HARVARD UNIVERSITY
JOHN F. KENNEDY SCHOOL OF GOVERNMENT
Caspian Studies Program

Mini-Case and Illustrative Paradigm

U.S. Policy on Russian and Caspian Oil Exports: Addressing America's Oil Addiction

Graham Allison and John Grennan

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Including student answers from a Kennedy School course,
International Security and Political Economy 202:
"Central Issues of American Foreign Policy," taught by Graham Allison

PREFACE

On April 8, 2002—the same day that Iraq instituted an oil export embargo and only weeks after the U.S. Senate rejected new fuel efficiency standards for automobiles—students in my "Central Issues of American Foreign Policy" course at the Kennedy School of Government were in the middle of presenting policy recommendations to address America's "addiction to oil."

In response to a case study I prepared in conjunction with the Caspian Studies Program, sixty-five students considered different policy options designed to lessen America's vulnerability to a disruption in petroleum supplies. At present, the United States consumes 19.7 million barrels of oil a day—which equals almost 3 gallons of gas for every person in the United States—and accounts for over 25 percent of all global oil consumption. The United States currently relies on foreign producers to provide over half of the oil it uses every day, and this figure is expected to climb to two-thirds by 2020. OPEC countries—including Saudi Arabia, Iraq, and Iran—have the largest untapped petroleum reserves in the world and are in a position to take a bigger share of the growing energy market in the future.

This case study was designed to make students think about America's energy policy from both a supply and demand perspective, and in foreign and domestic contexts as well. On the supply side, students had to consider how foreign oil producers outside of OPEC—particularly in the oil-rich Caspian basin countries of Russia and Kazakhstan—might help address the United States' growing petroleum needs over the coming decades. Students ultimately had to answer whether or not the United States' attempts to promote better relationships with a greater number of oil producers would significantly reduce America's vulnerability to a disruption in petroleum supply.

This case also required students to evaluate the various domestic policy options available to help address the United States' growing energy concerns. These options include an array of choices ranging from increasing automobile fuel efficiency standards, to offering tax credits for hybrid vehicle research and development, to drilling in the Arctic National Wildlife Reserve (ANWR). The class quickly realized that any attempt to change U.S. energy consumption patterns, however, will encounter opposition from powerful political groups—most significantly, opposition from the American consumer.

We are now presenting this same challenge to you. **How will the United States address its addiction to oil over the next several decades?** For your consideration, we have included the original case study, a list of relevant reading material that the students used in preparing their answers, an example of some student answers, as well as an illustrative "answer" to this question. Some of the terminology students used in writing their policy memos and their hierarchical breakdowns of U.S. policy priorities are part of the policy training that they receive at the Kennedy School.

Questions about the United States' energy dependence and about emerging oil producers in former Soviet states will continue to spark debate—at the Kennedy School certainly,

but also among oil executives in Houston, automakers in Detroit, and policymakers in Washington. This debate will continue to be one of the more important discussions in American policy circles for many years to come.

Yours sincerely,

Graham T. Allison
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April 8, 2002

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This case has multiple teaching objectives:

- First, it illustrates how you can create a case for yourself from each issue of the *Economist* at approximately the level of complexity of ISP-202 cases and of assignments that policymakers in the U.S. government actually face.

- Second, this case illustrates one of the important sub-themes of ISP-202: the intractable link between security and economics.

- Third, it highlights the artificiality of efforts to conceptually or bureaucratically distinguish between "foreign" and "domestic" policy and behavior: U.S. energy policy is both domestic and foreign and aims to influence behavior both at home and abroad.

- Fourth, it displays the complex and often subtle connections between government and private enterprises in addressing public policy issues.

This case is taken directly from the *Economist* (December 15, 2001), supplemented by course readings for the week.

The date is April 8, 2002. National Security Advisor Condoleezza Rice has asked you for a memo analyzing options and recommending actions President George W. Bush should take in upcoming meetings with the presidents of Kazakhstan and Russia in order to realize the main objective of the Bush energy policy: diversifying supplies of energy to the United States in ways consistent with U.S. national interests. Assume that the world is as it is today (April 8, 2002) or assume a straight-line evolution from this point except for hypothetical additions introduced in the case.

1. **The U.S. "oil addiction" is as it is:** Americans consume 19.7 million barrels of oil per day (mbd)—almost three gallons per day per American man, woman, and child—

which accounts for more than one-quarter of all global oil production. The United States imports 11.1 mbd—equal to about 59 percent of total U.S. oil consumption. In their recent letter to members of the U.S. Senate, former CIA Director James Woolsey and former National Security Advisor Robert MacFarlane unequivocally assert that "America's oil dependence endangers our national security and economic well-being."

2. **Global supply and demand of oil and other sources of energy are as they are:** In February 2002, the world produced 76.4 mbd of oil. Approximately 54 mbd of this total was exported and traded on the global market. OPEC countries produced 28.4 mbd (37 percent of the global supply) and exported 21.7 mbd per day (28 percent of the global supply). The United States produced 9.1 mbd of its own oil (equal to approximately 47 percent of U.S. demand).

   Russia produced 7.1 mbd and exported approximately 4 mbd. Kazakhstan produced 0.81 mbd, but this figure could reach 3 mbd by 2010 when the country's Tengiz and Kashagan fields in the Caspian Sea will be producing fully.

   The global demand for oil is currently at 76.5 mbd. As noted, the United States represents over one-fourth of that demand. Organization for Economic Cooperation and Development (OECD) countries as a whole use 48.1 mbd, which represents 63 percent of global demand.

3. **The underlying realities of energy, industrial production processes, reserves, and technologies are as they are:** The United States' "oil addiction" will almost certainly demand increasing oil supplies. The Department of Energy projects that by 2020 the United States will be <u>importing</u> approximately 18 mbd. If this projection holds true, over two-thirds of the United States' oil supply will come from foreign sources by 2020.

