

Testimony of David L. Goldwyn before the Senate Foreign Relations Committee
“Energy Security in Latin America”

June 22, 2006

The Challenge to US Influence

Mr. Chairman and Members of the Committee, it is an honor to speak with you today about the intersection between growing resource nationalism in Latin America and the erosion of US influence in the hemisphere. The energy trends in the hemisphere are mixed, but overall investment is declining, production is flattening, and resource nationalism is rising in some key producing nations. US energy diplomacy is increasingly confined to North America. Most of our longstanding bilateral and multilateral energy dialogues are not functioning. We have no strategic engagement on energy with two of the three key producers: Venezuela and Brazil. US influence in the hemisphere is declining fast. The US needs a fresh approach to energy diplomacy in the hemisphere. The Energy Diplomacy and Security Act (EDSA) provides an excellent framework for such an approach. In addition, the United States will enhance its energy security by engaging the region on issues that concern its people: job creation, poverty alleviation, migration and trade promotion. An asymmetrical approach, one that addresses a broad range of issues rather than just energy security, may pay dividends equal to or greater than one focused solely on energy. The “Energy for Development” component of the EDSA is an excellent example of this kind of approach. EDSA should also, however, ensure that the US has the flexibility to utilize sub-regional energy dialogues and that any new framework strengthens, rather than weakens the energy diplomacy mission of the Department of Energy. I will discuss current energy trends in the hemisphere, their impact on US foreign policy, the status of existing energy security dialogues, and the utility of a fresh approach, with a specific focus on EDSA.

I. The Importance of the Hemisphere

Latin America is a strategic region for US foreign policy for many reasons. We are neighbors, trading partners, investment partners and we share deep family and cultural ties. The hemisphere is democratic, with one notable exception. In the energy sphere, the hemisphere provides the US with a large portion of our diversity of oil and gas supply. For this reason, the failure of the hemisphere to realize its potential for growth is a serious concern for US and global energy security. Latin America is far closer to the US market than the Middle East. While the investment climate in key Latin American countries is deteriorating as state control increases, even in Venezuela access to exploration acreage remains superior to that in the Middle East. Additionally, the non-OPEC producers in this region exert counter-pressure on OPEC’s monopoly power.

Mexico and Central and South American nations delivered nearly 14% of global oil production in 2005, and possess approximately 9.7% of global oil reserves, with 6.5% in Venezuela and 1.1% in Mexico alone. The region is also a major refining center, with nearly 9.2% of the world’s refining capacity. Regional refineries are designed to serve the specialized needs of US markets. The most important exporters, Venezuela and Mexico, consistently rank in the top four sources of US oil supply along with Canada and Saudi Arabia. Venezuela averaged 1.29 million barrels per day (m/bpd) in 2005; Mexico averaged 1.59 m/bpd in that year.

II. Energy Trends in the Hemisphere

In Latin America today we see two trend lines. One trend is towards rising state control of energy resources – in Venezuela, Argentina, Bolivia and Ecuador in particular. The concern here is that this trend will limit the growth of global supplies of oil and gas by undermining the value of existing investments, discouraging future investment or barring foreign investment altogether. The economic consequence of these trends is that the hemisphere will contribute less to the diversification of oil supply, thereby increasing the importance of OPEC supply and over time undermining economic development in the region. The political consequences of these trends in the short run are the decline of US influence in the region to competing ideologies and the erosion of democratic structures.

A second trend is toward creative fiscal regimes that welcome foreign investment and require state owned companies to compete with international companies, with independent regulators that promote fair and efficient regulation. Countries observing this model are increasing production or stalling the decline of existing reserves. Brazil, Colombia, Trinidad and Tobago and Peru are key examples of this creative model.

When we consider that Mexico so far continues to bar foreign investment in its upstream oil and gas sector, and the size of the reserves and production of the countries practicing the resource nationalism model, the net effect is negative. Foreign investment in the oil sector is shifting away from South America to North America, particularly to Canada's oil sands. When we compare 2005 to 2004, only Brazil and Trinidad managed to increase production significantly, while other countries faced decline or very modest gains.

