

Testimony
“The Geopolitics of Oil
And
America’s International Standing”

Committee on Energy and Natural Resources
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Mr. Chairman, Senator Domenici, members of the Committee, thank you for the opportunity to speak with you about the global oil balance and its implications for America’s national security and foreign policy.¹ In my view, the most profound challenges to America’s global leadership during the next quarter century are *not* posed by the risk of strategic failure in Iraq, further proliferation of weapons of mass destruction, or the growth and consolidation of extremist forces in the Islamic world. **Rather, the most profound challenges to U.S. preeminence during the next 25 years flow from the strategic and political consequences of ongoing structural shifts in global energy markets, especially the global oil market. Most notably, cooperation between China and Russia on energy matters is bolstering Sino-Russian cooperation on strategic issues, effectively creating a Sino-Russian “axis of oil” as the principal counterweight to America’s global hegemony.**

Resource Nationalism and Resource Mercantilism

The basic structural shifts in global energy markets I see boil down to two important trends:

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¹ For more detailed presentations of the ideas offered in this testimony, see Flynt Leverett and Jeffrey Bader, “Managing China-U.S. Energy Competition in the Middle East”, *The Washington Quarterly* (December 2005); Flynt Leverett and Pierre Noel, “The New Axis of Oil”, *The National Interest* (Summer 2006); and Flynt Leverett, “The Race for Iran”, *The New York Times*, June 20, 2006.

- The first is the tightening of margins between global demand for crude oil and installed upstream productive capacity. The global oil supply has grown steadily in recent years, and there is considerable evidence that it will continue to grow for many years to come, given suitable oil prices and appropriate levels of investment. But, in recent years, global demand for crude oil has been growing faster than supply—in no small part because of **burgeoning energy demand from emerging economic powerhouses in Asia, particularly China and India**. In coming years, demand is likely to continue bumping up against installed productive capacity.
- The second important structural shift in the global oil market is **the progressive concentration of the world's oil reserves under the control of national governments and national oil companies, especially in the Middle East and the former Soviet Union**.

Taken together, these two trends are generating strategic and political responses on both the supply side and the demand side of the global oil market. On the supply side, many have noted the rise of “**resource nationalism**”. Resource nationalism is often defined as national governments’ assertion of ownership rights over oil and gas reserves against the interests of international energy companies. But there is another dimension to resource nationalism on which I want to focus—that is, national governments making decisions about the production and marketing of the hydrocarbon reserves under their control not only on the basis of economic factors, but also on the basis of strategic and political calculations.

There are many examples of how resource nationalism can challenge a wide range of American interests. These include:

- Russia’s application of energy “levers” to reestablish its hegemonic position in the post-Soviet space and bolster its strategic position *vis-à-vis* Europe and East Asia;
- Venezuela’s exploitation of its dominant position as a Western hemisphere energy producer and exporter to weaken America’s standing in parts of Latin America; and
- Saudi Arabia using its unique status as the “swing producer” for the global oil market to cultivate a deepening strategic relationship with China as a “hedge” against precipitous deterioration in the Kingdom’s traditional strategic partnership with the United States.²

² On this point, see also Flynt Leverett, “Reengaging Riyadh”, in Flynt Leverett, ed., *The Road Ahead: Middle East Policy in the Bush Administration’s Second Term* (Washington, DC: The Brookings Institution Press, 2005).

On the demand side, we are witnessing an analogous phenomenon, which I describe as “**resource mercantilism**”—that is, the reliance of energy importing states on national energy companies to secure access to overseas oil and gas resources on more privileged bases than simple supply contracts. Resource mercantilist states provide various kinds of support to their national oil companies’ efforts to acquire hydrocarbon assets abroad and, like resource nationalist states, often seem to base their actions in global energy markets on strategic calculations as well as on commercial and economic considerations.

The outstanding exemplars of resource mercantilism today are, of course, China and India, both of which perceive increasingly acute vulnerabilities to their energy security stemming from their growing reliance on imported hydrocarbons to fill critical portions of their energy mix. And, there are a growing number of examples of how resource mercantilism can work against U.S. interests, although not in the way that many observers initially anticipated. In this regard, while increased demand from China and other rising Asian economies has had a very direct effect on global oil prices, there is little evidence that Chinese and Indian “equity oil” deals are keeping or will keep an economically or strategically significant part of the world’s oil reserves “locked up” and unavailable to international markets.

