<u>The Surprising Sources of Oil's Influence</u>

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Should countries care about where they and others buy their oil from? The answer has wide ranging consequences for public policy. As Middle Eastern oil exports to Asia rise while shipments to the United States and Europe fall, analysts are asking whether this trade shift will carry geopolitical consequences, drawing China politically closer to the Middle East while driving the West further away.[1] In North America, the recent debate over the Keystone XL pipeline, which would have transported crude from Canada to the U.S. Gulf of Mexico, featured proponents who trumpeted the value of relying on a friendly source of oil and skeptics who insisted that the origin of U.S. oil imports doesn't matter. Throughout the world, many still worry that dependence on the Persian Gulf leaves countries exposed to blackmail; others analysts, though, insist that markets have rendered such threats impotent.

Indeed scholars and policymakers are sharply split on the fundamental question of whether the precise patterns of oil trade matter. One camp, dominated by economists, asserts that the answer is a resounding no.[2] There is one world price for oil, and all consumers pay it regardless of who their suppliers are. The only preference consumers should have is that they get the cheapest (and perhaps least polluting) oil possible—where it comes from is immaterial. The other camp, dominated by security strategists, is equally confident that the answer is yes.[3] They see countries as wise if they carefully choose their oil trading partners in order to strengthen their own position in the world. Their worries date back to the two world wars and the oil shocks of the 1970s, and despite massive changes in global oil markets since then, their concerns persist.

This debate is unlikely to be resolved any time soon. But there is a related and equally important question that is rarely discussed: regardless of whether precise patterns of oil trade *should* influence the policymakers' decisions, are they consequential in practice?

The answer has broad implications. As Asian consumers cement their positions as the dominant buyers of Middle Eastern oil, will Western ties with Persian Gulf oil exporters fray? If Canada, spurned by the United States, starts selling its oil to China, will that alter international politics in North America and beyond? Are there potential consequences of Chinese investment in Africa or contracts for Venezuelan oil that should concern other countries? As oil production rises in the western hemisphere, making the United States, Canada, Brazil and others critical producers rather than just major consumers, might other countries' attitudes and approaches toward them change as a consequence?

These questions can be illuminated by looking at history. It is striking, then, that there has been no systematic study of how international oil trade affects international relationships, and vice versa. To carefully investigate potential connections between the two, we brought together a diverse group of scholars, industry veterans, and former policymakers. We asked twelve of them to prepare short case studies of specific oil trade relationships that we suspected might be illuminating.[4] Three contributors examined links between oil investment and international politics, in order to help distinguish between the influence of cross-border investment and that of international trade. Another three explored trade relationships involving the United States, including those with Venezuela, Canada, and Saudi Arabia, both to shed light on an important player in the international

system, and to drill down on a set of cases involving at least one robust market economy. The next three looked at trade relationships involving China, including those with Iran, Angola, and Saudi Arabia. Again, part of the goal was to better understand a key consumer (China), and part of it was to delve more generally into how a less market-based economy interacted with others. A final trio of case studies helped us explore other special types of trade relationships: a look at Russia and several former Soviet states provided a window into what happens when countries don't have access to international markets; an examination of Brazilian relations with Iraq and several African countries helped us understand how oil and military relations can become entangled; and a study of French oil trade relations with former colonies highlighted the potential role of cultural ties, and simple inertia, in shaping oil-related relations among states.

These twelve cases, along with additional research, made clear that regardless of whether the detailed patterns oil trade should influence international politics, there is no question that, in practice, they do. That has wide-ranging consequences for international security.

Lessons wrongly learned

Is it really necessary to look at a dozen cases in order to conclude that oil and international politics are often intertwined? Anyone who lived through the 1973 Arab oil embargo can tell you that they are closely connected. Reams of careful scholarship have shown that natural gas trade and international politics are essentially inseparable.[5] And anyone who has followed fights over OPEC production quotas or investment regimes in countries like Russia and Venezuela knows that international relations and oil go hand in hand.

Each of these observations, though, stops short of showing that oil trade and international politics influence each other. Oil markets have changed enormously in the nearly four decades since the first Arab oil embargo. Deeper spot markets, cheap international oil shipping, rise of oil trading in futures markets, removal of import quotas, and creation of national strategic petroleum reserves have all make the global market far more robust and integrated than it was when the first oil shock rocked the world. Past performance, in this case, is an unreliable predictor of future results.