   The United States has only 21.8 billion barrels of known oil reserves—or about 2 percent of the world's total oil reserves. OPEC countries, meanwhile, have close to 800 billion barrels in reserves, almost four-fifths of the world's known reserves (Saudi Arabia alone has over one-quarter of the world's known reserves) and will be ever-larger suppliers in meeting energy demand in the coming years.

   The combined oil reserves of Russia and Kazakhstan are estimated to be somewhere between 6 and 12 percent of the world's total reserves. However, there are significant obstacles involved in bringing oil from these countries to market—the most important of which are the uncertain investment climate in these countries, obsolete petroleum infrastructure left over from the Soviet era, and limited pipeline and port access to global markets.

   There are, however, promising foreign and domestic ventures currently underway in the petroleum sectors of former Soviet countries (including the Chevron-led Caspian Pipeline Consortium (CPC) pipeline, ExxonMobil's exploration of the Sakhalin fields

in the Russian Far East, a consortium of international companies exploring and producing in Kazakhstan and Azerbaijan, and the BP-led Baku-Tbilisi-Ceyhan pipeline in the Caspian region). In addition, new Russian oil companies that emerged out of the post-Soviet privatization period—such as YUKOS and LUKoil—look increasingly robust. But the future of the petroleum sectors in these countries is far from certain.

4. **The Cheney Energy Task Force and Bush Administration national energy policy are as they are:** In May 2001, the Cheney Energy Task Force released its 170-page National Energy Policy Report. This report recommended that U.S. energy policy be driven by the following five principles:

   (1) Energy productivity and efficiency
   (2) Modernizing and expanding U.S. energy infrastructure
   (3) Increasing and diversifying traditional and alternative fuels
   (4) Promoting environmental protection
   (5) Promoting energy security

   Since the terrorist attacks of September 11, 2001, the Bush administration has become even more concerned about the need to increase and diversify energy supplies in order to ensure American energy security.

5. **Presumptions, perceptions, and stakes in the Executive Branch, Congress, and the public are as they are:** The Bush administration pushes for drilling in ANWR; this past month the U.S. Senate rejected a proposal to require automakers to increase fuel efficiency standards on cars and (more importantly) on light trucks and sport utility vehicles (SUVs); most Americans believe that the Bill of Rights guarantees cheap gasoline.

   The National Resources Defense Council (NRDC), a respected energy and environmental research organization, recently reported that it would be possible for the United States to improve fuel efficiency standards from 24 miles per gallon to 40 miles per gallon by 2012 with negligible rises in auto prices (which would be offset by savings in fuel efficiency) and without compromising engine power or safety.

   Nevertheless, the energy bill recently before the Senate—which contained less stringent fuel efficiency standards than those proposed by the NRDC—was extremely unpopular. Automakers, organized labor, and representatives from rural states were among the most vociferous critics of the bill, which failed by a 62 to 38 margin. A revealing moment occurred when Trent Lott held up an enlarged photograph of a tiny, purple, one-seat European car and asserted, “I don’t want Americans to have to drive this car.”

6. **After 9/11, President Bush has been seized by the war against global terrorism—and has begun asking harder questions about implications for business as usual:** In fashioning the U.S.-led response to the September 11 attacks, Bush began with a

clear-eyed recognition that the U.S. confronts serious adversaries that are serious about causing the United States the maximum amount of harm.

Like many Americans, Bush has been mystified by Osama bin Laden—and uncertain why groups like al-Qaeda could hate America so much. Unlike many Americans, however, Bush has been studying bin Laden, reading his *fatwas*, and reflecting on his motivations. As a former oil executive, he has found particularly striking bin Laden's little-noticed proclamation on energy economics in which he indicted the United States' exploitation of Saudi oil as "the biggest theft in history"—a larceny he estimated to amount to $30,000 per individual Muslim in the world.

President Bush has repeatedly asked Vice President Dick Cheney (who headed the Energy Task Force), Energy Secretary Spencer Abraham, and others whether U.S. dependence on foreign oil for more than half of Americans' daily consumption of gasoline constitutes an unacceptable security vulnerability. If it does, what should the U.S. government do about it? On more than one occasion, Bush has wondered aloud whether al-Qaeda could disrupt the flow of oil from Saudi Arabia or the Persian Gulf. He recently called the director of the CIA and a team of analysts over to the White House to query them about an unsettling report on Saudi Arabia's political stability and the possibility that an Islamic extremist government could come to power in Saudi Arabia.

Assignment:

In the context of the concerns described above, President Bush has asked National Security Advisor Condoleezza Rice for an analysis of the specific actions the U.S. should propose or take in upcoming meetings with Kazakhstani President Nursultan Nazarbayev and Russian President Vladimir Putin to advance the objective of the Bush administration's energy policy and American national interests.

The national security advisor has asked that you—as a member of the National Security Council staff—identify the U.S. interests at stake; analyze the nature and the magnitude of the threat; propose operational objectives; develop strategic options with pros and cons; and make a recommendation with a sketch of an implementation plan. Specifically, she asks that you address the following:

- How serious a threat does dependence on foreign oil imports present to U.S. security and well-being?

- What are the major strategic options for promoting diversification of energy supplies, specifically from Russia and Caspian countries, in ways that will reduce U.S. vulnerabilities to a disruption in global oil supplies?

- Are there other variables that should be examined when addressing this problem?

- What will be the main sources of domestic resistance to U.S. attempts to achieve a more secure energy posture?

In addition to your policy memo (or presentation or outline), you may attach an appendix of no more than one half-page identifying questions of fact or analysis that you do not know the answer to, but which you believe the individual writing the memo in the real world would be able to answer, and that would, you suspect, have a decisive influence on your analysis or recommendations.

