

Tipping Point: What Falling Oil Prices Mean for US & NATO Security Policy

By Rex R. Wempen

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The significant drop in oil prices in the second half of 2014 may be a bargain for the American consumer, but it may come at the cost of an increase in global security challenges. The recent steep drop in oil prices is roiling oil markets and will destabilize many oil producing countries as domestic spending decreases and attendant social dissatisfaction feeds insurgencies in the Middle East and adventurism in Eurasia. This will increase international security challenges going forward, and the cost to the Pentagon to contain them. While America has enough supply to protect against supply disruptions, its NATO and non NATO allies and trading partners do not. The US has almost doubled crude oil production in the past five years from approximately 5.5 million barrels of oil per day (bopd) in 2010, to a projected 9.3 million bopd in 2015, according to the US Department of Energy Information Agency (EIA).¹ The US has surpassed both Saudi Arabia and Russia to gain the mantle as the world's largest oil producer, making US production the decisive driver of global crude oil prices. Spare Saudi capacity, the linchpin of OPEC price leverage, has hovered between 2 and 2.5 million barrels per day for the past decade, while the growth in US production has outstripped it.² Low prices may well bring attendant security issue for oil dependent states for an extended period.

The price of West Texas Intermediate (WTI) has fallen below \$70 for the first time in four years, and the price of Brent is only just over \$70.³ This represents a 40% drop in the global price of oil since the June 2014 high of \$107 per barrel. While the US may be within reach of insulating itself from physical supply shocks, its NATO allies, dependent upon OPEC and Russia for the majority of their supply, do not. This price drop will not only roil markets, but increase global security challenges as well. While the US has the means to rapidly insulate itself from the physical issues of supply disruptions in the Middle East and Eurasia, its NATO and non-NATO allies and trading partners are not. Europe may import less oil from OPEC in total than Asia, but the EU imports approximately 40% of its daily petroleum requirements from OPEC countries, and approximately another 40% from Russia. 15.5 of the approximately 17.5 million barrels of oil that transit the

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Persian Gulf daily under the US regional security umbrella are bound for Asia according to the EIA.⁴

¹ EIA, International Energy Outlook 2014, <http://www.eia.gov/forecasts/ieo/>

² EIA, Energy and Financial Markets, "What Drives Crude Oil Prices," <http://www.eia.gov/finance/markets/supply-opec.cfm>

³ Bloomberg, Commodity Prices, <http://www.bloomberg.com/markets/commodities/futures/>

⁴ EIA, World Transit Oil Chokepoints, <http://www.eia.gov/todayinenergy/detail.cfm?id=18991>

Geopolitical events, such as the removal and re-entrance of a million barrels of Libyan crude between the summer of 2013 and the summer of 2014, may no longer have an impact on oil prices if supply continues to expand in Non-OPEC countries. The EIA projects that 1.9 million barrels of production will be added to global supplies this year, including 1.5 million from the US alone.⁵ OPEC did not cut production in response to these events at its November 27th meeting in Vienna. Does OPEC pricing power remain? OPEC leader Saudi Arabia is in a complicated position. It may be better to do nothing from its political point of view, and let prices fall, and let market perception continue that OPEC does have pricing power, than to act, and perhaps find pricing power has markedly diminished. The dramatic increase in supply of oil from non-OPEC countries may mean that the US has replaced Saudi Arabia as the global price maker, and that neither OPEC cuts or supply shocks can as effectively dictate prices as they once did.

While purposeful supply shocks from OPEC may no longer be a threat to the global price of oil due to increased global supply, and while this means greater economic security for industrialized nations, this new reality may conversely mean increased physical insecurity for several oil dependent regimes and perhaps as importantly, the regimes they support. Saudi Arabia and the UAE provided \$8 billion to Egypt in July 2013 to stabilize the country after the ouster of President Morsi by General Sisi, double the \$4 billion offered by the IMF, which would have required socially destabilizing economic austerity.⁶ The Financial Times reported on March 14th of this year that Saudi Arabia had provided \$1.5 billion in aid to Pakistan which endured riots and protests which threatened to topple the government of Prime Minister Nawaz Sharif. Saudi Arabia has approximately \$735 billion of reserves, and the national annual budget is approximately \$235 billion, but the IMF had predicted that at present rates of spending, Saudi Arabia would not run a budget deficit until 2018.⁷ The logical Saudi response to lower prices would be to cut spending, specifically in the area of foreign aid. Should prices continue to fall lower, aid packages to ensure regional geopolitical stability may no longer be forthcoming. A major country such as Egypt or Pakistan could be denied stabilization funding, as might a smaller neighbor such as Yemen. The UAE and Qatar may no longer support Libya under current price conditions. Lower oil prices will also threaten countries such as Nigeria, currently threatened by terrorism and insurgency. Iraqi recovery will become more difficult in the midst of the ISIS crisis. Negative economic conditions which feed feelings of disenfranchisement among minority groups will intensify as government domestic spending decreases. Saudi Arabia may be counting on continued low price levels to destabilize Iran, already suffering under international sanctions, but Iran, accustomed to such suffering, may be able to sustain itself for years. Other nations may suffer earlier, however. OPEC member Venezuela may fail as a state within the next year due to bankruptcy and resultant civil unrest. Moody's downgraded the country's credit rating in December 2013, when oil prices were significantly higher, and warned of the danger of imminent

