



THE JAMES A. BAKER III
INSTITUTE FOR PUBLIC POLICY
OF
RICE UNIVERSITY

POST SEPTEMBER 11 UPDATE REPORT

**POLITICAL, ECONOMIC, SOCIAL, CULTURAL, AND
RELIGIOUS TRENDS IN THE MIDDLE EAST AND THE
GULF AND THEIR IMPACT ON ENERGY SUPPLY,
SECURITY, AND PRICING**

**TERROR, OIL AND GEOPOLITICS:
THE EVOLVING U.S.-RUSSIAN-IRANIAN TRIANGLE**

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PREPARED IN CONJUNCTION WITH AN ENERGY STUDY SPONSORED BY
THE PETROLEUM ENERGY CENTER OF JAPAN
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Introduction

Great wars are decisive moments in world affairs, marking the dramatic end of old orders and the introduction of new ones.¹ They create great powers and reduce others to second-class status; they forge new alliances and foster new rivalries; they sweep away regimes and give rise to alternate leadership; they destroy old mind-sets and usher in new ideologies. The major wars of the last century – World Wars I and II and the Cold War – represented truly tectonic shifts in the international landscape. The world was a vastly different place in 1918 than it had been 1914; the upheavals that occurred between 1939 and 1945 were even more far-reaching in their impact. The end of the Cold War, though it came without the catastrophic death and destruction of World Wars I or II, was no less violent in the change that it wrought in the international system, leading, as it did, to the emergence of the United States as the world's sole superpower.

Will the war on terror sparked by the September 11, 2001 attacks on the United States usher similar dramatic and unpredictable changes in international affairs? After just a year, the war is altering the geostrategic environment. In particular, the attacks of September 11 and the exigencies of the war on terror have led Washington to reassess its relationships with individual governments and to rethink more general policies. Moscow and Tehran are among the former; energy security is one of the latter. Indeed, Russia and Iran have important roles in both the war on terror and international energy markets. This essay proposes to offer a tentative analysis of the evolving three-sided relationship among Washington, Moscow and Tehran – the “triangle” of the title – in terms of the war on terrorism and an emerging U.S. energy strategy. While there will be some discussion of natural gas, particularly its role as a source of competition between Iran and Russia, this essay's focus will be on oil, reflecting the United States' vital interest in international petroleum markets and relative self-sufficiency in natural gas.

¹ See *After Victory: Institutions, Strategic Restraint, and the Rebuilding of Order after Major Wars* by G. John Ikenberry (Princeton University Press, 2000).

Pre-September 11

U.S.-Russian Relations

George W. Bush assumed office in January 2001 among general speculation that his administration would pursue a less accommodating policy towards Russia than his predecessor's. Conservative Republicans had long been critical of what they perceived as excessive deference to Russian sensitivities under Bill Clinton. They believed that the Clinton Administration had moved slowly on enlarging NATO to bolster the independence of former Soviet satellite states in Eastern Europe, particularly the Baltic countries.² They were also concerned that Clinton had been too accommodating of traditional Russian interests in the former Soviet republics of the Caucasus and Central Asia. Conservative Republican suspicion of Moscow's motives increased when ex-KGB officer Vladimir Putin was elected president in 2000. Perhaps most of all, conservative Republicans were harshly critical of what they believed to be the Clinton Administration's unenthusiastic embrace of national missile defense (NMD) – a hesitance they attributed, rightly, to the Administration's unwillingness to abrogate the 25 year-old Anti-Ballistic Missile (ABM) treaty with Moscow.

While candidate Bush had not made U.S. policy towards Russia a major campaign theme, there was little doubt that he shared many of these conservative views. His chief foreign policy counselor and later national security advisor, Condoleezza Rice, certainly suggested as much in a much-discussed article she published in *Foreign Affairs* magazine during the campaign.³ Many read one of her comments -- that "The (Chechen) war is a reminder of the vulnerability of the small, new states around Russia and of America's interest in their independence. If they can become stronger, they will be less tempting to Russia." – as an overt U.S. challenge to Russia's traditional dominance in the region.⁴ The early months of the Bush Administration certainly

² Russia's concerns with NATO expansion are not only strategic but also economic. With NATO expansion, almost all of Russia's oil and gas exports must now pass through current or possible NATO members to reach markets in Western Europe. See "Russia, Energy and the West" by Amy Meyers Jaffe and Robert A. Manning, *Survival*, Summer 2001, pgs. 133-152.

³ "Promoting the National Interest" by Condoleezza Rice, *Foreign Affairs*, January/February 2000, pgs 45-62.

⁴ *Ibid*, pg. 60. Her comments immediately preceding the quote are also interesting, in light of the post-September 11th US attitude towards terrorism: "The (Chechen) war has affected relations between Russia and its neighbors in

gave much credence to those predicting more problematic U.S.-Russian relations. The Administration made clear that it would put the development and deployment of NMD at the very top its foreign policy and international security agenda, whatever the objections of Moscow. It also took smaller steps – the expulsion of a Russian diplomat accused of spying and a meeting at the State Department with a representative of Chechen separatists – that signaled a firmer line with Moscow.

It is important, however, not to overdraw the shift away from the Clinton Administration’s policy towards Russia. With the exception of the question of NMD, indeed, the new Administration’s policies reflected more continuity than change. Once at the White House, National Security Advisor Rice made reassuring statements about the importance that the Administration attached to U.S.-Russian relations.⁵ With the exception of disagreement over the ABM treaty, Bush-Putin meetings during the summer of 2001 were marked by the usual rhetoric about the importance of cooperation between Moscow and Washington on a range of economic and strategic issues.

Oddly enough, Washington’s concern over Russian transfers of potentially dangerous technologies to Iran actually played a smaller role in the U.S.-Russian dialogue during the early months of the Bush Administration than it had during the late Clinton years, reflecting the dominance of acquiring Moscow’s acquiescence in terminating the ABM treaty in the new administration’s bilateral agenda. This occurred despite the Administration’s early and sharp public criticism of Russia for its role in proliferation.⁶

U.S.-Iranian Relations

Less change was expected of the new Bush Administration in terms of U.S.-Iranian relations. Despite increased talk of a possible “thaw” since the election of moderate Mohamed Khatami in 1997, Washington’s relations with Tehran at the end of the Clinton Administration remained

the Caucasus, as the Kremlin hurls charges of harboring and abetting Chechen terrorists against Saudi Arabia, Georgia, and Azerbaijan.”

