

WILL ENERGY-RICH AMERICA DEPART FROM THE MIDDLE EAST AND EURASIA?

The American shale oil and gas boom has crowned the U.S. as an emerging energy superpower. This development is beginning to influence U.S. strategic posture in the Middle East and Central Asia. But given the early state of knowledge and technology, it is premature to determine if the shale boom is a temporary bubble or rather is a lasting event capable of scaling up beyond the boundaries of North America and reshaping the world energy outlook. Until more clarity is reached the Middle East, despite its chronic problems, will remain the only large source of low-cost oil and the U.S. will remain the chief guarantor of its security.

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The development of new technologies to extract oil and natural gas from unconventional geological formations has unleashed new energy resources in North America, crowning the U.S. as an emerging energy superpower. Thanks to hydraulic fracturing, or “fracking”, U.S. crude oil production has grown 60 percent from 5.1 million barrels a day in 2005 to 8 million in 2013, and the share of U.S. oil demand met by imports has fallen from 60 percent in 2005 to 36 percent over the same period of time. According to the International Energy Agency, the U.S. could surpass Saudi Arabia as the world’s number one oil producing country as early as 2015. In natural gas, U.S. performance has been equally impressive. Gas production rose roughly 50 percent between 2005 and 2013, and with so much excess capacity, the U.S. is about to assume a leading role in the global market for liquefied natural gas (LNG). Some experts even see it challenging the world’s number one exporter, Qatar.¹

With such impressive growth in its energy sector, many analysts believe that the shale revolution will permanently transform not only the global energy market but also U.S. foreign policy. Commentator Fareed Zakaria summed up the widely held view that “the rise of shale gas is shaping up to be the biggest shift in energy in generations. And its consequences –economic and political– are profoundly beneficial to the U.S.”² Others go even further, arguing that as U.S. oil imports from the Middle East drop, its interest in the chronically tumultuous region would wane, resulting in a gradual military and diplomatic withdrawal.

Not so fast. To be sure, the new energy conditions in the U.S. have already produced dividends for American policymakers, enabling a freer hand in their foreign policy endeavors at a time of public fatigue from two taxing wars and a shaky economy. But the assertion that the U.S. could depart from the Middle East due to a change in its energy landscape is based on an oversimplification of U.S. strategic interest in the region, as well as vastly optimistic assumptions about the sustainability and scalability of the shale boom. America’s experience with nonconventional hydrocarbons is too fresh to make such assertions, and there are too many question marks about the economic, geological, and environmental characteristics of the new resources to allow the U.S. to peg its foreign policy to their development. To the degree that the U.S. might change its strategic posture in the Middle East, the changes in its energy mix would be a minor driver of such a development.

1 Amy Myers Jaffe and Edward Morse, “Liquefied Natural Profits,” *Foreign Affairs*, 16 September 2013.

2 Fareed Zakaria, “Natural Gas, Fueling an Energy Revolution,” *Washington Post*, 29 March 2012.

The Shale Boom: A Game Changer?

Tom Donilon, President Barack Obama's former National Security Advisor, described the shale boom as a "transformational moment," which "affords us a stronger hand in pursuing and implementing [the U.S.] international security goals."³ This "stronger hand" has already presented itself in more than one way. While increased U.S. oil production has not been able to lower the real global price of oil due to the budgetary imperative of OPEC to ensure oil prices stay high, it brought oil price volatility to its lowest point in a decade.⁴

As a result, U.S. policymakers have less to worry about in terms of the impact of their decisions on the oil market. The sanctions against Iran, for example, were more successful than anticipated because Northern Hemispheric oil was able to replace the lost supply in world markets, thus avoiding an economically painful oil price hike. U.S. ability to keep oil prices stable also reassured major importers like Japan and India that joining the sanctions regime would not hurt their economies. The U.S. also enjoys a freer hand in its relations with

Saudi Arabia, whose power has traditionally derived from its role as the world's swing producer. This position has been somewhat diminished, and Washington no longer feels as obligated to placate the House of Saud on foreign policy and national security matters as it did in the past. Additionally, with less Middle Eastern and African oil flowing to the U.S., more crude oil is available for the rapidly growing Asian market, sparing the U.S. and China the need to compete over access and influence in those regions.

Significant geopolitical changes can occur in the global natural gas market as the U.S. builds its LNG export infrastructure. For years, Russia has been able to use its position as the world's largest natural gas exporter for leverage over its smaller neighbors, especially Ukraine, and to strengthen its influence in countries such as Germany and Italy. That position is now threatened by potential competition in the European gas market from North American LNG supplies.

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3 Remarks by Tom Donilon, National Security Advisor, at the launch of Columbia University's Center on Global Energy Policy, 24 April 2013.

4 Russell Gold and Chip Cummins, "Rising U.S. Oil Output Gives Policy Makers More Options," *Wall Street Journal*, 2 July 2013.

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the heart of Europe. In 2008, the Bush administration even appointed a dedicated envoy for Eurasian energy tasked with coordinating policy in the Caspian region and facilitating progress on the Nabucco pipeline project. But during Barack Obama's presidency, the U.S.'s commitment to the region has weakened and its activism in pursuit of the Southern Corridor has subsided.