A. The Rise in State Control

Venezuela and Mexico are the most important oil exporters in the hemisphere. While Brazil, Colombia, Ecuador, and Argentina are important destinations for foreign investment, and helpfully produce enough oil to meet their own domestic needs and make some contribution to the global export market, they are not strategic suppliers to the global market at this time. Only Mexico, Brazil and Venezuela produce more than a million barrels per day. Bolivia has enormous gas reserves, but exports mostly to Brazil and modestly to Argentina. Only Trinidad and Tobago is a key supplier to the world gas market.

From those countries now committed to increasing state control, the US faces two key challenges: the loss of production growth and diversity of supply from the region if new economic frameworks are unattractive to foreign investors and, most critically, the loss of US influence from well financed political competition.

The Economic Impact of Rising State Control

The recent wave of changes in contractual terms and dramatic changes in tax regimes in Venezuela, Bolivia, Ecuador and in recent years Argentina, threatens to slow new investment and eventually deepen instability and poverty in these nations as well as destroy shareholder value for the companies invested there. The deterioration in the investment climate for energy in these countries is primarily an economic threat, helping to lock in constrained supply and high prices. We are seeing the revision of economic terms at a time when producers rather than companies hold more market power.

Venezuela passed a hydrocarbons law that mandated a 51% share by the national oil company and a higher royalty rate. Operations, such as those under Operating Service Agreements, which may have stretched the legal interpretation of the law when they were begun, were subject to a strict and adverse legal interpretation when they appeared to be poor earners for the government. Taxes once renounced, like the export tax, have been revived so that the government can earn, in essence, a fixed 33.33% royalty. The impact, according to expert analysts like Deutsche Bank and Wood Mackenzie, is a massive flight of investment capital from Venezuela's heavy oil sector to Canada's oil sands, effectively freezing development of the hemisphere's largest oil reserves during one of the greatest oil booms in history.

In Bolivia President Evo Morales's May 1, 2006 decree declared that the state would take control of all gas fields. Royalty payments to the Bolivian government at the largest gas fields, including San Alberto and San Antonio, will now increase from 50% to 82%. All producers are obliged to sell at least 51% of their holdings to the Bolivian government, with the value of that share to be assessed by audit and negotiation. The state will take 60% of production from other fields. Bolivia has left itself an open door through which it can compromise or retreat: details of new contracts are to be worked out on a case-by-case basis. But companies were given only six months to renegotiate contracts or be expelled.

In Ecuador President Palacios seeks to increase windfall revenues from 30% to 50% and to renegotiate production sharing contracts, while still embroiled in disputes over company claims for refunds of value added tax payments denied by the government. Ecuador has now seized and will attempt to operate an oil field developed by Occidental Petroleum. Argentina reversed a successful fiscal regime by imposing export taxes and other restrictions which have returned it to being a net oil importer.

The net effect of these developments is that new investment in these countries is virtually frozen at a time when prices should be driving new exploration and production. It is notable that even China, which is aggressively competing for exploration acreage worldwide, is not a major player in the hemisphere. China holds less than 10% of upstream assets in the hemisphere, primarily recent acquisitions of Western assets in Ecuador and Peru, and enjoys no preferential access in Venezuela at this time. No new investment has been made under Venezuela's 1998 Hydrocarbons law. New investment is unthinkable in Bolivia until existing companies can determine the extent of their losses. Ecuador's investors are mulling legal action for expropriation and suspension of existing investments. The future growth potential of the hemisphere is being undermined and the region's economies risk a major contraction if oil prices drop significantly anytime over the next decade.

B. The Market Model

The hemisphere is not monolithic. We have seen remarkable success stories like Brazil, Colombia and Peru, which have created independent regulators and obliged their national energy companies to compete with outside companies for exploration rights. Such progressive cases provide bright spots in the region. Brazil has received enormous, and well deserved credit for the contribution that sugar based ethanol has made to its self sufficiency in oil. But equal credit should go to Brazil for a remarkable change in its terms for welcoming foreign investment, which made Brazil one of the most desirable destinations for exploration. Brazil's aggressive oil production strategy increased domestic oil production by 1 m/bpd over 10 years. In 1995, Brazil produced less than 700 m/bpd. In 2006 they are forecast to produce close to 1.7 m/bpd. Their jump in domestic production has had as great an impact on reduction in oil imports as anything else.

