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NOCs AND U.S. FOREIGN POLICY

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ABOUT THE POLICY REPORT

THE CHANGING ROLE OF NATIONAL OIL COMPANIES IN INTERNATIONAL ENERGY MARKETS

Of world proven oil reserves of 1,148 billion barrels, approximately 77% of these resources are under the control of national oil companies (NOCs) with no equity participation by foreign, international oil companies. The Western international oil companies now control less than 10% of the world's oil and gas resource base. In terms of current world oil production, NOCs also dominate. Of the top 20 oil producing companies in the world, 14 are NOCs or newly privatized NOCs. However, many of the Western major oil companies continue to achieve a dramatically higher return on capital than NOCs of similar size and operations.

Many NOCs are in the process of reevaluating and adjusting business strategies, with substantial consequences for international oil and gas markets. Several NOCs have increasingly been jockeying for strategic resources in the Middle East, Eurasia, and Africa, in some cases knocking the Western majors out of important resource development plays. Often these emerging NOCs have close and interlocking relationships with their national governments, with geopolitical and strategic aims factored into foreign investments rather than purely commercial considerations. At home, these emerging NOCs fulfill important social and economic functions that compete for capital budgets that might otherwise be spent on more commercial reserve replacement and production activities.

The Baker Institute Policy Report on NOCs focuses on the changing strategies and behavior of NOCs and the impact NOC activities will have on the future supply, security, and pricing of oil. The goals, strategies, and behaviors of NOCs have changed over time. Understanding this transformation is important to understanding the future organization and operation of the international energy industry.

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NOCs AND U.S. FOREIGN POLICY

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INTRODUCTION

The world's energy landscape is again shifting. Rising petroleum prices, war in the Persian Gulf, and a growing worry about the ability of major oil producers to meet future demand are reigniting a debate about U.S. energy policy. The debate is broad-reaching, touching upon both domestic and foreign elements of that policy. And it includes renewed interest in the special role played by national oil companies (NOCs) in global petroleum markets.

The purpose of this paper is four-fold: first, to explain the current salience of NOCs in the debate over U.S. energy policy; second, to address, in general terms, the economic and strategic challenges to the United States represented by NOCs; third, to sketch a brief history of U.S. policy towards NOCs; and fourth, to present preliminary proposals on how the United States might best promote its interests in a world energy market shaped by the activities of NOCs.

The Strategic Context

As will be discussed, U.S. policy towards NOCs is a complex phenomenon. It reflects – at a minimum – our commitment to free trade and investment, our concern for a ready flow of moderately priced petroleum to global markets, our support for U.S.-based private oil companies, and, not least, our promotion of broader foreign policy interests.

The last is important and frequently decisive. Since World War II, these broader geopolitical considerations have included the global struggle to minimize Soviet influence, support for moderate Arab regimes in the Middle East, stability in such regions as the Persian Gulf, and, since September 11th 2001, efforts to curb terrorist activity against the United States. Related to the last is a decisive shift in U.S. policy in the Middle East, based upon the doctrine of preventive war and democratization. This new policy places the option of altering the regional strategic balance, if necessary by military means, above stability as the prime objective of U.S. foreign policy in the Middle East.

This shift is manifest in the invasion and occupation of Iraq, tacit U.S. support for the Israeli invasion of Lebanon in 2006, and the ongoing policy of confrontation with Iran. While the Persian Gulf may be of intrinsic interest to the United States because of its petroleum (and, by extension, the NOCs that control that oil), the precise form of U.S. involvement has been shaped by broader geopolitical considerations and conceptual frameworks. A clear example of the former was the U.S. policy of denying Persian Gulf oil to the Soviets; an example of the latter is the ongoing effort – of dubious success, to be sure – to create a "new Middle East" centered upon a democratic, pro-Western Iraq. In many ways, the primacy of geopolitics is the central theme of this paper: it is impossible to assess U.S. policy towards NOCs, their governments, or The Organization of the Petroleum Exporting Countries (OPEC) without full consideration of Washington's strategic considerations.

THE PLAYERS

In discussing U.S. policy towards NOCs, it is important to distinguish related but distinct entities – players, if you will. The first are the NOCs themselves. While commonalities exist among national oil companies, the NOCs differ by size, function, organization, competence, and relationship to the state. As Valerie Marcel and John V. Mitchell note, these characteristics are, in turn, very much dependent upon the histories of individual NOCs; they are, to use a term from social science, highly path-dependent.[1] The relatively high technical competence of Saudi Aramco, for instance, reflects its gradual transformation into a NOC; this contrasts, for instance, with the turbulent history of the National Iranian Oil Company (NIOC), beginning with the nationalization of 1951 and continuing through the dramatic changes wrought by the 1979 Islamic Revolution, which caused NIOC's production to fall from a high of nearly 6 million barrels per day (b/d) in 1977 to a low of approximately 2 million b/d in 1982.[2]

NOCs often have roles in both international and local markets; they run the gamut of upstream oilfield and downstream refining and marketing activities; their decision-making reflects an effort – sometimes successful, sometimes not – to balance social and political objectives with commercial imperatives. Any group that contains both Norway's Statoil and the Nigerian National Petroleum Corporation – in many ways,

[1] "How It All Started" by Valerie Marcel and John V. Mitchell in *Oil Titans: National Oil Companies in the Middle East*, Valerie Marcel, ed. (London: Royal Institute of International Affairs, 2006), p. 30.
[2] "Iran," Country Brief, U.S. Department of Energy, Energy Information Agency, August 2006: http://www.eia.doe.gov/emeu/cabs/Iran/Oil.html

polar opposites when it comes to governance and transparency – is one about which it is dangerous to make generalizations.

The second set of players is governments. These often use NOCs for various domestic purposes that transcend the production, distribution, and marketing of petroleum or, indeed, broader objectives of economic development. For governments, NOCs are an important and often irresistible source of subsidies to important constituencies and of political patronage. As such, NOCs are often considered vital instruments of regime legitimacy. But more than rent-seeking and distribution are at play.

For many oil exporters, collective ownership of natural resources as embodied through NOCs is a symbol of national unity and international importance. Many NOCs, in fact, were created against a backdrop of struggle against direct colonial rule (Algeria) or less formal foreign domination (Mexico). Nationalism is a central – perhaps decisive – factor in the origins and development of NOCs. It continues to drive both the maintenance of existing NOCs – such as Mexico's Petróleos Mexicanos (Pemex) – and the extension of government control, as shown by Venezuela's move that forced foreign investors to cede majority shareholding status in a number of major projects to state-owned Petróleos de Venezuela (PDVSA).[3] It is noteworthy that while the U.S. Provisional Authority in Iraq moved to privatize a number of industries – including telecommunications – following the U.S. invasion of Iraq, it deferred decisions on the oil industry to an elected Iraqi government. This reflected, at least in part, an appreciation of the nationalist backlash such a step could prompt.

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[3] "Chavez Puts Squeeze on Big Oil," *The Houston Chronicle*, February 5, 2007.

The major impact that governments have had on global oil supplies is worth discussing in additional detail. As mentioned previously, resurgent oil nationalism portends potential structural change in oil markets related to two, traditionally major U.S. suppliers: Venezuela and Mexico. In Venezuela, the buoyancy of oil prices has emboldened the government there to seize majority stakes in the Orinoco Basin projects as well as operational control from international oil companies. After failing to reach an agreement with the Government of Venezuela on revised terms, ExxonMobil and ConocoPhillips announced that they would leave Venezuela. Still, other international oil companies including Total, Statoil, BP, and Chevron accepted the government's terms in order to keep a minority stake in these projects. Presiding over the largest oil reserves in the world if unconventional oil is included, President Chavez has often expressed his desire to shift some of Venezuela's total exports from the United States to China, a hard to implement and expensive (but still conceivable) option of potential significance for U.S. energy security. China and Venezuela "signed $11 billion of energy and transportation accords last August [2006] when Chavez visited China" and "Beijing-based China Petrochemical was among seven foreign oil companies to sign agreements with Petroleos de Venezuela SA on June 26 [2007]." [4] For his part, President Chavez has said that "we've found in Russia a real strategic ally like in China and many other countries too."[5]

By contrast, in Mexico, state control has had a stultifying impact. Since the 1990s, state control over the oil sector has been marked by prolonged stagnation at Pemex. A

[4] Winnie Zhu, "China Seeks Venezuelan Oil After Exxon, Conoco Quit," *Bloomberg*¸ June 28, 2007. http://www.bloomberg.com/apps/news?pid=20601086&sid=a.xDMUZTWEeI&refer=news
[5] "Chavez Hails 'Strategic' Alliance with Russia, China," *Associated Press,* June 6, 2007. http://www.iht.com/articles/ap/2007/06/07/america/LA-GEN-Venezuela-Russia.php

marked decline in production from Cantarell, Mexico's biggest field, combined with vastly insufficient funds for reinvestment in new exploration and production heralds a reduction in company royalties to the Mexican government, which in turn derives 40 percent of its revenue from Pemex. This situation, which Pemex's CEO has called "critical," has proven more intractable than would otherwise be the case because of the potency of popular oil nationalism in Mexico.[6]

Countries also use their NOCs for strategic purposes. China clearly sees its NOCs, at least in part, as means to ensure security of petroleum supply. Other countries, notably Saudi Arabia, Venezuela, and Russia view NOCs as a way to give them international influence they would otherwise not possess. Today, Iran prizes its role in international oil markets as a key asset in its dispute with the international community over Tehran's nuclear program; at the very least, Iran's threats to cease exports should it be attacked has complicated efforts to isolate it.

The last entity is OPEC. This is the institutional mechanism by which member states attempt to exert control over prices through limiting or increasing production. OPEC's success in this is a matter of dispute, though there are occasions – the late 1990s, when members cut production in a successful effort to reverse a sharp decline in prices – when the organization appears to have been effective.[7] Perhaps as important as decisions to cut or increase short-term production are longer-term investment considerations. While not formally coordinated under OPEC, these decisions are shaped by the organization's ability to affect prices. Underinvestment in Venezuela's oil sector under

[6] See Appendix One for more details on the national oil companies in Mexico and Venezuela.

[7] See M. A. Adelman's "The Clumsy Cartel," an early but still influential discussion of OPEC's built-in bias towards reducing production. *The Energy Journal*, Vol. 1 (1), 1980, pp. 43-53. Not be confused with his article by the same name appearing in 2001. See footnote 7.

President Hugo Chavez, for instance, is clearly related to a variety of factors, from turmoil in the country's oil industry to unappealing terms for foreign investors. But it has also occurred against a backdrop of rising oil prices engineered in part by OPEC. It is not a coincidence that one of the first international initiatives of the Chavez administration was to work for collective OPEC action to raise prices. At one level Chavez's policy reflects a huge gamble – that increased prices would offset stagnant production. To date, it has paid off. (Should prices tumble, however, the result could be catastrophic for Venezuela.)[8]

These three players – NOCs, states, and OPEC – are intimately related. NOCs permit states to exercise extensive control over production and investment decisions. OPEC allows states, in turn, to coordinate these decisions to affect prices in the global marketplace. But again, we must be careful. A number of major NOCs exist in importing countries. China's firms are a case in point. A number of states with major NOCs or semi-independent companies are not members of OPEC: Russia, Mexico, and Norway are the most important of these. (It is interesting to note, however, that all three of these countries have cooperated with OPEC to drive up prices in the past.) Moreover, some OPEC producers – Indonesia and Qatar, with oil production of less than a million barrels per day – are very modest players in international oil markets. By definition, most U.S. government interactions with these three players occur within the framework of bilateral relations; governments, after all, usually deal with governments. But much of that interaction is shaped by the power given other governments by their NOCs and membership in OPEC.

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[8] Francis Fukuyama calls Chavez's style of governance "postmodern authoritarianism." See "History's Against Him," *The Washington Post*, August 6, 2006.

NOCs: Why Worry?

The current focus on NOCs is largely attributable to five factors.

The first – and surely the most dramatic – has been the sharp rise in oil prices since 2000. While the real cost of petroleum has yet to reach the peak reached during the oil crises of the late 1970s and early 1980s, it has more than doubled since 1999, rising from an average of $21 per barrel in 1999 to $65 in 2005.[9] In the United States and elsewhere, this rising cost has been passed on to consumers, directly in the form of higher fuel prices and indirectly through higher prices for the full range of goods that require petroleum for their production.

The second – and related – factor is a growing suspicion that these high prices may represent a long-term upward shift in the cost of oil. Predicting future petroleum prices is a highly risky endeavor; experts have been – and famously so – wrong before. But two facts – the resilience of demand in the face of higher oil prices and the absence of major production increases on the horizon – suggest that a higher price level is in fact sustainable.[10]

A third factor for increased attention to NOCs is the increasing share of proven reserves held by NOCs or private firms, like Russia's Lukoil, which show great deference to their governments.[11] A full 77 percent of proven reserves are owned by NOCs with no equity access for international oil companies (IOCs). Another 11 percent are held by

[9] Prices are for Brent crude. U.S. Department of Energy. See http://tonto.eia.doe/gov

[10] As recently as 1999, there was a broad consensus within OPEC that $30 per barrel was too high. See M. A. Adelman, "The Clumsy Cartel: OPEC's Uncertain Future," *Harvard International Review*, Vol. 23 (1), Spring 2001. It is also important to note that OPEC's growing domestic consumption also constrains its ability to increase exports dramatically. See Dermot Gately, "What Oil Export Levels Should We Expect From OPEC," *The Energy Journal*, Vol. 28 (2), 2007 for a discussion of this and a full range of other problems associated with predicting OPEC output. .

[11] See "Lukoil" by Isabel Gorst in this study for a discussion of the complex relationship between Lukoil and the Russian goverment.

NOCS with equity access. Yet another 6 percent represent reserves of Russian oil companies. This leaves only 11 percent of reserves unrestrictedly open to IOCs. Moreover, reserves controlled by NOCs and semi-independent companies represent some of the largest and most lucrative fields in the world. It may well be that the slow investment response by IOCs to high prices is due in part to cumbersome decision-making and an emphasis on capital discipline rather than investment. But it also reflects the relatively limited areas open to them for development.