ISP 202 Central Issues of American Foreign Policy
April 8, 2002

Illustrative Paradigm for Case #7
U.S. Policy on Exporting Oil from Russia and the Caspian:
Addressing America's Oil Addiction

Overview

Issue: Addressing the United States' "oil addiction." More specifically this will require:

(1.) Recognizing U.S. dependence on foreign oil and the security problems this dependence presents.

(2.) Considering the major strategic options for promoting diversification of energy supplies, particularly from the Caspian and Russia, in ways that will reduce U.S. vulnerability to a disruption in oil supplies.

(3.) Addressing U.S. domestic energy consumption patterns.

Recommendations: There are four primary policy recommendations, each of which has a set of secondary recommendations.

(1) PRESIDENT BUSH SHOULD ASK RUSSIA AND KAZAKHSTAN TO INCREASE OIL PRODUCTION AND EXPORTS.

Policy choices include:

(1a) Working toward improving the investment climate in Russia and Kazakhstan by supporting these countries' bids to join the World Trade Organization (WTO). President Bush should also encourage the Department of Commerce to move swiftly in granting Russia and Kazakhstan "market economy status" when they meet all necessary criteria. These types of actions should help Russia and Kazakhstan integrate more deeply into the global economy and compete on the international oil market.

(1b) Coordinating infrastructure-oriented loans from international lending organizations, such as the European Bank for Reconstruction and Development (EBRD), especially for the pipeline system in Russia and Kazakhstan. Multiple pipelines will be of importance in both countries.

(1c) Increasing coordination between the United States, Russia, and Kazakhstan on energy issues, possibly through cabinet-level diplomacy between these three countries.

(1d) Gradually promoting greater privatization of the energy industry in Russia and Kazakhstan.

The ultimate goal of this strategy is to encourage both Russia and Kazakhstan to become full production, multiple pipeline oil exporters.

However, Russia and Kazakhstan, even at full production, will not be able to satiate the United States' appetite for oil. Consequently, the U.S. must take some measures to lessen demand, increase energy efficiency, and limit vulnerability to petroleum supply disruptions.

(2) DIRECT THE DEPARTMENT OF ENERGY TO PROPOSE MEASURES TO INCREASE EFFICIENCY AND REDUCE OIL DEMAND IN THE UNITED STATES.

In 1997, the President's Committee of Advisors on Science and Technology made an extensive report to President Clinton on how the United States could improve energy efficiency standards and reduce its oil demand.

On the most fundamental level, this report suggested that Department of Energy should explore the following options:

- Developing cost-effective alternatives to petroleum-derived liquid fuels
- Encouraging alternative means and modes of transportation
- Supporting related areas of research, such as advanced materials and underlying science
- Improving energy efficiency in all sectors of the economy
- Enhancing diversity of oil supply technologies
- Improving the economic productivity of U.S. energy industries
- Strengthening energy system reliability
- Supporting applied research in advanced technologies across the full spectrum of R&D opportunities

The model the Department of Energy should follow when making its recommendations to Congress comes from the example set by James Schlesinger, who was named "energy czar" by President Jimmy Carter during the oil embargoes of the 1970s and was subsequently named the first cabinet-level Secretary of Energy in 1977. Schlesinger issued the county's first "National Energy Policy"—which redefined the U.S. national discussion on energy issues with more than 100 recommendations on reducing energy consumption, promoting energy conservation, and developing alternative fuels and technologies.

Policy choices include:

(2a) Changing U.S. Corporate Average Fuel Efficiency (CAFE) standards from 24 miles per gallon (mpg) in 2002 to 30 mpg by 2012 and to 45 mpg by 2022.

(2b) Placing a tax on carbon emissions to encourage fuel efficiency by reducing energy demand.

(2c) Offering incentives for research and development into a variety of alternative fuel options, particularly hydrogen fuel cells.

(2d) Offering government incentives to encourage the use of mass transit and to support "smart development projects" that promote shorter commutes.

(3) INCREASE "STANDBY" SUPPLIES OF PETROLEUM.

Policy choices include:

(3a) Increasing the stockpiles at the U.S. Strategic Petroleum Reserves (SPRO) from 50 days U.S. domestic supply to at least 100 days supply.

(3b) Promoting strong relationships with a number of countries that are maintaining petroleum "spare capacity"—i.e., oil that they are withholding from the market—with the hope that these countries can help compensate for supply disruptions (as Saudi Arabia is currently doing with regard to Iraq).

(4) GLOBAL STRATEGY: ENGAGE OIL-PRODUCING COUNTRIES THROUGH POLITICAL AND ECONOMIC DIPLOMACY IN ORDER TO ASSURE CONSISTENT PETROLEUM SUPPLY TO THE UNITED STATES.

Address policy issues that are of concern to oil-producing nations—including the Palestinian-Israeli conflict, World Trade Organization accession, and the Free Trade Agreement of the Americas.

U.S. INTERESTS

ISSUE: Global energy supplies and security

QUESTION: What can the United States do to limit its vulnerability to (or the impact of) a disruption in its energy supply?

Vital:

- Ensure the viability of global energy supplies and minimize the possibility (or impact) of a disruption in international petroleum supply.
- Ensure that the aims of the campaign against international terrorism are not compromised because of global energy demands.

Extremely important:

- Add greater consultation on energy issues to the United States' already-strengthened post-September 11 relationship with Russia.
- To the extent that it is politically possible, promote positive trade relationships with all oil-producing countries.
- Promote strong relationships with Caspian states, particularly the energy producing states of Kazakhstan and Azerbaijan.
- Work to limit the influence of Persian Gulf petroleum producers (especially Iraq and Iran) over the international petroleum market.
- Ensure that U.S. policymakers continue to address energy issues even as public attention toward these issues oscillates.

Important:

- Ensure the possibility for continued sanctions against Iraq and Iran.
- Promote greater opportunities for U.S.-Russian cooperation in the business sphere (especially in the energy sector).

