

Low and Behold

Making the Most of Cheap Oil

Edward L. Morse

AFTER DROPPING from close to \$150 in the summer of 2008 to under \$34 last winter, the price of oil had more than doubled by the spring and was hovering around \$60 in July. It is unlikely to rise to last summer's peak anytime soon. To the contrary, there are good reasons to believe that lower prices are here to stay for a while. Last year's high prices and the recession have severely damped demand, and the growth of new production capacity, especially in Saudi Arabia, is buoying supplies.

The rapid fall and then rebound in oil prices over the past year surprised many people. But it was not unusual: commodities markets are cyclical by nature and have a history punctuated by sudden turning points. Although this generally makes it difficult to forecast prices, it is safe to say that commodities markets will remain lower over the next few years than they have been over the past five. In the oil industry, the most important new factor that accounts for low prices is the return of surplus production capacity among the members of the Organization of the Petroleum Exporting Countries (OPEC) for the first time since 2002-3.

Most oil industry analysts expect high prices to return soon, along with economic recovery. This is probably a mistaken view; more likely, the prices for oil and other commodities will be range-bound again. This would be a happy development, as it would provide unusual

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opportunities to tame the volatility in prices. An extended period of low prices could reverse the trend toward resource nationalism, the tendency of producing countries to concentrate control over their resources in the hands of state-run entities, that has characterized energy politics for most of the last decade. It would also translate into new chances for constructive diplomacy with oil producers and set the stage for more balanced relationships between energy producers and their buyers.

The United States has a major stake in providing constructive leadership for change in the oil market. Until now, however, President Barack Obama and his administration have not appeared interested in seizing these opportunities. They seem to be sticking to the energy agenda they developed during the 2008 presidential campaign, which focused on making the United States energy independent by rapidly reducing the country's reliance on fossil fuels and promoting renewable resources. But they are ignoring the fact that these changes cannot take hold in less than a decade and that in the meantime they might miss a unique chance to forge changes in the oil sector.

FROM GLUT TO LACK AND BACK

EXTRA PRODUCTION capacity traditionally has a damping effect on prices, and so from about 1981 to 2001, the governing assumption was that if oil prices rose, OPEC countries would release more supplies into the market. When prices fell, producers would curtail output and set production quotas, and when they rose again, OPEC countries would leak additional oil into the market. And the cycle would repeat itself. Energy Intelligence, a leading market analyst, estimates that the world's surplus oil-production capacity peaked at around 12 million barrels per day in 1985, was eliminated soon after Iraq invaded Kuwait in 1990 and the United Nations embargoed oil from Iraq, and climbed back up to over five million barrels a day in mid-2002. Until about 2002, the conventional wisdom held that the world was mired in a permanent oil glut and that with so much oil around investments to find and develop more of it were too risky.

Then, in 2002-3, the overhang in production capacity evaporated rapidly and unexpectedly. Some analysts invoked the so-called peak oil theory and blamed the situation on an unprecedented acceleration

in the decline of oil production caused by the gradual exhaustion of underground resources. But there were more reasonable explanations for what put pressure on oil supplies. Even those countries with plenty of oil resources suffered political impediments to production that could not easily be removed. Venezuela's state oil company went on strike in protest against President' Hugo Chavez, civil disorder over living conditions in the Niger Delta crippled Nigeria's oil sector, Iran failed to put in place an investment regime to attract foreign capital, the United States launched a war to oust Saddam Hussein, and resource nationalism in Russia and other non-OPEC countries reduced production growth.

As the market tightened, prices escalated relentlessly. Consumers and producers worried that supplies might be disrupted. They worried particularly about Iran, whose supplies might drop if Israel or the United States attacked its nuclear sites or if Tehran decided to reduce its exports; with reduced spare capacity in the system, there would be no extra oil to replace any from Iran that might be lost. In western Europe, the fear was that Moscow would suspend natural gas supplies for political reasons. As always, the fear of consumers played into the greed of producers, creating a complex dance between the two groups. Western governments promoted an energy dialogue with individual producers. But these producers, on their own, were largely powerless in the face of rising prices. They, in turn, blamed the countries of the Organization for Economic Cooperation and Development (OECD) for not curbing financial speculation in the oil market and failing to invest enough in refining capacity.