⁵ See “Don’t Let Them Spook You” by Robert G. Kaiser, *Washington Post*, February 25, 2002.

⁶ See “Ending Russian Assistance to Iran’s Nuclear Bomb” by Robert J. Einhorn and Gary Samore, *Survival*, Summer 2002, pgs. 51-70. Their article provides an invaluable summary of the issues involved and a useful chronology of US-Russian negotiations.

troubled despite small, largely symbolic steps on both sides.⁷ Iran still rankled at implicit U.S. support for Baghdad during the Iraq-Iran War. Tehran, moreover, bridled at what it considered the injustice of U.S. sanctions policy and particularly the Iran-Libya Sanctions Act (ILSA) of 1996, which had hampered Iranian efforts to develop its oil and gas sectors. Despite the political rise of moderate forces after Khatami's victory, moreover, vast power continued to be exercised by conservative, anti-American clerics led by Iran's "Supreme Religious Guide," Ayatollah Mohamed Khamenei. Over a decade after the death of Ayatollah Ruhollah Khomeini in 1989, the architect of the Iranian revolution who had branded the United States "the Great Satan," U.S.-Iranian relations were marked by abiding mutual mistrust.

But the new Bush Administration had to deal with more concrete concerns than simple long-standing ill will between the United States and Iran. During the Clinton years, the United States was deeply worried about Iranian support for terrorism. Tehran was widely suspected of playing a role in the 1996 bombing of the U.S. military barracks in Al Khobar, Saudi Arabia; while Tehran apparently ceased targeting the United States directly in the years that followed, its support for terrorist groups in the Middle East – notably Hezbollah and Hamas – was public knowledge.⁸

Of equal, if not greater concern, was Iran's purported intent to acquire weapons of mass destruction and the means to deliver them. Tehran's efforts to develop and deploy a medium range missile were well known; indeed, in 1998 Iran successfully tested its Shahab-3. Based on a North Korean design, the Shahab-3 has a range of 1300 kilometers, bringing Israel and much of Saudi Arabia and Turkey into its range.⁹ The United States believed that Russia had provided support to the Iranian missile program. Iran -- signatory to the Non-Proliferation Treaty (NPT) -- has formally denied any plan to develop nuclear weapons; indeed, in a CNN interview of January 1998, President Khatami forthrightly declared that Iran was not a nuclear power nor had any

⁷ See *Thinking beyond the Stalemate in U.S.-Iranian Relations*, Atlantic Council (Washington, DC, 2001).

⁸ See *America and Iran: Road Maps to Realism* by Geoffrey Kemp, Nixon Center (Washington, DC, 1998). While Kemp is slightly outdated, he remains an excellent source on such matters as Iran's role in terrorism, Tehran's missile program, and its efforts to develop nuclear capability.

⁹ According to Bush Administration sources, Iran is developing a longer-range missile – the Shahab-4 – that would bring much of Europe within its range. See "Official Says Iran Is Developing Missile," *San Diego Union-Tribune*, May 8, 2002.

intent of becoming one.¹⁰ But U.S. intelligence remained convinced that Iran was in fact pursuing the “nuclear option.” Again, concern focused on foreign assistance to Iran’s nuclear program – specifically, Russia’s formal 1995 agreement to finish the Bushehr light water nuclear power plant project abandoned by the Germans a decade earlier. The United States was alarmed at the prospect of spent fuel produced at the Bushehr plant being recycled to produce weapons-grade fissile material. Washington was also worried by informal Russian assistance to Iran’s nuclear development program.

Despite the lingering mistrust between Tehran and Washington, not to mention the outstanding concerns about Iran’s support for terrorism and its WMD programs, there was some expectation, especially among observers in the energy sector, that the Bush Administration might make some steps, however tentative, towards improving U.S.-Iranian relations. The President himself, for instance, was an “oil man,” presumably inclined to listen to the complaints of U.S. energy companies about Washington’s sanction’s policy towards Iran – policies widely perceived as disadvantaging U.S. firms. Both Vice-President Cheney and Secretary of State Powell, moreover, had made comments about the limited usefulness of sanctions in general. As chief executive of Halliburton, a major energy services company, Cheney had criticized ILSA specifically.¹¹ Indeed, an early draft of now-Vice President Cheney’s report on energy security (discussed at length below) apparently recommended a review of sanctions against Iran, Libya, and Iraq in light of their importance to world oil supply. When the news of the draft broke in the press, President Bush reaffirmed his support for sanctions; the draft language was dropped from the final report.¹² The new Administration was clearly intent on increasing pressure on Saddam Hussein’s regime in Baghdad with the intent of toppling him from power. At least in theory, this raised the possibility of closer cooperation between Washington and Tehran as part of a *de facto* anti-Iraqi alliance.

¹⁰ See “The Clouded Mirror: the United States and Iran, 1979-99” by Gary Sick in *Iran and the Crossroads*, edited by John L. Esposito and R.K. Ramazani (New York: Palgrave Press, 2001), pgs. 191-210.

¹¹ “Political Oil Slick” by David Ignatius, *Washington Post*, July 30, 2000.

¹² “Oil Production in Iraq, Iran and Libya Seen as Critical” by Peter Behr and Alan Sipress, *Washington Post*, April 19, 2001 and “No Plan ‘as of This Moment’ to Lift Restrictions, Despite Panel’s Draft Report” by the same authors, *Washington Post*, April 20, 2001.

Again, however, it is important not to overdraw the case. When ILSA came up for renewal by the Congress in the summer of 2001, the Administration supported it and the President signed it into law without complaint. The policy of “dual containment” of both Iraq and Iran, formulated in the wake of the Gulf War, remained – at least for the time being -- firmly in place. The only major change was that Saddam Hussein’s regime was no longer merely to be contained but, if possible, overthrown. The new Administration also reiterated U.S. support for a major oil export route from Central Asia that by-passed Iran, a centerpiece of the Clinton’s Administration’s policy towards the region.