Lessons from the global gas trade are difficult to extrapolate for a related set of reasons. While the global oil trade is marked by the presence of large and liquid spot markets that allow all participants to identify consensus prices without resort to political bargaining, spot markets for natural gas are often nonexistent, forcing parties to determine contract terms through painstaking, and politically charged, negotiations. Moreover, while inexpensive arbitrage is possible between most parts of the world oil market, trading natural gas across long distances requires expensive ships and specialized port facilities, all of which means that the oil market is far more flexible than the gas one. Natural gas trading also requires up-front investment in expensive infrastructure that typically exceeds what is needed in the case of oil. Financing that infrastructure usually requires long-term deals between buyers and sellers. Those create lasting relationships that can more easily acquire a political character than the shorter term deals and spot trades that dominate oil.

What about fights over investment? There is no question that cross-border investment in oil production is often politically charged. In many ways, though, this does not make oil special. China, for example, discriminates between domestic and foreign firms, and among foreign companies too, in determining when to allow investment in a host of industrial sectors, from telecommunications to banking. That said, in some cases, oil investment is particularly touchy. In Latin America, for example, oil is typically seen as a country's patrimony, and selling it to foreigners is something that triggers deep emotional reactions.[6] Oil investment decisions can thus take on a special cast.

It is important, though, not to push this too far. In some cases where one would expect international politics to play a major role in shaping oil investment, it does not. Saudi Arabia, Kuwait, and Iraq, for example, all appear to select foreign firms for inward oil investment more on the basis of contract terms and technological potential than on the bilateral relationship with those firms' home countries.[7] Chinese oil companies, meanwhile, appear to select their targets for outward investment primarily based on assessments of commercial attractiveness, with foreign policy objectives taking a decisive back seat. But that does not mean that politics has not have not affected where these companies have deployed their capital. Chinese national oil companies have opportunistically taken advantage of investment opportunities in places like Sudan and Burma, where Western sanctions have kept Western oil majors at bay.

Decisions about oil production levels can also become entwined in international politics. Oil consumers consistently try to persuade producers to pump more oil and thus lower world prices. In times of market tension, pivotal countries, particularly Saudi Arabia, the UAE, and Kuwait, often come under pressure to dip into their "spare capacity" and put more oil on the market in order to calm prices.[8] Political bargaining can also take a front seat in discussions about whether to release emergency oil inventories. The decision in 2011 by the International Energy Agency (IEA) decision to tap strategic stocks came only after senior energy officials visited Riyadh in an attempt to persuade the Kingdom not to undercut the release by slowing production.[9] All of this, inevitably, is a matter of international politics and bargaining, rather than pure economics.

But all of this is distinct from questions of who buys oil from whom, and what consequences that has. It is entirely possible for production and investment decisions to be politically charged but for global trade patterns to simultaneously be the province more of pure economics. To understand this critical dimension of international oil politics, we need to examine how specific trade relationships actually work.

Physical Constraints Matter

If globalized and flexible crude markets supposedly divorce oil trade from international politics, then the best place to start is by looking at cases where markets aren't actually as globalized or flexible as most people assume.

The relationship between Russia and several former Soviet states is one example of an oil trade relationship where geography, and hence politics, looms large.[10] Kyrgyzstan, Uzbekistan, Tajikistan, and Belarus are all landlocked. They have little access to imported oil except through Russian pipelines. This lack of ready alternative supplies gives Russia political leverage that it has not been shy about exploiting. Russia halted deliveries to refineries in Belarus on New Year's Eve in 2009 after a dispute over tariffs; Kyrgyzstan, which imports 70 percent of its oil from Russia, also found itself on the wrong end of a Russian export ban in April 2010 after it condemned a spike in Moscow's transit fees. Prices in Kyrgyzstan skyrocketed, precipitating the fall of authoritarian regime of then-president Kurmanbek Bakiev just one week after the ban was imposed.

