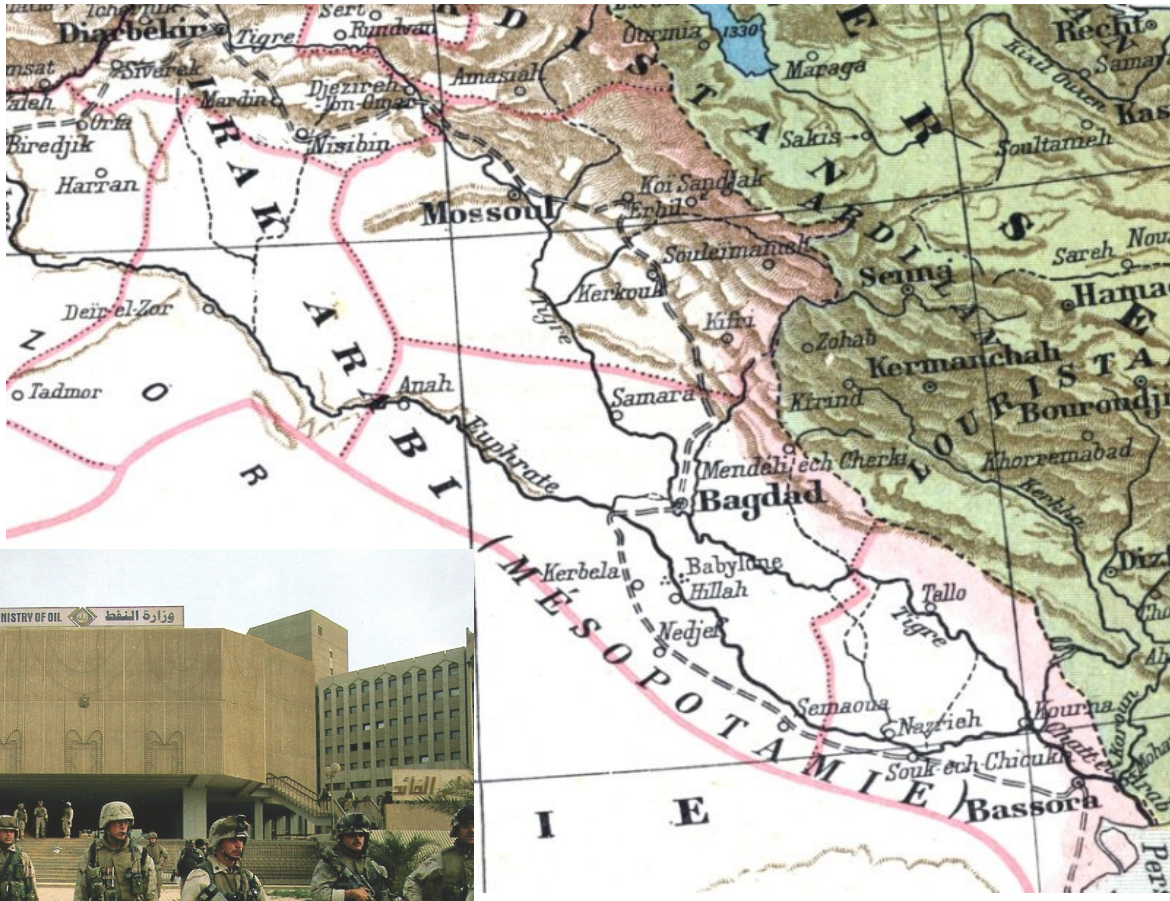
Oil Regime Change in Iraq

Possible Strategic Implications for OPEC

Timothy A. Boon von Ochssée



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Author's note
This paper is a re-written version of my original thesis, submitted in candidacy for the degree of Master of Science in Economics in December 2004. In the mean time, much of the work concerning scenario building at the *Clingendael International Energy Programme* has undergone various shifts in methodology. It should be noted that for this reason the scenarios used in this paper differ in terms of methodology, orientation and content from the ones used in recent publication(s) of the *Clingendael International Energy Programme,* most notably the study named *Tomorrow's Mores*.[1] I would like to thank Coby van der Linde, Lucia van Geuns and Femke Hoogeveen at the *Clingendael International Energy Programme* as well as Mr. Goldthorpe, Mr. Vitullo and Mr. Cuno for their valuable contributions.

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[1] F. Hoogeveen and W. Perlot (Eds.), *Tomorrow's Mores: The International System, Geopolitical Changes and Energy*, (The Hague: CIEP, 2005).

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Glossary

Notations

bbl(s)	barrel(s)
b/d	barrel per day
mb/d	million barrels per day
$/bbl	dollar per barrel

Intergovernmental organizations

NATO	North Atlantic Treaty Organization
OECD	Organization for Economic Development and Cooperation
OPEC	Organization of the Petroleum Exporting Countries
UN	United Nations
IMF	International Monetary Fund
GCC	Gulf Cooperation Council

Countries, federal or supranational entities

EU	European Union
UAE	United Arab Emirates
UK	United Kingdom
US	United States (of America)
USSR	Union of Soviet Socialist Republics

Research institutions and organizations

CGES	Center for Global Energy Studies
CIEP	Clingendael International Energy Programme
IEA	International Energy Agency
US EIA	United States Energy Information Administration

Oil companies

BP	British Petroleum
INOC	Iraqi National Oil Company
IOC(s)	International Oil Company(ies)
NOC(s)	National Oil Company(ies)

Other

CENTCOM	Central Command
CIA	Central Intelligence Agency
CPA	Coalition Provisional Authority
FDI	Foreign Direct Investment

GDP	Gross Domestic Product
ILSA	Iran-Libya Sanctions Act
LNG	Liquid Natural Gas
MENA	Middle East and North Africa
NSA	National Security Council
PSA(s)	Production Sharing Agreement(s)
RDF	Rapid Deployment Force
UNSCR	United Nations Security Council Resolution

'Oil in the next war will occupy the place of coal in the present war, or at least a parallel place to coal. The only big potential supply that we can get under British control is the Persian [now Iranian] and Mesopotamian [now Iraqi] supply… Control over these oil supplies becomes a first class British war aim.' –Sir Maurice Hankey, Britain's First Secretary in 1918.

1

Introduction

Since OPEC's inception in 1960, Iraq is the first member country to experience regime change forced upon on it by an external power. The US venture to remove Saddam Hussein from power in Iraq in March 2003, now having almost entered its third year, is manifestly symbolic of Western concerns over oil supply security. At this moment the US and the UK are trying to extricate themselves from a second oil war in Iraq, whether openly acknowledged or not, was visibly an attempt at restoring Middle Eastern stability and maintaining Western access to a steady supply of oil.[2] US involvement in Iraq presently involves a bitter counterinsurgency against a well-organized and cunning group of militants as well as a struggle to reconcile the three main Iraqi ethnic groups. Stabilizing Iraq is central to US foreign policy; not only would it bring the Middle East under US control. Control of and access to oil as well as oil prices dominates everything from foreign and economic policies to stock market performance, trade accounts and global economic health at large.

Hence, the expected concentration of oil exports in the medium to long-term in only a handful of geographically close countries which share many political and economic instabilities has lately alarmed policy-makers in consuming countries.[3] At present, the Middle East is being re-shaped by strong exterior forces, a development which has serious implications not only for all of the world's major economies, but also for OPEC. With some two thirds of the world's global petroleum reserves, the Middle East (and the Persian Gulf in particular) is a geopolitical focal point as the backbone of future oil supplies. With these facts in the background, this paper is a bid to illustrate the strategic impact of the Iraqi 'regime change' on OPEC. For OPEC it is yet another blow to an economic alliance that has already shown signs of troublesome cooperation and malaise as its economic power has waned throughout much of the 1980s and 1990s.

Consumer countries are in open competition amongst each other for a position in which they can support their oil companies to have a share in the future development of the oil industry in Iraq. This trend shows striking similarities with the break-up of the remains of the Ottoman Empire at the end of the First World War.[4] September 11th 2001 marked a major change in US foreign policy. The events of '9/11' gave the Bush Administration enormous political leverage, especially in its foreign policy, in which energy concerns play an ineluctable role. For the US, fighting terrorism can go hand-in-hand with securing oil

[2] P. Roberts, The End of Oil, The Decline of the Petroleum Economy and the Rise of a New Energy Order, (London: Bloomsbury Publishing, 2004), p. 10.
[3] C. van der Linde, (2003), 'Is Iraq a 'game changer'?'. In: van Staden, A., Rood, J., Labohm, H. (eds.), *Canons and Cannons, Clingendael Views of Global and Regional Politics*, Assen: Van Gorcum, p. 3.
[4] Ibid., p. 7.

interests.[5] Since the collapse of the Soviet Union as a capable adversary in the international arena, the US has begun to concentrate more on its own security interests, including the control of vital energy resources. Central to US foreign and security policies is access to oil and the ability to exert political, military and economic control over the countries which possess it. With the diversity of oil sources set to decrease over the next few decades, competition between the great power blocs can only increase.

At the end of the Cold War, it was hoped that globalization as a notion would lead the way with mass liberalization across the globe and increased international trade. Though liberalization did take place, especially in the international capital markets, for example, the oil market has undergone dramatic shifts, mainly of a geopolitical nature and away from any form of purely market-based activity. This is mainly because oil is a commodity like no other in terms of historic and economic significance, found in large exportable quantities in only a small number of countries. Following two decades of a market-based system of energy supply, a re-politicization of energy is emerging and changes in the oil market are compelling consuming countries to re-think their energy policies in light of increased levels of political uncertainty, particularly in oil producing countries.[6]

The regime change in Iraq will have significant long-run effects in both the economic and geopolitical dimensions of the oil market. As far as the US is concerned, a pro-American Iraqi government is of paramount importance to US energy interests. The new Iraqi government will decide to what extent the Iraqi oil sector will be privatized. In addition, of particular concern for the US vis-à-vis Iraq was that with UN sanctions against Iraq and Iran would erode and other countries' oil companies would move in before US companies would be permitted.[7] Strategically located on the doorsteps of the Eurasian continent and the Persian Gulf, Iraq boasts the third largest oil reserves in the world. Achieving the installment of a pro-US regime in Baghdad could undermine OPEC as a coherent and sound economic alliance in the future. A similar US move in Iran would magnify this effect yet further.

The goal of this paper is to explore the strategic impact of regime change in Iraq on the future of OPEC by means of a brief and simple game-theoretic analysis. Will OPEC collapse or will it remain intact? How is the possible privatization of the Iraqi oil sector likely to have an impact on OPEC? These are some of the questions relevant to the theme of the paper and an attempt is made in the last chapter to highlight some answers to the questions posed above. In order to come to a final game-theoretic analysis of OPEC, contained in the last chapter, this paper is organized in four chapters. It is important for the reader to be aware of how the future oil market is likely to be structured.

Therefore, the first chapter is a brief overview of oil supply projections into the first decades of the 21st century. This chapter will point to the rising call on OPEC oil, in particular from the Persian Gulf oil exporting countries. It will also highlight the US import balance and policy concerns. In order to fully comprehend the background of why regime change came about in Iraq, it is important to grasp some of the reasons why the US may have taken such a drastic measure to protect its interests. Chapter 2, then, is a pithy account of the evolution of US strategy in the Persian Gulf and plausible US strategic objectives vis-à-vis regime change in Iraq. Chapter 3 is a thorough review of geopolitical developments at the highest level and at a regional level of the Persian Gulf. A brief account of OPEC follows with a discussion about OPEC and Iraq in a future context, in order to prepare the reader for a more thorough analysis of the strategic issues involved. Subsequently, Chapter 4 is a projection of future scenarios, applied to OPEC and the Gulf with Iraq as a focal point. A presentation for the logic underlying possible regime change in Iran opens this last chapter.

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[5] Ø. Noreng, *Crude Power, Politics and the Oil Market*, (London: I.B. Tauris & Co. Ltd., 2002), p. 82.
[6] C. van der Linde (2005), 'Energy Security in a Changing World'. In: P. Bracken, I. Bremmer and D. Gordon (eds.), *Managing Strategic Surprise*, (New York: published by the Eurasia Group for the National Intelligence Council, 2005), p. 203.
[7] Ø. Noreng, *Crude Power, Politics and the Oil Market*, (London: I.B. Tauris & Co. Ltd., 2002), p. 50.

'I call petroleum the devil's excrement. It brings trouble… Look at this *locura* - waste, corruption, consumption, our public services falling apart. And debt, debt we shall have for years.'
– Juan Pablo Pérez Alfonso, a Venezuelan founder of OPEC.

2

Oil and its future supply structure

No natural resource in the world has so rapidly and irrevocably become as indispensable as oil during the 20th century. Oil was at the heart of economic expansion after the Second World War.[8] Ever since the industrial revolution, energy as such has become the currency of political and economic power, the determinant of the hierarchy of nations and access to it has become a measure of material advancement and success.[9] The economic and military significance of oil gives it a politically charged character for governments and businesses around the world. Given this fact, an undeniably strong link exists between governments and their national or private oil companies. The demand and supply patterns of oil are projected to change dramatically over the coming decades.

Oil is vital for a modern economy and the role it plays in a nation's ability to act militarily is indispensable. It should then come as no surprise that the world's biggest oil companies are seated in the world's most powerful states. The risks involved for the consumers make oil a matter of state interest, even in times of ostensible oil market stability.[10] Governments have played an active role in the regulation of the industry, producing an international industry with active public and private market players that compete, coordinate and at times control the market.[11] These states often view the global interests of their oil companies as identical to national interests at large and they willingly support the efforts of the companies to gain control over new production sources and distribution channels.[12] Trying to overwhelm foreign rivals is thus no exception to this government policy.

The acute political risks, high fixed capital investments, enormous economic rents and the strategic nature of oil compel strong involvement of the state, both in producer and consumer countries. Particularly, economic rent[13] has played a pivotal role. The importance of economic rent arises from the fact that it can be taxed away without reducing the quantity of output supplied.[14] The various players in the market, including governments, are rent-seekers and rent-seeking behavior is a major driving force in the control over oil at large. In regard to the control of oil, there are issues of national pride and self-assertion that

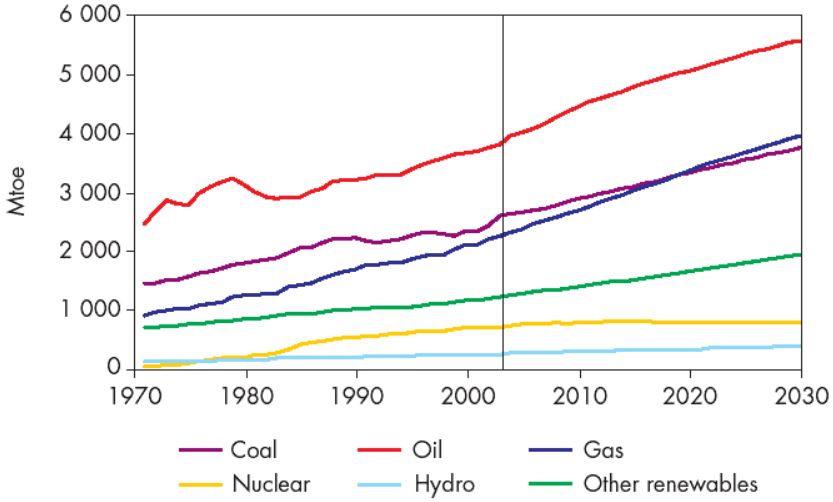
[8] CIEP, Study on Energy Supply Security and Geopolitics, (The Hague: CIEP, 2004) p. 53.
[9] P. Roberts, The End of Oil, The Decline of the Petroleum Economy and the Rise of a New Energy Order, (London: Bloomsbury Publishing, 2004), p. 6.
[10] Ø. Noreng, *Crude Power, Politics and the Oil Market* (London: I.B. Tauris & Co. Ltd., 2002), p. 45.
[11] C. van der Linde and P.A.G. van Bergeijk, (1995) 'Economic Alliances, cartel instability, and the future of OPEC', *Acta Politica*, vol. 30, no. 3, pp. 265 – 288.
[12] J. A. Paul, 'Oil companies in Iraq', Global Policy Forum, November 2003.
[13] Economic rent is: 'any payment made to a production factor above the amount necessary to keep that factor of production in its present employment'; see W.J. Baumol and A.S. Blinder, *Economics Principles and Policy*, (Mason OH: South Western College, 1991), p. 753.
[14] C. van der Linde, 'Is Iraq a 'game changer'?'. In: van Staden, A., Rood, J., Labohm, H. (eds.), *Canons and Cannons, Clingendael Views of Global and Regional Politics*, Assen: Van Gorcum, 2003, p. 4.

render intolerable a situation where the most significant resource of a country, one on which the well-being of that country crucially depends, is entirely in the hands of foreigners.[15]

2.1. Global oil demand and supply projections

World primary energy consumption is projected to rise by 52 percent between 2003 and 2030 as projected by the *World Energy Outlook 2005 (WEO2005)*. Oil is set to dominate energy usage well into the future and its share is to remain almost unchanged over the projection period, slightly shifting from 35 percent of total energy usage in 2003 to 34 percent in 2030, refer to Figure 2.1. The *WEO2005* further estimate that OPEC will continue to supply the largest share despite the competitiveness of non-OPEC suppliers including offshore production in the Caspian Basin, Latin America and West Africa.

Figure 2.1: Relative energy shares, 1970 – 2030

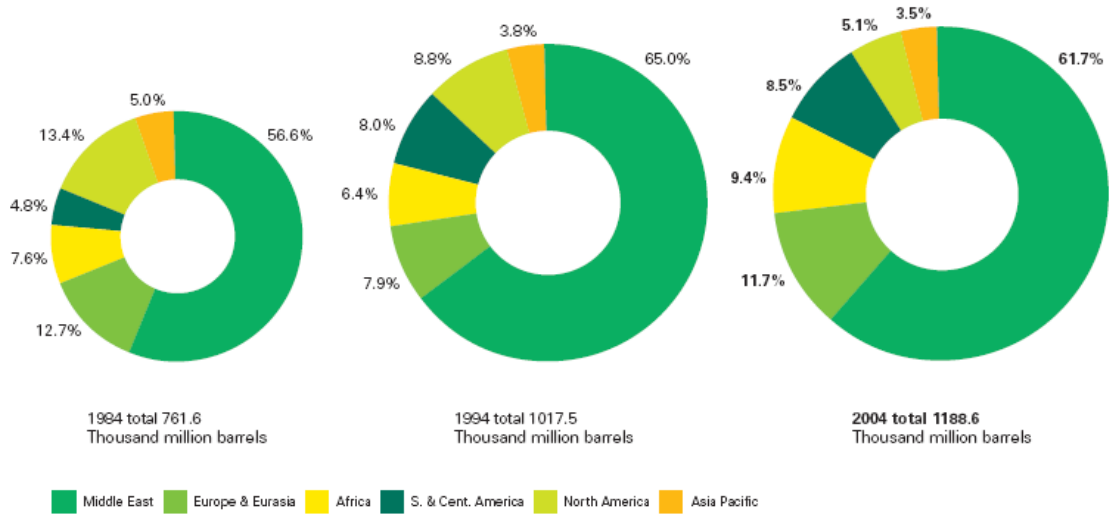


Source: IEA, World Energy Outlook 2005, figure 2.1, p. 81.

The Middle East holds the majority of the reserves; about 61.7 percent of the world total (see Figure 2.2). The share of reserves in the Persian Gulf countries is illustrated in more detail by Figure 2.3; the Gulf holds 90 percent of the oil reserves in the Middle East. Figure 2.4 further illustrates the concentration of oil reserves in the Middle East and the Gulf countries.

