Chapter 5

Russia and the West: Energy Warfare

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The nature and shape of the Russian oil and gas industry is not just Moscow's concern. The ups and downs of Russia's energy production and exports are factors that affect the global political environment. The influx of revenues from hydrocarbon sales determines the way the Kremlin behaves in the world arena, and the notorious unpredictability of the Russian political leadership becomes even more pronounced when oil prices show an appetite for instability.

Russia is a major energy supplier. In 2015 it accounted for 11.6% of global oil production and 17.8% of global natural gas production. Its natural gas export sales equaled 19.1% of the world's total. Russia remains the world's largest supplier of piped gas (covering about 30% of the EU's total demand), even though it plays a much smaller role in global LNG trade.

It would be wrong to assume that Russia and foreign consumers of its oil and gas are equally dependent on each other. While stable revenues from energy exports are an important to domestic socioeconomic stability and even survival of the incumbent regime, international consumers' dependence on Russian supply is shrinking. Recipients of Russian oil can relatively easily switch to other sources, and the EU, the principal market for Russian natural gas, is slowly adopting very practical measures to enhance its energy security by encouraging energy saving, energy efficiency, the use of alternative types of energy, diversifying suppliers, building interconnectors, and raising the proportion of LNG in its gas imports.[1]

Russia's financial health depends much more on exports of raw materials (predominantly represented by oil and gas) than is officially recognized. In June 2016, Prime Minister Dmitry Medvedev said that the share of oil and gas revenues in the federal budget had fallen to 34%, from 45% in

[1] In the last quarter of 2014 and the first quarter of 2015, President Putin ordered Gazprom to cut its gas deliveries to Western Europe to a minimum, to prevent "reverse" gas sales to Ukraine, yet gas prices at European trading hubs were unaffected.

the previous year.[2] Pro-government media hastened to declare that the decline was caused by an increasing share of revenues from other sectors of the economy. In fact, both figures are open to doubt.

According to the economy research team at the Carnegie Moscow Center, the Russian federal budget received over 90% of its revenues from the sale of mineral resources in 2014, and the following year 2015 witnessed another decline of other revenues.[3] In Russia, taxes from citizens do not constitute a significant part of federal revenues, and the majority of the population's income (from salaries of government-fed labor force to pension funds) has to be subsidized by revenues that come from exports of mineral resources. These vitally important revenues have been shrinking since the fourth quarter of 2014, when oil prices started plummeting in the wake of the shale revolution in North America.

Foreign factors such as low energy prices and poor prospects for global energy demand are amplified by domestic issues: politicized investment decisions, monopoly practices, inefficient government-run corporations, an investment-discouraging fiscal system, rampant corruption, discrimination of private business and foreign investors, a notoriously unfair judicial system, lack of rule of law, and other issues. Russia's intervention in Georgia, Ukraine, and Syria has led to international self-isolation of the Russian regime and aggravated its economic problems. Western sanctions against Russia have made it hard for petroleum operators to procure long-term funding and gain access to sophisticated technologies as well as credits for investment.

Confronted with challenges that may result in a catastrophe for the national economy, the Russian government has been unable to respond adequately. One of the main reasons is the specific economic system of today's Russia. The system is based on collecting and distributing natural rent, and the deficiencies of such an arrangement are aggravated by a management pattern that can be referred to as "crony capitalism." A few people associated with the president of the country control cash flows from the federal budget to specific businesses, and from these businesses to the budget, and then appropriate part of the flows in the interests of themselves and the whole group. The key questions for the rest of the world, and especially for the developed nations, is how Russia's basic industry may evolve, and how to engage with Russia and its regime.

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[2] http://www.ntv.ru/novosti/1634737/.

[3] https://www.facebook.com/andrei.movchan/posts/1268406526548888.

