Global Oil: U.S. Independence

By Matthew Hulbert and Jochem Meijknecht*

Supply Side Risk Returns

If we thought 2011 was rough, 2012 has seen a serious return of supply side risk. It has come in its most vivid forms as far as political and security risks are concerned. Forget the normal rough and tumble of contractual wrangling and fiscal fights that have dominated energy headlines of late. These factors will gently rumble on in the Middle East, Latin America, Central Asia and even major resource players in Australasia. What we need to focus on now, is what used to be coined 'black swan' events, that now resemble 'common Canadian geese': that's to say, truly explosive political and security risk factors afflicting key producer states, both on an internal and external basis.

Top of the list is Iran. One of OPECs larger producers (3.3mb/d) is starting to come under serious economic pressure from Western sanctions, yet Tehran remains adamant that nuclear enrichment is a national priority. This Iranian 'hedge' between enrichment ambitions and threatened oil price spikes will continue to unfold until someone makes a rash – or indeed radical – move. Markets will keep misreading long term Iranian intent relative to short term theocratic bluster. Benchmark prices will be heavily influenced by Persian politics as a result; especially when the Strait of Hormuz is put into the mix.

Then there is Iraq. US exit has been rapidly filled by renewed sectarian politics that bode very badly for oil production. With Shia and Sunni fighting things out in Baghdad, and Kurds understandably trying to stand above contractual fray, expect Iraqi production to remain closer to 3 million barrels a day by 2016, rather than the 12 million barrels a day the central government has envisaged. Head North towards Libya, and despite initial recovery, 1.3mb/d production still remains significantly below original output levels as internal 'East-West' divides sharpen. Indeed, the Arab Awakening is still keeping Gulf States on edge across the Peninsular; a point that can be applied to the UAE, as much as Kuwait and the world's largest producer, Saudi Arabia. The closer the Saudis get to maxing out production, the closer the market spotlight will be on Riyadh. Risk premiums have been adjusted accordingly; the IEA have similarly warned of tight inventories.

But beyond OPEC heavyweights, problems have been cropping up in more marginal, yet still significant non-OPEC players. State implosion in Syria has seen 150,000 barrels a day slip offline to Europe through sanctions, a move that IOCs should have seen coming without dragging their feet to exit Damascus. Yemen is in a similar state of disarray, while Sudan is vastly reducing African production on the other side of the Gulf of Aden. Some 350,000 barrels a day are locked into a resource rich South Sudan, production that is seemingly impossible to ship through northern networks to bring precious hydrocarbon supplies to international markets. Meanwhile Russia has failed to attract major upstream investment into its Artic riches after the Kremlin botched the BP-Rosneft deal. No one is sure whether Moscow is adhering to 'rule of law' or the 'iron law of Vladimir's politics' to make investments stick. Few answers will be provided until President Putin is properly back and settled in the Kremlin. Things look a little steadier in Central Asia, although hydrocarbon lynchpins, Kazakhstan and Turkmenistan, still sit on unsecure political ground. Even where oil supplies look remarkably benign in places such as Canada, heavy carbon footprints are making things increasingly hard for Toronto to feed international markets.

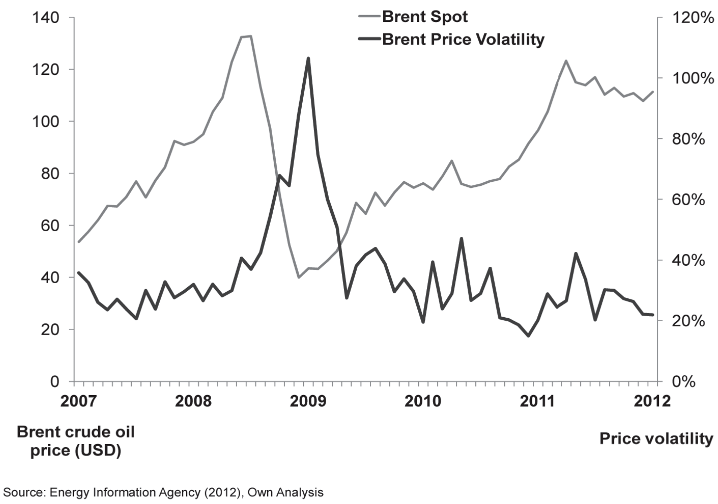

Figure 1: Oil Price Volatilty: Rough Ride Ahead?