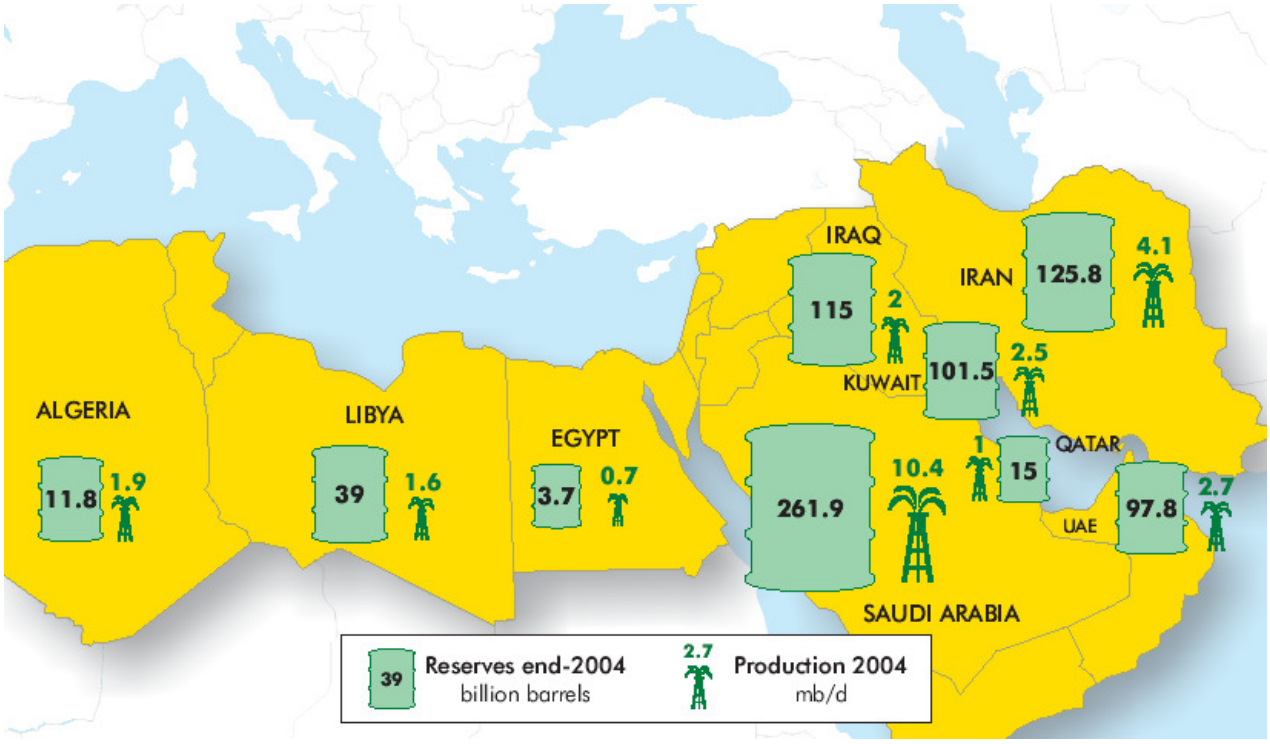
[15] G. Luciani, *The Oil Companies and the Arab World*, (London: Croom Helm, 1984), pp. 26 - 27.

Figure 2.2: Distribution of proven oil reserves in 1984, 1994 and 2004



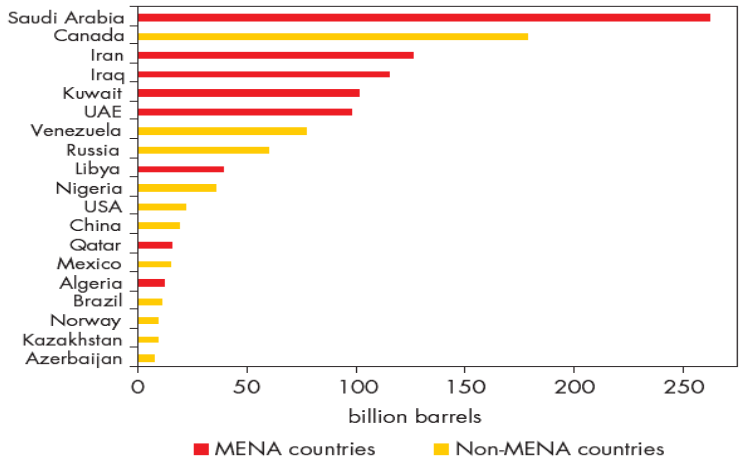
Source: BP Amoco, BP Statistical Review of World Energy 2005, p. 5.

Figure 2.3: Middle East oil reserves and production, 2005



Source: IEA, World Energy Outlook 2005, figure 4.6, p. 127.

Figure 2.4: Leading countries for proven oil reserves, 2005



Source: IEA, World Energy Outlook 2005, figure 4.4, p. 124.

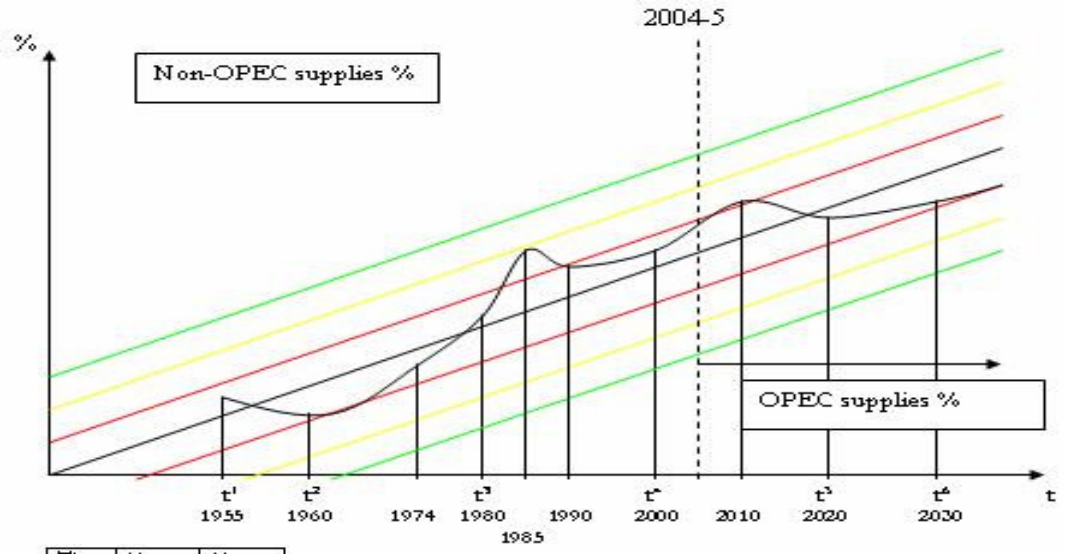
The *WEO2004* projects that OPEC production will leap by 36.6 mb/d between 2002 and 2030 while production in the MENA countries will rise from 29 mb/d to 50mb/d in 2030 according to *WEO2005*. Many newly discovered oil fields are in OPEC countries.[16] The rate of discoveries outside OPEC is falling, while many oil rich regions outside OPEC, the non-OPEC sources, are either set to mature soon, are mature already, or are already declining in terms of market share. The rate of discovery of giant oil fields has fallen sharply since the 1960s and additional production will be coming from smaller fields discovered later on.[17] Essentially, the dependence on OPEC versus non-OPEC supplies as a trend from the 1950s into the first three decades of 21st century, see Figure 2.5 below.

The five major Gulf producers are at the core of Middle East (and OPEC) oil production simply in terms of their reserves, providing almost 30 percent of the world's oil. The *WEO2004* estimates for future Persian Gulf output ('OPEC Middle East' in the *WEO2004* includes only the major Persian Gulf producers) are 19 mb/d, 22.5 mb/d, 37.4 mb/d and 51.8 mb/d in 2002, 2010, 2020, and 2030 respectively. Meanwhile, OPEC suppliers such as Venezuela and Nigeria are experiencing increasing degrees of internal political instability and as such they are bound to be unreliable in the long-run. Indonesia, itself an OPEC member too, is on the verge of becoming a net oil-importer by around 2010 rather than an exporter as its own energy needs continue to rise.[18]

Thus, on average, non-OPEC supply is decreasing incrementally in the future while the demand for and supply of OPEC oil is projected to rise. With the average yearly growth rate of demand for Persian Gulf oil expected to be 1.6 percent, the call on OPEC Persian Gulf oil is accelerating faster than the call on non-OPEC oil. Non-OPEC supply is expected to peak around 2010 or just prior to that year, at roughly 59.6 percent of world supply at that time, and will decline slowly but surely thereafter[19], see Figure 2.6. Non-OPEC supply simply is not large enough to offset the supply of OPEC oil in the long-run. The *WEO2004* emphasizes that 'Saudi Arabia, Iraq and Iran are likely to contribute most of the increase in Middle East Production.'[20]

[16] Petroleum Review, 'Oil field mega projects 2004', January 2004.
[17] IEA, World Energy Outlook 2005.
[18] IEA, World Energy Outlook 2004, p. 272.
[19] Ibid., p. 110.
[20] IEA, World Energy Outlook 2004, p. 110.

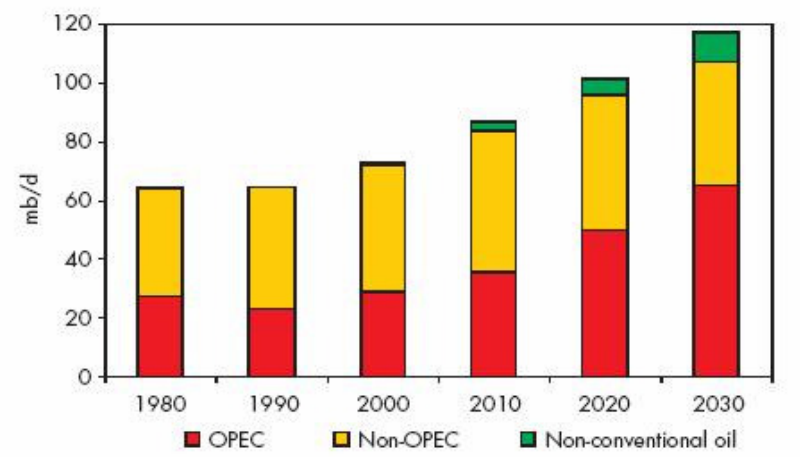
Figure 2.5: Rough trend representing the rising call on OPEC versus non-OPEC production



Time	% Non-OPEC	% OPEC
t'	52	48
t²	42	58
1974	44	56
t³	56	44
1985	72	28
1990	64	36
t⁴	61.6	38.4
2010	59.6	40.4
t⁵	51.7	48.3
t⁶	45.9	54.1

Source: Data from CGES. This figure is not drawn to scale with full accuracy; the percentages in the table are rough market share estimates for the years 1955, 1960, 1974, 1980, 1985 and 1990. The middle diagonal line represents a 50 percent line; to its left the world is more dependent on non-OPEC supply while to its right this dependence shifts more towards OPEC.

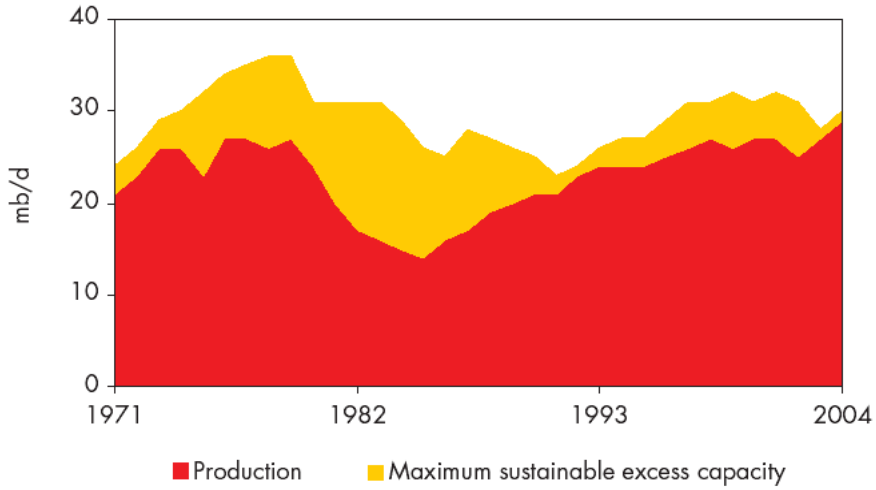
Figure 2.6: World oil production, 1980 – 2030



Source: IEA, World Energy Outlook 2002, figure 3.3, p. 98.

Another fact of importance is that the level of spare capacity in key producing countries has diminished significantly since the early 1970s (see Figure 2.7 below). This is owed in no small part to a lack of investment in production capacity and energy infrastructure. Spare capacity has played an important role in mitigating supply disruptions and sudden, unexpected surges in demand.[21] Therefore, those countries (where significant spare capacity is and will be available in the future) will remain crucial to the international oil market.

Figure 2.7: MENA crude oil production and spare maximum sustainable capacity, 1971 - 2004



Source: IEA, World Energy Outlook 2005, figure 1.14, p. 139.

2.2. US oil-import dependence and energy policy concerns

The US, with only 5 percent of the world's population, consumes a stunning 7.5 liters of oil per person every day, or about a quarter of the world's oil consumption.[22] North American (those of the US for the most part) imports of oil from the Persian Gulf region are expected to double between 2001 and 2025.[23] Though it is the world's largest consumer of oil, gas, coal and nuclear energy, it is also the world's first or second producer of all four forms of energy. The US is actually the second largest producer of oil in the world, but due to its high consumption it needs to import about half of what it consumes. The reasons for the relatively high level of oil consumption in the US are diverse and significant. A major driving force, amongst others, is the traditional consumption behavior of US automobilists. The utilization of and access to inexpensive oil is seen in the US at large as a natural right; for most Americans it is inconceivable not be able to travel long distances in their own country at affordable costs. High oil consumption in the US can also be attributed to economic growth, the energy efficiency of automobiles and other factors.[24]

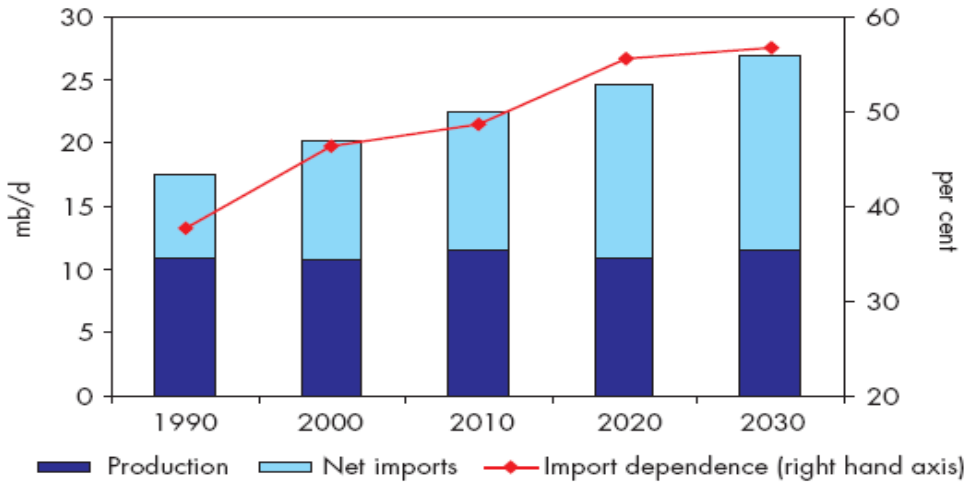
Figure 2.8 below is an overview of oil imports versus exports for the US and Canada, and illustrates the dependence of the US on imports at present and up to 2030. The US will obviously need a rise in imports to satisfy future demand over the next few decades. Recently, some new offshore oil fields were discovered in the Gulf of Mexico and production from these sources is expected to increase as part of non-

[21] IEA, World Energy Outlook 2005, p. 138.
[22] National Geographic, 'The End of Cheap Oil', vol. 205, no. 6 (June 2004), p. 85.
[23] EIA, International Energy Outlook 2004, p. 41.
[24] Petrol is traditionally cheap in the US and it has fuelled US economic growth since the 1870s, thus stimulating an oil-based economy into switching to other cleaner fuels may be difficult, given the political stakes. Yet there are signs of possible change, a geo-green coalition of 'tree-huggers, do-gooders, sod busters and cheap hawks'–as described by former CIA director James Woolsey–is already taking shape in the US as a potent political force in favor of more cleaner fuels rather than oil. See The Economist, 'Rethinking the axis of oil', April 30th 2005.

OPEC capacity.[25] Nevertheless, the US has a direct interest in diversifying its imports of oil as much as possible, to insulate itself against possible disruptions or price fluctuations.

Confronted with a failure to implement an effective oil efficiency policy and of the gradual depletion of domestic oil, the US has been increasingly compelled to import most of its oil.[26] The Bush Administration has even signed an agreement with Russian President Putin to establish an 'energy partnership' between the US and Russia.[27] Russia has been positioning itself as a reliable source of energy supplies to the global economy; though its future lies in natural gas exports[28] (it holds 30.5 percent of the world's gas reserves).[29]

Figure 2.8: Oil balance in the US and Canada, 1990 – 2030



Source: IEA, World Energy Outlook 2002, Figure 4.7, p. 150.

In 2000 and 2001, the US energy market suffered a major crisis as energy prices rose and the Californian electricity sector nearly collapsed. Production and refining incapacities, demand management, the organization of infrastructure, a lack of attunement between energy needs and supplies together with different environmental regulations all combined to yield this crisis.[30] It arose at a time when the petroleum industry had run down inventories for essentially commercial reasons in a deregulated marketplace while decreased refining capacity and years of under-investment in energy infrastructures inside the US left little room for shortfalls.[31] In May 2001, Richard Cheney, Vice President of the US, presented a national energy plan aimed at boosting US production and alleviating the energy crisis at hand.

