

## Energy, Resources, and Geopolitics



Global Leadership Seminar, September 26-29, 2007  
Tufts University European Center, Talloires France

Summary Report  
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## Preface

This report covers the second conference of a new initiative to foster dialogue between students, faculty members, and personalities with a rich practical background in private or public international organizations, drawn from Europe, the United States and Asia. The Global Leadership Seminar is a unique project in scope and aspiration. At this stage, the participating universities include five leading graduate schools of international affairs and public policy: College of Europe, Bruges, Belgium; Fletcher School of Law and Diplomacy at Tufts University, USA; Graduate School of International Studies of Yonsei University, Korea; Lee Kuan Yew School at the National University of Singapore, Singapore; and the Master of International Affairs and Governance Program at the University of St. Gallen, Switzerland.

The Global Leadership Seminar 2007 was again held at the Tufts University European Center in Talloires, France from 27-29 September. The center provides state-of-the-art conference facilities in a renovated medieval Benedictine monastery, located in a scenic village on the shore of Lake Annecy in a beautiful mountain setting. The event combined a two-day Student Seminar with 35 participants—seven from each school—and a one-day Leadership Seminar with students, faculty members and practitioners. The Student Seminar focused on "Institutions and Processes of Global Economic Governance". After a general discussion of theories of international governance, the seminar concentrated on legal, political and economic aspects of the World Trade Organization (WTO). Prof. Dr. Simon Evenett (economist, University of St. Gallen), Prof. Dr. Ann Florini (political scientist, Lee Kuan Yew School at National University of Singapore), and Prof. Dr. Joel Trachtman (professor of international law at the Fletcher School) chaired the sessions and facilitated a wonderful learning experience for the international group of students.

The Leadership Seminar of September 29, 2007 convened upper echelon managers and administrators from private and public organizations together with faculty members and students from the five participating institutions for an informal, broad-based exchange of ideas focused on the topic, "Energy, Resources, and Geopolitics". Energy resources are distributed very unevenly between world regions, and geographic location of supply does not match the distribution of demand. These disparities are a potential source of economic and political strain and pose serious challenges for political and business leaders in times of turmoil.

The discussions were enhanced by short presentations which provided factual background and raised critical controversial issues. Their clarity and thought-provoking inputs greatly contributed to the understanding of these complex questions and proved enormously helpful for the deliberations. I thank the presenters in alphabetical order for their very helpful insights:

*Anders Aslund*, Senior Fellow, Peter C. Peterson Institute of International Economics, Washington, D.C.

*Hans-Peter Bauer*, Senior Advisor to the Wolfsberg Group and the Basel Institute of Governance

*Charles Bralver*, Executive Director of the International Business Center at the Fletcher School of Tufts University

*Ann Florini*, Visiting Professor and Director of the Centre on Asia and Globalization of the Lee Kuan Yew School of Public Policy at National University of Singapore

*Giacomo Luciani*, Senior Adviser, Gulf Research Center, and Visiting Professor at the College of Europe, Natolin Campus

*Peter Nolan*, Professor of International Business, Judge Business School, University of Cambridge

*Vahan Zanojan*, Chairman and CEO of PFC Energy International.

The meeting respected the Chatham House Rule enabling participants to express their personal opinion without risk of public disclosure. Nevertheless, we find it helpful to make the main results of the discussion available to a wider public. Christoph Frei authored the following report, which gives a candid summary of the issues discussed and the areas of convergent interpretations. Readers should keep in mind that the reported facts and figures reflect the situation as of fall 2007, when the conference took place. I am convinced that I speak for all participants in thanking Christoph Frei for his lucid summary of a rich if not always fully coherent discussion.

In closing, I want to express my deepest gratitude to the institutions and organizations which made this seminar possible. The Ecosciencia Foundation and the Holcim Group have provided invaluable financial support. Tufts University offered their splendid European Center in Talloires on the shores of Lake Annecy. The hospitality of Gabriella Goldstein, Director of the Tufts European Center, and her staff makes the Center a place to remember far beyond its physical attraction.

Heinz Hauser

# Energy, Resources, and Geopolitics

Christoph Frei, University of St. Gallen

## Introduction

Coping with change, coming to terms with transformation, these were the guiding threads and targets of our discussions in September 2006. One year later, the focus has shifted, yet coming to terms with change and transformation is—once again—the main objective of our exchange. Renewed control of the Russian government over strategic energy resources and, more generally, recent developments in world commodity markets raise a multitude of questions.

The broad subject-matter of the colloquium—“Energy, Resources, and Geopolitics”—was structured into five sessions to give greater focus and thrust to our exchanges. The summary presented here does not make any claims to completeness. All it hopes to achieve is to concentrate on selected focal points, questions as well as answers, which may in turn serve as starting points for further exploration and discussion. Last but not least, readers should keep in mind that the reported facts and figures reflect the situation as of fall 2007.

## I. The Two Faces of Russia

Early in 2004, Andrei Shleifer and Daniel Treisman published a provocative article in *Foreign Affairs*. Russia, they argued, had become a country just like any other with per capita GDP comparable to that of Argentina or Mexico. “Almost all democracies in this income range are rough around the edges: their governments suffer from corruption, their judiciaries are politicized, and their press is almost never entirely free. They have high income inequality, concentrated corporate ownership, and turbulent macroeconomic performance. In all these regards, *Russia is quite normal.*”

The assessment rang true at the time. Ever since, however, the imbalance between economic freedom and those political “rough edges” has grown. As President Putin’s second term is drawing to a close, Russia is a market economy, but no democracy. We shall look at the economy first.

### A bright economic picture

In hindsight, it looks as if the terrible financial crash of 1998 was the catharsis that Russia needed in order to complete its transition to a market economy. Ever since, the country has staged an impressive economic recovery. Today, it is one of the world’s ten biggest economies. Between them, foreign-exchange reserves and the stabilization fund are worth over \$500 billion, up from nothing after the 1998 devaluation and default. Foreign investment may have hit \$45 billion in 2007 and Russian companies are themselves increasingly investing abroad. All of this is reflected in rising living standards and a burgeoning middle class that is busily splurging on cars, washing machines and holidays abroad.

A key feature of market economies is that economic decisions are predominantly made by free individuals and independent firms. On that account, Russia has come a long way over the last decade. Its allocation system is mostly private and independent. No state planning committee tells enterprises what to produce, nor does the state allocate goods to consumers. Prices and trade are predominantly free, and state subsidies are small. Transactions are overwhelmingly monetized, financial markets have evolved.

Thus the private sector is firmly established. In 2006, it contributed 65 percent of Russian GDP. The number of private enterprises is increasing by 7 percent a year and has done so steadily since 1999. With 5 million registered private enterprises and at least 4 million registered individual entrepreneurs, Russia has a total of well over 9 million firms, which means one enterprise per 16 people—approximately as many as in Western European countries. Stock market capitalization has reached \$1 trillion, equalling the country's GDP, as is common in Western Europe. The World Bank and International Finance Corporation *Doing Business* index (2006) ranks Russia as 96<sup>th</sup> among 175 countries—average, that is. Russia receives its best rankings for enforcing contracts (25), starting a business (33), and registering property (44). The final proof of Russia's status as a market economy is that since 2004, the European Union and the United States have recognized Russia as such according to exceedingly strict legal criteria.

Privatization may have slowed down, but it continues. Russia's power industry is being divided up and privatized. Big state corporations are moving from full state ownership toward 51 percent state control. Two major state companies—Rosneft and VTB—made initial public offerings in 2006 and 2007, respectively, to move in that direction. As a result, state-dominated corporations are exposing themselves to assessment by the stock market.