A fourth factor driving interest in NOCs is rising uncertainty about the ability of major oil exporters and their NOCs to meet future global demand for petroleum. This uncertainty in turn reflects a variety of concerns. These include insufficient investment by exporters like Saudi Arabia, the threat to production posed by terrorist groups, current and potential conflict in the Persian Gulf, and instability in other major OPEC producers such as Nigeria and Venezuela. The numbers are surely not heartening. Projections of additional OPEC production required to meet future demand are staggering. An additional 20 million barrels per day (mmbd) in output needs to be brought on line by 2030.[12] It is far from clear that major OPEC producers, especially Saudi Arabia, will be able to deploy the resources – financial and technological – necessary to achieve this goal.[13] To do so, moreover, they will have to reverse 25 years of stagnation; OPEC capacity is actually lower today than it was in 1979.[14] There is also concern that the

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[12] *ExxonMobil's Energy Outlook: A 2030 View*. August 2005. Available online at: http://www.exxonmobil.com/AP-English/Files/Energy_Outlook_LLM_Aug_05.pdf

[13] Most predictions of massively expanded OPEC production simply assume that it will increase to meet demand.; these estimates merely represent the difference between projected world demand and non-OPEC production. Dermot Gately, "How Plausible is the Consensus Projection of Oil Below $25 and Persian Gulf Oil Capacity and Output Doubling by 2020," *The Energy Journal,* Vol. 22 (4), 2001, pp. 1-27.

[14] Amy Myers Jaffe. "Sustaining Energy and Mobility in the 21st Century: Challenges and Opportunities for the U.S." Presentation, August 2006. Available online at http://www.purdue.edu/energysummit/presentations.shtml

world's largest producer – Saudi Arabia – may be experiencing exhaustion of some its largest and most profitable fields. Matthew Simmons has raised these concerns forcefully in his *Twilight in the Desert: The Coming Oil Shock and the World Economy.*[15] One need not concur completely with all of Simmons's conclusions to agree with him on two related points. First, we should be very wary of blithe assumptions about the ability of Saudi Arabia to increase production. Second, greater transparency by Saudi Arabia and other major OPEC producers is urgently required if governments and firms are to make critical projections of future production.

A fifth and distinct factor is growing concern about NOCs as instruments of state policy inimical to U.S. national interests. Here the focus has been on the activities of Chinese NOCs in places like Sudan and Iran. Many observers are worried that China's ties to Khartoum and Tehran complicate U.S. efforts to isolate these regimes and compel changes in their policies. More generally, there is a concern that China's aggressive posture is evidence of a brewing global struggle over access to oil. NOCs are also viewed as sources of power – domestic and international – for oil exporting states that are either autocratic, anti-American, or both, with Iran (now that the United States has occupied Iraq) usually cited as the main culprit.

NOCs and the U.S. National Interest

How much weight should we give to these concerns? The answer – as is so often the case when discussion turns to NOCs – is complicated. What are the U.S.'s national interests in the activities of NOCs, their governments, and those governments' collective action through OPEC?

[15] Hoboken: John Wiley and Sons, 2005.

Sheer economics surely ranks high. As the world's largest importer of oil, the United States has a clear interest in a stable supply of moderately priced petroleum. The recent run-up in oil prices has certainly contributed to rising inflationary pressures here and elsewhere. But the macroeconomic effect of recent oil price increases has certainly been muted, both in the United States and globally. This is in sharp contrast to severe dislocations prompted by the oil crises of the 1970s and early 1980s.[16] Despite rising fuel costs, U.S. GDP grew by 3.2 percent in 2005 and an estimated 3.4 percent in 2006. Global GDP similarly grew by a healthy 4.9 percent in 2005, with a slight increase, to 5.1 percent, estimated for 2006. The limited impact of rising fuel costs on the United States – at least thus far – is attributable to several factors. We are a much richer country than we were in the 1970s and early 1980s and therefore better able to pay higher prices. Our economy is also less energy intensive, a result both of gains in efficiency and a long-term shift from manufacturing to services. Higher prices have also had a modest aggregate impact on the less developed world. Chinese economic performance has remained strong despite higher petroleum prices, with its economy growing by a scorching ten percent in 2005 and roughly the same in 2006.

Commercial factors also play a part. The United States, after all, is home to a number of major IOCs, though this has diminished in recent years because of international mergers, BP/Amoco being perhaps the best known. It is easy to exaggerate the influence of the "oil majors" on U.S. foreign policy. This is true even under an Administration headed, like the current one, by two former energy company executives. As will be discussed later, history provides countless instances of Washington sacrificing the interests of U.S. oil companies to broader goals. For example, U.S. IOCs proved

[16] *IMF World Economic Overview,* September 2006, p. 30. Available at www.imf.org.

singularly impotent in influencing the U.S. tilt towards Israel during the 1973 Yom Kippur War.[17] However, U.S. oil companies – influential as they are – surely bear no resemblance to the sinister and pervasive all-powerful force often depicted on the political Left. In recent decades, the economic sanctions imposed on Libya, Iraq, and Iran have all been vehemently opposed by U.S. IOCs, but have nevertheless been put into effect. In the domestic arena, huge areas (in Alaska, much of the Atlantic and Pacific coasts, and elsewhere) remain closed to commercial exploitation. Nonetheless, IOCs remain powerful political players, with a raft of experienced lobbyists and well-placed defenders in the Administration and on Capital Hill; their voice may not always be decisive but it is surely heard.

Strategic factors, too, play an important and often overriding part in U.S. policy towards major oil exporters and, by extension, their NOCs. Fear that others could use oil as a weapon against the United States or our allies is an abiding element of our strategic calculation. During the Cold War, for instance, we were fearful of Soviet influence in the Persian Gulf; this fear shaped our policies towards anti-Communist regimes like the Shah's Iran and Saudi Arabia.[18]

Yet nearly two decades after the end of the Cold War, there still remains talk of a possible conflict between great powers over access to oil. Today, China is routinely cited as a potential competitor – if not adversary – in a new "energy war." Oil producing countries – and their NOCs – would presumably be the chief area of contest in any such war, either hot or cold. These concerns are exaggerated. Given U.S. dominance of sea

[17] See "Saudi Aramco" by Amy Myers Jaffe and Jareer Elass in this study.
[18] "The Saudi leadership considered its geostrategic competition with the Soviets and its relationship with the United States more important than the Arab-Israeli one, and viewed the United States as its long-term central partner in that larger struggle" (Bronson, 120). Rachel Bronson, *Thicker Than Oil: America's Uneasy Partnership with Saudi Arabia* (Oxford: Oxford University Press, 2006), 22, 26, 43, 46, and 120.

lanes, military presence in the Persian Gulf, and unique ability to project power over immense distance, it is unclear precisely how China, for instance, would challenge the United States in an "energy war." The idea that Sudan or Iran, for instance, would provide China with the oil it needs in an emergency is risible. If a Sino-American crisis arose, the United States Navy could simply interdict Sudanese exports at will. In any case, neither Khartoum nor Tehran is likely to sacrifice revenue for an ally that is unlikely to help them militarily should they come into direct conflict with Washington.[19]

Indeed, when it comes to oil, China faces a huge strategic dilemma.[20] The regime in Beijing derives much of its legitimacy from its ability to deliver a rising standard of living to its citizens. That standard of living, in turn, will depend upon increased imports of petroleum. But these imports increase China's strategic vulnerability to the United States. China's involvement in Iran and, especially, Sudan surely reflects an effort, however well-or ill-advised, to ease this vulnerability by seeking oil exploration and development opportunities in countries where American and European companies have been barred from doing business. As noted above, it is unlikely to do so in any significant way, at least in the short to medium term. Indeed, despite the alarm China's energy cooperation with Sudan and Iran has raised in certain quarters, Beijing's involvement with so-called rogue regimes reflects Chinese strategic weakness, not strength. Moreover, China's increasing dependence on imported oil may actually decrease the

[19] Chinese policymakers should carefully study the activities of the Shah, that staunch ally of the United States, who was a leading OPEC price "hawk" in the wake of the 1973 Arab oil embargo. China could of course put troops and/or missiles in Sudan and/or Iran; but their presence would merely raise the stakes for Beijing without affecting U.S. control of sea-lanes.
[20] Joe Barnes, "Slaying the China Dragon: The New China Threat School," Baker Institute Study, April, 1999. Available online at http://www.rice.edu/energy/publications/asianenergysecurity.html

chances of Sino-American conflict. As a major importer, Beijing now shares with Washington a vital interest in a stable supply of oil from the Persian Gulf.[21]

Potential cooperation is, however, constrained by a number of factors. These include deep mutual suspicion by important elements in both capitals, Beijing's antipathy to U.S. dominance, Washington's fears of China's emergence as a global rival, and – not least – the fact that stability no long holds its traditional place of prominence in U.S. policy towards the Persian Gulf and Middle East. By opposing U.S. policies in the Gulf – the invasion of Iraq and a possible military strike against Tehran – Beijing can plausibly argue that it is merely promoting stability.

In 2005, there was what could be considered a test case of official U.S. attitudes towards NOCs in general and Chinese NOCs in particular. That June, the China National Offshore Oil Company (CNOOC), 70 percent owned by the Government of the People's Republic of China, bid an initial $18.5 billion to purchase UNOCAL. The announcement prompted a firestorm on Capitol Hill, where the U.S. trade deficit with China was already the source of simmering anger and where lobbyists for Chevron, which earlier offered Unocal $16.8 billion for a merger, pulled out all the stops to kill the takeover.[22]

On June 30, 2005, the U.S. House of Representatives voted 398-15 in favor of a resolution stating that the CNOOC's bid for Unocal posed a "threat to the national security of the United States" and called for a "thorough review" by President George W. Bush. Representative Richard Pombo, then chairman of the House Natural Resources committee, argued that "we cannot afford to have a major U.S. energy supplier controlled

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[21] Nawaf E. Obaid *et al.* "The Sino-Saudi Energy Rapprochement: Implications for U.S. National Security," Baker Institute Study, January 2002. It may found online at: www.rice.edu/energy/publications/otherpapers/html
[22] Steve Lohr, "The Big Tug of War Over Unocal," *New York Times,* July 6, 2005.

by the Communist Chinese" and "if we allow this sale to go forward we are taking a huge risk."[23] In rebuttal, U.S. Representative Jim Moran (D-Virginia) pondered "if we don't let them invest in Western firms, what are they going to do? They are going to invest in Iran or Sudan and make those governments much stronger than they are today."[24] On the Senate side of the debate, Charles Grassley (R-Iowa) and Max Baucas (D-Montana) wrote to President Bush, saying that "the offer raises an important question, namely whether it is appropriate for state-owned oil enterprises to subsidize investment transactions to acquire scarce natural resources that are in high-demand."[25]

The Bush Administration, for its part, urged Congress not to pass legislation targeting the takeover, but held to a noncommittal stance towards the purchase itself, pending an assessment by the interagency Committee on Foreign Investment in the United States (CFIUS). "There are procedures in place, and if a bid goes through then we would expect the appropriate procedures to be followed," White House spokesman Scott McClellan said.[26] Nevertheless, there was a general sense that the Administration simply wanted the problem to go away before the takeover bid further complicated its efforts to keep relations with Beijing on an even keel.[27]

Having initially agreed to an April 2005 offer from Chevron valued at $60.14 per share, Unocal was approached with a higher value bid from CNOOC ($67 per share).[28] Despite CNOOC's higher offer, regulatory obstacles to the company's bid proved

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[23] Alexei Barrionuevo, "Foreign Suitors Nothing New in U.S. Oil Patch," *New York Times*, July 1, 2005.
[24] Congressional Record, U.S. House of Representatives, June 30, 2005, p. H5570-H5577.
[25] http://www.senate.gov/~finance/press/Gpress/2005/prg071305a.pdf
[26] "White House to Review CNOOC Bid for Unocal," *CNN Money*, June 28, 2005.
[27] The CFIUS, chaired by the Secretary of the Treasury, merely makes a recommendation to the President; the Bush Administration clearly did not relish the prospect of exercising this presidential prerogative.
[28] "Chevron is offering $16.25 in cash and a fraction of 1.03 Chevron shares for each share of Unocal. With the cash portion amounting to a quarter of the offer and the stock portion to three-quarters, that values Unocal at $60.14 a share." Jad Mouawad and Andrew Ross Sorkin, "Unocal's Board Decides to Continue Talking with Chinese," *New York Times*, July 15, 2005.

insurmountable. A measure passed by Congress on July 27, 2005 prevented CFIUS from reviewing the issue for 120 days and empowered the Departments of Defense, Energy, and Homeland Security to first make their own assessments.[29] Adding the time needed for CFIUS to begin its review and present its report, the review process would have taken 141 days. These complications enhanced Chevron's position. To make its own tender more attractive, Chevron sweetened its offer from $16.8 billion to $17.6 billion ($64-65 per share), leading Unocal's advisors to back Chevron's bid. A comment by the proxy services firm Institutional Shareholder Services stated that "the $64 Chevron bid is for all intents and purposes 'certain,'" while "in contrast, the $67 CNOOC bid is highly uncertain due to U.S. and Hong Kong regulatory issues and U.S. political opposition in some quarters."[30]

On August 3, 2005, CNOOC announced that it would withdraw its offer. In its public statement, the company "said it would have raised its bid [from $18.5 to $20 billion] 'but for the political environment in the U.S.'" and for political opposition that the CNOOC called "regrettable," "unjustified" and "unprecedented."[31] Despite spending no less than $1.96 million on lobbying Congress and Bush Administration officials, "the Chinese giant's failure to recognize the complex challenges such a bid would face may have sealed its fate." [32] Thus, in the end, the Bush Administration got its wish: faced with a barrage of bipartisan criticism, CNOOC withdrew its offer and Chevron acquired UNOCAL.

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[29] "U.S. Congress Moves to Hold Up CNOOC Bid for Unocal," *Oil Daily*, July 27, 2005.
[30] "Accept Chevron Bid, Unocal Adviser Say," Reuters, August 2, 2005.
[31] "Why China's Unocal Bid Ran Out of Stream," *Business Week Online*, August 4, 2005.
[32] Bara Vaida, "Big Tab, Failed Bid," *National Journal* 38, no. 11, March 18, 2006, 49; "Why China's Unocal Bid Ran Out of Stream."