- Expand engagement with Russia and other Caspian countries on issues outside the energy sphere (security, counterterrorism, conflict prevention, nonproliferation, etc.)

- Ensure that new petroleum wealth in Caspian countries is used to promote political and economic reforms in these countries.

- Support energy research and development in the United States.

- Improve environmental standards in the United States and, ultimately, across the globe.

POLICY RECOMMENDATIONS

Choices on addressing the U.S. oil addiction range across three categories: addressing supply, addressing demand, and addressing vulnerability.

I. Addressing Supply: Promoting Russia and Kazakhstan's Role as Oil Producers

Recommendations include:

1. *Support Russia and Kazakhstan's bids to join the World Trade Organization (WTO).* Russia and Kazakhstan will both need to do as much as possible to improve the investment climate in their countries—this will include adopting international accounting standards, promoting the rule of law, and improving corporate governance. These efforts should help the petroleum sectors in both of these countries attract foreign investment and should also lead to better management practices over the long run.

The main vehicle to facilitate this process of reform will be accession to the WTO. The WTO admission process will force Russia and Kazakhstan to do more to promote market economy principles and rule of law in order to obtain the benefits of membership. One of the most important aspects of this accession process will be to decrease government regulations in various sectors of these countries' petroleum industries—particularly the pipeline system in Russia, which is a virtual monopoly. A less stringent regulation regime should give producers greater incentives and opportunities to bring crude to market.

2. *Coordinate infrastructure-oriented loans from international lending organizations.* Russia has had a desultory relationship with international lending organizations over the past decade, but there still may be room for international aid toward specifically-targeted business projects in Russia. The archaic Russian pipeline system seems to be one of the best candidates for investment from organizations such as the International Monetary Fund (IMF), the Overseas Private Investment Corporation (OPIC), and the European Bank for Reconstruction and Development (EBRD). These loans would serve the greater aim of promoting private enterprise in Russia and would strengthen Russia's ties with the West (especially if energy pipeline routes have their terminus in the West). There are

similar opportunities for the West to make strategic lending decisions to support the oil industry in Kazakhstan.

3. *Support gradual privatization of Russian and Kazakhstani oil companies.*
Russia and Kazakhstan are still making the transition from non-market to market economy status. Understandably, there is still significant state involvement in the energy sectors of these countries, particularly in the Russian gas conglomerate Gazprom, the Russian pipeline company Transneft, and the Kazakhastani national oil company Kazmunaigaz. Since both of these countries are still in transition toward market economies, privatization will necessarily be a gradual process. But the United States should continue to support the promotion of market economic principles—and particularly privatization—in the petroleum sectors of former Soviet countries.

II. Addressing Demand: Domestic Policy Options

This chart of policy recommendations was proposed and designed by Harvard Kennedy School of Government students Theresa Lawson, Alessandro Nardi, and Edita Tahiri.

Reducing Fossil Fuel Needs

Measures	*Pros*	*Cons*
1) Emissions Tax	• Curbs OPEC's price-setting abilities • Stimulates development of new transport technologies	• Strong at-home opposition
2) Raise Fuel Efficiency Standards	• Oil savings • Consumer cost savings	• Difficulty of Private investors • Could harm US economy • Strong at-home opposition
3) Tax Incentives for Hybrids and Fuel Cells	• Speed up the market penetration of oil-saving technologies • Help to meet higher fuel economy standards	• Fossil fuel lobby opposition • Costs of transition to new technology
4) Govt Incentives to Encourage Use of Mass transit	• Tax relief • Reduces dependency on personal vehicles	• Costs to the Gov't • Availability of Mass transit
5) Expand Renewable Fuels	• Near-zero emissions of pollutants • Likely to use two-thirds less energy than today's average car	• Billions of dollars in R&D without committing to produce vehicles over next decade

Recommendations include:

1. Direct the Department of Energy to propose measures to increase efficiency and reduce oil demand in the United States.

In his December 9 article, *New York Times* columnist Thomas Friedman talked about Americans' desire to be able to do more at home to help address the war against terrorism. Friedman rightly points out that one of the best ways for the U.S. government

to address the threat of terrorism is to set policy goals that ask Americans for sacrifices in energy consumption that they would be willing to make in order to improve the country's security. He writes:

"Imagine if tomorrow President Bush asked all Americans to turn down their home thermostats to 65 degrees so America would not be so much of a hostage to Middle East oil? Trust me, every American would turn down the thermostat to 65 degrees . . . . Imagine if the president announced a Manhattan Project to make us energy independent in a decade . . . . Liberating us from the grip of OPEC would be our Victory Garden."

The Department of Energy will be the focus of much of this type of research into alternative energy. The model the Department of Energy should follow when making its recommendations to Congress comes from the example set by James Schlesinger's tenure as Secretary of Energy under President Carter. In the middle of the oil embargos of the 1970s, Schlesinger's "National Energy Policy" redefined the U.S. debate about energy issues with its more than 100 recommendations on reducing energy consumption, promoting energy conservation, and developing alternative fuels and technologies.

Under the aegis of a revitalized Department of Energy, the U.S. government could pursue two important policy goals:

a) *Change CAFE standards to 30 mpg by 2012 and 45 mpg by 2022.* Rather than waiting for another supply crunch like those that the United States faced in 1973–74 and 1979–80, the U.S. government should consider taking a proactive stance toward increasing automobile fuel efficiency.

Corporate average fuel efficiency standards have not increased since 1985. The Kerry-McCain Bill recently before the Senate proposed an increase in CAFE standards from 24 miles per gallon (mpg) to 36 mpg by 2016, which would have led to a savings of 2.5 billion barrels a year, about the same amount of oil that the United States imports from Middle Eastern producers each year.

