

FUNDING THE THREAT

*A fresh perspective on energy security &
national defence*

September 2006

Dr. Liam Fox MP

Shadow Secretary of State for Defence

Introduction

In my speech to Chatham House, consequently published as 'Over a barrel' I set out what I believed to be the dangers facing our economic and national security as a result of insecurity in the supply of energy. These were threefold: that politicians had failed to grasp the implications of interdependency resulting from globalisation that we lacked a coherent energy security strategy in this country and that global defence structures were inadequate to deal with the emerging terrorist threat.

Events have been moving quickly. Only this week, Russia suspended an environmental permit for an oil and gas project led by Shell on Sakhalin Island, a blow to those naïve enough to still talk about market solutions and Gazprom in the same breath.

I want to return later to the resource nationalism that is increasingly a feature of the Putin Government and its potential consequences. But I want to begin by focusing on a different consequence of our addiction to oil and the security implications that result from it.

We are all too familiar with the fact that recent years have seen substantial rises in the price of crude. What is seldom discussed is the cumulative wealth shift that this represents, how it is being spent and the foreign and security policy implications that flow from it.

Let me begin with a few numbers. In the past five years Europe alone has pumped \$49bn into the economy of Iran and an astonishing \$232bn into the former Soviet Union, mainly Russia for crude oil alone. This does not include the financial transfers resulting from gas or petroleum product sales. Of these two examples, at a national level, Germany has contributed \$54bn to Russia while Italy handed \$10.1bn to Iran. The global figures are, of course, much greater still.

In both Russia and Iran this windfall has been used to finance military buildup. In other words we in the West find ourselves in a security Catch-22. Our dependence on oil means that we cannot avoid paying whatever price is demanded of us. That in turn produces huge financial flows out of our economies into those oil producers, some of whom may be hostile to us. They in turn use this to finance a defence build up. In other words, our addiction to oil results in us funding the potential threat against us and our interests. There is, in addition, the consequence that there is little incentive for a state like Iran to reduce international tension as greater uncertainty will inflate the oil price and keep revenues high.

Our inability to wean ourselves off our oil habit may be providing us with more immediate threats to our security and wellbeing than the effects that climate change may bring. Let me show you exactly where this money is going, what it is buying and what it may mean for our ability to exercise an independent foreign policy.

Iranian Defence

Let's begin with Iran. As with many autocratic states it is difficult to know exactly what the true figure is for defence spending in Iran. The official figure, for what it's worth, of \$6.2 bn excludes a large proportion of defence related spending. For example, a lot of defence spending is hidden as manufacturing where civilian and military programmes funded by the state overlap – for example, car manufacturing which doubles as research for tank programmes. Additionally, some defence expenditure comes under the religious ministries e.g. the Pasdaran elite force.

Iran's oil revenue has risen from \$23.7 bn in 2003 to a staggering \$46.6bn in 2005. This economic windfall has enabled the Iranian regime to undertake a spending spree on defence. The Stockholm International Peace Research Institute has estimated defence spending at US\$ 5.9bn in 2003, US\$ 6.8bn in 2004 and US\$ 8.47bn in 2005.

It is worth reminding ourselves of the sheer quantity of forces Iran possesses. Its manpower strength is currently estimated at 545,000 active personnel with a reserve strength of some 350,000. Compare that with a British Army about to fall below the 100,000 mark. On top of these figures Iran has the Basij paramilitary resistance force. Unlike the Iranian Army and the main Iranian Revolutionary Guard Corps forces, Basij recruits both female and male members. Russian news sources have claimed Iran has plans to make a third ground force consisting of one million basij members. As such, Iran has the largest military capability in the Middle East region at least, in sheer numbers.