It is difficult to draw many clear lessons from the takeover attempt, except that U.S.-Chinese relations are both complex and fraught with tensions. Reasons for opposing the deal included security concerns, anger over China's trade and investment policies, and effective lobbying by Chevron.[33] Its resolution – or, rather, non-resolution – reflected a conscious effort by both governments to avoid a very public conflict at a time of simmering economic tensions.

One lesson, or unintended consequence, may have been the impact on China of the U.S.' stated concern for China's energy interactions with "rogue states" accused of nefarious [or clandestine] nuclear programs and gross human rights abuses. CNOOC's chief executive officer, Fu Chengyu, long "had argued in company meetings that CNOOC ought to avoid countries in Africa and the Middle East because of the political risks associated with some countries there" but, as a company adviser underlined, "the political risk turned out to be higher in America."[34] While not directly connected, the Chinese government's subsequent intransigence from late 2005 to early 2007 on resolving the Darfur conflict through UN channels was perhaps the logical result of that government's desire to retain Chinese equity assets and influence in Sudan after being rebuffed on the open market.

More broadly, what are the overall implications of Congress' response to CNOOC's failed bid for Unocal? After all, foreign acquisition of U.S. corporate assets from key sectors like information technology and petroleum is not news. In 2005, after a CFIUS security review and minimal public hassle, the Chinese IT company Lenovo paid

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[33] Some of the security concerns cited are clearly far-fetched. The idea, for instance, that ownership of UNOCOL would put China in a position to pressure LNG supplies to Taiwan and Japan simply overlooks the whole range of countermeasures available to the United States, ranging from trade sanctions against Beijing to U.S. naval interdiction of fuel supplies to China.
[34] "Why China's Unocal Bid Ran Out of Stream," *Business Week Online*, August 4, 2005.

$1.25 billion to acquire IBM's personal computing business. Saudi Refining, part of state-owned Saudi Aramco, has operated a 50-50 refining joint venture, "Motiva Enterprises," with Shell Oil Co. since 1988.[35] In 2000, Russia's Lukoil bought gas stations formerly owned by Getty Petroleum on the U.S. East Coast, giving a major Russian company a firm stake in the American downstream sector. What made CNOOC's experience so different?

In essence, world politics and the dynamics of energy security have substantially evolved since 2000, as Amy Myers Jaffe and Edward Morse have discussed in *Energy and Security: Towards a New Foreign Policy Strategy* (2005).[36] A laundry list of domestic concerns in the U.S. about employment outsourcing, trade imbalances, rising gasoline prices, supply security, peak oil, technology transfers, and China's increasing international clout have contributed to a political atmosphere unfavorable to acquisitions of U.S. energy assets by Chinese companies. Given the very mild geopolitical implications of CNOOC's bid, the flap over Unocal was hardly worth the public media frenzy that arose. While other state-owned companies might well face comparable hurdles for similar bids, China's position is nearly unique; a bid by Norway's Statoil, Brazil's Petrobras, Malaysia's Petronas, or the Japan Oil, Gas and Metals National Corporation (JOGMEC) likely would have not received the same treatment. The CNOOC-Unocal flap was a public flogging of the U.S.-China relationship more than a reasoned discussion of the consequences of a takeover of UNOCAL by CNOOC.

[35] Originally, Shell, Texaco, and Saudi Refining held equal stakes in the joint venture. Shell and Saudi Refining bought out Texaco's share, when Texaco and Chevron merged to become ChevronTexaco, now known as the Chevron Corporation.

[36] Amy Myers Jaffe and Edward L. Morse, "OPEC in Confrontation with Globalization" in *Energy and Security: Toward a New Foreign Policy Strategy*, Jan H. Kalicki and David L. Goldwyn, eds. (Baltimore: John Hopkins University Press, 2005).

While alarm over foreign government ownership of U.S.-based oil companies is probably exaggerated, there are certain risks associated with it. These include the possibility that government change or instability in the foreign country might complicate the financial or legal situation of the U.S.-based firm. U.S.-based CITGO Petroleum—wholly owned by Venezuela's PDVSA—apparently had trouble getting letters of credit to run its U.S. refining operations during a three-month strike in 2002. Led by PDVSA's upper management in Venezuela, oil workers unsuccessfully protested the petroleum policies of Hugo Chavez's government, creating a political and economic crisis; the standoff ended as the government asserted control by firing thousands of employees and installing loyal management staff. During the upheaval in Caracas, "CITGO struggled for several weeks to obtain the crude oil it needed from Venezuela to feed its American refineries. Creditors lowered CITGO's credit ratings, creating a cash squeeze for the company" during the strike and two-day coup that momentarily removed Chavez from power.[37] (During the 2002 strike in Venezuela, U.S. gasoline prices rose 37 cents.) In the event of a refining shortage in North America, the incapacity of CITGO refineries could be an additional constraint on U.S. gasoline supplies. If political relations between the U.S. and Venezuela were to deteriorate further and PDVSA sold CITGO's refineries, regaining these downstream assets for an American oil company could be a positive action, as long as Venezuelan oil would still be exported to and processed in the United States.

But it is not only NOCs that face strikes or domestic turmoil; private companies can too. NOCs with downstream assets in major consuming countries may, paradoxically, open themselves up to seizure during a crisis. In an emergency, of course,

[37] Alexei Barrionuevo, "Foreign Suitors Nothing New in U.S. Oil Patch," *New York Times*, July 1, 2005.

the U.S. government can either guarantee credit to keep domestic refineries going or – in extremis – seize foreign assets. In 2005 foreign companies owned 28 percent of American refining capacity; their stake in 1983 was only 15 percent.[38]

Again, CITGO is a relevant example. From 2005, Hugo Chavez has occasionally mentioned an interest in selling CITGO's refineries in the United States, saying that "we are subsidizing Mr. Bush."[39] In early May 2007, he repeated this aspiration and "said that he aims to sell CITGO's refineries in order to build refineries elsewhere and sell oil to places other than the [United States]" (China in particular).[40] However, an additional reason may be that, given the poor state of U.S.-Venezuelan relations, keeping CITGO's assets makes little strategic sense if a crisis should erupt. "When it comes to national security, exploration and production assets are immaterial compared to refining assets. If anything happened to refining capacity anywhere, the impact would be global and almost immediate," commented Fadel Gheit, an oil analyst with Oppenheimer and Company.[41] In this sense, a potential U.S. government seizure of foreign downstream assets within U.S. borders offers another political dimension and tactical tool in the event of a new oil crisis against governments with investments inside U.S. borders.

In addition to concerns about great power conflict over energy, there is today a heightened focus on the role of oil revenue in supporting regimes and activities hostile to the United States. Iran is the chief case in point but some neoconservatives include Saudi Arabia – a nominal U.S. ally – among these hostile regimes. The argument is a fairly simple one. Oil revenues finance anti-American policies, notably support for terrorist

[38] *Ibid*
[39] Simon Romero, "Venezuela Considers Sale of U.S. Refineries," *New York Times*, February 2, 2005.
[40] David Luhnow and Peter Millard, "How Chavez Aims to Weaken U.S.," *Wall Street Journal*, May 1, 2007.
[41] Alexei Barrionuevo, "Foreign Suitors Nothing New in U.S. Oil Patch," *New York Times*, July 1, 2005.

groups and weapons programs. Under this theory, lower oil prices are not only good for U.S. consumers but a key weapon in the global struggle against Islamic fundamentalism.[42] A related argument posits that oil revenues prop up authoritarian statist governments, allowing them to suppress democratic opposition and avoid economic reform. Surely high energy prices have contributed significantly to the internal support and external confidence of regimes like Venezuela's Chavez and Russia's Putin. Under this analysis, NOCs are critical instruments of authoritarianism and anti-Americanism.

But this theory – in both its forms – is problematic on many counts. At a very basic level, it neglects the fact that some oil exporters are friends of the United States. Canada and Mexico are two cases in point. More importantly, so is Iraq. Surely, a dramatic decline in the price of oil could do terrible damage to the fragile democratic government in Baghdad.

We should also be careful of analyses that directly link major oil resources with authoritarian government. While a large number of major oil exporters are indeed authoritarian, this may merely reflect the capricious global dispersion of hydrocarbons more than any iron-clad linkage between oil exports and authoritarian government.[43] Canada and Norway are major energy exporters and sturdy democracies, much like their neighbors. The countries with significant oil in the Middle East are not noticeably more autocratic than those without. One major Middle Eastern oil exporter – Iran – is,

[42] See Amy Myers Jaffe and Edward L. Morse's "OPEC in Confrontation with Globalization" for a discussion of the neoconservative argument. *Energy and Security: Toward a New Foreign Policy Strategy*, Jan H. Kalicki and David L. Goldwyn, eds. (Baltimore: John Hopkins University Press, 2005) pp. 88-9.

[43] 50 percent of world oil supply, after all, reflects the output of a mere 120 fields producing over 100,000 barrels per day; the 14 largest of these fields pump roughly 20 percent of total world supply. Simmons, *op. cit.* xxvi.

however imperfectly, much more democratic than Egypt, a country of modest oil exports.[44] Latin America's largest oil exporter—Venezuela—was for many years one of the few democracies in the continent. Despite its creeping autocratic character, even Hugo Chavez's regime is still far from a dictatorship.[45] Indeed, the two remaining communist dictatorships in the world—Cuba and North Korea—are energy importers; so is the world's largest and most important autocratic regime, China. Russia's President Vladimir Putin may have been emboldened by high energy prices in his drive to centralize domestic power and exert Russian influence abroad, but he also represents the latest embodiment of a long national tradition reaching back to the Tsars.

Furthermore, the argument that democratization will promote U.S. interests is problematic, especially when it comes to oil. There is highly suggestive evidence that any dramatic regime change can lead to declines in production. Production fell in Libya after Muammar Qadhafi overthrew King Idris in 1969; after the Islamic Revolution swept the Shah from power in 1979, and after the collapse of the Soviet Union in 1990. Iraq is a slightly different case. After an initial collapse, Iraqi production is slightly below levels seen in the later years of Saddam Hussein's regime. But it hasn't increased, despite a depressed Iraqi production baseline resulting from the 1990-91 Gulf War and international sanctions.

In the Middle East, moreover, the likeliest outcome of regime change – with the possible exception of Iran – would be a more anti-American government. Saudi Arabia

[44] To put it crudely: Saudi Arabia without a lot of oil isn't Sweden; it's Yemen.
[45] Official American concerns about human rights and democratic government in Venezuela, for instance, surely take a back seat to our distaste for Chavez's foreign policy, notably his harsh criticism of the Bush Administration. This was made startlingly clear when we initially failed to condemn the military coup that overthrew him briefly in April 2002. In short, Washington's major problem with Hugo Chavez is not his autocratic character; it is with his foreign policy. We consider unambiguous dictators like Hosni Mubarak of Egypt and Parvez Musharraf of Pakistan to be dependable allies of the United States.

is the most striking example; the regime's generally pro-U.S. stance is one source of its unpopularity. But even a democratic government in Syria – generally considered one of the most anti-American states in the region – might well lead to a regime controlled or dominated by radical Islamic fundamentalists. Alternately, democratization might lead to domestic instability, even civil war. The recent regime change in Iraq is sobering. The burgeoning sectarian conflict there – despite the presence of over 100,000 U.S. troops and the direct expenditure of several hundred billion dollars – bodes ill for the idea that regime change is an easy or even possible solution to our strategic concerns (energy and otherwise) in the hydrocarbon rich but volatile Middle East.

Our fears about petroleum supply are often couched in terms of our dependence on foreign oil in particular and Middle Eastern oil in specific. The United States is, undeniably, dependent upon imported oil, which represents more than half our consumption. Nor is this picture likely to change in the near to medium term; our domestic oil production peaked long ago. As will be discussed later, we can increase production by opening new areas to exploitation; but such new production—politically unlikely at the moment—will not even begin to approach the roughly 11 million b/d of oil that the United States currently imports.

Additionally, there is little prospect – barring a sharp recession – of a significant fall in demand for petroleum. After staying relatively constant over the course of the 1980s, consumption has been on the rise over the last 15 years. While there has been a great deal of focus on China's contribution to demand, it should be recalled that advanced countries – notably the United States – remain deeply dependent upon petroleum. While the rate of growth may be smaller than China's, the absolute levels are staggering, particularly for the United States We consume roughly a quarter of world petroleum output. What do we use all this oil for? The answer is simple: transportation, and, more specifically, automobiles. Perhaps two-thirds of our oil consumption goes to the various fuels – gasoline, diesel, jet fuel – that move people and merchandise from one place to another. Over forty percent of our oil consumption is gasoline alone. The dependence of our transportation sector on petroleum is very nearly absolute, with oil supplying the sector with over 95 percent of its fuel.[46] Barring a dramatic shift away from the internal combustion engine (a most unlikely prospect) U.S. demand for oil – imported oil – is here to stay.

We are also clearly vulnerable to supply disruptions in oil producing regions. In an age of international spot markets and domestic deregulation, these disruptions will manifest themselves as price increases, not physical shortages; but their impact could still be severe. We are similarly vulnerable to joint action by OPEC to restrain production. But the argument about U.S. dependence on foreign oil has nonetheless been markedly confused. There has been, for instance, an inordinate focus on the national origin of U.S. imports. Thus we hear a great deal about imports from this country or that, usually suspect on one ground or another. But, in an age of truly global markets, it does not matter where we import our petroleum from; what matters is global supply and demand.[47] This means that, even if the United States did not import one ounce of oil from Saudi Arabia, the prices Americans faced at the pump would still be highly dependent upon the Kingdom's oil production. Not least, the talk about U.S.

[46] According to the U.S. Department of Energy, 97 percent of future rise in U.S. oil demand will be for transportation.
[47] Think of global oil markets like a swimming pool; add (or remove) a cup of water anywhere and the level will rise (or decline) everywhere.

vulnerability has been unmatched by genuine action to slow growth in consumption or open new areas for production, a subject to which we will return later.