On many accounts, Russia's economic dynamism is impressive. Real growth has been nearly 7 percent annually since 1999. In current dollars, Russia's GDP has even sextupled from \$196 billion in 1999 to \$1.2 trillion in 2007. This corresponds to a staggering annual increase of 25 percent. Russia's GDP *per capita* at current exchange rates is still lagging behind Portugal's, but is four times higher than China's. In a recent paper, Goldman Sachs projected that even with an average annual growth of 'only' 3.9 percent, Russia's GDP would overtake Germany's in 2028, and Russia would become the fifth largest economy in the world behind the United States, China, Japan, and India. Incidentally, the Goldman Sachs study preceded the current oil boom, which has further boosted the Russian economy. Since 1999, the oil price has soared from \$15 to \$100 a barrel.

Another factor stimulating Russia's markets is the country's fast integration in the world economy. Russia's total exports have surged from \$42 billion in 1992 to \$305 billion in 2007. It is true that much of the increase has come from rising oil prices, but Russia's economy is gradually diversifying. While oil and gas sales accounted for 63 percent of exports and 50 percent of tax revenues in 2006, officially they accounted for only 9 percent of GDP. Since domestic energy prices are held low artificially, it is legitimate to double that number to 18 percent of GDP. Still, economic growth is clearly not driven by raw materials, but by rising demand in various fields such as construction, retail, banking, and manufacturing.

Let us briefly touch upon the fundamental conditions fostering Russia's steady and rapid economic growth. The first is the establishment of a full-fledged market economy based predominantly on private enterprise and a liberal tax system with moderate and relatively flat tax rates. The second is that the severe financial crash of 1998 traumatized the Russian government, so to speak, into maintaining a strict macroeconomic balance. The third is a single-minded focus on economic growth on the part not only of the president but also of the aca-

demic and intellectual establishment. Peer pressure from neighbouring countries may be strong as well. The entire Eurasian region from China via India to the Baltic States has been growing steadily by 7 to 11 percent a year since 2000.

Yet another indication of remarkable dynamism is the fact that Russia is gradually turning into a middle class society with those middle income segments accounting for at least 20 percent of the total population. Ever more young Russians opt for higher education. According to UNICEF statistics, the share of Russian college-age youth that go to university nearly doubled from 25 percent in 1989 to 47 percent in 2005. On the basis of a broader definition of higher education, UNESCO arrived at 71 percent for 2005, which is more than the average number for the European Union.

These are spectacular figures, which confirm the impression one often gains when looking at the BRIC states: the economy is prospering.—But how about the political situation?

### **Authoritarianism instead of democracy**

As early as July 1986, Mikhail Gorbachev asserted that something extraordinary was happening in his country: “I would equate the word *perestroika* with revolution.” In hindsight, it may be argued that Russia’s capitalist revolution succeeded because a critical mass of reforms had been undertaken early on. In particular, prices and imports were liberalized and decisive, large-scale privatization launched. These radical and early steps, boldly taken in a brief window of opportunity, irreversibly implanted a market economy.

The problem with democracy, on the other hand, was that the short period of extraordinary politics was not really exploited. Democratic institutions were never properly built up. Boris Yeltsin never once gave a big reform speech on democracy, an indication that ideas along these lines were lacking or had a low priority. As no political reform was under way, no political reformers were brought into the government, and there was nothing to implement. The empirical evidence is strong. While Russia became a market economy after only a couple of years of transition, it has persistently grown less democratic since 1992. A country’s degree of democracy, or the quality of its civil and political rights, is authoritatively assessed by a renowned NGO. Freedom House rated Russia as ‘partially free’ from 1992 to 2003, and ‘not free’ ever since. In fact, the political situation has steadily deteriorated from 1992—when the country was close to ‘free’—to its present state of mild authoritarianism.

Ever since he became acting president on the last day of 1999, Vladimir Putin has moved progressively to snuff out even the faintest flickers of democracy that he inherited from Boris Yeltsin. He has crushed opponents, emasculated the courts and parliament, eliminated independent broadcast media, scrapped the autonomy of Russia’s regions and blatantly manipulated elections. In short, President Putin has managed to dismantle all democratic institutions and build a highly authoritarian system. Today, Russian state TV spews nationalist propaganda, and if Putin himself does not encourage racism, he does call for ethnic discrimination in favor of Russians.

There are many different views about Vladimir Putin and his policies. Some observers suggest that all the man cares about is power. Putin’s grandfather, after all, was Stalin’s cook. In this perspective, Putin appears as cold, conniving, and immensely ambitious. A shrewd manager of his own image, he has established a strong personality cult reminiscent of the czars, not least with the aid of broad and firmly entrenched youth organizations such as *Nashi*. A politician rather than a statesman, he seems to pursue neither higher purposes nor a political vision. His main objective, instead, is power—the more of it, the better.

The notorious fact that Putin is driven by personal ambitions is put in perspective by other observers. They refer to the broader historical context in the aftermath of the collapse of the Soviet Union—and to the remarkable degree to which both political clout and state capacity were destroyed at that time. Mr Putin, according to this view, came to power at a critical juncture when the primordial task was to restore Russia's influence abroad and the government's power at home. Small wonder, then, if he chose to pursue an increasingly assertive, anti-Western foreign policy in the name of re-establishing Russia's greatness. Also, it can come as no surprise that he would, indeed, embark on a major exercise in re-building state capacity. State-owned and re-nationalized industries thus appear as mere instruments in a larger, systematic campaign. Democracy never was an objective, let alone the primordial one.

While President Putin has certainly managed to restore centralized power, many Russians find it hard to see a stronger government today. They still have to put up with a patently flawed bureaucracy, notoriously weak law enforcement, and poor public infrastructure. The common denominator of all these problematic sectors is public ownership. Bad governance and state failures, in turn, are reflected in endemic corruption, high murder rates, and high numbers of traffic deaths. Few social indicators have actually improved for ordinary citizens. Sadly, drawbacks of this kind are common features of the new Russia, and they are not likely to go away. Corruption, in particular, has become more pervasive than ever, and it is sometimes quite difficult to escape the impression that it is a driving force in the upper echelons of business and politics. Particularly at those higher levels, being corrupt is totally acceptable.

Putin, it seems, has reintroduced major elements of the failed czarist system: over-centralization, minimal feedback, and pervasive corruption. The more power he secures, the more carefully he delimits the core of his base, a personalized structure that consists mainly of old KGB cronies from St. Petersburg. What, then, holds this structure together? One interpretation is that Putin, really, is a Godfather who has split the elite into fiercely competitive groups to make sure that all sides need his arbitration. Each group of his men sit on one or several state companies. Since these corporations pertain to different industries, they often have opposing interests and cannot collude.

It has long been obvious that Vladimir Putin is determined to stay in control when his second term as president of Russia expires early in 2008. The only question was just how the country's ruler proposed to skate around the constitutional limit of two consecutive four-year terms in office. The simplest approach would have been to change the constitution. But even to Mr Putin that must have seemed too bare-faced. Instead he placed himself at the head of the pro-Kremlin United Russia party, prior to the manipulated parliamentary election of December 2007. The two-thirds majority that United Russia then gained in the Duma could thus be interpreted as a personal mandate. Next came the announcement that he favored Dmitry Medvedev, his protégé, legal adviser and first deputy prime minister, as United Russia's candidate in the presidential election on March 2, 2008. Judging by the conduct of all recent elections in Russia, Mr Medvedev will be a shoo-in. The third card was played a day later, when Mr Medvedev shyly let it be known that upon becoming president he wanted Mr Putin himself to serve as his prime minister... History, of course, suggests that Russia cannot cope with two czars. More likely, Mr Putin will go on ruling and arbitrating at home, perhaps leaving foreign policy to Mr Medvedev. Be that as it may, the cynicism of the Kremlin's 'Operation Successor' is truly worthy of the old KGB, Mr Putin's former employer.