⁵ EIA, International Energy Outlook 2014, <http://www.eia.gov/forecasts/ieo/>

⁶ Peel, Michael, Hall, Camilla, Financial Times, July 10, 2013, Saudi Arabia and UAE Prop up Egypt Regime with \$8 Billion

⁷ Wempen, Rex, Interview with Glen Carey, Senior Correspondent, Saudi Arabia, Bloomberg November 30, 2014

national fiscal collapse.⁸ There will be collateral ramifications for Saudi Arabia and the GCC. They can afford to deal with price cuts by cutting their budgets, but this will lead to discontent in youthful populations largely dependent on government spending for their livelihoods.

The drop in oil prices is not completely due to the rise in US production. Saudi Arabia, as leader of OPEC, is maintaining production rather than cutting it as customary when faced with lower prices. If oil drops another ten dollars per barrel, US shale oil production will become revenue neutral, ending investment in and stalling the American energy revolution. Saudi ARAMCO oil production costs per barrel are approximately four dollars. Saudi Arabia can easily win a price war with relatively higher cost US producers, as shale oil extraction costs run over \$40 per barrel in most cases, and in many cases over \$50. Lower oil prices will drive many of the new highly leveraged American oil producers out of business and curtail new investment in US production. This means the American energy revolution will at minimum slow down, and may grind to a halt. This may be exactly what Saudi Arabia is counting on, and may be the motivating factor behind Saudi approval of current OPEC policy to keep production at current high rates against the protests of many sovereign members. The oil markets have seen this scenario before. Oil prices dropped from over \$140 per barrel in 2007 to under \$40 per barrel in 2008 due to the global financial crisis.⁹ Prices recovered as economic activity improved. OPEC reaped enormous profits as the market recovered. Oil dependent states might hope for a price recovery based upon a drop in production that would shutter tight oil production stateside, but this time, even the medium term price recovery prospects are against this outcome. There has been a permanent increase in US production potential, and any increase in price above the profitable threshold to current levels would lead to a resurgence of production, and end any lengthy return to oil near a hundred dollar per barrel price point.

This leaves a geopolitical event as the last best hope to take away significant production. Iran is a strategic rival of Saudi Arabia, and the world's sixth largest oil producer after Canada, and exports the majority of its oil to China, India, and Japan, all vital links in the global economic supply chain. Saudi Arabia may hope that in the face of Iranian intransigence during negotiations to limit its nuclear program to internationally verifiably peaceful purposes in six-party talks with the five permanent members of the UN Security Council, the US, UK, France, Russia, and China, plus Germany, the US and EU will impose harsh financial sanctions on Iran that would remove Iranian crude oil from the market. The removal of significant amounts of Iranian oil from global markets would accomplish the same goals as an OPEC production cut of over three million barrels of oil per day, with the entire cost borne by Iran.¹⁰ This would be a significant boost for oil dependent states (except Iran). The renewal of significant international sanctions on Iran may

⁸ Rating Action: Moody's downgrades Venezuela to Caa1; outlook negative, Moody's Investor Services, https://www.moody.com/research/Moodys-downgrades-Venezuela-to-Caa1-outlook-negative--PR_289285

⁹ Bloomberg, Commodity Prices, <http://www.bloomberg.com/markets/commodities/futures/>

¹⁰ EIA, Country Analysis Brief, Iran, July 21, 2014, <http://www.eia.gov/countries/analysisbriefs/Iran/iran.pdf>

not materialize, however. China and Russia may have significant reservations and delay implementation. Certainly it would not be in the interest of Russia for a deal to be made that would mitigate sanctions on Iran and bring new oil production to market, however, Russia may not want sanctions imposed which would increase the regional US military presence. Prolonged continuation of the present status quo in Iran would mean no relief through geopolitical events for Saudi Arabia. The current price situation may be prolonged meaning continued and significant budgetary pain for all emerging markets dependent upon petroleum revenues.