- Currently, oil produced from Chinese and Indian overseas equity assets represents less than one percent of the oil produced and traded worldwide.
- If the most optimistic projections of Chinese and Indian oil and gas acquisitions abroad prove correct, overseas equity oil production by Chinese and Indian national energy companies might represent roughly 2 percent of total worldwide production in 2020.

However, **statist approaches in the external energy strategies of rising Asian economies are becoming a serious source of geopolitical tension.**

- In East Asia, competition between Beijing and Tokyo over a variety of specific energy deals, a bilateral dispute about sovereignty over possible natural gas reserves in the East China Sea, and jockeying over the ultimate destination of a projected Russian oil pipeline to Asia have all contributed to the deterioration of Sino-Japanese relations in recent years.
- Even more significantly, **China’s statist approach to external energy initiatives has become a source of geopolitical tension between China and the United States. In particular, China’s search for oil is making it a new competitor to the United States for influence, especially in the Middle East, Central Asia, and Africa.** This, in turn,

is creating new foreign policy as well as commercial options for energy exporting states at odds with U.S. foreign policy goals, including Iran, Sudan, and Syria.³

The New Axis of Oil

As separate phenomena, resource nationalism and resource mercantilism are posing increasingly serious challenges to U.S. interests around the world. But **the challenge to America's global leadership becomes far more profound when these phenomena intersect, as they do in what I have called a "new axis of oil" that is acting as a counterweight to American hegemony on a widening range of issues.** The heart of this undeclared but increasingly assertive axis is a growing geopolitical partnership between Russia (a major energy producer) and China (the paradigmatic rising consumer) against what both perceive as excessive U.S. unilateralism in world affairs. Sino-Russian collaboration provides the essential frame for a loose and shifting coalition of energy exporting and energy importing states that acts in specific ways to challenge U.S. leadership in world affairs.

The impact of the new axis of oil on American interests has already been felt in the largely successful Sino-Russian effort to minimize U.S. influence in Central Asia. Sino-Russian cooperation has been critical to the rise of the Shanghai Cooperation Organization, the world's largest regional security organization (in terms of the populations and territory of participating states) and the only regional security organization in the world in which the United States does not participate. Working through the Shanghai Cooperation Organization, Moscow and Beijing have collaborated over the past three years to cap and then roll back the post-9/11 extension of American influence into Central Asia.

The new axis of oil is also reflected in Sino-Russian cooperation to frustrate a significant segment of U.S. policy objectives regarding the Iranian nuclear issue. Both Russia and China have complicated policy agendas toward the Islamic Republic. To be sure, neither Moscow nor Beijing sees Iranian acquisition of a nuclear weapons capability as a Iran as a desirable turn of events. But both are prepared to tolerate a higher-level of Iranian nuclear development than the present U.S. administration. Moreover, each has other interests that it wants to pursue with Iran.

³ Statist strategies for accessing hydrocarbon resources around the world—with their associated inclination toward corruption, provision of "soft" loans, and offers of investment and aid in unrelated projects and sectors—also challenge the rules-based international order for trade and investment in energy that the United States has long championed and, in some cases, weaken the leverage that Western governments and international financial institutions can use to promote better governance and transparency in oil-producing countries.

- For Russia, these interests include exporting civil nuclear technology and conventional military equipment. For China, they include cultivating Iran as an energy supplier.
- And, both Moscow and Beijing have interests in collaborating with Tehran in Central Asia to manage Sunni extremist threats there and minimize U.S. influence. To these ends, Russia and China have now included the Islamic Republic in the Shanghai Cooperation Organization as an observer.

In this context, neither Russia nor China will support multilateral sanctions against Iran that would put these various interests at risk. As a result, there is no prospect of getting the United Nations Security Council to impose sanctions on the Islamic Republic that would be stringent enough to leverage changes in Iranian behavior on the nuclear issue.

Even more significantly, **Russia and China see the controversy over Iran's nuclear activities as an important issue on which to "draw lines" against what both Moscow and Beijing consider excessive U.S. unilateralism in international affairs.** In this regard, Russian and Chinese leaders considered the Iraq war a dangerous precedent and are determined not to see that precedent repeated in Iran. In the end, the United States or others may use military force unilaterally to try to delay Iran's nuclear development, but Moscow and Beijing will use their status as permanent members of the Security Council to ensure that there is no plausible international legitimation for such unilateral action.

