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CENTRAL AMERICA: GROWING ROLE IN U.S. ENERGY SECURITY

INTRODUCTION

The tenth anniversary of the Arab oil embargo finds the public as complacent as it was in September 1973. Yet today's sanguine public attitude overlooks a potentially greater threat to U.S. energy security than that of a decade ago. While policy makers focus on oil supplies from the Middle East, they ignore the fundamental shift in the source of U.S. oil imports. For the first quarter of 1983, only 29.5 percent of U.S. oil imports came from the Organization of Petroleum Exporting Countries (OPEC)--and a mere 8.9 percent of imports from the Arab members of OPEC--down from 70.3 percent in 1977.

While America's reduced dependence on OPEC imports may seem to indicate that the energy security problem is solved, quite the opposite is true. America's energy vulnerability merely has shifted to the Western Hemisphere.

As imports from OPEC have decreased, those from Latin America and the Caribbean Basin have risen. Excluding OPEC member Venezuela, the share of U.S. imports of crude oil and refined products from Latin America and the Caribbean increased from 16.6 to 37.8 percent between 1977 and 1983.¹ When Venezuela is included, the total jumps to 45.3 percent. Imports from Mexico, in particular, have assumed great importance, rising from 2 percent of the total in 1977 to 20 percent now. By April 1983, 6.6 percent of total U.S. oil demand was met by Mexican crude.

In short, the U.S. has merely shifted its dependence on the Middle East to reliance on Latin America. As yet, there have been

¹ Estimate based on "gross imports" figure and therefore includes some oil produced in the U.S. or Middle East, but refined in the Caribbean.

no overt moves against Latin American oil producers. But the threat is real. Mexico's gigantic Reforma oil field, the largest in the Western Hemisphere, lies off the coast of Yucatan Peninsula, a haven for rebel forces hostile to the government of Guatemala--itself a possible major producer. Moreover, operations by Nicaragua's Sandinistas could eventually endanger Panama, through which 44 percent of all Alaskan crude oil is shipped. Even without direct attacks on the oil producers, guerrilla activity could disrupt the flow of oil from the region.

The major danger involves the region's future potential. Central and South America hold among the most promising of the world's undeveloped oil resources. Since 1977, Latin America's proved oil reserves have increased an astounding 187 percent; some geologists believe its oil riches could rival the Middle East's. Mexico alone may contain up to 500 billion barrels of oil offshore, and Guatemala is believed to have as many as 20 billion barrels off its coast. Venezuela, Ecuador, Peru, Argentina, Colombia, and Brazil are all known or believed to have significant oil deposits.

An interruption of U.S. oil supplies from just Mexico would be more damaging than the cut-offs of 1973 or 1977. It is clear therefore that the United States has a vital interest in the continued stability of Latin America and the Caribbean Basin.

What should be done to preserve the region's stability? First, the U.S. should provide the economic and military assistance needed to support friendly governments in the region. Second, U.S. firms should be encouraged to assist Latin American nations develop their petroleum resources, perhaps by providing "political risk" insurance similar to that offered through the Overseas Private Investment Corporation (OPIC). Third, the U.S. should expand efforts to reduce imports by eliminating economic restraints on domestic oil production, decontrolling natural gas prices and expanding federal leasing programs.

By promoting stability in Latin America and the Caribbean Basin, while stimulating increased domestic oil production, the U.S. would reduce its energy vulnerability. It would be doing so in a manner which would enhance the economic and political stability of its Latin American neighbors.

BACKGROUND

Not until 1947 did the U.S. rely constantly on foreign crude oil to meet a significant portion of its requirements. In that year the figure was a scant 8 percent of total domestic needs; 99.6 percent of imports came from Latin America. As late as 1970, 72.7 percent came from the Western Hemisphere--although Canada had replaced Latin America as the principal Western Hemisphere supplier. Of the oil imports from the Eastern Hemisphere, less than half came from the Middle East.

Just three years before the Arab oil embargo, there was little sign of an energy security problem. Imports came from diverse sources, and the largest single foreign source of crude oil was America's stable and friendly neighbor. Yet things are not always what they seem. From virtually the moment the U.S. became a consistent oil importer, a series of events changed fundamentally the structure of the world oil market.

THE EARLY FEDERAL ROLE

Between 1947 and 1958, the share of U.S. oil needs met by imports rose from 8 percent to 18.6 percent. More important, an ever greater proportion of that oil came from unstable Middle East countries. President Dwight Eisenhower imposed import quotas on crude oil to brake this import rise and spur further domestic production.