Accelerated Depletion

Russia produced 547.5 million metric tons (MMT) of oil and condensate in 2016 (10.965 million barrels per day (MMbpd)), consumed 284.3 MMt domestically, exported 235.8 MMt beyond the former USSR, and sold 18.4 MMt within the Commonwealth of Independent States (in Belarus). Overall production of liquid hydrocarbons was 2.5% larger than in the previous year.[4] The physical volume of oil and condensate exports from Russia increased 7% in 2016, but low prices eroded the value of these sales by 17.7% to $73.676 billion.[5]

The growth of oil production in Russia deserves a closer look. The factors that exert a depressing effect on upstream operators' activities are obvious:

- Low prices of oil, generally expected to continue for at least a few years with an uncertain outlook, prevent companies from investing in new projects that require large capex and a protracted period of negative cash flow.[6]
- Low prices also make it hard for investors to finance development of tight reserves—and about 70% of Russia's remaining oil reserves are officially recognized as "hard to recover."
- Most of the large Russian oil projects that are currently on stream are past peak production and their reserves are facing depletion. New discoveries are minuscule in size. According to the Ministry of Natural Resources, Russia's recoverable oil reserves would be depleted by 2044 at the current rate of production.[7]
- The government definitely wants to tap the oil and gas industry for extra taxes. It has already frozen the promised decrease of the oil export tax after a markup of the mineral extraction tax and intends to undertake other actions for increasing the tax burden on oil and gas producers (there are no other sectors in the national economy

4 https://rg.ru/2017/01/02/dobycha-nefti-v-rossii-za-2016-god-obnovila-rekord.html.

5 https://rns.online/energy/Dohodi-Rossii-ot-eksporta-nefti-v-2016-godu-sokratilis-na-178—do-737-mlrd-2017-02-08/.

6 Oslo-based Rystad Energy estimated in June 2016 that the breakeven price of barrel for Russian oil projects that have not yet seen a final investment decision averages $110, although this estimate covers all types of projects, including Arctic offshore and hard-to-recover reserves.

7 https://rg.ru/2016/03/16/glava-minprirody-rasskazal-kogda-v-rossii-zakonchitsia-neft.html.

that can be used as a source of additional income for the ailing state budget).[8]

The factors that work in the opposite direction and enable the oil and gas companies to remain in business, and even contribute additional volumes of oil to the country's overall output are also evident:

- The majority of Russia's ongoing oil projects have had their capital expenditures reimbursed long ago, and production costs there do not include an investment amortization component. Sunk costs make it commercially viable to continue production.
- Final investment decisions were made for a large number of projects well before oil prices started their downward slide in the last quarter of 2014, and significant funding has been approved. Companies are going ahead with the projects because dropping them at this stage would mean a big loss of cash. Still, they maintain a no-fringes regime at such projects to minimize costs.
- The depreciation of the Russian national currency (from 35 rubles per U.S. dollar in the middle of 2014 to 60 rubles in December 2016) has enabled companies to save on costs of labor, power, domestic materials and equipment, taxes, etc., while earning hard currency for exported gas, crude oil, and refined products. As a result, the breakeven price of Russia's exported crude oil from brownfield projects is tentatively estimated to average in the range of $24 to $27 per barrel of Urals blend, which ensures a comfortable profit against the 2015–2016 average of around $45 per barrel of Brent.[9]
- Fiscal incentives available for specific categories of Russian upstream projects help them remain commercially viable.[10]
- Three grandfathered projects that operate under production-sharing schemes (Sakhalin 1, Sakhalin 2, and Kharyaga) enjoy special tax regimes that enable them to maintain, and even increase, production levels.

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8 http://www.vedomosti.ru/business/articles/2016/08/25/654406-minfin-sobrat-neftyanikov.

9 When Russian government officials quote a figure around $2 per barrel as "production costs" of regular oil and over $20 for tight and offshore oil, they mean only lifting costs (opex). Effective (total) production costs have to include capex, administrative and marketing expenses, transportation costs, taxes, interest on credit, etc.

10 http://www.ey.com/GL/en/Services/Tax/Global-oil-and-gas-tax-guide—-XMLQS?preview&XmlUrl=/ec1mages/taxguides/GOG-2016/GOG-RU.xml.

Driven by those conflicting factors, Russian oil companies are pursuing strategies that lack long-term vision. They keep recording high-volume investment programs (in rubles) but the structure of investments has changed dramatically in comparison with the high-price period prior to 2014. In the low-price environment Russian oil producers prefer to focus on quick gains from marketing whatever cheap oil they still can recover from ongoing (brownfield) projects rather than investing in exploration and development of new (greenfield) projects. An onshore greenfield project may take between seven and fifteen years to reach payback, and the price of oil during that period is a great uncertainty, especially in view of the poor quality (and high recovery cost) of Russia's untapped yet reserves.