In short order, the virtual disappearance of surplus oil-production capacity jolted the market. The loss of that cushion, which had seemed a fixture for decades, surprised both consumers and producers, not least Saudi Arabia, whose commitment to readily supply the world market is the basis of its political clout both within OPEC and globally. The tightness in supplies exposed the complacency or, rather, the failure of Saudi Arabia and other producers to adequately invest in exploration and the production of crude. Western oil companies, such as BP and ExxonMobil, were also being timid: their executives knew they would be penalized by Wall Street analysts if they invested too much capital in new production at the expense of distributing dividends.

By 2003-4, Saudi Arabia was concerned. It responded by raising production: from 7.5 million barrels per day in 2002 to 9.2 million

to make up for shortfalls elsewhere, there was only a little surplus capacity for the world.

Further disproving the peak oil theory, since 2003 Saudi Arabia has also successfully engaged in a massive campaign to increase its production capacity (not just its actual production). This means it has committed to being able to raise its output quickly and massively in the event supplies from the second- and third-largest producers

in OPEC are disrupted. Saudi capacity was 9.5 million barrels per day in 2002. Huge production expansions, including a new field that opened in June and can yield one million barrels a day, have raised capacity to 12.5 million barrels per day. Another one million barrels per day of potential capacity is on standby, meaning that it could be developed within 12 to 18 months. And because of Saudi

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Arabia's efforts to increase its production capacity, OPEC'S total production capacity could exceed 37 million barrels per day in 2010.This would be a record level: five million barrels per day more than in 2002 (before the strike in Venezuela) and more than ten million barrels per day above today's level.

The disappearance of spare Saudi production capacity was the most critical element in driving up prices from 2003 to 2008—and its reemergence should be the most critical element in keeping them low over the next three years (or more, if global demand fails to rebound enough). Saudi Arabia wants spare production capacity for multiple reasons, including, importantly, to give it influence in the G-20 (the group of finance ministers and central-bank governors from the leading economies) and other international forums. Riyadh's ability to increase production is the key to its being taken seriously.

Saudi Arabia will also likely use its surplus capacity to keep prices moderate in order to spur global economic growth, maintain long-term demand for oil, and deter investments in alternative sources of energy. In addition, by increasing Riyadh's ability to keep prices low, surplus capacity will help it reduce the revenues of oil producers—such as Iran, Russia, and, to a lesser extent, Venezuela—that use them in ways that undermine regional stability. And it will help Saudi Arabia

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ensure discipline within OPEC by enabling it to, at any time, threaten to increase production and thereby lower prices.

Surplus capacity benefits others, too. It brings lower prices to consumers. It reduces speculation that takes advantage of price spikes in paper markets. To the degree that Saudi Arabia chooses to set a price band within which it hopes to maintain prices—at the moment it would seem that band is between \$40 and \$75—speculators will be reluctant to test those limits. Saudi Arabia has used its capacity to add or reduce production quickly in order to punish speculators in the past.

WHERE THERE'S A DRILL, THERE'S A WAY

EVEN so, many market observers who concede that Saudi Arabia and other OPEC countries have raised capacity claim that oil prices will inevitably rise because of stagnating production in non-oPEC countries and because lower prices reduce investments in new capacity. They argue that the lower prices of late 2008 and 2009 have prompted non-oPEC producers to curtail their capital expenditures, which will accelerate the decline in output. But this view is wrong. For one thing, these analysts ignore the fact that the lead-times in finding and developing oil are long, sometimes as long as ten years. Investments from the past half-decade will start to bear fruit over the next few years, which means that even the price downturn of late 2008 will have little impact on supplies in the years ahead.

