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Increasing the Global Transportation Fuel Supply

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Despite soaring oil prices, oil and gas producers worldwide have failed to expand either supply or investment levels, falling short of meeting the rapidly growing global demand. The key challenge is ensuring an adequate supply of transportation fuel for cars and airplanes—not electricity, which can be generated from coal and nuclear reactors.

- Expansion of oil and natural gas supplies is inhibited by insufficient infrastructure, overregulation, a poor investment environment, unpredictable international actors, and weak lending institutions.

The war on terrorism and operations in Iraq and Afghanistan, as well as high rates of economic growth in China and the United States have caused additional gasoline and jet fuel shortages that have led to higher prices. Fuel costs represent an indirect tax that may seriously affect the economy, possibly even causing a global recession. Furthermore, leading industry experts believe that the global oil well is running dry. Even if this is not the case, developing the remaining supply poses problems that continue to confound the industry.

Insufficient Infrastructure. Currently, supply is limited by insufficient transportation and refining capacity. No new refineries have been built in the U.S. in the past three decades. In addition, world spare tanker capacity, which is essential to transport oil from overseas, no longer exists, and excess refinery capacity is at an all-time low.

Overregulation. While many oil fields are headed for depletion, national oil companies control 58 percent of oil and natural gas reserves. Laws requiring the government to own and/or control significant shares in oil ventures are common in many oil-producing countries. Overregulation prevents oil companies from owning mineral rights, while weak rule of law and insufficient protection of property rights in many oil-rich regions makes multibillion-dollar investments too risky.

A Poor Investment Environment. In many oil-producing countries, arbitrary laws, failing and corrupt legal systems, selective taxation, conflicting legal codes, and government failure to enforce contracts have created a murky investment environment. Nationalization has a particularly chilling effect. Russia frightened many investors away by breaking up its major oil company, Yukos, and suing British Petroleum's Russian partner for $790 million in back

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taxes. Saudi Arabia abandoned its much-touted privatization of natural gas production.

Unpredictable International Actors. Pipelines must often cross unstable regions and borders to reach markets, so elaborate international agreements are needed before pipelines can be built. Political and ethnic conflicts and terrorism in the Middle East, Africa, the Caspian region, and South America also create grave investment concerns. Some analysts warn that a carefully targeted terrorist attack on oil facilities in Saudi Arabia could reduce Saudi oil production to 4 million barrels per day or less for up to three months, which would have disastrous results for the global economy.

Weak Lending Institutions. In many countries, lending institutions are weak, and excessive taxation diverts oil revenues before appropriate investments for future development are made. This limits the funds available to develop new fields and tempers the profit motive to expand production. These anti-business barriers have hindered investors from expanding oil and natural gas supplies, even in the face of surging demand.

Steps to Be Taken. To help ensure energy security in the near future, the Administration should:

- **Develop a comprehensive strategy to change the oil investment climate.** Such a strategy should involve the Departments of State, Energy, and Treasury and be coordinated by the National Security Council. Consumer countries, including the G-8 and major oil consumers, should use diplomatic and economic means to pressure OPEC and non-OPEC suppliers to liberalize their foreign investment laws, break up state monopolies, and phase out undue government intervention. Efforts to promote such policies through international financial organizations should be increased. Economic assistance should emphasize economic freedom in potential recipients, including a liberal investment climate similar to Millennium Challenge Account requirements. Arms and vital equipment sales should be conditioned on improving the investment climate in the energy sector. The U.S. should also condition accession to the World Trade Organization (WTO) on policy changes that facilitate foreign investment.
- **Build more tankers, pipelines, and refineries.** The Departments of State and Energy should provide economic aid incentives and technical assistance to oil-producing and refining countries to simplify regulations and speed up the licensing process for the expansion of existing and building of new pipelines and refineries, especially in Mexico, Central America, and the Caribbean. Major shipbuilding companies should be encouraged to expand their tanker fleets. The U.S. Trade Representative should use the WTO, North American Free Trade Agreement, and Central American Free Trade Organization to reduce barriers to oil-sector investment and development.
- **Remove tariffs on imported ethanol.** Since the 1973 Arab oil embargo, Brazil has reduced its dependence on foreign oil by more than half by developing "fuel-flexible" vehicles that run on any combination of gasoline and ethanol. Currently, 4 million such cars are on U.S. roads. Adding such a feature costs as little as $150 per car. The U.S. should follow Brazil's example by turning ethanol into a fuel of choice. However, making fuel-flexible cars viable will require lifting the U.S. tariff on imported ethanol (currently 54 cents per gallon) because the U.S. ethanol industry relies on corn and grain sorghum, which yields much less ethanol per pound than sugar cane.

Conclusion. There is no silver bullet that will increase the supply of oil and natural gas or wean the United States from its dependence. The future may bring significantly higher energy prices, but an unabated and sharp hike in oil prices could cause a global recession, as has happened twice in the past. To avoid a massive crisis, the U.S. government, in cooperation with the private sector, needs to expand the transportation fuel supply before it is too late.

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