Even as companies assure the government that they are not trimming down their investment programs, investments are mostly made not in development but in drilling extra wells at the most productive reservoirs and in enhanced oil recovery (EOR) methods from the reservoirs that are already on-stream. This approach translates into an accelerated depletion of underground reserves. In the Khanty-Mansi Autonomous District of western Siberia, Russia's main oil producing area, production fell from 270.6 MMt in 2009 to 239 MMt in 2016, and is expected to decrease by another 20% by 2030.

According to Fitch, the Russian oil industry is already in the red. The main companies' costs (including the dividend and investments in future production) exceed the size of their cash income. The agency estimates that each barrel of produced crude oil removes an average of about $0.50 from the companies' financial balance.[11]

Paradoxically, the same companies that boast ridiculously small production costs and ability to remain in business in the low-price environment warn the government that oil production in Russia is going to drop sharply without additional tax incentives. When the Ministry of Energy collected oil companies' forecasts of their performance for the next twenty years in 2015 and summed the forecasts up, it discovered that the industry was predicting a decline of national oil production from almost 11 MMbpd to less than 6 MMbpd (297–310 MMt a year) by 2035.[12]

Some of these dire predictions have to be ascribed to the companies' desire to blackmail the government into fiscal benefits for the industry,

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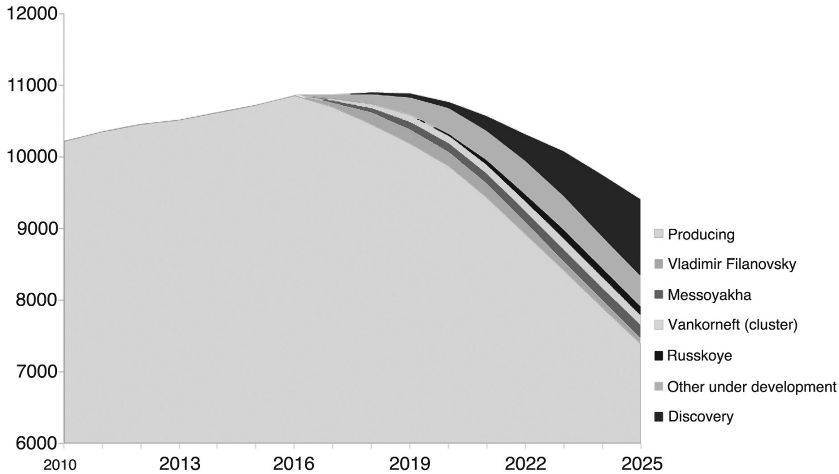
[11] http://www.finanz.ru/novosti/aktsii/Fitch-rossiyskiy-neftyanoy-sektor-teryaet-po-$0-5-na-kazhdy-barrel-dobychi-1001379462.

[12] Draft General Scheme of Development of RF Oil Industry through 2035.

Figure 1. Russian Oil and Condensate Production Outlook with New Projects, thousand bpd



Source: Rystad Energy UCube (2016).

but the negative tendency cannot be avoided in view of the depletion of brownfields and shortage of newly discovered and developed reserves of cheap oil. The Ministry of Natural Resources and Energy estimates a peak of oil production in Russia to occur around 2020.[13]

Gas Galore

The natural gas sector of the Russian economy is also ailing, but not from lack of commercial production capacity. Gazprom's records for 2014 are a good example. The company's CEO Alexey Miller told President Vladimir Putin[14] that the company could have produced 617 billion cubic meters (bcm) of gas, but had been able to sell only 444 bcm during the year. The sold category included 217.2 bcm to the domestic market, 48.0 bcm to former Soviet republics, and 126.2 bcm to the far abroad, that is, to western Europe and Turkey. Some of the gas volumes Gazprom posts as sales were not physical exports from Russia but gas consignments the

