

FOREIGN AFFAIRS

MARCH/APRIL 2003



Axis of Oil?

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Volume 82 • Number 2

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THE NEW RUSSIAN-AMERICAN RELATIONSHIP

EVER SINCE the Iron Curtain came crashing down, American and Russian diplomats have been searching for a special relationship between their countries to replace Cold War animosity. Security matters have not yielded much. On issues such as the expansion of NATO, stabilizing Yugoslavia, and the war in Chechnya, Washington and Moscow have sought each other's tolerance more than cooperation. Nor have the two nations developed much economic interaction, as a result of Russia's weak institutions and faltering economy. Thus, by default, "energy" has become the new special topic in Russian-American relations.

At a Kremlin summit in May 2002, Presidents George W. Bush and Vladimir Putin pledged to work together to reduce volatility in global energy markets and promote investment in Russia's oil industry. Soon after, at the first-ever summit of U.S. and Russian oil executives in Houston, Russia's energy minister, Igor Yusufov, reiterated this goal. The two governments have created a special working group on energy cooperation, and Russia will host the next commercial energy summit in 2003. In Moscow, especially, the potential of new oil ties has attracted extensive media coverage and political speculation. For

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instance, Grigory Yavlinsky, head of Yabloko, one of Russia's leading opposition parties, has suggested that the United States and Russia could sideline the Organization of Petroleum Exporting Countries (OPEC) as the arbiter of world oil prices.

This enthusiasm is misplaced, however. A collapse of oil prices in the aftermath of an invasion of Iraq may soon lay bare Washington's and Moscow's divergent interests. Russia needs high oil prices to keep its economy afloat, whereas U.S. policy would be largely unaffected by falling energy costs. Moreover, cheerleaders of a new Russian-American oil partnership fail to understand that there is not much that the two governments can do to influence the global energy market or even investment in Russia's oil sector.

The focus on oil has also eclipsed another area in which U.S. and Russian common interests could run deeper: nuclear power. Joint efforts to develop new technologies for generating nuclear power and managing nuclear waste could result in a huge payoff for both countries. These issues, which are the keys to keeping nuclear power viable, are formally on the Russian-American political agenda, but little has been done to tap the potential for cooperation. Given Russia's scientific talent and the urgent need to reinvigorate nuclear nonproliferation programs, a relatively minor commitment of diplomatic and financial resources could deliver significant long-term benefits to the United States.

A MARRIAGE OF CONVENIENCE?

ON THE SURFACE, energy cooperation seems a wise choice. Russians are rich in hydrocarbons and Americans want them. Oil and gas account for two-fifths of Russian exports. In 2002 Russia reclaimed its status, last held in the late 1980s, as the world's top oil producer. Its oil output in 2003 will top 8 million barrels per day and is on track to rise further. Russian oil firms also made their first shipments to U.S. markets in 2002—some of it symbolically purchased as part of the U.S. government's effort to augment its Strategic Petroleum Reserve (SPR). In addition, four Russian oil companies are preparing a large new port in Murmansk as part of a plan to supply more than 10 percent of total U.S. oil imports within a decade.

Meanwhile, the United States remains the world's largest consumer and importer of oil. This year the United States will import about 60 percent of the oil that it burns, and the U.S. Energy Information Administration expects that foreign dependence will rise to about 70 percent in 2010 and continue inching upward thereafter. Although the U.S. economy is much less sensitive to fluctuations in oil prices than it was three decades ago, diversification and stability in world oil markets are a constant worry. War jitters and political divisions cast a long shadow over the Persian Gulf, source of one-quarter of the world's oil. In Nigeria, the largest African oil exporter, sectarian violence periodically not only interrupts oil operations but also sent Miss World contestants packing in 2002. A scheme by Latin America's top producer, Venezuela, to pump up its share of world production helped trigger a collapse in world oil prices in the late 1990s and ushered in the leftist government of President Hugo Chávez. In 2002, labor strikes aimed at unseating Chávez shut Venezuela's ports and helped jerk prices to more than \$30 per barrel. Next to these players, Russia is a paragon of stability.