Our vulnerability to supply disruptions makes the United States extremely sensitive when other countries threaten to use the "oil weapon." The United States has consistently decried the use of oil as a weapon, e.g., from the Arab oil embargo of 1973 to Tehran's recent threat to cut off oil exports should the UN impose sanctions on Iran. In May 2006, Vice President Cheney sharply rebuked Moscow for using Russia's oil and gas resources as "tools of intimidation or blackmail."[48] This was a clear reference to Russia's cut-off of gas supplies to Ukraine when Kiev refused to bow to Moscow's demand that it pay world prices for natural gas.[49]

At one level, our opposition to using oil – or natural gas – as a foreign policy tool merely represents an extension of our support for general principles of free trade.[50] But our position is also an expression of our interest as an oil importer. And it is a bit more than disingenuous. When the United States *was* a major oil exporter, it used oil as a weapon – notably the embargo on Imperial Japan in early 1941.

During the late 1930s, as Japan moved aggressively to extend its influence over mainland Asia, American officials were divided over how to respond in regard to U.S. petroleum policy.[51] As U.S.-Japanese bilateral discussions went nowhere, Washington's freedom to act seemed constrained, at least to President Roosevelt, by the immediacy of

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[48] "Strong Rebuke for the Kremlin from Cheney," *The New York Times*, May 5, 2006.
[49] Moscow cut off oil shipments to Belarus in January 2007 and resumed them only when Minsk reduced its transit fee for oil and agreed to a higher price for gas. The action against Belarus undermined arguments that the earlier cutoff of Ukraine was driven by Moscow's displeasure with a new and less pro-Russian government in Kiev; Belarus is probably the most pro-Russian country in Moscow's "near abroad."
[50] Jaffe and Morse stress the extent to which OPEC stands in stark contrast to the emerging world regime in free trade and investment. *Op. cit.* 90-91.
[51] Yergin, 310.

war in Europe and the Nazis' invasion of the USSR. Although drafted in response to the outbreak of war in Europe, the passage of the National Defense Act (1940) gave President Roosevelt the ability "to control exports; that would be the lever with which to regulate oil supplies to Japan."[52] In the meantime, Japan's desire to secure oil supplies in the Dutch East Indies (now Indonesia) was a driving factor behind the projection of Japanese power into Southeast Asia. When Japan moved to invade Indochina, the U.S. enacted what was intended to be a limited cut-off of supplies but proved in practice to be a *de facto* embargo.[53] The virtual embargo prompted a vigorous reaction in Japanese government circles.[54] As oil imports fell—and Japan lacked the major domestic reserves needed for a prolonged war with the United States—Japanese strategists came to favor a bold, knockout strike against America. By November 1941, the embargo had proven effective; however, in its strength, it also seemed to propel Japanese war plans forward. Oil, then, played a key part in the lead-up to the Pacific War.

In more recent decades, we have used sanctions – specifically aimed at reducing revenue by denying investment to hostile regimes – as instruments of foreign policy against oil-producing countries. According to Princeton University scholar John Ikenberry's review of *Shrewd Sanctions* by sanctions expert Meghan O'Sullivan, [55] "economic sanctions have a mixed record as a tool of statecraft. The realities of

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[52] Yergin, 312.
[53] Yergin, 318.
[54] Japanese foreign minister Toyoda wrote on July 31,1941 that "Commercial and economic relations between Japan and third countries, led by England and the United States, are gradually becoming so horribly strained that we cannot endure it much longer. Consequently, our Empire, to save its very life, must take measures to secure the raw materials of the South Seas. Our Empire must immediately take steps to break asunder this ever-strengthening chain of encirclement which is being woven under the guidance and with the participation of England and the United States, acting like a cunning dragon seemingly asleep." Yergin, 319.
[55] Meghan L. O'Sullivan, *Shrewd Sanctions: Statecraft and State Sponsors of Terrorism* (Washington, DC: Brookings Institution Press, 2003).

globalization and U.S. preeminence have complicated their use, even as the threats of terrorism and weapons proliferation have made them a vital instrument of national security."[56] The U.S. Congress has passed legislation aimed at making it difficult for European and Japanese companies from investing in Iran and Sudan. Sanctions were also in place against Saddam Hussein's Iraq until 2003[57] and Libya until 2004,[58] when the Libyan regime renounced terrorism and gave up its weapons of mass destruction. As another reviewer of *Shrewd Sanctions* observed, "Simply put, O'Sullivan views sanctions as tools that are most effective when used with other instruments of foreign policy in support of an overarching strategy."[59] At a fundamental level, the rules of the international game – at least when it comes to energy – are what the United States government finds advantageous.

A LITTLE HISTORY

The history of U.S. policy towards NOCs – notably their creation through nationalization – is highly instructive. Domestically, the United States has generally left oil exploration, production, and distribution to private companies. But this does not denote an absence of government involvement. Indeed, the petroleum industry was highly regulated for decades. Direct price controls were lifted during the 1980s and 1990s. But the United States government continues to deploy a variety of tools – tax policy, access to public lands, environmental regulation – that shape, sometimes decisively, the production of petroleum in the United States.

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[56] John Ikenberry, "Political and Legal," review of *Shrewd Sanctions: Statecraft and State Sponsors of Terrorism* by Meghan L. O'Sullivan, *Foreign Affairs,* March/April 2004.

[57] http://www.eia.doe.gov/emeu/cabs/sanction.html#iraq

[58] http://news.bbc.co.uk/2/hi/africa/3336423.stm

[59] J. Andreas Hipple, review of *Shrewd Sanctions: Statecraft and State Sponsors of Terrorism* by Meghan L. O'Sullivan, *SAIS Review,* Winter/Spring 2004, 197.

Internationally, the United States came close to creating its own NOC during World War II. Called the Petroleum Reserves Corporation, it was promoted by Secretary of the Interior Harold Ickes, and supported by the military, as a means to ensure access to foreign oil reserves (specifically in Saudi Arabia) through direct ownership of the U.S. government.[60] Ickes' belief that the U.S. Government should—at least—strongly back American oil companies' overseas ventures, and consider carving out a role for the government in oil production and marketing, eventually generated insurmountable opposition from other cabinet members and industry leaders.

The idea of a U.S. Government role in the petroleum industry created a minor stir within war planning circles. Secretary of State Cordell Hull opposed the idea, as did most of the major American oil companies. "[…] Whereas War, Navy and Interior favored some form of government ownership and development of Saudi Arabian oil, the State Department believed that the [U.S.] Government should merely contract with private companies for the creation of new oil reserves to be drawn up as needed."[61] In contrast, Ickes "was of the opinion that it had been a mistake for the United States to rely on private companies for its oil supply, because the interests of the companies were not, in his view, always compatible with the national interest."[62] Despite his domestic mandate, Ickes had considerable influence in the Roosevelt Administration through his personal ties to the president, as well as his other role as U.S. Petroleum Coordinator during WWII. Arguing in favor of an expensive remit for the corporation, Secretary Ickes wrote in June 1943 that,

[60] Daniel Yergin, *The Prize* (New York: Free Press, 1991), 397-9; Bronson, 39-40.
[61] Julius W. Pratt, "The Ordeal of Cordull Hull," *Review of Politics* 28, no. 1 (1996), 96.
[62] Stephen J. Randall, "Harold Ickes and United States Foreign Petroleum Policy Planning, 1939-1945," *The Business History Review* 57, no. 3. (1983), 368.

> Private entrepreneurs have been in competition not only with themselves but [also] with foreign companies in which foreign governments have exercised direct and participating controls…Any realistic appraisal of the problem of acquiring foreign petroleum reserves for the benefit of the United States compels the conclusion that American participation must be of a sovereign character compatible with the strength of the competitive forces encountered in any such undertaking.[63]

By the winter of 1943, however, Harold Ickes' initial idea of U.S. Government shareholding in the California-Arabian oil company (later renamed Aramco), a joint venture in Saudi Arabia by U.S. major IOCs, had given way to contract purchasing of oil. Some administration officials had contended that "[…] direct government involvement in foreign oil would have a disturbing effect on United States relations with foreign oil producers, especially in Latin America," and others had grown concerned about possible criticism alleging cartel behavior.[64]

Equally considerable, though not united, resistance to Ickes' initiative from industry proved too strong to overcome. The Petroleum Industry War Council concluded in December 1943 that "under no circumstances should the United States Government…engage in foreign oil exploration, development or operation."[65] This opposition to an operational role for the U.S. Government in the petroleum industry prevented the Petroleum Reserves Corporation from becoming a nascent U.S. national oil company. The idea eventually died, largely because of the ferocious opposition of private U.S. oil companies and the coming end of the war.

But, abroad as at home, the U.S. government continues to possess tools – ranging from moral suasion to sanctions legislation – that affect investment and other decisions

[63] Randall, 375.
[64] Randall, 376.
[65] Randall, 378.

by U.S. oil companies. In short, the U.S. official approach to its oil industry, though grounded in an appreciation of free market principals, is far from laissez faire.

The U.S. Government has been repeatedly prepared to subordinate the interests of American oil companies and ideological support for free markets to other strategic considerations, as shown in the case of Mexico's nationalization of its oil industry in 1938. Furthermore, the expropriation of U.S. and U.K. oil companies in Mexico exemplifies how Washington's strategic concerns overrode economic ones well before America's postwar rise to global power; it also demonstrates the failure of limited leverage to roll back Mexico's nationalization. Finally, Mexico's nationalization was a harbinger of many national governments' relationships with foreign oil companies in years to come and foreshadowed how the U.S. Government could do little, absent drastic coercive measures, to shield American oil companies from the specter of nationalization.

The Mexican Constitution adopted in 1917 stated in Article 27 that the "subsoil" belonged to the Mexican state as the patrimony of all Mexicans—not oil companies. While the Mexican Government did not enforce this rhetoric during the 1920s, most especially since foreign oil companies were needed to produce and export the oil, intermittent tensions over the ownership of Mexico's petroleum came to a head with the election of President Lazaro Cardenas in 1934. As foreign oil companies scaled down operations in Mexico for more profitable and accessible reserves in Venezuela, Mexico's production fell dramatically from 499,000 b/d to 104,000 b/d, hurting the government's revenue flow.[66] A staunch nationalist, Cardenas sought from the outset to strengthen state

[66] Yergin, 272.

control over foreign oil companies as part of his larger agenda of social and political development in which sustained oil revenue was an important component.[67]

When oil workers in Mexico went on strike over wages in 1937, Cardenas came under tremendous pressure from domestic constituencies to champion their grievances before the foreign oil companies. To head-off brewing turmoil, he authorized the formation of a national commission, which undertook a study of foreign oil companies' activities and concluded that workers should be given increased wages and new benefits. The commission also called for Mexicans to fill technical jobs held by foreigners within two years.[68] The oil companies protested, in vain, all the way to the Mexican Supreme Court. After intense negotiations, the oil companies agreed to the government's 26 million peso wage increase (US$7.3 million in 1938), but they adamantly refused to give unions the management and administrative power that the unions had demanded.[69]

Cardenas faced a difficult, even explosive situation. On March 16, the Supreme Court declared the foreign oil companies to be in a state of "rebellion." To control the deteriorating political and economic circumstances, and thereby confirm the state's paramount role in Mexico's oil sector, Cardenas issued his decree of nationalization on March 18, 1938.[70]

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[67] Yergin, 274; Frank L. Kluckhohn, "Cardenas Seeks to Cast Mexico in a New Mold," *New York Times*, April 10, 1938.
[68] Yergin, 275.
[69] Lorenzo Meyer, "The Expropriation and Great Britain," in *The Mexican Petroleum Industry in the Twentieth Century*, ed. Jonathan C. Brown and Alan Knight (Austin: University of Texas Press, 1992), 155.
[70] Catherine Jayne, *Oil, War and Anglo-American Relations: American and British Reactions to Mexico's Expropriation of Foreign Oil Properties, 1937-1941* (Westport, CT: Greenwood Publishing, 2001), 36-37.

While the nationalization received widespread acclaim within Mexico,[71] it took Washington and London by surprise. In the words of Ambassador Daniels, "Neither President Roosevelt, Secretary of State Cordell Hull nor I knew about the expropriation in advance. . . . It came like a bolt from the blue!"[72] Despite shared economic interests in Mexico, a British-American united front was not in the offing. "For Washington, feelings of animosity towards British interests, which had made officials unwilling to help Britain in this case, were more symptoms than causes of wider resentment."[73] The British, ever more angry about the nationalization than the Americans, nevertheless knew that overturning or limiting the nationalization would be impossible without U.S. backing. In the U.K., former diplomat Lord Newton commented that "unless we can secure cooperation with the Americans, or unless we follow their example, whether they're acting with us or not, the chances of our doing any good is remote."[74] After the nationalization took place, U.S.-Mexico relations soured but did not break, notwithstanding U.S. attempts to mitigate the nationalization.[75]

Between 1938 and 1950, the Roosevelt and Truman Administrations made tactical adjustments in U.S. foreign oil policy to penalize and pressure Mexico into moderating its position on nationalization—without causing lasting economic or strategic harm. "Although most officials in Washington wanted a return to the status quo ante in Mexico, they realized the importance of at least outwardly adhering to the Good

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[71] "News of the expropriation was met with such resounding approval that Mexicans helped the government cover the cost of the compensation Cardenas promised the oil companies and which was necessary under international law by donating cash, jewelry, and other personal items and purchasing bonds the government issued" (Jayne 37).
[72] "Workers' Victory," *Time*, March 28, 1938. www.time.com/time/magazine/article/0,9171,759370,00.html.
[73] Jayne, 183.
[74] House of Lords, *Parliamentary Debates* (London: HMSO, 1938), March 30, 1938.
[75] In contrast to the U.K-Mexico diplomatic rupture from 1938 to 1941.

Neighbor policy and working more subtly towards their goal."[76] While the Roosevelt and Truman Administrations failed to regain access to Mexico for American oil companies, they did so only after multiple, though modest, attempts to reverse Mexico's nationalization.

In fashioning a response, Franklin Delano Roosevelt "was engaged in a ticklish balancing act."[77] As war in Europe loomed on the horizon, the U.S. Government valued an amicable working relationship with Mexico—part of the Roosevelt Administration's "Good Neighbor" policy towards Latin America—and strongly wished to avoid any economic or strategic entanglements between the Mexican republic and Nazi Germany or Imperial Japan.[78] Nonetheless, time after time, the U.S. Department of State argued that oil companies affected by the nationalization should be duly compensated for their loss.