## **Worries, grievances, and prospects**

For many years, demographers have claimed that the Russian population would decline by as much as one third over the next 50 years. According to recent findings by the World Bank, however, the Russian population has barely shrunk by 3 percent in the last 17 years, whereas many post-Communist countries have lost between 15 and 30 percent of their respective population. The explanation is easy: Russia has benefited greatly from the immigration of millions of people from former Soviet republics, many of them ethnically Russian and all of them Russian-speaking.

A major concern, however, is that male life expectancy has fallen quite dramatically since the collapse of the Soviet Union. For years, the figure has lingered around 59 years, which by all standards is extremely low. The main killer is cardiovascular disease, followed by manifold types of violent death. The overwhelmingly accepted explanation is excessive alcohol consumption. Russian women, by contrast, live 13 to 14 years longer than their men and enjoy a more or less 'normal' life expectancy for a relatively developed country. Strangely, the Russian government pays precious little attention to alcoholism and does hardly anything to improve the situation.

What are, more specifically, the country's economic worries? Concerns about the oligarchs' dominance of the economy appear exaggerated. They may wield power in heavy industry, primarily energy and metals, but in energy they are increasingly squeezed out by the state. Furthermore, the oligarchs do not own a large share of the economy and, in fact, face severe market competition. The approximately 30 oligarchic groups probably contribute about one quarter of total GDP in all.

Another threat, however, is real. It is the threat posed by a centralized state willing to expand its control through systematic re-nationalization. This re-nationalization occurred in steps. When international oil prices took off in 2004, Russia's state treasury was flooded with easy money. Initially Putin's men took charge of the main state enterprises in energy, transportation, military production, and banking. As a consequence, the private share of Russia's oil production fell from 90 percent in 2004 to 45 percent in the second half of 2007. The impact was immediate and drastic as both production and investment fell sharply. Currently, the state accounts for 85 percent of gas production and 55 percent of oil production.

The overall pattern is clear. State enterprises are buying good private companies either at a high price in a voluntary deal including sizable kickbacks, or the sale is forced and the price is low. Beyond a controversial effort to enhance government capacity (see above), no economic rationale is evident, socialist or ideological motives are conspicuously absent. The most likely purpose of re-nationalization is crude, direct rent-seeking and corruption.

Thus, we may be well-advised to look at Russia's current energy policies not in terms of 'energy policy' proper, but in terms of corporate policy. Overall, Russian state-dominated companies are remarkably focused on their stock prices. Some of these companies hold monopolies, the most notable example is Gazprom with its 51 percent public ownership. Foreign investors happily buy these stocks as they are reassured that companies with excellent Kremlin contacts can purchase valuable Russian assets cheaply. Apparently, these assets and related prospects are so attractive that little or no attention is paid to limited transparency, corporate governance or even poor economic results. In fact, in view of short-term maximization of gas (and stock) prices, Gazprom has little incentive to raise production. The contrary is more plausible. In the short term, a strong incentive is to reduce production of gas rather than invest in the company's long term productive development—a remarkable calculus

indeed. And in fact, Russia's energy sector has nearly stagnated since 2004 when the oil bonanza started.

The worst economic scenario for Russia is that continuous re-nationalization renders the state sector dominant again. Then, however, the Russian state would be killing the private geese that have been laying all those golden eggs it is living off. Yet, re-nationalization is more likely to be limited on several grounds: the focus on economic growth, the absence of socialist ideology, and the faster growth of private enterprises. Neither the dominant private sector nor the market economy appears to be in danger. The higher the oil price remains, however, the worse Russia's economic and energy policies are likely to be. In this view, the country is indeed suffering from an oil curse, if not one in macro-economic terms. This focus on the short run and on large profits is at the expense of longer-range, strategic considerations, at the expense of reforms and investments.

What about political prospects? In the short term, there may be little or no reason for optimism. The farther we are looking ahead, the brighter the prospect becomes. Historical experience shows that economic and political pluralism has largely developed in parallel, with market developments usually preceding democracy. Perhaps Russian society is already too rich, too economically pluralist, too educated, and too open at this time to be ruled in an authoritarian way for much longer. A natural development would then be that Russia in due time will throw off its authoritarian yoke and opt for more genuine and more tolerable versions of democracy.

## **II. Russia and European Energy Security**

In the wake of the collapse of the Soviet Union, hopes were high that Russia and Central Asia would become privileged energy partners to the OECD. Throughout the 1990s and beyond, the standard view was that Russia, with its huge reserves of oil and gas, was a reliable alternative to a Gulf region seen as threatened by social and political instability. Today, President Putin's Russia is increasingly perceived as making political use of energy supplies, becoming a nationalist and unreliable partner, and a threat to European security. – What has gone wrong?

For some time, European hopes seemed justified. Given its market economy, a strong and booming private sector, macro-economic stability, growing technological capabilities and an increasingly well-educated population, Russia looked different from Saudi Arabia—and there still are good reasons to believe that the conditions for genuine industrial development are in place. In fact, why should Russia not keep developing in the direction of becoming an exporter of diversified, sophisticated manufactured and industrial goods?

The key to a plausible answer is, again, to be found in oil. If you have an export item the price of which jumps from \$15 to \$90, incentives to diversify strongly diminish. Where oil and gas become the essential source of national income and political influence, the essence of power resides in controlling the energy sector. Small wonder, then, that President Putin reasserted control over Gazprom and progressively laid his hands on 'independent' oil companies. Again, we touch upon his policy of creeping, undeclared re-nationalization.

Due to remarkable shifts in the price of energy, Russia has turned into a rentier state—a regime which derives a substantial portion of its national revenues from selling natural re-

sources. In a rentier state, the ruling elite have little interest in establishing a complex fiscal infrastructure and inducing decent tax returns. They do have every interest, however, to keep the citizens in line politically—and start collecting the oil rents themselves. For a long time, rentier state theory has been advanced to explain the predominance of authoritarian regimes in the Middle East and the apparent lack of success of democracy in the region. In this context, however, Russia is no different from Saudi Arabia, Iran, Kuwait and other states in the Gulf region.

A dire conclusion is obvious, then: In the foreseeable future, Russia will not provide the reliable alternative that Europeans have been hoping for with respect to gaining a secure energy supply. Instead, we may expect Russia's behaviour to be increasingly in line with the behaviour of many other oil-exporting countries. Given today's incentives, re-nationalization of oil resources and the squeezing out of foreign companies merely reflect a rational pursuit of economic interest. If the ruling elite and their powerful networks have what it takes to extract natural resources on their own and capture the rents, why would they let others do it in their place?

Thus Russia and its big state-owned corporations pursue rent maximization as best they can. Gazprom's immediate interest is to increase domestic prices gradually and, at the same time, to increase anachronistically low prices offered to their neighbours in former republics of the Soviet Union. In that context, too, rational choice is bound to replace brotherhood and solidarity.

### **Security yes, competition perhaps**

On the eve of Bastille Day 2007, Vladimir Putin handed a royal present to the newly elected Nicolas Sarkozy, by allowing a national French company into Russia's energy sector. After years of deliberations, Gazprom had chosen France's Total to develop a giant offshore gas field in the Arctic. Under the deal, Gazprom will retain 51 percent of the new infrastructure company that will develop the field, and 100 percent of the actual reserves. The decision to strike a deal with Total perfectly fits in with Russia's tactic of striking bilateral energy deals within European countries and converting their national energy companies into lobbyists for Moscow's commercial and political interests.

The expansion of Gazprom and other Russian champions into Western markets has long been a Kremlin ambition. The deal with Total completes a set of joint ventures that Gazprom has built with Germany, Italy, Britain and France. Germany's former chancellor, Gerhard Schröder, is the boss of a joint Russo-German consortium that is building the Nord Stream pipeline across the Baltic Sea to Germany. He is one of the Kremlin's most vocal advocates. In Italy, Gazprom has a warm relationship with ENI and Enel. Also, ENI is Gazprom's partner to build an extension of the Blue Stream pipeline across the Black Sea. And just as the relationship between Russia and Britain reached new lows, BP agreed to enter a joint venture and swap assets with Gazprom.