Competition has also made Petrobras a better company and a fearsome global competitor. Peru is set to become a net gas exporter if plans to build an LNG terminal and production from the Camisea project meet expectations. But these market based energy producers are not the dominant economic models in the hemisphere, are not major oil exporters and, with the exception of Brazil, do not operate in the countries with the greatest reserves. Colombia is battling a rapid decline of its reserves and production. Peru is net exporter.

Mexico

Mexico has been a long time reliable supplier, but its upstream oil sector has been closed to foreign investment and it is projected to decline unless this policy changes or unless the Mexican government dramatically increases the amount of PEMEX earnings it can keep for capital investment. In 2004 PEMEX paid the government 60% of its revenues. Mexico has enormous oil potential on its side of the Gulf of Mexico and a change in policy could both change global oil markets and create a formidable source of wealth for development of the country itself. Mexico will hold a closely contested Presidential election this July and the winner will have to address how to avoid seeing Mexico decline as an oil power. For now all candidates appear to oppose foreign investment in the energy sector but economic reality, opportunity and perhaps creative political action could yet provide this generation of Mexicans with an economic bonanza.

III. The Impact of Hemispheric Energy Trends on US Foreign Policy

The most important challenge to the US from these hemispheric energy trends is political, not economic. US influence in the hemisphere is waning in key areas, support for liberalized markets and free trade is declining, and democratic structures are under stress as populist governing models reduce the space for political opposition. The November 2005 Mar De Plata Summit of the Americas could not produce a consensus statement. Military cooperation with nearly ten countries has been suspended for the failure of these neighbors to conform to US orthodoxy on the International Criminal Court. The US could not muster support for its candidate for Secretary General of the Organization of American States.

Much of this decline is self inflicted. The hemisphere has not been a priority for US foreign policy for many years, other than as target for our counternarcotics policy. Bilateral relations are focused on whether the hemisphere supports US policy in other areas. The image of the US is declining in the hemisphere due to US policies in the Middle East and human rights issues raised by our treatment of detainees from Abu Ghraib to Guantanamo. Non-military aid for development assistance and child survival is declining for budgetary reasons. The US is widely perceived as insensitive to the region's concerns and our influence has been harmed as a result.

The Venezuelan Challenge

For the first time since the fall of the Soviet Union, the US now has an ideological and political competitor for political influence, arising primarily from Venezuela.

High oil prices have enabled President Chavez to maintain very high revenues for his government, allowing increased domestic social spending, high levels of foreign assistance, and modest reinvestment by PDVSA in countries in South America and the Caribbean. President Chavez has a competing vision from that of the United States on a broad range of issues. He opposes the US on trade integration, our liberal (versus his Bolivarian) model of democracy, on Iran and Iraq, and seeks to exclude the US from regional economic energy arrangements in South

America and the Caribbean. His economic policy is to raise taxes and royalties on foreign energy investment, demand majority control of projects, and in the non-oil sector to seize land or other underutilized industrial resources for the state.

Venezuela competes with the US in the hemisphere, offering aid for solidarity. Venezuela has capitalized on the different needs of the hemisphere's sub regions by creating PetroCaribe, PetroAndina and Petrosur to foster cooperation and joint investment on a sub regional basis. It has created an alternative trade grouping called ALBA, the Bolivarian Alternative for the Americas –which attempts to force nations to choose between trade agreements with the US and with Venezuela. Venezuela is also identifying places where trade liberalization has a negative impact and stepping in to provide redress. Venezuela purchased debt issues from Argentina and Ecuador, and when the Colombia free trade agreement with the US threatened Bolivia's soybean crop, Venezuela agreed to purchase it.

The jury is still out on whether the Venezuelan economic model is viable at \$25 oil and whether their neighbors support the Bolivarian vision and will really allow joint investment, or if they are just accepting president Chavez's assistance. But the political challenge to the US vision for the region is unmistakable.

