

The United States, Europe, and Russia: Toward a Global Energy Security Policy

David L. Goldwyn

Executive Summary

Together, the United States, Europe, and Russia can help to diversify the global energy supply by creating a Global Strategic Petroleum Reserve (GSPR) filled largely with oil from Russia and other states in the Caspian Basin. Such a move would mitigate U.S. and European dependence on Middle East oil and help to stabilize world oil prices. Other important beneficiaries of a GSPR would be the Asia-Pacific economies outside the OECD that currently lack strategic reserves. A GSPR offering access to China and other Asian economies would help anchor these states in an important, positive-sum arrangement that highlights shared energy security interests with Russia and the West. If managed responsibly, creating the GSPR will not antagonize OPEC countries, which themselves benefit from stable energy markets. Moreover, developing the GSPR will encourage the reform and modernization of Russian and other transition countries' energy economies and give real substance to collaboration on energy issues between Russia, the EU, and the U.S. If coupled with close collaboration on Caspian energy development, the creation of a GSPR would make U.S. and EU energy ties with Russia and its neighbors sources of substantial, long-term strength.

Key Recommendations

- **Create a Global Strategic Petroleum Reserve.** Based largely on Russian and Caspian oil input, leverage the market-friendly policies and expertise of the International Energy Agency (IEA) to help create a global reserve for petroleum. Work through the G-8 to initially finance the reserve, but make it self-financing by selling drawing rights to consuming countries. Use this project to encourage economic reforms and improvements in corporate governance.
- **Build an Asia-Pacific Emergency Response System.** The United States, Europe, and Russia should work together to help create a system to facilitate systematic planning and cooperation among Asia-Pacific governments in case of a disruption in the oil supply. This system would mitigate vicious competition over scarce resources and consider demand-side measures these countries could take to respond to crisis.
- **Take action before 2003.** G-8 leaders should commission the IEA to create a framework for a GSPR and make recommendations for resource allocation and implementation. The U.S. and Russia should work to endorse a GSPR during their October 2002 bilateral meetings on energy security in Houston. APEC leaders should endorse the GSPR and Asia-Pacific Response System at their Summit in Mexico this October.

David L. Goldwyn, President of Goldwyn International Strategies, LLC, an international consulting firm, is an International Policy Scholar at the EastWest Institute. He was a U.S. Assistant Secretary of Energy for International Affairs under President Clinton.

THE POLICY CONTEXT

Less than a year after September 11, political leaders in the United States and Europe no longer appear concerned about the growing dependency of their economies on Middle East oil. New supplies of non-OPEC oil from Russia, the Caspian, Mexico, and West Africa, as well as demands for increased quotas by Venezuela and Algeria, will put downward pressure on prices in the near term. OPEC is threatening a price war with Russia, which has been the single greatest incremental source of oil supply in each of the past two years, if Russia does not voluntarily cut back on production to support high oil prices. The U.S. and Russia have formed a new partnership emphasizing cooperation on energy issues and ameliorating competition for influence in the Caspian. China, India, and other Asian nations are, for the first time, questioning their reliance

the U.S., the EU, and China is unprecedented. Leaders in Washington, Brussels, Moscow, and Beijing should leverage this opportunity to make a major geostrategic shift, uniting the U.S., Europe, Russia, and Asia in a global energy security alliance. Without antagonizing OPEC nations, the G-8 can finance a new strategic petroleum reserve, filled largely with Russian, Caspian, and Central Asian oil. This new, self-financing reserve can stabilize global oil prices, cement a new U.S.-Russia energy security partnership, and encourage the Asia-Pacific region to diversify oil imports. We should not lose the moment.

Oil Dependency: A Strategic Liability

For a brief period after 9/11, American and European publics questioned the long-term reliance of the United States and Europe on governments that fail to address the

The greatest, yet undiscussed, economic and geopolitical risk to global energy security is East Asia's deep dependence on Middle East oil and its vulnerability to a supply interruption.

on Middle East oil and considering ways to diversify their sources of supply and build strategic stocks to protect their economies against a potential oil supply interruption.

This awareness of the need for strategic stocks and the confluence of interests among Russia,

development needs of their growing populations or fund extremist groups to keep themselves in power.

There is no reason for us to feel more secure today than we did on September 12, 2001. With the Arab-Israeli conflict still in turmoil, the use

of oil as a political weapon against the U.S. is a real possibility. Terrorism against Middle East oil fields or loading facilities remains a threat. And, OPEC has demonstrated its resolve (and ability) to maintain oil prices at \$25 a barrel or higher, a hindrance to economic recovery in the United States and elsewhere.

Help the East, or Western Economies Could Go South

The greatest, yet often undiscussed, economic and geopolitical risk to global energy security is Asia's deep dependence on Middle East oil and its vulnerability to a supply interruption. The U.S. has taken a small but important step to enhance U.S. energy security by filling its Strategic Petroleum Reserve (SPR) entirely with American oil. But the U.S. cannot defend itself against a major supply interruption, a price shock, or an oil market failure by use of the SPR alone. In a global oil market, where a shortage in any region, real or perceived, can force a spike in prices everywhere, there is a glaring hole in our energy security strategy. That hole is Asia.