Pipeline politics can also exert influence much closer to home. The United States and Canada are each other's largest trading partners and enjoy an oil trade relationship that is typically open, but that has not always been the case. The United States curtailed imports from Canada in the 1950s to protect its own domestic producers until finally exempting Canadian crude in 1959. Following the 1973 embargo, the Canadian government experimented with energy nationalism, raising its asking price for oil from U.S. buyers.[11] This period appears to have largely passed, but the battle in 2011

over the Keystone XL pipeline suggests that domestic politics can still complicate even the most natural trade relationship.

Refinery configurations also add some rigidity to markets. The common description of oil as a fungible good, where supplies can be moved from one market to another with ease, is usually a good approximation to reality, but has important limits. Not all oil is the same. Different sources of crude vary primarily in their so-called gravity, ranging from light to heavy, and in their sulfur content, which ranges from sweet to sour. Each refinery is tuned to accept a particular source of oil and produce a particular slate of high-value products, including gasoline, diesel, and jet fuel. Venezuelan crude, for example, is particularly heavy and sour, and refineries in the Gulf of Mexico are specially designed to process it. Were Venezuela to refuse to sell oil to the United States, many U.S. refiners could be left without attractive alternative sources. Venezuelan producers, though, might have parallel difficulties finding new customers for their oil. The same dynamic could also work in reverse, with the United States shunning Venezuelan oil during a crisis, with similar results.

How much leverage this gives each side is ultimately unclear. Matching refineries to crude supplies is more a matter of relative suitability than of absolute compatibility. Venezuelan crude, for example, can be processed in less sophisticated refineries than those in the Gulf of Mexico, but the products it yields will be less valuable; similarly, complex U.S. refineries that are built to handle Venezuelan oil can process lighter, sweeter supplies. In each case, though, the shift would be economically painful for the companies involved (precisely how much so is unclear), which is why they tend to prefer the stable status quo. Scholars of U.S.-Venezuela relations who look at this situation conclude that although both countries would like to diversify away from their dependence on each other, both are too compelled by the economics (including sunk costs) of the current relationship to let a frosty political situation get in the way.[12]

Expectations and Outcomes

Physical supply and transport constraints are not the only things that can inject politics into the oil trade. In many cases, the oil trade is politically consequential simply because policymakers believe that it is. Put another way, the suspicion that oil and international politics are tightly intertwined is often self-fulfilling.

Take the case of the U.S.-Saudi relationship. Beginning in the 1970s and extending well into the first decade of the twenty first century, Saudi Arabia offered crude oil to U.S. refiners at a slight discount to the price that it quoted Asian buyers.[13] The goal was straightforward: Riyadh wanted to remain the number one supplier of crude to the United States. Why? Saudi policymakers, observing the U.S. political scene, concluded that U.S. leaders and citizens believed that it was important to maintain good relations with their country's leading suppliers of oil. By manipulating markets ever so slightly to retain their lead in the United States, Riyadh was able to secure better relations with Washington than it would have otherwise had. This is not to suggest that other factors didn't dominate the U.S.-Saudi relationship – Cold War politics, Middle East security, and the Saudi position as a swing producer of oil were critical – but, at a minimum, leaders believed that this stratagem would influence outcomes too.

Nor is Saudi Arabia the only country whose leaders have thought in similar ways: at various times, the governments of Kuwait has also instructed its national oil companies to price its crude carefully in order to win a particular share of an importer's domestic market. (Others may well have taken similar steps.) Until recently, Riyadh also offered discounted crude to Bahrain, which U.S. policymakers valued that behavior as a sign of Saudi goodwill to Washington because they saw it as

helping to ensure the stability of a strategic ally of the United States. Indeed the basic Saudi insight – that market shares can affect international politics because policymakers think that they matter – implies that international politics can influence oil trade patterns even without active interference from participants. Had Saudi Arabia been the top crude supplier to the United States even without offering it a discount, many U.S. might still have responded by treating Riyadh with special care.

Perceptions also conspire to link oil trade and international relationships through concerns about trade imbalances. Most economists believe that bilateral trade balances don't matter under normal circumstances; what matters when it comes to trade balances (to the extent that trade balances matter at all) is the difference between each country's total exports and imports. If, for example, the Germany imports a billion dollars of oil from Saudi Arabia and exports a billion dollars of widgets to Japan, the fact that it has bilateral imbalances with each of those two countries shouldn't bother anyone.