Dislocation

What this leaves us with is a massive supply side mess: The fact that Brent has hit historic $125/b highs (in real terms Euro & Stirling) despite deep-seated Eurozone problems, inflationary bubbles bursting in China, and a mispriced U.S. dollar, should give serious cause for concern. Supply side disarray has won the 'price war' over dubious demand fundamentals. Market sentiment was always going to be influenced more by which part of the supply-demand equation

*Matthew Hulbert is a Senior Research Fellow and Jochem Meijknecht is a Researcher in the Clingendael International Energy Programme at the Netherlands Institute of International Relations. Hulbert may be reached at mhulbert@clingendael.nl

proved to be *most* dysfunctional, not which element 'performed' best.

You'd think this would be enough to get the IEA to consider releasing strategic reserves to quell market concerns. The Paris based body certainly didn't waste much time last year when Libya flared prices up to $127 a barrel. But this time around, the IEA has only started making noises over the strategic reserve due to price increases in the U.S. WTI benchmarks are trading around $110 a barrel – 'super cheap' as far as Europeans are still concerned, but still enough to translate into $4 a gallon at the U.S. pumps.

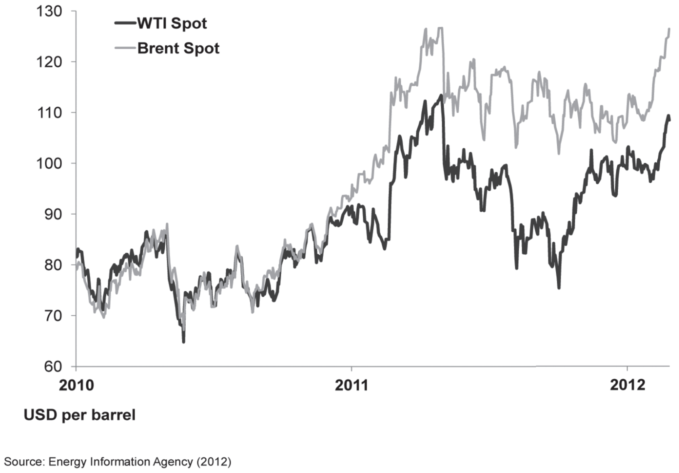

Figure 2: WTI vs. Brent: Cheap, but not Cheap Enough?

This 'iconic' $4 figure has trigger visceral U.S. political attacks on producer states across the board, and especially from Republican presidential candidates. GOP Congressmen are even pitching the related idea that U.S. resources should be strictly used for domestic purposes only. While we'd normally pass this stuff off as campaigning hot air, the problem is that similar thinking is now deeply embedded in the Obama Administration. President Obama made significant reference to U.S. energy independence in his latest State of the Union address, and more importantly, looks likely to give the go ahead to the Keystone XL pipeline from Canada, a pipeline that had previously faltered on environmental grounds. Obama is well aware that elections aren't fought on environmental pledges, but cheap energy, new jobs and America prosperity. The overriding message is clear: the U.S. wants 'American oil for American consumers at American prices'. Hence the Strategic Reserve debate is merely symptomatic of a far larger problem: U.S. disconnect between mounting international oil pressures and domestic American rhetoric. Washington not only demands cheap oil under $4 a gallon, it is trumpeting the virtues of energy independence, at precisely the same time that supply side states are in serious turmoil.

Numbers Narrative

None of this should come as a major shock. The U.S. has long proclaimed energy independence as a top-line political priority dating back to President Nixon, but it's been subterranean shifts that are starting to make this narrative far more serious. Headline figures show 6.4 trillion unconventional barrels of oil across the America's running from Canada all the way down to Argentina vs. 1.2 trillion conventional barrels in the Middle East & North Africa. According to industry forecasts, we should expect to see anything up to 22mb/d of North American oil production over the next decade. The U.S. would not only be the world's single largest producer of crude; oil will flow from North to South across the America's rather than 'East to West' across the globe.

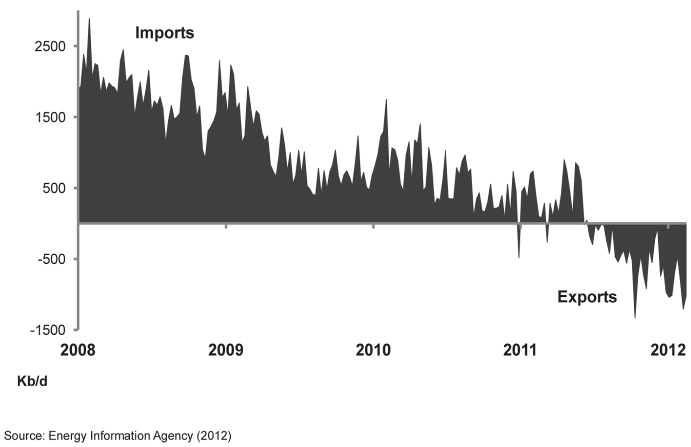

Figure 3: U.S. Looking Good - Net U.S. Crude and Oil Products Import (2008-2012) kb/d