Russian-Iranian Relations

During the 1980s, possible cooperation between Iran and the Soviet Union was seriously undermined by the Soviet war in Afghanistan. After Moscow’s withdrawal from Afghanistan and the collapse of the Soviet Union, relations improved, as the two countries found a number of areas where their strategic and economic interests converged. Moscow’s concern about Iran’s role as a fomenter of Islamic agitation in Southern Russia, the Caucasus and Central Asia was eased by the increasingly pragmatic turn of Iranian foreign policy as the Islamic Revolution receded. In the wake of U.S. victory in the Gulf War, there was some alarm in Moscow and Tehran about the rise of a U.S.-dominated international system; to some extent, increasing Russian-Iranian cooperation reflected an effort to offset U.S. preponderance.¹³ Nonetheless, it stopped well short of a formal anti-U.S. alliance; many areas of Russian-Iranian cooperation reflected interests that were only marginally related to American influence, such as regional stability.

Both countries, for instance, found much common ground in the Caucasus and Central Asia. Iran and Russia, for their own reasons, supported -- Moscow explicitly, Tehran indirectly -- Armenia against Azerbaijan in those countries’ long-standing dispute. Each steadfastly opposed the Taliban regime in Kabul; long before the United States showed particular interest in the Northern Alliance of forces against the Taliban, Iran and Russia were providing it material support. During the course of the 1990s, Russia and Iran also found a number of areas where

¹³ “Iran’s Foreign Policy toward Russia, Central Asia, and the Caucasus” by Mohiaddin Mesbahi in Esposito and Ramazani, *op cit*, pgs. 149-174.

their economic interests converged, most notably in the arena of oil exploration and transportation. Both opposed the efforts of the other littoral states (Azerbaijan, Kazakhstan, and Turkmenistan) to demarcate economic rights in the energy-rich Caspian; both opposed the so-called “western route” for oil exports from the Caspian, a U.S.-backed pipeline from Baku, Azerbaijan to the Turkish Mediterranean port of Ceyhan, preferring northern and southern routes that went through their own countries. Iran represented a large market for Russian military equipment in the 1990s as well, with Moscow providing Tehran with aircraft, submarines, tanks, and anti-aircraft missiles.¹⁴ Not least, Iran found Moscow an important partner in the development of its nuclear energy program. Whatever its role in Tehran’s secret nuclear weapons program, the Iranian-Russian agreement to complete the Bushehr reactor project represented a welcome symbol of recognition by an isolated Iran. Russia’s economic stakes in its nuclear cooperation program with Tehran, at roughly \$800 million for completing Bushehr, were significant; important domestic constituencies in Russia supported the program. More generally, Moscow also saw its nuclear cooperation with Tehran as a demonstration of its continued technological prowess and regional influence. Under U.S. pressure, President Putin instituted new and tighter export controls in 2000. But Russia did not yield to U.S. demands that it cancel the Bushehr project altogether.¹⁵

U.S. Energy Policy

Once in office, President Bush immediately commissioned Vice President Cheney to undertake a major study of U.S. energy policy. This urgency reflected, in large part, public concerns associated with rising gasoline prices during 1999-2000, and electricity shortages in California during 2000-2001. The Vice President’s report, issued in very short order, immediately raised a storm of controversy.¹⁶ Some of this criticism focused on the manner in which the study was conducted – specifically, the role of energy industry lobbyists in formulating it. As of mid-2002, the Vice President’s office, citing the need for confidentiality, refuses to divulge full details of the deliberations leading to the study. But other criticism focused on the Cheney Report’s

¹⁴ “Countering Russian-Iranian Military Cooperation” by Ariel Cohen and James Phillips, Heritage Foundation (Washington, DC), April 5, 2001.

¹⁵ As discussed below, Russia continues to refuse to stop its involvement in Bushehr project.

proposals to enhance U.S. energy security by increasing domestic oil and gas production and resuming a major program in nuclear power generation. In particular, the study's endorsement of oil and gas development in Alaska's Arctic National Wildlife Refuge (ANWR) prompted attacks by environmental groups.

Less controversial than the Cheney Report's domestic recommendations was its discussion of international energy markets. The report stressed the need for the United States, the world's largest importer of petroleum, to increase the quantity and diversity of international oil supply, with an emphasis upon the importance of private sector development in doing so. It described the continuing importance of the Persian Gulf and noted the critical -- and positive -- role that Saudi Arabia plays as a "linchpin of supply reliability to world oil markets."¹⁷ The Cheney Report, in other words, reflected the established U.S. policy -- dating back at least two decades -- of making Riyadh Washington's main partner in ensuring stability in world oil supply. That relationship had been based on a simple *quid-pro-quo*: Riyadh would use its market power to moderate oil prices in return for Washington's guarantee of Saudi Arabian security. During the Gulf Crisis of 1990-1, both sides had fulfilled their parts of the bargain. In the wake of Iraq's invasion of Kuwait, Saudi Arabia had dramatically increased oil production to avert a major, sustained increase in prices; the United States had committed half a million troops to ousting Saddam Hussein from Kuwait and ending the immediate threat he represented to Saudi Arabia.

The Washington-Riyadh relationship reflects two fundamental realities. The first is the military vulnerability of Saudi Arabia; few doubted, for instance, that Iraq could have seized Saudi oilfields on the Persian Gulf had Baghdad been given time to consolidate its position in Kuwait. The second reality is the reliance of the United States on oil imports, running nearly sixty percent -- or 11.6 million barrels per day -- of U.S. total gross oil demand in 2001.¹⁸ While much has been made of Saudi's role as a major supplier of oil to the United States (it represented about 14.5 percent of U.S. oil imports in 2001, second only to Canada as a supplier), Saudi Arabia

¹⁶ "The Report of the National Energy Policy Development Group," henceforth called the "Cheney Report." It may be found at whitehouse.gov.

¹⁷ See the Cheney Report, pg. 64.