This new groove in Russian-American relations, however, will not run deep. Buoyant oil prices in 2002 allowed a convenient but untested partnership to flourish. Both governments do have a durable common interest in boosting Russia's oil exports: this benefits the United States through a more diverse world supply and helps Russia by creating revenue and jobs. Intergovernmental relations, however, are not capable of exerting much influence over the business conditions that actually determine private investment in Russia's oil sector. Moreover, when oil prices drop, Washington and Moscow will discover that they have very different interests. The United States does have some capacity to tame wild extremes in prices through its manipulation of the SPR and coordination with other oil-importing governments that also manage strategic reserves. In practice, though, the government has—rightly—used the SPR only to deter severely high prices and has allowed markets to operate unfettered when prices are lower. In Russia, on the other hand, state finances and the nation's economic health are extremely sensitive to shifting prices, making illusions about the ability to stabilize prices particularly dangerous.

The aftermath of a war in Iraq would likely provide a first test for the shallow new Russian-American partnership. Most attention on

Russian interests in Iraq has focused on two issues: Iraq's lingering Soviet-era debt, variously measured at \$7 billion to \$12 billion, and the dominant position of Russian companies in controlling leases for several Iraqi oilfields. Both are red herrings. No firm that has signed lease deals with Saddam Hussein's government could believe those rights are secure. Russia's top oil company, Lukoil, knew that when it met with Iraqi opposition leaders in an attempt to hedge its bets for possible regime change. (Saddam's discovery of those contacts proved the point: he canceled, then later reinstated, Lukoil's interests in the massive Western Kurna field.) Russian officials have pressed the United States to guarantee the existing contracts, but the U.S. gov-

A war in Iraq would provide the first test of the new Russian-American relationship.

ernment has wisely demurred. There would be no faster way to confirm Arab suspicions that regime change is merely cover for an oil grab than by awarding the Iraqi jewels before a new government is known and seated.

The real issue in Iraq will be the Russian and American responses to volatile prices.

Russia laments that Iraq has not paid its debts. In fact, war jitters have created higher prices for Russia on world markets—an increase of about \$5 per barrel since last summer—and allowed Russia to earn from world consumers a sum equal to about half the amount it is owed by Iraq. (Exactly who pays is an academic issue when dealing with a rogue regime at the edge of extinction.) Russia's real problem after a war would be the likely, but not certain, crash in oil prices as uncertainties ease about Persian Gulf exports and Iraqi supply resumes. Nobody knows how war and sabotage would take their toll on oil fields in Iraq and its neighbors, but the United States could neutralize those uncertainties in part by releasing oil from the SPR, as it did in the last Gulf War. A clear plan for indexing SPR releases to the state of postwar Iraqi oil fields would help markets adjust quickly to Iraq's high production potential.

It is neither wise nor effective to use strategic reserves to manage prices, but the likely result of these actions would be much lower prices that will expose a rift between consuming nations and producers such as Russia. Every \$1 shift in world oil prices translates into about \$1 billion for the Russian state budget. Russia ran a surplus of \$5 billion

in 2002, and the 2003 state budget (which forecast a price for Urals crude of \$21.50 per barrel) calls for saving \$17 billion of oil revenue for the future by paying down the current external debt. Contingency plans predict red ink if oil prices fall below about \$18 per barrel. Low prices would be a disaster for Russia. If they also trigger disarray in OPEC, then a sustained period of cheap oil could spread fiscal pain across the oil-producing world. In the past, however, U.S. policy has not changed in response to collapses in world oil prices; U.S. energy firms generally fare poorly in that environment, but consumers gain when they can guzzle more at lower cost and the economy is freer to soar when prices are low.

Of course, the impact of a war on world oil supply and price is hard to predict. A long war and a tortuous rebuilding process could deprive the market of Iraqi crude (about two million barrels a day in 2002). Damage to nearby fields in Kuwait and Saudi Arabia could make oil even more scarce. And already tight inventories and continued troubles in Venezuela could deliver a “perfect storm” of soaring oil prices. The most plausible scenario, however, is bad news for Russia: a brief war quickly followed by increased Iraqi exports, along with a clear policy of releasing oil from the SPR to deter speculators.

