Heritage Lectures
Published by The Heritage Foundation
No. 1079
Delivered March 11, 2008
May 6, 2008

Meeting Energy Challenges in the Western Hemisphere

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One cannot isolate the challenge of preserving energy security in the Western Hemisphere from the overall global challenges confronting the United States. Today, we face a rising growth in petroleum demand. This demand is driven by rapid economic growth in China, India, and elsewhere; the narrowing margin between global petroleum supply/capacity and demand; continued uncertainty and instability in the Middle East; and systemic assaults on the efficiency of state-run energy companies to fund everything from social welfare programs, government operating budgets, arms purchases, and aid to subsidize oil for foreign friends. We are witnessing increasing dominance by national energy companies as they expand their share of petroleum exploration and production at the expense of the traditional corporate energy titans such as ExxonMobil, Shell, and Chevron.

With oil hovering near $120 per barrel, we all begin to think we are experts on energy security. Today, and in the months and years ahead, meeting U.S. energy needs will be critical to the success of U.S. foreign policy.

Energy Security Begins at Home

Dr. Kim R. Holmes, Vice President of Foreign and Defense Policy Studies at The Heritage Foundation, writes in his book, *Liberty's Best Hope: American Leadership for the 21st Century*, "The next President of the United States must develop a strategy to thwart the capacity of coercive or unfriendly regimes to use energy resources as an economic weapon. Regimes that withhold or restrict energy supplies as an instrument of national policy threaten not only regional stability

Talking Points

- Meeting the nation's petroleum needs from affordable and secure sources is vital for national security.
- In Canada and Mexico, the United States is fortunate to have two reliable, democratic partners who currently supply 30 percent of our petroleum imports. Preserving this energy access will require strong trade relations through the North American Free Trade Agreement.
- Resource nationalists, such as President Hugo Chávez in Venezuela, want to use oil as an instrument of economic blackmail against the people of the United States. Mapping out ways to prevent petroleum shock will weaken the capacity of nationalists to harm the U.S.
- Brazil, South America's true democratic and economic powerhouse, is an innovative leader on the global energy scene. Its biofuels programs and its success in deep-water drilling to expand reserves make Brazil an important energy partner of the future.

This paper, in its entirety, can be found at:
www.heritage.org/Research/LatinAmerica/hl1079.cfm

Produced by the Douglas and Sarah Allison Center for Foreign Policy Studies of the Kathryn and Shelby Cullom Davis Institute for International Studies

Published by The Heritage Foundation
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Washington, DC 20002–4999
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and prosperity, but also the economy and national interests of the United States."[1] Dr. Holmes and Dr. Stuart Butler have already established a solid set of guidelines in their 2007 paper, "Twelve Principles to Guide U.S. Energy Policy."[2]

The U.S. faces a critical need to encourage domestic petroleum production. It seems as if the U.S. has unilaterally disarmed itself in the competition for energy supplies by imposing a host of unnecessary restrictions on domestic energy production and upon offshore exploration of the Continental Shelf. Indeed, in the past three decades we've thwarted construction of refineries and nuclear power plants that could have helped to ease the competition for energy supply and secured greater energy independence.

Further taxes on the major domestic oil producers confer an additional comparative advantage on the Organization of Petroleum Exporting Countries (OPEC) and other non-U.S. suppliers whose imports are not subject to most of these provisions. It also lowers incentives for new investments and adds more costs to finished products at the pump. There is growing doubt that the recent rush to develop corn-based ethanol and other alternative and renewable energy sources will bring genuine relief or true energy security. New subsidies and mandates threaten to turn us into victims of the law of unintended consequences.

By creating a bonanza for corn growers and agro-industry giants, we have succeeded in driving up food prices both in the U.S. and abroad, something that will be noted by consumers abroad—particularly by the poor of the lesser developed world, who may face deprivation and possibly starvation. We have also closed off our markets to biofuel producers abroad.

Our NAFTA Partners

The U.S. is very fortunate to have two solid, reliable energy suppliers as NAFTA (North American Free Trade Agreement) partners. Neither Mexico nor Canada belongs to OPEC. Our North American populations are closely interconnected by trade, investment, and migration patterns. We share key democratic values and look to competitive, free markets to resolve many of the material challenges before us. We have periodic and productive fora for regular consultation and strong intra-governmental links. Canada and Mexico are respectively our first and third most important trading partners and our first and second suppliers of petroleum.