¹⁸ Unless otherwise noted, all data on reserves, production and trade in this paper are drawn from information provided by the US Department of Energy's Energy Information Administration (EIA). Data are drawn from

would be vital to U.S. energy security even if it did not export one barrel of petroleum to the United States. This reflects the global nature of today's international oil markets. Some have likened those markets to a swimming pool. Remove water at one end of the pool and the water level drops everywhere. Add water at one end of the pool and the level rises everywhere.

In terms of today's global petroleum markets, Saudi Arabia is key. It is not only the world's largest exporter of oil at roughly 7.5 million barrels per day in 2001; it possesses ample spare capacity, about three million barrels per day in early 2001, to increase production in a crisis. This makes it possible for Saudi Arabia to single-handedly replace the exports of any other country in the world, except Russia. These facts give Saudi Arabia immense potential leverage in determining international oil prices. Riyadh can do so directly, by raising or lowering production or, indirectly, by using its excess capacity to threaten fellow members of the Organization of Petroleum Exporting Countries (OPEC) into setting production quotas and adhering to them. Moreover, Saudi Arabia is likely to remain a critical player in international oil markets for decades to come; it has the world's largest proven reserves of petroleum (264.2 billion barrels or just over one-fourth of world's total) and low production costs.

A number of other developments had, by the late 1990s, increased the relative importance of Saudi to international oil markets. Venezuela, under President Hugo Chavez, had reversed the policies of previous governments in Caracas to increase oil production and turned instead to limiting output in cooperation with other OPEC countries. Development of oil reserves in Central Asia, beset by economic, technological and political problems, was proving slower than many had anticipated in the mid 1990s. And Iraq, though still exporting significant amounts of oil under the auspices of the U.N., was clearly producing far less than it would were sanctions lifted. Ironically, the United States had played a part in the last two developments. In Central Asia, it had worked hard -- and with some success -- to exclude an oil export route through Iran, in the view of many experts the quickest, easiest and cheapest way to deliver the region's oil to international markets. And Washington, of course, remained the staunchest advocate of economic sanctions against Saddam Hussein.

appendices to the EIA's *International Energy Outlook 2002*, *Country Briefs* for the United States, Russia, Iran and Saudi Arabia and *OPEC Factsheet*. All are available at eia.doe.gov.

Iran and Russia were -- and remain -- “underachievers” in global oil markets. Iran holds approximately 90 billion barrels of oil in proven reserves, about nine percent of the world total. In 2001, it exported roughly 2.75 million barrels of oil a day, making it the fourth largest supplier of petroleum to international markets after Saudi Arabia, Russia, and Norway. In 1999, Iran announced its largest oil discovery in 30 years – a field called Azadegan near the Iraqi border with a potential production of 300-400 thousand barrels per day. Nonetheless, Iran’s production remains well below the peak of six million barrels of oil per day achieved in 1974 under the regime of the Shah. A number of factors have contributed to Iran’s track-record of poor production over the last twenty-five years. These include the turmoil of the revolutionary years of 1978-9, the Iran-Iraq war of 1980-8, and the impact of U.S. sanctions on limiting foreign investment in Iran’s energy sector in the 1990s.¹⁹ Another important factor – one recognized implicitly by president Khatami in 1999 when he embarked on a program of encouraging foreign involvement in the Iranian energy sector – is a generally hostile investment climate. Despite ambitious plans to expand production by perhaps 1.5 million barrels of oil per day over the course of the next five years, the Iranian oil sector is plainly in urgent need of upgrading. Severe damage has already been done to existing fields, leading to alarmingly high rates of depletion. Iran has cooperated with other OPEC members in limiting output; the resultant price increase doubled Iranian oil export earnings from 1998 to 2001. But Iran’s modest excess capacity – 200-400,000 barrels per day in early 2002²⁰ – and the obstacles it faces in modernizing its oil sector put it in a poor position should there be a sustained dip in international prices.

Until recently, Russia’s oil sector has also been a study in decline. Russia boasts roughly 49 billion barrels in proven oil reserves, or about five percent of the world total. In 2001, it was the world’s second largest exporter of petroleum, after Saudi Arabia, providing international oil markets with approximately 4.8 million barrels of oil daily. But its overall oil production has plummeted since the dissolution of the Soviet Union in 1991. Soviet oil output (roughly 90 percent of which was drilled in what is now the Russia) peaked in 1987 at 12.5 million barrels of oil per day. Production in the former Soviet Union reached its nadir in 1996, when petroleum

¹⁹ One major exception was the ILSA waiver granted by the Clinton Administration to European and other firms to help Iran develop its giant South Pars gas field, discussed below.

output was only seven million barrels per day; Russian production represented six million barrels of this total. Superficially, the 1990s were less dire for Russia in terms of exports; indeed, throughout most of the decade, Russian oil exports were actually higher than the level achieved by the Soviet Union in the late 1980s.²¹ This, however, was not the result of the strength of the Russian oil sector but of domestic economic collapse. Demand for oil in the Soviet Union and its successor states fell from nine to 3.5 million barrels per day between 1987 and 1999 -- a staggering sixty percent. Russian demand fell to a mere 2.4 million barrels a day the same year. Beginning that year, however, Russian production started showing a significant rebound, growing from 6.3 to 7.3 million barrels a day in 2001; given relatively flat Russian demand, this yielded a significant increase in exports. Some observers believe that Russia could increase output by up to two million barrels per day over the course of the next five years.