OIL 101

THE REASON that the American and Russian governments cannot exert much leverage over the price of oil is rooted in the fundamentals of the world market. More than half the world’s total oil production is traded openly on a single, integrated world market, and most of the oil that does not move across an international border is still priced in national markets that move with world prices. Although oil is a “fungible commodity” that responds to the beat of one global market, the actual route traveled from wellhead to final consumer by any particular barrel is determined by knife-edge differences in transportation costs, as well as by vagaries in viscosity, sulfur content, and other factors that affect how crude oil is refined into useful products. Thus oil from Canada, Mexico, and Venezuela is shipped mainly to the United States, nearly all Russian exports go to nearby Europe, and the Middle East sends its oil to all corners of the world, though mostly to Asia. Although

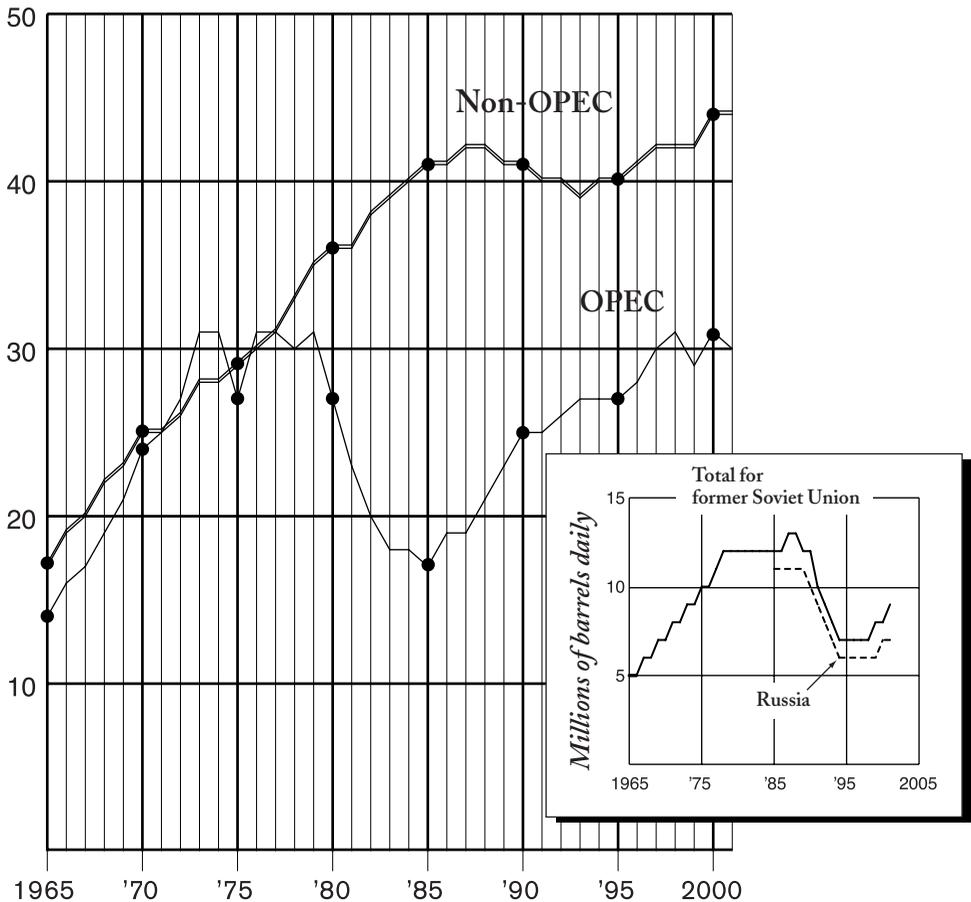
prices are essentially set by a single world market, most public discussion of oil policy is based on the fiction that the identity of particular barrels is relevant. Loathing invisible hands, arbitrage, and other abstractions, the press and politicians focus on the proper nouns. The real measure of a Russian-American partnership, however, is not the capacity to supplant America's less savory suppliers but rather whether dialogue can have any influence on the world oil market, regardless of which countries buy Russia's barrels.