While the National Resource Defense Council (NRDC) and even the Department of Energy seem to suggest that the Kerry-McCain Bill's goals are reasonable, proponents of greater fuel efficiency should be willing to make greater sacrifices on this issue in the short term in order to ensure greater gains over the long term.

When the Senate revisits this issue (which should be in the next one to two years), fuel-efficiency supporters should propose increasing fuel efficiency standards to 30 mpg by 2012 and 45 mpg by 2022. In the meantime, they should do as much as possible to support the studies that suggest these gains are economically feasible.

b) *Offer incentives for research & development into a variety of alternative fuel options, particularly hydrogen fuel cells.* The U.S. Congress should do as much as possible to continue to encourage alternative sources of fuel through tax breaks and research grants. Hydrogen fuel cells hold the most promise because they would require the least amount

of infrastructure adjustments, would promote higher environmental standards (they have no harmful emissions), and would lead to a weaning from traditional fossil fuels.

III. Addressing Vulnerability

Recommendations include:

1. Increasing the stockpiles at the U.S. Strategic Petroleum Reserves (SPRO) from 50 days of U.S. domestic supply to at least 100 days supply.

2. Promoting strong relationships with a diverse number of countries that are maintaining petroleum "spare capacity"—i.e., oil that they are withholding from the market—with the hope that these countries can help compensate for supply disruptions (as Saudi Arabia is currently doing with regard to Iraq.)

3. To the extent politically possible, engage oil-producing countries in economic and political diplomacy. While the United States cannot sacrifice its political objectives in order to satisfy its oil demands, there still may be opportunities to engage with oil producing countries in order to ensure continuity to supply.

This type of engagement can take on the form of negotiating trade agreements with Latin American producers such as Mexico and Venezuela, promoting the WTO candidacy of former Soviet countries such as Kazakhstan and Azerbaijan, and dialogue with Persian Gulf producers that have more positive relationships with the United States, such as Kuwait and the United Arab Emirates. The extent that the United States seems to be concerned about and actively engaged in political issues that matter to oil-producing countries (such as the Palestinian-Israeli conflict, the Free Trade Agreement of the Americas, etc.), the more likely it is to have positive relationships with these countries over the long run.

To: Condoleezza Rice, National Security Advisor
From: E. Fritz Morris
Date: April 8, 2002
Re: Exporting Oil from Russia and the Caspian (Case #7)

Issue: Given current levels of U.S. oil consumption (19.7 million barrels per day or mbd) and regardless of any additional drilling in the Alaskan Wildlife Refuge, over two-thirds of U.S. oil and natural gas supply may need to be imported from abroad by 2020. Although U.S. reliance on OPEC will inevitably increase, importing oil from OPEC nations has become less predictable in the wake of 9/11, due to the potential for terrorist groups to disrupt oil flow from OPEC nations. At the same time, alternate means of curbing U.S. demand for oil consumption (such as stricter controls on gas efficiency) have met with stiff domestic opposition.

These factors combine to create a potential national security risk. Although the amount of oil in reserves in Russia and the Caspian nations (estimated at 6 to 12 percent of global supply) is not precisely known, these reserves represent one way to buffer the increase in prices that a restriction in supply from the Middle East would cause. However, producing and transporting this oil involves negotiating with unstable Muslim nations.

U.S. Interests:

Vital: Prevent a near term oil crisis in the U.S. triggered by anti-U.S. sentiment in OPEC nations or terrorism (high threat); prevent long-term energy shortage caused by a shift in OPEC-U.S. relations due to anti-U.S. sentiment. (threat: medium)

Very important: Preserve U.S. strategic presence in Saudi Arabia and Middle East (implies maintaining in the near-term the oil for protection role of U.S. military in Saudi Arabia.) (threat: high); Russian integration into Western security and political frameworks (threat: medium)

Important: Establish U.S. strategic presence in Caspian region (threat: medium); Reduce reliance on OPEC energy sources in long-term (threat: medium)

Objectives:

- Establish short-term oil import substitution options through external suppliers in Russia and the Caspian region that will help prevent a U.S. oil crisis in the case of terrorist hijacking of one or more OPEC nations.

- Clarify a shift from Clinton administration policies (the policies worked against each other: assisting both U.S. energy firms in Russia and Caspian nations seeking to develop oil and natural gas sources independently of Russia) to a market-based energy development approach.

- Persuade Russian and Caspian leaders that joint pipeline construction is a "win-win" situation for all nations.

- Engage Russia and Kazakhstan in antiterrorism efforts.

- Strategize with Russian and Caspian energy ministers to identify the most effective pipeline routes (via Iran, Turkey, Georgia, or Russia).

- Ensure a strong U.S. price bargaining position in oil and natural gas pipeline negotiations.

Discussion: Joint U.S.-Russian development of southern Caucasus oil reserves would give the U.S. a "buffer" supply of oil that would help stabilize prizes in the short term in the event of an OPEC decision to cut supply to the U.S. and would further bolster U.S.-Russian cooperation on antiterrorist issues. However, this would represent a reversal of U.S. policy, which attempted to establish strategic presence in the southern states at the behest of Russia (Russia assumed these states were interested in secession).

Option #1: The U.S. wolf in EU sheep's clothing. The U.S. should engage European allies to provide "downstream" markets for Russian and Kazakhstan oil supplies, thereby indirectly creating a market for itself. In addition, countries such as Germany and Italy could be invited to participate in joint EU-Caspian/Russian-U.S. pipeline planning sessions to determine the most effective pipeline routes. Moreover, the EU should play the lead role in helping Russia and the Caspian nations build legal and financial institutions that will support a freer energy market while deepening Russian and Kazakhstan political integration in the region (e.g., the Council of Europe).