In addition, while President Roosevelt and U.S. ambassador Josephus Daniels (former Navy secretary and presidential confidante) favored a temperate and conciliatory approach to negotiations with Mexico, Secretary of State Cordell Hull and other senior Department of State officials favored the application of limited penalties. Secretary Hull heavily criticized the nationalization in both private dispatches and official statements, saying that Mexico's action amounted to "hari kari in its commercial relations with us.[79] Even so, Hull's own opinions of the nationalization stemmed more from his general

[76] Jayne, 8.

[77] Clayton R. Koppes, "The Good Neighbor Policy and the Nationalization of Mexican Oil: A Reinterpretation," *Journal of American History* 69, No.1 June 1982: 71.

[78] R.H. Hippleheuser, "Relations Staked by Nations in Race for Mexico's Oil," *New York Times*, April 3, 1938.

[79] Jayne, 46. Recounting an April 2nd meeting with the Mexican ambassador, Hull wrote that, "I said to the Ambassador that his Government must therefore see the impossible position in which these proposed or threatened steps by the Mexican Government are placing this Government and this country […] they would occur just at the time when the world is on fire; when lawlessness is steadily expanding in many regions and when this Government is preaching to all nations the preservation of all the principles of law and order in every part of the world; that it would be an anomalous situation to announce in these preachments that we are making an exception in the case of Mexico." *Foreign Relations of the United States, 1938,* V, 742.

support for bilateral, reciprocal trade regimes than a rock-ribbed defense of the U.S. oil companies. In disparaging the nationalization, Hull was variously supported by his deputy Sumner Welles,[80] who as Undersecretary of State vacillated between the conciliatory approach suggested by Roosevelt on one hand and Hull's more hard-line views on the other.[81] The range of opinions expressed by U.S. officials did affect the execution of U.S. policy, serving to dilute the impact of statements and actions hostile to Cardenas' act of expropriation.

In fact, scholars disagree over the extent of U.S. backing for the American oil companies; most hold that the United States offered scant support for the companies' financial and property demands but a few suggest a stronger drive to reverse nationalization.[82] Daniel Yergen is of the orthodox opinion: he describes the penalties imposed on Mexico primarily though the State Department as "halfhearted."[83]

When U.S. oil companies accepted a compensation agreement in October 1943 under pressure from Washington, State Department leaders continued to ruminate over the (unlikely) possibility of the American companies returning to Mexico. Koppes has written that "the 1942 compensation agreement dealt only with expropriation of

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[80] "Washington's policy towards Mexico during the Roosevelt administration was the result of input from several officials involved in a struggle for influence over foreign policy and winning the president's favor" (Jayne 8) and "[…] Both Welles and Hull straddled conflicting defense and commercial objectives in forming policy towards Mexico, and Welles, more than anyone else, used the situation to his advantage. He acted consistently with Hull's policy some of the time, but would also support Roosevelt's and Daniel's reactions to the problem, which greatly softened Hull's preferred course of action. His changes of behavior can be attributed to his desire to gain influence in the administration at Hull's expense […]" Jayne, 15.

[81] In a memorandum of conversation dated March 21, 1938, Welles blasted the nationalization as "absolutely suicidal" to the Ambassador of Mexico. U.S. Department of State, *Foreign Relations of the United States: 1938*, "The Latin American Republics: Mexico," Vol. 5. (Washington, DC: Government Printing Office: 1954-56), 731.

[82] An unorthodox view advocated by Oberlin professor Clayton Koppes holds that, rather than acquiesce, "Washington's policy was devoted to reversal of nationalization […] at bottom the oil controversy was an issue, not of ownership or expropriation, but of the right to participation in a sector of the Mexican economy—in other words, of nationalization. Koppes, 62, 67. See Appendix Two for details of U.S. penalties regarding the Mexican nationalization.

[83] Yergin, 276.

immediate property interests, not the more basic issue of acceptance of nationalization" which he says that the U.S. continued to contest; Yergin counters that U.S. oil companies argued that "[…] they were being abandoned and betrayed […]" by the insistence of the United States on taking Mexico's compensation offer.[84] The events concerning U.S. oil companies' resolution of outstanding claims in Mexico are well-covered in existing literature, but the final U.S. attempts to water down the nationalization deserve brief mention.[85]

In the period from 1944-1950, for instance, the United States exercised an economic penalty against Mexico with the aim of re-opening access for American oil companies: restricting or denying loans to Pemex. Mexico sought a $100-$150 million loan for Pemex in 1944 and offered to repay the loan in oil. Secretary Ickes argued in favor of granting the loan; he nearly convinced Roosevelt to do so, but vigorous counter-pressure from Cordell Hull and U.S. ambassador Messersmith led Roosevelt to deny the request.[86]

During the Truman Administration, Mexico again lodged multimillion dollar loan applications in 1947, 1949, and 1950. "The United States rejected them, unless private firms were allowed to reenter," and in turn Mexico declined to accept the American

[84] Koppes, 81; Yergin 278.

[85] See Appendix Two for further details of U.S. penalties regarding the Mexican nationalization. Yergin, 277-79; Koppes, 71-76. Further Reading: Catherine Jayne, *Oil, War and Anglo-American Relations*: *American and British Reactions to Mexico's Expropriation of Foreign Oil Properties, 1937-1941* (Westport, CT: Greenwood, 2001); Jonathan C. Brown and Alan Knight, *The Mexican Petroleum Industry in the Twentieth Century* (Austin, TX: University of Texas Press, 1992); and J. Richard Powell, *The Mexican Petroleum Industry, 1938-1950* (Berkeley: University of California Press, 1956).

[86] One exception (opposed by Hull, Welles and U.S. oil company interests) that President Franklin Roosevelt allowed on national security grounds provided funding in 1943 for one Pemex refinery which Mexicans then called the "18 de Marzo" in commemoration of the nationalization. See Koppes, 76-78.

conditions.[87] Indeed, "one important characteristic of the Mexican expropriation was its irreversibility."[88] Finally, in September 1950, the U.S. gave Mexico a $150 million loan from the Export-Import Bank for infrastructure development—but, said the bank's chairman, "none of the funds are to be earmarked for the development of the country's oil industry" adding (perhaps disingenuously) that "our position has been that there is adequate money available in private capital for oil development."[89]

On balance, while the nationalization roiled relations between Mexico City and Washington, it never led to a break. Overall, the U.S. Government prioritized strategic considerations in its handling of Mexico's nationalization while promoting U.S. economic interests in Mexican oil indirectly, if not coercively.[90] The Mexican nationalization also foreshadowed later developments in which the United States would argue for principles of free trade and open markets but take only measured, limited steps to directly aid American oil companies threatened with host governments eager to nationalize.

This emphasis on strategic concerns continued into the Cold War. At the beginning, the Truman Administration took a largely hands-off attitude towards the conflict between Iran and the United Kingdom over nationalization of British oil assets in 1951. The UK's oil interests in Iran were held by the Anglo-Iranian Oil Company (AIOC). Although the U.K. government held a 51 percent stake in AIOC, it exercised

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[87] Koppes, 80; *Foreign Relations of the United States, 1948*, IX, 606 (fn 2): "The White House policy against U.S. Government loans for commercial development of the Mexican petroleum industry was established by President Roosevelt on December 19, 1944 and reestablished by President Truman on October 13, 1945;" Deck Reshuffled," *Time*, July 4, 1949. For Pemex's postwar development, see Roland Goodman, "It's the Oil that Keeps Mexico Running," *New Republic*, August 8, 1949: 12-15.

[88] George Philip, "The Expropriation in Comparative Perspective," in *The Mexican Petroleum Industry in the Twentieth Century*, ed. Jonathan C. Brown and Alan Knight (Austin: University of Texas, 1992), 184.

[89] "Mexico to Receive $150,000,000 in Credits; Export-Import Bank Fund Excludes Oil Aid," *New York Times*, September 2, 1950.

[90] Roland Goodman, "It's the Oil that Keeps Mexico Running," *New Republic*, August 8, 1949: 14.

only limited influence over the company's operations and decision-making. For its part, while not directly intervening early on, the U.S. privately urged the British government to push Anglo-Iranian towards a settlement that the Iranians themselves would perceive favorably—especially as Aramco, the American consortium in Saudi-Arabia, moved towards a 50-50 profit-sharing agreement. Nevertheless, AIOC obstinately resisted a new financial arrangement with Iran. When the company finally realized its weak position, it suggested an offer matching the Americans' 50-50 approach, but this offer was simply passé by the spring of 1951.

Tensions reached a boiling with the rise to power of Prime Minister Mohammed Mossadegh, an implacable foe of AIOC. On May 1, 1951 Prime Minster Mossadegh formally implemented legislation nationalizing Iran's oil industry. Although Britain's oil concessions in Iran were gravely endangered, the U.S. did not intervene on behalf of its ally's interests.

It was only when President Dwight D. Eisenhower's administration took office in 1953 that a policy consensus against Mossadegh coalesced. Washington came to believe (however rightly or wrongly) that Mossadegh was turning towards the Soviet Union, and subsequently the U.S. moved decisively, helping to engineer a coup against him and returning the Shah to power. Once the nationalization had been implemented on an operational level, the Iranian government "could not sell its oil, it was running out of money, economic conditions were deteriorating. But none of that seemed to count."[91] Wildly popular as a result of his nationalization policy, Mossadegh faced political, even personal peril were he to back down. With Mossadegh in power, the Tudeh (Iran's Communist Party) had become increasingly active. At the same time, U.S. policymakers

[91] Yergin, 466.

grew concerned over a perceived "tilt" by Mossadegh towards the USSR as a Soviet ambassador known for his political intervention in client states took up post in Tehran.[92]

Failed negotiations finally pushed the Americans and British closer together, culminating in a coup—"Plan Ajax"—which the CIA and British Secret Intelligence Service carried out. According to the official CIA history, "the aim was to bring to power a government which would reach an equitable oil settlement, enabling Iran to become economically sound and financially solvent, and which would vigorously prosecute the dangerously strong Communist Party."[93] When the Shah, pressed by U.S. operatives, finally dismissed Mossadegh in mid-August 1953, street protests by Mossadegh's supporters broke out, resulting in widespread unrest; in response the Shah fled the country for Baghdad and then Italy. However, the public mood shifted towards the Shah once his decrees dismissing Mossadegh were publicized; thereafter, the military and public security forces (backed by the U.S. and UK) favoring the Shah gained increasing mastery of events on the ground. Eventually, Mossadegh was deposed and arrested.[94] In sum, the U.S. had cared little about Britain's Iranian oil concessions, but the specter of Soviet domination of Iran quickly prompted a change in policy.

The U.S. Government's prioritization of strategic rather than oil interests continued after John F. Kennedy became president in 1961. Despite the hard-line approach to foreign oil companies taken by Venezuela's government under President Romulo Betancourt, the Kennedy Administration worked hard to establish a *modus*

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[92] Yergin, 468.
[93] "Secrets of History: The CIA in Iran," *New York Times*, http://www.nytimes.com/library/world/mideast/041600iran-cia-index.html
[94] "Secrets of History: The CIA in Iran," *New York Times*, http://www.nytimes.com/library/world/mideast/041600iran-cia-index.html

vivendi in U.S.-Venezuelan relations overall.[95] Venezuela played a central role in the establishment of OPEC in September 1960, for example.[96] In the wake of Fidel Castro's revolution in Cuba, the United States was looking for democratic but staunchly anti-communist allies in the Western Hemisphere. "Kennedy feared that Venezuela, the largest source of American petroleum imports, would fall prey to communism."[97] Keeping the relatively moderate government of President Betancourt in office necessitated a robust economy and thus a strong petroleum sector. When Betancourt's government vigorously objected to the U.S. import quota system, saying it said unduly limited oil exports, President Kennedy did not give the Venezuelans the preferential treatment they asked for, but he did double "loans to Caracas to $100 million in 1961 and encouraged Venezuela to take an active role in the Latin American Free Trade Association in order to promote its exports through a common market."[98] Between 1960 and 1970, U.S. petroleum imports from Venezuela rose from 451 million barrels to 536 million barrels.[99]

Later, in the late 1970s, Venezuela became caught up in the "wave" of nationalization then sweeping through many producing countries, especially in the Middle East. After the tumult of the early 1970s and the Arab oil embargo, the international oil companies had lost their leverage. "Prices were strong; circumstances in the market were emboldening all the countries, which assumed that what was happening would go on forever. The actual nationalization gave us [IOCs] very little room for

[95] Romulo Betancourt was president twice, from 1945-48 and 1959-64. He was president in 1945 when Oil Minister Juan Pablo Perez Alfonso implemented the 50-50 revenue agreements, adjusted to ensure correct cash flows. Yergin, 435-436 and 510-513.
[96] Yergin, 514-518.
[97] Thomas W. Zeiler, "Kennedy, Oil Imports, and the Fair Trade Doctrine," *The Business History Review* 64, no. 2 (1990): 291.
[98] Zeiler, 293.
[99] Zeiler, 309.

maneuver."[100] When Venezuela fully nationalized oil holdings of foreign companies in 1976, the U.S. Government simply accepted the action, especially after the American oil companies received compensation and retained the ability to get Venezuelan oil through contract purchasing. In the meantime, Venezuela's newly-created national oil company, Petróleos de Venezuela "was destined quickly to become a major force in its own right in the new world oil industry."[101]

The same primacy of other strategic considerations may be found in the 1970s. The Arab oil embargo of 1973 surely strained U.S. relations with Saudi Arabia, whose King Faisal was one of the chief instigators of the embargo. But relations between Washington and Riyadh were mended, as the United States looked to Saudi Arabia both as bulwark against Soviet influence and – in the wake of the Camp David Accord between Egypt and Israel – a force of moderation in the Arab world.[102] Even during the embargo, Saudi Arabia quietly permitted oil to be supplied to the U.S. military.[103] The Shah, who took the lead in urging OPEC action in the wake of the embargo to sustain higher oil prices, remained a firm ally and recipient of U.S. largesse until his overthrow in 1979. Notably, U.S. support for Israel—the proximate cause of the oil embargo of 1973 and a lingering source of strain between the U.S. and Muslim oil-producing states—has remained high, despite the damage it has done to U.S. energy interests. Whether this support for Israel reflects strategic concerns, an ideological support for a fellow democracy or the power of pro-Israeli lobbying is a complicated and controversial

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[100] Yergin, 649.
[101] Yergin,, 650.
[102] Bronson, 123.
[103] "Frontline: House of Saud, Interview with Frank Jungers," *PBS.* http://www.pbs.org/wgbh/pages/frontline/shows/saud/interviews/jungers.html; Comptroller General of the United States, "Report to Congress: Critical Factors Affecting Saudi Arabia's Oil Decisions," U.S. Government Accountability Office, May 12, 1978, p. 13; and, Anthony C. Brown, *Oil, God, and Gold: The Story of Aramco and the Saudi Kings* (New York: Houghton Mifflin, 1999), 296.

subject.[104] It need not be addressed here. But it is unquestionable that U.S. support for Israel, and the price for which the United States has paid for it in the Arab and, indeed, Muslim world, has not been based upon narrow U.S. energy interests.

