproduction of existing fields. If delayed, then a plateauing, as happening today, followed by decline can be anticipated.

The situation is very similar to 1988, when peak production was followed by a steady and prolonged decline, for the very same reasons.

Privatization of the oil sector following the December 1991 breakup had eventually led to the introduction and broad application of western know-how and advanced technology, with oil companies Yukos and TNK-BP in the forefront. Idle wells deemed to be good producers were quickly worked over and output restored. Minimal effort was devoted to exploration, while maximizing yields from easy-to-produce horizons was encouraged. Relatively stable domestic requirements allowed most of the incremental oil to be exported.

The rapid expansion in production and exportable surpluses seemingly faced just one constraint—export pipeline availability and capacities at ports of export. But then another constraint appeared: the recent use of pipelines and rail transport to deny oil, and natural gas, to buyers historically dependent on regularly scheduled deliveries. Even the most casual observer would conclude that geopolitical issues were behind the denial, and not just problems with the delivery systems.

Nonetheless, with only minor exception Russian oil and gas exports have moved to consumers on time and in the volumes contracted for. But these exceptions have attracted attention out of proportion to deliveries denied and to the lengths of denial.

All oil (crude oil and petroleum product) pipelines, including those carrying oil for export, come under the control of Transneft, the state-owned monopoly. With Transneft always arguing that there was no shortage of pipeline carrying capacity, and firmly opposed to the construction of any privately owned line, exporters had to turn to rail, water, and truck to handle increasing volumes, particularly of petroleum products.

Oil market watchers, reflecting upon the continuing uncertainties regarding Venezuelan, Nigerian, and Iraqi oil exports, and in an effort to more correctly judge the future, ask: What can Russia offer that these suppliers cannot? What is it that Russian oil exports could build upon?

For Russian officials, the answer is quite obvious. Russia offers reliability, security, and diversity of supply, distancing itself from the Persian Gulf.

Russia does play politics from time to time by interfering in scheduled oil and gas deliveries to certain republics of the former Soviet Union. But rarely has Russia ever employed oil as a political tool in its dealings with customers in the West. Income derived from the export of crude oil, petroleum products, and natural gas and its reputation as a reliable supplier are far too important for Russia to contemplate actions that might disturb these advantages.

Yet that should not be taken to mean that Russia will *always* be a reliable supplier. If an interruption in exports would serve a particular Russian national interest, then the order to do so goes out. The European Union, mindful of its relatively high dependence on Russia for oil and gas, learned its lesson in January 2006 when natural gas deliveries were reduced, ostensibly not by Russia, but by the transit state Ukraine. Russia had cut gas deliveries to Ukraine for failure to agree to a supply contract for 2006 that set out market rates for the gas supplied. In January, the weather is cold in Ukraine, so Ukraine just

helped themselves to volumes needed to keep warm. But that meant ongoing deliveries to Europe were reduced. As a result, energy security and diversity of supply became themes of the day in Brussels.

Russia also has avoided reducing oil sales as a way of supporting higher prices. Although Russia has thought now and then about OPEC membership, disadvantages clearly have outweighed the advantages. It has advised OPEC that it is supportive of high oil market prices, but nonetheless has stood by while OPEC acted alone. Indeed, Russia's approach over the years has been to sell whatever volumes of oil were considered surplus to domestic needs, at whatever price prevails at the moment. In sum, Russia is a market follower, not a market maker.

A slight shift in oil policy was noted in late September 2008, when Russia said that it wished to become more involved in global oil markets by using its position as a leading oil producer and exporter to influence prices. One way to accomplish that would be through the release of oil and gas forecasts that hopefully would moderate volatility, as well as delaying the development of newly discovered fields. Influencing prices not surprisingly can also be quickly translated into controlling prices, that is, parlaying the country's energy wealth into greater political influence.

Russia apparently believed that its position was not being properly recognized nor appreciated. But Russia may also have accepted that future crude oil and natural gas production levels may not achieve what planners had hoped for and, because of that, prices had become more important. At the same time future world oil and gas demand was suspect because of growing economic concerns and that realization could have also contributed to this staking out this new policy position.

Could Russia ever regain its past glories? Could it return to the latter part of the 1980s for example, when Russian oil production—averaging 11.4 million b/d in 1988—exceeded that of Saudi Arabia by millions of barrels daily? If that could be accomplished, and if domestic needs were not much above current levels, then Russia might well be in a position to challenge Saudi Arabia for world leadership in oil exports.

But this is a game that Russia would be unlikely to win. More importantly, it would be a game that Russia need not win.

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