So far, Europeans have kept energy largely within national borders. As a result, the cost of energy is more unevenly spread and higher than need be. Commercial customers in different countries are charged energy prices that vary by as much as 100 percent across what is supposed to be a single market. After months of consultation and investigation, Andris Piebalgs, the EU energy commissioner, concluded that big vertically integrated firms (that is, firms that both provide energy and also transmit it) are the main reason why Europe's energy market is so dysfunctional. Examples include France's EDF and GdF (to merge with Suez this year),

Germany's E.ON and RWE, Italy's Enel. These players, Piebalgs argues, keep prices unsteady and high, shut rivals out of their transmission networks and avoid reinvesting their profits in improving networks, as to do so would only increase competition.

Thus, two sets of opposing interests clearly collide. On the one hand, there is the European Commission and its explicit intention to create a transparent, competitive, and fully integrated European energy market. To accomplish that, the Commission would have to break up the oligopolistic structure that is currently operated and controlled jointly by European incumbents and Russian champions such as Gazprom. These integrated companies, in other words, would be forced to unbundle their gas pipelines or electricity grids into separate companies—or keep them but run them through independent operators. The idea is to open the European market by making it easier for small energy companies to buy and sell power across Europe, with the hope that this would lower prices. New and independent network companies would be more likely to upgrade facilities by improving cross-border links, for instance.

Gazprom and the big European energy conglomerates, on the other hand, have every interest in preserving a system that has generated fairly generous rents for a long time. In a recent speech, Wulf Bernotat, Chairman of E.ON, compared the Commission's pursuit of unbundling to the hunting of a mythical beast, and called for strong European energy companies. Given their economic position (and their owners, e.g., EdF), it goes without saying that the European incumbents have powerful allies on the political side. The French government, for one, insists that the European Union needs vertically integrated energy giants to bargain with Russian and Algerian gas suppliers. Germany, Austria, Bulgaria, Greece, Latvia and other governments are stonewalling, too. German and French regulators keep arguing that they have already done a lot to reduce the oligopolies held by their respective champions—and that it is possible to create a competitive market without resorting to unbundling.

Thus, much as the European Commission wants to unbundle generation and distribution of energy, the powerful opponents of liberalisation have a very different view of how the industry should look like. To complicate things further, it is fair to say that the current oligopolistic equilibrium hardly threatens price stability or the security of supply—which is what consumers care for most of all. Thus, the current *regime* clearly provides an arrangement around which, to paraphrase Stephen Krasner's famous definition, *many interests converge*. Given this natural alliance, it is hard to see why the current regime should give way.

To be sure, a more competitive system might eventually entail lower prices. Governments such as the ones mentioned above, however, seem hesitant to commit to reforms, not least for fear of short-term price variations. Therefore, we have every reason to expect more cozy arrangements and friendly competition among a small number of big players. For the time being, there is no European power grid, no European gas storage and not much of a competitive European energy market.

Incidentally, Europe's energy supply may be less secure than is commonly assumed for a different reason. Given Russia's notorious short-term profit orientation and, consequently, its lack of interest in developing its infrastructure, the Europeans may well face problems not so much because of the political relationship with Russia, but because the Russians might not maintain their export capacities over the medium term. If Gazprom, for example, should fail to develop the Shtokman fields in the Arctic as planned (its target is 2013), the Nord Stream pipeline now being built across the Baltic Sea to Germany will remain empty. In fact, there might be shortages as early as in 2010, and the European Union would be well advised to 'inquire' after the Russians whether and how they will secure gas supply after 2010, and to

push the construction of the Trans-Caspian Pipelines so as to diversify routes of supply sooner rather than later.

### III. A Paradigm Shift in Energy Markets

After devoting the second session to European energy security, the colloquium turned its attention to recent developments and prospects in the energy markets as such. Energy producers, energy users, and governments face a triple challenge over the next fifty years: providing two or three times as much energy as today; keeping energy supplies secure and price volatilities low; and reducing environmental impacts of energy provision and use. Meeting that challenge will depend not least on whether and how the major players in the energy markets cooperate. These major players are commonly referred to as NOCs and IOCs, that is, state-owned *national oil companies* and privately-owned *international oil companies*. Examples of the former include Saudi Arabia's Aramco, Brazil's Petrobras, or Malaysia's Petronas; well-known IOCs are British Petroleum, Exxon Mobil, Royal Dutch Shell, or Total.

For many years IOCs and NOCs were partners in mutually beneficial cooperation. The IOCs' main goal in this context was to gain *access* to reserves, that is, below-ground resources. Since IOCs did not in general own these reserves, access was the crucial variable that decided over growth and comparative advantage.

The IOCs' main contribution under the old paradigm was their command of above-ground resources such as managerial know-how, marketing skills, technology, and (in certain periods of the business cycle) access to capital. Above-ground resources are based or dependent on skills that may be acquired more easily than below-ground resources. Below-ground resources, in turn, are mostly owned by governments. The stewards or proxies who handle related assets are the NOCs. In the past, these national companies used to have little or no command of above-ground resources.

Thus, the old paradigm was remarkably simple. IOCs would offer their above ground resources in exchange for NOCs' below-ground resources. This kind of cooperation was common for more than thirty years. In fact, the old paradigm is still alive in some specific segments of the industry.

Overall, however, the old paradigm has disappeared as a consequence of two interconnected and mutually determining developments. For the sake of greater clarity, we will present them here in sequence.

#### **Good old times gone**

*First* of all, NOCs have evolved. Slowly, gradually they have developed their own above-ground resources by investing systematically in human capital and technology. In some instances, they have found ways around traditional IOC partnerships to get what they want. Technology can be bought, capital is more easily accessible than it used to be, managerial and marketing skills can be acquired over time. From an IOC perspective, then, traditional above-ground resources all but vanished as assets and trump cards in that they simply do not provide comparative advantages any longer.

A telling example of newly acquired and truly exceptional technical skills is provided by Saudi Aramco, today the world's largest oil company by far. Day after day, Aramco produces ten million barrels of crude oil—almost three times as much as the largest and most efficient IOC, Exxon Mobil. Experts add that, in fact, Exxon does not even know what it is like to manage that kind of production. But the remarkable detail here is that this kind of technical and managerial capability on the part of NCOs simply did not exist 20 years ago.

Thanks to this remarkable evolution, NOCs simply do not need IOCs as much as in the past. Ownership structure seems to reflect the shift: Among today's top 50 producers of oil and gas worldwide, more than half are state-owned, and 23 of these have their headquarters in emerging economies. Of the remaining 27 producers, 12 are based in Eastern Europe, leaving just 15 traditional western IOCs. There is a *caveat*, however. Changes in ownership occurred early on, in the 1970s and 1980s. The evolution discussed here is due not to changes in the structure of ownership but to enhanced capabilities on the part of NOCs and ensuing changes in patterns of dependency. Who needs whom and who needs what?

A *second* source of change pertains to politics. At the end of 2007, oil was almost five times as dear as at the beginning of 2002. In light of this latest and rather unexpected bonanza, governments of resource-holding states seem resolved to make the best of their treasures by controlling value chains themselves. What is more, many of them have been prompted to rethink economic development strategies. In their eyes, conventional policies inferred from the 'Washington Consensus' have utterly failed as they led to greater socio-economic disparities and diminished state capacity through privatizations. This time around, governments would like to rebuild and develop their economies with strong state institutions leading the way. In the context of this kind of strategy, they are increasingly relying on their respective NOCs. As a result of changed requirements on the part of their main shareholders, in turn, the mandates of the NOCs have evolved substantially. Their newly acquired above-ground resources and stacks of cash appear as assets that governments are all too willing to exploit in view of the broader expansion and development of their economies.

