

## Oil, Power and Trade

By Vito Stagliano\*

The geopolitical dimensions of reliance on oil cannot be effectively managed, either by the U.S. or the rest of the world. It would be consequently prudent to devise a trading structure for oil that would be less susceptible to the intervention of governments in the marketplace. Such a structure should be built on a foundation that will have been cleared of present legacies, including, most importantly, of the political intercourse between the House of Saud and occupants of the White House. The world of oil is badly served by the Washington-Riyadh axis, which also enables OPEC<sup>1</sup> and the parastatals<sup>2</sup> that mimic its market-manipulative behavior. A WTO<sup>3</sup>-sponsored free trade round of negotiations to fully commoditize oil would usher in an era of de-politicized commerce for one the world's essential commodities, and foster better international relations among producer and consuming nations.

Anecdotes abound of the perverse U.S.-Saudi ties. The one that follows illustrates how blithely one misunderstands the other and how close to the surface is mutual resentment. In the waning days of the Administration of George H.W. Bush, a desultory effort was organized to expand the U.S. Strategic Petroleum (SPR) reserve by seeking to "lease," from the Saudi Arabian government, 100 million barrels of oil, at below market prices, for storage in SPR caverns. The effort was desultory because the initiative was pursued at sub-ministerial level, when it was clear to everyone involved that a deal could be struck only by direct communications between the President and the King. The President, however, would not ask the King.

The proposal, which would have been profitable to the Saudis only if the "leased" oil were to be released into a disrupted market at the higher price engendered by a major supply disruption, was presented by a U.S. delegation<sup>4</sup> to Saudi Oil Minister Hisham Nazer in July 1991 and billed, *inter alia*, as a means to "further strengthen security and economic relations"<sup>5</sup> between the two countries. Nazer responded within twenty-four hours, dismissing the proposal as incompatible with Saudi policy and interests, a perfectly understandable position. But Nazer went further, seizing the occasion to complain about the financial burden that had been placed on the Saudis by the U.S. to partially offset the cost of the 1991 Gulf War;<sup>6</sup> a war in which the very existence of the Saudi Kingdom could have been at stake.

The "special relationship" between the U.S. and the House of Saud has been described by Taylor as "a self serving fiction that has governed American foreign policy for too long,"<sup>7</sup> even as it remains the frame of reference for U.S. oil policy, oil dependence, and, lately, for the "oil addiction" diagnosed by President George W. Bush in his 2006 State of the Union Address. It is worth noting that the American obsession with Saudi Arabia (oil and terror) has no equal in Europe, whose pathology is governed by Russia and its gas. The geopolitics of energy may well be in the eye, or at least in the perspective of the beholder, shaping perceptions rather than the substance of state-to-state, or, as is more frequently the case, statesman-to-statesman relations. The U.S.-Saudi partnership of convenience, underlying the insecurity of U.S. reliance on oil, especially Arab oil, has provided great political fodder to Democrats as well as Republicans<sup>8</sup>. Alternating perceptions of cooperation and conflict have fueled political posturing by Saudis and Americans, nearly eclipsing the mundane reality that each nation simply looks after its self interest.

U.S. oil policy operates on a sine wave, the upward curve conjunctive with the typically emotive, fluctuating price of gasoline. Oil policy is dormant at the State Department, the National Security Council and even at the Department of Energy, when markets are stable. The Federal policy-making apparatus awakens only when fresh turmoil in the Middle East combines with any accidental disruption of the supply chain, or with a unexpected increase in global oil demand, to unsettle traders in the world's most traded commodity. Conditions for emotional debate (and predictable White House response<sup>9</sup>) were especially favorable in 2006, when oil prices surged to unprecedented levels in less than six months. The resulting price "shock" was almost universally attributed to voracious demand in China and India. Lost in the clamor of an election year were data showing that the United States itself had been (literally) driving oil demand growth since 2002, followed by China. India's growth in demand was entirely marginal to the problem.<sup>10</sup> The prevailing wisdom of 2006 provided a nearly perfect symmetry of national prejudice: craven oil producers (American and Arab) responding to energy-hungry, amoral China at the expense of western consumers.