With the end of the Cold War, the administrations of George H. W. Bush and then Bill Clinton continued U.S. engagement in the Middle East on broad principles of supporting stability in the region. The limited war to eject Iraq from Kuwait, sanctions aimed at isolating Saddam Hussein's regime, ongoing efforts to broker a peace between Israel and its Arab neighbors, and – in the last years of the Clinton Administration – a tentative and temporary thaw in U.S.-Iranian relations reflect an emphasis upon stability. So did these two administrations' efforts to keep U.S.-Saudi relations on an even keel. This changed with the attacks of September 11th, 2001, the designation of Iraq and Iran as two of the three members of the "Axis of Evil," and the invasion of Iraq. Here the neoconservative strategic vision of a new Middle East less hostile to the United States (and Israel) displaced the emphasis on stability found in the policies of George W. Bush's two predecessors. Secretary of State Condoleezza Rice has made a number of statements at sharp odds with Washington's traditional concerns for stability.[105]

ACCEPTING REALITY

The last fifteen years have been marked by periodic bouts of enthusiasm over this or that development in international oil markets which would wean the U.S. from its dependence on major Middle Eastern producers. First came talk of the vast potential of

[104] "The Israel Lobby and U.S. Foreign Policy" by John J. Mearsheimer and Stephen M Walt prompted a firestorm of criticism by suggesting that the Israel Lobby drives U.S. policy. Kennedy School Working Paper, March 2006.

[105] See Rice's dismissal of stability in the Middle East as "stagnation." Interview with Brian Williams of NBC News, November 30, 2006. (Transcript available at www.state.gov/secretary.) See also her description of Israel's invasion of Lebanon as "the birth pangs" of a new Middle East. Special Briefing on Travel to the Middle East and Europe, July 21, 2006. (Transcript available at www.state.gov/secretary.)

Central Asia, then the prospect of a U.S.-Russian "Axis of Oil," and even – for a short while – the hope that a post-Saddam Iraq would expand production sufficiently to drive down oil prices and "break OPEC." Each of these hopes possessed elements of truth. Oil production in the former Soviet Union has, in fact, recovered from the collapse of the 1990s and is poised to play a greater role in world markets. Iraq does possess vast reserves and could increase its exports dramatically if it were to achieve a modicum of stability, though this is a very big "if," indeed. But in none of these regions has production provided a miracle cure for our dependence upon foreign oil, nor is it likely to solve our problems in the immediate future.

In a perfect laissez faire world, all NOCs would be privatized, foreign investors treated the same as local companies, and OPEC disbanded. The price of oil would plummet and the loci of production shift towards lower cost producers, probably a handful of countries in the Middle East. Why, exactly, producing countries—even if they were democratic and well-governed—would agree to this (as argued in neoconservative logic) is difficult to fathom. It may well be that major oil resources bring with them a raft of difficulties both economic and political. These include a domestic economy highly skewed toward the export of one product, with attendant damage to other sectors. Politically, these difficulties include the creation of a vast opportunity for graft and patronage. But it is hard to imagine that major producing countries—especially if populations could vote—would purposefully impoverish themselves.[106] Our policies should reflect this fundamental reality.

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[106] Influential columnist Thomas Friedman is a strong proponent of the idea that high oil prices are actually bad for exporting countries. "Not Their Parents' Russia" in *The New York Times*, February 9, 2007 is merely one of his many columns advancing this theory. "When oil prices rise," he writes, "Democrats'

From a U.S. policy perspective, the answer clearly lies elsewhere: the United States should accept the existence of NOCs as a fact of life but encourage steps that would make their activities more business-like, transparent, and – to the extent possible – free of too onerous government interference. Norway's Statoil may serve as a model for countries seeking to reform their NOCs. It also serves as an example of the extent to which multilateral organizations – in this case the European Economic Area (EEA) – can serve as vehicles for reform of NOCs. Under the EEA, Statoil found its monopolistic position much diminished.[107] Yet we must also recall that among major oil exporters Norway is in many ways a unique case: economically advanced, staunchly democratic, and already deeply integrated into the international economy.

Above all, we should not have unrealistic goals: Washington, for instance, has wasted a great deal of time and effort pressing Moscow to grant broad scope for production sharing agreements with IOCs. At a minimum, we should avoid talk of using privatization to "break OPEC" or drive down prices to destabilize unfriendly governments; both arguments play directly into the hands of nationalists in oil-producing countries. The idea of pressing action against NOCs and OPEC through the World Trade Organization (WTO) is fraught with difficulties: unable to resolve the question of agricultural subsidies despite years of negotiation, the odds of the WTO successfully tackling cartel behavior among NOCs and their sovereign owners seems slim.

We also need to distinguish between our economic and strategic concerns in dealing with NOCs. Our worries about China's involvement in Sudan, for instance, have little do with the Chinese commercial practices; they have to do with providing

spirits fall." This may be true, but it is hard to conceive of many Russians embracing poverty as a step towards more representative government.

[107] See "Statoil" by Richard Gordan and Thomas Stenvoll in this study series, p. 46.

revenue—and diplomatic support—to a regime we consider objectionable on any number of counts. In strictly economic terms, Chinese involvement in Sudan may actually economically benefit the United States by supplying oil to world markets that would be otherwise unavailable. If we have problems with China's support for Khartoum and Tehran—as well as Naypyidaw[108] and Caracas—we have a variety of incentives and disincentives available to alter Beijing's position; to date, we have clearly not considered Beijing's support of such "rogue regimes" of sufficient import to imperil our close economic links with China.[109] We should have no problems with Chinese NOCs investing in countries like Canada—or for that matter, the United States—unless they break the law.

On the international level, we need to continue working with major producing counties to ensure a stable supply of oil to world markets. The U.S.-Saudi special relationship is, admittedly, weakened. Opposition to communism no longer binds Riyadh and Washington, and many in the United States doubt the Kingdom's commitment to the war on terrorism.[110] For its part, Saudi Arabia is appalled and alarmed by the destabilizing consequences of the U.S. invasion of Iraq.[111] Nonetheless, some sort of relationship with Saudi Arabia – whether "special" or not – remains an important element of any international energy policy. For now, at least, no other country stands ready to

[108] Naypyidaw is Burma's new capital (as of 2007), formerly located at Rangoon.

[109] The fact that China holds hundreds of billions of dollars in U.S. official debt may also explain our unwillingness to use press China too firmly.

[110] In 2002, influential neoconservative Richard Perle organized a briefing at the Pentagon in which Saudi Arabia was described as "the kernel of evil, the prime mover, the most dangerous opponent" of the United States in the Middle East. "Briefing Depicted Saudis as Enemies," *The Washington Post*, August 6, 2002. Even so mainstream a foreign policy analyst as Michael Mandelbaurm raised the idea of putting Saudi Arabia's oil fields under some form of international control, presumably through invasion and occupation. "America's Saudi Dilemma," *The Milwaukee Journal Sentinel*, August 1, 2003. His views may, however, have changed in the wake of our protracted and painful occupation of Iraq.

[111] It may well be that the rising regional influence of Iran – a result, ironically, of the U.S. invasion and occupation of Iraq – will compel cooperation between Riyadh and Washington.

take its place as the world's swing supplier of oil. While there exist differences of opinion on optimal prices – not just between consumers and producers but among producers themselves – there does exist a common interest in price levels that do not severely damage the global economy. It is now clear that that level is higher than many imagined just a few years ago. But there surely exists a price which could risk plunging the world into recession. And it is in the interest of both producers and consumers to avoid such an outcome.

We also need to be more honest to ourselves about the costs of our energy policy. We tend to focus on the expenditures we have undertaken to ensure the steady supply of oil, notably our military deployment in sea-lanes and in major producing areas, such as the Persian Gulf. But we also need to be clear about other costs of our foreign policy. Our sanctions policy has clearly reduced world oil production.[112] As a 1997 Baker Institute study observed, a variety of factors including sanctions policy "limited the playing field within OPEC" during the 1990s, when Iran, Libya, and Iraq lacked the ability to immediately increase oil export levels and push for the sort of self-interested market-share increases that led to the market surpluses seen from OPEC during the 1980s.[113] Our invasion of Iraq has just as clearly roiled markets and raised prices. And a military strike against Iran would almost certainly do the same, at least in the short term. It may well be that keeping Iran from acquiring nuclear weapons would enhance long-term stability in the Persian Gulf.[114]

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[112] If it hasn't, then the sanctions failed: their object after all, was to squeeze the target countries.
[113] Amy Myers Jaffe, "Main Study," *Political, Economic, Social, Cultural, and Religious Trends in the Middle East and the Persian Gulf and their Impact on Energy Supply, Security, and Pricing*, Houston, James A. Baker III Institute for Public Policy, 1997. Available at http://www.rice.edu/energy/publications/.
[114] An argument could be made that a nuclear Iran could actually increase stability in the Gulf by making it unlikely that the United States would launch military action against Tehran for the purpose of regime

But it is also clear that the U.S. policy of regime change – dramatically demonstrated in Iraq – provides strong incentives for Iran to build a nuclear weapon. This is not to argue that Washington's policies are necessarily wrong. The broader interests at stake – in Iran's case, stopping nuclear weapons from falling into the hands of a hostile regime – may outweigh any short-term economic cost. But economic costs, however difficult they may be to pin down in precise terms, exist in this matter, and they should be put on the table in any debate. This is particularly true now, when the United States has plunged headlong into the Middle East in an effort to remake the region, leaving Iraq in chaos and raising the specter of Sunni-Shia conflict throughout the Middle East. The United States is now arguably a force for instability in the Persian Gulf, and instability bears costs, some of them economic. Higher oil prices are one of them. We should recall this as we press other countries in the region to reform their NOCs, increase foreign investment, and boost output. Our concerns will ring hollow and hypocritical coming from a country that has plunged the world's most important oil producing region into war. If we don't get our broad geopolitics right, specific policies will carry little conviction and have modest effect.

Not least, the United States must develop a respectable domestic energy policy. The Energy Policy Act of 2005 – despite the hoopla surrounding its signing – won't help much. Its supporters described the bill as the most significant energy legislation in over a decade. But this is less a comment on the legislation's merits than on our national disinclination to make tough decisions on energy policy. True, the bill did contain some useful elements. It will make it easier to site much-needed regasification plants, a critical

change. The idea that the Washington is a threat to stability is quite reasonable, given talk of "creative destruction" among the Administration's neoconservative supporters.

measure as the United States increases is imports of Liquefied Natural Gas. And it mandates an inventory of the gas and oil reserves in coastal areas currently off-limits to drilling. But the legislation stops short of actually opening those areas – or even the endlessly debated Arctic National Wildlife Refuge (ANWR) – to oil and gas development. Its support for renewable energy sources such as solar or wind power and the development of tar sands is welcome but modest, falling well short of a crash effort to wean us from imported crude oil.

On the demand side, the Act did next to nothing to improve the fuel efficiency of vehicles, which represent a lion's share of oil consumption. In fact, most of the legislation is given over to a grab bag of subsidies and tax-breaks for industries with powerful lobbies, rather than a coherent energy strategy. It does not represent a serious national effort to reduce our dependence on foreign oil. This was made utterly clear when a modest provision calling on the President to find ways to reduce domestic oil consumption by one million barrels a day by 2015 was cut from the final version, reportedly at the Administration's request.

There is endless talk of reducing our dependence on imported oil. President Bush, for instance, has raised the subject in all of his State of the Union Addresses.[115] But we have yet to make our actions match our words. We are still far from an energy

[115] They may be found at www.whitehouse.gov. In his 2007 State of the Union Address, President Bush proposed two major initiatives to promote energy independence: increased ethanol use and raised automobile efficiency standards. The latter marks something of a break-through for the Administration. But it is unclear whether either initiative will pass into law or, indeed, whether the Administration will expend its political capital pushing them. On increasing efficiency standards, there may be less to the President's proposal than meets the eye. Under it, setting actual standards would be the responsibility of the Secretary of Energy, not the Congress, and based on "cost/benefit analysis, using sound safety, and without impacting safety" in a "flexible rulemaking process." There would appear to be a hole in the commitment to increase fuel efficiency large enough to drive an automotive fleet through. See "Twenty in Ten: Strengthening America's Energy Security" released by the White House in conjunction with the President's 2007 State of the Union Address. Available at www.whitehouse.gov

strategy that seriously tackles either the supply or demand elements of our oil dependence. Such a strategy is not hard to envisage in general terms. It would include opening up both ANWR and coastal areas to oil and gas development. It would also phase in more rigorous efficiency standards for vehicles and perhaps mandate fleet shares for hybrid and fuel-cell vehicles.

While such a grand compromise would not bring us to full energy self-sufficiency, it would make a serious dent in the growth of our dependence on foreign oil. The June 2007 energy bill passed by the U.S. Senate is a step in the right direction. For example, increasing fuel efficiency standards to 35 miles per gallon by 2020 *will* help reduce gasoline use. Even so, China, Japan, and the European Union already have either comparable or higher standards, and, at time of writing, the energy bill pending in the U.S. House of Representatives does not include higher fuel efficiency standards.[116] A more comprehensive energy bill has, of course, a slim chance of passage in the current or foreseeable political environment. Environmentalists and politicians from coastal states have strongly resisted opening protected areas to exploration; the automotive industry has and likely will continue to pull out all the stops to oppose more rigorous efficiency standards, including pressing U.S. Representative John Dingell (R-MI) to block all legislation through the House of Representatives' Energy and Commerce Committee, which he chairs.