In North America, we remain energy interdependent. As long as we stick with our NAFTA commitments and as long as we recognize that a prosperous Canada and a more prosperous Mexico are in our national interest, we can have strong confidence in our capacity to work with our neighbors, north and, hopefully, south.

Canada. The immense deposits of oil sands in Alberta contain recoverable reserves equal to those of Saudi Arabia but will impose higher extraction and production costs. Access and use of these reserves will remain key to supplying the U.S. with oil from a stable, friendly source, influenced mainly by the movement of markets, not political whim. Canada experts, such as Chris Sands at the Hudson Institute, point out the need to be attentive to more technical issues such as upkeep and improvements in transnational infrastructure, especially for electrical transmission lines and pipelines to avoid bottlenecks and disruptions in supplies.

Mexico. The petroleum situation in Mexico is less rosy. Mexico is the world's fifth-largest oil producer and in 2007 the second-largest supplier to the U.S. Yet in many respects Mexico is paying the price for its past bout with resource nationalism. The Mexican oil industry was nationalized under former President Lázaro Cárdenas in 1938, which led to the creation of Petróleos Mexicanos (PEMEX). March 18, 2008, marks the 70th anniversary of oil nationalization in Mexico and will be celebrated widely in Mexico. Yet overall, Mexicans may have little real reason to be jubilant at this time.

Since 1938, a heavy reliance on PEMEX has powered Mexico's development, but the petroleum

1. Kim R. Holmes, *Liberty's Best Hope: American Leadership for the 21st Century* (Washington, D.C.: The Heritage Foundation, 2008), p. 67.
2. Stuart M. Butler and Kim R. Holmes, "Twelve Principles to Guide U.S. Energy Policy," Heritage Foundation *Backgrounder* No. 2046, June 26, 2007, at *www.heritage.org/Research/EnergyandEnvironment/bg2046.cfm*.

monopoly has also served as a huge fount of corruption to sustain workers' unions, inefficient bureaucrats, and state and national politicians. Today, earnings from PEMEX cover 42 percent of Mexico's national budget. State ownership of subsoil wealth and hydrocarbons remains firmly embedded in the Mexican psyche and political ethos. A majority of Mexicans continue to oppose opening PEMEX to private and foreign investment.

PEMEX, say most oil experts, is in serious trouble. It is the world's most indebted oil company. Output from Mexico's flagship oil field, Canterell, which is located in the Gulf of Mexico, peaked in 2004. The Canterell field once produced 60 percent of Mexico's petroleum. The field now yields 42 percent of national output, dropping by 5.7 percent in 2007. Production difficulties continue as a result of under-investment. Four of every 10 gallons of gasoline consumed in Mexico are imported from abroad, as is much of Mexico's natural gas.

According to Mexico's Energy Secretary, PEMEX has around 100 billion barrels of various categories of reserves, a quantity sufficient to meet Mexico's energy needs for another 60 years. But PEMEX is increasingly being forced to exploit less-accessible land locations and drill deeper, more than 1,000 meters beneath the Gulf of Mexico, to replace the declining output of Canterell. PEMEX is short on investment capital to get the job done and ideally needs strategic partners to remain viable.

Mexico's leadership is awakening to its dilemma, but will it do so fast enough? President Felipe Calderón is sounding the alarm bell, and some within the Mexican political class appear open to modifications of the constitution to permit private Mexican, if not foreign, investments in PEMEX. Mexican telecommunications billionaire Carlos Slim is often identified as a potential investor. But there are also signs that populist leaders, such as defeated presidential candidate Andres Manuel López Obrador, will employ disruptive tactics to derail any legislative initiative.

The U.S. will observe with keen interest future developments in Mexico. While we cannot alter what Mexicans consider a sovereign decision—no more than Mexicans can alter our decisions on immigration reform—we can demonstrate a constructive approach to bilateral relations and promote a favorable climate for energy cooperation. The United States can also work in other ways with Mexico, notably through the passage of the proposed package of counter-narcotics assistance known as the Mérida Initiative, which would help President Calderón beat back the threats posed by deadly drug cartels.