The national energy plan of May 2001 recognized that the US must continue boosting its own oil and energy production. It also acknowledged that much of US needs would have to come from abroad, and national energy security was named a top 'priority of US trade and foreign policy'.[32] The report further recognizes that US economic security remains very vulnerable to oil market price fluctuations and major

[25] Ibid., p. 149.
[26] Ø. Noreng, *Crude Power, Politics and the Oil Market* (London: I.B. Tauris & Co. Ltd., 2002), p. 70.
[27] By playing Saudi production off against that of Russia, the US helps assure itself of several things simultaneously: relatively low and/or stable world oil prices, diversity of oil imports and a check on OPEC's largest producer.
[28] G. Bahgat, (2003), 'The new geopolitics of oil: The United States, Saudi Arabia, and Russia', *Orbis,* vol. 47, no. 3, pp. 447 - 461.
[29] BP Amoco, BP Statistical Review of World Energy 2003, p. 20.
[30] C. van der Linde, De Europese Voorzieningszekerheid van Olie en Gas in de Komende Jaren: Economische en Geopolitieke Risico's, (The Hague: CIEP, 2001), p. 19.
[31] James A. Baker 3 Institute for Public Policy of Rice University and the Council on Foreign Relations, Independent Task Force on Strategic Energy Policy, *Strategic Energy Policy: Challenges for the 21st Century*, no. 15, April 2001, p. 2.
[32] National Energy Policy Development Group, *National Energy Policy*, May 2001, p. xv.

disruptions of oil supplies, whilst being heavily dependent on imported oil.[33] Since the late 1940s, every recession in the US has been preceded by sharp increases in energy prices and the economic slow down of 2000 is no exception.[34]

There is also a deep concern in the US over energy security especially vis-à-vis instability in the Persian Gulf, a concern which had arisen long before the '9/11' attacks. When the political and economic situation in the Persian Gulf is uncertain, security of oil supplies becomes a major issue, and remedies are sought.[35] With tensions high in the Middle East, chances are greater than at any time in two decades of an oil supply disruption that would severely test US security and prosperity.[36] A trend toward anti-Americanism could affect the ability of regional Gulf leaders to cooperate with the US in the energy area.[37] The strained relationship between the US and its traditional Saudi ally in the Gulf is one reason for this deep American concern over oil supply from the Gulf. The high dependence on imported oil from this region leads to significant economic and strategic ramifications for the US.[38]

Leaders in both Saudi Arabia and the US have perceived uninterrupted oil supplies as one of the most important elements of global energy security and the development of the world economy.[39] Indeed, in addition to their already troubled relations with some countries in the Middle East such as Iraq and Iran, the rising uncertainty over continued strategic reliance on Saudi Arabia has forced high-ranking policymakers to reevaluate energy security in the new international political context.[40] Persistent political instability in the Middle East signifies an unrelenting risk of another oil price shock.[41] There is concern too that within OPEC there is a limited 'playing field' due to the sanctions in place on potentially powerful members of the organization, leaving the role of constraining production in the hands of only a few other members.[42]

2.3. Conclusion

A clear problem for much of the oil-importing part of the world, in particular for the US, is the fact that so many oil exporting countries are not investing enough in their upstream oil sectors to expand production capacity. These countries, such as Kuwait and Saudi Arabia, have consistently refused to allow foreign investment in their oil sectors. Similarly, other producing countries wish to exclude US influence and domination in their upstream oil sectors yet they do not have the necessary financial resources to invest in their oil production infrastructures on their own.[43] Although OPEC's grip on global supplies has diminished somewhat over time since the 1970s, this will change again in the future as the world becomes more and more dependent on oil supplies from the Persian Gulf as non-OPEC sources mature.[44] Given the above information and projections, what one can see is a future, long-term, decrease in the diversity of oil supplies. The vast majority of incremental world oil demand can only be met over time by those countries with the largest reserves.[45]

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[33] Ibid., p. 13.
[34] G. Bahgat, *American Oil Policy in the Persian Gulf and the Caspian Sea*, (Gainesville: University of Florida, 2003), p. 2.
[35] CIEP, Study on Energy Supply Security and Geopolitics (The Hague: CIEP, 2004) p. 56.
[36] James A. Baker 3 Institute for Public Policy of Rice University and the Council on Foreign Relations, Independent Task Force on Strategic Energy Policy, *Strategic Energy Policy: Challenges for the 21st Century*, no. 15, April 2001, p. 1.
[37] Ibid., p. 3.
[38] G. Bahgat, (2003), 'The new geopolitics of oil: The United States, Saudi Arabia, and Russia', *Orbis*, vol. 47, no. 3, pp. 447 - 461.
[39] G. Bahgat, *American Oil Policy in the Persian Gulf and the Caspian Sea*, (Gainesville: University of Florida, 2003), p. 43.
[40] CIEP, Study on Energy Supply Security and Geopolitics, (The Hague: CIEP, 2004), p. 47.
[41] Ø. Noreng, *Crude Power, Politics and the Oil Market* (London: I.B. Tauris & Co. Ltd., 2002), p. 7.
[42] James A. Baker 3 Institute for Public Policy of Rice University, The Political, Economic, Social, Cultural, and Religious Trends in the Middle East and the Gulf and Their Impact on the Energy Supply, Security and Pricing, no. 3, April 1997.
[43] M.T. Klare, 'Les vrais desseins de M. George W. Bush', *Le Monde Diplomatique*, janvier – février 2003.
[44] CIEP, Study on Energy Supply Security and Geopolitics (The Hague: CIEP, 2004), p. 55.
[45] G. Bahgat, (2003), 'The new geopolitics of oil: The United States, Saudi Arabia, and Russia', *Orbis* 47, pp. 447 - 461.

'...The Middle East with two thirds of the world's oil and the lowest cost, is still where the prize ultimately lies, even though companies are anxious for greater access there, progress continues to be slow.' – Richard Cheney, today US Vice President, during a lecture at the *London Petroleum Institute* in 1999.

3

Evolution of US energy strategy and Iraq

In the aftermath of the 1991 Gulf War, it had become undeniably clear that the US stood supreme as the world's only remaining superpower. Despite this fact, the US has gradually been loosing its grip on the Persian Gulf region since 1991, principally due to its steadily weakening relationship with its most important ally in the region, Saudi Arabia. On the one hand, the September 11th attacks worsened this trend. On the other hand, they gave the Bush administration enormous political clout to help justify various military operations aimed primarily at securing access to oil. As the world's largest consumer of oil, with an economy implacably dependent on this resource, the US had to alter its strategy to ensure access to it.

The fear of running out of oil or losing access to it has been a continuous driving force, providing logic for seeking privileged positions and denying access to rival powers.[46] The control of and access to oil is a strategic prerequisite to the preservation of a modern hegemony. In recent years, an increasing number of US government leaders have begun to worry over instability in the Middle East and the security of oil supply. The controversy over Iraq in the UN Security Council in the run-up to armed intervention by US and UK forces in March 2003 epitomizes this battle over how best to secure Middle East energy flows in the future.[47] The safe supply of energy from the Middle East is a vital interest to US foreign policy and a matter of national security.

3.1. US strategy in the Persian Gulf

From the very beginning, US involvement in this region has been coupled with oil interests and every major US incursion there has always been over oil, not democracy or other political ideals.[48] Indeed, acting on the belief that access to Persian Gulf energy was essential to their nations' security; leaders of both the US and the UK have regularly sanctioned the use of force to overcome what were seen as impediments to continued production and supply.[49] Since the 1940s, the US has maintained a policy of restraining unwelcome influence of other foreign powers in the Persian Gulf, even if they were or are Western.

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[46] C. Tugendhat and A. Hamilton, *Oil – The Biggest Business*, (London: Eyre Methuen, 1975), p. 82ff.
[47] CIEP, Study on Energy Supply Security and Geopolitics, (The Hague: CIEP, 2004), p. 46.
[48] General Anthony C. Zinni, Commander-in-Chief of the US CENTCOM once testified that 'America's interests in [the Gulf] are long-standing, with over 65 percent of the world's oil reserves located within the Persian Gulf states;' the US and its allies 'must have free access to the region's resources.' This statement characterizes the nature of US involvement in the region, and hints at its willingness to use force if necessary. This statement was prepared before the Senate Committee on Armed Services, Washington D.C., April 13th 1999, as released by the Federal Information Systems Corporation and distributed electronically by the Congressional Information Service via Lexis-Nexis.
[49] M.T. Klare, *Resource Wars: The New Landscape of Global Conflict*, (New York: Henry Holt and Company, 2001), p. 53.

As early as 1943, President Roosevelt first articulated the principle of securing Gulf oil supplies and authorized the delivery of military assistance to Saudi Arabia. US companies were already active in the Kingdom at that time and since then unlike in other OPEC countries, (as they became in 1960) oil explorations and developments have been carried out almost exclusively by American firms.[50] The fear of Soviet control in the Middle East was so great that in 1949, US President Truman approved a detailed plan, known as NSC directive 26/2, to store explosives near oil fields to be able to deny access to the oil fields in the event of a Soviet invasion. In the wake of Britain's retreat from the Persian Gulf by 1971, American strategists saw the need to assume primary responsibility for the region.[51]

At a time when the US was still involved in its vaunted defense of South Vietnam, the decision to go ahead and send military units to the Gulf region posed a major dilemma for US strategists, including Henry Kissinger who headed the NSC and US President Nixon. Control of at least one large Gulf country is necessary, or at least desirable, in order to influence and control the region. The US chose such an approach as part of a 'Surrogate Strategy' – a policy of using friendly local powers to serve as protectors of Western interests with substantial US military assistance and strategic guidance.[52] In effect, these countries would serve as vassal states for US interests. Brzezinski refers to such states as 'geopolitical pivots', countries 'whose importance is derived not from their power and motivation but rather from their sensitive location…'[53]

This strategy was put into effect as early as 1953, on the heels of British withdrawal from the region. In 1950, the Iranian parliament removed the pro-Western shah's powers and in 1951 a radical nationalist government nationalized the British-controlled oil industry. The Iranian regime managed to resist British attempts at subversion and it took a US-backed coup in 1953, organized by the CIA, to re-install the shah, effectively moving Iran into the US sphere of influence.[54] Similarly, a nationalist coup against the pro-British monarchy in Iraq in 1958 threatened to nationalize the Iraq Petroleum Company[55] in 1963.

Once again, the CIA engineered what it called its 'favorite coup' against this nationalist Arab regime. The US effectively installed the Ba'ath party in Iraq during this coup. By the early 1970s, Iran and Saudi Arabia had close ties to the US while Iraq developed links with France and the USSR.[56] In this manner, the US had established a good hold on the Gulf without having to deploy significant military forces by controlling Saudi Arabia and Iran, while Iraq was in the Soviet and French spheres of influence. In 1979 the entire situation altered fundamentally when in January that year, the shah was overthrown due to popular discontent.

The rise of Ayatollah Khomeini and his Islamic rule in Iran after the shah's sudden departure forced a major re-assessment of US strategy in the region.[57] This event also caused the oil price spike of 1979 – 1980 and the resulting oil crisis. Ever since that year, the US has perceived Iran as a direct threat to its interests in the Gulf, not least because it guards the Strait of Hormuz, the main artery for international oil flows and the only way out for oil exports from the Gulf. The US also saw Iran as an ideological threat to US positions in the Gulf as well as oil supplies.[58] Therefore, the US has tried, via many different methods, to isolate Iran; containing Iran became imperative for US oil interests in the Middle East.[59] When Saddam Hussein rose to power in Iraq in 1979, he was seen by US policy makers as an ideal bulwark against revolutionary Iran.

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[50] G. Bahgat, *American Oil Policy in the Persian Gulf and the Caspian Sea*, (Gainesville: University of Florida, 2003), p. 43.
[51] M.T. Klare, *Resource Wars: The New Landscape of Global Conflict*, (New York: Henry Holt and Company, 2001), p. 59.
[52] Ibid,, p. 60.
[53] Z. Brzezinski, *The Grand Chessboard*: *American Primacy and its Geostrategic Imperatives*, (New York: Harper Collins, 1997), p. 41.
[54] Ø. Noreng, *Crude Power, Politics and the Oil Market* (London: I.B. Tauris & Co. Ltd., 2002), p. 59.
[55] This was the foreign consortium which exploited Iraqi oil throughout the 1950`s.
[56] Ø. Noreng, *Crude Power, Politics and the Oil Market* (London: I.B. Tauris & Co. Ltd., 2002), p. 59.
[57] M.T. Klare, *Resource Wars: The New Landscape of Global Conflict*, (New York: Henry Holt and Company, 2001), p. 60.
[58] Ø. Noreng, *Crude Power, Politics and the Oil Market*, (London: I.B. Tauris & Co. Ltd., 2002), p. 78.
[59] Ibid., p. 50.

The US abandoned its Surrogate Strategy and assumed direct responsibility for stability in the region. Saudi Arabia, the last US vassal state in the region was too weak to defend itself and the US chose to set up the RDF in 1980 under the Carter Administration, and under Reagan this was re-designated as CENTCOM in 1983.[60] Initially, both initiatives were designed to repel a hypothetical Soviet invasion of the Gulf region. Assisting the Mujahedeen fighters in their struggle against the USSR after it invaded Afghanistan in 1979 was part of this strategy of undermining Soviet influence in the region.

The US chose to temporarily support Iraq when it went to war in 1980 with the new arch enemy of US interests, Iran. The US even took Iraq off its list of countries sponsoring terrorism in 1982.[61] However, the US could not allow any one single power to dominate the region, yet France and the USSR were supplying Iraq with weapons and other materials. Indeed Iraq had become quite strong, so that by the late 1980s US strategists had already begun to worry about Saddam Hussein's regime, even while they supported it against Iran. The Iran-Iraq war briefly satisfied US interests as the two key countries in the Gulf not under US control fought each other and thus kept each other in a weak state. The US supported Saddam Hussein's regime and he was supplied with finances, weapons and protection against attempts at a coup d'état.[62]

Saddam Hussein emerged from the Iran-Iraq war with an ambition to lead the Arab world.[63] By 1990, Iraq had recovered from its war with Iran and proceeded to invade Kuwait. By occupying Kuwait, Iraq effectively controlled about one fifth of the world's oil reserves, a situation unacceptable to US interests. Under a UN mandate, a US-led coalition threw back Iraqi forces from Kuwait during the Gulf War in 1991. The collapse of the USSR made it easier for the US to deal with Iraq. Iraq's shifting alliances was a key to the region's instability while its position in its rivalry with Iran and Saudi Arabia affected the supply of oil and thus also the oil market.[64] Iraq was already a crucial player in the regional and global oil industry.[65]

In 1993, the US embarked on a policy of 'dual containment' in an effort to constrain both Iraq and Iran, two countries still not within the grasp of the US sphere of influence.[66] Simultaneously the US protected its own geopolitical pivot, Saudi Arabia. But 'dual containment' as practiced under the Clinton Administration ultimately proved unsatisfactory to US interests. In an effort to restrain French and Russian influence in Iraq and Iraqi power itself, the US persistently upheld UN sanctions on Iraq. At the same time, Iraq was repeatedly bludgeoned with air strikes throughout the 1990s.

As part of the policy of 'dual containment', both the US and the UK used various forms of 'coercion' to keep Saddam Hussein in check. Forms of coercion may include sanctions for instance. Generally however, coercion as such is the 'threat of future military force to influence an adversary's decision-making but may include limited uses of actual force.'[67] More specifically, it consists of compelling the adversary in question to act the way one wants him to act by using anything short of brute force whilst leaving him with enough strength to exert violence, but which option the latter then chooses not to exercise.[68]

Indeed, throughout the 1990s, things had changed in the Persian Gulf. Diplomatically, the US was finding itself increasingly isolated along with Israel.[69] Despite the UN 'oil-for-food' program and further US

[60] M.T. Klare, *Resource Wars: The New Landscape of Global Conflict*, (New York: Henry Holt and Company, 2001), p. 61.
[61] G. Bahgat, *American Oil Policy in the Persian Gulf and the Caspian Sea*, (Gainesville: University of Florida, 2003), p. 74.
[62] During the Contra scandal of the early 1980s, it became clear that the US actually also supplied Iran with weapons in its war with Iraq.
[63] G. Bahgat, *American Oil Policy in the Persian Gulf and the Caspian Sea*, (Gainesville: University of Florida, 2003), p. 74.
[64] Ø. Noreng, *Crude Power, Politics and the Oil Market* (London: I.B. Tauris & Co. Ltd., 2002), p.55.
[65] G. Bahgat, *American Oil Policy in the Persian Gulf and the Caspian Sea*, (Gainesville: University of Florida, 2003), p. 74.
[66] M.T. Klare, Resource Wars: The New Landscape of Global Conflict, (New York: Henry Holt and Company, 2001), p. 66.
[67] D. Byman and M. Waxman, The Dynamics of Coercion, (Cambridge, UK: Cambridge University Press, 2002), p. 3.
[68] T. C. Schelling, *Arms and Influence*, (New Haven: Yale University Press, 1996), p. 3.
[69] At the Teheran summit of 1998 for instance, the US and Israel were the ones being isolated, not Iran and Iraq as was the intention of the US at its own sponsored summit in Qatar that year.

efforts to isolate Saddam Hussein, France and Russia continued to enhance their ties with Iraq. Since 1997, Russia has exhibited more interest in the Middle East, specifically in renewing links with Iraq.[70] Recently Iran has also established good relations with Germany and possibly other European powers.

By 2001, the domestic and foreign policy interests of US allies in the region were perceived to be at odds with American strategic interests as they have become decreasingly inclined to lower oil prices in exchange for security of markets.[71] To be sure, the need to keep a distance from the US for the sake domestic political balancing may have induced Saudi Arabia to be a less compliant residual oil supplier.[72] Growing anti-Americanism throughout the Middle East led to the '9/11' attacks. Those attacks, together with a new Bush Administration, fundamentally changed the dynamics of Gulf geopolitics and led to a renewed US effort to pursue its strategic objectives, which can be seen as extensions of the evolution of affairs discussed above. American strategy in the Gulf, based on new security of oil supply concerns, entered a new chapter.

3.2. Plausible US strategic objectives in Iraq

To be sure, there are prominent members in the Bush Administration who have a long history in the oil business.[73] But what would motivate any country, government or political head of state to embark on such a dangerous military and political adventure?[74] The complex nature of Iraqi politics and the status of its oil industry are such that it is rather difficult for the US to exercise control and/or monopoly over that sector, even if it genuinely planned to do so.[75] Establishing a lasting pro-US regime in Baghdad and bestowing upon on it regional influence satisfies a number of plausible and legitimate strategic objectives for the US:

1) It provides the US and the governments which actively assisted the US in the war and its aftermath with an opportunity to finally open up Iraq for foreign investment and development. On the issue of future high US demand for imported oil, a *Baker Institute Study* published in April 2001 by an independent task force on strategic energy policy writes: 'In order to satisfy this demand, reliance on volatile Middle East oil resources could increase dramatically over the next two decades unless policies are put in place to promote oil development in other regions...' and the report further recommended to 'set the groundwork to eventually ease Iraqi oil field investment restrictions'.[76]

Anglo-US oil companies and oil services firms would finally be able to tap into this new oil source which has been denied to them for so long. The US government has consistently supported its private oil industry in seeking a foothold and benefits in foreign oil provinces.[77] This would open up a vast untapped amount of oil to the world market which had earlier on been inaccessible. The Iraqi oil sector has long been off-limits for Anglo-American oil companies due to years of sanctions, political turmoil, war and of course, Saddam Hussein's regime.

2) Not only is there an interest to open up Iraq for investment and development as such. As was mentioned earlier on, the US holds a direct interest in diversifying its sources of oil imports. Installing a pro-US regime in Iraq would also provide the US with a further large new source of oil, further diversifying its imports. Extreme concern prevailed in the US administration over supply disruption from the region. In the long-run, the US hereby enhances its energy security in the Persian Gulf. It is worthwhile to note that

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[70] Ø. Noreng, *Crude Power, Politics and the Oil Market*, (London: I.B. Tauris & Co. Ltd., 2002), p. 72.
[71] James A. Baker 3 Institute for Public Policy of Rice University and the Council on Foreign Relations, Independent Task Force on Strategic Energy Policy, *Strategic Energy Policy: Challenges for the 21st Century*, no. 15, April 2001, p. 3.
[72] Ø. Noreng, *Crude Power, Politics and the Oil Market* (London: I.B. Tauris & Co. Ltd., 2002), p. 102.
[73] P. Sperry, *Crude Politics*, (Nashville: WND Books, 2003), p. xiii.
[74] In one of his analyses, William Nordhaus estimated that the cost of a war with Iraq would be around $1.9 trillion in a worst case scenario. See W. Nordhaus et al., *War With Iraq: Costs, Consequences and Alternatives*, (Cambridge: American Academy of Arts and Sciences, 2002).
[75] W. Khadduri, 'Iraq: Future of the Oil Industry' in C.P. Hanelt, G. Luciani and F. Neugart (eds.), *Regime Change in Iraq: The Transatlantic and Regional Dimensions*, (San Domenico di Fiesole: Bertelsmann Foundation, December 2003), p. 84.
[76] James A. Baker 3 Institute for Public Policy of Rice University and the Council on Foreign Relations, Independent Task Force on Strategic Energy Policy, *Strategic Energy Policy: Challenges for the 21st Century*, no. 15, April 2001, pp. 2-6.
[77] G.P. Nowell, *Mercantile States and the World Oil Cartel 1900 - 1939*, (New York: Cornell University Press, 1994) p. 112ff.

over 10 percent of US oil imports during the months leading up to the second Gulf conflict of 2003 came from Iraqi oil fields.[78]

3) The same *Baker Institute Study* mentioned in point 1) is very telling and goes on several pages later to say that 'the resulting tight markets [referring to market circumstances at the time] have increased US and global vulnerability to disruption and provided political adversaries undue potential influence over the price of oil. Iraq has become a key "swing" producer[79], posing a difficult situation for the US government.'[80] Indeed, 'political adversaries' such as the French, Russians and Chinese *were* developing close ties with Iraq and were furthering their own oil interests. In this pursuit of interests, Anglo-US firms were being excluded.