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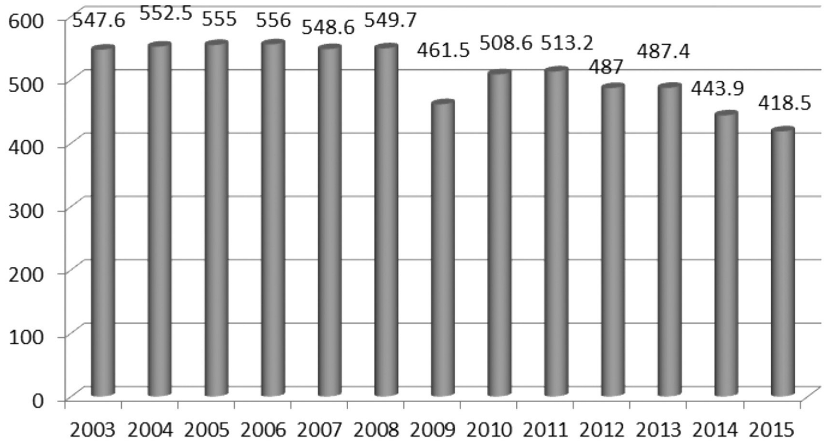
[13] https://regnum.ru/news/economy/2173652.html.

[14] https://www.1tv.ru/news/2015/06/15/19333-vladimir_putin_vstretilsya_s_glavoy_gazproma.

Figure 2. Natural Gas Production by Gazprom Group, bcm/year



Source: Gazprom

company's overseas trading arms obtained from non-Russian producers and resold (e.g., Gazprom delivers no Russian gas to the UK but reports sales of gas there.)

The overcapacity of gas production by Gazprom exceeds 200 bcm a year, and the Russian gas export monopoly could have easily added another Europe to the list of its customers, but there is no such thing as another Europe close to Russian gas fields and gas pipelines. Natural gas demand in Europe, the principal market of Gazprom, is not growing significantly and the company has had to slow down development of new fields on the Yamal Peninsula, which are expected to replace semi-depleted old ones. The domestic market is suffering from stagnation, and non-Gazprom gas producers snatch whatever opportunity appears to increase their hold on Russian consumers. LNG projects in Russia are somewhat questionable, mainly due to the scarcity of deep-water ice-free ports that are located close to major gas producing areas. Long-distance transportation of natural gas toward such ports is not economical.

Gazprom's attempts to play a role on the global LNG market have been unsuccessful. After some governmental pressure, the Russian monopoly acquired a controlling stake in Sakhalin 2, an international consortium (Shell, Mitsui, and Mitsubishi) that operates an LNG plant exporting about 10 MMt a year, but expansion plans in this business are still little more than declarations. The project of an LNG plant near Vladivostok on the Pacific coast is now forgotten, although Gazprom did make the investment decision on Putin's orders. There is neither adequate gas supply, nor finance, nor proof of commercial feasibility to go ahead with this project.

Russia's only LNG project that is actually going ahead is Yamal LNG, under a consortium of Russia's private company Novatek, France's Total, and two Chinese partners. To make it commercial, the Russian government has granted an exemption from all taxes and provided financing for costly infrastructure for the project. Without this unprecedented assistance, Yamal LNG would have been a commercial disaster.

The underlying reason for the overhyped pivot to China in Gazprom's plans is evidently political rather than commercial. On September 1, 2014 Vladimir Putin said that the Power of Siberia pipeline to China would enable Russia to switch gas flows from the west to the east and backwards depending on the price arbitrage.[15] And Gazprom managers claimed on multiple occasions that the volume of Russian gas exports to Asia would soon exceed that of westbound exports—an utterly unrealistic plan.

The problems with the pivot to China are obvious. To begin with, China does not need all the gas the Russians would like to deliver across the border. Moreover, as a monopoly buyer at the receiving end of the great transportation infrastructure, China will certainly insist on special terms. While Gazprom hoped to collect as much as $350–400 per thousand cubic meters for its gas in China to make the Power Siberia marginally economical, the spot prices in Asia have fallen by the middle of 2016 to about $130 ($4.40 per MMBtu), and the Russian project is now hopelessly infeasible.[16]

Russia's intention to double the capacity of its Nord Stream pipeline in the Baltic Sea is open to doubt as well. Moscow insists that the current transit route across Ukraine is insecure and wants European customers of Gazprom to switch to alternative routes, such as the Nord Stream or the abortive South Stream instead. This is not an economically feasible solution. While Gazprom is currently selling gas in Germany at prices that are on the verge of breakeven figures or below it, the idea of transmitting

[15] https://lenta.ru/news/2014/09/01/pipeline/.

