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Rising Oil Prices, Declining National Security

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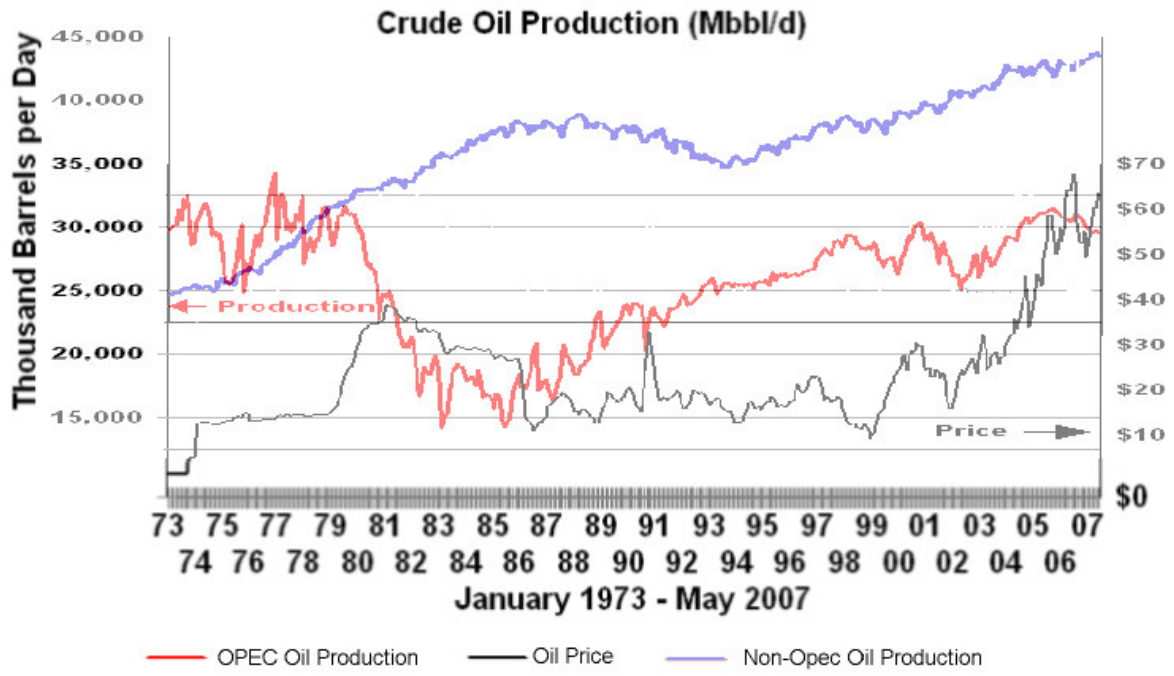
Mr. Chairman, Members of the Committee, about ten years ago, Osama bin Laden stated that his target price for oil is $144 a barrel and that the American people, who allegedly robbed the Muslim people of their oil, owe each Muslim man, woman, and child $30,000 in back payments. At the time, $144 a barrel seemed farfetched to most. Today, bin Laden is a mere $20 a barrel short of his target and there is little doubt it will be attained. I would like to impress upon this Committee that $144 a barrel oil will be perceived as a victory for the Jihadist movement and a reaffirmation that the economic warfare component of its campaign against the West is a resounding success. There is no need to elaborate on the implications of such a victory in terms of loss of U.S. prestige and our ability to prevail in the Long War of the 21st century. It is therefore imperative that the U.S. Congress do its utmost to forestall such a setback.

Deeply embroiled in a struggle against radical Islam, nuclear proliferation, and totalitarianism, the U.S. faces a crude reality: While its relations with the Muslim world are at an all-time low, more than 70 percent of the world's proven oil reserves and over a third of production are concentrated in Muslim countries. The very same Shi'a and Sunni theocratic and dictatorial regimes that most strongly resist America's efforts to bring democracy to the Middle East are the ones that, because of the market's tightness, currently drive the world oil economy. While the U.S. economy bleeds, oil-producing countries like Saudi Arabia and Iran—sympathetic to, and directly supportive, of radical Islam—are on the receiving end of staggering windfalls. In 2006, the United States spent about $260 billion on foreign crude oil and refined petroleum products. This year, with oil hovering over $125 a barrel, the figure could surpass $500 billion, the equivalent of our defense budget. At today's prices, foreign oil producers are extracting a tax of more than $1,600 a year from every American man, woman and child.

