

“Energy Interdependence and Security:
Russia and Europe”*

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Energy Cooperation or Conflict?

Are Russia and Europe forever destined to clash over issues of energy supply and energy security? Is there really a possibility for tenable producer-consumer cooperation in the long run? Energy producers and consumers have opposing interests. Producers want ample supply — defined by their own needs — at low prices. Producers want maximum revenues.

It is thus the issue of price that calls into question any possibility of a compromise solution. For what would the compromise look like? Would one try to choose a long run average price? Would that be the median price, or the mean price? Over what period? The hallmark of the oil market is extreme price volatility. Over the period of 1947 to the present, for instance, the mean price is \$24 a barrel and the median is \$19 a barrel. What producer would today accept such a “compromise”? In fact, the gap between almost any notion of a historically “normal” price and the current price is simply too great to be bridged.

The conflict hinges on producers’ and consumers’ differing notions of an acceptable price. From the economist’s point of view, there is a proper price of energy. Like that of any other commodity, it is the price determined in a competitive global market. However, note what that would entail. First, global demand and supply would have to be in equilibrium based on the individual activities of uncoordinated buyers and sellers. Second, there would be no borders constraining production, sale, or investment.¹

For the economist, the outcome determined in a competitive global market would be fair, given initial endowments. Unfortunately, the assumptions required for a competitive market — secure property rights, free entry into production and distribution, no

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¹ And for the price to be efficient there would be a third requirement: namely, that that decisions on depletion rates and investment in new sources would also be determined by the principle of highest value use.

transaction costs, and so on — do not hold in the real world. As a consequence, countries have developed notions of energy security, and these differ according to specific situations. As a result, they are led to behave in ways that distort or constrain the market to their advantage. In addition, borders do matter for production and investment. Endowments are not equal. (Some countries have energy deposits, others don't. Some countries are wealthier than others.)

Energy producers distort the market, hugely. The Saudis and other Middle East producers have successfully constrained development of their resources to the point that they “prevent abundance” globally. This, after all, is the point of a cartel. And this appears to be something that the consumer nations have accepted.²

In an unconstrained market, production would be driven by demand at prices equal to marginal cost (including a fair rate of return on capital). If there are deposits that could be developed at the prevailing long run marginal cost, they would be. The lowest cost deposits would be developed first. To jump directly to high cost deposits would be inefficient. With prices far above marginal costs, however, even producers with high cost deposits can earn rents. And this is exactly what happens in the case of Russia. In the world as a whole, energy development is hugely inefficient in this sense. There has been great improvement in the efficiency of trading the oil that is produced. But this is little compared to the inefficiency with regard to production of oil, and especially with respect to investment in producing oil. And the major beneficiary of this inefficiency is Russia.

The fact that an agreement on price is unworkable does not mean that there are no grounds for cooperation, however. To understand that we first turn to Russia's problem.

Russia's Problem No. 1: Managing the Oil in the Ground

It is a common perception that Russia's energy abundance gives it great leverage over consumers. This is certainly what many Europeans seem to believe. In fact, however, Russia has vulnerabilities that arise precisely because it is such a large supplier of oil to Europe and the rest of the world market.

Russia is a high cost producer of oil. Indeed, among major producers, it is the highest cost producer. This is a natural feature of Russia's climate and geography. Only thanks to current high oil prices is Russian oil profitable enough to develop. Russia thus does not merely benefit additionally from high oil prices in the sense that they add marginally more to Russia's earnings. It is vitally dependent on the high oil prices to make its oil profitable at all.

Prices are high because the low cost producers — mainly the Persian Gulf countries — have elected to constrain production in their fields. Because the Saudis value having a

² The consumer nations, led by the US, do so for pragmatic reasons of preserving political and social stability in the Mideast. The level of production and investment in Saudi et al. oil fields — and therefore the world oil price — is the result of a compromise judgment of what is permissible for political stability in the Mideast and in the United States.

slower depletion rate — keeping more oil in the ground — than an efficient global market would dictate, they generate huge rents for all producers. Those rents are paid for by consumers. They are, in effect, a tax on users of oil. Consumers pay \$80 a barrel for oil instead of, say, \$15 because all the Saudi low cost reserves are kept in the ground.

This means that Russia is intrinsically at odds with the West regarding the oil price. Lower oil prices would be very costly to Russia.³ Moreover, its investments in future supplies are contingent on high prices. High prices, however, are not a certainty. The price of a barrel of oil, measured in 2006 dollars, has fluctuated between \$10 and \$20 since 1867, aside from wartime. The record high oil prices that we currently observe were unexpected, as evidenced by futures prices. Thus, a rational decision maker must consider the likelihood that oil prices may drop significantly. Therefore, Russia needs foreigners to share the price risk of future development. In other words, it needs to diversify investments in new deposits. Although it is not always acknowledged by the Russians themselves, this is an objective necessity for Russia.

The need for Russia to diversify the risk of a fall in prices means is that Russia needs to open up opportunities for western oil firms to invest in new deposits in Russia. If Russia allows only domestic firms to invest in new deposits, it bears the entire risk of a fall in oil prices and the losses this would entail. A closed Russian environment would thus necessarily lead to lower levels of investment. An open Russian environment would attract greater levels of investment in new deposits because western oil firms lack good opportunities elsewhere. Hence, this is a win-win proposition for Russia and the west. This is the first part of Russia's problem of management of its oil and gas wealth.