[16] http://www.focus.de/finanzen/news/milliardengrab-power-of-siberia-warum-gazproms-giga-gasdeal-mit-china-fuer-putin-in-eine-katastrophe-ausartet_id_4890036.html?drucken=1.

this gas from Germany to Austria and then, via as-yet inexistent pipelines to Italy, Greece and Balkan nations defies commercial logic.

Meeting the Challenges

Two obvious solutions may be suggested for the alarming situation in the oil industry, and both require radical reforms, both structural and fiscal. The current structure of the industry does not encourage small-scale and medium-sized upstream businesses. Large integrated companies enjoy a domineering status even though the quality of remaining oil reserves calls for a larger role of small players: new discoveries are usually smaller than 3 MMt each, and cumbersome giants prefer dealing with large fields. Small enterprises that are prepared to assume financial, geological and other risks and take a stab at a new advanced technology are a rare case in Russia today.

Of course, it is impossible to expect a drastic change in the Russian legislation that makes the state the sole owner of mineral resources and allows developers to use subsoil riches under a license. The North American legal system (when the owner of a few acres of land possesses all the mineral wealth underneath) is unthinkable in Russian traditions, but an extra incentive for small privately-run companies would definitely help a lot.

Unfortunately, privatization in the Russian petroleum industry has been just a slogan for many years. Quite a few private, and commercially efficient, companies (e.g., Yukos, Udmurtneft, Slavneft, Sibneft, Itera, TNK-BP, Bashneft, et al.) have been taken over by either Rosneft or Gazprom, the quasi-governmental giants under politicized management. Government-controlled companies accounted for 61% of revenues in the oil and gas industry in 2014 as compared to 48% in 2005.[17]

Direct foreign investment in exploration and development is restricted by law (e.g., if a company discovers reserves in excess of 70 MMt of oil or 50 bcm of gas, the license may be transferred to a state-controlled company because such discoveries are recognized by law as strategic federal reserves.) Equity participation in offshore oil and gas production is banned. Foreign companies can only be partners in special vehicle companies, the operators of projects without any chances to book some reserves or claim a share of production.

[17] http://ac.gov.ru/files/publication/a/8449.pdf.

A tax reform could also benefit the Russian oil industry. The main obstacle to launching new innovative projects is the need to pay taxes on volume of production rather than on profit. For many years the industry has been lobbying for some form of a windfall tax (dubbed a tax on financial result, or a tax on extra profit), but the Ministry of Finance has successfully derailed all attempts at this reform stating that any such changes would leave the state coffers without a large portion of revenues for several years. Debates about a specific form of tax reforms can go on for a very long time, especially because the financial problems of the federal budget make it hard to endure even a short period of missing revenues because of the reform effort. Instead, the government keeps nurturing plans to increase the tax burden on the oil and gas industry.

Challenged by the prospect of seeing natural gas prices remain at a very low level for a long time, and with weakening demand for gas on the global market, the Russian government is behaving unreasonably. It is prepared to spend extravagantly on new export pipelines. Evil tongues allege that the only purpose of these infrastructure megaprojects is to make pipeline contractors richer (often without any tenders). And, since the lucky contractors are personal friends of the Russian president, such as Arkady Rotenberg and Gennady Timchenko, the allegations are not without foundation.

Investments in Russia's oil and gas industry are hardly growing. The Ministry of Energy expected them to increase from 16.7% from 1.2 trillion rubles in 2015 to 1.4 trillion rubles in 2016, but admits that growth could be eroded by new tax markups and inflation.[18] To make it worse, the structure of investments is a cause of worry. Oil operators prefer to intensify recovery at brownfield projects rather than explore new possibilities, and the major gas player, Gazprom, invests mainly in politicized projects of gas transportation infrastructure, which cannot yield any profit for a long time, if any.