Governments give oil a bad name. Although oil is traded in a highly complex global market valued at over \$2.5 trillion per year, it is not *freely* traded to the extent that marginal supply is manipulated by the OPEC cartel and by

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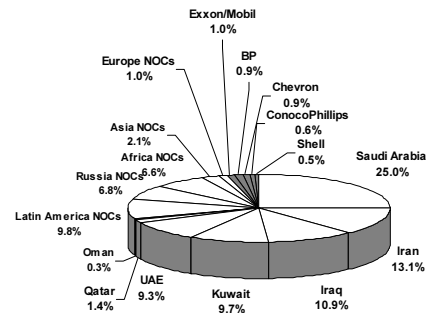
newly aggressive national oil companies (NOCs). Market-subverting governments, numerous even beyond the members of OPEC, chronically intervene in supply and demand decisions. Over one hundred countries produce oil and over eighty export it. But, seventy-five percent of proved oil reserves, and related production, is under the control of less than two dozen NOCs. The NOCs' participation in the marketplace is seldom entirely transparent; they may act on strictly commercial terms, or they may not; they may deal bilaterally on market or on invisible terms; they may barter, also for arms.<sup>11</sup> The non commercial dimensions of the global trade in oil, including OPEC decisions, are among the contributing factors of the energy security problem.

The debate on the geopolitical dimensions of oil has always presumed that diplomacy and political action can somehow address those consequences of reliance on oil that are not internalized by markets. History would seem to indicate, however, that diplomacy aimed at changing the course of energy policy has a spotty record at best. It is true that diplomacy and Henry Kissinger created the International Energy Agency in the wake of the first energy crisis (of 1973), seeking policy cohesion and Western solidarity against the challenge of THE 1973 presumptuous but effective Arab oil embargo. But it is difficult to imagine how diplomacy might today affect the forces at work in the oil sector. Diplomacy is unlikely to influence the production decisions of the majority of oil suppliers, beginning with the Saudis and including most OPEC members and other NOC producers. European and American diplomacy has failed to dissuade Russia, Venezuela and Bolivia from re-nationalizing their energy sectors, having proved ineffective in safeguarding private investment and Western economic interests. On the political front, the G-8<sup>12</sup> can claim little if any success in preserving even the appearance of international commercial law in the face of Russia's provocative curtailment of gas supplies to Ukraine and oil supplies to Belarus. Diplomacy may well be highly over-rated as an instrument of oil policy.<sup>13</sup>

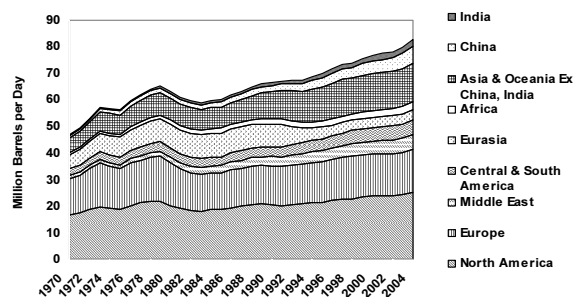
There are many reasons for the inherent limitations of oil diplomacy, the principal one being that Western governments have proved ineffective in instituting domestic oil policies that would provide effective leverage on the geopolitical front. Only marginal success can be claimed by the U.S. and Europe to changing or redirecting consumer and market behavior with regard to the use of oil. U.S. and European oil consumption has increased annually, almost irrevocably for the last two decades, notwithstanding numerous fiscal, regulatory and exhortatory interventions to moderate or reverse the demand trajectory. U.S. and global oil consumption patterns were reversed only once in the last thirty years, between 1980 and 1985<sup>14</sup>, and only as a result of radical measures, responding to the 1979 energy crisis, which in the U.S. included the statutory banning of oil use in non essential sectors of the economy and the imposition of aggressive automotive fuel economy standards.<sup>15</sup> Oil conservation and oil substitution has been much debated on both sides of the Atlantic, but as a practical matter oil continues to dominate the markets for liquid fuels, to the near total exclusion of alternatives, except for ethanol, which in the U.S. has become a legislatively mandated blending agent for gasoline. It is worth noting as a post script to this history that the temporary decline of oil demand in the United States coincided with the final decontrol of oil prices in 1981 and the subsequent launch of the NYMEX oil futures market.<sup>16</sup>