The Asia-Pacific region, unlike the U.S. and Europe, imports nearly all its oil from the Middle East. If an oil supply interruption occurred – as a result of war, embargo, or political change in the Middle East – the U.S. and the International Energy Agency (IEA) would act to address the crisis. The Asia-Pacific countries have no system of collective response. They have no slate of demand side

measures to put in place, and they have no strategic reserves. In a crisis, developing countries in Asia would be free riders on the IEA's emergency response system, weakening the effectiveness of that response.

The U.S. and the EU would respond to a crisis by drawing down their strategic reserves, with most of the crude oil being refined for product in American, European, and IEA country refineries. Major oil consumers without strategic stocks, such as China and India, would have to compete on the world market for crude oil and product, paying a very high premium for scarce supply or failing to obtain sufficient oil and product for their consumers. In a serious supply interruption, Asia-Pacific economies would be disproportionately impacted. In addition to taking care of our own economies, we would need to share crude supplies with Asia-Pacific countries (other than Japan and South Korea, which are already IEA members), or see Asian economies disproportionately damaged as the West outbid the East for oil supply.

The Energy Information Administration projects that developing countries in Asia will represent the fastest growing region for petroleum demand through 2020, accounting for 37 percent of total world demand growth for the forecast period. By most accounts, China is slated to double its oil consumption by 2020, from 4.2 million barrels/day in 2000 to 10.5 million in 2020. Unless purchasing patterns change, growing demand will make

China and the entire Asia-Pacific region increasingly beholden to Saudi Arabia and the rest of the Gulf countries for their economic survival. Import security is a serious issue for China and its neighbors; if it is not addressed, America's already weak ability to stem Chinese exports of nuclear, missile, and conventional weaponry and technology to our adversaries could diminish even further. Collaboration between China and Saudi Arabia, which is already growing, could be a strategic liability if a future Saudi government proves even less able, or less inclined, to deny the use of its financial resources to groups hostile to U.S., European, and Russian interests.

POLICY RECOMMENDATIONS

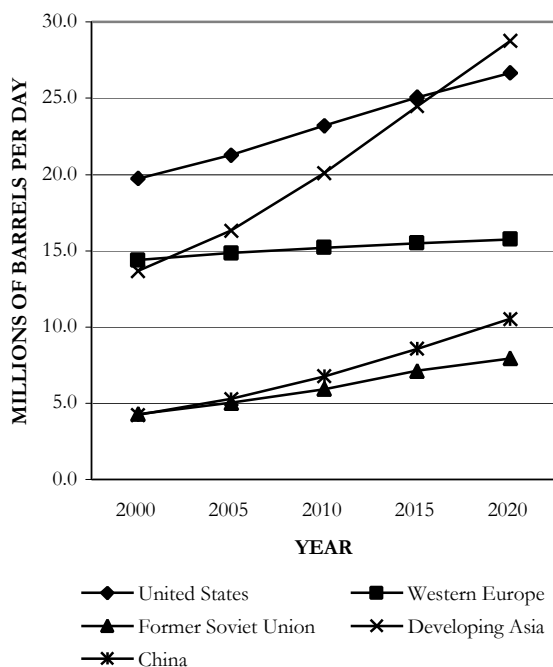
A New Energy Security Policy

Consigning Asia and other regions to dependence on Middle East oil is a geopolitical risk that the United States, Europe, and Russia should not and need not take. We can insure the U.S., the Asia-Pacific region, and indeed the global market against an oil supply disruption arising out of the Middle East by building a Global Strategic Petroleum Reserve and by creating an Asia-Pacific Emergency Response System. We should exercise American and Russian leadership in the G-8 and in the Asia-Pacific Economic Cooperation process to create these new mechanisms. By doing so, Washington, Brussels, and Moscow will create a powerful trilateral counterweight to OPEC influence.

Asia-Pacific Emergency Response System.

Through the IEA, or through a coalition of the willing, the West should create a framework whereby Asia-Pacific governments can systematically communicate with each other in case of an oil disruption, avoid vicious competition for scarce resources, and consider demand-side measures they could take to respond to an interruption. The IEA should create an associate membership or "living room" for IEA membership, much like the Partnership for Peace has done for NATO, to provide policy expertise, training, and a cooperation framework for consuming nations.

PROJECTED OIL CONSUMPTION, 2000-2020



SOURCE: United States Department of Energy. Energy Information Administration., *Annual Energy Outlook 2002*, DOE/EIA-0383(2002) (Washington, DC, December 2001), Table A21; and World Energy Projection System (2002).

A Global Strategic Petroleum Reserve.

More critically, however, we need to create a Global Strategic Petroleum Reserve that would store, at a minimum, 30 days worth of Asia-Pacific consumption at facilities near those markets. Estimating 30 days of regional demand (excluding Japan and South Korea) at 12.5 million barrels/day, we would need a reserve of 375 million barrels to start. At \$25 a barrel, this would require financing of about \$9.4 billion. Compared to the investment America alone makes in defense and homeland security, this would be a relatively modest allocation for the U.S., Europe, and Russia. (The Bush Administration requested a \$45.5 billion increase in the U.S. defense budget in FY03 over FY02, a 13% increase.)