While we in the U.S., which enjoys a per capita income of over $40,000 a year, are feeling the sharp pinch of high oil prices, we should all consider the impact of these prices on the world's poor. People throughout the world who live on $2 a day are suffering far more than we can imagine as their economies hemorrhage. This has profound implications for global security, driving regional unrest, increasing poverty, and nipping in the bud progress towards democracy. Countries that are still carrying debts from the 1970's oil shocks, are being now looted by OPEC price fixing. In fact, we are witnessing a tremendous transfer of wealth from the world's poorest to the world's producers of oil.

OPEC, spearheaded by Saudi Arabia, is deliberately keeping oil supply tight to prop up prices. Not only is Saudi production lower today than it was two years ago, despite the increase in demand, but the cartel has effectively deleted 2.4mbd from the global oil market in what amounts to an accounting scam. In 2007, OPEC expanded its member roster to include Ecuador and Angola – together the two had accounted for nearly 2.4mbd of non-OPEC oil. Yet, total

OPEC production remained constant, allowing existing members to reduce production. This translates into a net reduction in non-OPEC supply with no equivalent increase in OPEC supply. This is equivalent to the production of Norway disappearing off the market. Further, while non-OPEC production has doubled over the last thirty years, as the graph below shows, OPEC production today is virtually identical to its production thirty years ago, even as the global economy has grown and with it demand for oil.



Source: WTRG Economics

The flow of petrodollars from consuming economies to the coffers of producers not only casts a large shadow over America's prospects of winning the war on terrorism but it also limits U.S. diplomatic maneuverability on central issues like human rights and nuclear proliferation. Perhaps the most powerful statement of the impact on America's ability to accomplish its foreign policy goals came from Secretary of State Condoleezza Rice, who in April 2006 told the Senate Foreign Relations Committee: "We do have to do something about the energy problem. I can tell you that nothing has really taken me aback more, as Secretary of State, than the way that the politics of energy is . . . "warping" diplomacy around the world. It has given extraordinary power to some states that are using that power in not very good ways for the international system, states that would otherwise have very little power."

One of these states is Iran. With 10 percent of the world's oil reserves and the world's second largest natural gas reserve, Iran's President Mahmoud Ahmadinejad seems unfazed by the prospects of international sanctions against his country as a result of its efforts to develop nuclear weapons. At high oil prices, leaders of human-rights violating countries like Azerbaijan, Chad, Sudan, Turkmenistan, and Uzbekistan, too, can persecute their people with impunity. Another setback to democracy was delivered last May when Kazakhstan's leader Nursultan Nazarbayev declared himself president for life. The control over a large part of the world's oil and gas market allows Russia to bully its European neighbors, to play "hard to get" on Iran, and to undermine

democracy in former Soviet republics like Ukraine and Georgia. Should Russia and other major gas producers like Iran go forth with plans to create an OPEC like natural gas cartel, we can expect further consolidation of power among the energy producers. Oil also lubricates the so-called Bolivarian revolution led by Venezuela's President Hugo Chavez, who is using Venezuela's oil wealth to buy political influence in the Western Hemisphere and to consolidate an anti-U.S. bloc in the region.

U.S. diplomacy is further complicated by the indefatigable thirst for energy of emerging countries like China and India, which are becoming increasingly dependent on the very same countries the United States is trying to rein in. The growing appetite of developing Asian powers not only plays into the hands of the aforementioned rogue producing nations, but also feeds what could become a global competition for control of energy resources. Rogue nations like Iran and Sudan can now buy themselves the support of a third of humanity – not to mention the protection of Chinese veto power on the U.N. Security Council – by signing energy deals with China and India. India now at stands at a crossroads. As its electricity demand grows it faces three options. It can tie itself to Iran, the holder of the world's second largest natural gas reserve, via the proposed 1600 mile long Iran-Pakistan-India pipeline. Last month, Iran's President Ahmadinejad visited India and Pakistan in an effort to seal the deal on this project. The implications of such a pipeline should be very clear: decades long dependence of one billion Indians on Iran. Alternatively, India can continue to develop its coal reserves and expand coal power generation. This is a sound approach from an energy security perspective; however, India has been coming under global pressure – including that of the U.S. government - to curb its greenhouse gas emissions. India's third option is to expand nuclear power development, in collaboration with the U.S. At this point, foot dragging in Delhi is delaying ratification of a nuclear agreement with the U.S. It appears that the Iranian option may hold sway. As the largest democracy in the world, India is a vital ally to the United States. Congress should explore all options – including encouraging India and Pakistan to pursue an alternative pipeline route from Turkmenistan via Afghanistan – to ensure that India does not tie its economic future to Iran.