Comparative statistical data for the period of January–July in various years demonstrates the gravity of the crisis. In that period of 2012, state revenues from oil exports equaled $105.8 billion but in January–July 2016 they amounted to just $39.4 billion. Revenues from gas exports in the same period plummeted from $37.46 billion in 2014 to $17.05 billion in 2016.

[18] http://abnews.ru/2016/03/23/investicii-v-neftegazovuyu-otrasl-rossii-vyrastut-v-2016-godu-na-167-minenergo/.

On Deaf Ears?

The energy sector of the Russian economy is of particular concern not only for the Kremlin but also for the international community. A deterioration of Russia's relations with the rest of the world in the vitally important energy business might lead to dire political consequences. It may make the Russian regime more confrontational and dangerously unpredictable in its self-imposed isolation. It may tempt Moscow to continue ascribing domestic economic problems to allegedly unfriendly activities of the West and to indulge in a new round of hostilities. Given the importance of the oil and gas sector for the Russian economy and the stability of Russia's regime, the international community may choose to influence the policy of Moscow by providing either an impediment for this sector or encouragement of cooperating with it.

Efforts have been made to find a way for improving the environment for cooperation with Russia in the energy industry and other sectors of economy. The Rand Corporation, for instance, has been pursuing this goal since 1997 through its Business Leaders Forum.[19] In 2015–16 Germany's SWP organized a "Saturday Club" of Russian and European corporate and academic experts to prepare a position paper that could be a road map for developing energy cooperation with Russia through specific common projects.[20] The EU–Russia Energy Dialogue is also going on, but its half-frozen activities are limited to contacts on the expert level without involving actual decision makers.[21] These efforts have been fruitless so far.

Russia's domestic community of experts in economics and politics is ignored by the Kremlin. Formerly influential analysts, who could be sure their opinion was heard and appreciated by the political establishment in the past keep complaining: "After Crimea, nobody listens to our recommendations up there." An expert told the author: "People in the presidential administration said we can write and publish whatever we like but the word 'recommendation' is a taboo nowadays."

The current economic crisis in Russia is evidently going to be a slow-evolving affair and can hardly lead to serious social unrest or mutinies in the foreseeable future. The majority of the population is adapting to the

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[19] http://www.rand.org/international/cre/forum.html.

[20] http://ac.gov.ru/events/09172.html.

[21] http://www.interfax.ru/russia/533356.

crisis by trimming consumption in both quality and quantity. A recent poll demonstrated that 66% of households were looking for an extra job and 87% were already following an economy regime or planned to start such a regime.[22]

It remains to be seen how the West would react to an increasingly belligerent Russia whose behavior is determined by a mafia-like structure of government, ailing and failing economy, and shortage of cash (mainly because of low energy prices but also because of the government's inability to prevent corruption and to efficiently manage economic processes).

What the West Could Do

Essentially, there are three possible ways the West might act vis-à-vis Russia in these circumstances.

1. An appeasement strategy may eliminate some tensions in Russia's relations with other nations and create a better environment for economic cooperation (an improved investment climate, larger trade exchange, cooperation in important issues such as climate control, etc.) As former U.S. National Intelligence Director James Clapper said, commenting on Putin's arrogant attitude:

> I think he has this vision of a great Russia, as a great power. It's extremely important to him that Russia be treated and respected as a global power on a par with the United States. And I think that has a lot to do with impelling his behavior.[23]

In the energy sector, such rapprochement would open tremendous opportunities for international business. Even if the Russian government continues restricting direct involvement of foreign players in large oil and gas production projects, a softer set of sanctions (or elimination of sanctions) would benefit suppliers of advanced technologies and equipment, as well as international creditors. Cooperation with the outside world would help delay the imminent decline of Russia's oil production.

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[22] http://www.vedomosti.ru/opinion/articles/2016/10/21/661884-tunnel-sveta and http://www.bbc.com/russian/business/2016/03/160304_zubarevich_russian_regions.

[23] http://www.rferl.org/a/potention-us-russia-conflict-seen-clinton-syria-no-fly-zone-plan-trump-clapper-/28075466.html.

The strategy is not flawless. The soft approach will certainly be interpreted by the Kremlin as weakness, and the Russian leaders will feel free to engage in new aggressive actions on the global scene. Moscow has proven many times during the past two or three years that it was not ready to follow a joint course with the United States or with European nations and prefers a confrontational attitude.