In practice, though, many policymakers and analysts believe otherwise. This provides a window for economically driven oil trade to have non-economic consequences. Large oil import bills from particular states can drive policymakers to focus their energies on encouraging exports in the opposite direction, something that typically requires intervention beyond what markets will do on their own. This quest for so-called "balanced trade" with one's trading partners has been a political rallying cry in the United States and a guiding trade strategy in some major oil importers. A hallmark of Beijing's oil diplomacy in Africa, for instance, has been to ink deals with oil exporters that also provide new markets for Chinese exports.

Producers and Consumers

Americans naturally think about energy and politics from the perspective of oil consumers. When they claim that political concerns can distort oil trade, or argue that they cannot, they typically have consumer maneuvers in mind. The United States, for example, might seek to lessen imports from Venezuela and the Persian Gulf, while ramping up purchases from Canada, in order to position itself more effectively in the world.

In practice, trade distortions appear to be driven more by producers. We observed earlier, for example, that Saudi Arabia has historically tweaked prices to maintain leadership in the U.S. market, and that Kuwait has at times acted similarly in order to preserve market share too. Central Asian oil producers have been at least as eager to develop multiple export pipelines in order to evade Russian influence as consumers in the region have been to see multiple import pipelines come online.

Why do producers appear to be more active on this front than consumers? Much of the answer may lie in opportunity. Most oil imports have historically been to the market economies of the OECD, and private refiners have been the ones that purchased and imported crude (though both of these facts are gradually changing at developing countries become more prominent importers of oil). That has left little opportunity for governments to manipulate import sources, particularly after the world began to move to a system of relatively free trade in and after the 1980s. In contrast, a large portion of world exports have been (and still are) controlled by states or state-owned companies. Exporting governments can thus do things to price their crude in ways that ultimately lead markets to steer their oil to their preferred destinations; they can also steer trade through ownership of mid- and downstream assets (particularly refineries).

That leaves the question of why they might want to do that. In the case of Saudi Arabia, we have seen, part of the logic has been about perceptions. But there are other forces that can shape countries' preferences. Iran, for example, has courted markets that it expects would be less likely to stop buying in times of crisis. Oil exporters have also at times sought a foothold in domestic oil markets they expect to grow quickly. By buying an interest in several refineries in the U.S. Gulf of Mexico, for instance, Saudi Aramco may have tried to benefit from the option of importing and processing its own crude oil when market conditions make that strategy profitable. Caracas was likely thinking along similar lines when it purchased Citgo in 1990, which allowed Venezuelan state oil company PDVSA to penetrate the booming U.S. market, its major export destination, to a degree it could not possible through trade alone.

Russia also appears to use oil pricing to exert leverage. Contrary to what some might instinctively assume, though, it does not appear to overcharge for oil; instead, it actually undercharges some customers for crude. In 2010, Commonwealth of Independent States (CIS) members bought Russian oil at a 35% discount, on average, relative to what the rest of the world paid. Past discounts have been even deeper—up to 44% in 2008.[14] This preserves Russian leverage – Moscow can still threaten to raise prices in a crisis – and costs relatively little to Russian oil companies whose primary markets lie elsewhere. At the same time, by keeping its clients hooked on discounted crude, Russia deters them from pursuing pipeline arrangements with others (like China or Iran) that, in the long run, would give them more supply options (albeit more expensive ones) and thus more freedom in their affairs. Indeed Russia is not the only example of a country that has used below-market oil as a carrot for currying regional influence. Many members of OPEC have sold discounted oil to friends or potential friends at one time or another. Saudi Arabia has sold crude at a discount to Yemen and Bahrain.[15] Caracas makes refined products available to Caribbean nations on preferential terms via the PetroCaribe program, which helps extend Venezuela's influence among its neighbors.

Producers have also steered trade politically when confronted with particularly trying circumstances. In the early 1980s, for example, Iraq reportedly struck at a deal to provide Brazil with discounted oil in exchange for dozens of tons of uranium and unspecified technical know-how. By 1989, this bilateral cooperation, built around cheap oil, had grown to include Brazilian technicians training Iraqi military personnel in rocket aerodynamics, flight testing, and aerospace electronics. It ended only after the first Gulf War.