Pros: Fostering Caspian oil development through indirect means such as EU participation would accomplish the goal of reducing U.S. reliance on OPEC reserves while giving Saudi Arabia and OPEC fewer reasons to suspect U.S. disengagement in traditional OPEC partnerships. The U.S. will, after all, still rely heavily on OPEC reserves even if Caspian reserves turn out to be significantly larger than expected. Access to Caspian reserves is simply a "buffer" in the U.S. energy market but could be a main supply source for EU nations since Europe will be the a major importer of Caspian oil (along with China, perhaps). Moreover, integration of Caspian nations in EU political and economic organizations provides an indirect link to U.S. influence in Caspian regional policies.

Cons: European nations may not consistently follow U.S. interests in negotiations regarding Caspian energy since many EU nations have conflicting levels of support for U.S. initiatives (i.e., Britain vs. France). Furthermore, the EU is itself struggling to streamline energy policy. Hence, EU leadership in institution-building may only worsen the gridlock and corruption that characterizes the Russian energy market. Finally, EU leadership may push for ineffective pipeline options in terms of U.S. interests (i.e., pipelines north to Russia and/or south to Iran may not be appealing to Europe).

Option #2: One pipeline plus U.S.-led institution building. The U.S. should push for development of the Baku-Ceyhan pipeline line running from Baku, Azerbaijan to Ceyhan, Turkey. Additionally, the U.S. should build on relationships established through current energy working groups in Russia and Kazakhstan to assist each region in its development of legal and financial infrastructure related to the production and transport of oil and natural gas.

Pros: The Baku-Ceyhan Pipeline is the least controversial (from the U.S. perspective) and holds the greatest potential for producing oil in short order based on the fact that much of the preparatory work began during the Clinton administration. Financing and otherwise assisting Russian energy development initiatives in the Caspian region (currently Russia's main development priority) will help strengthen political ties and thus antiterrorism cooperation between the U.S. and Russia. However, destabilizing relations with Saudi Arabia (and other OPEC nations) by overtly committing to joint development of Caspian oil reserves beyond one pipeline may result in a loss of U.S. strategic presence in the Middle East. Thus, limiting U.S. assistance to institution building in the short term may allow the U.S. maximum leverage in its antiterrorism campaign in the future while providing some cushion to oil price shocks in the short term.

Cons: Under the Clinton administration, a "one-pipeline" policy was pursued in the Caspian region, a policy that promoted the Baku-Ceyhan line. While intended to prevent Russian involvement and Iranian participation in Caspian oil development, the plan only strained U.S.-Russian tensions and weakened Caspian states by impeding energy production and supporting corrupt state leaders who siphoned off signing bonuses. Additionally, if Caspian nations are trained solely by Americans in energy market building, there may be ideological backlash against the United States. Finally, European allies may withdraw funding for west-running pipelines based on their interest in pursuing pipeline plans of their own with certain Caspian nations.

Option #3: Multiple pipelines plus regional political and economic stabilization. The U.S. should encourage as many oil and natural gas export routes as possible from the Caspian region (north through Russia, east through Georgia, west through Turkey). Additionally, the U.S. should cooperate with the EU in assisting Russia in improving market efficiency by assisting in rule of law and financial institution development.

Pros: The level of oil and natural gas reserves in the Caspian region could be much higher than initially estimated (potentially up to 12 percent of global supply). When additional pipelines are in place, oil prices will be less susceptible to OPEC manipulation since substitutes for OPEC oil will have increased. Thus, although Russian oil companies currently produce more oil than they can sell, with enhanced European and Japanese demand for this oil, Russian oil will compete more aggressively with OPEC (and especially Saudi Arabian) energy companies. Joint EU/U.S. institution building will allay Muslim fears of overbearing U.S. influence in the region and will foster democracy building and market development in the Caspian region. Finally, encouraging Russian competition with other suppliers in oil

production will help prevent collusion to hinder Caspian oil production (rather than forming a monopolistic trading block as some Clinton analysts assumed).

Cons: Supporting multiple pipelines as well as improving Russia's institutional framework will likely be perceived by Saudi Arabia as an abandonment of a long-standing tradition of U.S.-Saudi cooperation in the energy trade business. There is a risk that the U.S. could lose strategic military presence in OPEC nations if a move toward Russian energy cooperation is perceived as an abandonment of commitment to OPEC.

Recommendation – Option #3: Multiple pipelines and open energy markets.

Implementation and Fallback Plans:

Short Term:

- Part of the problem in determining the best way to avoid an energy crisis is simply a lack of good information regarding the supply of oil in the Caspian region. Thus, it is important that the U.S. participate in exploration and confirmation of oil reserves in places like Kazakhstan and Azerbaijan. The U.S.–Kazakhstan Oil, Gas, and Commercial Energy Working Group and the U.S.–Russian Oil, Gas, and Commercial Energy Working Group should augment current tasks with monthly reports to the U.S. Secretary of Energy on the actual reserve levels in the Caspian region. Once the potential for oil production in the region is established more accurately, the U.S. will be able to mobilize international (especially EU) support for pipeline development.

- The above working groups, under the leadership of the U.S. Energy Secretary, should produce a report within three months on the best routes for pipelines and the resources required to streamline pipeline production in the Caspian region.

- Encourage access through Russia (such access was discouraged under the Clinton Administration).

- Bait Iran into an agreement on nonproliferation of nuclear weapons with a pipeline deal. 9/11 made the U.S. skeptical of Iranian engagement, although excluding Iran from Caspian oil development plans shrinks the potential market.

- Innovate and implement legal and financial integration between Russian, EU, U.S. and Caspian national institutions through a NATO affiliated working group called "Caspian Energy Working Group." Under a rotating national from member states, this group should encourage property rights legislation in the Caspian region.

Long Term:

- The U.S. should shift its policy toward "market creation." This shift will avoid simply taking the side of U.S. firms in their disputes with Russian companies. If Russia is to

evolve into a truly free marketplace, such favoritism will only undermine U.S. efforts to encourage competition between U.S. and Russian firms.