Geopolitical policy can, of course, equate to diplomacy by other means. Morse and Richard have estimated that the Saudis earn about \$1.00 per barrel less on oil sales to the U.S. than they do on sales to Europe, translating into a "subsidy" to U.S. consumers of \$620 million per year (in 2002),<sup>17</sup> in return for which, the U.S. deploys military force in the Persian Gulf to protect the House of Saud.<sup>17</sup> Is it possible to conclude that the interests of the United States in the Persian Gulf are essentially bound to Saudi oil? Does the U.S. military have responsibility for the protection of the shipping lanes on which the world's oil travels, or is this a self imposed obligation that masks other purposes? Do the oil lanes need protection at all, and if so by whom? Should the Saudis, Kuwaitis and Iranians, who are reliant on oil sales for their very fiscal survival, protect their own oil shipping lanes? Should the Europeans and

## Global Proved Reserves (Top 30 = 1.2 Trillion Barrels)



## World Crude Oil Consumption



Chinese and Japanese patrol the Strait of Hormuz to protect their supplies? Does the commerce in oil actually require the deployment of armies and navies, and, in the absence of the exercise of military power, would the global oil trade cease to exist?

If it is true, as many claim, that the U.S. government safeguards American interests in the Persian Gulf, however defined – oil dependence, protection of Israel, security umbrella for the Saudis, anti-terrorism, etc. – by force of arms and with Saudi complicity, one may wonder at the results. The U.S. today uses more oil than ever before at prices that are higher in real terms than in most of the last century. OPEC has greater influence on the oil market than it did at the time of the first energy crisis (1973). U.S. private investment in the Middle-East is less now than in history, confined to what may be considered a few token LNG projects. Iraqi oil production, one of the oft-stated reasons for the U.S. invasion, has failed to reach pre-occupation levels. No substantial success can be claimed in holding Iran accountable to the Security Council for its nuclear ambitions, which are fueled by oil revenues. And, although it remains by far the single most important consumer of oil in the world, and the largest importer, the U.S. has less direct control of the oil market than do most of the market’s suppliers.

Given this record, it can reasonably be argued that the U.S. might do well to set aside its geopolitical

oil strategy and, instead, concentrate its policy resources on trade, in pursuit of a free market for oil. Trade, under generally accepted and independently enforced rules, has been achieved for a vast array of goods and services produced and consumed world-wide. Producer and consumer cartels are rare, if they exist at all, outside the oil sector. With notable exceptions, governments continue to withdraw from most markets, other than through regulation, and private as well as public investments are driven by trade patterns that span the globe. Competitive markets have been good for consumers as well as producers, and standards of living have risen worldwide in conjunction with freedom to trade.

A competitive oil market, one characterized by government intervention that is limited to regulation of trading behavior and transactional transparency, would exert downward pressure on prices, direct investment towards market-driven ends (both in and out of the oil sector), reduce the need for expensive insurance policies such as

strategic petroleum reserves<sup>18</sup>, mitigate the requirement to hold commercial stocks at levels above prudent economic inventories, reduce the price volatility engendered by non market decisions, and generally dissipate the inter-governmental tensions that have become the norm in international energy policy.

A free oil market, negotiated under WTO rules, would require the dissolution of OPEC, the last of the archaic “trusts” of the 20<sup>th</sup> century. OPEC operates on premises that are anathema - indeed illegal - to the very policy foundations of WTO, the OECD, the G-8, and, not least, the USTR.<sup>19</sup> A free market for oil would produce immediate and tangible results on the energy security and the economic front, even among OPEC members whose sclerotic economies could be restructured, from exposure to competition, to join the world that is otherwise driven by private transactions among willing partners.

Oil policy is too important to be left to politicians. Governments can muster neither the discipline nor the economic efficiency of markets, and have proven incapable of making oil policy decisions that

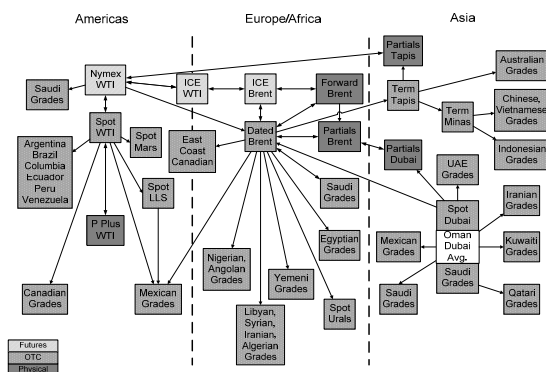
are in the best interest of consumers. Governments are the source and not the consequence of the energy security dilemma; their withdrawal from the marketplace would provide the condition precedent to rational use of oil. Free trade in oil would reduce conflict by reducing the financing of terror. It would moderate the boom and bust cycles to which the industry is hostage, produce revenue streams rather than windfalls for governments that are prone to misuse the income from oil, and provide fiscal and foreign exchange relief to oil-dependent nations in the developing world.