More than half the world's oil is consumed in the transportation sector, and the grip of petroleum on this market is unlikely to change soon. For now, the flexibility and efficiency of liquid fuels are hard to beat for automobiles and airplanes—vehicles that must compactly carry their own power as they move. Nearly all liquid fuels are derived from crude oil. As fuel prices fluctuate, people and firms can adjust their travel habits—driving less when prices are high, for example—but technology, not behavior, is the most powerful lever on oil consumption. Most transportation technologies have long useful lifetimes—15 years or more—and so the total demand for oil responds only slowly to changing prices. In 1974, for instance, in the midst of the first oil shock, American consumers started buying smaller and more efficient automobiles. But total U.S. oil consumption did not decline until after 1978, when these new “gas-sippers” had wedged themselves into a large share of the total number of vehicles on U.S. roads. Today, the average efficiency of the U.S. automobile fleet is headed downward as sport utility vehicles, trucks, and minivans dominate sales.

Although oil consumption is slow to change, supply is generally more responsive. Thus prices on the world oil market are mainly a function of swing suppliers—for three decades, a role dominated by OPEC. Russia's rising exports have rekindled talk of a twilight for OPEC and its leader, Saudi Arabia, but any “Saudifreude” is premature. OPEC's production has varied, as shown in the figure opposite, but its influence in setting oil prices is much greater than implied by market presence alone. The identity of the top suppliers has much less influence on price than does the ability to swing a few million barrels per day of production (only a few percent of the global total of about 76 million barrels per day). Indeed, when OPEC first made effective use of the oil weapon in 1973, the United States itself was the world's largest oil supplier.

World Oil Production, 1965–2001

Millions of barrels daily



SOURCE: BP, *Statistical Review of World Energy 2002*, www.bp.com.

What holds OPEC together is not merely an ideology of market manipulation but also the facts that production in OPEC fields is generally inexpensive—few capital assets are idled when a swing supplier cuts back—and that OPEC member governments are generally able to exert strong control over production decisions. In contrast, the structure of the Russian industry favors exporting at full capacity rather than the on-again, off-again behavior of a swing supplier. New wells in Russia generally require significant investment drawn from demanding capital markets, and the tightest bottleneck for Russian exports is not drilling but the infrastructure of pipelines and ports

needed to get oil to markets. Unlike the seaside Saudis, the center of today's Russian oil industry is inland in Siberia—more than two thousand miles by pipeline to markets in western Europe. Slightly shorter pipes also carry western Siberian oil to the Black Sea, but then the journey to market continues at high cost through the narrow and crowded Bosphorus. New and expanded routes to the Adriatic Sea and the Baltic Sea—as well as new fields and export pipelines from eastern Siberia to China and ports on the Pacific Ocean—all require massive infusions of capital. Once spent, this investment is immobile and thus creates a strong incentive for firms to pump at full capacity.

Privatization and competition also make it increasingly difficult for Russia's oil industry to identify a single national interest or to behave, like OPEC's members, as a coherent unit. As in any competitive market, lucrative niches and competing interests are arising in the Russian oil industry. Thus the oil sector's grip on Russian policy is much weaker than that of other energy sectors—such as gas and electricity—where single firms still dominate. When *Petroleum Intelligence Weekly* finished its latest survey of the world's largest oil companies, ten of the top fifty were in Russia, and only two of middling size had majority state ownership (Rosneft and Slavneft—and the latter's shares were on the auction block). In contrast, each of the 11 OPEC countries had just one entry: a fully state-owned enterprise. Some OPEC countries also make room for foreign investors—for example, Royal Dutch/Shell in Nigeria—but production and export decisions in OPEC's leading members are all dominated by the state. It is easier to control production when state and producer are one. In contrast, where ownership is private and fragmented, the odds are higher that market forces, rather than cartel instincts, will determine behavior.