- Encourage Caspian states' membership in Council of Europe. In addition, Georgia and Azerbaijan should be given roles in the "Partnership for Peace" program under NATO. Such political integration is a key element in integrating Russia and its neighbors into organizations that will eventually be the main consumers of Russian oil.

Fallback Discussion: If Putin and/or Nazarbayev fail to agree to multiple pipeline production based on the market argument, the Baku-Ceyhan proposal should be reinforced as a starting point, and the principles of allowing market forces to drive the Caspian energy question should be discussed. If the leaders fail to agree to cooperation within their nations on institution building, the President should focus on antiterrorism cooperation.

Appendix

- The Cheney Task Force's National Energy Policy report (which calls for development of domestic oil reserves and research into alternate and more efficient energy sources) should be used as a foundation to any of the above options pursued since it will help reduce domestic dependence on foreign oil reserves. These recommendations were not discussed as part of this memo since they do not relate directly to the development of oil in the Caspian region—the subject of the upcoming Bush meetings. However, reducing domestic oil dependence will also play a major role in protecting America against energy shocks. Priorities in reducing national dependence include increasing gas taxes for SUVs and increasing funding for alternate energy source projects at major technical universities. Knowing the potential reduction in domestic consumption possible through energy efficiency measures will help determine what impact will such reductions have on demand for foreign oil in the long term.

- A significant potential barrier to successful development of Caspian oil is that the final decision regarding which pipeline routes to use depends in part on the level of internal conflict in the host nations. For example, Uzbekistan's government is dealing with the threat of rising Islamic fundamentalism in the country; Afghanistan remains scarred by war; the Azerbaijan-Armenia war over Nagorno-Karabagh has yet to be resolved, separatist conflicts in Abkhazia and Ossetia in Georgia flared in the mid-1990s, and Russia's war with Chechnya has devastated the region around Grozny in southern Russia. Decisions on which route to use depend in part on which regions are viewed as strategic to U.S. interests. The potential tensions that arise are only compounded by recent terrorist events. Thus, both economics and joint antiterrorism measures should be referred to as the foundation for joint development initiatives.

- Other potential barriers to agreement include Putin's potential interest in building the energy industry within Russia to a more successful level before allowing U.S. oil companies to become more involved. This would allow Russia to have tighter control

over pipelines and reserve extraction decisions, which would compromise U.S. interests in much the same way that Saudi Arabian (and OPEC) monopoly over existing Middle East reserves gives them control over world prices.

To: President of the United States
From: Simon Saradzhyan
Date: April 8, 2002
Re: Exporting Oil from Russia and the Caspian to enhance U.S. energy security

Issue: The President needs to use the upcoming summits with leaders of Russia and Kazakhstan to advance his administration's efforts to diversify supply on the world energy market.

Diversity of supply on this market is a crucial foreign policy objective that this administration can and should pursue immediately to reduce the Persian Gulf states' ability to influence prices on the world oil market and reduce U.S. dependency on imported oil that remains a serious threat to U.S. national interests. Suspension of oil exports by Iraq, recent massive protests in a number of other Arab states, and al-Qaeda's threats to disrupt oil shipments from the Persian Gulf demonstrate that supply of energy from this region can become a hostage to instability or anti-Western sentiments as has happened in the past. In comparison, both Russian and Kazakh leaders have leaned towards the U.S. in the wake of 9/11, giving this administration an unique chance to compel these two largest of the Newly Independent States (NIS) towards cooperation in the Caspian region—cooperation that would exclude Iran.

One should remember, however, that while engaging Russia, we also need to end its virtual monopoly over transportation of oil and gas from the Caspian region. More importantly, the confirmed reserves of Russia, Kazakhstan, and other NIS states in the Caspian region are no match to the reserves of Persian Gulf countries. Thus, even if a complete success, engagement of Russia and Kazakhstan alone will not limit U.S. exposure to fluctuations of the world oil market unless the U.S. government compliments this engagement with achievement of long-term objectives.

These objectives include enhancement of energy productivity and efficiency, modernization of U.S. energy infrastructure, and diversification of energy sources through alternative fuels. These objectives are opposed by powerful domestic groups, such as the auto industry. However, the Bush administration still needs to pursue and achieve them in order to achieve U.S. energy security.

U.S. Interests:

Vital:

1. Ensure the viability and stability of global supplies of energy (threat: medium).

2. Reduce U.S. dependency on imported energy; keep prices on the world oil market at acceptable levels (threat: medium).

3. Establish productive relations, consistent with U.S. national interests, with Russia (threat: low - medium).

Extremely important:

1. Prevent the emergence of a regional hegemon in the Caspian region (threat: medium.)

2. That U.S. GNP growth from international trade and investment be maximized. (threat: low).

Operational Objectives:

- Promote development of multiple commercially viable oil and gas transportation routes from the Caspian region.
- End Russia's virtual monopoly over transportation of Caspian energy resources and prevent Russian hegemony in the Caspian region.
- Avoid antagonizing Russia and Kazakhstan over Caspian issues.
- Ensure Russian and Kazakh help to offset any significant slump in energy supplies from the Persian Gulf.
- Keep Iran excluded from exploration and transportation of energy in the Caspian region.

Items for Discussion:

Can the U.S. end Russia's monopoly on transportation of energy resources from the Caspian region without antagonizing Moscow?

If antagonized, will Russia ally with Iran and act as a spoiler in the region?

How can the U.S. incentivize Russia to shed the transportation monopoly voluntarily?

Political stability and pro-Western orientation of Russia would be crucial for smooth functioning of routes that would go through this country if the U.S. stops trying to limit Russian participation in Caspian oil projects. Will this stability remain during future transitions of power in Russia?