One consequence is that governments from Ecuador to Kazakhstan are trying to capture a greater share of the industry's bumper profits through NCOs. As they push their national champions to compete for the same oil fields and extraction rights as Exxon, Chevron, and Total, competition gets tougher and more complicated. To make things worse for traditional IOCs, their state-sponsored competitors dispose of comparative advantages that are sometimes hard to beat. Whereas NOCs are, for example, often unbound by governance issues, Western IOCs are subject to all sorts of scrutiny. How do you successfully compete against Sinopec and Petronas in Turkmenistan or in Uzbekistan?

Tough competition is one thing, squeezing out competitors is yet another. If it serves the purpose, governments of oil-rich countries resort to deterring private investment—or to excluding it altogether. In Venezuela the political authorities first raised the royalties on Total's output, and then demanded that the state-owned NOC be granted a majority stake in several fields operated by Total. When the two sides could not agree on one such project, the government simply expropriated the field. The world's oil supply would increase markedly if Total, Exxon Mobil and Royal Dutch Shell had freer access to Venezuela, Russia, and Iran.

Some argue that this is "resource nationalism" pure and simple. Others, however, do not agree. To them, going it alone reflects rational choice rather than narrow nationalism. In this line of argument, oil-rich countries will hardly open up their reserves for exploitation just to make life easier for western companies. Why should they? Why would they have others do what they can do themselves and just as well?

In the end, whether it is a matter of crude nationalism or simply one of rational choice does not matter all that much. The worrisome fact is that the share of global reserves accessible to private energy companies has shrunk dramatically over the last thirty years. In 1970, 85 percent of the world wide oil and gas reserves were fully accessible to IOCs. By 2005, that number had dropped to 7 percent.

At this time, western oil firms are struggling to produce more oil than they did three or four years ago. For one thing, the output of existing fields is declining by 5 million to 6 million barrels per day every year. This means that IOCs have to secure many new fields just to keep production at today's levels—no easy task indeed. What is more, private producers are paying the toll for two decades of underinvestment. Throughout the 1980s and 1990s, when prices and profits were low, they restricted hiring and investment to a minimum; many ancillary firms that built rigs or collected seismic data shut up shop at the time. Today, IOCs are in dire need to produce more, push exploration and secure new reserves, but do not have the staff or equipment they need. Moreover, the fields that Western oil firms are starting to develop are ever more challenging technically and financially.

Thus the first and most important requirement for IOCs—access to reserves—has become terribly fragile. Once, however, you cannot balance your assets, and once you fail to renew your booked reserves in view of next year, you are about to shrink your asset base—a nightmare all around.

In conclusion, the old paradigm has largely gone. For their part, NOCs have successfully developed above-ground resources. They are more competent, more powerful, and more ambitious than ever before. IOCs, in turn, find it increasingly difficult to re-engineer their part of the deal, that is, below-ground access. The result is a broken equilibrium, so to speak, of the traditional 'above-ground' and 'below-ground' relationship. As compared to this shift in paradigms, other trends seem truly minor.

### **Possible implications—a brief discussion**

Early in 2008, Exxon Mobil, the world's largest publicly traded oil company, announced the largest annual profit ever posted by a U.S. company. Do you have to worry when your profits reach \$41 billion in one year?

On the face of it, the good life might continue. More particularly, the fruitful cooperation among IOCs and NOCs need not necessarily stop anytime soon. Today's NOCs may indeed be more sophisticated technologically and stronger financially, yet they, too, will continue to benefit from an intelligent division of labour. They may not want the same thing from IOCs, but they still want something in the future. Optimists, then, hope and expect new partnerships around shared long-term interests such as improved recovery of existing reserves, maintaining security of demand, limit price volatilities and reducing environmental impact.

Sceptics paint a different picture. It is true, they say, that IOCs on more than one occasion have managed to bounce back on grounds of improved technology and new areas of extraction. The question is, however, whether they will accomplish the same feat once again. In the perspective cultivated by the sceptics, the centrality of NOCs in major resource-holding economies is likely to be a long-term phenomenon. This could mean that only those IOCs which enhance specific capacities of NOCs will continue to get some degree of access to resources.

Some IOCs seem to remain in a state of denial. Others try hard to adjust to their new competitive landscape, but do so without a convincing corporate vision. One strategic response is to seek synergies and economies of scale. Here, we touch upon the rationale behind recent mergers and acquisitions. Western IOCs are driven by the demands of capital markets and investment communities. When they cannot grow organically by producing more but still need to demonstrate growth, the idea of buying someone comes easily. Total bought Elf, Exxon bought Mobil, and the process is still going on. Over the last few years, both production growth and reserve growth of major IOCs has occurred through merger and acquisition activities, whereas additions secured through exploration did not manage to replace production.

Mergers and acquisitions may have become popular over the last few years, yet they will carry IOCs only so far. In the medium and longer term, private energy companies are condemned to seek refuge, once again, in advanced technology. Related lines of research and development include the search for new tools to understand the subsurface, drill more productive wells, use digital Smart Field technology to manage reservoirs, realise the potential of Enhanced Oil Recovery, and improve deepwater capabilities. From all we know, it is safe to expect huge investments both on the demand and the supply side of technology.

Obviously, strategic responses depend on strategic beliefs as to the further evolution of the competitive landscape. Will it be possible to overcome current access constraints in the medium or longer term? Just how sustainable is the ascendancy of NOCs? Are they here to stay? More optimistic IOCs who bet on short-term access constraint and transitory NOC ascendancy are likely to focus on volume growth and long-term positioning in the very resource base of today's NOCs either through IOC-NOC arrangements or direct government negotiation. On the other side, less optimistic IOCs who bet on long-term access constraints and sustained NOC ascendancy will be more likely to focus on near-term value maximization and—in the longer term—develop entirely new business models with strategic positioning in unconventional fuels such as oil shale, oil sands, and hydrates.

Are there any direct consequences of the aforementioned paradigm shift for the average consumer? Does it change the dynamics of the markets? Should we expect distortions or even disruptions in the international energy markets?—The experts among us do not think so. The market for crude oil, they argue, has become truly global. Whether it's NOCs or IOCs that produce and transport the juice does not really change the nature of the game. Thus we should not worry much about the security of supply. We should, however, be concerned about secure markets.

The United States, for example, seem to do just that. After 9/11, all previous deals were put on the table. Ever since, and more explicitly than ever before, the U.S. administration seems resolved to trust only in those pillars of national security that they can control—including energy. In a systematic effort to increase control, the Bush administration has opted for unilateral action more often and has also been open to new alliances if need be. To them, the security of markets is of supreme importance: it is through the security of markets that the security of supply is secured. In this context, bilateral treaties (e.g., investment agreements, investor-state-dispute settlement procedures) are helpful in building a more stable environment for transnational companies in the host countries.

#### IV. Recent Trends in Regulation and Compliance

In the face of stiff competition on the part of NOCs, if not governmental “resource nationalism” pure and simple, IOCs understandably yearn for a level playing field. The matter is complicated, however. Both extraction and trade of natural resources are embedded in a strong interface between national governments and multinational enterprises (state owned or private). Appropriate governance of this interface calls for concerted initiative and action. Our focus today thus shifts towards the issue of *regulation*.

Generally speaking, the private sector rarely opposes regulation per se. In fact, many believe that the only thing worse for business than too many rules is no rules at all. Again, companies want a level playing field. Hence they do seek regulation—regulation that is as non-discriminatory and global as possible. The absence of coherent and effective regulation tends to distort markets and leave industries, employees, customers, and communities irritatingly unprotected.