As John Ikenberry points out, a state like the United States, unlike smaller, less powerful countries, can attempt to externalize its response to challenges like increasing

[116] Kenneth B. Medlock III, *The Price of Gasoline: How High for How Long?*, James A. Baker III Institute for Public Policy, Rice University, July 20, 2007. Available at: www.bakerinstitute.org/Pubs/WWT_price_gas.pdf; "Answers to Frequently Asked Questions Regarding U.S. Gasoline Markets and U.S. Oil Import Dependence," James A. Baker III Institute for Public Policy, Rice University. Available at: www.rice.edu/energy/publications/otherpapers.html#_FAQs

oil prices.[117] In the crises of the 1970s and early 1980s, for instance, we struggled – with admittedly mixed success – to organize a coordinated response to the energy crises of the era. More recently, the United States has undertaken a variety of measures – from ejecting Iraq from Kuwait to encouraging production in Central Asia – aimed at ensuring a stable supply of moderately-priced oil to world markets.[118] This ability by the United States can be a great advantage, not least because it creates, at least in theory, the opportunity for collective action: we can use our international influence to foster joint policies with other interested countries. But our power in the international arena also bears a risk: it can permit domestic policy to drift. This has certainly been the case over the course of the last two decades. At one level, U.S. foreign policy has been attempting to externalize the consequences of our political system's weakness. We may be the most powerful country in the world but our political system appears singularly incapable of tackling a domestic energy policy. This may reflect the system's shortcomings or – alternatively –- the sense that, rhetoric aside, the crisis is, perhaps, not as critical as it seems.[119]

In addition to its substantive effects, a "grand compromise" would also help U.S. credibility on the world scene. Countries have long since grown weary of the United States hectoring them on domestic policies when Washington itself seems unprepared to do much in its own domestic arena. While we wring our hands about non-OPEC

[117] *Reasons of State*. (Ithaca, NY: Cornell University Press, 1988). pp. 197-8.
[118] Other countries can and do also benefit from U.S. actions. Insofar as the United States undertakes and pays for policies that protect international energy markets and promote stable moderate prices, other counties enjoy the benefits of a free ride. But we should also recall that such countries can suffer from our policies as well; many Western Europeans, for instance, would presumably describe our invasion of Iraq in precisely such terms.
[119] The muted macroeconomic effect noted above would suggest that this analysis has merit. How big an energy crisis do we in fact face if the U.S. and global economies are growing at a healthy, if not spectacular, rate? Perhaps the feeble U.S. response to the rise in prices merely reflects a rational assessment of the situation.

production, we forget that we are, after Russia, the second largest of these producers. U.S. production is roughly triple that of Mexico, Canada, or Norway. And our national unwillingness to undertake serious domestic measures also feeds suspicions – however mistaken – that U.S. policy is merely an attempt to control the oil resources necessary to meet our ravenous appetite for oil while keeping our coastal vistas uncluttered by oil platforms and our wildlife preserves pristine.

This approach to the problem of oil supply – and by extension NOCs – is hardly dramatic. It promises no new huge shifts in world production, no overnight switch to renewable energies, no flowering of democracy among major oil producers; but it does have a two-fold advantage: it reflects the world as it is, as opposed to what we would like it to be; and it bears a decent chance of success, if the goal is a decrease in, if not an end to, our dependence on imported oil.[120]

[120] The idea of the United States forming its own NOC appears a non-starter on any number of grounds. First, it would run counter to decades of U.S. policies aimed at reducing the government's role in the energy sector. Second, it would almost certainly face the vociferous opposition of U.S.-based IOCs, which would see it as a competitor for potentially lucrative investments. Third, it could easily create as many foreign policy problems as it solved. Many in the Middle East and outside it are already convinced that U.S. policy towards Iraq, for instance, is driven by our desire to control the oil there. Were the United States, though its own NOC, directly to own or operate oil fields would merely confirm this suspicion and likely lead to even greater anti-American sentiment.

APPENDIX

APPENDIX I

Oil Nationalization and Resurgent Nationalism: Venezuela and Mexico

PDVSA

Resource nationalism has been a driving force behind Venezuela's two periods of oil nationalization, including the late 1970s and early 2000s. "Nationalization of the oil industry has been tried in Venezuela before, though with a different tack. Venezuela shut [international] companies out of the oil sector completely between 1976 and 1992 before beginning a series of partial privatizations, which Chavez is now rolling back."[121] While the ongoing, second epoch of nationalization in the 2000s has been marked by a degree of acrimony between the U.S. and Venezuelan governments absent in the 1970s, both periods represent a pushback against U.S. foreign policy and stem from negative opinions of perceived U.S. economic dominance in Latin America. This portion of the paper will highlight developments in the oil sector of Venezuela during the presidency of Hugo Chavez and assess implications for U.S. policy. Venezuela's first period of nationalization (1976-1992) will be discussed in the subsequent historical overview.

On May 1st 2007, Venezuela nationalized oil holdings in the country, taking majority stakes in unconventional oil projects, after earlier acquiring majority shares and operation of conventional investments. While not removing foreign oil companies from the country, the Venezuelan government forced international oil companies to reduce their stake in oil projects to less than half, or face expropriation and ejection. As a result, PDVSA will now operate as well as control all projects in Venezuela's oil sector. These

[121] Natalie Obiko Pearson, "Venezuela Seizes Last Private Oilfields," *AP*, May 1, 2007.

moves come as no surprise to oil market analysts; in fact, increasing state control over oil in Venezuela has been an essential component of the government's socialist vision.

First elected in 1998, Venezuelan president Hugo Rafael Chavez Frias has rolled out an incremental program of socialist governance and economic development in which PDVSA is both the key financier and major service provider of the government's broad social welfare initiatives. As a result of PDVSA's noncommercial social obligations, the company increasingly has become a clearinghouse for government welfare programs. This has been to the detriment of PDVSA's future as an efficient, commercial enterprise: PDVSA's 2005 spending on social programs ($6.5 billion) exceeded the company's oil reinvestments ($5.8 billion).[122] At the same time that PDVSA's work has become blurred by the government's social-welfare focus, Chavez has moved to bolster the state's control over the oil sector, leaving PDVSA with the difficult task of having to handle increased responsibilities in its core oil business while financing huge social expenditures for the government.

While numerous analysts, as well as Chavez himself, have described his move to expand state control in Venezuelan oil as a full nationalization, at time of writing it is—in practice—a *partial* nationalization. The state, through PDVSA, now has the majority stake in both conventional and unconventional oil production. PDVSA also has become the operator of joint-venture projects formerly run by international oil companies. Notwithstanding the importance of these moves, U.S. and other foreign oil companies still retained the right to remain in Venezuela as minority partners, albeit under less favorable circumstances.

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[122] Mares and Altamirano, "Venezuela's PDVSA," 78.

Some industry analysts have contended that Venezuela's request for a larger share of the oil sector is a reasonable response to the large jump in oil prices experienced since the 1990s, when Venezuela first signed the oil deals with Western firms. At that time, the risks remained that oil prices could tumble back below $20 into the teens, as they did in 1998 (requiring Venezuela to offer foreign investors a sweet deal and larger take to offset the possibility of losses if prices fell over the course of the investment arrangements). Now, with oil prices tens of dollars a barrel higher than expected and showing no prospects of falling, companies do not need as attractive terms to render the Venezuelan operations profitable.[123]

PEMEX

The case of Pemex during negotiations for the North American Free Trade Agreement (NAFTA) demonstrates the power of popular nationalism to affect the efficiency of an NOC. American attempts to open up the Mexican oil sector fell flat, despite the framework of the free trade talks. Created from Mexico's nationalization of the oil sector in 1938, Pemex became an oil monopoly, a state behemoth, and a living symbol of Mexican national identity: "[…] every year, successive governments have used the anniversary of the seizure of United States and British oil companies in 1938 as a way of reaffirming their own nationalism."[124] Still, however popular, state control has sometimes prized social development at the expense of economic efficiency. When Pemex reduced its workforce by one-third in 1992, the company still had 140,000 employees on its pay-role. Pemex's work historically has extended beyond its core

[123] For more on Venezuela and global energy security, see: "Energy Security: Meeting the Growing Challenge of National Oil Companies," Matthew E. Chen and Amy Myers Jaffe, *Whitehead Journal of Diplomacy and International Relations*, 9, no. 2 (2007); Mares and Altamirano, "Venezuela's PDVSA and World Energy Markets."
[124] Alan Riding, "In Mexico, A Fight for the Mantle of Revolution," *New York Times*, March 19, 1988.

activities in the oil sector to include public works, such as constructing public housing and operating hospitals.[125] Pemex's domestic position in Mexico meant that efforts to liberalize the oil sector would face major hurdles, as U.S. negotiators working on NAFTA soon found out.

While NAFTA was being finalized, Mexican leaders publicly swore their fealty to state sovereignty over Mexican petroleum. In March 1993, then-president Carlos Salinas de Gortari proclaimed that "with facts, not rhetoric, and with a firm nationalistic conviction, Petroleos de Mexicanos stays in the hands of Mexicans and exists to serve the whole nation."[126] In turn, the director of Pemex "praised Salinas for 'jealously' defending the principle of state control over the oil monopoly—'the symbol of our sovereignty'—during NAFTA negotiations."[127] Initially, U.S. negotiators sought to work around Mexico's constitutional restrictions on foreign participation in the oil sector. While the Mexican Constitution bars foreign ownership of Mexican oil, "it did leave open the possibility of foreign investment in some service contracts and 'secondary petrochemicals.'"[128] However, further liberalization of the oil sector was a non-starter within Mexican domestic politics. According to one Mexican official, "For the critics of NAFTA, oil was the signal of whether Mexico would give in or not. This was the issue people cared most about."[129] Still, if unable to get a share of exploration and production, the U.S. sought a 'proportional sharing' provision, which would "prevent Mexico from

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[125] Drew Fagan, "Nationalist Symbol Pemex Protected from NAFTA," *The Globe and Mail*, Toronto, Canada, September 24, 1992. Also, see: Roland Goodman, "It's the Oil that Keeps Mexico Running," *New Republic*, August 8, 1949: "Petroleos Mexicanos' … work does not consist solely in producing riches economically useful to the public, but in serving directly the interests of the nation itself" (14).
[126] Andrew Cawthorne, "Oil Giant Pemex Will Stay in Mexican Government Hands," UPI, March 18, 1993.
[127] Ibid.
[128] Frederick W. Mayer, *Interpreting NAFTA: The Science and Art of Political Analysis* (New York: Columbia University Press, 1998), online at: www.ciaonet.org/book/mayer/mayer05.html .
[129] Mayer, *Interpreting NAFTA.*

cutting off oil supplies in the event of a shortfall."[130] This issue, too, touched on national sensitivities; the Mexicans rejected the U.S. proposal. "In the end, Mexico refused to budge on proportional sharing, but it conceded ground on procurement, allowing foreign firms to bid on Pemex service contracts for the first time."[131]

In August 1993, the Clinton Administration tried to re-open discussion on Mexico's oil sector, before NAFTA received formal ratification. As a Mexican analyst described at the time, "the prospect of renegotiating NAFTA's energy clauses has sparked friction between Pemex and the Mexican trade ministry."[132] Nevertheless, Pemex won the final argument: "the Mexican Constitution's supremacy clause clearly compels the NAFTA to be adjusted in accordance to the Mexican Constitution, not the Constitution adapted to the NAFTA."[133] As passed into law, NAFTA's Chapter 6 (Annex 602.3) reaffirmed the Mexican Government's control over the country's oil reserves.[134] While participation in exploration and production remained off-limits for foreign companies, "NAFTA's importance for Canadian and U.S. trade with Mexico lies in its extension of energy to include petrochemicals, foreign investment and trade in services related to energy," as Canadian professor Andre Plourde wrote in 1993.[135]

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[130] Mayer, *Interpreting NAFTA.*
[131] Mayer, *Interpreting NAFTA.*
[132] "Washington Presses Mexico on 'Pemex' Oil Monopoly," IPS, August 4, 1993.
[133] Rogelio Lopez-Velarde, "Mexico's New Petroleum Law: The Internal Reforms at Pemex and the North American Free Trade Agreement," *International Lawyer*, Spring 1994, 28 Int'l. Law 1.
[134] NAFTA Chapter 6 (Annex 603.2) reads, "The Mexican State reserves the right to itself the following strategic activities and investment in such activities: (a) exploration and exploitation of crude oil and natural gas; refining or processing of crude oil and natural gas; and production of artificial gas, basic petrochemicals and their feedstocks; and pipelines; and (b) foreign trade; transportation, storage and distribution, up to and including first hand sales of the following goods: crude oil; natural and artificial gas; goods covered by this Chapter obtained from the refining or processing of crude oil and natural gas; and basic petrochemicals."
[135] Janet McFarland, "NAFTA Protects Mexico's Energy Monopoly, Study Says," *The Financial Post*, May 25, 1993.

Today, opposition to reducing Pemex's exclusive control over the exploration and production of Mexico's hydrocarbon resources tends to elide a key problem, which bedevils the company: insufficient reinvestment capital. The oil sector funds some 40 percent of government expenditure; in 2006, Pemex repatriated $53 billion to the Mexican Government. According to Pemex's investor relations chief, Pemex "pays taxes on third-party sales, a percentage greater than its profit, about 68 percent of its total revenue" (This amount dropped to approximately 54 percent in 2006).[136] "In spite of booming oil prices and record sales worth $86 billion, it ended last year [2005] $7.1 billion in the red and has debt of $54 billion."[137] Pemex's debt and tax burdens continue to adversely impact the company's ability to maintain a favorable reserve replacement rate. In 2006, new discoveries totaling 966 million barrels set the replacement rate (proven, probable and possible) at 41 percent, while proven reserves stood at 15.51 billion barrels, 955 million less than in 2005.[138] In its 2007 report *Hydrocarbon Reserves of Mexico*, Pemex said that production is guaranteed for another 9 years.