Whether you believe this or not, and whether the numbers eventually stack up, isn't the important point. Thanks to its shale gas bonanza, the U.S. is in *no doubt* that it can apply the same rules, lessons and conclusions for unconventional oil. Political messages are already being put out to this effect. U.S. oil imports fell to their lowest level for a decade to under 9mb/d in 2011 (around 45% of total consumption); the EIA thinks net oil imports will fall further to 36% over the next twenty years or so, while industry estimates think 1.6 million jobs will be created in the energy sector over the same period. The deficit can supposedly be clipped by $145bn towards 2020 assuming benchmark prices remain around $100/b – and more importantly, greenbacks will stay in U.S. pockets rather than filling OPEC coffers. Heck, the U.S. could even take the leading producer spot as early as 2017 if North Dakota plays pan out: this is nothing short of American 'energy independence nirvana'.

U.S. Perception, Global Realities

For now, let's put aside depletion rates, cost uncertainties for viable extraction, local environmental risks, contrasting production priorities across the America's, and the small fact that oil and gas output accounts for just 1% of U.S. GDP (J.P. Morgan Chase). We can also overlook the fact that Asian NOCs have been some of the key investors in the America's oil rush to date: none of that stuff really matters. The *core* problem is not where U.S. energy independence *ultimately* ends up, but the fact that American politicians are *already* touting energy independence as a self-fulfilled prophecy being played out in 'real time' today, rather than seeing it as a gradual process of increments and change.

This flies in the face of global hydrocarbon realities, and what's more, it's going to leave major geo-political gaps on international markets. The blunt fact is that over the next decade, OPEC market share is going to be more concentrated than ever. The cartel will control over 50% of physical market share as mature non-OPEC reserves continue to drain and new finds in Russia, Central Asia and Africa struggle to make it to the wellhead. Prospective U.S. reserves and potential production will do nothing to change that. But what it has *already* shifted, is a sharp withdrawal from Washington's long standing role as the guarantor of global oil supplies. That's deeply problematic, precisely because supply side dynamics are looking more fragile now than they have done for a very long time; what's more, the U.S. is playing two versions of its energy independence geopolitical game.

Version one is Libya. The U.S. made it crystal clear to Europe, that Tripoli was not considered a vital national interest of the United States. Britain and France were left doing most of the heavy geopolitical lifting relative to U.S. firepower and political muscle that *could* have been brought to bear. The chances of that happening had the U.S. not struck its new found oil would have been unthinkable in the 2000s. Europe will need to adapt to such shifts if it wants to secure new supplies from North Africa, Central Asia and the Middle East without a U.S. flag to cover them.

Version two is Iran. The U.S. has applied major sanctions pressures over the Iranian Central Bank, safe in the knowledge it now takes less than 15% of its oil supplies from the Middle East, and that WTI (U.S. benchmarks) continue to trade at steep discounts. But the same can't be said for U.S. allies such as Japan and South Korea, who will feel severe economic pain if they fully apply the letter of U.S. law. Europe has followed the U.S. lead to appear a credible actor in the Middle East, but an embargo on Iranian oil is about the last thing Southern European economies need right now – especially debt ridden Spain, Greece and Italy. Containing nuclear enrichment has been deemed a higher priority policy in Washington than the collateral impacts this will have on European oil prices. Roughly translated, this is a Southern European economic funeral, sponsored by U.S. cremation policies on Iran.

The upshot is that the U.S. will increasingly only act in its own perceived national security interests. As long as these interests went hand in hand with safeguarding international oil supplies, consumer states could rest easy. But perceived U.S. energy independence has torn up the script, and the new narrative has created a blunt bottom line: we have a brave new world in which Washington is not only no longer willing to cover prospective supply side gaps through military/political action (Libya), but if needs be, will put its own perceived national security interests ahead of oil market stability (Iran). The core factor opening this policy space is U.S. energy independence; an article of 'political faith' in Washington that is now rapidly being translated into actual policy practice.

International Realignment

We shouldn't blame the U.S. for following through on its own energy independence instincts, of course. As misguided as it might prove to be, it's entirely up to the U.S. whichever path they chose to take. The important point for net importers to register is that American geopolitical gaps resulting from this are only going to get wider from hereon in.