Yet, who should make the rules? On the face of it, there seem to be manifest advantages to government regulation as opposed to self-regulation and privately set standards. One is democratic accountability in governmentally formulated standards; a second is more consistency and openness in the formulation and application of those standards; a third one is more formal enforcement of those standards; a related fourth is that governmental regulations are mandatory while privately-set standards are voluntary in character and thus open to non-compliance.

Thus, there is much to be said for government regulation. In the transnational and global arena, however, public governance—let alone good governance—does not come easily as national governments and international organizations are often unwilling or unable to regulate effectively.

*The financial sector is a case in point.* Here, too, the clamor for reform and regulation is intensifying as the first big banking crisis of the 21st century is taking shape (September 2007). In societies with a well-developed division of labor, services are not exchanged in kind but monetized. Every exchange of goods and services has a financial counterpart. The finance industry, therefore, provides an infrastructure that is indispensable for the operation of today’s economies. Und like every other industry, it is confronted with global problems that call for cooperation and generally recognized ground rules, for instance in policy areas such as Know Your Customer, Anti-Money Laundering and Counter-Terrorist Financing. Global finance, goes the argument, cannot rely on Balkanized domestic oversight.

##### **The Wolfsberg Process—when the private sector turns active**

Throughout the 1990s, bank supervisors at the national level struggled with their respective banking communities to implement regulations in the context of anti-money laundering. The outcome was the creation of a patchwork of rather diverse rules which had the effect of immediately increasing both regulatory competition and regulatory arbitrage, thus enabling the money launderer to profit from such discrepancies between the various financial centers. This was particularly disquieting for internationally active banks since they had to apply these diverse standards concurrently. At the same time, they constantly risked losing clients to competitors operating under a more flexible regulatory framework elsewhere.

Thus the need for harmonization became ever more apparent. Banks waited for regulators to make the decisive move—but nothing happened. When a number of senior political officials were found to have laundered large amounts of cash through US and European banks who, in turn, had displayed too lax an attitude to money-laundering, things evolved. The reputational damage to the banks involved was serious, as became apparent in a report by the US-sub-committee on private banking which levied heavy criticism not only against the banks involved, but also with regard to the very nature of global private banking.

These developments contributed to the creation of a climate of change—with the notable difference that this time the affected banks themselves decided to take a more proactive approach. Upon reporting to the sub-committee, John Reid, then CEO of Citibank, asked his senior private banking management to take all appropriate steps to re-establish Citibank's reputation—and to avoid a repetition of such an embarrassment. This led Citibank to look out for international industry best practice. Swiss banks, too, had come under international criticism for accepting moneys of dubious origin and, in particular, from senior foreign politicians such as Ferdinand Marcos. To them, such criticism seemed unfair, as they felt that the Swiss regulatory environment and its implementation in the banks were much better than the perception thereof abroad.

Thus, when Peter Eigen, founding chairman of Transparency International and Mark Pieth, chairman of the OECD Working Group on bribery and the Basel Institute on Governance, suggested that a group of international banks consider establishing common standards by which they would conduct business, their initiative was more than welcome. Starting in 1999, the twelve largest private banks in the world were united in the effort. Negotiations resulted in a public commitment which in the meantime has become internationally known as the Wolfsberg Principles (see [www.wolfsberg-principles.com](http://www.wolfsberg-principles.com)).

All parties involved agreed that, while they would keep competing on pricing and on products, they would no longer compete on quality of standards. More importantly, it was agreed that the best way to protect the integrity and reputation of the industry was to agree on standards that should apply to activities and organizational units around the world. Global banks need global standards. A real strength of the Wolfsberg Principles lies, then, in the fact that the participant banks commit to apply the rules to all their operations at home and abroad, including in offshore centers. If it may be assumed that the Group members make up more than 60 percent of the world market in private banking, with perhaps 50 percent of market share in each key offshore destination, the Wolfsberg rules appear to have great potential indeed for becoming the leading principles throughout the industry.

This kind of self-commitment, if not self-regulation, has served remarkably well. The Wolfsberg Principles have become the basis for further regulations. Moreover, they have initiated a sustained and ongoing dialogue with both national and transnational regulators. Today, the Group is regularly consulted by the FATF (Financial Action Task Force) and by the Basel Committee of the Bank for International Settlements, which was not the case before. Furthermore, these kinds of consultations have taken on a new and enhanced significance in the context of fighting transnational terrorism.

Representatives of the Basel Institute of Governance feel that their model could and should be taken up and applied to other industries – even though the necessary prerequisites may not always be taken for granted elsewhere. When ABB was facing problems and corruption-related investigations, they contacted the Basel Institute and asked for help in view of applying the Wolfsberg approach of standard setting to a concerted effort in the power industry. Major players of that industry (amongst them Mitsubishi, Alstom, General Electrics, and

Siemens) agreed on a provisional body of standards and were close to success. On the very day of closing the deal, however, all came to naught when one of the partners refused to sign along with another member of the group because the latter was suspected of practices such as active bribery. Clearly, trust is a major factor in this context.

### **A growing scope of regulation in finance**

What sets the financial sector apart from other industries is a wider scope of regulation, more control of activities, and far greater direct financial penalties for violating specific rules and regulations. Also, in the realm of financial services there is a specific authority that actually is in charge of regulations in that it issues, monitors and enforces them. Examples are the Federal Banking Commission in Switzerland or the Financial Services Authority in the U.K. The regulator's task is to license newcomers to the industry as well as individuals. Moreover, it is the role of the regulator to make sure that those who qualify for the license continue to do so. Companies are subject to regular inspections and, in cases of non-compliance, to specific sanctions. Fines, in particular, have increased dramatically over the years. In the United States, everything below a three digit million-figure is considered peanuts. Finally, those who give licenses may also take them away, and the consequences of withdrawal are serious. Nobody can conduct financial business without a license.

Since the industry has learned to take both regulations and regulators seriously, all the major players have set up compliance departments. Their role is to ensure that business is conducted in ways that do not violate the regulations. In particular, compliance departments are supposed to protect the senior management (see the John Reid episode mentioned above). This includes not only that management and employees are being told what the rules are. It has now become good practice that the compliance departments monitor and control actively in order to find out whether there is any wrongdoing within the organization. Thus, regulation commits and even forces companies and individuals to a kind of self-policing activity since, obviously, everyone has a keen interest in avoiding violations and sanctions. One would hardly find that kind of mechanism in other industries.

Self-policing goes so far today that, in many instances, you are obliged to report any wrongdoing or violation committed by your firm as such or by individual employees to the appropriate authorities which then will investigate the matter and take further action if required. Note that employees are obliged to report themselves, which means that they cannot claim certain traditional rights in this context. Moreover, they are expected to fully cooperate with regulators throughout the ensuing investigation. Today, many companies also make provisions in regard to whistle blowing. Under such provisions, employees must have an opportunity to talk to someone if need be. They should, however, never have to go beyond senior management and directly to the Board of Supervisors or even outside the company as this could would necessarily undermine trust within the company.

An example may illustrate the evolution of the sheer dimension of compliance over the years: In the early 1990s, UBS had four compliance officers—two in Switzerland, one in New York and one in London. Today, the total number of staff in the Legal and Compliance Department is in excess of 2,000 individuals. About 50 per cent of these individuals are compliance officers. Thus we are looking at an industry that within fifteen years has grown from four to one thousand. If we assume a cost of 200,000 per compliance officer and roughly include the investment for supporting infrastructure and the like in the calculation, we are looking at numbers of well over 200 million a year. Even as a cost factor, therefore, compliance has be-

come significant. Still, in view of what you want to achieve—that is, avoid multi-million-dollar fines and damages to your reputation—the investment certainly seems worthwhile.