This made the US vulnerable to the influence of those adversaries as Iraq was already recognized as being a potential new swing producer capable of having a marked effect on the oil market and prices. Chinese companies for instance, would not have made Iraqi oil available to the world market, but would have monopolized it entirely, for China has a voracious economy in desperate need of oil. By replacing Saddam Hussein's regime with a pro-US government, the US has not only effectively put these relations between Iraq and its former supporters on hold. With UN sanctions no longer in place, Anglo-US oil firms are thus provided with an ideal platform for lucrative concessions in the upstream Iraqi oil sector (particularly if a pro-US government is in place).[81]

The US may even deny its political adversaries access to oil reserves altogether; after all, the legal status of the contracts, which were to be signed by Saddam Hussein and his political supporters, has been obfuscated.[82] There is thus a big chance that Iraq's new allies such as the US, the UK and the Netherlands, stand to gain these concessions. As a matter of fact, the French oil giant *TOTAL*, one of the potential big winners if Saddam Hussein had stayed in power, already voiced its reticence at bidding for the Kirkuk and Rumailah oil fields.[83] The key is that installing a pro-US regime would vastly shift bargaining power to Anglo-US firms and create a level playing field for oil investments in Iraq's upstream oil sector.

4) The US was in effect losing its grip on the Persian Gulf region, especially in comparison to 1991 when it had committed itself fully to the Gulf. Due to the political circumstances recently prevailing in the Persian Gulf, and the apparent diplomatic marginalization of the US and Israel, there was a growing fear in both countries that Iraq might strengthen further and develop good ties with Saudi Arabia and Iran at the expense of the US. This would have had an immense impact on the oil market.

After all, pan-Arab collusion on the oil market, as in the 1970s, would have undermined the US goal of stable and low oil prices in the long-run. The *Baker Institute Study* recommended a 'Review [of] Iraq policies to lower anti-Americanism in the Middle East and elsewhere...'[84] Some had already voiced attacking Iraq before it was too late.[85] 'Dual containment' via coercion techniques was unsuccessful in isolating Iraq.

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[78] P. Roberts, *The End of Oil, The Decline of the Petroleum Economy and the Rise of a New Energy Order*, (London: Bloomsbury Publishing, 2004), p. 4.
[79] The term 'swing' producer in the oil market is described by Griffin and Teece as 'the "balance wheel"…absorbing demand and supply fluctuations in order to maintain the monopoly price.' See J.M. Griffin, and D.J. Teece (1982), 'Introduction'. In: J.M.Griffin and D.J.Teece (eds.), *OPEC Behavior and World Oil Prices*, (London: George Allen and Unwin, 1982), p. 27.
[80] James A. Baker 3 Institute for Public Policy of Rice University and the Council on Foreign Relations, Independent Task Force on Strategic Energy Policy, *Strategic Energy Policy: Challenges for the 21st Century*, no. 15, April 2001, pp. 2-3.
[81] Traynor et al., *Baghdad Bazaar: Big Oil in Iraq*, Deutsche Bank, October 2002, p. 14.
[82] Volkskrant, 'Wedloop naar olie in Irak komt op gang', July 17th 2004.
[83] CNN Money, 'Companies bid to measure Iraq's oil', August 4th 2004. Also see Petroleum Intelligence Weekly, 'Majors step lightly around Iraqi opening', August 16th 2004.
[84] James A. Baker 3 Institute for Public Policy of Rice University and the Council on Foreign Relations, Independent Task Force on Strategic Energy Policy, *Strategic Energy Policy: Challenges for the 21st Century*, no. 15, April 2001, p. 6.
[85] Ø. Noreng, *Crude Power, Politics and the Oil Market* (London: I.B. Tauris & Co. Ltd., 2002), p. 4.

5) Firm control of at least one of the three major Gulf states (Iran, Iraq and/or Saudi Arabia), as mentioned, is a prerequisite for further domination of the Persian Gulf. Of particular concern to the US was its weakening relationship with its traditional ally, Saudi Arabia. The extensively destabilizing anti-American sentiments there were of acute concern to the US Administration (see also point 4). Combining this trend with Iraq's close ties to France, Russia and China and Iran's *rapprochement* to other political adversaries such as Germany, there was a real danger that the US faced the long-term prospect of having to leave the Gulf altogether.[86] Naturally, installing a pro-US regime in Iraq would restore control of the Persian Gulf to some degree. Iraq would hereby provide the US with a new geo-strategic pivot *à la Brzezinski,* pivots which according to Brzezinski 'in some cases gives them a special role either in defining access to important areas or denying resources to a significant [geo-strategic] player.'[87] This relates directly to point 3). Such a new vassal state would also give the US further strategic leverage in the region.

6) Iraq still remained a threat to its neighbors insofar as it could unpredictably destabilize the oil market by using oil as a political weapon or commit yet further physical aggression by conventional military means. It persistently did use oil as a weapon, and removing Saddam Hussein eliminated this destabilizing factor in the oil market. Iraq, even when operating at far under its production potential, was already an important power in the oil market. Oil market stability in the future required the replacement of the Iraqi regime by preventing it from dominating the Gulf, and in particular, the oil market.[88]

Removing Saddam Hussein from power also meant that no more 'dual containment' would be necessary. The US did not have to face the dilemma anymore, on the one hand of having to allow Iraqi oil shipments to the oil markets whilst, on the other hand, of facing the threat of Saddam Hussein wanting to change the status quo of the region due to territorial or other disputes.[89] The added benefit was to remove a relatively minor military threat but in particular, prevent Iraq from regaining too much strength by cooperating with 'political adversaries' of the US.

Refer to Figure 3.1 below. Acquiring Iraq and installing a pro-US regime there almost completes US dominance not only of the Persian Gulf region, but it would also have a major impact on the Caspian Sea region, another energy-rich area of the world. The US can, in the long-run, put further pressure on its arch enemy in the region, Iran. Iran happens to be an ideal transit route for Caspian oil and gas to the Gulf.[90]

[86] Ibid.
[87] Z. Brzezinski, *The Grand Chessboard*: *American Primacy and its Geostrategic Imperatives*, (New York: Harper Collins, 1997), p. 41.
[88] Ø. Noreng, *Crude Power, Politics and the Oil Market* (London: I.B. Tauris & Co. Ltd., 2002), p. 12.
[89] G. Bahgat, *American Oil Policy in the Persian Gulf and the Caspian Sea*, (Gainesville: University of Florida, 2003), p. 75.
[90] N. Dolay, 'Grandes manœuvres dans le Caucase', *Le Monde Diplomatique*, July 1995.

Figure 3.1: Map of the Persian Gulf region

Source: Central Intelligence Agency (CIA)

Finally, with its enormous potential reserves (see Chapter 4), an Iraq under US influence can help moderate OPEC oil prices in the future, even if other OPEC members follow an opposite policy of maintaining high oil prices for their own interests. Iraq's dormant oil power may in the future enable the US to dismantle the OPEC decision-making mechanism, which is, at least in theory, based on raw cartel power. The US in particular knows that it will become increasingly dependent on the Persian Gulf OPEC members for its oil imports. The US (and other consuming blocs) is also aware that non-OPEC reserves are bound to wane in the long-run; it thus has a direct interest in having the power to undermine OPEC pricing policies and its bargaining power. After all, undermining OPEC has been an objective of the US since the Clinton Administration.[91] A *Baker Institute Report* from as early as 1997 concluded that 'a host of factors, including sanctions policy, has limited the playing field within OPEC, leaving the role constraining production in the hands of only a few members.'[92] Furthermore, the US not only has an interest in moderate oil prices today, but increasing access to oil at moderate prices in the future.[93]

[91] CIEP, *Study on Energy Supply Security and Geopolitics,* (The Hague: CIEP, 2004), p. 209.
[92] James A. Baker 3 Institute for Public Policy of Rice University, *The Political, Economic, Social, Cultural, and Religious Trends in the Middle East and the Gulf and Their Impact on the Energy Supply, Security and Pricing*, no. 3, April 1997, p. 1.
[93] Ø. Noreng, *Crude Power, Politics and the Oil Market*, (London: I.B. Tauris & Co. Ltd., 2002), p. 73.

3.3. Conclusion

The US is the world's largest oil consumer and sees access to oil as an object vital to its national security. Its present and rising dependence on Persian Gulf oil makes top US strategists uncomfortable with the idea of having a weak grip on the region; control of the Middle East is hence a key issue.[94] A key geopolitical conclusion one may draw from this discussion is that the regime change in Iraq was carried out to ensure a US-UK sphere of influence in one of the last great oil provinces in the Middle East. From a realist perspective, this was done to remain a few steps ahead of Chinese and Russian moves in the region. With an Iraq under US influence, the US will indirectly have a strong hand in OPEC policy-making, partially through the privatization of the Iraqi oil sector (see Chapter 5). A concentration of bargaining power in the hands of only a few major OPEC producers is against US interests in the long-run.

[94] Ibid, p. 75.

'In politics there are no love affairs, only interests.'
– Kurt v. Schuschnigg, Austrian Chancellor 1934 - 1938, reflecting after the war on the failure of the Western powers to help Austria at the time of the *Anschluss* by Germany in 1938.

4

Geopolitics, the Persian Gulf, OPEC and Iraqi oil

Since the discovery of oil in the Persian Gulf, the region has experienced major upheavals and clashes between local players and foreign ones. As with most scenes of international power politics, the vying for control in the Persian Gulf is about creating spheres of influence. Often foreign powers have done so by supporting or antagonizing local regimes and governments, or by pitting them against each other in order to protect their own interests in the region. Geopolitics is a major driving force in the world oil market and, more decisively, in the functioning of the OPEC cartel.

Hence the Persian Gulf region and the Middle East more broadly have traditionally been the scene of a host of great power and at the same time local rivalries.[95] Since the end of the 20th century competition between the great powers has increased, further complicating an already precarious and unstable part of the world. The evolution of US strategy in the region since the 1940s bears witness to the extensive foreign involvement in the Gulf. This volatile region will continue to play a central part in supplying the world's demand for oil well into the foreseeable future.

This poses a major problem for the world's oil-dependent states, which have to rely on various means and policies to ensure the free flow of oil from this region. Leading oil-importers naturally have a common interest in oil price moderation, yet they are also rivals for supplies, trading positions and influence.[96] This means access to and control of oil through strategically located countries will become increasingly important in the future. In discussing the fundamentals of access to and control of resources, one touches upon the realm of geopolitics. This spectrum of international affairs concerns itself primarily with the struggle between rival powers for control over territory, natural resources, vital geographic features and other sources of military and economic advantage.[97] This is a natural result of the fact that oil and gas deposits are unevenly distributed, often along borders or disputed areas.

In this geopolitical contest, the US, Russia and China–and to a lesser extent India, Japan and the large EU member states–are the major geopolitical players, each one pursuing different strategies to gain leverage in energy-rich parts of the world. The '9/11' attacks have further provided an ideal foreign and security policy platform upon which the US can secure strategically sensitive areas ahead of China and at the expense of Russia. Containing China's rapid expansion is a reason for which the US is gradually re-deploying its military and naval strength from Europe to the Pacific and Central Asia.[98] US global power allows the US to pursue long-term energy security strategies, in which short and medium–term coalitions

[95] As early as 1798, the UK and France were in military (and naval) conflict in the Middle East during the rise of imperialism.
[96] Ø. Noreng, *Crude Power, Politics and the Oil Market*, (London: I.B. Tauris & Co. Ltd., 2002), p. 15.
[97] M. T. Klare, *Blood and Oil*, (New York: Metropolitan Books, 2004), p. 147.
[98] R. D. Kaplan, 'How we would fight China', *The Atlantic Monthly*, June 2005.

with other powers play a key tactical role.[99] Meanwhile, the IOCs have expended much effort to establish firm toeholds in valuable non-OPEC oil exploration and production projects throughout the 1990s.

While the US is the preponderant force in the Persian Gulf, the other two major geopolitical players, China and Russia, have been seeking to maintain some form of influence there too. Great powers will tend to prevent rival great powers from dominating the wealth-generating areas of the world and will attempt to occupy those regions themselves.[100] Chris Toensig, an analyst at the *Middle East Research and Information Project*, says that 'by controlling the Gulf and the Middle East, the United States gains leverage over countries that are more dependent on the Gulf for oil, like China and Europe [and Japan].'[101] Without a doubt, the major consumer countries have begun to worry about the future structure of supply, when non-OPEC supplies begin to decline.[102]

4.1. Change in the Persian Gulf

The Persian Gulf has been profoundly shaken by various events in its recent history and recent economic trends have further undermined the region's stability. The region faces persistent economic uncertainties and demographic problems which have begun to emerge over the last two decades. The September 11th attacks gave the region's instability a new dimension. Political instability can be a major barrier to investment and the oil and gas industries are subject to acute geopolitical risks and uncertainties.

Prior to Saddam Hussein's removal from power and earlier still, rivalry within the Persian Gulf has consisted of a four-cornered structure where on the one end Iraq and Iran compete for dominance, each occupying one corner of the structure.[103] On the other end of the structure there were the upper Gulf countries, who have favored Iran for fear of Iraq and the lower Gulf countries who favored Iraq for fear of Iran, each group occupying its own corner. In the mean time some smaller Gulf countries resent Saudi dominance and its open alliance with the US. The removal of Saddam Hussein from power has completely altered this four-cornered balance of power. The main catch is that essentially, for any large external power, control of and/or influence in one of the three big Gulf countries – Iraq, Iran and/or Saudi Arabia – is vital in order to control the Gulf. It is even preferable to control two of the three if possible. All three of these countries are the biggest players at the heart of OPEC's powerhouse, the Persian Gulf.

The oil exporting countries of the Persian Gulf are popularly thought to be wealthy nations facing minor economic difficulties due to the size of their oil revenues. Contrary to such popular belief, the oil exporting countries have already experienced economic difficulties and will do so increasingly in the future, notwithstanding enormous revenues due to very high oil prices over the last two years. Since the early 1980s, economic growth has begun to slip while population figures have been rising steadily. War and sanctions have already seriously affected key oil exporters such as Libya, Iraq and Iran. Most states in this area of the world are ruled by authoritarian and repressive regimes whose economies are either weak or undiversified or both because of their over-dependence on oil revenues, as has been the case for decades past.

Since the oil boom of the late 1970s, economic development has been very poor in these countries while population growth has simultaneously been rising. In fact, low oil revenues in the late 1990s have affected every major oil and gas producer in the Middle East and have reduced the region's ability to maintain both welfare payments and short-term investment. Some key Middle Eastern governments were even entering their tenth year of budget deficits as late as 1999.[104] Investment needs up to 2030 in the Middle East

[99] CIEP, *Study on Energy Supply Security and Geopolitics*, (The Hague: CIEP, 2004), p. 211
[100] J. Mearsheimer, *The Tragedy of Great Power Politics*, (New York: W. W. Norton and Co., 2001), p. 144.
[101] R. Burbach, 'Bush ideologues trump big oil interests in Iraq', *Redress Information and Analysis*, see http://www.redress.btinternet.co.uk/rburbach21.htm, September 2003.
[102] CIEP, *Study on Energy Supply Security and Geopolitics*, (The Hague: CIEP, 2004), p. 51.
[103] CSIS, *Geopolitics and Energy in the Middle East*, September 1999, p. 33.
[104] Ibid., p. 3.

energy sector are projected to be $1 trillion, representing a massive burden for the economies in this region.[105]

In fact, some observers question whether the Persian Gulf oil exporting countries can continue to finance the energy development they need without privatization and higher rates of foreign investment.[106] The unrelenting population growth and a lack of economic diversification, combined with already existing political tensions inside and outside the region's countries will lead to even more threats to economic and ultimately also political stability. Civil war or grave political instability is not unthinkable in some Persian Gulf countries such as Saudi Arabia, a situation which could potentially halt oil exports or cause significant under-investment in energy export facilities.[107]

The '9/11' attacks have exacerbated an already rising instability and malaise in the Persian Gulf region. The interests of the major powers in Persian Gulf oil are as acute as ever.[108] The most notable change in Persian Gulf geopolitics is the denting of the US-Saudi alliance, one being the largest oil importer and the other being the largest single oil producer. The alliance was based on mutual interests: Saudi Arabia needed US military protection and bought US weaponry while the US needed access to the Persian Gulf and its oil. Over the last decades the US and the Saudi elite have had complementary interests in oil, finances, defense and Middle Eastern affairs while Saudi Arabia's oil production policies are central to oil market price formation.[109]

Though the relationship between the two countries has been under strain since before '9/11', the terrorist attacks have brought further tensions as has the war against Iraq in 2003, which in fact is still brewing. This places Saudi Arabia in an awkward position with respect to the US, traditionally its main ally and military protector. Saudi Arabia cannot let itself be drawn too close to the US in the face of its other Arab neighbors and growing anti-Western sentiments on the part of a rising proportion of unemployed youth in its demographic composition. The '9/11' attacks on the US were as much an attack on Saudi Arabia's regime as an attack on its relationship with the US.[110] Saudi Arabia is becoming increasingly unstable due mainly to its domestic problems.

As a result of tensions inside Saudi Arabia and in its relations with the US, the latter has had to operate largely outside Saudi Arabia and its war against Iraq in 2003 was waged on the ground from Kuwait as Saudi Arabia placed restrictions on American military operations. Therefore, the US increasingly perceives Saudi Arabia an unreliable ally in this respect. This reciprocal alienation on behalf of both the US and Saudi Arabia has greatly undermined their alliance.