Energy Policy in Brazil

The future direction of energy policy in South America will, to a very large degree, be determined by developments in Brazil. With its 190 million citizens and a $1.83 trillion economy, Brazil has become the globe's eighth-largest economy. In the past decade, it has developed strong macroeconomic stability and combined market growth with novel and effective programs aimed at tackling poverty and improving human capital. It is a center for regional trade, via MERCOSUR, and a major player on the international commodities and economic scene. It is also a potential leader for a more unified South America. But it can, as The Heritage Foundation's *2008 Index of Economic Freedom* indicates, do much more to improve its current rank of 101st out of 157 nations.[3]

In 1997, Brazil opened the way for energy competition. The national oil company, Petróleo Brasileiro, SA (Petrobras), engages in energy partnerships with foreign investors and is developing into a global energy powerhouse. Petrobras' current investment plan calls for spending $112.4 billion between 2008 and 2012, including approximately $5 billion for exploration, production, and refining in the United States. Off Brazil's coast, recent discoveries—the Tupi field and the Jupiter gas field—have substantially raised the hope that Brazil may actually equal or surpass the reserves of Venezuela and become a net exporter of oil. Petrobras could become one of the five biggest integrated energy companies in the world by 2020.

The 2007 memorandum of understanding between Brazil and the U.S. was an important

3. Kim R. Holmes, Edwin J. Feulner, and Mary Anastasia O'Grady, *2008 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2008), pp. 115–116.

symbolic step forward for sugarcane-based ethanol and draws together the two nations responsible for 70 percent of global ethanol production. As noted previously, there is good reason to be concerned about the negative consequences of subsidized corn-based ethanol production in the U.S.

While Brazil's ethanol producers are apparently working at full capacity, eventually removing the 54-cent per gallon tariff on Brazilian ethanol would help promote free trade in biofuels and could have a catalytic effect on U.S.–Brazil relations. I will note that this proposition was most recently endorsed by Federal Reserve Chairman Ben Bernanke. This positive move could also encourage Brazilians and others to invest in more research in promising second-generation biofuels such as cellulosic ethanol. Also, working with Brazil to revitalize the Doha Round of global free trade talks will strengthen our hand and forge a stronger U.S.–Brazil partnership.

Populism and Resource Nationalism in the Andes

There is nothing new about resource nationalism in Latin America. As noted before, Mexico nationalized its oil industry in 1938. Nations as diverse as Chile, Peru, and Bolivia previously nationalized key exports commodities such as copper, tin, etc. The rise in the last decade of what scholar Alvaro Vargas Llosa has termed the "carnivorous left" has brought a political movement that blends old-style *caudillo* leadership; polarizing politics; statist, socialist economic policies; intensified resource nationalism; and anti-Americanism. The "carnivorous left" controls an important swath of Central and South America.

The chief proponent of this "carnivorous," populist approach, President Hugo Chávez of Venezuela, commands the largest proven reserves of petroleum in the Western Hemisphere and potential reserves that may equal those of Saudi Arabia. In 2008, Chávez still relishes the role of being the pit bull of 21st century populism—a Juan Domingo Perón with petroleum or, in the descriptive language of *Miami Herald* correspondent Andres Oppenheimer, a "narcissistic-Leninist" leader.

Chávez achieved political power via the ballot box, but during his nearly 10 years in office he has substantially replaced representative democracy with an authoritarian model of government that removes customary checks and balances on power, produces top-down leadership, and undercuts basic political and press freedoms. He has become an unreliable partner on three accounts.

In accordance with his Bolivarian, anti-American agenda, Chávez favors reducing/breaking the linkage of interdependence and integration with the U.S. for political rather than economic reasons. He looks to China and other markets to reduce Venezuela's dependence on the U.S. oil market and on U.S.-based refineries and distribution systems, notably CITGO. Chávez has forged what he terms an "axis of unity" with Iran's President Mahmoud Ahmadinejad and signed over 200 bilateral agreements. Whether these are viable undertakings or the Potemkin villages of bilateral diplomacy remains to be seen. Iranian–Venezuelan connections open fresh worries about potential challenges to U.S. national security by terrorism and subversion. As OPEC members, Venezuela and Iran are price hawks seeking to lower production and raise prices. Chávez has lobbied in OPEC's inner councils to convert the organization into a Robin Hood instrument for accelerating the global redistribution of wealth.