The causes of the decline and recent recovery of the Russian oil sector are fairly clear. Chronic mismanagement and inadequate investment under the former Soviet regime had left Russia with an antiquated and inefficient oil production system. The collapse of the former Soviet Union led to disruptions in long-standing distribution systems and delays in implementing new transportation projects. Not least, the administrative chaos and rampant corruption of post-Soviet Russia put a damper on needed foreign investment. After a period of initial euphoria, international energy companies grew disenchanted with doing business in Russia; foreign investment in its oil industry has been minimal. The recovery in production, beginning in the late 1990s, also has several reasons. One was high international petroleum prices during 1999-2000, which allowed Russian oil companies to reinvest healthy profits in order to increase production. Russia's remarkable economic recovery from the 1998 financial crisis and devaluation of the ruble, though it has yet had little impact on domestic oil demand, has surely increased confidence in the country's future among Russian oil producers. Reforms undertaken during the 1990s are finally beginning to bear fruit; privatized Russian oil companies -- notably the largest, Lukoil -- are growing more efficient and independent in their operations. Not least, the tenure of Vladimir Putin has been marked, in general, by firmer control of the bureaucratic apparatus and greater general stability. Nonetheless, despite its high potential, Russia's oil sector

²⁰ Industry sources indicate that the lower figure is the more likely.

remained suspect in the minds of many foreign investors, who would have to play a critical role if Russia is to exploit large but technically challenging production areas such as the Caspian Sea, the Arctic region, Eastern Siberia and Sakhalin Island.

Post-September 11

U.S.-Russian Relations

The period after September 11th in many ways marked a sea-change in U.S.-Russian relations. The Bush-Putin Moscow Summit of May 2002 symbolized this transformation. Personal relations between the two men, which had apparently grown warmer with each meeting, were now intimate; President Bush, as is his wont, had given Putin the nickname, “Pootie-Poot.” While the meeting took place, thousands of U.S. troops supporting operations in Afghanistan remained stationed in the former Soviet republics; U.S. advisors were training Georgian security personnel in anti-terrorism tactics. Given traditional Russian sensitivities about foreign – and especially U.S. – involvement in the region, this was a state of affairs literally inconceivable a year before. U.S. abrogation of the ABM treaty was no longer an issue; it would expire, quietly, within a month. Instead, Putin and Bush signed an historic agreement slashing U.S. and Russian deployment of nuclear weapons by two-thirds. Despite lingering concerns about NATO expansion, Russia had, just days before, been granted special partnership status with that organization. There was much talk of future economic cooperation, especially the possible role of U.S. firms in helping Russia to develop its oil and gas sectors. In recent months, Russia has taken a significantly more accommodating stance towards a division of the Caspian seabed and opened up the possibility of Russian participation in the Baku-Ceyhan pipeline long opposed by Moscow.

Many of these developments merely reflected Russia making a virtue of necessity. Opposing the stationing of U.S. troops in Central Asia, to support the attack on the Taliban regime in Afghanistan, would have opened Moscow up to public humiliation were the former Soviet republics of the region to go ahead despite Russia veto – a very likely prospect, given Moscow’s

²¹ See International Energy Agency (IEA) data at iea.org. The IEA provides a useful supplement to the EIA for historical data in particular.

dwindling influence in the region and Washington's willingness to offer blandishments for cooperation. The Bush Administration was adamant on repudiating the ABM Treaty; further Russian opposition would merely have revealed Moscow's impotence. Even the dramatic cuts in the deployment of nuclear warheads reflected Russian weakness; the disrepair of Moscow's strategic forces meant that many of Russia's delivery systems were no longer operational in any case. Putin did achieve a victory of sort on the arms reduction, insisting on a formal treaty instead of the "gentleman's agreement" that the Bush Administration had originally proposed. But, in general, the summit was marked by Russian acquiescence in U.S. positions – a fact not missed by anti-U.S. elements in the Russian political and security establishments. Prior to the Bush-Putin Summit, for instance, a group of ex-military officers wrote to Putin declaring: "Your foreign policy is the policy of licking the boots of the West."²²

But the increased U.S.-Russian cooperation symbolized by the May Summit was also grounded in broader convergences of interests between the two countries. Moscow had been long concerned by a perceived "Islamic threat" along its massive Southern boarder, including Afghanistan. It was therefore prepared to make common cause with the United States against the Taliban regime. Moreover, Putin was clearly set on increasing Russian integration with the West, particularly in the economic arena. He was acutely aware of Russia's poverty – Putin had made "catching up with Portugal" in terms of per capita GDP one his political mantras – and looked to the United States both as a source of investment and an ally in gaining Russian admission to the WTO.

One issue, however, marred the otherwise positive tone of the Summit: Russian nuclear and military cooperation with Iran. While Putin acknowledged the need to keep Iran from developing nuclear arms and Bush called the Russian's assurances "comforting," Russia refused to suspend its assistance to Tehran on the Bushehr reactor project.²³ The reactor continued to be subject of disagreement in subsequent U.S.-Russian talks.²⁴

²² "The Next Oil Frontier" by Paul Starobin, *Business Week*, May 27, 2002

²³ "Russia's Role in Iran and Iraq" by Stephen Sestanovich, *New York Times*, June 3, 2002.

²⁴ "Iran Nuclear Issue Sours U.S.-Russian Talks of Energy" by Steven Lee Myers and Sabrina Tavernise, *New York Times*, August 2, 2002.

U.S.-Iranian Relations

In the wake of September 11th, U.S.-Iranian relations, already troubled for decades, reached a new nadir. Immediately after the attacks, there was some speculation that Washington might find Tehran a useful ally against the Taliban. After all, prior to September 11th, no government in the world detested the Taliban regime in Afghanistan more than Iran; indeed, in 1998, Iran nearly went to war with the Taliban following the alleged murder of ten Iranian diplomats and journalists in Mazar-e-Sharif.²⁵ But U.S. concerns about Iran's nuclear weapons program – made critical in the wake of September 11th by the possible future acquisition of Iranian WMDs by terrorists – overwhelmed any possibility of entente. The Bush Administration's concern about ongoing Iranian support for terrorism were also heightened, in January 2002, when Israel seized a ship, *Karine A*, carrying arms to the Palestinian Authority; Iran was believed to have supplied the arms.²⁶ Washington also charged Tehran with providing sanctuary for Al Qaeda and Taliban fleeing from Afghanistan.²⁷ Iran had moved up – and rapidly – on Washington's anti-terrorism agenda.