Stripping Oil of Its Strategic Value

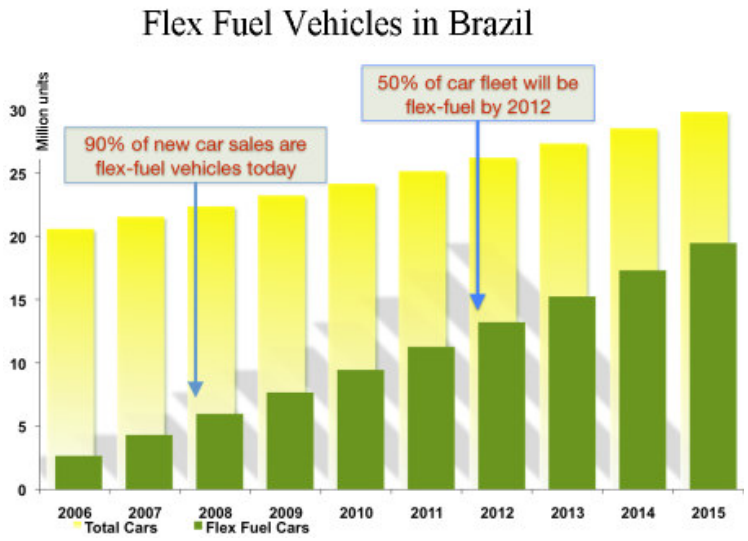
The unique strategic importance of oil to the modern economy—beyond that of any other commodity today—stems from the fact that the global economy's very enabler, the transportation sector, is utterly dependent on it, with 220 million cars and trucks in the United States alone (today, contrary to popular belief, only 2 percent of U.S. electricity is generated from oil, and conversely only about 2 percent of U.S. oil demand is due to electricity generation.) With 97 percent of U.S. transportation energy based on petroleum, oil is the lifeblood of America's economy. America is poor in oil relative to its need. It consumes one of every four gallons in the world but has barely 3 percent of the world's proven reserves of conventional oil. The United States now imports over 60 percent of its oil, more than twice the ratio of imports before the 1973–74 Arab oil embargo.

Neither efforts to expand petroleum supply nor those to crimp petroleum demand will be enough to reduce America's strategic vulnerability anytime soon. When the British Navy made the shift from coal to oil, then Lord of the Admiralty Winston Churchill famously remarked, "safety and certainty in oil lies in variety and variety alone." To diminish the strategic importance of oil to the international system it is now critical to expand the Churchillian doctrine beyond geographical variety to a variety of fuels and feedstocks.

Oil's strategic value derives from its virtual monopoly on transportation fuel. This monopoly, which gives intolerable power to OPEC and the nations that dominate oil ownership and production, must be broken. Not long ago, technology broke the power of another strategic commodity. Until around the end of the nineteenth century salt had such a position because it was the only means of preserving meat. Odd as it seems today, salt mines conferred national power and wars were even fought over control of them. Today, no nation sways history because it has salt mines. Salt is still a useful commodity for a range of purposes. We import some salt, so if one defines independence as autarky we are not "salt independent". But to most of us there is no "salt dependence" problem at all — because canning, electricity and refrigeration decisively ended salt's monopoly of meat preservation, and thus its strategic importance. We can and must do the same thing to oil.

17 X 17

Today's vehicles have an average lifespan of 17 years and, for the most part, can run only on petroleum. Every year 17 million new cars roll onto America's roads. For a cost of less than $100 extra as compared to a gasoline-only vehicle, automakers can make virtually any car a flex fuel vehicle, capable of running on any combination of gasoline and a variety of alcohols such as ethanol and methanol, made from a variety of feedstocks, from agricultural material, to waste, to coal. (Alcohol does not just mean ethanol, and ethanol does not just mean corn.) Flex fuel vehicles provide a platform on which fuels can compete and let consumers and the market choose the winning fuels and feedstocks based on economics. In Brazil, where ethanol is widely used, the share of flex fuel vehicles in new car sales rose from 4 percent to 67 percent in just three years, and this year stands at about 90 percent. These cars are manufactured by the same automakers that sell to the U.S. market and entail no size, power, or safety compromise by consumers. The proliferation of flex fuel vehicles in Brazil has driven fuel competition at the pump to the point where the Brazilian oil industry has had to keep gasoline prices sufficiently low to compete with ethanol in order not to lose more market share, so low that it actually just received a government subsidy to do so. Competition in Brazil is working so well that a big Brazilian sugar and ethanol firm just bought out the distribution assets of Exxon in Brazil.