INDEPENDENT INVESTORS

THE GOVERNMENTAL WORKING GROUPS established by Bush and Putin have little leverage over the market-driven business decisions that now dominate the Russian oil industry. Indeed, Russians themselves have avoided investment at home. In 2000 alone, about \$20 billion in capital left Russia—roughly the same amount that Russia's oil exports earned on world markets. That same year, which saw a peak for foreign

direct investment worldwide, the UN Conference on Trade and Development estimated that Russia attracted only \$2.7 billion in outside investment—about one percent of the country's GDP, or less than seven Big Macs a head.

Investors face obstacles everywhere in the Russian oil business—not only in developing new oil fields and pipelines (known as “greenfield” investment), but also for “brownfield” buyers of existing operations. In the early 1990s, British Petroleum, one of the first major foreign players in Russia, invested about half a billion dollars in Sidanco and nearly lost the whole sum

when the Russian firm plunged into a Byzantine bankruptcy. Under Putin the tide seems to be turning. Confidence in Russian institutions is rising, and official statistics (though notoriously unreliable on the subject) suggest that the outflow of money from Russia has slowed. However, suspicions of

insider dealing and other deterrents to investors remain. For instance, when the Russian government auctioned its stake in Slavneft in December 2002, every potential foreign bidder was discouraged from participating in the process. The auction itself lasted only four minutes; one team submitted three of the four bids, and the winning bid was barely above the reserve price. The low values that open markets assign to Russian oil companies measure the enormous difficulties that lie ahead in building appropriate corporate institutions and assuring investors of the safety of their stakes. According to a recent study by PricewaterhouseCoopers, Western oil assets changed hands in the late 1990s for about \$5 per barrel; Russian assets, on the other hand, traded at less than 20 cents per barrel.

In the energy industry, the most common demand is for Moscow to create greater certainty in its tax and regulatory laws. In an interview with the Russian newsmagazine *Itogi*, Mikhail Khodorkovsky, president of Russia's second-largest oil producer, Yukos, counted 50 changes in Russia's energy taxes and regulations in recent years. In Houston, potential Western investors echoed this theme and have focused, in particular, on the need for better “production sharing agreements” (PSAs). Commonly used where predictable and transparent markets

There is little Moscow and Washington can do to influence investment in Russia's oil exports.

and regulation do not exist, PSAs are designed to create an “enclave of stability” around a project. Typical PSAs lock in tax regimes, clarify resource ownership, and guarantee payments in fungible exportable assets (such as oil) that are not so vulnerable to changes in exchange rates. The need for stability is hardly new to Russia, and in fact a Russian PSA regime has been in place since 1996. In practice, however, that regime has not eliminated the uncertainties that deter investors, and legislation for an improved PSA mechanism remains stalled in the Duma.

The limited influence of the current PSA regime reveals why there is little that intergovernmental cooperation between Washington and Moscow can do to bring about more investment in Russian oil exports. In the broadest sense, two industries are emerging in Russia. One, centered on the aging fields of western Siberia, is dominated by Russia’s major producers and is geared for so-called brownfield behavior. Oil firms, now owned mostly by Russians who bought their stakes at fire-sale prices, have the option of using the PSA regime but do not do so because the transparency of PSAs is bad for them—their profits thrive on transfer pricing and insider deals. A regime that was concocted to attract external investors is not attractive to them because they do not need outside money.

Russia’s other oil industry rests on the harsh margins of the traditional core: it develops new fields in the Arctic and the far eastern parts of the country, such as those off Sakhalin Island. Players in this sector include Russia’s own major firms as well as the top multinational energy companies. In this second industry, a viable PSA regime is more important; even for insiders, the political environment is less predictable in these new areas which are both geographically and politically distant from Moscow. For outsiders, the most lucrative opportunities are where the fields are “green” and technological advantages, such as the capacity to work in deep water and icy environments, are useful. So far, major projects on Sakhalin, slated to export oil to world markets and gas to nearby Japan and South Korea, have been the visible fruits of the effort to attract outside investment. Government-to-government contacts have played a role in this process, especially in cases where investors have found the existing PSA regime incapable of resolving uncertainties about tax and regulatory treatment. Indeed, governments can assist deals when the fundamental economic forces align, and this

function of aiding particular deals is an important intergovernmental task, whether ad hoc or institutionalized. No PSA really provides an enclave of stability—investors know that they are always vulnerable to “renegotiation” where the law is weak and once their investments are entrenched.