Paradoxically, it was also during the Eisenhower years that the erosion of incentives for domestic producers began--the full impact of which would not be felt for nearly two decades. This took the form of a Supreme Court decision extending the Federal Power Commission's (FPC) authority to set prices, including the wellhead or field price, for natural gas. Since many independent oil companies--responsible for some 90 percent of exploratory wells--retained the rights to any natural gas they discovered, the decision profoundly affected the industry. This was aggravated after 1960 when the FPC adopted an "area wide rates" policy under which all gas wells in a given region were limited to one price, regardless of their costs. Thereafter, the number of new field wildcat wells began to decline.

The foreign royalty tax credit was also a factor in making the U.S. vulnerable. Imposed soon after the Second World War, the tax allowed firms to deduct foreign taxes from their federal income taxes to avoid double taxation. Instead of treating royalties as a cost of doing business, deductible from the firm's taxable income, this change allowed a dollar for dollar reduction in federal taxes payable. This was a tremendous incentive to explore overseas.

Most industry and government officials remained oblivious to the threat posed by these developments. Despite the growth of imports, most energy planners felt confident that even if an exporting nation attempted to use its oil as a form of blackmail, it would be countered easily. When the Iranian government attempted to nationalize foreign oil holdings in 1951-1953, for instance, the large international oil companies boycotted Iranian crude. This was successful at forestalling the Iranian move largely because the U.S. had some 2 million barrels per day of spare production capacity to offset the loss of Iranian crude.

The most important reason for the complacency, however, was that world oil production was outstripping world demand, creating

a buyer's market. In real terms, the price of a barrel of oil declined between 1950 and 1970, and in nominal terms it rose by just 67 cents.

This seemingly rosy picture masked the danger signals. While some sounded the alarm, few listened. One critical development noted by experts was the steady decline of investment in exploration. Disincentives at home, combined with incentives to move overseas, were having their effect, and U.S. proved reserves began to taper after 1969. Most disturbing was the rapidly increasing importance of the Persian Gulf, which by then had displaced the United States as the world's most productive oil province.

THE GROWING IMPORTANCE OF MIDDLE EASTERN RESERVES

Few industry analysts were prepared for the Saudi Arabian oil bonanza, discovered in 1948. The average well in the new field was capable of producing an astounding 5,000 barrels per day, without artificial stimulation. This meant that Saudi production costs were so low--about 10 cents per barrel--that even after transportation and shipping it was still cheaper than oil from any other reservoir then known.

Iran, Iraq, Kuwait, and the United Arab Emirates also saw major discoveries. By 1974, half of the top ten oil producing nations were located in the Persian Gulf, accounting for 44.5 percent of the Free World's oil production, and 35.8 percent of total world oil production. By 1977, the U.S. share of world oil production fell to 13.7 percent of the total--down from 61.4 percent in 1947.

By the late 1960s, then, the stage was set for U.S. dependency on oil imports to reach a critical level. Only a catalyst was needed: The government provided it.

THE SECOND PHASE OF FEDERAL INTERVENTION

Although earlier federal intervention discouraged domestic exploration, actions between 1969 and 1973 virtually guaranteed a rapid decline in domestic oil exploration and increasing imports. The first blow came in 1969 when Congress reduced the depletion allowance for oil production and imposed a minimum tax on so-called preference items. These moves cut oil exploration investment by one-third, just when firms were finding it necessary to search for oil in remote and very expensive areas such as Alaska and deep offshore waters.

Congress was not the only culprit. In 1971, responding to pressures to "do something" about inflation, President Richard Nixon slapped wage and price controls on a wide range of commodities, including crude oil and refined petroleum products. These controls were a heavy blow to oil exploration, because it

is a "cash-flow" business using sale revenues, rather than credit, as the major source of new capital. The controls reduced cash flow and hence internal investment funds. And by restricting the price a producer could get for his oil, the government also limited his borrowing power by reducing the value of his ground reserves. Nixon also liberalized the import quotas imposed on foreign crude oil, totally lifting them in 1973--just in time for the OPEC embargo.

These actions fostered a dependence on oil imports unimagined just a decade earlier. Between 1970 and 1977, imports rose from 23.3 percent of total U.S. oil consumption to 47.7 percent. From a security point of view, the share of imports from the Eastern Hemisphere grew from 27.3 percent of the total to 86.4 percent during that period--despite the well-known instability of the Middle East.