4.2. The OPEC cartel

The international oil market has progressed through earlier cycles of concentration and dilution, where market players assumed control and were later challenged by competitors.[111] While OPEC's 11 members[112] supply roughly 30% of the world's oil and together possess 75 percent of the reserves, the cartel's true power lies in its control over low-cost *spare production capacity* (the amount of potential production above current levels).[113] The fact that OPEC member countries are asymmetric in terms of reserves, production capacity, economic absorption capacity, and dependency on oil revenues, amongst other

[105] IEA, *World Energy Investment Outlook 2003*, p. 48.
[106] Ibid, p. 41.
[107] CSIS, *Are Energy Wars Still Possible?* February 1999, p. 15.
[108] Ø. Noreng, *Crude Power, Politics and the Oil Market*, (London: I.B. Tauris & Co. Ltd., 2002), p. 5.
[109] Ibid., p. 94.
[110] C. van der Linde, (2003) 'Is Iraq a 'game changer'?'. In: van Staden, A., Rood, J., Labohm, H. (eds.), *Canons and Cannons, Clingendael Views of Global and Regional Politics*, Assen: Van Gorcum, p. 6.
[111] Ibid.
[112] At present, OPEC consists of 11 member states, of which the five most significant ones are located directly in the Persian Gulf region, namely Saudi Arabia, Iraq, Iran, Kuwait, Qatar and the UAE.
[113] V. Fotuhi (Ed.), *Understanding The Oil and Gas Industries*, Fourth Edition, (New York, NY: Energy Intelligence Group Inc., 2004), p. 2.

factors, implies short- and long-run contradictions in their interests as far as desired price and production levels are concerned.[114]

Saudi Arabia, with the largest reserves and the most dominant position in the cartel, tends to act as a *swing* producer. This role entails the ability to rapidly increase or decrease production according to conditions prevailing in the market as well as maintaining the monopoly price. This ability rests on the amount of spare capacity. The role of swing producer, though mostly founded on raw market power and reserves, is a costly one, as it involves the investment in such spare capacity which basically is idle production. The basis for bargaining over oil prices within OPEC can be observed as the correlation between withholding capacity and idle capacity, which determines the strength of those who want higher prices and those that want lower ones.[115]

When oil is held from the market, it enlarges the spare capacity but simultaneously requires higher levels of investments. The cartel members often disagree over market shares or price levels or both as they face shifting oil demand. The low-cost oil suppliers have discretion to adjust volumes of production or prices.[116] The strategy of aiming for market share in importing countries rather than price formation benefits low-cost, large producers but harms high-cost, relatively smaller producers, which do not have the production capacity to follow suit. The inability on the part of the member states to make binding agreements is inherent to the inter-governmental nature of the organization.[117]

Thus, when agreements are reached in the cartel, they are a reflection of a bridge between different economic interests and regional or political concerns.[118] Simultaneously, the geopolitical maneuvers of regional (OPEC) countries, fuelled by foreign interventions further strain the cohesion of the cartel as an economic alliance. Thus, while classic cartel-based interests push the members together, centrifugal forces simultaneously pull the members away from each other. The only periods during which prices were stable were the periods when the Rockefeller monopoly and when the Seven Sisters dominated the industry.

4.3. The lure of Iraqi oil

With the exception of a few major powers in the world, the upstream oil sector of Iraq remained closed for many years since its nationalization in 1972. Before the removal of Saddam Hussein from power in March 2003, Iraq had signed several multi-billion dollar contracts with foreign oil companies from China, France and Russia, amongst other countries. *Deutsche Bank* estimates that the contracts signed for various so-called 'greenfield' projects were worth $38 billion in total.[119] The fact that Iraq was subject to comprehensive trade sanctions in accordance with UNSCR 687 of March 1991 as well as other Security Council resolutions basically meant that Anglo-American firms were legally locked out of Iraq. Furthermore, the ILSA of 1996 further locked out American and British companies from both Iran and Libya too. This vastly reduced further investment opportunities for these companies, while similar constraints were not imposed on their competitors.[120]

The ILSA also discouraged many other non-Anglo-American firms from investing in these countries. Despite the UN sanctions in place on Iraq throughout the 1990s, mainly Russian, French and Chinese oil companies, backed by their respective national governments, *were* prepared to negotiate with the Iraqi regime under the 'oil-for-food' program established under UNSCR 986 in 1996. As it was, their hands were not bound by any sanctions. Saddam Hussein was no fool; it is likely that he strengthened his ties to the Russian, French and Chinese governments through lucrative contractual agreements with their oil

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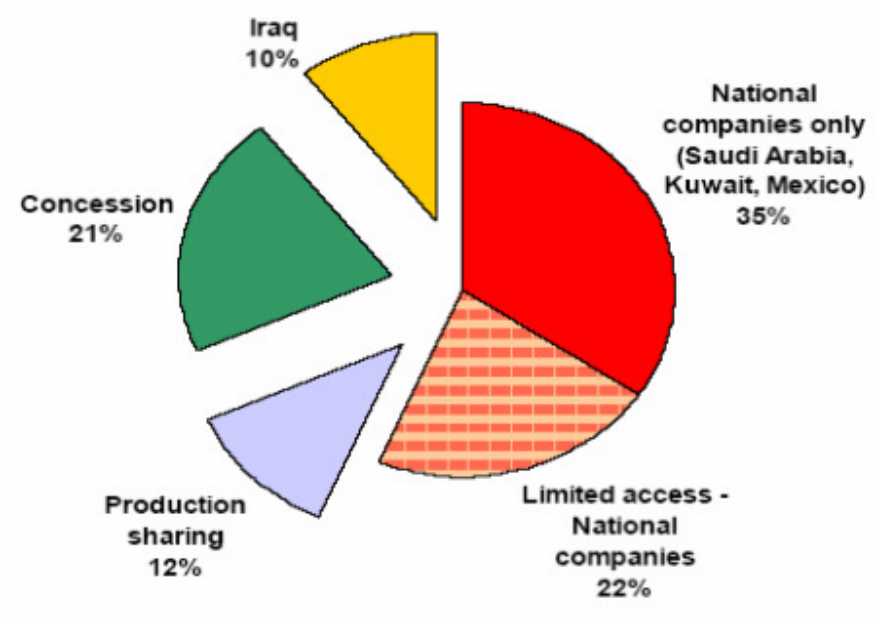
[114] C. van der Linde, *Dynamic International Oil Markets*, *Oil Market Developments and Structure 1860 – 1990*, (Dordrecht: Kluwer Academic Publishers, 1991), chapter 5.
[115] Ø. Noreng, *Crude Power, Politics and the Oil Market*, (London: I.B. Tauris & Co. Ltd., 2002), p. 115.
[116] Ibid., p. 10.
[117] C. van der Linde, *The State and the International Oil Market*, (London: Kluwer Academic Publishers, 1999), p. 73.
[118] Ø. Noreng, *Crude Power, Politics and the Oil Market*, (London: I.B. Tauris & Co. Ltd., 2002), p. 10.
[119] Traynor et al., *Baghdad Bazaar: Big Oil in Iraq*, Deutsche Bank, October 2002, p. 1. And EIA, "Iraq", *Country Analysis Brief*, April 2004.
[120] CSIS, *Geopolitics and Energy in the Middle East*, September 1999, p. xiii.

companies in a bid to win favors in the UN Security Council.[121] The cooperation with French and Russian oil companies was also part of an Iraqi strategy to increase its oil production capacity to 6 mb/d, following the lifting of the UN sanctions.[122]

Figure 4.1: Limited access to oil reserves



Source: IEA, World Investment Outlook 2003, figure 4.18, p. 130.

Figure 4.1 shows the proportion of Iraqi reserves blocked out of the oil market with respect to other types of oil market production sources; 10 percent is a very sizeable amount indeed. The oil available at low-cost to the market, such as the oil in Iraq, was hereby not available for FDI and the IOCs are eager to gain access to these reserves.[123] At any rate, 'The US made overhauling operating fields a priority and says that only an internationally recognized government can initiate development of new fields. […] This policy effectively freezes out, for the indefinite future, countries that were pursuing multi-billion barrel oil projects with Saddam Hussein, including Russia, France and China.'[124]

The *Oil and Gas Journal*, which the EIA uses as a reference, confirms Iraq's 115 billion bbls of proven oil reserves. This means Iraq is in third place in terms of reserves, after Saudi Arabia and Iran. What is more, Iraq never really had the chance to develop as an oil producer. The country's oil deposits are under-explored, under-developed and simultaneously of good quality. Iraq definitely has the potential to increase production by several mb/d, and to what extent and how fast it will be able to do so depends on three factors according to the WEO2004: '(1) How effective the recently appointed Iraqi government proves to be and how successful it will be in restoring law and order, (2) the opportunities for foreign oil companies to invest in Iraq, and the commercial and fiscal terms they might be offered and (3) OPEC policy towards Iraq and Iraq's willingness to accept production quotas.'

Only 17 out of 80 discovered oil fields have been developed in Iraq and it is estimated that only 10 percent of the country has been explored.[125] This means Iraq is potentially the most important new player in the

[121] Traynor et al., *Baghdad Bazaar: Big Oil in Iraq*, Deutsche Bank, October 2002, p. 11.
[122] G. Bahgat, *American Oil Policy in the Persian Gulf and the Caspian Sea*, (Gainesville: University of Florida, 2003), p. 86.
[123] C. van der Linde, 'Olie-industrie aast op nieuwe investeringen', *Energie Nederland*, September 2004.
[124] Petroleum Intelligence Weekly, vol. 42, no. 22, June 2, 2003, p. 1.
[125] EIA, "Iraq", *Country Analysis Brief*, April 2005, available at: http://www.eia.doe.gov/emeu/cabs/iraq.html.

global oil market.[126] Not only does Iraq potentially hold far more oil reserves than current assumptions estimate, but it is also relatively cheap to produce oil there because much of it is located onshore and close to the surface.[127] Privatization in Iraq would allow IOCs to regain some control over the upstream elements of the value chain in the Persian Gulf region.

4.4. Privatization of the Iraqi oil sector

The most likely outcome for the Iraqi oil industry is some form of privatization of the sector – at least a partial one – because of a combination of factors, including overall US involvement on a number of levels and the need for FDI and foreign expertise.[128] The key for the US is to minimize state political influence in the oil sector to an acceptable level and ensure US access to oil policy-making. Some experts believe PSAs will be a likely investment vehicle for oil companies in Iraq.[129] Typically PSA mechanisms lock in tax regimes, clarify resource ownership and ensure payments in fungible exportable assets that are not so vulnerable to fluctuations in exchange rates.[130] Furthermore, they usually provide favorable terms for IOCs, especially in a country such as Iraq where reserves are plenty and extraction costs low. Installing PSAs in Iraq can be described as the wholesale privatization of its oil sector.

Prior to the 2003 invasion, the main US entity planning the new post-war Iraq was the US State Department's *Future of Iraq* project, an initiative which began in April 2002 involving Iraqi exiles and international experts selected by State Department.[131] In December 2004, the interim Iraqi government at the time was planning to pass a new law that would further open Iraq's huge oil reserves to foreign companies.[132] The current government is negotiating contracts with oil companies parallel to the constitutional process, elections and passage of a petroleum law.

As a matter of fact, slowly but surely, amidst the chaos Iraq is still in, the new *Iraqi Oil Ministry* has quietly been drawing up privatization plans while the 'Big Oil' companies have worked hard to build relationships with the Ministry.[133] The new October 2005 Iraqi Constitution, accepted in a referendum by the Iraqi population, states that: 'The federal government and the governments of the producing regions and provinces together will draw up the necessary strategic policies to develop oil and gas wealth to bring the greatest benefit for the Iraqi people, relying on the most modern techniques of market principles and encouraging investment.'[134]

The *Iraqi Oil Ministry* enjoys a certain amount of autonomy, but the US government is likely to 'call the shots'. Ibrahim Bahr al-Uloum, who had been a member of the US State Department's oil working group, was reappointed to the position of minister of Oil in early 2005, after having held the same position under the CPA in 2003.[135] This is no doubt a move designed to extend US influence at the highest level of the

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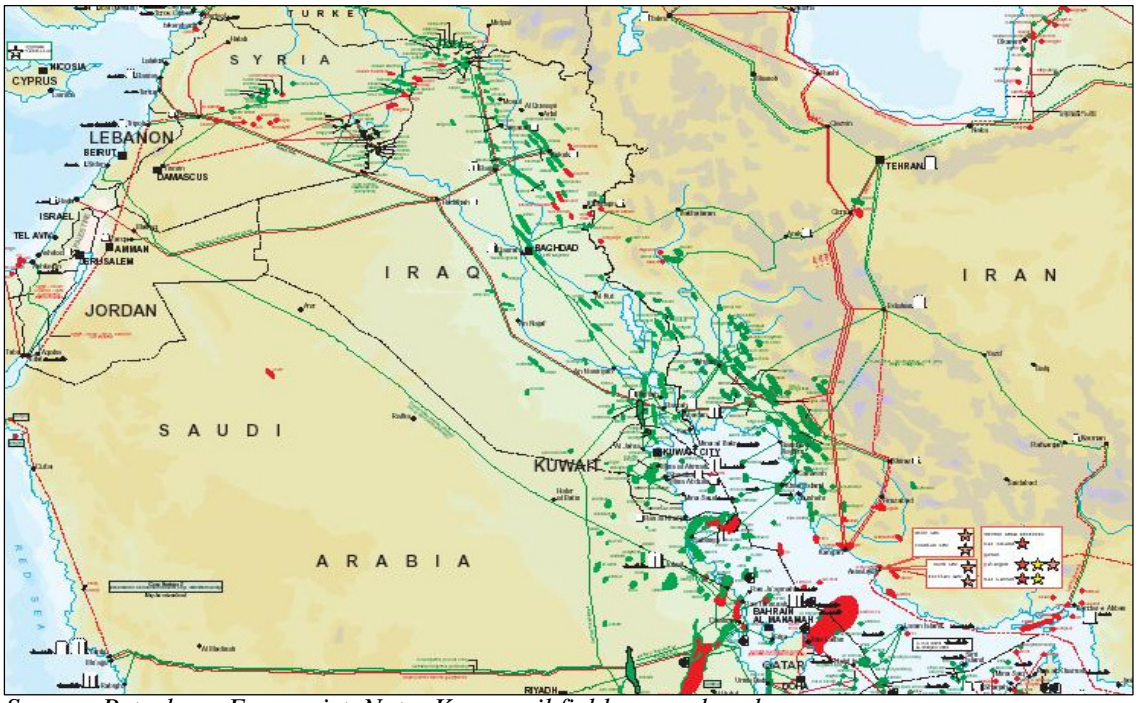
[126] Time Magazine, 'Iraq's crude awakening', May 19th 2003.
[127] According to *Energy Intelligence*, it costs $2.50/bbl to develop oil in Iraq, compared with $4.00/bbl in Saudi Arabia, $4.50/bbl in Iran and $7/bbl in Russia. See V. Fotuhi (Ed.), *Understanding The Oil and Gas Industries*, Fourth Edition, (New York, NY: Energy Intelligence Group Inc., 2004), p. 3.
[128] Michael Smith, a senior analyst at one of the world's largest oil companies, believes that 'the Iraqis will want to attract foreign investment to the upstream oil sector. They are short of everything that foreign investors can bring - capital, expertise, management and the latest technology. In the short-term, they can patch up the existing system and re-complete or drill additional wells with the help of contractors but for anything more complex, e.g., a major new greenfield development, they will need to bring in foreign investors. The fact that they have invited the major companies to get involved in studies of redeveloping the two major fields in the country, Rumaila and Kirkuk, is instructive.'
[129] Michael Smith argues that 'it is quite likely that PSAs will be the vehicle by which foreign investment is attracted to the Iraqi upstream oil industry in the longer term. However, negotiation of such agreements is unlikely to begin until an elected government is in place and it will take some time to develop and agree terms. I think it is unlikely that any PSAs will be signed before the middle of 2006.'
[130] D. G. Victor and N. M. Victor, (2003), 'Axis of oil', *Foreign Affairs*, vol. 82, no. 2, p. 56.
[131] Marc Grossman, Under Secretary for Political Affairs, Testimony before the Senate Foreign Relations Committee, 11 February 2003; Eli J. Lake, 'US plans for post-Saddam Iraqi government', The Washington Times, 5 June 2002.
[132] IPS/Common Dreams, 'US to Take Bigger Bite of Iraq's Economic Pie', December 2004.
[133] Greg Muttitt, 'Crude Designs', PLATFORM, November 2005.
[134] Text of the draft Iraq Constitution, translated by Associated Press, August 28th 2005, article 110.
[135] Greg Muttitt, 'Crude Designs', PLATFORM, November 2005.

Iraqi oil sector. However in late December 2005 he was temporarily removed amid a dispute over the Iraqi government's petrol pricing policy and Ahmad Chalabi took over, for the time being. In the mean time, the latter had been chosen to run the *Energy Council*, which replaced the old *Supreme Council for Oil Policy* as the principal custodian of energy and oil policy in Iraq. Back in 2002, as one of the favorites of the Bush administration to run Iraq, he submitted that 'US companies will have a big shot at Iraqi oil.'[136]

Chalabi voiced in late 2004 that sixty out of Iraq's eighty known oil fields may be explored under PSAs, handing at least 64 percent of Iraq's known oil reserves over to foreign investors.[137] The highly probable privatization of the Iraqi oil sector would signify a re-conquest by the IOCs of ground lost during the nationalization process which took place across the Middle East in the 1960s and early 1970s. Even partial privatization would have profound and long lasting effects on OPEC cartel functioning and decision-making.[138]

Figure 4.2: Map of Iraq and its oil fields



Source: Petroleum Economist. Note: Known oil fields are colored green.

4.5. OPEC and Iraq in a future context

A natural question which arises at this point and is, indeed, a fundamental one is how a strong and stable Iraq, operating at its full potential might have an impact on OPEC from *within* the cartel in a game-theoretic fashion. Its potential as a large producer in the future, if capacity expansion does take place, is large enough to have a major impact on the OPEC price stimulus associated with its current production cutbacks.[139] The idea is that Iraq will open its oil sector to FDI, thereby making more oil available to the

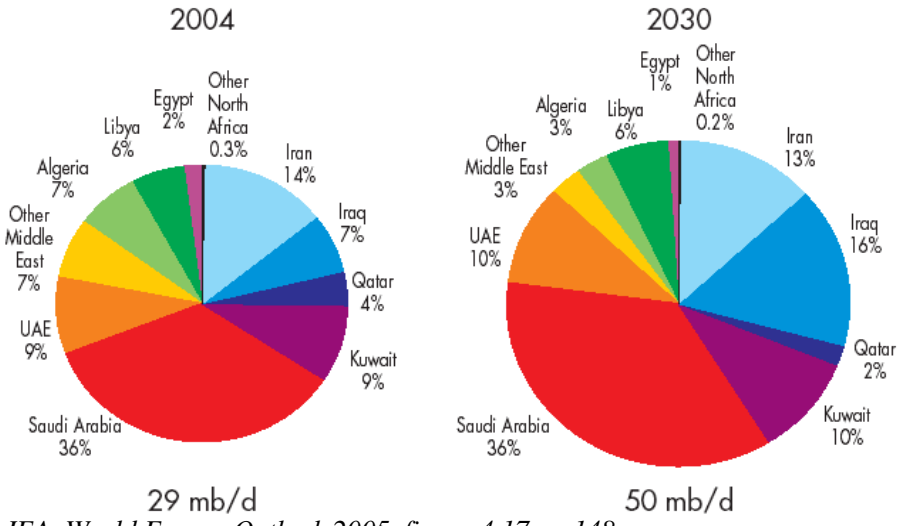
[136] Dan Morgan and David B. Ottaway, 'In Iraqi War Scenario, Oil Is Key Issue', Washington Post, 15 September 2002, Page A01.
[137] Energy Compass, 'Iraq: Puzzling over the future', 1 October 2004.
[138] C. van der Linde, (2003), 'Is Iraq a 'game changer'?'. In: van Staden, A., Rood, J., Labohm, H. (eds.), *Canons and Cannons, Clingendael Views of Global and Regional Politics*, Assen: Van Gorcum, p. 1.
[139] EIA, *International Energy Outlook 2004*, p. 37.

world oil market.[140] This would represent a major shift away from the traditional policy of nationalization of oil sectors in the OPEC Gulf countries.

Thus for the major oil producers in the OPEC cartel, Iraq represents a major oil market risk, since it has been locked out of formal OPEC decision-making for many years.[141] Therefore, any return of Iraqi oil will affect internal relations in OPEC and the manner in which production shares can be distributed among the member states of the cartel.[142] As for factors such as production costs, proven reserves and extraction technologies, Iraq may well possess enormous future potential. Given the uncertainties surrounding Iraq's stability and the length of time it takes for oil fields to be developed, any analysis of Iraq and OPEC will strictly be placed in the long-run.