DIVERSITY, EFFICIENCY, SECURITY

A MORE DURABLE energy policy requires recasting the current effort. The Russian-American partnership needs to be balanced by other forces. Insofar as the real goal of this relationship, at least for the United States, is to help temper America’s exposure to volatile oil markets, partnerships with other potential producers could be equally advantageous. Angola, Brazil, Canada, Mexico, Nigeria, and possibly a postwar Iraq are among the many candidates. Each would bring its own obstacles to raising production—but in each case, as with Russia, intergovernmental cooperation offers only limited leverage. Such cooperation could have a greater impact on oil consumption, however, because the chief barrier to raising efficiency is often the lack of appropriate policy models and public-sector financing. More responsive consumer markets anywhere in the world could help dampen volatility. In fact, policies for promoting efficiency can have effects on the oil market similar to those caused by a boost in production, often at less expense.

For the United States, especially, efficiency is the sturdiest defense against volatile energy prices. From 1930 through the early 1970s, the U.S. economy delivered roughly \$750 (in today’s money) of economic output per barrel of oil consumed; that amount has risen to about \$1,500 today—a doubling brought about partly through higher oil prices, which encourage frugality, and partly through regulations that mandate more efficient technologies. A 2002 report by the U.S. National Research Council lays out useful ways to lift the efficiency of U.S. passenger vehicles still further, but in recent years American politicians have been caught in gridlock over fuel economy.

Russian consumers also offer significant potential for limiting demand through more efficient oil usage. This topic, however, has attracted barely any attention in the new Russian-American energy partnership. Russia burns about one-third of its oil at home, but price controls, a

glutted local market, and a long history of neglecting conservation explain why the Russian economy produces only \$300 per barrel burned. (This is about the same level as in Iran and even worse than in Saudi Arabia.) Russian economist Yuri Kononov at the Energy Systems Institute of the Russian Academy of Sciences estimates that consumer energy prices in Russia are still only one-half to one-third the prices in Western markets. As the Russian export infrastructure expands, however, oil saved at home can be sold abroad at world prices.

These two actions—seeking diversity of supply and a global effort to tame demand—are the real keys to enhancing America's energy security. The quantity of oil that the country imports and the identity of particular suppliers, on the other hand, are not good indicators of U.S. vulnerability. The world's greatest trading nation certainly should not shy away from trade when it comes to oil, but it should augment its open door with diversity and efficiency.

BEYOND PETROLEUM

A MORE LASTING Russian-American energy agenda would focus on subjects beyond the current, fleeting common interest in oil. An obvious alternative is natural gas. Indeed, U.S. Commerce Secretary Donald Evans underscored Russia's potential in this area at the Houston energy summit. But for American consumers and policymakers, Russian gas offers little to sustain interest. Unlike oil, gas trading is generally a regional business because most gaseous fuel is moved by pipeline, and long-distance pipelines are prohibitively costly. A small but growing fraction of gas is being compressed and cooled to liquid form, sold at prices set by world markets, and shipped long distances to destinations including the United States. Only a small amount of Russia's vast gas reserves, however, presently have the characteristics needed to make this export option economically worthwhile. Thus, to find an area in which governmental dialogue can truly make a difference, Russia and the United States should look to the subject that occupied much of their effort in the 1990s but that both sides then neglected too quickly: nuclear power.

With the end of the Cold War, the United States and Russia created a multi-billion-dollar program to sequester Russia's prodigious quantities

of fissile material and nuclear technology. The goal was to prevent these “loose nukes” from falling into the hands of terrorists or hostile states. The Cooperative Threat Reduction (CTR) program also included funds to employ Russian scientists through joint research projects and academic exchanges. Inevitably, this effort has failed to meet all its goals. In a country where central control has broken down and scientific salaries have evaporated, it is difficult to halt the departure of every nuclear resource. Nor is it surprising that U.S. appropriators have failed to deliver the billions promised for this collective endeavor. Other priorities have constantly intervened, and Russia’s uneven record in complying with arms control agreements has made appropriation of CTR funds a perpetual congressional battle. Various good ideas for reinvigorating the CTR have gone without funding and bureaucratic attention—even in the post-September 11 political environment, in which practically any idea for fighting terrorism can get money.