The Venezuelan model is an issue in every nearly every election in the hemisphere. In Bolivia, the mobilization of long disenfranchised indigenous forces – aided by years of US assistance in party building and election organizing – led to the election of President Evo Morales, who is following the Venezuelan model. In Peru, Alan Garcia defeated Ollanta Humala, a proponent of the Venezuelan model, in a close election. In Mexico, the PAN candidate Felipe Calderon has closed a large gap with his PRD opponent Manuel Lopez Obrador by asserting he will follow the Venezuelan model if he is elected.

Given these mixed results we should be careful not to overstate the salience of the Venezuelan model or to dismiss too quickly the forces that gave rise to it in the first place.

The Roots of the Anti-markets Approach

It is important to understand what is behind the challenge to the US model. We are seeing the rise of state control and forced revision of contracts for two reasons. One is that trade liberalization and increased GDP growth have not led to poverty alleviation or inclusion of excluded minorities in countries like Venezuela, Bolivia, Ecuador and Peru, leading to a rejection of liberalized markets and the Washington consensus in many countries. Another is that growing populations have increased the pressure for governments to raise revenues in economies that are still resource dependent, so governments are appropriating the best available source of cash regardless of the long term consequences. This latter trend has led to higher taxes and royalties all over the world, including the UK.

The US should protest violations of contracts or expropriations where these takes place and deny benefits such as bilateral trade agreements to countries that do not respect the agreements they have signed. The US suspension of free trade agreement talks with Ecuador is a good example of this. But the market will either tolerate or punish the economic actions of governments that raise tax and royalty rates or other fiscal terms adversely. If companies can make money under the new terms offered by Venezuela or Bolivia, they will pursue these opportunities. If companies cannot profit, they will close their operations, and if countries do not spend their own capital to develop their resources, then production will fall, their revenues will shrink, and the popularity of their

programs will shrink with them. This may lead to higher energy prices, but foolish economic policy is not a basis for US government intervention.

The Need for a New Hemispheric Foreign Policy Approach

What the United States lacks is a positive agenda in the hemisphere, one that recognizes the need to improve education and infrastructure, addresses the negative social impacts of trade liberalization, and offers the respect and cooperation of the US to those countries that work with us. This will advance US interests no matter what the price of oil is. We need to address legitimate issues like poverty and advocate how our model can address them. Examples of this are addressing trade barriers to agricultural imports, expanding educational opportunities in the US for future leaders, improving the visa application process, expanding military to military contacts, especially exchanges under the International Military Education and Training Program, dealing with migration issues with Mexico in a spirit of respect and fairness, supporting World Bank and Inter American Development Bank infrastructure programs in the hemisphere, supporting the development of civil society and the capacity of democratic institutions and treating our relations with our hemispheric neighbors as intrinsically important, not as litmus tests of loyalty to the US on Iraq or other issues external to the region itself. In countries where we face ideological competition, like Venezuela and Bolivia, it is crucial that we do not abandon the field. We need to increase our diplomatic engagement and defend our way of thinking.

I believe that Bolivia's recent actions will mark the nadir of the turn toward repudiation of contracts. Countries like Bolivia and Ecuador are too poor and frankly too insignificant to global energy markets to sustain the kind of behavior they are engaging in. Powers like Brazil can communicate this to Bolivia better than the U.S. can. The US should maintain dialogue with Bolivia and give it our best, even if unwelcome, advice and cooperate where we can.

Venezuela is a more complicated case. Venezuela is a competitor, but it is not likely to halt supply to the US as an act of political warfare unless we embargo them first. They have in fact remained reliable suppliers of oil and products, despite the heated rhetoric reported in the media. An act of energy aggression by Venezuela against its neighbors is also unlikely at this time. Any hope Venezuela has for regional leadership would evaporate if they used their oil wealth for acts of military aggression against a neighbor. Withdrawing oil supply from the market will harm their new friends and future markets as well as cut the government's supply of revenue. The US could, would and should use the Strategic Petroleum Reserve to redress the unlikely event of a production halt by Venezuela, or another (equally unlikely) strike by its workers. For now, the Venezuelan challenge is ideological.