Anthony Cordesman of the Centre for Strategic and International Studies suggested in a recent report on Iran's military capabilities that:

“Iran has never rebuilt the level of conventional forces it had before its defeat in its war with Iraq in the 1988 and that this inability to modernize its conventional forces may one of the reasons for Iran's ‘nuclear ambitions’ and its focus on building its asymmetric capabilities”

Iran has certainly compensated for this weakness in its conventional forces with increasing sophistication in particular capabilities and with the support it has received for its ballistic missile programme from North Korea, China and Russia. The Islamic Revolutionary Guard Corps' Naval Force has been highlighted as one such capability.

In the CENTCOM 2006 Posture Review, CENTCOM commander General John Abizaid stated:

“The IRGC Navy has been developed primarily for the Strait of Hormuz scenario in which Iran would attempt to “internationalize” a conflict by choking off oil exports through the Strait. To disperse large quantities of recently purchased small boats, high speed missile boats, torpedo fast attack craft, and midget submarines, Iran has embarked upon an expansion project for naval bases throughout its littoral. Asymmetric military strategies and naval

force modernization, a key national priority, enhance Iran's capability for power projection in the region. The IRGC Air Force maintains control over most of Iran's ballistic missiles and rockets. The accuracy and reliability of its rocket systems vary, but Iran is capable of targeting all Gulf States, the Arabian peninsula, Israel, and U.S. and Coalition forces in the region with little warning."

An article in Jane's Defence Weekly on 13 September 2006 commented:

"Iran's inventory of ballistic missiles, and its assessed pursuit of a longer-range potential, are its primary means of delivering weapons of mass destruction to an array of potential targets in the region. Mindful of its inferiority in terms of strategic air assets, Iran's pursuit of a powerful indigenously produced strategic missile inventory is perceived in Tehran as critical to its regional security and as a deterrent to potential foreign aggression. Tehran's ballistic missile assets should be seen not only as a deterrent but also, in terms of their capability to project power, as extended strike force-multiplying systems - primarily armed with conventional warheads, but with options for the delivery of biological, chemical and perhaps eventually even nuclear payloads with longer-range systems."

In order to demonstrate the capability and effectiveness of its naval forces, Iran has recently conducted a number of major military exercises in the Persian Gulf and Strait of Hormuz in April & August 2006.

So, Iran's focus has been on its conventional naval and ballistic missile capabilities as a means to projecting power on a regional scale. Consequently the country's procurement priorities over the last few years have concentrated in this area and appear to be continuing to do so. In December 2005 Russia announced that it had entered into an agreement with Tehran for the upgrade of a number of attack aircraft, patrol boats and T-72 tanks.

And what of the ballistic missile capability? With the assistance of North Korea, China and Russia, Iran is considered by many analysts to be increasingly self-sufficient in the production of ballistic missiles, a capability which has received increasing attention in light of Iran's perceived nuclear ambitions.

Over the last few years Iran has made several pronouncements regarding its ballistic missile programme, and in particular the development of longer range versions of the Shahab 3 missile. In October 2004 the Iranian government announced that it had extended the range of the Shahab 3 to 2,000- 3,000km (Shahab 4), whilst it also suggested that it was capable of mass producing this missile. In January 2006, various media reports suggested that the Shahab 4 had been successfully tested. A missile variant with an even greater range in excess of 4,000km (Shahab 5) has also been reported to be in development.

Just think what the effect would be on the geopolitical balance if this increasingly sophisticated capability were to be augmented with a nuclear

arsenal. It is a picture that should cause us a good deal of anxiety but it is far from the only potential problem that is developing.

Russia's Military Buildup

In his Annual Address to the Federal Assembly on 10 May this year, President Putin placed special emphasis on Russia's rearmament. In the speech, he spoke of "substantially upgrading the strategic nuclear forces over the course of the next five years with modern long-distance aircraft, submarines and launching facilities for the special missile forces". Perhaps more worryingly, he also spoke of having "armed forces capable of fighting, if necessary, a global, a regional, and a few local conflicts". Before we consider what he might be referring to, let's look at how much he has been spending and what our petrodollars are purchasing.