The Race for Iran

The geopolitical and geoeconomic stakes at play in Iran go well beyond the nuclear controversy. **There is now a broader strategic competition underway between the United States, on the one hand, and Russia and China, on the other, concerning Iran's economic and political role in the Middle East and global energy markets in coming decades.** The outcome of this competition hinges in considerable measure on which countries will assume leading roles in helping Iran develop its enormous hydrocarbon resources.

Iran's resource base is truly impressive. If one converts Iran's reserves of natural gas—the second-largest in the world, after Russia's—into barrels of oil equivalent and adds them to Iran's proven reserves of conventional oil—the second-largest in the world, after Saudi Arabia's—Iran's hydrocarbon resources are effectively equal to those of Saudi Arabia and significantly greater than those of

Russia.⁴ Moreover, Iran's low rates of production of crude oil and natural gas, relative to its reserves base, suggest that the Islamic Republic is perhaps the only major energy-producing state with the resource potential to increase production of both oil and gas by orders of magnitude over the next decade or so.

Iran, however, cannot realize this potential without significant infusions of investment capital and transfers of technology from abroad. Since the mid-1990s, **U.S. policy has sought to constrain the development of Iran's hydrocarbon resources by barring U.S. energy companies from doing business there and threatening European companies undertaking projects in Iran with secondary sanctions. These policies, combined with a problematic investment climate in the Islamic Republic, have limited investment flows and transfers of technology into Iran's oil and gas sectors.** Recently, Iran's Oil Minister publicly acknowledged this.

Some have suggested that insufficient investment in new productive capacity, along with the combined effects of the depletion of already developed oil and gas fields and the growth in its domestic energy demand has put the Islamic Republic's oil and gas exports into a precipitous decline. **But, it would be a mistake to assume that, absent rapprochement with the United States, these trends will continue unchecked and put the Islamic Republic in an increasingly precarious economic and strategic position.**

Over the last several months, Iranian officials and energy executives have told me that **Iran is developing an alternative strategy for increasing its production and exports of crude oil and natural gas, a strategy that does not rely on substantially improved relations with the United States or the West generally.** This strategy has three principal elements.

- First, Tehran continues to explore the possibility of energy deals with European energy companies that are willing to do business in the Islamic Republic. While some significant European energy companies are reducing their involvement in Iran, there are still prominent Europe-based international energy companies with upstream investments there that are pursuing additional deals.

⁴ In its December 19, 2005 issues, the *Oil and Gas Journal* lists Iran's proven reserves of crude oil as roughly 133 billion barrels. The same source lists Canada as holding the world's second-largest oil reserves, roughly 179 billion barrels, putting Iran in third place. However, the reserves estimate for Canada includes 175 billion barrels of reserves in oil sands; this justifies the statement that Iran holds the world's second-largest reserves of conventional oil. When one converts natural gas reserves into barrels of oil equivalent (boe), Saudi Arabia has 302.5 boe in combined reserves of oil and natural gas and Iran has 301.7. By way of comparison, Russia's aggregate hydrocarbon reserves—the world's third-largest—are 198.3 boe. I am grateful to Bijan Khajepour of Atieh Bahar Consulting for sharing the results of his calculations.

- Second, Iran is developing ties to state-owned energy companies in other Islamic countries (i.e., Petronas in Malaysia) and, more importantly, to national energy companies in China and India. Chinese companies, in particular, are making commitments to invest substantial amounts of capital in Iran's oil and gas sectors.
- Third, Iran is exploring possibilities for cooperation with Russia to develop its energy production and export capabilities. In particular, Tehran is now willing to "coordinate" the marketing of Iranian gas exports with Moscow to ensure that Iran's emergence as a gas exporter does not work against Russia's economic or strategic interests. In return, Moscow has agreed to provide financial and technical support to help Iran boost its natural gas production.⁵ In this context, at the most recent summit meeting of the Shanghai Cooperation Organization, Russian President Vladimir Putin and Iranian President Mahmoud Ahmedinejad announced that their two countries would explore possibilities for cooperating to provide energy exports to Asia.