A GSPR would be, in effect, a global energy insurance policy. A reserve would yield five strategic benefits:

- First, the existence of a substantial reserve, in tandem with America's SPR and the IEA system, will put an implicit check on OPEC's ability to raise oil prices. No reserve should be used as a tool to intervene in the market in the absence of a supply emergency. OPEC will understand, nonetheless, that excessive constraints on supply could create such an emergency. A new reserve could also send a signal to exporting countries that there is an off-quota source of demand for their oil. This is especially relevant for countries like
- Second, in the event of a supply interruption, real supplies of crude oil would be close and available to Asian markets.
- Third, the consuming nations of the world would have a new and powerful tool to prevent a market failure by vastly increasing the ability of governments to provide supply liquidity in the event of a panic. This liquidity, which only the U.S. can effectively provide at present, could deter economic coercion by producing countries and prevent hoarding or even crisis in the Asia-Pacific region. New mechanisms for communication among these governments would facilitate transparency and build confidence during a crisis.
- Fourth, a reserve could mitigate OPEC's long-term dominance over Asia. Western protection of Asian economic security would bind that region closer to the West. Russian commitment to provide the oil for the reserve would give Asia an assured diversity of supply, greatly reducing OPEC's ability to exercise coercive power over China or other countries.
- Fifth, granting Russia and Central Asian nations preferred status as suppliers to a GSPR will allow them to fulfill a public role

Russia, Mexico, and Venezuela, which are voluntarily restraining their production to the detriment of their economies and ours.

as partners in energy security, and give real substance to rhetorical commitments of renewed energy security partnerships between the U.S., Europe, and Russia. Their participation should be structured to improve the global competitiveness of Russian firms and foreign investment in Russian energy companies.

The GSPR could also be supplied by other non-OPEC nations that welcome foreign investment in their hydrocarbon sector. This initiative need not antagonize OPEC, whose members welcome the creation of strategic stocks by consuming nations. At a time when it appears that the oil market will be oversupplied over the next 7-10 years, OPEC nations will look favorably on efforts by consuming nations to purchase oil in amounts greater than global demand would otherwise warrant.

Structuring a New Reserve

Ideally, the consuming nations of the Asia-Pacific region would each create reserves of their own, adopt IEA-style policies on the use of reserves, and soon have them in place. This, however, is unlikely to happen. The costs of tankage, as well as the cost of the fuel purchase itself, would be prohibitive for some countries, like India, that need it most. China is beginning to create a reserve for 25 days of consumption, which is a good start. But even this plan is too small, and it may operate under rules different from those that would benefit the global market.

The most effective and realistic way to create a GSPR is for the IEA to oversee the creation of a structure that would be financed by the G-8. Physically, a GSPR could be located in several places in the region – in unused salt domes, demobilized military facilities, and if necessary, new tankage that could be created at strategic locations. To guard against manipulation of the oil market, the IEA should create a reserve that would be managed under IEA policy guidelines. The G-8, for its own energy security, should collectively finance the purchase of the oil. Russia, or IEA members, could provide contributions in kind, rather than in cash. The authority could be self-financing and self-sustaining. It could sell Asia-Pacific and other countries options or drawing rights on the reserve and collect fees necessary to maintain the operation itself.

With forceful leadership in the United States, Europe, and Russia, a Global Strategic Petroleum Reserve could be created this year.

- The U.S. and Russia will meet this October in Houston to collaborate on energy security. Both should endorse a GSPR as a priority objective. G-8 Energy Ministers, including Russia's, who met in Detroit this past May, should create a working group to prepare this initiative by the next G-8 Summit in France. G-8 leaders should task the IEA with creating a framework for a GSPR and recommend to leaders that they commit the financial resources to fund both the creation of the reserve and the

purchase of the necessary crude oil. They should also task the IEA with creating an IEA Energy Security Partnership that welcomes Russia, China, India, and other consuming countries to coordinate on data sharing and emergency management planning.

- APEC leaders meet in Mexico this October. They should continue an effort to look at strategic stocks begun at the APEC Energy Ministers' meeting in May 2000 by endorsing the creation of an Emergency Response System and a GSPR. They should also pledge their ministries to cooperate in the development of these initiatives and commit themselves to have both operational in 2003.

For a relatively modest investment, the U.S., EU, and Russia can together build a global reserve for petroleum. In doing so, we will greatly improve our ability to manage a major supply interruption. We will provide economic security for the Asia-Pacific region. We will create a serious counterweight to OPEC's market power. We will enhance the relevance and power of the International Energy Agency. And, the EU, U.S., and Russia can solidify and strengthen their relationship and take an important step toward pursuing common strategic interests with China.

The time is ripe for this new alliance for energy security. We should not miss this historic opportunity.

The views expressed here are the authors' own and do not necessarily reflect those of the EastWest Institute, its Directors, staff, or sponsors.