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INTERNATIONAL: Fuel autarky will transform US policy

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Abstract

US fuel autarky and foreign policy.

Energy demand has fashioned US foreign policy since the Second World War but advances in drilling technologies since the 1990s unlocked large reserves of 'tight' oil and gas in shale deposits across the country beyond domestic needs. The United States becoming a net energy exporter will significantly alter its role in the world.

Full text

SUBJECT:US fuel autarky and foreign policy.

SIGNIFICANCE: Energy demand has fashioned US foreign policy since the Second World War but advances in drilling technologies since the 1990s unlocked large reserves of 'tight' oil and gas in shale deposits across the country beyond domestic needs. The United States becoming a net energy exporter will significantly alter its role in the world.

ANALYSIS: Impacts.

US oil output will surge past Russia and Saudi Arabia, increasing US exports to China and giving the US leverage in bilateral relations.

Projects underway are set to more than triple US liquefied natural gas (LNG) capacity by the end of 2019, and further projects are likely.

Fuel independence will reduce US interest in Middle East stability but could increase US efforts to combat Islamic terrorism.

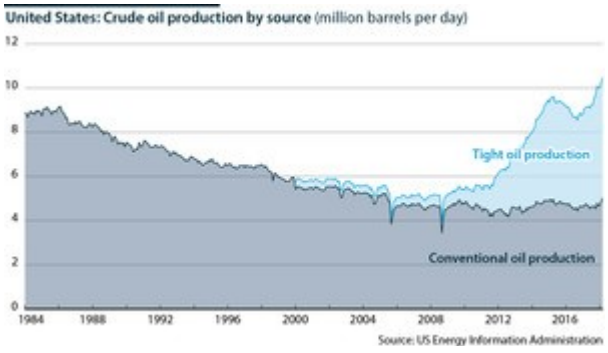
Eastern Europe and Baltic states will invest more in regasification facilities to increase the diversity of their energy supply.

Throughout the latter half of the 20th century, the United States became more dependent on unstable sources of foreign oil and more vulnerable to OPEC decisions. Concerns about the country's long-run economic vitality rose as US crude oil production fell by nearly 50% from 1985 to 2006 while imports surged by more than 200% over the same period.

Various pieces of legislation were enacted to conserve the country's energy resources and minimise US dependence on foreign oil, including the Energy Independence and Security Act of 2007. Oil had soared towards 150 dollars per barrel, and many expected prices to remain above 100 dollars for decades.

Finding fracking.

Enlarge this image.



Tight oil production expanded rapidly in the United States from 2009 due to decisions made in the early 2000s. Between January 2009 and December 2014, tight oil production surged from 11% to 50% of US oil production. Breakthroughs in horizontal drilling technology and hydraulic fracturing pioneered in the 1990s propelled the United States from a position of chronic energy dependence into an era of abundant energy.

This technology is utilised primarily in horizontally-drilled wells (which increased in number from under 400 wells in 2009 to more than 1,300 wells in 2014), while the number of vertically-drilled wells was largely unchanged.

2014-16 Oil price collapse .

Many observers suspected that fracking might be a gamechanger, but nearly all underestimated the extent of the improvements in US drilling technology. As US output climbed, OPEC boosted production between 2014 and 2016 in the hope of driving comparatively-costly US producers out of business.

Oil prices plummeted to below 30 dollars per barrel. The US economy suffered, with real business investment declining by 0.6% in 2016, driven by the collapse in oil drilling. US oil company bankruptcies rose by 379% between 2014 and 2015.

US transformation.

OPEC appeared to have achieved its goal, but remaining US producers began experimenting with the mixture of sand and water they were injecting into their existing wells. The Permian Basin, the largest US oil producing basin, is proving to be the 'gift that keeps on giving' -- firms more than quadrupled the consumption of sand and other proppants per horizontal well from 2013 to 2017.

'Breakeven' prices for US firms fell and profitability improved in line with improvements to fracking technologies

and proppant concentrations. The average price needed to cover operating expenses for existing wells fell to just 35 dollars per barrel for firms operating in Texas (mainly in the Permian Basin). As breakeven prices dropped, the US oil industry got back on its feet. Output surged.