With the hastening decline of the Cantarell field—the second largest oil field anywhere in the world—Pemex's need for capital and new fields to maintain production remains imperative. Between January 2006 and February 2007, Cantarell, which has produced some 12 billion barrels of oil in its lifetime, lost one-fifth of its daily production capability, which fell from 2 million b/d to 1.6 million b/d. Pemex has pledged to invest $2.4 billion in the Cantarell field during 2007, but this investment will essentially delay,

[136] Augusta Dwyer, "Will Mexico Be Ready When Oil Runs Dry?," *The Globe and Mail*, Toronto, Canada, November 14, 2006; "Lower Tax Rate Not Enough for Pemex," *Oil Daily*, May 8, 2007.
[137] Augusta Dwyer, "Will Mexico Be Ready When Oil Runs Dry?," *The Globe and Mail*, Toronto, Canada, November 14, 2006.
[138] "Mexico's Pemex Releases Report on Reserves," BBC Monitoring Latin America, March 24, 2007.

not stop, the field's decline rate, estimated at 10-15 percent per year (Cantarell is forecast to produce 600,000 b/d in 2013).

Especially since Cantarell's production is declining precipitously, Mexico faces the prospect of becoming an oil importer between 2015 and 2020. Already, Mexico imports nearly 40 percent of its gasoline, and it imports one-fifth of its natural gas demand—despite possessing untapped natural gas resources in northern Mexico and in the Gulf. Mexico currently produces 3.31 million b/d of oil and is often one of the top three oil exporters to the United States.[139]

Debate continues to rage within Mexican policy circles over how to reform Pemex. While Mexican President Felipe Calderon has affirmed that state control of the oil sector will continue, he also has said that, "it is pointless that the oil is ours if, in the medium term, we can't exploit it…the modernization of Mexico necessarily depends on the modernization of Pemex."[140] Cuauhtemoc Cardenas, leader of the Party of the Democratic Revolution (PRD), has argued for a greater role for the private sector, especially private investment, to boost Pemex's production levels.[141] In March 2007, Jesus Reyes Heroles, Pemex's chief executive, publicly called for a new operational model for the company. Mr. Heroles bluntly stated that "a winning Mexico needs a stronger Pemex that doesn't pay so much tax and increase its debt like it has…the conclusion is clear. Pemex can't continue like this."[142] Pemex's future success largely depends upon how the Mexican Government decides to reconcile the competing economic and social interests that have hamstrung Pemex thus far.

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[139] David Luhnow, "Mexico Tries to Save Big, Fading Oil Field," *The Wall Street Journal*, April 5, 2007.
[140] "Calderon's Warning Over Oil," Latin American Weekly Report, March 22, 2007
[141] "Regional Focus—Mexico and NAFTA," *Latin News Daily*, March 26, 2007.
[142] Thomas Black, "Reserves Plummet, Leaving Pemex Critical," Bloomberg News, March 19, 2007.

A final element in Pemex's situation relates to the U.S.' own oil industry. In 2000, the U.S. and Mexico reached an agreement defining the "western gap" boundary in the Gulf of Mexico. The agreement supplemented the U.S.-Mexico maritime boundary treaty that came into effect in 1997. According to a 2000 press release from the U.S. Minerals and Management Service, the supplementary treaty created

> a small 1.4 nautical mile buffer zone on each side of the new boundary because both countries recognize the possibility that a trans-boundary oil and gas reservoir may exist. Within this small buffer area, Mexico and the U.S. have agreed to a 10-year moratorium on oil and gas exploitation. This provides time to learn more about the geology and geophysical characteristics of the zone. After the 10-year period, each country could permit drilling and exploitation of oil and gas in its respective buffer zone. Under the terms of this treaty, each side must notify the other when any of the buffer area is made available for oil and gas exploration and development.[143]

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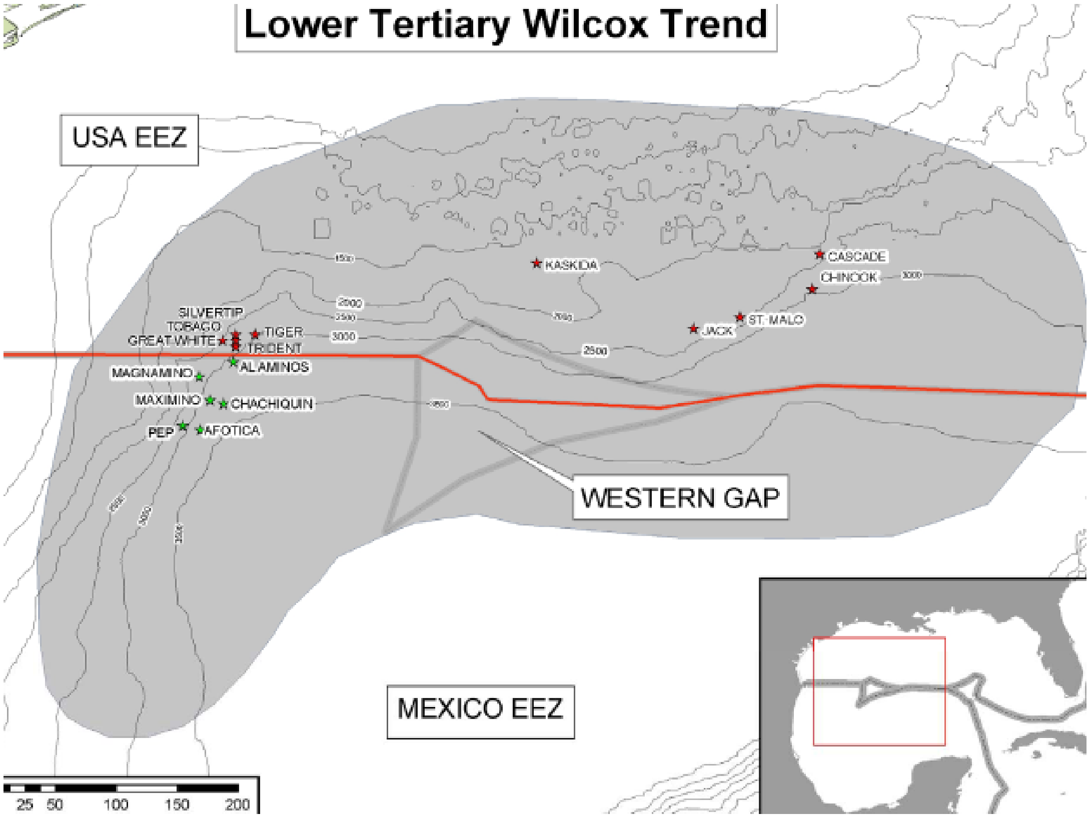
143 http://www.mms.gov/ooc/press/2000/061300.htm



Source: Hart Institute for Gulf of Mexico Research, Texas A&M University, Corpus Christi

The treaty "gave Mexico access to about 62 percent of the Gap, while the U.S. retained about 38 percent."[144] Given the terms of the 2000 agreement, the moratorium is scheduled to end in 2010 but could potentially be lengthened if both sides agree.[145] "Although the depth of the water is 10,000 feet, with advances in deepwater drilling the area has generated considerable interest."[146] Some legal clarifications may remain necessary, in the event that development of the western gap should proceed. According to Texas A&M University professor Richard J. McLaughlin, "because the U.S. is not a party to the UNCLOS [United Nations Convention on the Law of the Sea] it must rely on

[144] http://www.agu.org/meetings/sm07/sm07-sessions/sm07_OS53B.html
[145] "U.S.-Mexico Continental Shelf Boundary in Gulf of Mexico," *American Journal of International Law* 95, no. 2 (2001), 393-394.
[146] "Mexico," *Latin American Energy Handbook*, Energy Intelligence Group, 2005.

unpredictable customary law for legal authority to exploit its extended Continental Shelf. It is unclear how a joint development regime would fit within existing regulatory structure for offshore oil and gas development." [147] The U.S. Government has signed but not yet ratified the UNCLOS, leaving the convention nonbinding upon the United States; however, President George W. Bush issued a statement on May 15, 2007 urging Congress to ratify the Convention.[148]

[147] http://www.harteresearchinstitute.org/

[148] http://www.state.gov/g/oes/rls/or/84923.htm

APPENDIX II

U.S. Limited Penalties Arising from Mexico's Oil Nationalization

To put limited force behind the United States' vociferous disagreement over the Mexican nationalization, the Department of State either used or allowed the use of a select number of economic instruments against Mexico. First, U.S. and U.K oil companies enacted a boycott of Mexican oil. The boycott received greatest support from the U.K. Government, though the Roosevelt Administration, as described by Catherine Jayne, also provided some grudging support for the boycott (the two governments did not coordinate jointly). "The one remaining hope," said U.K. petroleum official Frederick Starling, "lay in the possibility that Mexico's difficulties in production, shipping and disposition of her oil might *compel* the government to seek reconciliation with the companies."[149] Though effective only for a short time, the boycott initially eliminated most of Mexico's former export markets. Between March 1938 and March 1939, "the amount of Mexican oil sold abroad dropped by more than 50 percent; sales to the U.S. fell by 61 percent; to Latin America, by 75 percent. In desperation Mexico signed sale and barter deals with Germany, Italy, and Japan."[150] However, these fell apart with the imposition of the Allied blockade once war broke out in Europe, and Mexico halted its oil trade with Japan nearly a year before the U.S. took similar steps. The boycott, which was never airtight even among U.S. companies, broke down by 1940 having failed to sustain its primary aims.[151] In addition to the boycott, the State Department also "discouraged

[149] Jayne, 85 (emphasis added). Frederick Starling was principal assistant secretary and director of petroleum supplies, 1940-1946 (Jayne 189).
[150] Koppes, 69.
[151] J. Richard Powell, *The Mexican Petroleum Industry, 1938-1950* (Berkeley: University of California Press, 1956), 112-115. N.B. Powell and Jayne appear to disagree over the extent of U.S. Government support for the boycott, which oil companies first initiated.

most private lenders" and "attempted to curtail United States purchases of Mexican silver"—no inconsequential matter for Mexico's economy.[152]

Secretary Hull hoped to permanently halt American special purchases of Mexican silver, which the U.S. had been buying directly from Mexico at above-market prices "[…] to help it obtain badly needed revenue and foreign exchange."[153] At the time, the U.S. was the world's biggest silver buyer, while according to a contemporary account in *Time* magazine, "Mexico is the world's biggest silver producer and its silver mines are even more important to its domestic economy than its oil fields."[154] For its part, the *New York Times* sniped that "despite communistic leanings there, the United States Government in recent years, through its silver-buying program, has furnished Mexico with much-needed funds to carry out its social reforms."[155] Under some pressure from the British, whose oil stake in Mexico had been even greater than that of the United States, on March 26th, Hull sent Ambassador Daniels a diplomatic dispatch containing a curt note for the Mexican Foreign Ministry,

> In view of the decision of the Government of the United States to reexamine certain of its financial and commercial relations with Mexico, the Treasury will defer continuation of the monthly silver purchase arrangement with Mexico until further notice.[156]

Additionally, "[…] Cordell Hull's note of 26 March 1938, requesting Mexico to pay compensation before Washington could recognize the expropriation as legal, was far more malign in its intent than its language conveyed, since it was well known that

[152] Koppes, 69-70.
[153] Jayne, 33.
[154] Silver-Dollar Diplomacy," *Time*, April 4, 1938.
[155] J.H Carmical, "Mexico's Oil Move Hits U.S. Policies," *New York Times*, May 27, 1938.
[156] "Telegram of the Secretary of State to the Ambassador in Mexico," *Foreign Relations of the United States, 1938,* V, 734; "Mexico's Oil Move Hits U.S. Policies," *New York Times*.

Mexico was in no position to pay."[157] Aware that the contents of the note could inflame diplomatic relations, Ambassador Daniels suggested to the Mexicans that it "might be considered as 'not received' […]."[158] This insubordinate act proved possible because of Daniels' closeness to President Roosevelt.[159]

Despite Daniels' personal intervention, however, the U.S. officially suspended its special, direct purchases of Mexican silver on March 27, 1938, but—with President Roosevelt's agreement—Treasury Secretary Morgenthau later bought Mexican silver "on the open market and refused Hull's request to lower the price."[160] A *New York Times* reporter covering the crisis remarked that "the change in silver policy was regarded in Mexico City as an economic sanction, a punishment for expropriation"[161] and the American government's action apparently helped to "drive the ailing peso off the foreign exchange market."[162] Although Secretary Hull sought to further rebuke the Mexican government, harsher measures were not adopted for geopolitical expediency and competing policy reasons.

U.S. officials nonetheless hypothesized about a possible reopening of the sector for American companies. Undersecretary Welles wrote that "I have instructed Mr. Messersmith [Daniels' successor as U.S. ambassador to Mexico from 1941] that above all other duties he should give first place to endeavoring to work out a plan satisfactory to all under which the United States interests could again participate in the Mexican oil

[157] Jayne, 5.
[158] Koppes 70.
[159] Jayne 44.
[160] Jayne, 48-50; Robert Freeman Smith, "Who's Afraid of Sonj? Energy and Nationalism in International Relations," review of *Mexico and the United States in the Oil Controversy, 1917-1942*, by Lorenzo Meyer, *Reviews in American History* 6, No. 3, 1978: 394-399 (397); "Millions for Defense," *Time*, October 20, 1941. http://www.time.com/time/magazine/article/0,9171,851290,00.html
[161] "Relations Staked by Nations in Race for Mexico's Oil," *New York Times*.
[162] Jayne, 5.

industry."[163] In an August 6th telegram to Ambassador Messersmith, Welles, acting for Secretary Hull, commented that "in the event that the Mexican Government has in mind to permit the participation of private foreign interests, this Government would be interested to know the attitude of the Mexican Government towards any such participation by American oil companies."[164] Interestingly, Cardenas' successor, President Manuel Camacho "did not rule out participation by foreign capital" but U.S.-Mexico negotiations came to naught when Mexico made clear that private capital would be subject to state control.[165]

[163] Koppes, 74.
[164] *Foreign Relations of the United States, 1942*, VI, 532.
[165] Koppes, 76.

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