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## ECONOMIC NEWS UPDATE

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Ukraine is the West writ small. Its confrontation with Russia over energy supplies, during the course of which Vladimir Putin gave “cold war” a new definition, is a warning to major energy-consuming countries that their long term prosperity is in the hands of very dangerous people.

It’s no news that the OPEC oil cartel is not the most reliable supplier of the oil that advanced economies need to keep their trucks and cars moving, their planes flying, and some of their homes heated. These oil-producing countries have combined to keep prices above competitive levels, and have not hesitated to “unsheathe the oil weapon” -- read, boycott consuming countries -- when dissatisfied with American foreign policy, as they were in 1973-1974. That includes, most notably, Saudi Arabia which nevertheless attempts to pass itself off as a reliable supplier of energy.

As does Vladimir Putin, who kept a straight face when announcing that his willingness to end his cutoff of gas supplies to Europe -- a supply shutdown that included refusing to allow gas from

Turkmenistan and Kazakhstan to flow through Russian pipes -- proves that Russia is a reliable supplier. Never mind that it was on his orders that Gazprom cut off supplies to Ukraine, and by extension to Germany, France and other countries, despite existing contracts that run until 2009. Remember: this dispute was not only about prices: Belarus, the former Soviet republic that has elected to stay in Russia’s sphere of influence, has not been faced with the massive price increases Russia’s Gazprom has imposed on more Western-oriented Ukraine, Georgia and Moldova.

Putin’s message is clear: Russia’s energy resources, now completely under the control of the state, provide it with a new weapon, petropower, and he will use it to restore Russia’s influence to levels that existed when it was a superpower. That’s what the destruction of Yukos was all about, and that’s what the renationalization of Russia’s energy infrastructure is all about. Putin reasons that if oil could be used for decades to mute American

criticism of Saudi domestic policies, Russian oil and gas can be used to shut down Western criticism of his increasingly dictatorial policies at home.

The supply cutoff to Europe had no direct effect on America. But it served as a warning that what is left of the nation's energy security strategy is in tatters. The Bush administration had hoped that Iraq would return to world markets as a major, and American-friendly, oil producer. The Pentagon predicted that Iraq would ratchet up its production to over twice the prewar level of about two million barrels per day. In the event, production is stalled at only a bit more than one million barrels per day, as sabotage and decades of underinvestment combine to limit production, and virtually free petrol for Iraqis keeps domestic consumption so high that there is little left to export.

The second strand of the administration's policy was to persuade congress to open up parts of Alaska for drilling. This, congress has refused to do. Finally, the White House sought to reduce its exposure to OPEC by increasing purchases from Russia. That plan, too, has come a cropper: Putin has invited OPEC representatives to a meeting to coordinate their policies with his.

There's worse. Venezuela, one of America's top crude oil suppliers, has always been a reliable business partner, even honoring its supply contracts when the Arab members of OPEC instituted their boycott. Now, however, the country is run by rabidly anti-American, pro-Castro, Hugo Chávez. He has raised taxes, sued for massive back taxes (shades of Putin's assault on Yukos), forced the major international oil companies to give state-owned PDVSA majority ownership of their oil

concessions, and forged an anti-Yankee alliance with other Latin American oil producers such as Bolivia's Evo Morales.

All of this is bad news for countries such as the US and the UK where major companies -- BP, Exxon and others -- operate within the constraints of shareholder-imposed requirements to maximize profits. They are private-sector players in a game increasingly dominated by state-run entities pursuing geopolitical objectives that have nothing to do with mere profit maximization.

Putin keeps prices to favored allies below market levels; Chavez makes cheap oil available to Cuba; Middle Eastern countries, with the possible exception of Kuwait, refuse to allow Western oil companies to invest capital and expertise to develop new reserves although the host countries would benefit from such development; China pumps \$1.2 billion into Sinopec, a listed company, to cover its losses. These are the acts of power-maximizers, not profit-maximizers.

These geopolitical players have raised the price of the premiums that policymakers in Western oil- and gas-consuming countries should be willing to pay for energy security. Since the risk of supply interruptions and price gouging has increased, so must the willingness of consuming countries to pay for insurance against those higher risks.

That probably means reflecting this new risk when calculating the viability of nuclear power and other non-hydrocarbon energy sources. It means, too, being willing to finance on generous terms the construction of the proposed oil pipeline to bring Caspian oil to market.

And it means, for America, both adopting a carbon tax and taking a tougher line with Mexico. The Mexican government, rich in oil and natural gas resources, won't allow American firms to help develop those resources. So its economy stalls, and job-hungry Mexicans stream across the border to find work in the US. It might be time for President Bush to explain to his Mexican counterpart that immigration policy will henceforth only be as open as Mexico's oil investment policy.

None of these steps, or any being proposed by Andris Pielbalgs, EU energy commissioner, will soon reduce the risk created by dependence on suppliers who are more than mere profit-maximizing sellers. Too bad Western Europe's gas-consuming nations didn't heed Ronald Reagan when the actor-cowboy tried to persuade them not to build gas pipelines to Russia.



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