Logic dictates that consumers, therefore, need a plan B, and fast. The good news is that China already has one. It is expanding its international energy footprint in the Middle East, Africa, Russia, Central Asian, Asia-Pacific, reaching as far as resource plays in the America's to secure its energy needs. We could hardly blame China if it decided to enhance its 'equity' oil options in future given U.S. rhetoric. As the second largest consumer of oil in the world and one of the most import dependent, Beijing is well aware that it will have to ensure its own security of supply over the next decade as the U.S. winds down its hydrocarbon presence. China doesn't expect the U.S. to step back into Iraq to shore up oil supplies should things take a serious turn for a worse, any more than it thinks Washington will provide serious state building measures in jurisdictions such as Sudan. Likewise, U.S. strategic interests in Central Asia now have more to do with vested American concerns over South Asia (aka Afghanistan) than they do hydrocarbon provision. If Russia decided to re-exert its regional dominance over the Caucuses, as it did in 2008, the U.S. would be highly unlikely to take any assertive measures to the contrary. Such out-posts are now seen as 'nice to have' assets for U.S. geopolitical standing, not crucial global oil interests for the U.S. to critically underwrite and secure.

As usual, the EU has been slow to cotton onto this. Europe still assumes that transatlantic relations hold good, and that U.S. will secure its hydrocarbon flows. That's looking increasingly unlikely in the Middle East, Central Asia or North Africa. So far, Europe has only had the imagination to talk to prospective suppliers adjacent to Charlemagne's borders; it has totally failed to appreciate that it needs to work hand in hand with consumers at the other end of the Eurasian pipeline - namely China - to ensure its own security of supply. As the Middle Kingdom comes to play a more prominent energy role, European energy security will increasingly depend on its ability to exploit Chinese influence in Central Asia as a mutual Beijing-Brussels 'hedge' against Russia, while working towards a consumer driven market to enhance supplies from the Middle East and North Africa. In effect, Europe is far better served looking for scraps off China's energy table rather than relying on an increasingly isolationist U.S., hell bent on 'energy independence' to keep plugging global oil supplies. Fundamental demand side realignment is therefore badly needed; the question is whether we are going to wake up to this in time.

Irony all Round

If anything, the core problem we currently face from a hydrocarbon perspective isn't that China is becoming too dominant in its own back yard, but that it isn't yet sufficiently advance to fill in all the geopolitical gaps being left by the U.S. energy independence band wagon. U.S. global draw-down should always have been a function of unsustainable public finances kicking in around 2020 – not an active political choice made from domestic resource booms. What's worse, is that this à la carte approach to global energy security, still entails that Washington can promote its broader geopolitical interests at the expense of others deemed fit. The U.S. will do all it can to contain the rise of China, even to the point of preventing a credible 'G2' geopolitical division of labour in key producer regions. If Beijing wants to become the key external player in Asia-Pacific and MENA regions, they will have to do so through political *fait accompli* towards Washington, certainly not by way of U.S. invitation.

The deep irony for the U.S., of course, is that it would actually be in American interests to let China play a more prominent hydrocarbon role, precisely because U.S. energy independence is a myth – at least in the form that U.S. politicians are currently peddling. No matter how far removed the U.S. thinks it is from international oil markets or supply side shocks, American prices will remain linked to global trends to one extent or another, particularly if its neighbours including Canada, Venezuela, Brazil, Mexico, Argentina and Ecuador all strive to keep feeding global oil markets as a fungible, free flowing commodity rather than a regional affair. What happens in the Gulf of Aden still ultimately affects the Gulf of Mexico. Whether Washington likes it or not, global oil supplies still remain a vital national security concern for the U.S.

Iran is actually living proof of this. U.S. sanctions against Tehran have ultimately rebounded into a political crisis in the U.S., not least because American consumers are now paying $4 a gallon at the pumps. If energy independence was 'real' and the U.S. was truly divorced from international price pressures, President Obama wouldn't now be facing an unedifying choice of either backing down over Iran and face looking weak in the Middle East, or going into a Presidential election with American consumers disgruntled every time they top up their tanks. This strikes at the heart of the problem to hand: America believes its own energy independence press, and assumes cheap oil is now a national right. That will prove a costly political mistake for U.S. politicians as global realities continue to batter U.S. consumers at the pumps, but not as costly as it will be to international consumers generally – and especially the likes of Japan, South Korea and the EU who have blindly followed the U.S down a sanctions path. 'Iranian egg on Western faces' will be the likely result as and when the US. gets '$4 a gallon' cold turkey.

We desperately need the 'real world' of historically high oil prices to realign with U.S. fantasy land of cheap and abundant 'national oil'. If the U.S. keeps following its own energy independence logic, then global gaps will continue to widen. This will prove disastrous for oil supplies over the next decade, where the only serious game in town is OPEC to meet global demand. Energy independence might look more credible in the 2020-2030s, but all things being even, Asian and European consumers need to work on the basis that the U.S. will keep buying into its own energy hallucinations long before then. That being so, new demand side agreements are needed across the board, and especially between China and Europe; it would also be nice to see more ships and more international flags making their way across 'hydrocarbon oceans'. After all, America is fully energy independent: Republicans and Democrats have told us so…