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"Oil and Security Perceptions in the Middle East"

by

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While it may be debatable how important oil was in determining political developments in the Middle East before 1973, hardly anyone would deny that today Western perceptions of the Middle East situation, fears of Soviet expansionism in the region, as well as feelings about the Arab-Israeli conflict are strongly conditioned by oil availibility and prices. Oil has in fact increased the perceived importance not only of the Middle East as a whole, but also of the balance of power among the numerous actors involved in the region.

Since the fall of the Shah we have heard ad nauseam that Saudi Arabia is essential to the survival to the West, and that the House of Saud may be on the verge of collapsing any moment. Despite all such talk, the House of Saud is safely in power, and developments in the oil sector in the coming decade, along with many other important details, may very well change the perceived importance of Saudi Arabia.

In this paper I will review some of the developments in the oil sector which may have important repercussions on Middle East politics. Let me stress that only some developments will be discussed, avoiding the temptation of formulating global energy scenarios. The latter often tend to overlook important details, laying excessive stress on the alternative between global oil gluts and oil shortages.

I. Oil companies and Arab countries in the 1980's.

Profound changes occurred in the oil industry in the 1970's, affecting more than prices. At the start of the decade the oil industry was for the most part still vertically integrated at the international level; however, as the decade unfolded, the producer countries came to play an increasingly important role in the handling of oil, greatly reducing the part played by international oil companies in intermediating oil on the world markets. (1)

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(1) This section is based on a study which took into consideration the situation and behaviour of ten oil companies: Amoco (Standard Oil of Indiana), British Petroleum, Gulf, Mobil, Royal Dutch-Shell, Socal (Chevron), Texaco. G. LUCIANI - Compagnia petrolifere e paesi arabi negli anni '80 - IAI mimeo.

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The way in which developments in the 1970s have affected the individual oil companies is often overlooked and discussion tends to be focussed exclusively on the overall "abundance" or "scarsity" of oil, as if oil were automatically distributed on equitable terms to oil companies and governments. This is not however the case, and the individual oil companies have widely different approaches to the new situation.

The extent to which vertical integration was broken down during the seventies is shown by data in Table 1.

Table 1

The rising share of world crude supply moving through producer-nation channels - 1973-79

	% Supply Mix		Volumes in Million barrels daily							
Producer Nations	1973	1979	1973	1974	1975	1976	1977	1978	1979	Chg. 1979/73
State-to-State	5.0	16.5	1.5	2.0	2.3	3.8	3.7	4.6	5.0	+3.5
Commercial	2.9	25.7	0.9	1.7	2.2	3.3	5.9	5.1	7.8	+6.9
Total	7.9	42.2	2.4	3.7	4.5	7.1	9.6	9.7	12.8	+10.4
Oil Companies										
Affiliates	69.5	46.6	21.1	20.0	18.1	17.1	14.2	14.5	14.1	-7
Third-Party	22.5	11.2	6.8	6.3	3.9	4.7	5.9	4.8	3.4	-3.4
Total	92.1	57.8	27.9	26.3	22.0	21.8	20.1	19.3	17.5	
Grand Total	100.0	100.0	30.3	30.0	26.5	28.9	29.7	29.0	30.3	

Source: PIW, 25/2/80 p.3-4

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The share of world crude oil that was internationally traded by oil companies passed from 92.1% in 1973 to 57.8% in 1979. In the early months of 1980 the oil companies' share further declined because of cuts in volumes available to some of the major companies (see table 2). The Iran-Iraq war has temporarily blurred this tendency because Iraqi and Iranian oil was partly substituted by S. Arabian oil. Saudi Arabia entrusted the four Aramco partners (Exxon, Mobil, Socal and Texaco) to market the additional 1 m b/d of oil which is produced to offset the loss of Iraqi oil, selling it to buyers nominated by Iraq. The relative shares of international oil companies and producer governments thus vary depending on the way we account for this 1 m b/d.

A tendency to reduce the role of the international oil companies is however clear throughout the seventies. Will this trend continue in the 1980s? The answer depends partly on the policies adopted by the oil producing countries and partly on the behaviour of the oil companies and their willingness to work out a new relationship with the producers.

Table 2

Losses of crude available to individual companies between average 1978 and 2nd quarter 1980 (m. b/d)

BP	1.45
Gulf	0.70
Shell	0.69
Mobil	0.45
Exxon	0.40
Texaco	0.26
Socal	0.15
CFP	0.08
Total	4.18

Source: Gulf Oil Co. estimates

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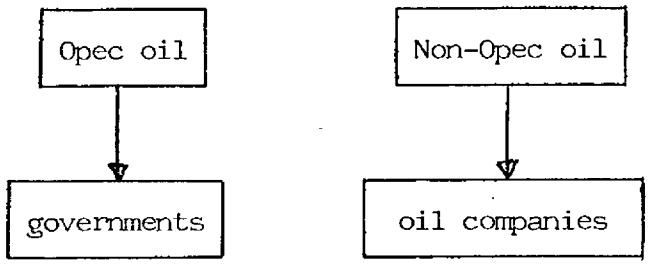
Depending on the behaviour of the two sets of actors, three different scenarios might develop - and individual companies appear to be "betting" differently on each of the three.