To be sure, the focus on domestic economic recovery, the pullout from Iraq and Afghanistan, the Arab Spring, and the Iranian nuclear program have all diverted the Obama administration's attention from the Caspian. European disunity on Caspian energy and the termination of the Nabucco project have also made it hard for the U.S. to maintain its interest in bringing Caspian gas to the EU market. There are also political and personal explanations. The position of envoy for Eurasian energy was not filled since the departure of Ambassador Richard Morningstar to become U.S. Ambassador to Azerbaijan. Senator Richard Lugar, former Chairman and later ranking member of the Senate Foreign Relations Committee—and tireless advocate of the Southern Corridor—retired in 2013. The current chairman, Senator Robert Menendez, known for his uneasy relations with the government of Azerbaijan and his close relations with the Armenian lobby, has demonstrated less interest in Eurasian energy.

The forthcoming North American LNG exports constitute another reason for Washington's reduced interest in the Southern Corridor. While LNG prices in Asia are higher, the U.S. also views Europe as a potential market for its gas. Europe is geographically closer and its interest in reducing its import dependency on Russia is

Impact on the Eurasian energy landscape is also apparent. Since the end of the Cold War, the U.S. has been a strong supporter of developing energy corridors from the Caspian to Europe via the Caucasus and Turkey in order to help Europe diversify its energy resources away from Russia while supporting economic and political development of the former Soviet Republics in Central Asia. Hence, the Clinton administration set as a policy priority the construction of the Baku-Tbilisi-Ceyhan oil pipeline, and the George W. Bush administration saw high priority in opening a southern natural gas corridor from the Caspian to

strong. The U.S. is currently negotiating with the European Union over a free trade agreement –the Transatlantic Trade and Investment Partnership– which will make it easier to export American gas to Europe. Therefore, with the U.S. pursuing international markets for its own gas, its interest in facilitating the flow of Caspian energy into Europe is not as strong as it used to be.

Impact on Future Engagement in the Middle East

With all of the above changes in the U.S. geopolitical calculus, and despite the optimistic winds blowing from North America, it is important to put the shale boom in perspective and recalibrate the expectations that the shifts in U.S. energy production will dramatically alter its strategic posture in the Middle East. It is also time to give the myth that U.S. presence in the Middle East is tied to its dependence on imports of the region's oil a decent burial. Put bluntly, the U.S. is not very dependent on oil imports from the Middle East. In fact, it never has been. Today only nine percent of U.S. oil demand is met by imports from the Middle East. Indeed, Middle East imports have never exceeded 15 percent of U.S. demand. Most U.S. oil imports originate from the Western Hemisphere: Canada, Mexico, and Venezuela. Mexico's recent historic energy reform, which for the first time in 70 years allows foreign investment and production sharing agreements in the country's energy sector, is likely to increase the flow of Mexican oil to the U.S. and hence decrease even further U.S. dependence on Persian Gulf crude imports.

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While the U.S. is not dependent on the Middle East for the physical supply of oil, it is dependent on the region for price stability. The U.S. economy is highly susceptible to spikes in oil prices. Over the past 40 years every major hike in oil prices was followed by a recession, and most of those spikes occurred as a result of turmoil in the Middle East: the Arab Oil Embargo, the Iran-Iraq War, the Iraqi invasion of Kuwait, etc. Oil is a global commodity with a more or less global price so when oil prices spike, the U.S. is impacted regardless of how much of its crude comes from the Persian Gulf. For example, in 2011 the war in Libya caused oil prices to American consumers to spike by 25 dollars per barrel despite the fact that the U.S. imported no oil from Libya. Therefore, even if the U.S. miraculously became self-sufficient in

oil it would not be shielded from the world market, just as other countries that used to be self-sufficient at one point or another –like Canada, the United Kingdom, and Norway– have not been immune to shifts in world market prices.

Simply, what the U.S. cares about is not the origin of its oil but its price. And the global price of oil is largely affected by the political events in the Middle East. When Saddam Hussein invaded Kuwait in 1990, Persian Gulf oil constituted less than five percent of U.S. oil consumption. The U.S. could surely have survived without that oil, but the concern that Saddam would be able to threaten Saudi Arabia and manipulate oil prices led it to embark on a major war to liberate Kuwait. Therefore, as long as oil enjoys a virtual monopoly over the global transportation fuel market it is difficult to see how the U.S. could afford to withdraw from the Middle East, even if its imports from the region dropped to zero, and leave the world's largest pool of oil in the hands of unstable regimes.