As outgoing Defense Secretary Ash Carter said in an interview, Vladimir Putin's efforts to blunt American influence have been increasing and are making it harder to find areas in which Washington and Moscow can work together:

> It seems to be part of his self-conception. And one of the ways he defines the success of his policy is not by results on the ground but the level of the discomfort he can create in the rest of the world and show to his people as the point of his policy.... That's what makes it so difficult to build a bridge.[24]

It would be naïve to assume that the Russian leader

> hopes to scale back tensions with the United States and secure Washington's assent for a new, multipolar world order based on the spheres of influence of the great powers rather than on the liberal norms and institutions that dominated the post-Cold War era.[25]

Efforts of some Russian non-governmental foreign policy organizations, such as the Russian International Affairs Council, to propagate a dialogue with the West for the sake of a multipolar world are either ignored or resented by Kremlin decision makers. A senior official of the Presidential Administration told the author angrily during a rare frank conversation: "They are making more harm than benefits for us. In a nutshell, we want a new Yalta."

Efforts to either contain or accommodate Russia are failing, associate fellow at Chatham House Lilia Shevtsova warns, explaining:

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[24] http://www.wsj.com/articles/ash-carter-says-putin-is-making-it-harder-for-u-s-to-work-with-russia-1483698600.

[25] https://www.foreignaffairs.com/articles/2017-01-04/rapprochement-russias-terms?cid=soc-fb-rdr.

> The new mantra of "transactional relations" (a policy expected to be supported by U.S. president-elect Donald Trump) does not exactly inspire hope, either. Moscow is ready for a new "grand bargain" and has made its demands clear. It wants not only a "New Yalta," but also Western endorsement of Russia's right to interpret global rules as it sees fit and to build an order based on a balance of interests and powers.[26]

To make it even more hopeless, the issues of Crimea, southeastern Ukraine, and Syria make it hard to hope for success of any dialogue or, in a larger sense, détente, for the time being.

2. An opposite approach, a containment and stop-and-punish-the-aggressor strategy, may also work in unpredictable ways. The most effective measures would have to include international sanctions against Putin's close associates and Putin himself (especially targeting their assets abroad); international persecution of Russian officials accused of war crimes; enhancement of the West's relations with the countries in Moscow's sphere of interests; accelerated development of energy sources and methods that could erode Russia's domination on some energy markets; and a propaganda and counter-propaganda campaign.

A new set of sanctions against Russia,[27] including probably a ban on investing more than a few million dollars in Russian oil and gas projects, would undermine the Russian energy industry's ability to maintain the current level of oil production and expand gas exports. An abrupt decline of oil and gas revenues to the federal budget would affect the socioeconomic vitality of the regime and probably lead to social unrest. It is hardly possible to expect a turn toward democratic reforms and liberalization of the economy because of new hardships. The regime will probably resort to new belligerent acts abroad and ascribe the problems to foreign conspiracies. The duration of such attitudes, as well as the survival potential of the Russian regime in these circumstances, are open to speculation.

This confrontational strategy would provide the Russian leadership with new fuel for its domestic propaganda (the nation is surrounded by enemies, let's tighten our belts, eliminate the fifth column, and support the great leader). Moreover, driven into a corner, the Russian regime may

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[26] https://www.chathamhouse.org/expert/comment/efforts-contain-russia-are-failing.

[27] http://www.cbsnews.com/news/senators-introduce-sweeping-russia-sanctions-in-response-to-hacks/.

become desperate and nasty. In addition, the interests of European business in Russia have to be taken into account—and the Kremlin will do its best to capitalize on European unwillingness to spoil relations with Russia.

3. A wait-and-see strategy aimed at outliving the Russian regime is another option. The international community may opt for monitoring the situation in Russia without much interference and make attempts at minimizing the impact of negative developments. The goal would be to expect the internal processes in Russia to reach a critical phase, which would require a radical change from within in the economic and political management of the country.

Looking for the limelight is evidently the Russian president's major weakness. "Indifference of the world to statements and actions of Putin would be the worst punishment for him," as a prominent political analyst in Moscow says off the record. Combined with a containment strategy, it might be a powerful instrument in dealings with the Kremlin. On the other hand, accommodating Putin's desire for publicity—without actually making serious concessions—may become a lubricant for maintaining some sort of a détente.