Free-market oil, traded in the highly developed market structure illustrated above, would reduce structural inflation and global trade imbalances, deflect the potential for supply competition between East and West, and likely make infeasible barter arrangements that currently fuel arms exchanges in politically volatile regions of the world.

**U.S. Dependence on Oil Imports**  
(As Percentage of Total Oil Consumption)

Nixon Administration (1974)	37%
Ford Administration (1976)	42%
Carter Administration (1980)	41%
Reagan Administration (1988)	43%
Bush Administration (1992)	46%
Clinton Administration (2000)	58%
Bush Administration (2005)	66%

**World Petroleum Market Structure**



The world, in sum, would be better served by a market for oil that is free of government meddling and consequently also free of its long-standing geopolitical perversions.

#### Footnotes

- <sup>1</sup> The Organization of Petroleum Exporting Countries (OPEC) was established in September 1960, initially at the instigation of Venezuela and partly in response to the imposition of oil import controls by the Eisenhower Administration. The members of OPEC include Saudi Arabia, Venezuela, Nigeria, Libya, Kuwait, Indonesia, Algeria, Iran, Iraq, Qatar, United Arab Emirates, and Angola. Gabon and Ecuador were members but withdrew from OPEC in 1995 and 1993, respectively. Prospective OPEC members include: Norway (the only European nation so-inclined), Bolivia, Mexico, Syria and, possibly, Sudan.
- <sup>2</sup> State-owned companies that may or may not be independently managed.
- <sup>3</sup> The World Trade Organization (WTO) has 150 members, including all members of OPEC except for Algeria, Libya, Iran and Iraq.
- <sup>4</sup> The delegation was led by John Easton, then assistant secretary of energy for policy and international affairs, and included me, then associate undersecretary of energy.
- <sup>5</sup> Stagliano, Vito: "A Policy of Discontent: The Making of a National Energy Strategy," PennWell, 2001.
- <sup>6</sup> Ibid: Nazer stated that the U.S. had "the most expensive army in the world."
- <sup>7</sup> In an introduction to Charles Ebinger's "The Critical Link," Henry Kissinger wrote that the energy crisis (of 1973) is not a mere problem of transitional adjustment; it is a grave challenge to the political and economic structure of the free world." And, in his speech of 1977, President Jimmy Carter stated that "our decisions about energy will test the character of the American people, and the ability of the President to govern this nation... This effort will be the moral equivalent of war."
- <sup>9</sup> As expected, President Bush ordered to federal Trade Commission to investigate price gouging by the oil companies. Numerous presidents from Nixon onward have reacted in a similar fashion to gasoline price increases. However, not once in three decades has the FTC found evidence of oil price collusion.
- <sup>10</sup> According to EIA data, U.S. imports rose by 2.2 million barrels/day between 2002 and 2005; China's rose by 1.8 million barrels/day and India's by 450,000 barrels/day in the same period.
- <sup>11</sup> National Commission on Energy Policy: "Collaborative Design and Development of Petroleum Sector Performance Indicators," January 2007.
- <sup>12</sup> Group of 8: U.S., France, Italy, the U.K., Germany, Japan, Spain, Russia.
- <sup>13</sup> The possible exception would be Henry Kissinger's negotiations to establish the International Energy Agency in the wake of the 1973 Arab oil embargo.
- <sup>14</sup> EIA data show world oil consumption in 1980 at ~64 million barrels/day, decreasing to ~58 million barrels per day by 1985. Growth in consumption resumed in 1986 and has remained on an upward trajectory since.
- <sup>15</sup> Among the Federal statutes that contributed to a restructuring of oil use in the U.S. were the CAFÉ law and the Powerplant and Industrial Fuel Use Act.
- <sup>16</sup> The final decontrol of the U.S. oil sector was accomplished by Executive Order, issued by President Ronald Reagan in January 1981.
- <sup>17</sup> Morse & Richard: "The Battle for Energy Dominance," Foreign Affairs, April 2002.
- <sup>18</sup> EIA and IEA data indicate that OECD government-controlled emergency oil stocks currently equal 1.5 billion barrels; commercial stocks held for strategic purposes are at 2.7 billion barrels.
- <sup>19</sup> OECD: Organization for Economic cooperation and Development. USTR: U.S. trade Representative.

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