As with Iran, calculating Russia's defence budget is notoriously difficult. The State Budget reclassifies defence spending each year, making it difficult both to compare and to elucidate. Using percentage of GDP spent on defence is an unhelpful comparison. Whereas 4.95% of GDP was spent on defence in 2003, only 4.23% was spent in 2004. However, the defence budget actually increased – just at a slightly slower rate than GDP overall. In 2006, defence expenditure is set to rise by 25% compared with 2005 to some 666 billion roubles. Indeed, nominal defence spending will have doubled 2003-6.

Testing of missiles to improve quality has been a marked feature in 2005 and 2006: Bulava submarine launched ballistic missile were tested in September and December 2005 from the Dmitry Donskoi nuclear submarine and two Topol-M ICBMs will be tested during 2006 at the Plesetsk Space Centre near Archangel.

This is what Russia will be adding to its Armed Forces this year, 2006:

- 6 ICBMs
- 12 launch vehicles
- 31 T90 main battle tanks
- 125 armoured personnel carriers
- 1 Tu-160 strategic bomber
- 'Several' Su-34 interdiction aircraft
- 7 Mi-28N night-attack helicopters

Each of Russia's main fleets (that is, Caspian, Baltic, Black Sea, Pacific and Arctic) will receive five new frigates over next 15-20 years. These will have cruise missiles, anti-submarine missiles, air defence systems and will accommodate Ka-32 helicopters. The Russian Navy will also procure over this 15-20 year period 1 or 2 new-generation aircraft carriers and an unspecified number of 5,000 tonne destroyers.

It is important to remember that whilst Russia may be a much smaller entity

than the former Soviet Union, its armed forces retain the same geographic reach as before 1991. All four fleets are crucial for energy security.

For example, in Kaliningrad (on the Baltic, surrounded by EU states Poland and Lithuania) there are 10,500 in an Operational Strategic Group. The Baltic Fleet comprises two submarines, two destroyers, four frigates 26 patrol and coastal combatants, 13 minesweepers, 65 naval aircraft and 55 helicopters.

Russia's Black Sea Fleet is separated from it by the Ukraine, and the Ukraine has been talking of upping the rent Russia has to pay for its Sebastopol base in retaliation for the increase in gas prices. The Black Sea Fleet comprises 1 submarine, 2 cruisers, 2 destroyers, 2 frigates, 15 coastal combatants, 14 minesweepers, 36 aircraft and 42 helicopters.

Worryingly, in June 2006, Kommersant reported that Russia was investing heavily in the Syrian ports of Tartus and Latakia – preparatory to a possible transfer of the Black Sea fleet. This would be Russia's first permanent Mediterranean base since the brief siting at Vlore in 1958 before Albania retreated into isolation. Indeed, if the shift to Tartus were to go ahead, Russia's Mediterranean fleet would outrank anything the Soviet Union ever achieved. Clearly this development would increase Russian influence on Syria, and on the Middle East more generally.

Should we be worried by these developments? Let's put some pieces of information together. As I said in 'Over a barrel' some EU countries, such as Hungary, are 80% dependent on Russia for their oil and gas. We have seen how Russia behaved over the Baltic States and more recently their dealings with the Ukraine. Would they behave this way to a country like Hungary, an EU and NATO member, attempting to influence their international orientation.

Hungry

Last week the Hungarian Prime Minister Ferenc Gyurcsany visited President Putin. Hungary's crisis-plagued Prime Minister seems to have embarked on a "third-path" course between the institutional West, where Hungary belongs, and Russia - toward which Gyurcsany and his closest associates seem increasingly to gravitate. The concept of a "Third Path" (Harmadik Ut) between the West and Russia has antecedents in Hungary's right-populist and left-populist thought before and after World War II but most thought it had disappeared since Hungary became a member of the European Union and NATO.

Hungary's choice between the EU's and Gazprom's rival grand projects -- the Nabucco pipeline for Caspian gas or the South European Gas Pipeline for Russian gas -- has become a touchstone of the Gyurcsany government's allegiances. Although the EU has declared its project to be a high priority for European energy security, Hungary's government is holding talks with both sides while reportedly signalling to Russia and Gazprom an actual preference for the latter option.