This became startlingly clear when, in his January 2002 State of the Union Address, President Bush linked Iran with Iraq and North Korea as part of an “Axis of Evil.” Focusing on the role of rogue states in the possible transfer of WMDs, Tehran – like Pyongyang and Baghdad – was put on formal warning about its efforts to develop nuclear weapons. This was followed by President Bush's June 2002 commencement address at West Point, when he enunciated a policy of possible preemptive strikes against those threatening the United States. The official Iranian response in Washington's designation as a member of an “axis of evil” was, unsurprisingly, harshly negative. But its effect domestically in Iran appears to have been more ambiguous. Initially, observers predicted an anti-American backlash among even moderate Iranians.²⁸ In fact, at least in some instances, Iranian reformers have been emboldened by President Bush's designation into sharper criticism of Tehran's conservative clerical leadership.²⁹

²⁵ See Kemp, *op cit*, pg. 25.

²⁶ “A Secret Iran-Arafat Connection is Seen as Fueling the Mideast Fire,” *New York Times*, March 24, 2002.

²⁷ “Iran Helped Al Qaeda and Taliban Flee, Rumsfeld Says” by Esther Schraeder, *Los Angeles Times*, February 4, 2002.

²⁸ “End of a Brief Affair? The United States and Iran,” by Daniel Bromberg, Carnegie Endowment for International Peace (Washington, DC), March 14, 2002.

U.S. Energy Strategy

While less dramatic, there has also been a marked change in discussion of U.S. energy strategy since September 11th. These have centered on the continuing role of the Washington-Riyadh “special relationship” in securing stable international oil supplies. Criticism centered on Saudi Arabia’s unreliability as an ally.³⁰ Oussama Bin Laden was, after all, a Saudi national; so too were 15 of the 19 suicide bombers of September 11th. While Riyadh condemned the September 11th attacks, it was widely perceived as uncooperative in U.S. efforts to investigate the attacks and counter the broader threat represented by radical Islamic militants. Saudi Arabia’s long support for Islamic fundamentalists – it was one of the very few countries that ever recognized the Taliban regime in Kabul – also came under closer scrutiny. Heightened criticism of Riyadh did not extend to the Bush Administration, at least not publicly. There were protestations of continued partnership between Riyadh and Washington, culminating by a very public stay at President Bush’s Crawford, Texas ranch by Saudi Crown Prince Abdullah in the spring of 2002.

Nonetheless, there has been growing discussion of a need to reduce the dependence of international oil markets – and through them, the United States economy – on Saudi Arabia. Much of this discussion has focused on Russia’s potential future role in international petroleum markets.³¹ By most standards, Russia is the only viable alternative to Saudi Arabia as guarantor of stability in world oil markets. It is already the world’s third largest producer of petroleum (after the United States and Saudi Arabia) and the second largest exporter (after Saudi Arabia); just as importantly, it possesses the potential for major increases in both production and exports. Although Russia has cooperated with OPEC in recent years, its adherence to export quotas has long been fitful; on May 17, 2002, in fact, Russian Prime Minister Mikhail M. Kasynov announced that Russia would cease its cooperation with OPEC and “export as much oil as we can.”³² Russian oil companies clearly bridle at governmental efforts to limit exports. More generally, Russia -- a poor country with a dire need for foreign exchange -- has a strong incentive to export large volumes of oil at the earliest possible opportunity. A major increase in Russian

²⁹ “Iran: Scared Straight,” by Ray Takeyh, Washington Institute (Washington, DC), May 3, 2002.

³⁰ See “Weak Realpolitik: The Vicissitudes of Saudi Bashing” by Adam Garfinkle, *National Interest*, Spring 2002, pgs. 144-150.

³¹ See “The Battle for Energy Dominance,” by Edward L. Morse and James Richard for a particularly compelling argument that Russia is positioned to displace Saudi Arabia as guarantor of stable oil supplies to the world markets. *Foreign Affairs*, March/April 2002, pgs. 16-31.

exports could potentially diminish Saudi Arabia's role in international oil markets, lessening the United States' economic dependence on a now-suspect ally. It would also, all other things being equal, lead to lower oil prices than otherwise would have been the case – a development also to the advantage of a major oil importing country like the United States. The increasing role of Russia in international oil markets was an important element of the Bush-Putin Summit; an official meeting is planned for October 2002 to discuss possible U.S. help in developing Russia's oil and gas resources.

Looking Forward

The future of the evolving relationship among the United States, Russia and Iran is highly uncertain. Much will depend ultimately upon internal developments in each of the three countries. In Washington, the war on terror remains very much a work in progress. While there is clearly a firm intent within the Bush Administration to topple Saddam Hussein, the exact means and timeframe of doing so continue to be undetermined. An invasion of Iraq – by all accounts strongly supported by important figures in the Administration – could have important and in many ways unpredictable consequences for U.S. relations with both Moscow and Tehran. So could the way the United States handles the reorganization and reconstruction of Iraq in the wake of victory, in many ways a more daunting task than defeating Saddam Hussein's army.³³ Even less obvious is how the United States will deal with the other two members of the "Axis of Evil," Iran and North Korea. A clear outline of this policy -- including possible preemptive strikes against nuclear development facilities -- may emerge only after the United States deals with Iraq. Even the results of official U.S. efforts to bolster Russia's position as an alternative to Saudi Arabia in international oil markets are also uncertain. The ability of the Bush Administration – or, indeed, any U.S. presidential administration – to encourage private U.S. investment in foreign countries is limited. In the final analysis, the local investment climate is decisive and, as noted below, Russia's remains in many ways wanting.

³² "Oil Price Expected to Fall for Second Year," *Los Angeles Times*, June 3, 2002.

³³ See "Next Stop Baghdad?" by Kenneth M. Pollack, *Foreign Affairs*, March/April 2002, pgs. 32-47.

In the case of Russia, internal developments will also prove critical. It appears that Putin's pro-American policies may be well in advance of both elite and popular sentiment in Russia.³⁴ To date, his high popularity – based in large part on robust economic growth – has shielded him, by and large, from effective criticism. Should the Russian economy falter or, worse yet, plunge into another crisis on the order of 1998, all this could change. Russian economic growth is, in turn, highly sensitive to global energy price movements; much of the decline in Russia's GDP growth between 2000 and 2001, from about eight percent to roughly five, was directly attributable to the decline in world oil prices during the period, which fell from about \$24 per barrel for benchmark Arab Light at the beginning of 2000 to approximately \$17 at the end of 2001. A further significant decline in oil prices could seriously damage both Russia's overall economy and balance of payments position. With an outstanding foreign debt of \$150 billion, Russia remains potentially vulnerable to recurrent currency crises.