Source: UNICA

Expanding U.S. fuel choice to include biofuels imported from developing countries has significant geopolitical benefits at a time when U.S. global standing is eroding. Sugar, from which ethanol can be cheaply and efficiently produced, is now grown in one hundred countries, many of which are poor and on the receiving end of U.S. development aid. Encouraging these countries to increase their output and become fuel suppliers, opening our fuel market to them by removing the protectionist 54 cent a gallon ethanol tariff, could have far-reaching implications for their economic development. By creating economic interdependence with biomass-producing countries in Africa, Asia, and the Western Hemisphere, the United States can strengthen its position in the developing world and provide significant help in reducing poverty.

At this point, the fallacy that increased use of biofuels in general, and corn ethanol in particular, is driving world hunger must be addressed. The primary drivers of price increases for food commodities spanning the spectrum from fish to rice (neither of which are used to make fuel) and beyond are the massive increases in oil prices -- raising the cost of distribution, labor, packaging and so forth; commodity speculation driven by a weak dollar and increased calorie demand from hundreds of millions of people in China and India who have risen out of poverty and bare subsistence. Further, despite corn ethanol production, the U.S. corn food and feed product has increased 34 percent over the last five years, and U.S. food exports overall have increased 23 percent on the year. America is clearly doing its share to feed the world.

The International Energy Agency has reiterated that biofuels are key to keeping the lid on an overheated transportation fuel market. According to Merrill Lynch, without the increase in biofuels production, oil prices would have been 15 percent higher, which at current oil prices translates into a savings of over $80 billion a year to the U.S. economy. The much derided biofuels program which has facilitated this $80 billion saving, costs the taxpayer $4 billion a year. By any reasonable standard it is a far better deal to send money to America's farmers than to various petro-dictators.

Since we hardly generate any electricity from oil, using electricity as a transportation fuel enables the full spectrum of electricity sources to compete with petroleum. Plug in hybrid electric vehicles (PHEVs) can reach oil economy levels of 100 miles per gallon of gasoline without compromising the size, safety, or power of a vehicle. The key is changing our thinking from miles per gallon to miles per gallon of oil-based fuel – it is not the total energy consumption of the vehicle which is the problem, it is the portion of that energy that comes from petroleum. If a PHEV is also a flexible-fuel vehicle powered by 85 percent alcohol and 15 percent gasoline, oil economy could reach over *500 miles per gallon* of gasoline. Ideally, plug-in hybrids would be charged at night in home or apartment garages, when electric utilities have significant reserve capacity. The Department of Energy estimates that over *70 percent* of the U.S. vehicle market could shift to plug-in hybrids without needing to install additional baseload electricity-generating capacity.

Thinking Out of the Barrel

A nationwide deployment of flex-fuel cars, flex fuel plug-in hybrids, and alternative fuels could take place within two decades. But such a transformation will not occur by itself. In a perfect world government would not need to intervene in the energy market, but in a time of war, the United States is taking an unacceptable risk by leaving the problem to be solved by the invisible hand. This is especially true since the energy market is anything but free. It is manipulated by a

cartel, heavily rigged in favor of the status quo, and, as the case of the ethanol tariff shows, riddled with protectionism.

Every year that passes without Congressional action to ensure that new cars sold in America are flex fuel vehicles is another year in which 17 million gasoline-only cars start their 17-year life on U.S. roads, further binding us to foreign oil. On the grounds of national security and in the interest of stemming the hemorrhaging of our economy, Congress should take swift action to require that new vehicles sold in the United States are flexible fuel vehicles. Such an Open Fuel Standard would level the playing field and promote free competition among diverse energy suppliers. Choosing not to embrace an Open Fuel Standard, is choosing to preserve oil's monopoly in the transportation sector, and with it OPEC's growing stranglehold over the global economy.