The Saudi national giant Saudi Aramco massively increased its investments to develop new resources after 2003. So did oil firms large and small throughout the world. But unlike their Saudi and other Middle Eastern state-controlled counterparts, international oil companies did not have an inventory of discovered but undeveloped fields readily available. They had to go out and find new ones. Some energy analysts have suggested that these firms' efforts were hindered by diminishing prospects, hikes in production taxes, or moves by the governments of producing states to reserve increasing shares of potential finds for their state-owned firms. In fact, there were plenty of deep-water resources waiting to be tapped—in the Gulf of Mexico; off the coast of Brazil; in the eastern Mediterranean; in the Gulf of Guinea; in the Caspian Sea; off the shores of India, China, Indonesia,

and Australia; and along the shores of Arctic-bordering states (the United States, Canada, the United Kingdom, Denmark, Norway, and Russia)—and oil companies spent increasing sums to do so.

If there was an obstacle, it was not a lack of hydrocarbon reserves—deep-water resources appear to be even more abundant than was thought a decade ago—but a lack of equipment to discover and produce them. Fewer than two dozen drilling vessels (each costing \$1 billion) were available in 2000. But as contracts were put in place at the time of very high oil prices, the fleet of vessels started to expand. By 2012, there should be closer to 150 such units available for finding and developing deep-water resources.

The high prices of the last decade have also spawned massive technological breakthroughs, including in some surprising places. The United States used to be considered a country that would eventually suffer a long-term natural gas deficit and be condemned to import

supplies, some piped from Canada, others shipped as liquefied natural gas (LNG) from around the world. But high gas prices—as high as \$13 per million BTUS in 2008, some 160 percent more than prices today—have spurred phenomenal developments in technologies to drill for natural gas trapped in shale rock throughout the United States. The Haynesville Shale, in Louisiana, is so large

and prolific that even as the use of gas rigs has fallen in other parts of the United States, current activity there makes up for a quarter of the decline elsewhere. Even at today's lower natural gas prices, total production in Haynesville could increase tenfold by late 2010. What is more, the Marcellus Shale, which stretches from West Virginia through Pennsylvania and into New York, may contain as much natural gas as the North Field in Qatar, the largest field ever discovered. Shale resources in North America are so vast that plans are being made to develop them for export as LNG from Canada's west coast.

Shale resources are also widespread throughout Europe, and in the aftermath of Moscow's hardball diplomacy vis-a-vis Ukraine in early 2008 and early 2009, interest is growing among European governments to find replacements for Russian supplies. Tapping into shale

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resources has raised some environmental concerns—over excessive water consumption and the injection of fluids underground to facilitate production—including in the U.S. Congress and at the U.S. Environmental Protection Agency. But so far, there is little evidence that these new technologies are damaging underground water supplies. High prices have triggered similar technological revolutions all along the energy production chain, lowering the costs of extracting oil from Canadian oil sands, the Siberian tundra, and off the coast of Brazil. The fact is that the market for the goods and services needed to find and develop resources, like all markets, responds to price signals.

After the volume of drilling rigs, supply boats, and tubular steel rose for five years because of higher demand for oil and higher oil prices, the costs of finding and developing resources plateaued in 2008. They have since fallen by more than 30 percent and are still falling. There was concern last winter that lower prices would result in lower capital expenditures to develop new resources and then in rapidly falling production. But as the markets for construction materials and services have weakened with the recession, the costs of production have fallen faster than capital expenditures. In such an environment, it is rational for companies to postpone projects until costs are as low as possible. Yet projects that have historically been costly, such as the development of Canadian oil sands or deep-water developments, have not been canceled. Deep-water exploration in the Gulf of Mexico and off the shores of Brazil is increasing 50 percent faster than was expected a year ago. Executives at the U.S. energy company ExxonMobil and the Canadian firm Suncor Energy say that the costs of developing oil sands have dropped so much that their companies are going ahead with large projects they had postponed until now—projects that, combined, should provide 300,000 barrels per day of new output by 2012. Last year, these projects would not have been viable with the price of oil at less than \$90 a barrel. Today, they make sense with oil at \$60 a barrel.