Policy Options:

Option 1. Immediate results. Use the presidential summits to make it clear that this administration favors immediate development of the Baku-Tbilisi-Ceyhan pipeline coupled with construction of trans-Caspian pipelines from Kazakhstan to Azerbaijan. Provide economic incentives, such as U.S. ExIm Bank loans and loan guarantees to speed up construction of these pipelines and economically compel Kazakhstan to use these routes for oil shipments.

Pros: ∗ 60% chance that oil transportation from the Caspian region will be less vulnerable to the situation in Russia in the short-term

Cons: ∗ 40% chance that Russia will try to become a regional hegemon or unite with Iran, will start acting as a spoiler in the medium-term, undermining the fragile stability in Azerbaijan and Georgia through separatism, or muscle Kazakhstan out of Baku-Ceyhan.

Option 2. Long-term engagement. Adopt a genuine multiple pipeline policy concerning Caspian oil and stop limiting Russian participation. Tell the two presidents that the administration favors multiplicity of routes but will not provide any special incentives for any of the proposed routes, allowing those most commercially viable to be built. Secure firm Russian and Kazakh guarantees that they will not seek to disrupt the functioning of the planned Baku-Ceyhan pipeline and that they will increase oil production to help offset significant slump in supplies from the Persian Gulf. Also secure Russia's promise to exclude Iran. Apply sticks and carrots to have Russia and Kazakhstan give these guarantees. Carrots should include loan guarantees for projects to overhaul the two countries' aged oil transportation and refinery infrastructure in the region and assistance in Russia's WTO bid. Sticks could include reduction of aid and acceptance of Azerbaijan's and Georgia's invitation to host NATO bases.

Pros: ∗ 80% chance that there will be sustainable multiple oil transportation routes from the Caspian region.

Cons: ∗ 20% chance that some of the Caspian oil projects will become hostage to possible instability in Russia.

Recommendation & Rationale: Option 2 is recommended as it offers medium-term and long-term stability in flow of energy resources from the Caspian region with risks from Russian involvement acceptably low. Russia has too much sway in the region and can seriously destabilize Azerbaijan and Georgia if it finds itself sidelined from the Caspian oil projects. Using Kazakhstan's dependence on Russian imports and large Russian minority in Kazakhstan, Moscow can also compel Astana to divert to Russian routes even if Nazarbayev is initially anchored to the Baku-Ceyhan pipeline as proposed in Option 2.

To: NSA Condoleezza Rice
From: Steingrimur Sigurgeirsson
Re: Russia/Kazakhstan summit and energy

Issue: How to use the upcoming presidential meeting with the presidents of Kazakhstan and Russia to advance the goal to diversify global supply of energy in line with U.S. interests.

U.S. National Interests:

- Fulfillment of U.S. energy needs (vital)
- Lessening economic dependence on volatile Middle East (vital)
- Regional stability in the Caspian (extremely important)

Analysis: Two trends are defining U.S. interests regarding the global supply of energy. In the next years, the U.S. will become more dependent on imported oil to satiate its increasing demand for oil. The importance of Middle Eastern oil on the world market will increase gradually. Given increased instability in the Persian Gulf and the risk of political chaos in the world's most important oil producing states, it becomes vital to ensure a diversification of energy sources to reduce the risk of an energy crisis. These are not an alternative to Middle Eastern oil, but, since this oil is produced at the margin, it can have a major effect on price trends. Caspian oil is the prime candidate.

Operational Objectives:

- Stability in the future supply and pricing of oil
- Diversification in the global supply of oil
- Firm U.S. political and economical presence in Caspian region

OPTIONS

No. 1 Go With Russia. The U.S. and Russia increasingly see their interests aligned in the post-9/11 world. The quickest way to develop the capacity to exploit the Caspian oil reserves is through cooperation with Russia, concerning both exploitation and transport of the oil. This would call for broad inter-governmental cooperation as well as private cooperation between Russian and U.S. oil companies.

PROS	*CONS*
• Quick fix to the need to exploit Caspian oil reserves • Deepens U.S. and Russian cooperation • Shuts out China and Iran from the region	• Undue dependence on Russia => Russia can pressure U.S.; other states could become "hostages" to Russia • U.S. oil companies likely to draw the short straw • Angers Turkey => Presents environmental dangers for the Bosporus

No. 2 Caspian Diversification. Support multiple routes of transport for Caspian oil. Support a partial flow of oil through Russian pipelines to the Black Sea but firmly promote the construction of the Baku-Ceyhan pipeline.

PROS	CONS
• Undermines Russian hegemony in the region => Strengthens position of U.S. firms • Multiple routes of transport for Caspian oil => Decreases risk of disruptions	• Complicated situation on the ground in the Caspian region; Russia will oppose • Expensive => Dependent on Kazakh cooperation to be a realistic possibility

No. 3 Radical Comprehensive Energy Strategy. Independent of option No. 1 and No. 2 the U.S. should take the necessary steps to decrease its reliance on fossil fuels as its primary energy source. This option has two main components: increased fuel efficiency standards on all levels and active support through the tax system for the development of alternative energy sources like hydrogen.

PROS	CONS
• Addresses the demand side of the problem => Demand↓ => Proportion of domestic oil production in relation to consumption ↑ • Long-term viable solution of energy problem	• Amounts to political suicide in current climate • Takes time to have effect

Recommendation: Option No. 2 but take steps to lay the political groundwork for realizing Option No.3.

Implementation: Assure Russia that the U.S. supports a strong Russian role in Caspian region. Use Bosporus argument as stick (threaten to support Turkish drive for a change to Montreaux) and economic incentives as carrots (help towards WTO membership?). Pressure Kazakh premier to come on board regarding the Baku-Ceyhan route. Pressure Chevron, ExxonMobil, and other interested parties. Facilitate credit for pipeline.

The fallback strategy is to rely on Option No. 1 but try to keep No.2 open as a future option.

ISP 202 CASPIAN WEEK
READING LIST
Case #7: U.S. Policy on Exporting Oil from Russia and the Caspian

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