In any case, the possibly profound impact of Iraq on OPEC is reflected by the view of various analysts in the oil industry. Michael Smith (a senior analyst at one of the world's largest oil companies) claims that 'From a resource perspective, there is nothing to stop Iraq becoming a major player within OPEC.' He further posits that 'If Iraq's reserves to production ratio fell merely to the 2003 OPEC average (80 years), its production would rise to almost 4 mb/d, making it joint number 2. This level of production might be an aggressive target for 2010. Given the resource base and the likely demand for OPEC crude, there is no reason why Iraq should not be able to produce 6 mb/d or more in the longer term; 6 mb/d might be a realistic aspiration for 2020.' Indeed, the IEA projects in its 2030 reference scenario that Iraq could attain a sizeable share in MENA (and global) oil production of 16 percent by 2030, see Figure 4.3.

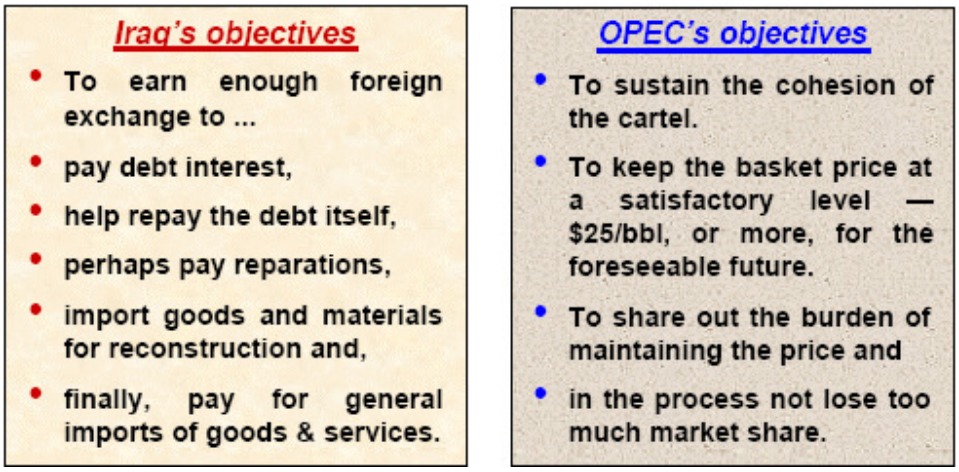
Figure 4.3: MENA crude oil production by country in the IEA 2030 reference scenario



Source: IEA, World Energy Outlook 2005, figure 4.17, p. 148.

[140] CIEP, *Study on Energy Supply Security and Geopolitics*, (The Hague: CIEP, 2004), p. 210.
[141] Ø. Noreng, *Crude Power, Politics and the Oil Market* (London: I.B. Tauris & Co. Ltd., 2002), p. 111.
[142] C. van der Linde, (2003), 'Is Iraq a 'game changer?'. In: van Staden, A., Rood, J., Labohm, H. (eds.), *Canons and Cannons, Clingendael Views of Global and Regional Politics*, Assen: Van Gorcum, p. 1.

Figure 4.4: Potential conflicts of interest between Iraq and OPEC



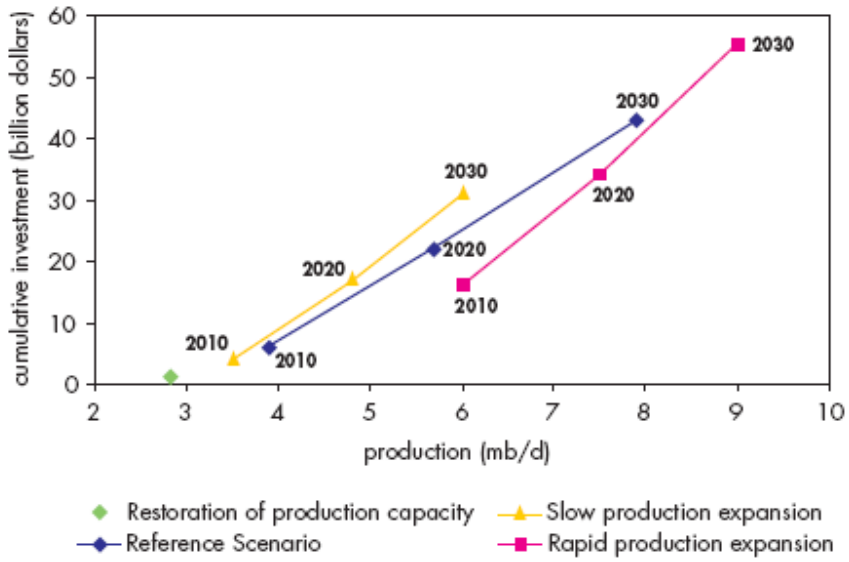
Source: CGES, Presentation 'The oil market after the Iraq war – short- and long-term prospects', sheet 50.

With respect to the already existing asymmetries inside the cartel, Iraq's course may well exacerbate the coordination problems of the cartel (see Figure 4.4 above, which gives an overview of potential conflicts of interest between both parties.) It will want to constrain Iraq's production to a certain extent through the quota system. In order to be able to form such a constraint, the cartel would have to preserve its cohesion. The CGES believes that OPEC will not be able to maintain its target price level because of diverging Iraqi interests such as using oil revenues necessary for the rebuilding of the Iraqi economy.[143] The limited return of Iraqi petroleum to the oil market as early as the mid-1990s already created a substantial market overhang and depressed prices.[144]

A key element to depart from, in this context, is that Iraq will most likely be privatized to a large extent. If member states wish to attract private investors they have two options: either (1) leave OPEC altogether (as Ecuador did in 1992) or (2) adapt OPEC strategy to take member states' diversity and new national oil regimes into account.[145] Iraq's possible privatization may go in the face of rising resource nationalism in other oil-producing countries. A stable Iraq recovering relatively quickly from the perilous quagmire it finds itself in at present will be able to produce oil according to three different scenarios developed by the IEA: slow, rapid and fast recovery, as depicted in Figure 4.5 below.

[143] CGES, presentation 'The oil market after the Iraq war – short- and long-term prospects' at the ENI Corporate University, October 2003, sheet 45.
[144] C. van der Linde and P.A.G. van Bergeijk, (1995), 'Economic Alliances, cartel instability, and the future of OPEC', *Acta Politica*, vol. 30, no. 3, pp. 265 – 288.
[145] C. van der Linde, *The State and the International Oil Market*, (London: Kluwer Academic Publishers, 1999), p. 73.

Figure 4.5: Upstream investment needs in Iraq (for different production profiles)



Source: IEA, World Energy Investment Outlook 2003, figure 4.33, p. 165.

Previous nationalization in Iraq has been driven as much for economic as for ideological reasons.[146] These different scenarios go hand in hand with differing levels of required investments, ranging from less than $10 billion to well over $50 billion. Yet another fundamental issue to take into account in considering Iraq's impact on OPEC in the future is the volume of undiscovered reserves which might be added to Iraq's oil portfolio in the form of more certain reserves. Saudi Arabia, too, is expected to discover further oil in its territories over the coming decades. Iraq however, is relatively untouched in comparison to its southern neighbor and so it has yet to unlock its own potential. Detailed field studies carried out by the CGES in the 1990s have confirmed the higher remaining reserves for Saudi Arabia and Iraq.[147]

The crucial question is whether Iraq will wish to stay inside the organization as a loyal member, given its plausible interests being as divergent from the ones of the cartel. This is a very tricky question, indeed. There are some authors such as Walid Khadduri, Executive Editor at the MEES, who believe that Iraq has a strong interest in staying loyal to the cartel because it has an interest in stable oil markets, secure oil demand and prices.[148] If it stays in the organization, it would definitely always be able to cheat and not stick to OPEC agreements. Just as in the 1980s, Iraq could produce more than has been agreed upon at OPEC conferences.

The dilemma facing OPEC countries today and increasingly so in the future, is that they cannot allow themselves to make too many substantial investments in idle capacity.[149] Since the cartel acts as a swing producer, it faces the ever-present paradox of being compelled to make investments in production capacity expansion during times of high demand; but during times of suddenly falling demand these investments may prove to have been in vain. Thus investing in spare capacity and abiding by the cartel's swing producer role can be costly.

Then the next question is whether Iraq will wish to play along with OPEC policy as a swing producer and invest in idle spare capacity, thereby foregoing market share. Production in Iraq may be subject to quota restrictions determined by OPEC. Or will it step out of OPEC entirely and join non-OPEC as an

[146] The Economist, 'Global or national', April 30th 2005
[147] Oil and Gas Journal, 'Oil-for-Food Questions', April 12th 2004.
[148] W. Khadduri, 'Iraq: Future of the Oil Industry' in C.P. Hanelt, G. Luciani and F. Neugart (eds.), *Regime Change in Iraq: The Transatlantic and Regional Dimensions*, (San Domenico di Fiesole: Bertelsmann Foundation, December 2003), pp. 83 – 90.
[149] C. van der Linde, 'Olie-industrie aast op nieuwe investeringen', *Energie Nederland*, September 2004.

independent producer, thereby avoiding investment in spare capacity while expanding market share at will? Due either to economic or political fundamentals; Iraq may envisage traveling down a path separate from that of the cartel. It is also possible that Iraq may chose to remain loyal to the cartel despite the privatization – limited or extensive – of its oil industry.

Another important consideration is Saudi Arabia, presently the largest single producer of oil and traditionally the voice of price moderation in OPEC. Saudi Arabia's main fields, which are some 40 to 45 years old, are estimated to be close to their peak of production, meaning that they are expected to enter a long-run decline soon.[150] It is quite plausible to believe that Iraq will be the larger swing producer by the period of 2020 to 2030, while Saudi Arabia's power will most likely have declined in relative terms. Recent events in the oil market have shown that Saudi Arabia has been operating at close to maximum capacity while not only Iraq, but Iran too, has not reached this level of production. With OPEC already now operating at close to or at maximum capacity, much new capacity will have to be made available to the world market over the next decades. In fact, Iraq is one of the only countries left in the world with significant future excess spare capacity.

4.6. Conclusion

Geopolitics and the global oil market are uniquely linked through prices, economic rent, competition for access to oil and the strategic value of oil as a commodity. Here then is the quandary of the oil-consuming world: Oil is so vital, so indispensable, its use projected only to rise in the coming decades, but it has to come from increasingly volatile and unstable parts of the world. The world's oil consuming blocs will do their utmost to secure their oil imports, which have become a central element of their foreign policy. In the mean time, resource nationalism is on the rise as oil-rich countries protect their energy sectors from undue foreign control and influence.[151] The concern of several major oil-importing countries, including the US of course, was that cheap Iraqi oil was never making it to the market because of Saddam Hussein's regime and a host of UN sanctions.

The future shape, prosperity and continuity of the oil industry lie in large mega projects, those that yield production of over 100,000 b/d and contain 500 million bbls.[152] Only comparatively fresh oil provinces such as Iraq can still provide the necessary reserves for such projects. The major IOCs realize that in the long-term the NOCs in the Gulf will continue to dominate projects on that scale.[153] Iraq, provided the security situation improves, holds many such potential mega projects through access to low-cost oil fields. Considering all the present and future possible political and regulatory barriers vis-à-vis both OPEC and some non-OPEC oil sources, Iraqi oil (Iranian and Libyan oil too) will be pivotal to the world oil market over the next few decades in satisfying future projected oil demand.

[150] The Economist, 'The world's biggest oil firm opens up', January 6th 2005.
[151] The Economist, 'Global or national', April 30th 2005.
[152] Petroleum Review, 'Oil field mega projects 2004', January 2004.
[153] The Economist, 'Global or national?', April 30th 2005.

'It is better to be vaguely right than precisely wrong.'
– John Maynard Keynes.

5

Changing the game: The future of Iraq and OPEC

The upshot for OPEC of a regime change in Iraq is difficult to foresee with any real certainty. The political and economic parameters involved are as dauntingly complex as they are numerous. Likewise, concrete pointers for the future are few and far between. The persistent political, social instability, which Iraq is subject to at present, invariably leads to dubious projections of what the broader ramifications are for OPEC, the world oil market and the oil industry at large.

As far as the present situation is concerned on the ground, Pentagon strategists miscalculated to what extent and how rapidly Iraqis would see their liberators as oppressors.[154] Counterinsurgency campaigns require close integration of civil and military efforts.[155] Another set of elections and a redeployment of US forces should promote and underpin a more sustainable political process.[156] Iraq's division among Sunnis, Shia and Kurds has created a balance of antagonisms.[157] Hence the key is finding the right political, social and economic balance between these three major ethno-religious groups. Indeed, if the US is to achieve its long-term aim of diminishing OPEC's power, it must stabilize Iraq and its pro-US government.

5.1. Regime change, take 2: Iran

A relatively stable pro-US Iraq is a necessary condition in order to undermine the OPEC cartel mechanism, i.e., the ability of the core oil-producing countries of the Gulf to come to concrete, binding production restriction commitments. This is a long-run goal that can be achieved with more certainty through another regime change in Iran. The US is attempting to establish a democratic Iraq, in the hopes of encouraging similar changes in Iran and Saudi Arabia.[158] The basic objective of any 'regime change' in this context is to install a pro-US regime that allows FDI in its energy sector. At the very least, the preference of all major consuming blocs, including China and the US, is an Iranian government prepared to invest extensively in production and export capacity to satisfy their future demand.

Section 2.3 contains various motives for regime change in Iraq, which also hold for Iran and are consistent with the '2/3' rule-of-thumb: At least two out of three of the major Gulf oil-producing countries need to be under control through pro-US regimes. The US motives for Iranian regime change are mainly two-fold: (1) a further geo-strategic consolidation of the Gulf and (2) enhancing energy security through control and access to relatively cheap and abundant oil.[159] Besides the obvious advantages of such a US move, Iran is an even more special case than Iraq for two further key reasons: (1) its ideal geographic location and (2)

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[154] J. L. Gaddis, 'Grand Strategy in the Second Term', *Foreign Affairs*, vol. 84, no. 1, p. 8.
[155] J. Dobbins, 'Iraq: Winning the Unwinnable War', *Foreign Affairs*, vol. 84, no. 1, p. 19.
[156] The Economist Intelligence Unit, Iraq Country Report, April 2005.
[157] J. L. Gaddis, 'Grand Strategy in the Second Term', *Foreign Affairs*, vol. 84, no. 1, p. 8.
[158] Ibid.
[159] Iran possesses 132.5 billion bbls, the second largest reserves in the world. See *BP Statistical Review of World Energy June 2005*.

its nuclear capabilities. A broad geopolitical trend in US security and foreign policy is its attempt to strengthen its control over both the Caspian Sea region and the Persian Gulf. The Caspian Sea basin holds vast oil and gas reserves and is seen as an important source of non-OPEC oil. As section 2.3 highlighted, Iran is ideally located between the Caspian Sea and the Persian Gulf regions. Regime change in Iran would solve most US concerns over how best to secure Caspian energy without having vital pipelines crossing through rival and/or enemy territory, e.g., Russia and presently, Iran.[160]

Moreover, in the current state of affairs Iran continues to pose a major energy security risk to the US (and the world) because it guards the narrow Straight of Hormuz, the biggest oil supply choke point on the globe (40 percent of the world's oil exports pass through it on a daily basis). Iran is located such that it can threaten all the major oil producers of the Gulf by conventional means.[161] Should it be successful at developing nuclear weapons–even basic ones–it would be the first 'nuclear' OPEC member state. The notion of a possibly 'nuclear' Iran can have a major impact on the oil market, for Iran would gain much bargaining power with respect to the other Gulf States and it would enable Iran to threaten the entire Gulf region by unconventional means. This would explain the concerns of Western leaders over Iran's real intentions with its standing nuclear program. Hence the Western concerns vis-à-vis Iran's nuclear programs are about energy security; at least it would not be surprising if this were indeed the case.

Next, Iran boasts even greater proven oil reserves (126 bbls) than Iraq does at the moment, the second largest reserves in the world and it is also a core member of OPEC. Just like Iraq was, Iran is off-limits for US energy companies because of the US ILSA and the *Executive Order 12959* (which was renewed in July 2001). These orders have designated Iran as an 'unusual and extraordinary threat' to US national security.[162] Indian and Chinese companies have shunned the US sanctions and have gone ahead with business in Iran nonetheless.

Presently, Iran is trying to attract foreign investment in its oil sector, though the Iranian constitution forbids the granting of petroleum rights on a concessionary or direct equity basis.[163] Though Iran's production remains far from its historical high of 6 m/b in 1974, its potential is expected to grow substantially in the coming decades. Iran is already a major energy supplier however, exporting around 2.7 mb/d, with major customers including Japan, China, South Korea, Taiwan, and Europe.[164] The *Iranian Ministry of Petroleum* prepared an ambitious plan in November 2003 to supply 8mb/d by 2020.[165]

So the 'Iran factor' should be taken into account in a long-run view of OPEC and Iraq. Iran differs from Iraq in numerous ethnic, religious, cultural and political ways. Until recently, there was no telling which way the struggle between reformists and hard-line conservatives in Iran would turn. In June 2005, the Iranians elected the hard-line conservative Mahmoud Ahmadinejad, whose apparent belligerence towards the West and Israel is bound to generate a new security risk in the region and will have a major impact on US foreign policy, which is already at odds with Iran.[166] Until recently, Iran's pragmatic conservatives have tried to develop economic and security ties with geopolitical rivals of the US, such as China, the EU

[160] The BTC pipeline, linking Baku oil with the Turkish port of Ceyhan, is now one of the only ways out for Caspian energy (when it becomes operational) through the tortuous Caucasus region and cleverly avoids Russian and Iranian soil.
[161] M.T. Klare, 'Oil, geopolitics and the coming war with Iran', April 11th 2005. See www.globalsecurity.com.
[162] EIA, "Iran", *Country Analysis Brief*, January 2006, available at: http://www.eia.doe.gov/emeu/cabs/iran.html.
[163] Ibid.
[164] Ibid.
[165] IEA, *World Energy Outlook 2004*, p. 113.
[166] Mr. Ahmadinejad's election marked the ascendancy of a younger generation of conservatives dedicated to the original ideals of the Islamic revolution.

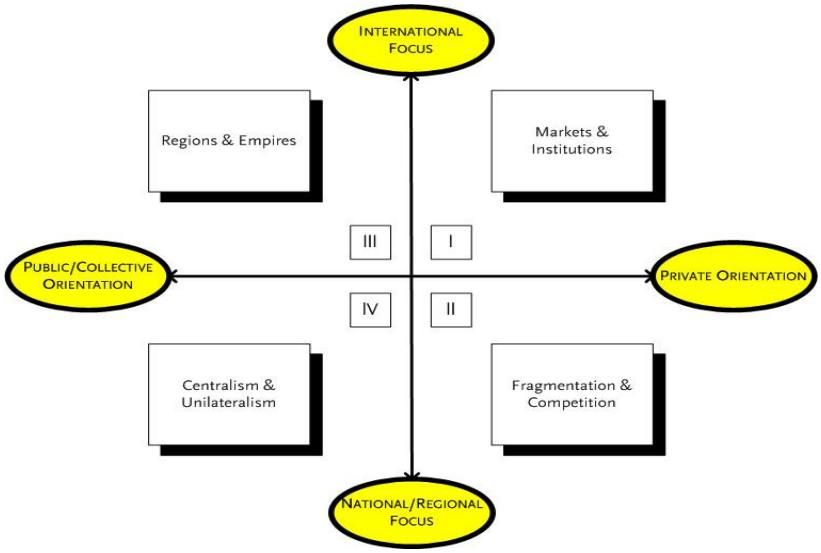
and Russia.[167] The Bush administration and its successors would need to regain multilateral support for any pre-emptive use of US military force, should that worst case scenario arise.[168]

5.2. Four scenarios

The oil crises of 1973-1974, 1979-1980 and 1990-1991 surely underline the wider political complexities of the oil market.[169] Given the non-OPEC and OPEC supply projections of the IEA as well as recent surges in demand, it is realistic to say that the cartel's powers are already returning and will continue to do so. Therefore much depends on the future relations between Iraq and other Persian Gulf OPEC members. Four scenarios are chosen to represent possible future developments in, say, twenty to thirty years.