As a result, last year's gloomy forecasts of waning production are being proved wrong. Last December, the International Energy Agency and the U.S. Department of Energy were forecasting drops in the oil and gas output of non-oPEC countries, particularly Russia, for this year and next. But by mid-August, non-oPEC output was surprisingly

robust. At midyear, the International Energy Agency was projecting growth in the output of non-oPEC countries, and the Department of Energy was also projecting an increase. Russia's output could rise by 200,000 barrels a day this year rather than falling by 600,000-700,000 barrels a day, as many had forecast at the end of last year. And barring disruptions from hurricanes, output in the United States seems likely to rise this year and in 2010.

THE SOFT BIGOTRY OF HIGH EXPECTATIONS

THERE ARE also surprising developments on the demand side, and the conventional wisdom has not yet caught up. Most analysts expect that once the world economy starts recovering, global oil demand will rebound to its former growth rate of 1.5-1.8 percent per year—a rate that would require the production of at least 1.8-2.0 million barrels of new oil a day. This forecast is based on the anticipated increase in demand for motor transportation and motor fuels, itself the expected result of population growth and higher per capita income.

But a return to prior growth rates is unlikely. For one thing, the market is responding to last year's high prices. Tracking the trend, the International Energy Agency has lowered its estimates for oil demand in 2030: it forecast 106 million barrels a day in its 2008 report, down from 116 million barrels a day in its 2007 report. Projections of future demand will inevitably be cut even further: one extraordinary lesson of the last 60 years is that after every spike in oil prices, demand growth flattens considerably.

For two decades before the 1973-74 oil shock, global demand grew at a rate of 7.6 percent a year, requiring global oil supplies to double each decade. But in the late 1970s, in response to higher prices associated with the Iranian Revolution and the resulting global recession, fuel-substitution measures, and conservation, demand declined from 65 million barrels a day to 60 million barrels. When global demand growth resumed in the mid-1980s, it reached only 4.3 percent a year. Countries with historically high demand growth, especially, have experienced unexpected and sharp drops in demand. For example, Japan's oil appetite was growing at a sustained rate often percent a year before 1973, when global oil prices spiked, and South Korea's demand growth was at

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double-digit levels before 1998, when the effects of the 1997-98 Asian financial crisis began to be felt. Japan has never again exceeded its pre-1973 oil needs, nor South Korea its demand of pre-1998.

Likewise, the great energy consumers of today are likely to have been chastened by the high prices of last year. In recent years, global demand growth has been driven mainly by demand in the United States, the Middle East, and China. In recent decades, the greatest engine of global oil demand has been the United States—it increased imports by a total of about six million barrels a day between 1990 and 2007, an average of 350,000 barrels a day per year—as a result of growing gasoline demand and declining domestic crude oil production. But now, due to the higher oil prices in 2008, oil demand in the United States has reached a plateau, even as the output of U.S. crude has been rising. And with new mandates for increased biofuel production and higher fuel-efficiency standards for cars, U.S. gasoline consumption is unlikely to return to its peak of 2007 anytime between now and 2020. The United States is no longer a driver of growth in the global demand for oil.

In the Middle East, too, the causes of recent growth in demand are receding. Over the past three years, total demand for oil in the Middle East rose by about 350,000 barrels a day every year. This was due not only to population increases and higher per capita income levels but also to a one-off surge in demand for power during a period of extraordinary economic growth. Double-digit growth in the demand for power, which was needed to support industrial expansion and urbanization, outpaced the development of the infrastructure necessary to convert natural gas into power. The result was a surge in the demand for fuel oil and crude oil, which can be burned to generate power. But that time is over. The natural gas infrastructure, as well as natural gas supplies, has expanded, while growth in the demand for power has dropped by more than half, falling to more sustainable levels. Oil demand growth in the Middle East is now 35-40 percent below the rates of 2003-8.

In the three main oil-consuming regions—the United States, the Middle East, and China—demand growth will be lower than has been assumed.

