

The changing geopolitics of energy

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Unless you are over 50, you will not remember the days before energy exports became a potent geopolitical weapon. At the onset of the second world war, the US supplied about 63 per cent of the world's oil, with a barrel of oil costing about a dollar (roughly \$17 in 2014 dollars). Decades later, an important shift took place when the US reached its peak oil production in 1970; as output became squeezed, oil was shifting from a suppliers' market to a demand market.

That is why Opec's oil embargo in conjunction with the Yom Kippur war in 1973 was such a game changer. In the weeks before the Arab-Israeli conflict, oil was just \$2.90 a barrel (in the same range as the pre-second world war price in today's dollars). During the war, the oil producers' cartel began flexing its economic muscles, and the price of oil quadrupled by the end of that year. It never returned to its pre-1973 levels. A new dynamic emerged: energy exporters discovered their influence in global markets, the global balance of power in energy shifted and importing countries found themselves vulnerable as never before.

The low energy prices of the 1960s and early 1970s are unlikely ever to return, but with the development of new drilling technologies in the US and a surge of new production there and elsewhere, the balance of power has begun to shift yet again. And in 2014, the impact of that trend on global oil markets – and on international politics – will begin to emerge.

According to the US Energy Information Administration, US crude oil production is forecast to reach 9.5m barrels a day by 2016, “approaching the historical high achieved in 1970 of 9.6m barrels per day” and up from 5m b/d produced in 2008, the last year of

declines in US crude oil production.

Last year, with the US energy revolution under way, the US imported 37 per cent of its oil supplies. That number should fall to 25 per cent or even less in 2016. The EIA now also forecasts, in its baseline scenario, that the world benchmark Brent crude oil price will fall from an average of \$109 a barrel in 2013 to just \$92 in 2017.

Meanwhile, by the end of last year, the US had become the largest natural gas producer in the world, and natural gas prices in the US had fallen by almost 70 per cent since June 2008. Today, a million British thermal units of natural gas in the US costs about \$5 (even after being driven up by recent cold spells), with prices in Europe and Asia some two to four times as much. This gives industries such as petrochemical production that use natural gas as a raw material and those such as cloud computing providers that use large amounts of electricity (increasingly provided by low-cost natural gas) a huge comparative advantage over competitors elsewhere.

The US energy revolution is far from the whole story. In Mexico, President Enrique Peña Nieto is moving forward with a historic energy-sector reform programme. Though much work still has to be done, it is clear the state-owned oil group Pemex will finally be forced to shed its monopoly and allow production-sharing contracts (and thereby reverse years of declining production). Long lead times for exploration and development of deepwater offshore acreage suggest that large production increases will take time, but the long-overdue Mexican reforms are welcome.

The energy boom also extends to Canada. There, America's number one trading partner continues to increase production as it also seeks to diversify its market outlets for oil and gas exports, though it clearly will continue to export the vast majority of its oil resources to the US, where it supplies more than one-quarter of crude oil imports. Beyond that, after

considerable delay, the Obama administration will probably approve the Keystone XL pipeline this year, providing a useful export route from Canadian oil sands to US refining markets. The cumulative effect of the developments in gas and oil production in the US, Canada and Mexico will be a continent that has much greater energy independence.

Meanwhile, discoveries in Brazil, Colombia, east Africa and elsewhere will come on line, adding to the supply surge.

Even in the turbulent Middle East, oil production capacity will rise this year. In Iraq, deteriorating security conditions in the Sunni Arab areas are hundreds of miles from oil facilities in the south, where the bulk of the country's oil is produced. Oil production in the rest of Iraq represents less than 15 per cent of total volumes, and almost all of this year's increases in export capacity will come from southern fields – though markets will watch developments in the Iraqi Kurdish region in the north.

In Libya, central governance is severely challenged, but the country's competing factions have been careful not to kill the “golden goose” by damaging oil infrastructure. And assuming some deals between regional power brokers and the central authorities, export volumes should increase in the first half of 2014 from a few hundred thousand barrels a day to half or more of their pre-crisis volumes of 1.4m b/d.

Over the course of this year, the negotiation over the future of Iran's nuclear programme will be the wild card to watch. For now, a six-month interim agreement has relaxed sanctions somewhat and reduced the risk of military action, at least until autumn. A breakdown of talks would possibly keep Iranian exports offline indefinitely. Market worries over air strikes would return an “Iran risk premium” to oil prices. But the more likely outcome will be a further extension of the interim agreement,

pushing the issue into next year. If an agreement is reached, gradual oil sanctions relief will delay any resumption of full volumes into 2015, at the least, but supplies would then increase sharply thereafter.

All of these developments are bad news for governments that depend heavily on energy exports for their revenue. The Saudis, for example, who are anxious over the possibility of improved US relations with Iran, are watching this market shift closely, because market pressure to restrain output will leave them with less money to spend on projects meant to safeguard the kingdom's stability at a time when those outlays are increasing substantially.

Russia has headaches too. When Vladimir Putin became president in 2000, oil and gas accounted for less than half of the country's export revenue. Since then the percentage is now about two-thirds. Moreover, Russia's European energy customers will have new options as US liquefied natural gas projects progress and as other potential exporters develop natural gas production. Lost revenue from oil and gas exports would weigh heavily on Mr Putin's government and its ability to provide the capital needed for new,

more costly and difficult-to-access resources.

Venezuela's troubles are the most immediate of all. That country, mired in its worst economic crisis in 30 years, is already plagued with spiralling inflation, consumer good shortages, power cuts and one of the world's highest crime rates. And it sold much of its future production to China to generate funds to help win the recent national election. The challenges have accumulated so much that Caracas no longer publishes oil production or export statistics. Meanwhile, President Nicolás Maduro has maintained the Hugo Chávez-era habit of treating the state-owned oil group PDVSA as a national piggy bank for financing social spending projects. That is why lower oil prices are a potential disaster for Venezuela's ruling party – and for Cuba's Communists, who get by with cheap energy imports from their friends in Caracas.

Finally, there is also an important potential geopolitical upside here. No two countries consume more energy than China and the US, and no relationship is more important for international peace and the health of the global economy. China does, of course, have the world's largest

deposits of shale gas, but they will be difficult to access due to remote location and lack of the technology – and water – needed for fracking. Meanwhile, the US has emerged as the world's leader in shale extraction and production technology. This situation could be the basis for a durable commercial partnership. In the meantime, potential Chinese investment in US energy production presents mutually profitable possibilities.

For decades, shifts in energy markets have reshuffled the deck of geopolitical winners and losers. That is now happening again. The latest trend looks here to stay, and the fallout has just begun.

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