US oil and gas companies, and especially small and medium-sized exploration and production companies, are largely funded by debt, and thus those that could rapidly adjust their financing (and avoid bankruptcy) also gained some cushion against OPEC-driven low oil prices from the extended period of ultra-low interest rates that followed the global financial crisis in 2008.

The future .

Due to the technological advances and pursuit of lower breakeven points, US oil production is expected to increase over the next several years, and is unlikely to peak until the middle of the 2020s, when the consequences will be felt of more intensive fracking leading to faster deplenishment rates. This effect is already been seen in some shale plays, although it is masked by the overall increase in drilling activity.

The total expansion in output, however, will allow for energy to be exported, an unthinkable development in the early 2000s.

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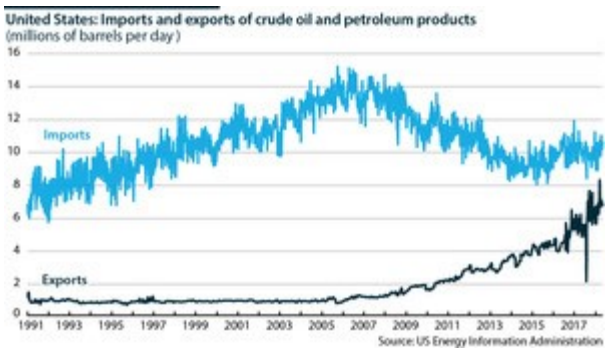

The ban on US exports of crude oil was removed in 2016, and oil and petroleum product exports surged, now hovering around the 7 million barrel a day mark. The US Energy Information Administration (EIA) expects the United States to be a net energy exporter by 2022.

This will give the United States an outsized influence on global oil prices in the future, placing an effective cap on oil prices in the 70-80 dollar per barrel range, and weakening OPEC's ability to direct prices.

Gas.

While crude oil is key to the US goal of energy independence, natural gas production and exports will also play a role in shaping US foreign policy in years to come.

In 2017, the United States exported 0.4 billion cubic feet (bcf) per day of LNG. However, the economy currently has 2.8 bcf a day of LNG export liquefaction capacity, and it is operating at nearly 100% capacity utilisation. By the end of 2019, the EIA expects this capacity to grow to 9.5 bcf a day based on projects currently under construction.

Following this capacity expansion, LNG exports are forecast to grow elevenfold, to 4.6 bcf a day in 2019 from 0.4 bcf a day in 2017.

Foreign policy.

The United States' transition from being a major oil importer to having energy independence -- and most recently becoming an oil and gas exporter -- will transform US foreign policy.

This shift may already be bolstering Trump's 'America First' strategy, as what was previously a major US vulnerability fades away and is replaced by a new source of leverage, giving the administration more

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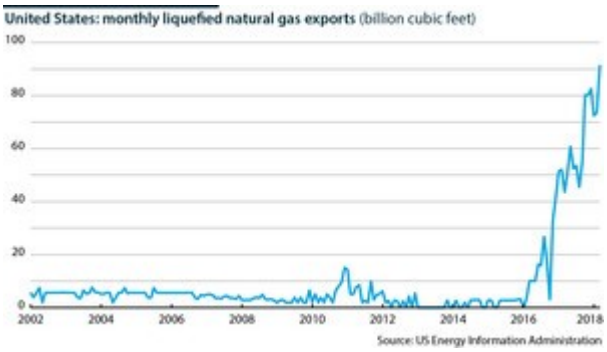

confidence in the negotiations with its key trading partners (see PROSPECTS H2 2018: Global economy - June 1, 2018).

All else being equal, renewed US strength and influence on the energy front is likely to strain relations with key energy exporters, particularly Saudi Arabia and Russia (see SAUDI ARABIA: Non-OPEC ties may come first - June 19, 2018).

Meanwhile, the United States' presence in the energy-importing markets of East Asia and Europe is set to increase, while US engagement in the Middle East is likely to continue to fade, creating a power vacuum that may increase tensions between states.

Middle East.

The most significant energy-related shift in US foreign policy is occurring in the Middle East.

From the late 1970s to the mid-2010s, US foreign policy towards the Middle East focused on protecting access to oil by counterbalancing various regional interests between Middle Eastern states -- particularly between Iran and Saudi Arabia, two of the region's largest exporters (see IRAN: Partners will struggle to save the nuclear deal - May 9, 2018).