A first possibility is that the vertical cleavage in the international oil market will be consolidated. At the end of the process we would have a dual oil market, with Opec oil (plus that of Mexico and perhaps some minor non-Opec producer) being traded on the basis of government-to-government agreements, and non-Opec oil traded by vertically integrated oil companies. Because of Opec pricing policies, the oil companies would be left with a smaller but highly remunerative part of the business.

Companies that place their bets on this scenario make no effort to improve their long-term relationship with the Opec producers and concentrate on developing non-Opec sources, firmly believing that profits are less related to the quantity of oil handled by the company than to its freedom of decision-making in a suitable business climate. Fig. 1 depicts the simple "Dual Market" scenario.

Figure 1

Dual market structure scenario



The second scenario is that of a continuing and possibly increasing vertical disintegration. In this case (fig. 2) oil would increasingly be sold in small quantities and on the basis of short-term contracts which would allow greater flexibility in the patterns of trade. In other words, some sort of international market would

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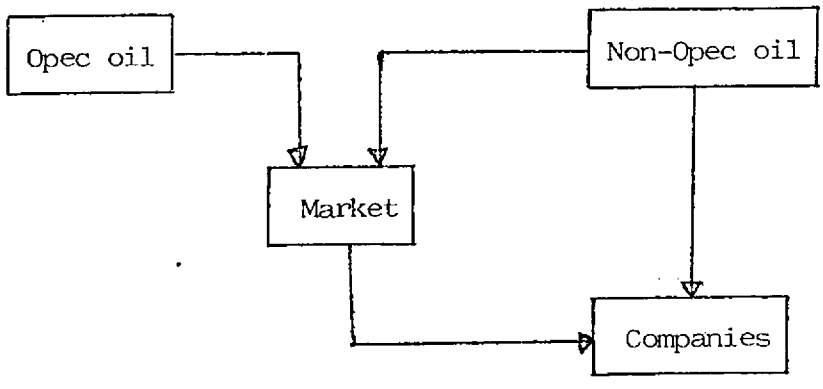
develop, through which oil would be traded. Neither stability considerations or long-term relationships would play a role, except perhaps in the narrowly commercial sense (quantity discounts). A scramble among companies to establish preferential access to certain sources would not develop because oil would normally be in abundant supply on the "market". If the supply were to become tight, prices would jump up, until excess supply conditions were recreated; crises would tend to be short, as experience has shown, preventing any actual physical shortage from taking place. From the point of view of the oil exporting countries this is though to be the optimal solution: according to this view, attempts to integrate downstream will be mostly abandoned by the Opec members because they are not profitable and their best option is to sell oil at the highest possible price.

Figure 2

Vertical disintegration



A third scenario envisages a process of vertical reintegration (fig. 3). Although Opec countries would continue to sell some oil on a government-to-government basis or through the "market" on a short term basis, most of it would still be traded internationally by the oil companies with which a new relationship would be worked out.

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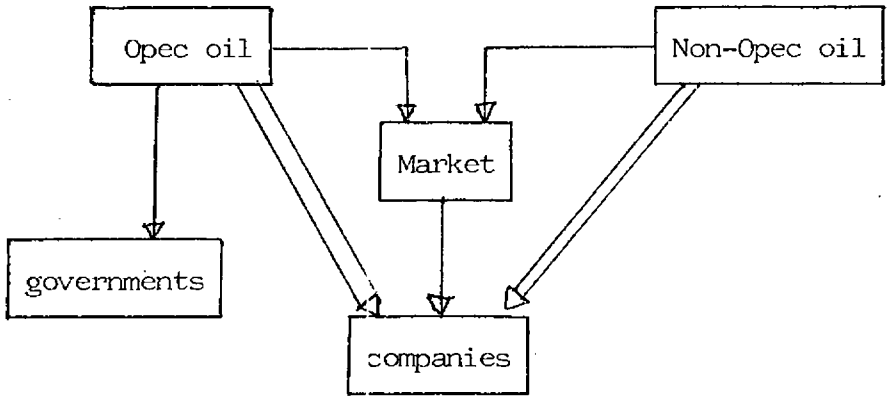
Companies would have an incentive to secure reliable access to a certain quantity of oil because of the inherent instability of any "market" arrangements, as is proved by the "natural" tendency to vertical integration which has characterized the oil business since the early days of John D. Rockefeller. Oil producing countries would seek the cooperation of oil companies to explore and develop new fields, improve the exploitation of existing fields, develop natural gas resources and integrate downstream.