In its broad analysis of energy supply security, the *Study on Energy Supply Security and Geopolitics*,[170] from which this section draws some of its concepts, focuses on two of these main scenarios, which offer differing views on the future possible constitution of the international political and economic system. Each scenario explanation consists first of a brief exposition of the state of international affairs or geopolitical relations, both on a global level and on the level of the Gulf region. In all four cases OPEC is assumed to consist only of the core Persian Gulf oil producers and non-OPEC sources have further declined in terms market share. This is consistent with the premise that OPEC's configuration will change over time so as to include the countries with the largest oil reserves only.

Figure 5.1: Four long-run scenarios



Based upon work by the Clingendael International Energy Programme. See for example C. van der Linde (2005), 'Energy Security in a Changing World'. In: P. Bracken, I. Bremmer and D. Gordon (eds.), Managing Strategic Surprise, (New York: published by the Eurasia Group for the National Intelligence Council, 2005), pp. 234-235. Note: The vertical axis pertains to the degree of international orientation among countries. The vertical axis is linked to the scope of Gulf State behavior in the international and regional arena. The horizontal axis refers to the organizational principle which states use: either guided by strategic political interests or by the market. In essence this is an expression of the contrast between the public or collective orientation and the degree of privatization of the economy (energy sectors).

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[167] K. Pollack and R. Takeyh, 'Taking on Tehran', Foreign Affairs, vol. 84, no. 2, p. 22. Further note: Russia and Iran have signed a multi-million defense deal in late 2005 and Russia actively assists Iran in finding a good compromise in Iran's negotiations with the West over its nuclear program. Both and China and Russia are likely to support Iran in any moves against the Islamic republic by the US in the UN arena.
[168] J. L. Gaddis, 'Grand Strategy in the Second Term', Foreign Affairs, vol. 84, no. 1, p. 7.
[169] Ø. Noreng, Crude Power, Politics and the Oil Market (London: I.B. Tauris & Co. Ltd., 2002), p. 49.
[170] CIEP, Study on Energy Supply Security and Geopolitics, (The Hague: CIEP, 2004), pp. 81 – 137.

Scenario 1: Markets and Institutions (See Figure 5.1, quadrant I: International focus and private orientation)

International relations

In the Markets and Institutions setting, international cooperation prevails through strong international institutions[171] and a multilateral approach by the world's main powers. International organizations play a fundamental role in shaping both national–and ultimately–international policies.[172] Regional and international conflicts of interest are successfully resolved through open dialogue between nations, through the UN or UN-supported regional institutions, for example.

Energy security concerns are resolved through the medium of multilateral solutions. Economies have become more integrated and oil-producing countries have become embedded in a framework of multilateral cooperation. Treaties on emissions are moderately stable, though the private sector retains much influence through lobby groups and international organizations. The overall result is that countries and organization retain an international focus with strong private sector orientation.

The Gulf and OPEC

As a by-product of this multilateral state of international affairs, regional conflicts in the Gulf tend to be dampened by a continuous dialogue between local countries. Disputes over oil production and transport issues are resolved through face-to-face meetings and institutional mediation. Despite reduced consumption of oil for the purpose of emission reductions, demand remains high in various countries, particularly in the developing world. As an international organization, OPEC remains strong and the member countries continuously reevaluate their common strategy.

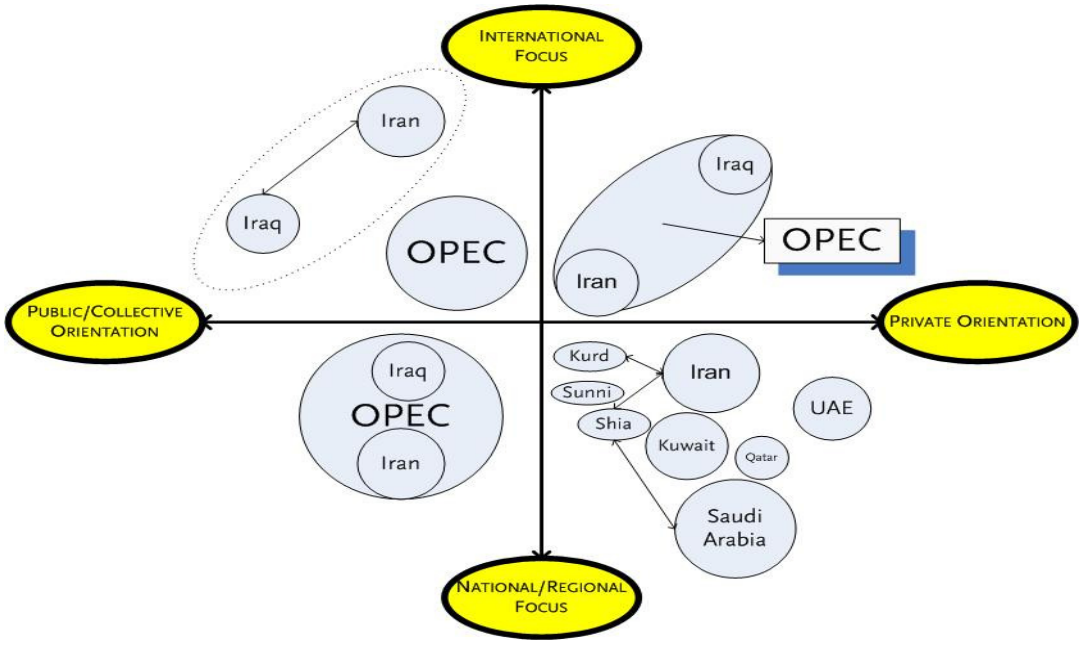
Anticipation of an ever-present shift away from oil compels key cartel members, such as Iraq and a moderate regime in Iran to maintain a fair level of production and prices; even though the Gulf now forms more than half of the global oil supply. Meanwhile, LNG has become more readily available to world markets. With reduced spare capacity, Saudi Arabia and the other cartel members cooperate with Iraq and Iran to manage the oil market, though they would actually prefer to see higher oil revenues.

Iraq and OPEC: Cohesion and moderation (Figure 5.2, top right quadrant)

Together with Iran, Iraq is embedded in a tight framework of regional and international cooperation. Both countries have opted for increased privatization of their oil and gas sectors while key decisions are still taken by the government. Iraq has become a successful democracy as tensions between the ethnic groups are reduced. Economic diversification has allowed social unrest to be kept at a minimal level, but the oil sector remains comparatively important. The overall result is cohesion between the member countries and moderation in price-oriented production strategies in OPEC. The name of the game is to keep oil competitive as a fuel.

[171] The terms international 'organization' and/or 'institution' designate multilateral organizations such as the WTO, OPEC, the World Bank, the IMF, the EU, etc.
[172] A.F. Correljé, J.J. de Jong, E.O. Weeda, Th. Westerwoudt, Dertig Jaar Nederlands Energiebeleid (The Hague: CIEP, 2005), p. 60.

Figure 5.2: Four long-run scenarios applied to OPEC



Scenario 2: Fragmentation and Competition (see Figure 5.1, quadrant II: National focus and private orientation)

International relations

The Fragmentation and Competition approach is a variant of the Markets and Institutions approach on a global level. The same conditions prevail as in the latter scenario, the main difference being that not all regions of the world are as stable and converge towards economic integration as smoothly. In terms of influence, the private sector overall is not as strong. The world's main powers cooperate well and international treaties on emissions are stronger than in the Markets and Institutions scenario. Regional cooperation succeeds in some areas of the world and fails in others, hence international relations evolve unevenly.

Though the private sector overall continues to play an important role, leading governments place a premium on emission reductions and environmental protection. However the developing and emerging countries are by far not as able to keep up in this respect. Oil-producing countries have diverging interests as to how to best ensure their own economic security. Hence some international organizations are strong and serve as a platform for cooperation between countries, while others are not as countries pursue differing strategies. The overall result is that some countries and organizations retain a national/regional focus with strong private sector orientation.

The Gulf and OPEC

First and foremost is that the Gulf is not stable and regional cooperation is almost absent. Real and perceived future reduced demand for oil in this scenario has encouraged the Gulf producers to pursue differing strategies in order to ensure economic security. Despite the falling level of oil usage across the world's leading economies, oil still remains the fuel of choice in the developing world. The OPEC member nations focus more on their own national priorities by balancing FDI with nationalization and by diversifying their exports and their economies.

Qatar, for example, has opted for LNG as its main export, while Iran and Saudi Arabia have begun similar moves. The technological challenge and capital intensity of LNG production has encouraged these countries to involve the IOCs in their energy sectors. With tighter regulations on oil consumption at home, the IOCs gladly invest in the Gulf for lucrative exports to developing countries. The world's major economies are actively reducing their oil consumption. Oil has lost much of its competitiveness as a fuel in the developed economies as demand levels off. On the whole, regional oil suppliers experience uncertainty and under-investment.

Iraq and OPEC: Collapse and strategic drift (Figure 5.2, bottom right quadrant)

As for Iraq, its three ethnic groups are unable to build on the democratic system and insurgencies become widespread. Competing rival factions fight for control over Iraq's oil deposits. A lack of economic diversification, economic uncertainty and social instability are key driving forces in this eventual break up. Regional competition for control of Iraq's energy sector leads to a disintegration of the State of Iraq into three parts, which are absorbed by neighboring powers such as Iran, Syria, Turkey and Saudi Arabia.

Key countries such as Saudi Arabia still see a future in oil, once so predominant a commodity. Other states hesitate about which strategy is best to pursue and perceive the move by industrialized countries to other fuels as irrevocable. As a result, some member countries pursue an LNG-based strategy while others privatize their oil sectors extensively; still others opt for a nationalized system. Conflicting views in OPEC member countries on how to deal with this changed demand pattern makes cartel coordination and cooperation impossible, notwithstanding regional difficulties. Not surprisingly, the overall result is that OPEC collapses as countries enter a period of strategic drift. The name of the game is to survive by any means of economic diversification possible.

Scenario 3: Regions and Empires (see Figure 5.1, quadrant III: International focus and public/collective orientation)

International relations

The Regions and Empires view depicts an altogether different picture from that which was presented in the previous two scenarios. This view holds that international cooperation is undermined by weak international institutions as well as a correspondingly unilateral approach by the world's main powers. The fabric of international affairs is such that countries are pulled into regional clusters dominated mostly by a major power: China, Russia and the US. This scenario can be described as a 'new' Cold War, where deterrence and a balance of power are the guardians of peace, not the UN. Regional and international conflicts of interest are either unsuccessfully resolved because of reduced dialogue between nations or they may even evolve into outright war, unless they are resolved by hard-line diplomacy.

Energy security concerns are resolved through the medium of power politics; access to both oil and gas dominate foreign and security policies. Economies have become integrated to a limited extent and oil-producing countries have little means of cooperation. Treaties on emissions are weak, and the private sector retains influence, primarily as a function of government backing. In many countries the government actually exerts much control over the private sector, rather than the other way round. The overall result is that countries and organizations retain an international focus with strong public/collective sector orientation.

The Gulf and OPEC

Demand for oil remains high as countries fail to cooperate in reducing emissions, seeking only to ensure fossil fuel supply security. Meanwhile, the remaining large oil reserves are found almost entirely in the Persian Gulf and the Caspian Sea regions, but with a number of other non-OPEC sources of oil. Foreign powers are therefore extensively involved in Persian Gulf politics and the region has become heavily

contested, not least by the US and China. The attempt by large oil-importing powers to influence key countries along with military competition with foreign rivals has created a tense situation in the region.

Regional conflicts and disputes significantly hamper relations between the upper Gulf States and lower ones. Persistently high oil prices and unequal access to low cost oil dominate the foreign policy agenda of the major powers, in particular the US. Except for Iraq and Iran, the OPEC members maintain a policy of oil sector nationalization, with the NOCs firmly in control of production decisions. Just as in Iraq, a moderate pro-US regime is now installed in Iran, effectively also bringing Iran into the US sphere of influence.[173] After all, military intervention seems to be the only means by which access to oil can be secured.

Iraq and OPEC: Collapse and confrontation (Figure 5.2, bottom left quadrant)

Instability in the Gulf region is by itself a source of instability in the world oil market, leading to high prices. Though Iraq and Iran have attempted to moderate OPEC behavior, the cartel has collectively employed its rising power to maintain high oil revenues. Opening up cartel members' oil sectors for private investment through regime change seems to be only feasible strategy for the US to ensure the unimpeded flow of oil. Unlike their neighbors, Iraq and Iran have well-diversified economies though the oil sector remains comparatively important. For example, Iran has opted for increased gas exports while Iraq makes clever use of the Tigris and Euphrates rivers in its good bilateral relations with Turkey and Syria. Sufficient economic diversification has enabled Iraq to stabilize itself to a large extent.

While Iraq and Iran aim for moderation in oil prices, the rest of the cartel members are fervently attempting to restrain production. Since there is no readily available replacement for oil as a fuel, the other cartel members are confident they can wield maximum market power. Hence there is no common strategy within the cartel and strong disagreements persist. The overall result is a collapse of the cartel as key members end up in a confrontation. The name of the game for the 'price hawks' is to maintain oil price levels despite rising internal conflicts for the cartel.

OPEC, the game of boxed pigs

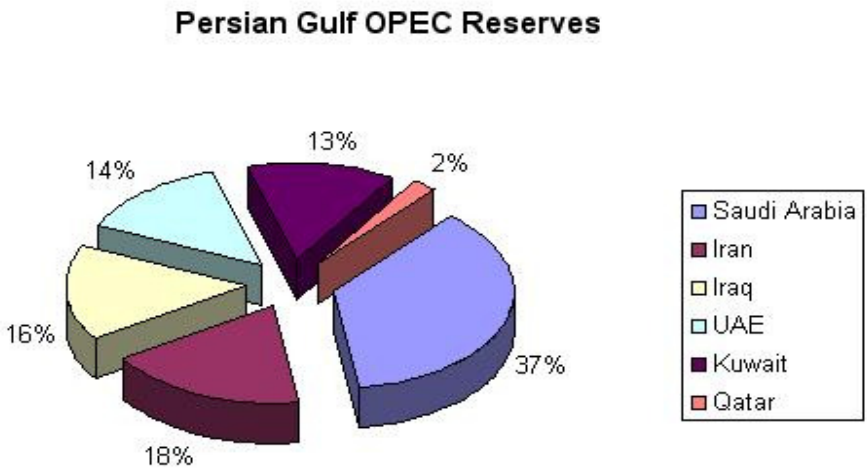
Game theory[174] at large can be useful in for evaluating the strategies[175] which result from the interaction between relatively few players in an economic (or other) setting. This topic belongs to the realm of oligopoly, the study of strategic interactions between few economic agents. The well-known Nash equilibrium[176] is the most widely used outcome in non-cooperative games.[177] Most problems of industrial organization can be solved and/or analyzed with a handful of basic game-theoretic concepts.[178] With its implications for OPEC, the Regions and Empires scenario allows for the application of basic game theory

[173] A regime change in Iran is the 'wild card' of the analysis, and its eventuality fits well in the overall US posture towards Iran and its security strategy.
[174] Game theory, as a branch of mathematics and economics, is a useful tool in analyzing the strategic behavior of agents in economic settings and their possible outcomes. It has allowed for the study of the behavior of economic agents in a broad range of economic phenomena such as bargaining, market entry, and conflicts of interest amongst many others. It has also served as a useful instrument in analyzing the strategic behavior of agents in non-economic circumstances.
[175] The word strategy here is concordant with the definition provided by Thomas C. Schelling in his work, The Strategy of Conflict (1960) where he describes it as being taken from "the theory of games, which distinguishes games of skill, games of chance, and games of strategy, the latter being those in which the best course of action for each player depends on what the other players do. The term is intended to focus on the interdependence of the adversaries' decisions and on their expectations about each other's behavior. This is not the military usage."
[176] The Nash equilibrium is a dominant strategy equilibrium such that no player has an incentive to deviate from the chosen strategy given that the other players do not deviate either.
[177] Rasmussen distinguishes between an equilibrium and an outcome as two separate concepts. An equilibrium is a combination of strategies chosen by each player while an outcome is a set of interesting elements that the modeler picks from the values of actions, payoffs and other variables after the game is played out. See E. Rasmusen, Games and Information, (Malden, MA: Blackwell Publishing Ltd., 2001), p. 14.
[178] J. Tirole, *The Theory of Industrial Organization*, (Cambridge, MA: MIT Press, 1988), p. 207.

to model the essence of this confrontation. Although 2-by-2 games (bi-matrix games, i.e., involving two players) may seem facetious, they are simple and intuitive enough for application to economic situations.[179] OPEC members play such a game because, for example, Saudi Arabia knows that Kuwait's oil output is based on Kuwait's forecast of Saudi output, and the output from both countries matters to the world price.[180]

To illustrate this confrontation, a modification of the game of boxed pigs is used.[181] Since Iraq and Iran are economically diversified and are undergoing a process of privatization, they do not need high oil prices and are able to absorb lower prices more easily. Besides, it is best not to stimulate oil-consuming countries into finding alternative fuels to replace oil due to high prices. In theory, the existence of so-called backstop fuels plays an important role with respect to the price of oil.[182] Hence Iraq and Iran together form one player, aiming for price moderation, a long-run strategy. Because Iraq and Iran have smaller combined reserves than the other OPEC members, the group they form is small compared to the other Gulf States, see Figure 5.3 below.

Figure 5.3: The Persian Gulf: Oil reserves of the core OPEC countries (in percentages)



Source: Based on reserve data of the BP Statistical Review of World Energy 2005

The other Gulf States (Saudi Arabia, Kuwait, the UAE and Qatar) therefore form a group of countries with bigger combined reserves. This group badly needs every dollar worth of oil revenue it can get because of towering unemployment figures (hence increasing social unrest) and 'resource cursed' economies. They need to maximize the value of every barrel of oil sold, for lack of any other sources of income in the short-run. The bigger group does not fear a switch by oil-consuming countries to other fuels, for oil demand is high anyhow and economic survival is now a top priority. Saudi Arabia is obviously still a strong player in the bigger group and in the oil market at large.