Here too US policy has failed to understand what factors have led to President Chavez's enormous popularity. Venezuelan governments prior to the Chavez government governed poorly, practiced corruption, ignored poverty and excluded minority sectors of its society. The Chavez government came to power determined to return control of energy policy from the national oil company to the government ministry, to reclaim some of the oil rents held by the national oil company for the government's own account, and to change the economic terms of its acreage allocation from those set when oil was \$10. This is a policy the US would support in any other country. The government has spent lavishly and allegedly unwisely on social programs, but this is what we pray most African government would do with their own oil wealth. The famous strike of 2002-2003 was a battle between the national oil company and the government and the government won. I cannot imagine the US supporting the PEMEX in a battle against the Mexican Government for control of the PEMEX Board of Directors. The US rhetorical support

for the coup that displaced the President for a day was foolish, destructive and devastating to our bilateral relations.

Where Venezuela has gone wrong economically is by changing contract terms with impunity and hostility rather than by negotiation with companies who have been its partners for decades, invested billions in its energy sector, and created the production that now enriches the nation. The manner in which the recent changes have taken place has been short sighted, destructive and unnecessary. Venezuela has changed its interpretation of its own tax laws, but it is provocative and disingenuous to accuse companies of being tax cheats as a consequence. Time will tell whether the attractiveness of Venezuela's tremendous oil and gas reserves overcomes the pain inflicted by the way these changes have been made. Oil companies tend not to be emotional about these issues as long as they are making money.

Where Venezuela has gone wrong politically is by using legal methods to restrict freedom of the press, prosecution to intimidate political opposition, and constitutional assemblies to unbalance formerly balanced institutions like the Supreme Court and national election commission. The regime itself, helped by the failure of a political opposition to mount a campaign describing what it was for, and high oil prices sufficient to fund the government and external programs at the same time, does not appear to need to use either tactic to win large majorities. These internal governance issues should be the focus of a regional policy, which includes, but is not led by the United States. We should have objective assessments as to whether Venezuela's actions are undermining any other important US security interests. Venezuela has positioned itself as an ideological competitor to the United States in the hemisphere. We need not and should not treat Venezuela as an enemy; we should, however, try to compete. We should also end our dialogue via the media and resume the dialogue between our senior foreign affairs, commerce, energy and cultural officials. We should work with Europe and with hemispheric partners to reinforce a message of respect for democratic institutions.

IV. The Status of Current Dialogues and the Need for a Fresh Approach

The US has had a number of bilateral and multilateral energy policy fora in the hemisphere over the years. Some are active, while others have lapsed or are stagnant. These fora are platforms to understand market dynamics, share best practices on energy efficiency and conservation, share understanding on ways to enhance energy production, and exchange views on how a nation's energy policies may be enhanced or reformed to promote the nation's own policy. These policy dialogues are also essential for building the understanding and relationships that are essential for trade promotion and conflict resolution.

The premier multilateral energy forum was the Hemispheric Energy Initiative (HEI), a multilateral meeting of the hemisphere's energy ministers, with many active subgroups, which was co-chaired by the US and Venezuela. The HEI is dormant due to the status of our relationship with Venezuela, leaving us with no effective forum at all. Bilaterally the US had a Principal Coordinators Energy Dialogue with Venezuela as well as a thirty-year technical cooperation agreement with Venezuela. The bilateral Venezuelan dialogues were suspended for political reasons.

The US has a trilateral energy policy dialogue with Canada and Mexico, which has addressed electric power, energy conservation, harmonization of standards and market outlooks. It has taken many forms, but it functions very well.

What remains of engagement is not adequate. A fresh approach which engages the United States with all the region's producers and consumers is sorely needed. I commend the Chairman for the vision contained in EDSA and for the framework it provides. I wish to comment on four aspects of the bill.

With respect to Section 3, on the Sense of the Congress on Energy Security and Diplomacy, I strongly share the call to integrate energy security into national security policy coordination by an interagency grouping and by creation of a new position at the State Department. In practice there will be a need for energy security to be considered in many of the bilateral policy groups as well, so the issue is not marginalized, but these are important new measures. I would hope that the Secretary of Energy will be a player on bilateral policies in the Middle East, Central Asia and other regions as well, so that the Energy Department's expertise is enhanced and not diminished.