A different story is unfolding in China and other emerging markets with growing energy appetites, but the moral is the same: demand growth will be lower than has commonly been assumed. Like India and other oil-importing countries, China is learning that subsidizing energy drains government budgets and hampers economic adjustment. When emerging markets are left to operate more freely, prices are indeed high, but they bring substantial macroeconomic reform. The Chinese leadership now believes that this is doubly good because it reduces the high costs of subsidies and allows markets to adjust more rapidly. The surge in China's exports from 2004 to 2007 was in sectors that both used a lot of energy and received subsidies for their energy costs—the steel, aluminum, and cement industries. But price reform and increased energy efficiency in China and, of course, the recession and subsequent protectionism in international markets have ended the trend. The result has been a drop in oil demand growth from eight percent to six percent—or a drop of about 150,000 barrels of oil a day.

About 150,000 barrels will also be saved annually in the United States and the Middle East each, for a total of 450,000 barrels annually. Thus adjusted, the world's total rate of demand growth can be readily satisfied by current production, as it is increasing, without the need to put pressure on prices and without fear that they will exceed \$75-\$80 per barrel. Moreover, given the changing situations in the United States, the Middle East, and China, when global demand growth eventually rebounds, it is likely to be substantially lower than it was before the current economic crisis. Instead of reaching rates of 1.5-1.8 percent per year, as in the previous decade, demand growth is more likely to fall in the range of 1.0-1.3 percent—a difference of 500,000 barrels of oil a day.

THE GEOPOLITICS OF OIL

THE PROSPECT of more reasonable growth in energy demand creates opportunities for the Obama administration, as well as the governments of other OECD countries: it is a chance to make energy markets less volatile and strike arrangements with producing countries that will better serve the United States' long-term interests. But to do so, Washington will have to put as much vigor into developing an international energy strategy as it has devoted to its domestic environmental and energy programs.

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One of the Obama administration's major objectives should be to expand to the oil and gas markets the rules of global trade and investment that govern the United States' relationships with OECD countries when it comes to manufactured goods—and likewise expand them to China, Mexico, Russia, and the restrictive markets in OPEC. This would be an antidote to resource nationalism and the use of oil as a tool of leverage in foreign policy, two practices that became more prevalent among large energy exporters as prices rose in 2007 and 2008.

The underlying geopolitics of the oil market is, of course, defined by the world's dependence on oil as an energy source, particularly in the transportation sector, and by the concentration of oil resources in a handful of countries. These basic features divide the world roughly into three groups of states. The first category is made up of states—in particular, the United States, Canada, the western European countries, and the OECD countries of Asia—that have essentially relinquished the use of oil as an instrument of policy in their relationships with one another. They have given up trying to impede one another's access to energy or prevent one another from realizing profits from the sale of energy. And the energy exporters in the group have stopped currying favor with their importer counterparts by granting them arms shipments or construction projects, voting in their favor in international organizations, or engaging in other activities that have little to do with oil. That said, these states entertain more nuanced relations with the rest of the world—other OPEC countries, Russia, emerging-market countries. They have unabashedly used oil as an instrument of policy in some instances—an example is the United States' and Europe's dealings with Iran and, until recently, Libya.

In a second group of countries, for which oil and gas revenues are critical sources of income, energy diplomacy remains a core instrument. In relatively benign environments or when prices are low, resource-rich countries are at least as dependent on energy markets as their markets are on them. This means that they cannot simply take advantage of their customers or make gains at their expense. Rather, sellers and buyers must think in terms of relative gains and losses: they might both gain or both lose, but one will gain or lose more than the other. In tight markets, however, some producers nakedly resort to using energy as a tool of leverage. This can take on the brutal face of Russia's gas

diplomacy—of withholding supplies to blackmail buyers for money or political ends. Or it can take on the more subtle face of Iran's or Venezuela's tactics. Tehran uses its oil revenues to promote its interests in Iraq, Lebanon, Palestine, and Saudi Arabia, sometimes by backing insurgents against these countries' governments, and Caracas uses its own to undertake anti-American activities throughout Latin America.