Dogs That Don't Bark

All of this might leave one with the impression that politics is everywhere in the international oil market. That is not the case. In several important instances, we investigated cases based on suspicions that we might discover links between oil trade and international relationships, but found none.

Large departures from the assumption of one world oil price appear to be relatively rare. Trade between Russia and several former Soviet states is an exception; so is trade between Venezuela and several Latin American countries. Parts of the market are also too opaque to allow sweeping conclusions: scholars often point out that spot market prices move in unison across the globe, but that does not mean that prices under term contracts (which make up a larger part of world trade) always do too, at least in the short run. (Prices under term contracts should generally track spot prices over the medium to long term.) Broader stresses can also influence outcomes: facing a dearth of buyers from tightening sanctions in early 2012, Iran tried to unload its exports onto whoever would take them—likely China—at prices that likely were well below typical market ones.

Nonetheless, informed observers generally believe that large variations among prices on different trades are unusual. This all implies that it is possible for oil trade to have real consequences for international politics without trade itself, or oil prices, being particularly distorted at the same time.

We also looked to see if old colonial relationships had consequences for oil trade, particular in the case of France and Africa. The answer was in part was mostly no. Corporate legacies and technological inflexibility lend inertia to trade relationships that once upon a time had political logics but no longer do. Old investments in specialized refining capacity, also driven once upon a time by strategic considerations, can also continue to steer oil trade even once those foundations have become obsolete. Yet as time has passed, these have exerted increasingly less influence. Today, France imports less than ten percent of its oil from its former African colonies, though French oil major Total continues to have an outsized presence in countries like the Congo and Gabon.

The last place that we looked for a link between oil trade and international politics was in the realm of military calculation. There is ample historical evidence that countries have cultivated relationships with suppliers that they believed would be reliable during times of war.[16] Our case studies, though, did not turn up much along these lines in the modern era, particularly after the advent of robust global oil markets in the 1980s. Strategic oil trade decisions appears to be more tightly connected to diffuse diplomatic goals, such as Brazilian efforts to attract support in Africa and Chinese desire to forge strong relations with Venezuela, rather than to efforts that would hedge against wartime supply loss.[17] (Chinese oil trade with Venezuela, for example, has little military logic, since the United States could easily blockade nearby Venezuela in a time of genuine war.) This may be a result of that fact that fears of major power war are lower than at any time in memory, or it may be because countries see little prospective contribution from peacetime trade partnerships to wartime security.[18]

An exception to that rule, though, appears when some countries weigh the strategic benefits of pipelines versus seaborne trade as a means of sourcing their oil imports. Analysts were quick to note the advantages China would gain through the Russia-China crude oil pipeline. The pipeline was compelling on purely economic terms: it was cheaper and more practical than rail for the Chinese and allowed Moscow to diversify its exports. But another crucial advantage of the pipeline, as strategists saw it, was in providing China with a land-based source of crude oil impermeable to a maritime blockage. Beijing has favored oil and gas pipelines from Kazakhstan, Turkmenistan, and Burma on similar grounds. The same logic has long figured into policymaking discussions in the United States about where to source crude imports. A U.S. Congressional report from 1968, for instance, argued that "Canadian sources of crude should continue to be considered within the scope of our national security planning and therefore should receive special treatment" from U.S. importers.[19] Many policymakers who favor Keystone XL stress the security benefits that indigenous North American oil gives the United States, presumably in comparison to ocean-borne imports, especially those from Washington's political adversaries.[20]

An Uncertain Future

There are undoubtedly connections between oil trade and international politics, whether the result of geography, perceptions, or producers' strategies. Yet these have declined in recent decades. Our case studies repeatedly revealed that the link between oil trade and political relationships changed substantially in the 1970s and 1980s. Spot markets, once a marginal feature of the world oil scene, became more prominent, giving consumers a big buffer and lessening the substantive importance of particular trade patterns. Shipping became cheaper, and oil became more expensive, making arbitrage across great distances more attractive, thus integrating oil markets further. Meanwhile, as

the world moved to freer markets in a wide range of goods, quotas and tariffs targeted at particular oil sources gradually disappeared. The international monetary architecture also shifted from one based on fixed exchange rates to a more flexible system, which lessened the need for policymakers to intervene in order to correct trade imbalances, including those generated by oil trade. All of this happened at a time of relative peace, particularly after the Soviet Union fell in 1989.