China may want an end to sanctions on Iran altogether, expanded Iranian oil production, and lower oil prices for Chinese industry. China has a history of supporting the Iranian military. There may be significant pressure from China on parties to the six party talks to successfully conclude the six party talks and end sanctions. An unacknowledged geopolitical calculation that China could make is that a nuclear Iran might not be a negative prospect. A nuclear Iran could be an ally to help dislodge US military hegemony in the Gulf. This would of course destabilize China's relationship with its G2 partner in global trade, the US. Given that China continuously advances the concept of a "peaceful rise," and sees itself as gradually overtaking the US and assuming an equal role, or passing the US altogether as the leading global nation state, Chinese leaders may not actually relish the long term prospect of a nuclear state in the Gulf, or more probably, multiple nuclear states, as the emergence of a nuclear Iran could well catalyze a regional nuclear arms race.¹¹ Certainly China would want an end to sanctions and expanded production in Iran followed by lower global oil prices, a stance which all parties in the talks, including the EU parties and the US, with the exception of Russia, would want, and all parties profess to desire as the final outcome. Whatever the motivations of any party to the six party talks, should rapprochement between the US, the other five parties, and Iran occur, and sanctions be ended altogether, inviting massive investment in and an increase in low cost Iranian production, the national revenue models of oil dependent states would face a significant negative revision, with commensurate negative internal security ramifications due to declining state revenue. Iran produced six million bopd in 1979, and never recovered from sanctions imposed by the West after the Iranian Revolution. Today it produces 3.1 million bopd, according to the EIA. The implementation of sanctions on Iran would be the best case scenario for oil dependent states. It would single out one member, and leave the remaining states to benefit from higher prices. The benefits would not last more than two to three years however, unless a significant conflict erupted, because if sanctions took Iranian production off line, and current prices returned, galvanizing expansion in global supply at the current rate of close to 2 million barrels per day, the production loss would be fully compensated in less than two years from the imposition of sanctions. A geopolitical event involving Iranian sanctions would not be significantly helpful in the long term for oil dependent states given current rates of and potential for oil supply increases. The worst case scenario for the US would be the prolonged expense of a full scale sanctions regime necessitating an enhanced military presence in the Gulf. However, oil prices would probably not rise significantly due to the aforementioned factors. No likely scenario for six party

¹¹The State Council Information Office, *China's Peaceful Development Road*, December 15, 2005, <http://www.china.org.cn/english/2005/Dec/152669.htm#1>

talks produces a likely long term benefit for oil producing states except possibly Iran. Oil supply will continue to increase in most scenarios, and eventually, OPEC will have to return higher production rates to the market, as member states cannot indefinitely maintain their position. New lower cost extraction technologies are on the horizon in the US, but will require significant investment. OPEC price cuts may encourage US R&D, exacerbating the global supply glut. While the US will probably have to continue to import over half of its oil on a daily basis for some time, the expansion in capacity from the American energy revolution will remain, as will its ultimate pricing power. There are few good choices for Saudi Arabia and oil dependent states. The inexorable technological advances of shale production and horizontal drilling mean that truly high priced oil may not ever return without a significant and prolonged geopolitical event.

Multiple years of lower oil prices catalyzed by high OPEC production rates played a significant factor in the collapse of the Soviet Union. They are significantly affecting Russia now. Russian political leaders and businesses associated with them are being sanctioned and prohibited from visits and further business in the US and Europe in retaliation for Russian annexation of Crimea and support for separatist rebels in Eastern Ukraine. More significant, however, is the effect of increased US oil production and resultant lower oil prices. The ruble, dependent on the price of oil, has lost forty percent of its value in 2014.

Increased security tension in the Middle East may well be echoed by increased security tension in Eurasia. The ruble continues to devalue commensurate with the drop in oil prices. Russia may be tempted to assert increased control over Eurasian energy basins to compensate for loss in revenue by increasing market share. While there has been a high degree of press commentary upon the possibility of Russian intentions regarding a possible move to annex Russian majority regions in the Baltic states, the Russians may in fact be focusing on countering US support for the Trans Caspian pipeline initiative announced on November 21st during the 2nd Azerbaijan and Caspian Sea Oil and Gas Week 2014 conference in Baku. US support for the construction of a significant non-Russian pipeline to Europe may well engender a response similar to that by Russia to US and EU support for Ukrainian attempts to leave the Russian orbit. The most obvious target is Georgia. President Putin announced that he had signed the long anticipated Eurasian Customs Union treaty with Belarus, Kazakhstan, and Armenia on October 3rd, and announced a strategic partnership agreement with the autonomous region of Abkhazia in Georgia the following month. The Council of Armenian NGO's of the Samtskhe-Javakheti Region of Georgia, the majority ethnic Armenian enclave through which both the Baku Tbilisi Ceyhan and planned Trans Caspian pipeline would run enroute to Turkey, presented a petition to members of the European Parliament in Brussels in March 2012 requesting international recognition of their self-proclaimed regional autonomy.¹² Russian recognition of this region, to bring all Eurasian