In the third group of countries, which includes much of the emerging world, including, most important, Brazil, China, and India, the picture seems more mixed. China and India are major oil importers, and although state-controlled companies play a large role in the energy sector of those countries, their activities are also subject to market mechanisms. In their relations with other states, especially members of the OECD, the governments of Brazil, China, and India have tended to adopt market solutions, treating investments and trade flows as commercial, not political, matters. This has generally limited their ability to use energy as leverage. But when dealing with non-OECD countries, they, and the Chinese government in particular, have backstopped the activities of their state companies, donated or sold arms to producers at reduced prices, and offered construction projects as side payments for access to resources. When energy prices are low, such extra costs can seem excessive—and so the United States should focus its diplomacy on pointing out to these states the benefits that could accrue to them if they treated oil investments and trade as purely commercial ventures. These emerging-market countries already know that subsidizing the use of energy is costly. But for them, especially China, it is important that the West become more open to investments by their national companies in the OECD.

Now that China has unusually large amounts of foreign currency, it can afford both to buy companies abroad to secure access to commodities in the long term and to offer long-term credit to secure long-term imports at advantageous prices. It is thus important to forge policies that urge China to rely on international energy markets. In order to discourage China from seeking resources only in other emerging-market countries, Chinese companies should be invited to invest in Western companies that produce oil, gas, and other commodities—at least so long as Beijing reciprocates by allowing Western companies in China to be on an equal footing with its national companies and

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by following the antibribery convention and the codes of conduct that govern OECD countries. With respect to Brazil, a democracy and a major long-term exporter of energy, Washington and its Western allies should encourage policies that keep the main national company, Petrobras, honest and competitive by forcing it to face competition at home. Allowing open investment flows and treating foreign investors on a par with national companies can go a long way toward taming self-defeating resource nationalism.

MOSCOW TAMED?

THE CHALLENGES are greater when it comes to resource producers. The abrupt decline in oil prices has had an immediate and corrosive impact on them, especially those states that rely heavily on oil revenues to finance both their domestic programs and their foreign policies. In Russia, revenues from taxes on energy sales, domestic or foreign, are critical to the legitimacy of the state and to its hopes of pursuing assertive policies abroad. Especially during the years of Vladimir Putin's presidency, when oil prices rose steadily, the former superpower grew critically dependent on its oil and gas sales as a form of influence. Russia has built its foreign policy on controlling the resources of former Soviet states and their access to pipelines that would connect them to third-party markets around the Mediterranean, in northern Europe, and in East Asia. But having pegged its hopes—and its budget—on oil priced at \$140 a barrel, Moscow has found its plans challenged when oil is \$90 and almost impossible to meet when it is \$40. With oil at anything less than \$75, Moscow finds itself needing to confront fundamental choices between capital expenditures at home and other spending.

And yet the Russian government has been slow to recognize that the effectiveness of its energy weapon has declined. Moscow's decision to play pipeline politics with Ukraine and so deny Europe access to natural gas has been undermined by two factors. The populations and governments of several European states have grown wary enough of Moscow that they are now seeking ways to limit their dependence on Russian gas supplies. Additionally, Russia's now-critical need for revenue from natural gas exports limits the credibility of its threats to deny supplies to buyers.

In response, Washington and other Western governments should focus on pursuing win-win solutions with Russia and reducing competition among those OECD countries that import energy from Russia. While prices were rising, Russian firms used their unfettered access to Western credit markets to borrow capital with few strings attached. This was particularly the case for the state-owned energy giant Gazprom, which has borrowed tens of billions of U.S. dollars in Western markets since 2004 without any requirements that it reinvest in new energy supplies—or any other conditions. Gazprom used the money to buy assets in the very countries where the credits were issued, and without any monitoring. Now, with the company's cash flow reduced to a fraction of what it was once expected to be and international credit having vanished, Gazprom is turning (as are other Russian firms) to the Russian state as a creditor of last resort—this at a time when the ruble has been depreciating and the state itself is struggling to maintain its revenue base, which has been drained by lower energy prices.