The question remains whether a dialogue for the sake of confidence building is still possible in view of Russia's determination to maintain the status of its military involvement in Ukraine, Syria and, probably, in some other regions in the future. Without a real dialogue, the West will have to resort to developing a joint effort to defend its interests against Russia's arrogant and provocative attitude—all the way to a dangerous military buildup. In these circumstances, Russian oil and gas potential will undoubtedly become a political instrument and a weapon in the confrontation. However, the probability that the West would adopt a united position against Russia's aggressiveness and lack of cooperation appears too small. In any case, it will take a lot of work in Washington to spearhead such efforts and to convince other Western partners to go along.

"Iron Fists in Kid Gloves?"

It is hard to develop a rational modus operandi for dealing with a frequently irrational player, but there exists a model that has proven to be effective. When Rex Tillerson, the new U.S. Secretary of State, headed ExxonMobil, the company's strategy and tactics in Russia gained it respect in the Kremlin and a carte blanche for pursuance of its own goals—often regardless of the Russian government's wishes.

On January 11, 2017 Tillerson, speaking at his Senate confirmation hearing as the future secretary of state, described some specifics of Russian leaders' ways of action, saying that they usually have a plan, then make a step and watch for reaction before making another step.[28] The pause between the steps could be a good opportunity for showing firmness or approval by the West.

The behavior of ExxonMobil in Russia from the very beginning has been unlike the conduct of other major oil and gas players. While Royal Dutch Shell and BP have opted for a model based on absolute obedience and loyalty towards the Russian leadership (and suffered quite a few humiliating losses because of this), Tillerson's company rejected such proposals and demands of the Kremlin that contradicted interests of ExxonMobil shareholders. Having established good personal contacts with Vladimir Putin and Rosneft CEO Igor Sechin, Tillerson has never made any real business concessions to the duo that could have harmed his company or his country. This is what they respect and accept in the Kremlin: firmness based on strength plus well-publicized friendly personal relations.

Rex Tillerson is apparently going to follow this model of dealing with the Russian leadership during his tenure at the State Department.[29] It looks like the most appropriate and efficient line of behavior under the circumstances, especially if the new U.S. administration manages to mobilize wide international support of its policy vis-à-vis Moscow.

The factors that determine the attitude of the United States and EU toward the energy industry of Russia differ greatly, and this difference makes it an uphill task to develop a joint policy in this respect. While for the Americans, Russian oil and gas are a big market for equipment, technologies and services (and mainly a nuisance in international politics), the Europeans remain dependent on supply of natural gas from Russia in addition to that. Moreover, being close neighbors of Russia and forced to coexist with Russian agents in the heart of the EU, they have to be very cautious in order to prevent or avoid Moscow's military outbursts.

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[28] http://www.cbsnews.com/news/rex-tillerson-confirmation-hearing-for-secretary-of-state-live-blog/.

[29] https://www.washingtonpost.com/news/josh-rogin/wp/2017/01/04/rex-tillerson-talks-tough-on-russia-in-private-capitol-hill-meetings/?utm_term=.747ed0bbecf9.

Choosing the right strategy in relations with Russia means encountering many ambiguities. A soft approach—a mixture of scenarios 1 and 3 in various proportions—may strengthen Russia's belief that the West is hopelessly weak, and encourage Moscow to get engaged in new expansionist actions. For Russia's energy industry, a softening of sanctions would help delay the imminent downfall of oil production and exports. In the Russian gas sector, hardly anything would change.

If a containment scenario becomes the preferred option for the West, tighter sanctions would undermine the Russian energy industry's potential for generating revenues to the state budget and accelerate a decline of the Russian economy. Under a worst-case scenario, the Russian government will be unable to support economically depressed regions by transferring funds the federal budget gets from oil-and-gas-rich areas, and the integrity of the Russian Federation will be in jeopardy.

The choice of the scenario in the West would depend on opting for one of the principal goals: helping Russia to survive regardless of the ruling regime's qualities or assisting Russia's economy to deteriorate, with dramatic consequences for the country as a whole.