Hopes for Russia to displace Saudi Arabia as the key player in international oil markets face high hurdles. Despite real progress over recent years in reforming the Russian energy sector and encouraging foreign participation, its investment climate remains dubious at best. International energy companies, badly burned in the early 1990s, will be hesitant to return to Russia in a significant way. Much reform needs to be done, most notably in enacting and, just as importantly, effectively implementing rational production sharing and tax regimes. Foreign investors prize stability and predictability above all else; this is true in the case of Russia, where Moscow has yet to prove its commitment to the rule of law.

The future course of Russia's relationship with OPEC is also uncertain. In the past – most notably in 1986 – Saudi Arabia has ramped up production, thereby leading to sharp declines in oil prices, to punish producers unwilling to cooperate with OPEC. While some Russian producers and Western observers³⁵ are sanguine about Russia's ability to weather a price war with Riyadh, a sustained collapse in international oil prices could put extreme pressure on Russia's balance of payments and discourage foreign investment in relatively expensive new projects. This would be particularly true were prices to drop into the low teens.

³⁴ "Summit Love Affair Brings Few Rewards for Putin" by Alice Lagnado, *Times (London)*, May 27, 2002.

³⁵ Notably Morse and Richard, *op cit*, pgs. 29-30

It should be noted that the problems associated with promoting Russia as a successor to Saudi Arabia as the most important player in international oil markets does not mean that it is not a worthy goal of U.S. foreign policy. From a U.S. perspective, increasing the supply of Russian oil to international markets is advantageous in itself. All other things being equal, it will tend to drive prices down and provide welcome diversity of supply to world petroleum markets.

The future of the Russian-Iranian relationship is also unclear. Even without U.S. pressure on Moscow to reduce its ties to Tehran, it should be noted, Russian-Iranian ties remain problematic at several levels. Perhaps the most obvious area of competition is economic. Iran and Russia are competitors in international oil and regional gas markets, both of which are critical to their respective economies. As a major oil supplier and OPEC member, Iran is clearly threatened by a significant expansion in Russian oil production. This is true whether increased Russian output leads to sustained downward pressure on international oil prices or prompts a Saudi decision to punish Russia's non-cooperation on production by engineering a sharp drop in petroleum prices. In either instance, Tehran, dependant on oil exports for about 80 percent of its exports earnings and 45 percent of its government budget, would face harsh balance-of-payments and fiscal difficulties. The threat is particularly acute because of Iran's inability – only partially because of U.S. sanctions – to generate significant foreign investment in its energy sector. Despite efforts by Iran to encourage foreign investment through so-called “buy-back” arrangements, many international energy companies continue to be wary of doing business in Iran.³⁶

Russian-Iranian competition is even more direct in natural gas markets. The two countries are true gas giants. Iran's proven natural gas reserves run an estimated 812 trillion cubic feet, making them the world's second largest. One gas field alone – the offshore South Pars, discovered in 1988 and currently undergoing development – represents a potential 280 trillion cubic feet in reserves. Yet, given its potential, Iran's natural gas output remains disappointing. It produced roughly two trillion cubic feet of gas in 2000, almost all of which was consumed domestically; exports were minimal. In short, Iran's interest in producing more natural gas, identifying markets and developing infrastructure – in terms of pipelines and liquefied natural

³⁶ “Iran's Delays Cast Doubt on Upstream Deals,” Energy Intelligence Group, November 5, 2001.

gas (LNG) facilities – is extremely high and urgent. Development of the South Pars field is central to Iran's plan to expand production and export of natural gas. Phases 1-8 of Tehran's program to develop the field have Western partners. With their participation, Iran hopes to produce as much as an additional seven billion cubic feet per day of natural gas by the end of the decade.

Russia's potential is even greater than Iran's, and its track record in terms of production and export is better. Russia possesses over 1,700 trillion cubic feet of natural gas, roughly a third of the world's proven reserves. In 1999, it produced approximately 20 trillion cubic feet of natural gas, exporting about 7.3 trillion cubic feet, most of it to Europe. This made Russia the world's second largest producer of natural gas, after the United States, and easily the world's largest exporter. Gazprom, the state monopoly that runs Russia's natural gas production, distribution and marketing system, is the country's biggest foreign currency earner and source of roughly a quarter of federal tax receipts.

Yet, Russian production and exports are also disappointing. While there have been recent efforts to introduce some element of competition into the Russian natural gas sector, Gazprom conforms to the model of the bloated, inefficient state-run enterprise. It has clearly underinvested in upgrading Russia's antiquated production and distribution systems; huge amounts of uncollected domestic payments represent a crippling financial burden. It is far from clear how – absent significant foreign involvement – Gazprom will be able to develop lucrative but remote gas fields such as Prirazlomnoye and Shtokmanskoye in Russia's Far North.

The chief area of direct Russian-Iranian competition in international oil markets is Turkey. The centerpiece of Russia's efforts to capture the lion's share of Turkey's growing gas imports is the Blue Stream pipeline underneath the Black Sea; when completed in late 2002, the pipeline can supply Turkey with 565 billion cubic feet of natural gas annually or roughly 1.5 billion cubic feet per day. A 623-mile natural gas pipeline to Turkey from Iran was inaugurated in January 2002; it has a capacity of about 1.4 billion cubic feet per day. But other areas of potential Russian-Iranian competition over natural gas markets loom on the horizon. Iran plainly sees Turkey as a possible transit route for a pipeline to Europe, threatening Russia's dominant import position in

that huge market.³⁷ Both Russia and Iran are eyeing China as a possible longer-term a market. Russia envisages transporting its gas to China via pipeline; Iran hopes to build LNG facilities to ship gas from South Pars to the Far East.³⁸ Economic competition does not, of course, automatically mean conflict; but, as Iran and Russia strive to increase their natural gas exports, competition may well lead to strains in their relationship. Certainly the idea – apparently held by some in Russia – that Moscow’s aid to Tehran’s nuclear energy program will convince Iran to defer to Russia in international gas markets is wide of the mark. If nothing else, Iran’s current and planned investments in the South Pars field indicate that Tehran is not just ready but eager to gain international market share, if necessary, at Russia’s expense.