Russia's Problem No. 2: Managing the Financial Wealth

The second dimension of Russia's challenge of managing its resource wealth is what to do with the financial wealth it earns from sale of oil. What are Russia's choices? It could keep the wealth internally, to either consume it or invest it. Certainly, consuming too much today is bad (although, note that this is exactly what has happened), since it leads to a bad future, no provision for a rainy day, and so on. On the other hand, investing internally is also problematic. Russia suffers from an extremely high relative price of investment.⁴ This is due to inefficiencies in the sector and a history of corruption. Suffice it to say that Russia has a very bad history of misinvestment. This means that the return on domestic investment in Russia is low, especially on investments outside the energy sector itself. Hence, Russia simply cannot absorb the volumes available.

It is therefore laudable that Russia three years ago took the steps it did to set up a stabilization fund. But here there are choices as well. Russia has so far pursued an extraordinarily cautious approach and used the money to pay down its foreign debt. From

³ The vital dependence of all of Russian society on continued rents — therefore, continued high prices — is a main message of the forthcoming book by Gaddy and Ickes, *Russia's Addiction: The Political Economy of Resource Dependence*.

⁴ Clifford G. Gaddy and Barry W. Ickes, "Investment and Transition in Russia." Unpublished manuscript. Pennsylvania State University Department of Economics. February 2005.

a strictly economic point of view, it has arguably gone too far in this direction. Putin has clearly decided that having virtually no state foreign debt is important in reducing Russia's political vulnerability to lenders.

With the foreign debt now repaid, the huge surpluses from oil sales flow into and accumulate in the stabilization fund. The stabilization fund until now has been filled with foreign government securities. These securities (debt) offer very low returns. If Russia continues to invest exclusively in foreign government securities, it loses very substantial potential returns.

Using the stabilization fund assets to purchase equity in the West, on the other hand, offers high returns. It is true that equity investments carry a higher risk, and that not all the funds should be placed in corporate equity. But risks can be diversified. Russia needs a portfolio approach, obviously. At the moment, it has nothing in equity. There should be some shift. The precise proportions of debt and equity in Russia's portfolio can be debated. The decision should be made on the basis of weighing risk versus return. But the general conclusion is that for its best economic self-interest, Russia should put a substantial part of its reserves and stabilization fund into shares of Western companies.

Europe's Interest

Russia's exclusive holding of government securities also represents a risk for the West. It leads to a "balance of financial terror," to use the words of former US Treasury Secretary Larry Summers in referring to a similar issue with Chinese investment in Western securities. Although debt is not a practical weapon, since it would damage the lender as well, it is a useable one. And it is too easy to make mistakes. It is like nuclear missiles on "hair trigger" alert as opposed to de-alerted missiles. There are easier ways to cause trouble than misusing one's own assets.

Therefore, the current investment policy of the Russian government gives the Russians great leverage over Europe and a bad return for them. An exclusively debt-based approach offers no diversification, and leads only to a balance of financial terror. An equity approach, in contrast, gives high returns to the Russians and ties Russia's interests more to the West than other approaches. It gives Russia a stake in the direct success of Western economies. It leads to commonality of interest.

The problem is that the potential recipient countries are nervous about accepting Russian money into corporate equity. People worry that the sovereign wealth funds will not play by the accepted rules of the market. Rather, it is said, they will be used by governments for political control of companies, and so on. There may be grounds for these concerns. But the fact is: the alternative is worse. Russia has this surplus in the first place because Europe bought Russia's oil and gas. Europe has no choice in this regard. It must continue to buy Russian oil and gas. So the only question for Europe is, are you better off being in debt to Russia or being a partner, a co-owner? It is definitely better to be a partner.

Notice that the partner solution is not contingent on one's generally being in favor of cooperation with Russia. It does not require a benign view of Russia or optimism about Russia's political future. In fact, if you have a negative outlook for Russia, you should logically be even more in favor of the equity approach. Consider two views/scenarios for Russia: a pessimist's view and an optimist's. In the pessimistic view, Russia intends to dominate. But if this is true, then being in debt is worse than being a partner. A Russia that is willing to pay a price to harm Europe will readily dump debt at a moment's notice and cut off deliveries. In the optimistic view, Russia is not a monolith. There are people inside the Russian elite who prefer economics over politics. If this is true, the equity approach bolsters those forces.

The Bottom Line

The bottom line is that Europe's dependence on Russia's energy is a fact. The issue is how should Europe formulate this dependence? Is it better to be a debtor or an equity partner? The message of these remarks is that the answer is clear. Debt in the hands of your enemy is bad. It leads to a balance of financial terror.

An even stronger argument is that equity can modify behavior and promote cooperation. It gives Russia a stake in Europe's prosperity. Despite the risk of politics, then, to encourage Russia to use its financial wealth to take an ownership stake in Europe's economy is the best policy for Europe as well as for Russia. It is best no matter what one thinks of Russia's intentions. It is not conditional on reciprocity.

What is presented here is not a magic bullet. Although economic self-interest is a powerful force, it often cannot overcome political interests. The issue is admittedly controversial. Yet it would be very bad if Russian ownership were discriminated against. The big Russian surpluses now and for years to come offer a unique chance for better East-West relations and for Russia's future. The West can find common ground with Russia if it recognizes that Russia has a fundamental problem of what to do with its wealth. Energy flows from east to west. Money flows west to east. The key problem for both sides is how the wealth is deployed. This is where a cooperative solution may be found.

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