THE PROLIFERATION OF OIL PROVINCES

Yet another major shift in world oil power was underway. The first indication came in 1968 with the discovery of the giant Prudhoe Bay oilfield in Alaska, at that time the largest single oilfield ever discovered in North America. Two years later, Phillips Petroleum announced the discovery of a gigantic oilfield in the frozen waters off the coast of Norway. Initial estimates put its size at 40 billion barrels--later revised to at least 50 billion barrels. The North Sea discovery turned Great Britain into a major oil exporter.

The biggest surprise was in the waters off Mexico's Yucatan Peninsula, the so-called Cantarell field. Oil also was found onshore in the "Reforma" field. Although Mexico in the 1920s and 1930s had been a major oil exporter, by the end of the 1960s it was believed that Mexican oil resources were nearing exhaustion.

Mexican exports to the U.S. had fallen from around 38,000 barrels per day in 1951 to zero in 1966. Cantarell changed this dramatically. By 1977, Mexican oil exports to the U.S. were 177,000 barrels per day and rising. Today, they are close to one million barrels per day, constituting the largest single component of U.S. oil imports. While official estimates of Mexican reserves are 250 billion barrels of oil and gas equivalent, some geologists estimate the potential at nearer to 500 billion barrels of oil, and more than 1,400 trillion cubic feet of natural gas. Even if the official estimates prove more accurate, Mexican reserves still would be enormous.

Mexico is not the only major Latin American source of oil for the U.S. Of the top dozen nations exporting oil to the U.S., seven are in the Western Hemisphere: Canada and six Latin American and Caribbean states. Only five of the top dozen are OPEC members. Saudi Arabia, once the largest exporter of crude oil to the U.S., now ranks tenth, just ahead of Trinidad and Tobago and Puerto Rico.

The remarkable speed with which the locus of U.S. oil imports shifted took many energy planners by surprise. Few were prepared for the change, and many still fail to recognize its full implications. As a result, most energy planning continues to focus on an interruption of oil supplies from the Middle East. Granted, such an eventuality would have severe consequences in Europe and the Far East, but the loss of oil from the Middle East would not be very important to the U.S., while an interruption of supplies from Mexico alone could have far more serious consequences than either the 1973 Arab oil embargo or the 1979 Iranian boycott.

PREVENTING ANOTHER CRISIS

To prevent another oil crisis in this new context, the U.S. must address two broad issues: 1) import independence, and 2) security of import sources.

Reducing Import Dependence

Decontrol of Natural Gas. Although the U.S. has made great strides in reducing its import dependence, thanks to President Reagan's decontrol of oil prices, more must be done. The most important next step is decontrol of natural gas prices. It is estimated that as much as one-third of U.S. proven gas reserves may never be utilized because producers are denied a sufficient return under current federal rules.

Gas controls adversely affect oil imports in two ways. First, since natural gas is a ready alternative to oil in a number of uses, the failure to fully utilize U.S. gas resources means oil must be used instead. A second link is that much gas is found in association with crude oil. To produce one of these fuels, it is often necessary to extract the other. Although gas can be re-injected into a reservoir to store it, if the controlled price does not warrant transportation and sale, re-injection is wasteful and eventually damages the formation, limiting the amount of the deposit that can be produced. By making natural gas uneconomic, controls reduce the attractiveness of the whole field. The best example of this is the Prudhoe Bay oil field where as much as one-third of the gas is used up in powering the re-injection process.

Restoring Production Incentives. Incentives to domestic oil production must be restored. This would be achieved in part by abolishing the so-called windfall profits tax. The tax limits the gross revenues of oil producers to a maximum of \$22 per barrel. If the U.S. is serious about reducing its import dependence, this artificial revenue ceiling must be eliminated to encourage more exploration. A computer model of the oil and gas market developed by Dr. H. A. Merklein, of Texas A&M University, indicates that if the windfall profits tax were eliminated, the U.S. could become oil self-sufficient within five years. Even if this is overly optimistic, there is little doubt that domestic oil production would be greatly enhanced by the move.

Leasing. A third action to enhance domestic oil production would be an expansion of the Administration's policy of leasing promising areas of federal lands for oil exploration. Many of the most promising exploration areas are controlled by the federal government. And denying access now, when exploration could take place in an orderly fashion, might result in panic exploration during some future crisis, with scant regard for the environment.

Depletion Allowance. The federal government could also restore the percentage depletion allowances to pre-1969 levels. This would help the oil industry to generate much-needed capital by improving the tax treatment of reserves, and so would act as a strong incentive to increase exploration.