There is no reason, though, to assume that these changes are permanent. Experts regularly warn that the world could backslide from its current, relatively liberal, approach to international trade. In a world where significant quotas, tariffs, and other barriers to trade in a wide range of goods were again commonplace, there is no reason to believe that oil would be exempt. Even without a broad-based move away from free trade, if national climate policies begin to discriminate among different sources of crude, one would see political decisions increasingly shape trade patterns.

Other forces could alter things further. Students of the international monetary regime warn that exchange rates are far less free than theoretical markets often suppose – and the trend may be toward a more rigid system, not a more flexible one. Scholars have asserted that the shadow of armed conflict should lead states to develop special relationships with dependable oil suppliers, lest their militarily critical crude supplies be cut off during war. This does not appear to be reflected in how states behave today, but there is no reason to assume that it would not if the world took a sharp turn toward greater military conflict. Even if those who argue that major power war is obsolete are correct, the prospect of regional wars could still influence countries' oil trade in important ways.

Yet for now, the most likely outcome is less revolutionary. Economists are right to argue that consumers should normally not obsess over the particular sources of their crude. But those who are focused on international politics and national security are right to warn against taking that rule too far: the relationship between oil trade and international politics has gone well beyond basic economics in the past, and will continue to do so in the future.

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[1] Compare *Statistical Review of World Energy 2012* (London, UK: BP, 2012) with *Statistical Review of World Energy 2007* (London, UK: BP, 2007).
[2] For example, Gal Luft and Anne Korin, "The Folly of Energy Independence", *The American Interest*, July/August 2012.
[3] For example, Michael T. Klare, *Blood and Oil: The Dangers and Consequences of America's Growing Dependency on Imported Petroleum* (New York, NY: Henry Holt, 2005).
[4] These studies, along with the workshop proceedings, can be accessed on the Council on Foreign Relations website at http://www.cfr.org/projects/world/workshop-on-oil-and-political-relationships/pr1594. They are cited throughout this article by author and topic.
[5] For example, David G. Victor, Amy M. Jaffe, and Mark H. Hayes, eds., *Natural Gas and Geopolitics: From 1970 to 2040* (Cambridge, UK: Cambridge University Press, 2006).
[6] See David Mares' case study for a discussion of resource nationalism and oil production in a Latin American context.
[7] See Valérie Marcel's case study on oil investment flows into and out of the Persian Gulf states.
[8] Robert McNally and Michael Levi, "A Crude Predicament", *Foreign Affairs*, July/August 2011.
[9] Blake Clayton, *Lessons Learned from the 2011 Strategic Petroleum Reserve Release*, Working Paper, Council on Foreign Relations, September 2012.
[10] See Ariel Cohen's case study on the political aspects of Russia's oil trade with its neighbors.
[11] See David Goldwyn's case study on the politics of the United States – Canada oil trade relationship.
[12] See David Mares' case study on the politics of the United States – Venezuela oil trade relationship.
[13] See Valérie Marcel's case study on the politics of foreign direct investment in oil among selected Middle Eastern countries for facts in this paragraph.
[14] See Ariel Cohen's case study on the political aspects of Russia's oil trade with its neighbors.
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[16] See Rose Kelanic's case study on politics and the oil trade in wartime.
[17] John Deutch and James R. Schlesinger, "National Security Consequences of U.S. Oil Dependency," Council on Foreign Relations, 2006; see also Trevor Houser's case study on Chinese foreign investment.
[18] See Rose Kelanic's case study and Jeff Colgan's remarks about the political economic and security scholarship on international trade.
[19] See Rose Kelanic's case study on politics and the oil trade in wartime.
[20] Recent statements from two U.S. Congressional officials on Keystone XL provide an illustration: http://www.boozman.senate.gov/public/index.cfm/keystone-xl and http://shimkus.house.gov/index.cfm?sectionid=24&itemid=453.