Chávez uses his oil revenues as a massive ATM for domestic spending and to prop up the Castroite Communist regime in Cuba ($2 billion to $4 billion annually), to purchase influence with smaller, energy-dependent Caribbean and Central American nations via PetroCaribe, and to spend billions on the purchase of Russian small arms, jets, helicopters, and submarines. He has dispatched bags of soft political cash as far as Argentina and is lending support to advance the electoral prospects of the leftist Farabundo Martí Liberation Front in El Salvador in 2009. Chávez's recent uptick in support for the Revolutionary Armed Forces of Colombia (FARC) and his momentary flirtation with war threats against Colombia lead to serious questions about his long-term ambitions regarding the future stability and democratic governance of Colombia. The enormous costs of these undertakings draw away from productive investments in energy and other sectors of productive growth.

Chávez's milking of the national petroleum company, Petróleos de Venezuela (PdVSA) does not come without costs. A massive 2002 strike led to the firing of 20,000 employees. Since 1999 there have been five different heads of PdVSA, and bureaucratic instability and mismanagement reign. Production has not recovered to 2002 levels, although record oil prices make it easier for Chávez to conceal mismanagement and investment and exploration shortfalls. In 2007, Chávez, as part of his re-nationalization campaign, tightened control over joint oil ventures in the Orinoco Belt, where he in essence confiscated approximately $6 billion in foreign assets. This action and the failure to reach a settlement led to Exxon's recent international suit and judgment against PdVSA that rankled Chávez and caused him to threaten to cut off oil supply to the U.S. Under Chavez's management, PdVSA has declined as a reliable international supplier.

While Chávez pursues his aggressive agenda and erodes the efficiency and long-term viability of his energy sector, Washington understands that a sudden reduction in the price of oil would ripple through PdVSA and Venezuela, severely undercutting Chávez and his ability to govern. Mounting inflation, widespread food shortages, and violent crime have lessened Chávez's approval ratings, and his domestic grip appears to have slipped. The failure to achieve popular approval of a package of constitutional reforms in December 2007 has raised hope in opposition circles that the Venezuelan people may be able to select new leadership in 2012.

Whatever steps the U.S. takes regarding Venezuela and our energy relationship, we need to keep in mind the enduring need for the friendship of the Venezuelan people in a possible, post-Chávez world. The prudent course is to attempt to diversify our sources of supply to more reliable, market-oriented producers. The U.S. should not automatically assume that Chávez's 21st century socialism will last as long as the Castro regime in Cuba.

The Chávez movement has emboldened two other Andean "carnivores"—President Evo Morales in Bolivia and President Rafael Correa in Ecuador—to embrace similar policies of resource nationalism. The nationalization of gas fields in Bolivia in May 2006 has set in motion strong regional tensions and divisions within Bolivia. Correa has tackled Occidental Petroleum, withdrawn from free trade negotiations, and reduced anti-drug cooperation.

Energy Security, Democracy, and Competitive Markets

There is no silver bullet, no quick solution to creating greater energy security in the Western Hemisphere. The Western Hemisphere, with one glaring exception, is made up of 35 sovereign states committed to democratic governance. Nations committed to democracy, free markets, and more open trading account for more than 85 percent of the gross domestic product of Central and South America. Some "carnivores" may face extinction quicker than we imagine.

The best guarantee for future energy security remains a stable, democratic Hemisphere with relationships based on genuine respect for democracy, constitutional government with real checks and balances, and the rule of law. We must continue to provide incentives that encourage governments to adopt free market principles and to embrace domestic reform. Our ties can be strengthened by prompt passage of pending free trade agreements with Colombia and Panama.

The U.S. should continue moving forward, not backward, on trade. Protectionism is a prescription for international failure that will reduce the chances for stimulating economic growth and development in the Western Hemisphere. Freer trade may not resolve all problems in the Hemisphere, but it remains the most powerful instrument for change readily available to American policymakers. Finally, we must work to refurbish America's image abroad and restore American leadership.

In general, the U.S. people and their representatives cannot afford to neglect the Western Hemisphere. Whether it is energy security, meeting new transnational security threats, responding to the challenges of poverty and inequality, or strengthening democratic institutions, the United States has a constructive and productive role to play.

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