In the concluding news conference with Putin in Sochi, Gyurcsany acted as a sounding board on energy security. Implicitly and at times explicitly, he distanced Hungary from the EU's evolving position on this and other issues. Endorsing the idea of mutual dependence between the Russian state monopoly Gazprom and European consumers, Gyurcsany obliquely cautioned Europe, "Those who do not understand something here will sooner or later go bust. We, Hungarians, do want to understand Russia".

Georgia

To the south, in Georgia, there are also tensions. The strains in Georgia's relationship with Russia were more than usually obvious in January 2006 when President Mikhail Saakashvili accused Russia of sabotaging a gas pipeline and a power cable supplying Russian energy. Mr Saakashvili said the explosions were an act of blackmail by an "enemy", designed to pressurise Georgia into selling its pipeline network, and halting its attempts to find alternatives sources of energy. Russia rejected the allegation. In Georgia politics, energy and security are explicitly linked.

Georgia began efforts to diversify energy supplies, when Russia doubled the price of gas to \$110 per 1,000 cubic metres in 2005. Georgia accuses Russia of supporting separatists in its breakaway regions, Abkhazia and South Ossetia. At the same time Russia opposes Georgia's push to join NATO and the EU.

Germany

And what about closer to home? Here, in the EU, Germany aspires to a special, strategic relationship with Russia, and nowhere more so than in the field of energy. It is Russia's largest trading partner, and buys more Russian gas than any other country - this gas makes up about 40% of its total consumption. Former Chancellor Gerhard Schroeder struck a deal in 2005 on construction of a new pipeline from Russia to Germany under the Baltic Sea, bypassing other transit countries, such as Poland - and then became chairman of the project's supervisory board.

This year the German chemicals giant BASF won a slice of a major Siberian gas development, in return for giving Gazprom a bigger share of a joint venture selling gas in Germany. German energy giant E.On is expected to do a similar deal soon. At a summit with President Vladimir Putin in April, Mr Schroeder's replacement as chancellor, Angela Merkel, spoke of unspecified "differences of views", but one German minister went on record saying that it would "spoil the atmosphere" to discuss controversial topics.

Yet controversial topics there will be in the years ahead in a world where there is increasing political tension between the consumers and many of the world's oil producers. Many commentators say that the market will sort it all out. But how free is the market?

As Adrian Blomfield put it so well recently in the Daily Telegraph:

“The international community has watched with queasiness as democracy in Russia has gone on the retreat and Kremlin assertiveness - neighbours might call it bullying - has grown. The move against Shell seemed to have confirmed the West's worst fears about Russia's trajectory: not only does the Kremlin seem intent on taking direct control of a vast and possibly dangerous energy empire, it seems prepared to do so by riding roughshod over some of the world's most powerful multinationals.”

The Shell dispute once again highlights the Kremlin's indifference to property rights and makes plain the threat we face from resource nationalism being operated by those oligarchs and politicians who see a chance to resurrect Russia's broken reputation.

Those who believe that this is still a free market, in the sense that we understand it, might like to ponder that if Gazprom were a country, only Saudi Arabia and Iran would have larger reserves- and there can be fewer companies so totally dominated by such powerful and potentially ruthless politicians. As Blomfield again put it:

“It has long been rumoured that Mr Putin wants to take over as chairman of the company when he steps down in 2008. Mr Putin has already stuffed Gazprom with his friends, including former German chancellor Gerhard Schroeder who runs a Gazprom subsidiary. If there is truth in the rumour, Mr Putin, would head not just a vastly wealth company but would continue to wield huge power over both the West, whose energy dependence on Russia is set to double over the coming decades, but also over large parts of Asia.”

We need to start to rigorously analyse how all these pieces of the jigsaw might fit together in the picture that is our future and we need to tie them into policy development. Sitting back and hoping for the best is not enough. If we are not prepared to shape our future then the future will certainly shape us.