¹² Council of Armenian NGO's of the Samtskhe-Javakheti Region of Georgia (Mr. Artak Gabrielyan, Coordinator), Memorandum, Resolving the Grievances of the Armenians of the Samtskhe-Javakheti Region of Georgia, Presented to the Members of the European Parliament and European Institutions in Brussels June, 2012 (Mr. ARTAK GABRIELIAN Coordinator)

pipelines to the West under Russian control through Armenia would be a logical strategic step. While outwardly aimed at the West, such an action might intimidate Turkmenistan into further cooperation regarding gas sales to China, solving problems on two fronts for Russia. Dominance of Eurasian reserves is the key driver of the Russian economy, and the basis of centralized regime control. Certainly the Russians have demonstrated their willingness to intervene abroad militarily and through strategic operations in the CIS when perceived vital national interests have been threatened, and given the continuation of instability in the Muslim world, a variety of pretexts exist to intervene in Muslim majority states.

The US will be affected in two ways by increased security threats to external energy supplies. It will be pressured to respond militarily and or with sanctions regimes. It will also face increased domestic political pressure to speed the expansion of energy links in North America to create continent wide energy security. Energy markets in Mexico are opening for the first time through new and revolutionary change in Mexican law allowing foreign investment in energy production. Increasing investment in energy transport links with Canada, the leading international oil supplier to the US, will also gain further appeal, enhancing the already strong economic logic for approval of the Keystone XL pipeline, which would not only create jobs but decrease both the cost and security of energy transport relative to current rail transport. Perhaps additional energy infrastructure links would logically follow. There is enough oil produced in North America, between Canada, the US, and Mexico, to account for all current petroleum requirements with the addition of an equivalent amount to daily production from Venezuela or Brazil. There may be a strong economic case made domestically to counter any OPEC or security induced supply reductions and price increases with fiscal measures to increase production and energy security. Were the North American energy revolution to continue apace, complete energy independence for North America would become rapidly feasible. Conversely, increased American energy security and lower global energy prices may well result in deterioration in the international security environment.

Europe and Asia have options to increase energy security, but they are limited. A North South Energy Corridor, as proposed at the November 2014 Atlantic Council Energy and Economic Summit, would enable exploitation of continental shale resources, link North Sea basins to Southern Europe and provide interconnectors between Western and Central and Eastern Europe to facilitate the transfer of new non-Russian LNG throughout the EU, and, could help alleviate the current high degree of dependency upon Russia in those regions. However, there would be a high price premium paid for substitution, as asserted by multiple speakers during the summit, and that is further assuming the Southern Gas corridor comes online. Further LNG is available from new production in Australia, but the majority of new production is from North America, which will not have enough to compensate completely for several years, and then, at a premium with negative economic ramifications. This means dependence upon Russia for a significant amount of energy requirements for some time. Asia is in a more dependent position upon the Middle East, Africa, and Eurasia. China, India, and Japan, have embarked on naval buildups, ostensibly to secure their trade routes in the Indian Ocean. However, this is a problematic option which will not only increase pressure on Washington to raise defense spending to compensate for Chinese military expansion, but may lead to a net loss in security for Asian states by exacerbating regional

tensions and increasing the tempo of an already growing Asian arms race. The extent to which Asian countries might be willing to support international security efforts to stabilize oil producing states has been successfully tested in Africa but not the Middle East. The extent to which such participation would be welcomed by Middle Eastern states is unknown, and the acceptance of such participation might raise regional questions about US military guarantees of the core GCC regimes, guarantees which have endured since the Suez crisis in 1956.

Both the Euro area economy and the combined economies of greater East Asia are larger than that of America, placing the majority of global markets at risk from geopolitically induced physical supply shocks, and attendant price shocks to globally priced commodities would be felt worldwide. Should such shocks occur due to geopolitical events, American political leaders will be subjected to pressure to intervene to defend the global trading system upon which her own economy depends. The peace dividend from the withdrawal of US forces from Iraq, already partially undone by engagement against the Islamic State, and from the withdrawal of the majority of US forces from Afghanistan, may evaporate all together.

The American energy revolution has created a tipping point in the global security environment. Significant economic dislocation in countries largely dependent upon energy production for national revenue may promote regime adventurism in Eurasia and instability in the Middle East and the global South. The probability is that the US will not countenance geopolitically induced supply shocks from the Middle East, and will take all necessary measures to ensure this does not occur. This may require significantly increased military expenditure, however. Russia will probably not voluntarily cut supply (and neither will OPEC), but any increase in Russian military activity would also lead to increased US military expenditure, assuming the US wished to maintain the NATO security guarantee. The US energy revolution has led to record price drops and significant good news for both American and international consumers, but it may also catalyze geopolitical instability, leading to additional US defense expenditures and accelerated changes in American and NATO security policies in reaction to geopolitical events.