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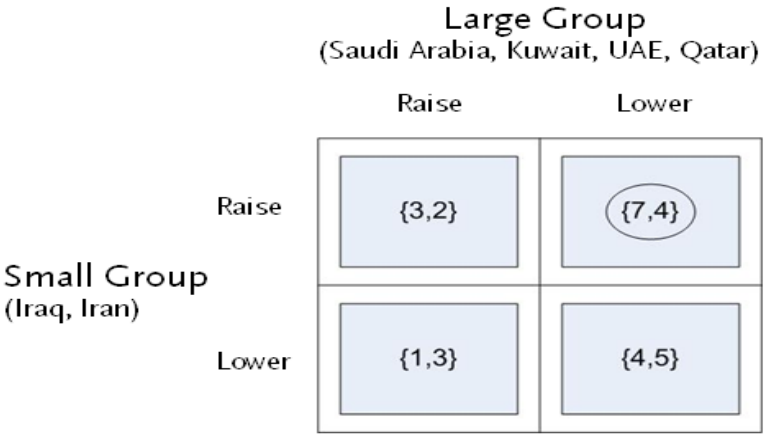
[179] E. Rasmusen, *Games and Information*, (Malden, MA: Blackwell Publishing Ltd., 2001), p. 25.
[180] Ibid., p. 11.
[181] This interesting experiment was made in 1979 by B. A. Baldwin and G. B. Meese with the Skinner sty: there is the snout-lever at one end of the sty, the food dispenser at the other. Each of two pigs–a dominant and a smaller one– can press the lever, causing food to be poured down a chute. Baldwin and Meese placed two domestic pigs into this sty. Such a couple always settles down into a stable dominant/subordinate hierarchy, one being perhaps bigger than the other. Which pig will press the lever and run across the sty and which will be sitting by the food trough? Each action and reaction has differing payoffs for each pig. See B.A. Baldwin and G.B Meese, (1979), 'Social Behavior in Pigs Studied by Means of Operant Conditioning', *Animal Behavior*, vol. 27, pp. 947–957.
[182] J.M. Griffin, and D.J. Teece (1982), 'Introduction'. In: J.M. Griffin and D.J. Teece (eds.), *OPEC Behavior and World Oil Prices*, (London: George Allen and Unwin, 1982), p. 20.

Both groups of countries can either raise or lower production (by a large margin) and both have significant combined spare capacity as well as low extraction costs; but they are asymmetrically sensitive to low oil prices. Refer to Figure 5.4 below, which is a 2-by-2 matrix of payoffs. If both raise production (raise, raise), oil prices fall as market shares increase, which hurts the big player more than the small player {3,2} because of less economic absorption capacity of low oil prices. The opposite result arises from mutual constraint of production (lower, lower), in which case oil prices rise, which is worth more to the nationalized countries and less to the privatized ones {4,5}. OPEC quota and risks damage FDI in their sectors, even though revenues may be higher in the short-run.

Figure 5.4: OPEC and the game of boxed pigs



Note: The payoff for the small group is the left number in each quadrant, the payoff to the big group is the right number in each quadrant. The top right quadrant contains the Nash payoffs.

If the smaller group constrains production while the others raise production (lower, raise), it is extra painful for Iraq and Iran because foreign investment falls and they lose a large chunk of the market {1,3}. In that case, the big group captures much of the market share at stable oil prices. However, if the small group raises production under a privatized regime while the big group constrains production (raise, lower), prices rise only slightly while the smaller group captures much market share. This is worth much more to the small group of countries and less to the big group {7,4}, but the big group still manages to avoid the worst alternatives ({3,2} and {1,3}) and makes revenues.

The pigs (the groups) in this game have to be smarter than the players in the famous Prisoner's Dilemma, for they act based on self-consistent beliefs.[183] At the end of the day, the big group knows that Iraq and Iran–as privatizing cartel members–will raise production and that they will not join the cartel in restraining production. This is the dominant strategy of Iraq and Iran while at the same time; the big group also wishes to maximize its payoff given what Iraq and Iran will do. In essence, the privatization of Iraq and Iran forces the lower Gulf countries to constrain production whilst accepting loss of market share, combined with a minor rise in prices. The asymmetric absorption capacity of low oil prices is a determinant factor, even though the big group has larger reserves. Iraq and Iran go for market share and price moderation regardless of rival actions, and hence the outcome {7,4}, corresponding with (raise, lower), is a Nash equilibrium.

[183] E. Rasmusen, *Games and Information*, (Malden, MA: Blackwell Publishing Ltd., 2001), p. 27.

Scenario 4: Unilateralism and Centralism (see Figure 5.1, quadrant IV: National/regional focus and public/collective orientation)

International relations

The *Unilateralism and Centralism* is as much a variant of the *Regions and Empires* view as *Fragmentation and Competition* was of the *Markets and Institutions* view. Hence many of the factors involved in the *Regions and Empires* scenario are also involved here, with some nuances. The *Unilateralism and Centralism* scenario is characterized by a similar development of affairs between major powers; the main difference being–again–that regions develop unevenly.

Some institutions are weak while others not, and emission treaties are frail. The private sector retains influence, primarily as a function of government backing. The inward orientation of countries is a main driving force in weakening most major international institutions. Energy security concerns are resolved through the medium of power politics; access to oil and gas dominate foreign and security policies. The overall result is that countries and organizations retain an *international focus* with strong *public/collective* sector *orientation*.

The Gulf and OPEC

Demand for oil remains high as countries fail to cooperate in reducing emissions, seeking only to ensure fossil fuel supply security. Gulf countries are engaged in limited LNG projects, the demand for cleaner fuels is down. The Gulf is the world's main remaining source of oil, with a number of fringe producers outside OPEC; basically this is the same market structure as in the previous scenario. Foreign influence is abounding in the Gulf, but again Gulf countries avoid too much of this in their oil sectors. The NOCs are firmly in control of national resources and the shrinking of non-OPEC sources has strengthened their grip on the oil market. The Gulf countries have managed to resolve many regional disputes and cooperate in a number of areas, including the oil market. In the meantime, however, their economies are highly dependent on oil revenues. OPEC as an organization has never been so strong, and with Iraq and Iraq firmly in the fold, the world's top three producers are well aligned. Though major powers resent this fact, none of them are fully able to subdue OPEC members for fear of further actions by rival powers.

Iraq and OPEC: Cohesion and control (Figure 5.2, bottom left quadrant)

Iraq has elected a pro-Iranian Shia government; the balance of power in Iraq has shifted away from the Sunnis and the Kurds. While in previous scenarios the government was pro-US, the Iraqi government is now firmly Islamic and thrives on the popular resentment of the (former) US occupation. The economies of the Gulf, including the Iraqi economy, are poorly diversified, but regional cohesion is strong. Oil exports have provided badly needed revenues. Iran too has experienced a shift towards rising conservatism.

Joined a by political as well as economic rationale, OPEC member countries use their renewed cartel power collectively to keep a ceiling on production. This is reminiscent of the early 1970s oil embargo, though now the reason for cartel power is position of OPEC producers–together–in the oil market as the only remaining single spare capacity 'kingpins'. The overall result is *cohesion* of the cartel as key members retain *control* of the market and cartel coordination. The name of the game is to keep oil revenues high for lack of economic diversification while oil remains the fuel of choice in industrialized countries.

5.3. Conclusion

The long-run can evolve in one of several directions, but regime change in Iraq is a forerunner of things to come. Either OPEC collapses completely or it remains intensely cohesive, with two possibilities between these two extremes. With large, relatively untapped reserves and low production costs, Iraq is bound to have extensive influence on the OPEC cartel's ability coordinate market activities, whichever way events turn.[184] The key to undermining OPEC is privatization of the Iraqi and the Iranian oil sectors, though Iraqi privatization in itself is likely to go a long way in doing so. The boxed pigs game illustrates that the strength of the bigger countries in terms of reserves and spare capacity is not necessarily always translated into a strategic advantage.

Advanced game-theoretic models can show that reserves and extraction costs can have a large impact on the production behavior of both fringe producers and the cartel. Continuing with the boxed pigs analysis, it is possible that eventually both groups of producers would start acting as Cournot duopolists together with other major producers: competing in terms of quantities and driving down prices. The application of a simple 2-by-2 matrix game can illustrate how privatized producers such as Iraq and Iran would be valuable suppliers in an increasingly oligopolistic market in the future. From the perspective of the oil market structure the '2/3' rule of thumb hence goes a long way indeed.

It could also well be that Iraq (and Iran) may acquiesce and agree to cartel-determined quotas. Yet again, this leads back to the trade-off between resource nationalism, i.e., short-run economic solutions and long-run ones accompanied by more FDI. Alternatively, in game-theoretic terms, the rest of the cartel could make a side-payment[185] to Iraq in order to 'buy' its loyalty. In the short-run though, it is likely that Iraq will wish to expand its market share and use oil revenues for reconstruction. Without a doubt, the US aims for extensive privatization of the Iraqi oil sector. Ultimately, if regime change takes place in Iran at some point in the future, and if its oil sector can be privatized as Iraq's will be, it would seal the fate of the OPEC cartel. From that perspective, Iraqi privatization would likely be the beginning of the end for OPEC.

The usefulness of scenarios is their ability to take into account vastly diverging paths of evolution on global and regional levels. Figure 5.5 summarizes the four scenarios and puts them in a historical perspective with respect to the history of OPEC and possible future outcomes. Nothing which is economically and/or politically stable or predictable today is necessarily so in the future and vice versa; history repeats itself but does not follow a straight line. Hence if the US could successfully enforce or stimulate political change in Iran coupled with privatization, it would precipitate the end of the OPEC cartel's ability to make collective production restriction decisions. A key question in this context is how the IOCs would fare and adapt to the new circumstances in each scenario.

The rules of the game were changed with respect to the traditional role of Saudi Arabia (as the undisputed power in the cartel). This role has been given less emphasis in this setting than has been the case in both previous studies and in observations of the real world oil market. In fact the analysis puts into question the long-run ability of Saudi Arabia to perform the role of oil producer of last resort; Saudi Arabia is likely to approach its maximum level of production soon while Iraq and perhaps Iran too will still have excess capacity in the future.

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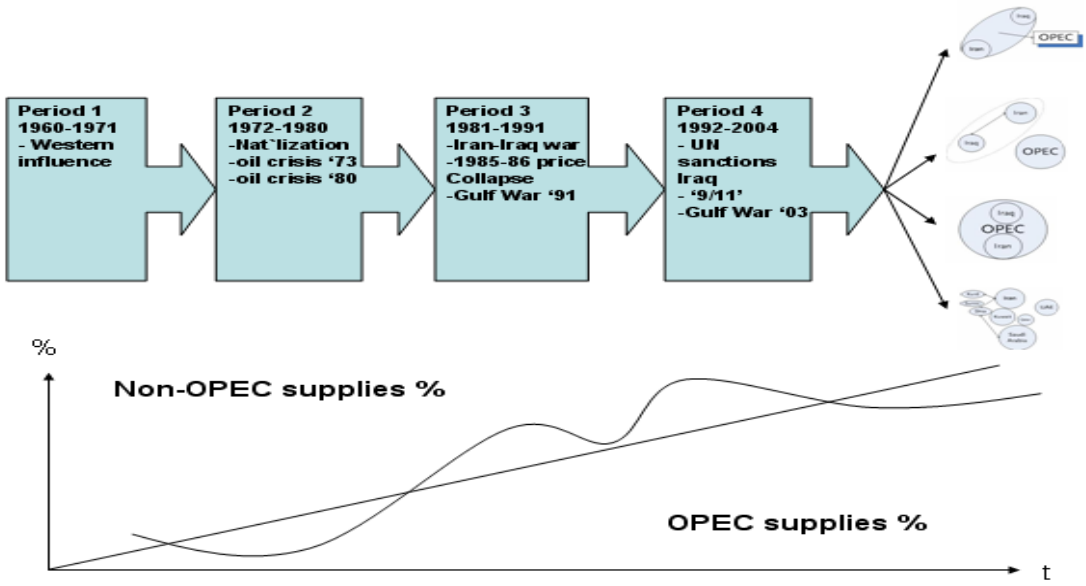
[184] Either way, if Iraq is to play any active role as a single entity in oil market, then first and foremost a necessary condition is political and economic stability in Iraq as well as a credible government.

[185] In game theory, a side-payment is a transfer from one player to another to change prescribed payoffs. See E. Rasmusen, Games and Information, (Malden, MA: Blackwell Publishing Ltd., 2001), p. 21.

Figure 5.5: OPEC history (1960 – 2004) and four possible future scenarios



Note: figure not drawn accurately to scale.

Given the fact that the Persian Gulf core oil producers retain control over the largest and cheapest (comparatively) oil reserves, the cartel's powers are likely to return, in any case. Karp and Newbery have already observed in their analysis that this is effectively taking place (in reality) when taking into account differing discount rates: 'Lower OPEC interest rates will encourage the cartel to delay, inducing fringe producers to extract first. As a result, OPEC will be left with relatively greater market power–and, indeed, this seems to be the current pattern, with the high–cost fringe producers like the UK, Norway and the US extracting as rapidly as possible… It would, therefore, be rational to expect OPEC's market power to increase over time unless non-OPEC discoveries proceed more rapidly…' [186]

[186] L. Karp and D. Newbery, (1993), 'Inter-temporal Consistency Issues in Depletable Resources', Handbook of Natural Resources and Energy Economics, vol. 3, p. 917.

'Those who do not remember the past are condemned to live it again.'
– George Santayana.

6

Conclusion

The regime change in Iraq in 2003 can be seen as the fourth phase of Saddam Hussein's removal from the international arena and the oil market.[187] The 1917 intervention of British troops–in what was then still a province of the crumbling Ottoman Empire–was designed to protect Persian oil reserves; and it a sense the Iraq campaign of 2003 is reminiscent of this British move.[188] One of the most important long-run strategic objectives of the US is to see OPEC's cartel power wane, and its ability to make coherent production restriction decisions reduced. In this respect, US aims have long been lower prices, the development of new energy sources and a desire to confront OPEC's rising power, seen especially by the US as an obstacle to its hegemony.[189]

The controversy over the Iraq conflict can only be fully understood when it is acknowledged that it is a product of international strategic and political maneuvering as well as future concerns about oil supply security.[190] After 2010-2015, it is likely that energy markets will experience increasing tightness and lack of excess capacity. Though it is not possible to estimate with perfect foresight the evolution of oil price volatility in this context, many observers foresee a prolonged and/or indefinite period of higher prices with a corresponding price floor.[191]

In the overall geopolitical struggle over control and access to vital resources, the three major players are the US, China and Russia; all three countries will be dominant players in any new context of this competition. The global balance of power will increasingly be governed by concerns over energy security, with a global political system dominated by a multi-polar type of rivalry rather than the presence of just one super power or only two, as was the case during the Cold War. The US wishes to see its hegemonic position maintained while China is clearly aspiring to close the gap with the US over global military, economic and political supremacy.

As for Russia–once a superpower in its own right–it will need to play its 'energy card' cleverly by balancing the need for foreign investment in its energy sector with national aspirations and a desire to maintain control over its own resources. Deterring China and preventing it from gaining too much clout in the Persian Gulf will be a major geo-strategic challenge for US strategy makers.[192] Both India and China are becoming redoubtable geopolitical players in the international arena and are likely to compete with the US and Western powers for control over sea routes, strategically sensitive areas in Central Asia and

[187] The first Gulf War of 1991, the UN sanctions period and the Anglo-US aerial bombing campaign can be perceived as the first, second and third phases in that process, respectively.
[188] De Volkskrant, 'Ook Britten leidden Irak naar chaos', June 4th 2005.
[189] Ø. Noreng, *Crude Power, Politics and the Oil Market*, (London: I.B. Tauris & Co. Ltd., 2002), p. 48.
[190] CIEP, *Study on Energy Supply Security and Geopolitics,* (The Hague: CIEP, 2004), p. 51.
[191] The Economist, 'Oil in troubled waters', April 30th 2005.
[192] R. D. Kaplan, 'How we would fight China', *The Atlantic Monthly*, June 2005.

ultimately access to the Persian Gulf. The political uncertainties prevalent in the energy world have led to the emergence of a new 'risk landscape', influenced by a host of geopolitical and geo-economic forces as well as by factors in producer and consumer countries.[193] Perhaps most decisively, energy-rich nations are becoming bolder and more assertive, aware of their place in the global energy markets. In the mean time, substantial investments will have to be made by the world's prominent energy producers in order to sustain current levels of capacity.

An issue of further interest is the future evolution of the international oil industry and the oil majors. A private oil industry is essential if future OPEC abuses are to be checked, especially since reserves are concentrated in the Persian Gulf.[194] The majors will be vital in order to apply new technologies to finding new non-OPEC sources while simultaneously generating the know-how and impetus when it comes to developing new fuels at large. At any rate, in the long-run, the IOCs have to hope either for an opening up of presently nationalized Gulf oil provinces or stick to their traditional edge of producing oil at greater cost in non-OPEC areas. Unconventional sources of energy are ultimately the best base upon which to diversify production for the majors as well as technological innovation, e.g., deep offshore drilling, etc.

Nonetheless, if a stable and reliable Iraqi government is in place in the long-run, Iraqi oil will prove to be particularly enticing for the majors. Much still needs to be done in Iraq if it wishes to play a major role again in the international oil market. The distribution of control over its oil wealth was a major topic during the struggle to find a national constitution throughout 2005. The issue of oil wealth distribution may well continue to split the Kurds, Sunnis and Shiites for years to come. Yet no matter which way events turn in Iraq, the competition for oil among the US, the EU and large Asian consumer countries such as China will have a substantial impact on the wider political and economic relations among oil-consumers, producers and between producers and consumers.[195]

The geopolitical risk arising from oil usage and its further effect on the future climate should be a compelling argument for governments around the world to switch to other fuel types and create incentives for increased use of renewable fuels as part of a sound energy strategy. Energy security will have to be inspired more by diversification to fuel type than to geographic oil sources alone.[196] Clean coal technology and other technological innovations combined with Kyoto obligations on emissions are together bound to have a major impact oil usage in the future. Natural gas, in the mean time, will play an important role as a transition fuel to cleaner and economically cheaper forms of energy (given high oil prices.) The environmental costs of oil usage–which can be translated into economic and social ones–should be internalized by discounting the value of switching to those other fuels. The shrinking layer of spare capacity in the world oil market and steadily rising future prices will remain key drivers in this regard. Without a doubt, the initiative lies with the world's major oil-consuming and industrialized economies. Energy policy hereby also belongs to a global dimension, which is and will remain the case.[197]

For the time being though, energy consumers will need to make do with oil as a main fuel, indispensable in many end-use sectors. In particular Europe, Japan, China and the US will need Iraqi oil and will need to ensure that it makes it to the oil markets. Both Iraq and Saudi Arabia will continue to play central roles in the oil market over the coming decades while both are and will continue to experience internal political shifts.[198] If demand persists and grows further, then the need for Iraqi oil at large and spare capacity in particular will be crucial for the oil market in the years to come. Anthony Cordesman from the CSIS once

[193] C. van der Linde (2005), 'Energy Security in a Changing World'. In: P. Bracken, I. Bremmer and D. Gordon (eds.), Managing Strategic Surprise, (New York: published by the Eurasia Group for the National Intelligence Council, 2005), p. 226.
[194] The Economist, 'Global or national?', April 30th 2005.
[195] C. van der Linde, (2003) 'Is Iraq a 'game changer'?'. In: van Staden, A., Rood, J., Labohm, H. (eds.), Canons and Cannons, Clingendael Views of Global and Regional Politics, Assen: Van Gorcum, p. 4.
[196] The Economist, 'The real trouble with oil', April 30th 2005.
[197] A.F. Correljé, J.J. de Jong, E.O. Weeda, Th. Westerwoudt, Thirty Years of Dutch Energy Policy (The Hague: CIEP, 2005), p. 61.
[198] Oil and Gas Journal, 'Oil-for-Food Questions', April 12th 2004.

wrote (as long ago as 1999): 'today's "rogues" had damn well better be tomorrow's suppliers.'[199] At least for now, whether Iraq can fulfill the role of a crucial future swing oil supplier remains to be seen.

[199] CSIS, Are Energy Wars Still Possible? February 1999, p. 17.

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