The credibility of the entire system ultimately depends on the credibility of enforcement. In order to make the regulatory framework work effectively, there must be sanctions for those who do not abide by the rules; otherwise, the entire exercise would not go beyond a declaration of good intentions.

One may sneer at the effectiveness of current regulation. It is also true that there is much room for improvement. Swiss banking legislation, for example, does not cover the financial sector as such, but pertains to banks and their activities only. Financial products and services offered by companies other than banks are thus quite free of regulation. Still, the financial industry has come a long way in its regulation and compliance efforts. In fact, it would be rather nice if governments—including European governments—were to support related efforts more consistently. As it stands, there still are irritating limits to government cooperation, particularly where regulation affects the *raison d'état* in all its guises. It is not unusual for governments to turn down investigations into suspected bribery on the part of national champions in the defence industry, for example, in light of lofty concepts such as *national interest* or *secret de défense*. This is irritating indeed as it nurtures suspicions that the private and the public sector operate under different moral and legal standards.

It is easy to carry the argument one step further. If an employee comes across a criminal act within a given bank, he or she is expected to report to the responsible supervisor within 24 hours. When the matter is transferred to public law enforcement, it will take authorities six months or a year to investigate the matter. When the European Union finally decided to look into the wrongdoings of Ms Edith Cresson, it took officials 18 months to do so. Under corporate governance, it would have taken two weeks. When governments of Mediterranean countries manipulate their national accounts and this is public knowledge, there are no sanctions. When banks or multinational corporations manipulate their books, they face a storm of protest—plus billions in fines. What about the quality of public governance in these and related instances? Apparently, different standards apply at different levels of governance. At times, one would wish that public officials who push so hard for more severe forms of corporate governance would consistently comply with these standards themselves.

Governments, of course, know the art of cover-up and of shifting blame. Money laundering is a case in point. Wherever banks (and the media) are faced with money laundering, law enforcement agencies have been at fault for failing to identify a crime and convict a criminal. Money laundering is possible only with the proceeds of crime. Yet, as long as everybody talks about money-laundering and the responsibilities of the financial sector, nobody talks about the underlying crime, about law enforcement and the lack thereof. Economic sanctions provide another example. Economic warfare can be used as a supplement to failed diplomacy—or as a substitute to fighting a costly physical war. But here again, public officials merely shift the burden to the private sector. Yet, there clearly are limits as to what the private sector can do.

### **How to tame the elephants**

In the good old days, corporate leaders around the world saw themselves as legally and morally bound to maximize profits above all, with some concern for employees and maybe a bit of corporate philanthropy thrown in. Today, corporations are increasingly being held to new standards of social responsibility—standards that go far beyond legal requirements to enrich

shareholders and obey the rules that governments make. Corporate social responsibility, once a do-good sideshow, is now seen as mainstream. Yet, what exactly does it mean and entail? Here, we enter into an ongoing debate over the relationship between business and society at large.

Often, new rules emerge at the behest of the private sector which needs rules to establish and protect property rights, to set technical standards, or—more broadly—in view of shaping a level playing field. In a surprising number of areas (such as Internet governance, bond-rating agencies, some insure markets), businesses have supplemented or even substituted for governments in the exercise of governance authority. Today, there is a gradual and broadly based extension of self-regulation across industries which have never seen that kind of commitment before.

Pressure, however, comes from the outside as well, and many new rules aim to rein in or even transform the private sector, whose activities generate some of the problems governance is supposed to solve. Industrial activities cause much of the world's pollution. Businesses hire workers and want to spend as little money on them as possible, making it necessary for someone to protect labor rights. Since the traditional counterpart to big business—big government—does not exist at the global level, and since intergovernmental cooperation falls short of what many people think is needed to keep the private sector under a reasonable degree of control, an extraordinary variety of non-governmental groups dedicated to filling the governance gap has sprung up. These groups are proving ever more adept at shaming or coercing corporations into paying attention to what the activists say are the broader social responsibilities of the private sector. Moreover, they have developed an entire range of techniques intended to supplement or, in many instances, to replace traditional state regulation.

The most renowned of these techniques is *codes of conduct*, a concept the origins of which go back to 1977 when Reverend Leon Sullivan undertook the task of helping to fight South Africa's notorious apartheid regime. As an American, he had little influence on South African politics, so he went after the more readily available target, that is, the multinational firms based in the United States that had operations there. As first formulated, his Sullivan Principles merely specified the workplace conditions American corporations should provide, including integrated and racially unbiased employment practices. Other principles and codes of conducts began appearing in the late 1970. Since then, their number has exploded.

Codes of conduct usually come in two quite different models. Model A types are aspirational codes—statements of what companies aim to do. Here, it is assumed that corporate leaders would happily do the Right Thing if they knew what the Right Thing was and how to accomplish it. The Caux Round Table Principles for Business provide a good example. Model B types are more demanding. They require specific commitments regarding labor standards, environmental standards, or both, along with independent confirmation of whether corporations are meeting those commitments. Here, it is assumed that corporations either want or should have to prove that they are doing what they say they are doing. Under Model A, it is quite easy to free ride on the codes by promulgating them and gaining the benefits of good publicity but avoiding the costs of compliance. Under Model B, an independent auditor comes in, assesses whether a company is in full compliance, and if so certifies the firm as being in compliance. The problem is, however, that consumers do not seem to bother much whether a product is certified or not.

More recently, a third type of code has emerged. Model C basically builds on Kofi Annan's Global Compact agreement which corporations are asked to sign to indicate that they will voluntarily adhere. This concept combines Model A's broad aspirations with Model B's belief

that corporations should make a public accounting of their efforts to live up to those aspirations. Model C, however, does not insist on hard proof, but relies on self-reporting. Activist groups, in turn, vow not to accept annual corporate reports at face value, but scrutinize them carefully. Whether they can actually do so depends on whether they can amass meaningful information about the degree of corporate compliance.

### **Beyond corporate codes**

Here, we touch upon a fundamental flaw of codes: Their effectiveness depends heavily on public exposure. One big and missing piece in the code puzzle has therefore been how to get the necessary information out in some systematic fashion. The mishmash of existing principles and reporting systems has made it all but impossible to compare organizations across time or with one another and makes it hard to evaluate claims of good or bad behavior.

Into the morass have stepped new initiatives aiming at *disclosure and reporting*. If you cannot get corporations to allow that they be regulated by a non-governmental process, can you at least get them to disclose publicly what it is that they are doing, and can you assume that this disclosure will create enough public pressure in order to oblige businesses to adjust their behavior? The Global Reporting Initiative, for example, was formally inaugurated in April 2002 and has developed a framework for voluntary reporting on corporate economic, social, and environmental performance. At least in the environmental field, the approach has been so successful that governments have picked it up. “Who are the worst polluters in the country?” An increasing number of governments, moreover, enact good-access-to-information laws. In light of local and regional experiments, even China has recently passed transparency legislation at the national level.

One aspect was conspicuously absent from our discussion of new and transparency-based solutions to the dilemma of collective action—that is, the Internet. Only briefly did we touch upon the worldwide web as a powerful vehicle for promoting transparency and the potential of such platforms as YouTube or whistleblower blogs for outing various kinds of misbehavior.

All disclosure-based techniques depend on the assumption that someone somewhere cares about the information that is released. The usual argument, especially by certifiers, is that consumers care. Unfortunately, the percentage of consumers who actually demonstrate a preference for “certified” goods is substantially lower than the percentage who (in market surveys) claim to be willing to pay a bit more to be sure that the products they buy are being produced by happy workers in ways that do not despoil the environment. Trying to regulate corporate behavior by mobilizing consumers can be effective indeed—but only in limited circumstances. ‘Branded’ companies such as Nike or Starbucks are vulnerable to such pressures, and they in turn can pressure their suppliers.