The priority of maintaining conciliatory relations with the region's oil exporters often competed with and outweighed other regional objectives, including combatting Islamist terrorism.

Where previous US presidents, particularly Barack Obama, attempted to bring about a large-scale US exit from the Middle East, that goal only began to become a reality near the end of Obama's presidency when the ban on US oil exports was lifted in 2016. With US oil exports set to surge over the next decade, US interest and engagement in the Middle East is likely to wane.

Europe.

The United States' entry into the liquefied natural gas (LNG) market in Europe is likely to strain relations with Russia.

However, it may contribute to a new source of cooperation between the United States and certain EU countries in an otherwise tense period in transatlantic relations. Large-scale exports of LNG from the United States to Europe are still expensive, meaning that the United States will not unseat Russia's dominance as a natural gas supplier to Europe anytime soon.

However, the mere arrival of US LNG into Europe is likely to force Gazprom, Russia's natural gas champion, to lower prices and provide more favourable contract terms to retain market share.

Poland and the Baltic states have already shown that they are willing to make costly investments in regasification plants to facilitate the import of LNG from alternative suppliers and wean themselves off Russian pipeline gas. Although these developments do not indicate a seminal shift, they nevertheless represent yet another front on which the United States threatens Russia's status as a major power.

China.

The surge in US oil exports likewise threatens the status of OPEC and Russia in the Chinese market, one of the world's fastest-growing energy demand centres. US crude oil exports to China more than doubled from 2016 to 2017 and have continued to surge in the first half of 2018.

US crude oil comprises 2% of China's oil imports (compared to 15% and 13% for Russia and Saudi Arabia, respectively) but that share is likely to expand significantly over the next five years as the United States surpasses both countries in terms of production.

Oil is likely to be a major bargaining chip that the Trump administration employs in attempting to negotiate a new trading relationship with China.

Beijing has included crude oil in its draft lists of US exports on which it might impose retaliatory tariffs should the Trump administration advance to its second-phase list of tariffs. However, China will not readily cut off an import of a commodity it needs, and there are alternative markets for US crude that would mitigate the harm such a sanction would impose on the US industry.

Similar arguments can be made regarding LNG. US exports accounted for 4% of China's LNG consumption in 2017 but will account for 30% of its incremental supply growth this year and 45% in 2019, according to a note by Wood Mackenzie, a London-based energy research firm.

The wider economic impacts of an extended US-China trade war could change patterns of global oil demand in ways that are difficult to predict.

Venezuela.

US shale oil production has benefited from the sharp drop in Venezuelan output, forecast to fall to 1.38 million b/d by end-2018, compared to over 3.0 million b/d a decade ago. Despite a deep decline in Venezuelan exports to the United States, however, the United States remains, with India, one of the few cash buyers of Venezuelan crude.

Thus far the United States has not imposed an oil embargo on Venezuela, choosing instead to focus on targeted sanctions and a ban on financial transactions in a bid to limit the humanitarian cost. However, it is far from certain that this will remain the case, not least given the declining importance of Venezuelan oil for US refiners (see VENEZUELA: Output collapse may boost global oil price - May 1, 2018).

Moreover, another source of tension will be the rising role of Russia's Rosneft in Venezuela's oil sector, given its large stakes in a number of key projects, as well as in state oil company PDVSA's US refining subsidiary CITGO.

CONCLUSION: Improvements in fracking techniques are rapidly increasing US oil and gas production, and production costs are dropping surprisingly fast. The United States' emergence as a top oil and gas exporter is likely to be a key driver of shifts in US foreign policy in coming years, bolstering many aspects of President Donald Trump's 'America First' strategy.

Details

Subject	International; Economic conditions; International relations; Politics; Energy policy; Foreign policy; International trade; Gas industry; Manufacturing; Petroleum industry; Territorial issues; Construction industry; Economic growth; Technology
Location	Russia; United States--US; Venezuela; Saudi Arabia; Permian Basin; China
Company / organization	Name: Organization of Petroleum Exporting Countries--OPEC NAICS: 813910
Identifier / keyword	International; United States; US; Economic conditions; International relations; Politics; Energy policy; Foreign policy; International trade; Gas industry; Manufacturing; Petroleum industry; China; Iran; Russia; Saudi Arabia; Territorial issues; Construction industry; Economic growth; Technology
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