The prospects for an improvement in the relationship between the United States and Iran appear grim. Despite the election of Khatami in 1997 and the victory of moderates in the parliamentary elections of 2000, conservatives still wield considerable power.³⁹ While there is some talk in the Western press of another revolution in Iran -- this one directly against clerical conservatives⁴⁰ -- outright civil war between moderate and conservative faction does not currently seem likely. In the short-term, it is difficult to imagine the conservative clerical leadership capitulating under any other circumstance. In the months and years ahead, much will depend on how the United States perceives Iran’s ongoing role in supporting terrorism in the Mid East and its efforts to develop weapons of mass destruction. Large-scale U.S. military action against Iran remains remote, at least until the United States deals, one way or the other, with the threat posed by Iraq; deposing Saddam Hussein clearly holds precedent in any U.S. military plans for the Persian Gulf region. But Iran’s inclusion in President Bush’s “axis of evil” has just as plainly put Tehran on notice that the Bush Administration is keeping all its options open -- including, presumably, a preemptive military strike -- when it comes to addressing what it considers to be Iran’s misbehavior. One thing is fairly certain: barring an about face in the current regime’s policy on supporting groups like Hezbollah and Hamas and acquiring advanced nuclear and missile

³⁷ “Iran, Turkey Talk of Broader Gas Links,” Energy Intelligence Group, January 23, 2002.

³⁸ Iran has also shown interest in building a pipeline to supply India. This route would cross Pakistan; given the strains between New Delhi and Islamabad, prospects for movement on this possible route are very slim. Iran has also shown interest in exporting gas to Kuwait, though it would face sharp competition from other Persian Gulf gas producers.

³⁹ See “Reform and Resistance in the Islamic Republic of Iran” by Mohsen M. Milani in *Iran and the Crossroads*, edited by John L. Esposito and R.K. Ramazani (New York: Palgrave Press), pgs. 30-56.

⁴⁰ See “Iran’s Third Wave,” by Thomas Friedman, *New York Times*, June 16, 2002.

technology, any further talk of a “thaw” in U.S.-Iranian relations and a possible easing of sanctions is premature. And – all questions of U.S. sanctions aside – the uncertainty engendered by a tough stance by Washington against Iran will impede Tehran’s efforts to encourage foreign investment in its energy sector. The possibility of U.S. military action against Tehran will surely increase risk premiums associated with investment in Iran.

It might be noted here that even the emergence of a fully “moderate” leadership in Iran will not necessarily end tensions between Washington and Tehran. While such a moderate regime would likely reduce or cease its support for terrorist groups as part of an effort to normalize its relations with the United States and the West, it might well continue efforts (despite the assurances of President Khatami) to make Iran a nuclear power merely as a matter of perceived strategic necessity and national prestige. In doing so, a moderate regime in Tehran would merely be following in the footsteps of New Delhi and Islamabad. Not least, as a large country with a proud history, Iran will continue to bridle at U.S. dominance of what Iranians – and we – call the “Persian Gulf.” Tehran, for instance, possesses enough naval and air power to close the Strait of Hormuz in the absence of a significant U.S. military presence in the Gulf; given the importance to the world economy of oil flowing through the Strait, that presence – whatever the complexion of the government in Tehran – will not disappear soon. Should Iran acquire WMDs and the means to deliver them, this threat will be all the greater.⁴¹

In the months since President Bush’s “Axis of Evil Speech,” his bracketing of Iran and North Korea with Iraq has been the cause of much criticism in the United States and abroad. Some of this is perhaps just. Unlike the Axis countries of World War II, Iraq, Iran and North Korea are not formal allies; relations between Baghdad and Tehran, in fact, remain poisoned by the bloody Iraq-Iran conflict of the 1980s. In the wake of the President’s speech, moreover, the focus of Washington has clearly been on Iraq. What the designation might mean in terms of possible future U.S. action against Pyongyang and Tehran remains unclear; the overthrow of the current regime in Baghdad is first on Washington’s agenda. In terms of U.S. relations with Tehran, this uncertainty might be a good thing. Any number of developments – a radical change in the

⁴¹ “The Sound of Distant Thunder” by Kenneth M. Pollack, paper presented at the CWC Conference on Oil and Middle East, New York, March 2, 1999.

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strategic environment in the Middle East following a U.S. victory against Iraq, successful pressure by Washington to get Moscow to cease or suspend its nuclear cooperation with Tehran, or a shift, however modest, towards a less anti-American Iranian foreign policy -- may make the options facing Washington in dealing with Iran less harsh and allow the U.S. to avoid the more controversial but obvious option to initiate a possible preemptive military strike against Iran's nuclear facilities. One of what many considered the greatest weakness of the "Axis of Evil" declaration – its lack of specificity when it came to Tehran and Pyongyang – may, at least in the case of Tehran, prove to be its greatest strength.

Appendix

Major Iranian Projects with Firm Commitments by Western Partners to Date

<u>Field</u>	<u>Company</u>	<u>Output</u>	<u>Start Up</u>
Sirri A and E	TotalFinaElf	120,000 b/d oil	2002
Balal	Total/ENI/Bow Valley	40,000 b/d oil	2002
Doroud	Total/ENI	75,000 b/d oil	2003
Soroush/Nowruz	Shell	190,000 b/d oil	2003
Darkovin	ENI	160,000 b/d oil	-
Bangestan	under development	500,000 b/d oil	-
Agazadeh	under development	500,000 b/d oil	-
South Pars Gas			
Phase 1	Petropars	900 MM cf/d	2002
Phase 2,3	Total/Petronas/Gasprom	1,800 MM cf/d	-
Phase 4,5	ENI	1,800 MM cf/d	2004
Phase 6,7,8	Enterprise	2,700 MM cf/d	2005
Phase 9,10,11,12	to be developed		