Fortunately, consumers are not the only source of funding that corporations need to satisfy. They also have to please investors. Today, large numbers of investors are adding social responsibility to their criteria for picking companies to invest in. Screens include everything from tobacco (no tobacco!) to environmental sustainability to treatment of workers to animal rights. Religious mutual funds and indexes have sprung up that use the beliefs of specific faiths as criteria.

In 1984, a total of about \$40 billion in assets under professional management had undergone some sort of social or environmental *screening*. By 1995, the total was \$639 billion, and by 2001 the number had reached \$2.3 trillion. Early on, screening met strong resistance because

of assumptions about what fiduciary responsibility required for the large investment products such as pension funds. Evidence is mounting, however, that screened investments do just as well as the market and may even outperform it. If the people who control those assets start taking social and environmental screens seriously, what is already a powerful trend could turn into a tidal wave. And focusing on investors, of course, addresses one of the key questions about the whole approach.

So much for these new and informal instruments designed to rein in private business. None is yet working efficiently or even very well. Corporate codes, reporting initiatives, and investments screens are a fairly recent and mendable result of broader concerns about controlling business in the name of society.

Today, however, corporations face 'social' pressure from other sources as well. They are increasingly called upon to provide public goods when and where governments are unwilling or unable to fulfill that task. Modest beginnings can be seen in Asia, most often in the context of public-private partnerships where companies are collaborating both with governments and NGOs. In this context, problems often arise from a lack of accountability. If a citizen has a problem with the way the good or service in question is being provided, he does not have access to the private provider in the way he ought to have access to his government. There is no obvious accountability mechanism yet.

Apart from efforts to control business in the name of society and apart from calling on the private sector to provide public goods, there is a third source of incremental change in thinking about the appropriate role of the corporation. It is the idea that you can come up with business models that actually make it possible to achieve social goals (or provide public goods) *in profitable ways* that are fully competitive in a free market. While the empirical record is still rather sketchy in this context, the very idea of a positive economics of doing public good is clearly gaining acceptance. Again, it is India that has led the experimentation in this area.

## V. Implications for Corporate Strategy

In the previous four sections, we touched upon a wide range of issues. In the fifth and final section, we shall examine how corporate decision-makers can effectively rise to these challenges. In light of what has been said, it seems safe to predict that tomorrow's economic landscape is going to be highly complex and highly unstable. In a troubled environment, the dynamics of change do not provide much lead time but require instant responses and, therefore, a high degree of preparedness. Sophisticated risk-opportunity management, then, becomes a sheer necessity.

It goes without saying that related considerations utterly depend on the kind, the scope and the geographic dimensions of one's specific business. If you sit on the board of a multinational oil corporation, the most important challenge in the context of corporate strategy appears as a natural consequence of recent and tectonic shifts in the energy markets. That challenge is to *know your competitive environment*. The mere comprehension of how your competitive landscape has changed, particularly in the upstream part of the business, is not at all an easy task. Old competitors have merged and new ones have emerged. There are new regulations, new forms of cooperation, and entirely new rules of engagement with governments. Clearly, if

you do not grasp the very newness of related developments, you will hardly remain successful for long.

One fundamental issue that multinational corporations in many industries will be confronted with over the next few years is how to prepare for stronger price volatility in the commodity markets. A key starting point in view of this challenge is to *build a common fact base and economic model* within the company or corporation. Thanks to a shared analytical framework available to the entire management team or board, it is possible to internalize external factors in ways that match corporate economics, tie them to previously existing business plans and adjust those plans if need be. What are the components of such a common framework?

On the quantitative side, important elements include a solid understanding of how a greater price volatility and price changes in relevant commodities affect your business on the cost (or revenue) side. Moreover, it is important to model the impact of changed variables on profitability, price-earnings-ratio, and market capitalization. Once you have identified related risks and determined their magnitude, it is important to ask a further question: What financial *hedges* are available to you in the markets *to mitigate these risks*, and at what cost? What other forms of strategic hedges (i.e., instruments not available in the capital markets) are available to you and at what cost? A real-world example of such a strategic counter-bet is provided by a downstream oil distribution company which decided to execute a sale and leaseback of its gasoline stations as a hedge against deeper penetration of hybrids. According to their model, deeper penetration of hybrid vehicles and high tech diesels was going to reduce gasoline sales and increase time between stops for gasoline. In other words, conservation and higher efficiency were actually going to change its business, thus the company concluded that it no longer wanted to be a real estate owner. The board was delighted that they actually had a model to address the issue even though no one could predict the timing or the magnitude of those kinds of changes.

Apart from stronger price-volatility or higher price levels, what is the relevance of increased supply risks for corporate strategy? One of the issues we did not get to discuss in due detail was the question of whether, historically, we have seen genuine supply breakages or mere price fluctuations where the availability of a given commodity was never in question. Obviously, these alternative circumstances would affect a company's economics in different ways. What, then, is your company's willingness to make substantive bets on alternative sources of energy or conservation? At what level of relevant commodity prices are you committed to make those investments and how long do those investments have to be amortized in order for you to make them? Are you going to bet on a price of \$50, \$75, or \$110 per barrel of oil, and how are you going to adjust your bets when each one of them involves significant investment? How can you network and diversify your sources of supply to mitigate the impact of key source disruptions? Are there ways through which you may actually achieve lower volatilities by building a network of supply at higher average cost?

It stands to reason that higher commodity price volatility and increased risks on the supply-side also create an entire range of new opportunities for smaller and medium-size enterprises. Higher oil prices redirect large amounts of venture capital into conservation, efficiency, and alternative options, for example. In these instances, economic models are less important than seizing new and unexpected opportunities. Again, it all depends on your specific business and its place in the markets.

Finally, based on all of the above, what kind of lobbying policy would you pursue on energy issues as they pertain to your company? Should you seek government regulation or opt for the non-governmental side and self-regulation? In the energy industry, at least, the very

question seems oddly out of place as it is all but impossible to avoid the government. More often than not, natural resources are owned by the state, most markets are regulated by governments. Oil companies in turn do not own resources and do not control the markets. Their business is merely to get a product from one place to another.

It is crucial that the responsibility for dealing with these strategic questions resides not outside but within the corporation. Ideally, what the management sees, what the board sees, what the shareholders and other stakeholders see, and even what regulators see, is essentially the same. Corporate governance structures, obviously, need to adjust in view of that requirement. What is more, you need a chief executive officer who is willing to look into the future, take up important trends and gauge their implications, particularly where they challenge the historically held view of the corporate strategy. Again, if you do not put together a process in which responsibility is held by business managers internally, all the numbers remain meaningless and have no impact whatsoever.

In the context of compliance, globalization entails specific challenges to corporate strategy. As state-owned and private corporations are increasingly operating in different jurisdictions, it is possible that they actually have to pay more attention to compliance elsewhere than at home. The Chinese and their companies may not always be zealous about certain types of regulatory or code compliance, but they certainly are zealous about reputation. In order to meet compliance requirements and to avoid a reputation for bad business dealings, companies must make sure to hire, train and coach employees who have specific knowledge of foreign countries and cultures.

How, then, do I bring globally experienced people into a company? The issue is particularly urgent for companies which to date have a low percentage of non-domestic nationals. The Chinese national oil company, for example, operates in 34 countries, yet they have no country risk management but operate along rather mechanical patterns and lines. From an objective point of view, they (too) need a strategic framework that helps them develop and implement operations beyond going to the Chinese Embassy and asking them to call the foreign ministry. – Thus, while Chinese state-owned companies have internalized the need to take compliance seriously, they have not put in place the institutional software yet. Be that as it may, intercultural competence is a prerequisite for success—in Asia as much as in other regions. Multinational business, therefore, is bound to go along with a multicultural composition of the executive board and management team.

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