Privately, Iranian officials and energy executives acknowledge that this approach is not the optimal way to develop their country's hydrocarbon resources. But, as a senior Iranian diplomat put it to me recently, Iran "cannot wait on the West forever."

The significance of Russian and Chinese cooperation to develop Iran's hydrocarbon resources goes far beyond its impact on the rate at which the Islamic Republic's oil and gas exports increase or decline or on the extent of Tehran's regional and international isolation. Such cooperation has the potential to help Moscow consolidate a position as the leading player in supplying energy resources to major markets in Asia as well as Europe, with considerable attendant strategic benefits. It also has the potential to consolidate a Sino-Russian axis of oil as the principal counterweight to U.S. hegemony in regional and international affairs.

Strategic Challenges and Policy Responses

There are other arenas in which structural shifts in the global oil market and strategic and political responses to those shifts pose serious challenges to America's leadership in international affairs. For example, **how major energy exporting states—primarily in the Middle East and Russia—handle their enormous**

⁵ According to both Iranian diplomats and current and former Russian officials, a high-level working group has been set up to oversee bilateral energy cooperation. On the Iranian side, the working group is headed by the Deputy Oil Minister; on the Russian side, it is headed by the chief of Gazprom's international activities.

and growing current account surpluses is now as important to the management of global economic imbalances and the future of the dollar as the world's leading reserve currency as the decisions of China and other major Asian economies. Here, too, there is considerable potential for a variant of the axis of oil to develop considerable strategic leverage over the United States.

Of course, the foregoing analysis poses the critical question: “What is to be done?” The intellectually and politically facile answer to this question is to advocate “energy independence” for the United States. Unfortunately, this is not a serious response to the strategic challenges facing our country. Simply put, **there is no economically plausible scenario for a strategically meaningful reduction in the dependence of the United States and its allies on imported hydrocarbons during the next quarter century.** Reducing our dependence on domestically produced and imported hydrocarbons has many attractions as a policy goal, but we should have no illusions about how rapidly this can be achieved or how soon it can provide meaningful relief to the strategic challenges I have described.

This means, above all, that **we must begin to take energy security seriously as a foreign policy issue and prioritize energy security as a national security objective relative to other foreign policy goals.** For example, how important is an abortive drive for Ukraine's accession to NATO to American interests compared to securing Russian cooperation with the United States and its allies on energy supplies, as well as cooperation on the Iranian nuclear issue and other pressing problems? Reasonable and honorable people can come up with different answers to this question and others like it, but to avoid addressing the questions is to avoid the responsibilities of political leadership.

Beyond this general proposition, I would suggest two other concrete policy responses to the strategic challenges growing out of trends in the global oil balance. First, **it is critical for the United States to pursue a “grand bargain” with the Islamic Republic of Iran**—that is, a diplomatic process aimed at resolving all of the outstanding bilateral differences between the United States and Iran as a package. My criticism of proposals for issue-specific or step-by-step engagement with Iran, such as those presented in the Iraq Study Group report, is not that these proposals go too far but, rather, that they do not go far enough. By continuing to reject a grand bargain with Tehran, the Bush administration has not only foreclosed any real chance that Iran will accept meaningful long-term restraints on its nuclear activities; it has also put the United States in a losing position in the longer-term geopolitical and geoeconomic struggle over Iran.⁶

⁶ I have written elsewhere on the content and feasibility of a U.S.-Iranian grand bargain; see Flynt Leverett, *Dealing With Tehran: Assessing U.S. Diplomatic Options Toward Tehran* (New York: The Century Foundation, 2006).

Second, it is important to induce the leading resource mercantilist states, China and India, away from statist approaches in their external energy strategies, so as to reduce the chances that they will bolster their strategic commitments to an axis of oil as an international counterweight to the United States. In this regard, it is critically important to bring China and India into the International Energy Agency, the OECD's established "club" for major energy importing states. Similarly, it is important to encourage the internationalization of Chinese and Indian national energy companies. There is considerable evidence, especially in the Chinese case, that these companies are becoming more market-oriented and profit-focused in their strategies and operations, and are increasingly willing to challenge their national governments over external energy initiatives that do not make commercial sense. In many ways, these companies are the most promising channels for promoting more market-based approaches to external energy policy in China and India.