The Strategic Energy Partnerships contained in Section 4 of the bill will be essential. We may have some of these on paper, but they need to have the diplomatic attention that has been lacking. The lack of high level engagement with Brazil is a case in point. Here I would caution that we should not exclude dialogue with countries that are ineligible to receive economic or military assistance. This kind of assistance gets suspended from time to time, with countries ranging from Nigeria to Venezuela. We should not tie the hands of our diplomats especially when we are using other measures like withholding assistance to impact a country's behavior.

The Energy Crisis Response Mechanisms in Section 5 are essential for bringing China and India into the international collective energy security system. Here too I would urge some flexibility to include other nations such as Thailand, Singapore or Indonesia in such a system so we do not marginalize them or miss the chance to build an even stronger collective energy security system with consuming nations who will have common interest with us.

Finally, with respect to Section 6, I share the Chairman's view that we need a new Hemispheric Energy Cooperation Forum with a strong private sector forum. The US needs to engage producing countries with successful policies, such as Brazil, Colombia and Peru, as well as competitors like Venezuela. We need to engage the consuming countries as well, in the Caribbean and Central America, as well as the Southern Cone, to address policies that favor consumers. One lesson we have learned from the HEI is that different regions of the hemisphere have different needs – some focus on power generation, others on integration of their grids, still others on access to oil and gas. The United States may be able to forge stronger bonds, and frankly compete more effectively on an energy security vision for the region, if we can organize along sub-regional lines, and meet in plenary when the timing is right. I think we have to recognize that while there is a state of conflict among the producing nations, a hemisphere-wide forum will face great challenges in achieving any meaningful consensus. I think we need one, but I suggest the bill provide some flexibility in how it is organized.

I have some concern, as a former Assistant Secretary of Energy, with putting the State Department in charge of this effort with Energy's cooperation, rather than the other way around. I recognize there may be jurisdictional issues here. One factor I urge you to consider is that we need to deepen the international energy diplomacy capacity of the Department of Energy. Their relationships with civil servants in ministries across the globe provide a bridge across changes in government here and there. They can talk when the politics of non-energy issues obstruct dialogue among the foreign ministries. It is easier to get Energy Ministers together for regular meetings than Secretaries of State. Their staff should be expanded and serious program budget established to make our cooperation more than rhetorical. For true reform to be achieved, I agree that foreign ministers, indeed heads of government will have to be involved. This will be the key

to integrating energy security into foreign policy. But I urge some flexibility on the bureaucratic leadership provisions of this section as well.

V. External Policies

In addressing challenges in Latin America, EDSA recognizes that the US cannot go it alone. I note with admiration that the Chairman has placed an emphasis on integrating energy security into NATO policy, and into dialogue with China and India. I would only add that we need to take an asymmetrical approach to our multilateral diplomacy outside the energy sphere. We need to focus the US - European Union Dialogue on democracy promotion and conflict resolution in Latin America. We must also begin a dialogue with China and India on security and stability in energy producing areas. Both are great powers and we share an interest in stable energy supply and conflict resolution. As these powers grow on the international stage we need to talk to them about their policies and how they interact with the IMF, World Bank and international multi-stakeholder efforts like the Extractive Industries Transparency Initiative.

While it is the topic of many of your other hearings, it must be said that regional approaches to combat the use of oil as a tool of foreign policy are tactical measures to manage the near term consequences of the impact of oil wealth on many oil producing nations. The energy dependency of the US, our allies in Europe and developed Asia, and the growing dependence of rising powers such as China and India on imported oil is rapidly eroding US global power and influence around the world. My colleague Jan Kalicki and I, and a host of energy experts from around the world, from producing and consuming nations, analyzed the sources of these problems and suggest a set of domestic and international solutions to them in a book we co-edited titled Energy and Security: Toward a New Foreign Policy Strategy (Wilson Center Press/Johns Hopkins University Press, 2005). As the Chairman so eloquently argued in his Brookings speech this year, a strategic approach to this program must focus on reducing the importance of oil as a global commodity. While this is a twenty or thirty year effort, a strategic energy policy that invests in new technology, uses tax and regulatory policy to accelerate the deployment of alternative fuels and vehicles and drastically increase fuel efficiency, and expands the system of collective energy security to include China and India, is the only way to protect America's power and influence for the long term. I commend the Committee for its historic attention to these fundamental issues.