The civilian dimension of the CTR, however, should do far more than simply try to occupy Russia’s idle nuclear minds. Russia has opened nuclear waste encapsulation and storage facilities near Krasnoyarsk, raising the possibility of creating an international storage site for nuclear waste. This topic has long been taboo, but it is an essential issue to raise if the global nuclear power industry is to move beyond the inefficiencies of small-scale nuclear waste management. Russia should also be brought in to worldwide efforts to design new nuclear reactors. The global nuclear research community, under U.S. leadership, has outlined comprehensive and implementable plans for the next generation of fission reactors. The Russian nuclear program is one of the world’s leaders in handling the materials necessary for new reactor designs. Yet, despite this fact, Russia currently is not a member of the U.S. government-led Generation IV International Forum, one of the main vehicles for international cooperation on fission reactors and their fuel cycles. Integrating Russia into that effort, endorsing Russia’s relationships with other key nuclear innovators (such as Japan), and delivering on the promise made at last summer’s G-8 meeting to help Russia secure its nuclear materials must be top U.S. priorities.

Nuclear power could be the basis for real Russian-American cooperation.

For opponents of nuclear power, no plan will be acceptable. But the emerging recognition that global warming is a real threat demands that nations develop serious, environmentally friendly energy alternatives. Of all the major options available today, only nuclear power and hydroelectricity offer usable energy with essentially zero emission of greenhouse gases. The era of large dams may be ending, however, as democracy spreads and more communities object to flooding—leaving nuclear power as perhaps the most attractive future option.

To be sure, sustaining serious Russian-American cooperation on nuclear power will not be easy. Unlike with oil, however, most of the necessary levers for effective nuclear cooperation are actually in government hands. Diplomacy thus offers the potential for major gains. To make this partnership work, Russia must do better to overcome the same challenge that dogged the CTR: keeping account of how money is spent locally and ensuring that Russian scientists and nuclear material do not move to adversary nations. The United States, for its part, must not only sustain financial support but also integrate a large, cooperative effort with Russia into current domestic programs for nuclear technology. These various initiatives have drifted away from the task of developing next-generation technologies and are now focused primarily on improving the function and longevity of existing U.S. reactors.

Neither government should be naive about the sustainability of this endeavor. Russia is not an ideal partner because its borders so far have been a sieve for nuclear know-how, and because its nuclear managers are suspected of abetting the outflow. Thus plans for nuclear waste storage, for example, must ensure that they render the waste a minimal threat for proliferation (focusing perhaps on techniques for physically immobilizing the debris, beyond merely locks and fences, and construction of a permanent repository). The United States must also be more mindful of Russian sensitivity to cooperation on matters that to date have been military secrets—a problem that has halted past efforts to invigorate the CTR. Another difficult issue that both nations must confront is Russia's relationship with Iran. A perennial thorn in Russian-American ties, Moscow's nuclear cooperation with Tehran owes not just to Iranian money but also to the complex relationship between the two countries over drilling and export routes for Caspian

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oil. This link to Iran cannot be wished away, as it is rooted in Russia's very geography. Any sustainable nuclear partnership between the United States and Russia must develop a political strategy to handle this reality.

A RELATIONSHIP RECONSIDERED

EFFORTS to keep up constructive dialogue between Moscow and Washington are admirable. But by focusing on oil, the two governments have seized on a subject in which cooperation will not much affect the real world. Despite the fact that the United States is the world's largest oil importer and Russia is now the world's largest producer, intergovernmental dialogue and grand industry conferences have little effect on where private investors place their capital. Although the United States depends heavily on imported oil, ironically it is Russia, because of its economy's sensitivity to price shifts, that has the most to lose from this illusory joint effort to manage prices. Without oil, the Russian-American political agenda is short, but important subjects—nuclear power first among them—are being neglected. The world, including the United States, needs the option of viable nuclear power. Yet Russia's talented scientists and nuclear resources sit idle, ready for action. 🌐