These conditions mean that now is a good time to change the credit policies of the United States and other OECD countries toward Moscow and foster changes in how Moscow runs its domestic oil and gas markets. Reciprocity and equal treatment should be stressed. In these times of financial reform, the governments of OECD countries should allow their banks to lend to Russian oil and gas companies only against collateral in resources and only with commitments from those companies to invest in more resources. Unlike Mexico or Saudi Arabia, Russia has allowed foreign investment in its hydrocarbon sector, but it has not treated foreign investors as the equals of local firms. Western governments should deny Russian firms unfettered access to Western markets until Russia treats Western companies as it does its own. Until that happens, one focus of any new policy should be to stress to Moscow what Russia would gain from extending national treatment to foreign firms. After all, treating ExxonMobil or Total as the Russian oil companies Rosneft and Lukoil are would not reduce the Russian government's regulatory control over the country's oil sector. And in return for leveling the playing field, Russia would be able to secure better international partnerships for its firms.

The drop in oil prices also creates opportunities for the United States to change its relations with Iran and Venezuela. The governments

of both those countries have faced greater strains and internal pressures and need more capital to develop their oil industries. As oil prices continue to stay below the level that can sustain these governments' oil-revenue-dependent budgets, Tehran and Caracas will be increasingly in debt and will need to turn to foreign firms for capital to boost their domestic production. And if the West holds out the prospect of greater capital, it might see a softening in the foreign policies of Iran and Venezuela.

A CHALLENGING OPPORTUNITY

THE MORE direct challenge for the United States will be to set the right policies for relations with Saudi Arabia. Saudi Arabia's objectives in the oil market naturally converge with those of the United States. Both countries want to keep prices moderate in order to spur global economic growth. Both prefer to see Iran with lower revenues than it has earned in recent years. Both hope to control the flow of petrodollars to terrorists. And both want to limit the volatility in prices created by wanton speculation. But Saudi Arabia has a very different view of the role of the state in managing energy and a dramatically different system of government.

The U.S.-Saudi energy dialogue, which Washington has neglected for years, needs to be reinvigorated. Now that Saudi Arabia has a huge spare production capacity and thus the tools to advance Washington's economic and political goals, it should be easier to establish between the two governments better and higher-level communications about the oil market and the global political economy. Such a dialogue cannot take place at the level of energy ministers. It requires the kind of political attention that can come only from the Department of State or the White House. Saudi Arabia appears to want to keep oil prices between \$40 and \$75 a barrel in order to promote global economic growth and limit the revenues of rival producers while nonetheless adequately funding its own budget. Washington's relations with Riyadh involve other difficult diplomatic issues, such as the creation of a Palestinian state and how to secure participatory governance in Iraq after the withdrawal of U.S. troops. With its spare production capacity, which is unlikely to disappear anytime soon, Riyadh has

earned itself special standing with Washington. Neither China nor any other country can do as much as Saudi Arabia can to bring change to the global energy sector. Thus, aggressively seeking to end oil imports to the United States from the Middle East—a policy articulated by Obama during and after his election campaign—is not the way to harvest the potential fruits of U.S.-Saudi relations.

Other critical areas will also require coordinated government action. The G-8 (the group of highly industrialized states) appears to be working on one of these areas: it is looking for ways to tame financial flows into energy markets and limit price volatility by promoting greater transparency and greater controls over swaps and derivatives. Financial reform in the United States is already heading in this direction. The United States should also use international institutions to promote transparency and better governance in energy-producing countries that have been weakened by lower oil prices—such as Nigeria and many sub-Saharan African states. Transparency in markets must also be encouraged in China, as a lack of basic data about the oil market there—are China's oil imports put into storage or consumed?—places undue pressure on world prices.

The opportunities presented by lower oil prices should not detract from the important goals of reducing global greenhouse gas emissions, enhancing the United States' energy security, and building a new generation of energy-efficient nonhydrocarbon fuel sources. But they should not be overlooked; it would be dangerous to ignore oil and "old energy." However laudable it might be to pursue clean energy, energy efficiency, and alternatives to oil and coal, oil will continue to be a critical factor in the world's economic stability and security. Defanging those that use oil as a weapon, prolonging moderate prices, and anticipating supply disruptions require an activist and global approach to energy, not a parochial and national one. It is time for Obama to publicly recognize that bringing energy independence to the United States is an impossible task and that pursuing more modest goals is a better way to ensure the country's energy security.