Any suggestion that U.S. foreign policy is “all about oil” ignores the complexity and multitude of U.S. interests. Geography, Cold War legacies, Israel, terrorism, religion, nuclear proliferation, and democracy promotion are just some of the factors guiding U.S. thinking on the Middle East. The U.S. has maintained prolonged military presence in the region at a cost tens of billions of dollars annually – in nonwar years.⁵ This investment barely benefits the actual supply of energy to the U.S. Iraq is a case in point. The U.S. carried most of the burden of the Iraq War in terms of blood and treasure, yet the oil spoils are shared today by China and Russia with almost no contracts awarded to American companies. Europe, China, India, Japan, and South Korea are all importing more Middle East oil than the U.S., yet their financial contribution to the mission of protecting the region is minimal. In essence, American taxpayers subsidize oil protection services in the Middle East region for the rest of the world while their cars and trucks use the region's oil the least. If the U.S. were to reduce its military presence in the region, this might be a result of either deep cuts in the defense budget or a shift in global priorities toward other troubled regions such as Asia-Pacific – not due to changes in its energy portfolio.

There are at least three good reasons to assume continued U.S. military commitment to the Middle East, even under conditions of energy self-sufficiency. First, with Asia's growing dependence on Middle East energy, a U.S. pullout from the region would essentially open the door to a stronger Chinese, and possibly Indian and Russian, military presence in the region. (China is projected to become the globe's largest oil consumer by 2030). Such an outcome is currently not perceived to be

5 Keith Crane et al., “Imported Oil and US National Security,” *RAND Corporation Report* (2009), http://www.rand.org/content/dam/rand/pubs/monographs/2009/RAND_MG838.pdf

in the U.S.'s strategic interest. Second, a sharp increase in U.S. energy production would strengthen the U.S. economy, thus bolstering its currency, reducing its debt, and improving its balance of payments. Such an economic upturn is likely to negate the need for cuts in military budgets and make it easier for American leaders to marshal the financial resources and public support needed to address global problems, including the security

of the Middle East. Third, the U.S. exports aerospace and defense products to the tune of 100 billion dollars per year. More than 60 percent of these products go to Middle East countries. The centrality of aerospace and defense industries to the U.S. economy entails that the U.S. remains engaged in the markets where its products are needed most and where the strongest growth in demand is likely to be.

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Boom or Bubble?

Two major questions will determine whether or not the North American energy boom will significantly and permanently change the U.S. and global energy outlook and have a long-term impact on U.S. strategic posture. The first is whether U.S. oil and gas production from shale is just a temporary bubble, or rather is a lasting event capable of scaling up. The second is whether the shale revolution could be replicated in other countries. Given the early state of knowledge and technology, answering both questions is premature.

As for the first question, the evidence gathered so far from shale oil and natural gas wells tapped by hydraulic fracturing cast serious doubts about the sustainability of the shale boom: the decline rates are remarkably fast, reaching 80 percent within 36 months for oil wells.⁶ Maintaining high output will therefore require continuous investment in drilling new wells to compensate for declines at existing ones. The complex nature and high cost of nonconventional hydrocarbons extraction make these resources extremely vulnerable to price drops, which means that there will be periods in which keeping drilling intensity high would be uneconomic.

There is also the risk of growing environmental opposition as drilling activities move closer and closer to densely populated areas. One should not discount the

⁶ Leonardo Maugeri, “The Shale Oil Boom: A U.S. Phenomenon,” *Belfer Center for Science and International Affairs* (June 2013).

possibility that a major disaster occurring as a result of fracking –such as a powerful earthquake– could awaken nuclear-like phobias among local populations. For many of these reasons and others, the International Energy Agency cautioned in its 2013 World Energy Outlook that the U.S. may not be able to sustain its current production growth beyond 12 million barrels a day and that by 2025 production might start to slowly decline. This means that even at peak production the U.S. will be forced to import nontrivial amount of oil.

As for the second question, much depends on the ability of other countries to replicate success of the U.S. Argentina, Russia, China, and the Middle East all contain significant reserves of unconventional oil and gas. But none of those places enjoy the combination of private mineral rights, a friendly legal environment, public and political support, and the maturity of the oil services industry necessary to make shale oil and gas development possible. In this, the biggest wildcard is China, which has total reserves 50 percent larger than the U.S. China's dearth of gas, its environmental crisis, and its rapid growth make the development of shale gas an imperative. However, China's shale gas formations are twice as deep and far costlier to tap into, and it is too early to determine if America's success can be replicated there.

Conclusion

A large scale expansion of the shale energy revolution beyond the boundaries of North America is therefore improbable in the foreseeable future, and it is likely that the Middle East, despite its growing ethnic, religious, and political rifts and its slow human development, will remain the only large source of low-cost oil. Owning three quarters of the world's conventional crude reserves, the region will also continue to be a price setter, especially when it comes to oil. The growing budgetary needs of the Gulf's major oil exporters like Saudi Arabia, Iran, Iraq, and Kuwait will force them to offset the growth in non-Middle East oil production with production cuts in order to keep prices more or less where they need them to be. As long as oil retains its strategic importance as the sole commodity powering the global transportation fuel market, and hence the U.S. economy remains vulnerable to its price spikes, the U.S. will have no choice but to maintain its dominance in the Middle East. While one can foresee changes in the division of labor in protecting the region's stability, perhaps including a bigger role for emerging energy importers like China and India, no global power seems to be either capable or willing to assume the role of the region's security guarantor.