THE NEED FOR A STABLE IMPORT BASE

Reducing the need for imports by increased domestic production and market-driven conservation is half the answer to the oil security problem. The other half lies in preserving reliable overseas sources. This requires a new and broader view of U.S. policy towards overseas oil suppliers. Mere economic analyses fail to note a host of other factors, such as political stability, social conditions, or the military environment. All of these bear directly on the security of oil supplies from a nation.

The Nature of the Threat: Short and Long Term Problems

Nowhere is this broad view more necessary than in the case of oil imports from Latin America and the Caribbean Basin, where, as never before, non-economic factors are critical to the security of the region's oil supplies.

The most immediate threat to U.S. energy security in the region comes from the growing influence of Marxist groups. Although there have been no direct military moves against oil producers, the chances of such action remain considerable. For example, bases in southern portions of the Yucatan Peninsula operated by forces opposing the government of Guatemala could readily be used to mount military operations against Mexico's huge Reforma oilfield. This is particularly likely if the insurgents in Central America succeed in consolidating their rule over the isthmus, allowing them to turn their attention northward.

Marxist insurgents traditionally have sought to disrupt local economies to undermine the legitimacy of governments they seek to overthrow. Oil production would be an ideal target in the case of Mexico. The remote location of some of Mexico's major oilfields makes them highly vulnerable to terrorism. One very promising deposit already has been abandoned due to attacks by guerrilla bands.

The Panama Canal is another potential target. About 44 percent of Alaskan crude oil passes through the canal on its way to

U.S. refineries on the Gulf and East coasts. Should access be restricted, Alaskan oil would have to be shipped around South America, adding greatly to its final cost.

Another threat is the potential use of Cuba or Grenada as a base from which submarines could harass shipping the Caribbean.² During the Second World War, for example, fewer than a dozen German submarines operating in the Caribbean during 1942 sank an estimated 3.5 percent of all allied tankers. And these submarines had no base of operations in the region.

Although the Reagan Administration has made some moves to counter the threat posed by insurgents in Central America, more must be done if U.S. oil supplies are to be protected. Governments in the region have indicated that they need equipment and training, not combat troops. By providing such aid now, the U.S. will avoid even higher military expenditures in the future to maintain oil security.

The military threat is but one part of the problem. A more basic set of issues involves economic, political and social consequences of oil wealth in the region. Here, the need for U.S. involvement is longer-term, but the result of a carefully crafted program could be lasting political and social stability throughout the region.

Technical and Economic Assistance

A lesson of the 1979 Iranian revolution is that sudden oil riches can become destabilizing in developing countries. Governments can find themselves caught in a political trap between the rising expectations of their citizens, and the need to invest revenues in long-term development projects. And all too often, new projects draw large segments of the rural population to the central cities, leading to social, economic and political disruption.

With proper technical assistance, however, it is possible to use new oil to foster development while preserving the social and political structure. In Latin America, such assistance would have to be relatively sophisticated, as most of the nations in that region are well developed compared with the Middle East. But there still are areas in which the U.S. could provide critical assistance, ranging from oil exploration and development help to enhanced agricultural production techniques. The proper form of assistance would depend on the individual country's requirements. For example, Mexico and Venezuela hardly need assistance in oil development, but Guatemala may. Providing "custom-made" technical support in this way would go a long way toward improving relations between

² See Edward Lynch, "Moscow Eyes the Caribbean," Heritage Foundation Background No. 284, August 17, 1983.

two halves of the Western Hemisphere, and thereby improve U.S. oil security.

CONCLUSION

Perhaps the most important step that the U.S. can take to meet the new threat to energy security is to recognize the profound changes that have occurred. Latin America and the Caribbean Basin now constitute a resource base rivalling the Middle East. The proximity of the region to the U.S. greatly reduces the strategic problems associated with its defense, but makes a strong U.S. commitment to defend it all the more necessary. The U.S. thus quickly must take the steps to counteract insurgencies in the area, to avoid a far greater military commitment in the future.

Simultaneously, the U.S. should enhance its domestic energy production so that the absolute level of oil imports is reduced. The U.S. should also provide the technical assistance necessary to help its southern neighbors to use their newfound oil revenues in a way that enhances political, economic, and social stability, rather than disrupting it. By acting in this manner, the U.S. could help transform a region now posing a threat to its oil security into a strong and dependable economic partner.

Milton R. Copulos
Policy Analyst