Figure 3

Vertical reintregration scenario



Which of the three scenarios will prevail is of extreme importance to the importing countries' perception of their security. The scenario of vertical disintegration would entail a maximum of insecurity because price volatility would be the only regulating mechanism. Barring the extreme hypothesis of a total cutoff in international oil flows, the essence of oil security is in reliable conditions of supply, both in terms of quantity and prices. Of course, market mechanisms always offer some security, in the sense that supply and demand must meet ex post if there are no limits to wild price fluctuations. However, this is what politically we could call no security at all.

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The dual market scenario would provide greater security, but at the same time would maximize politicization of oil supplies. In other words, it would increase the political costs and implications of achieving a desired level of security of supply. The result might be a complicated web of political and military pressures and interferences on the Opec producers.

Finally, vertical reintegration is a difficult proposition involving adjustment costs for the oil importing countries and potentially introducing a radical change in inter-company equilibria in the international oil business.

The position of the oil companies

The oil companies have traditionally enjoyed uneven access to oil resources, and their vertical structure never was perfectly in balance. Before developments in the 1970's there were companies with excess supplies of crude such as BP, Socal and Texaco, and companies which controlled insufficient resources and were obliged to buy crude from others, such as Royal Dutch-Shell. Thus in a sense the situation that developed during the seventies is not radically new, but certainly the geography of the international oil companies has profoundly changed. Overall, Opec oil available to the companies has decreased, but cuts have been strongly unequal as between companies. This is clearly shown by table 3 where one can see that some of the companies hardly lost supplies at all. The largest losers from the Middle East were British Petroleum and Gulf, while Socal, Texaco and Mobil lost very little: as a consequence the American predominance in the Middle East oil business was increased during the 1970's. This, however, is a phenomenon stemming entirely from the role and policy of Saudi Arabia, and a by-product of this policy rather than its main objective. Since 1978, as was already mentioned, the divergent trend has been reinforced, because some of the companies were further cut back by their traditional suppliers (BP and Gulf lost heavily from both Kuwait and Iran) while Saudi Arabia has increased its production, which is still predominantly marketed by Aramco through her former owners.

It is not surprising therefore that the oil companies have a widely different view of their interests and future presence in the Middle East. A careful analysis of the decision making of individual companies, which cannot be summarized here, led us to the following conclusions:

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Table 3

Oil supplies of major international oil companies (.'000 b/d)

Source: Companies' Annual Reports

	Worldwide supplies			Middle East supplies			M.E. supplies / Worldwide supplies x 100		
	1974	1978	Change	1974	1978	Change	1974	1978	Change
British Petroleum	4.440	3.720	-720	3.620	1.700	-1.920	81.5	45.2	-35.8
Gulf (1)	2.585	1.512	-1.073	1.345	716	-629	52.0	47.4	-4.6
Comp. Français des Pet. (2)	1.741	1.437	-304	1.284	765	-519	73.7	53.2	-20.5
Exxon	6.367	4.992	-1.375	3.265	2.500	-765	51.3	50.0	-1.3
Texaco	4.507	3.552	-955	2.755	2.280	-475	61.1	64.2	+3.1
So.Cal	3.814	3.289	-525	2.685	2.375	-310	70.4	72.2	+1.8
Mobil	2.462	2.117	-345	1.475	1.324	-151	59.9	62.5	+2.6
R.D. Shell	5.917	4.714	-1.203	2.433	1.721	-712	41.1	36.5	-4.6
TOTAL	31.833	25.333		18.862	13.381				
of which U.S. companies	19.735	15.462		11.525	9.195				
in % of Total	(62%)	(61%)		(61%)	(69%)				

(1) Gulf suffered cutbacks even before 1974, because of her overwhelming reliance on Kuwait. In 1971 her supplies reached a peak with 3.163.000 b/d worldwide, of which 1.986.000 (62.7%) came from the Middle East.

(2) The figures understate the losses of CFP, because this company still considers as "own oil" oil from countries where CFP had an ownership position and which is now sold on a government-to-government basis, Iraq being the most important one.

a) British Petroleum and Gulf are betting on the dual market scenario; they are not making any effort to stabilize their supplies from Opec generally and the Middle East in particular. Except in very tight international conditions, they will not go out of their way to maintain oil supplies even in the short run.

b) The attitude of Shell and Mobil is the exact opposite: they are making considerable efforts and displaying great ingenuity in trying to guarantee their long-term supplies. There is however a fundamental difference in the approach of the two companies: while Mobil is concentrating all her eggs in the Saudi Arabian basket, and making the largest contribution to the downstream development of that country, Shell is active in different ways in all Middle Eastern countries that will permit it.

c) Behaviour of other companies is less clear cut. Amoco is strongly interested in exploration, but will not enter the downstream business. CFP believes she has a long-term relationship with Algeria and perhaps Abu Dhabi but with all other Middle Eastern countries simply acts as a technical agent for the French government. Elf is interested in exploration only in politically safe countries, which to them means all Western African countries except Nigeria. Socal and Texaco are mostly interested in maintaining their supplies from Saudi Arabia, but are much less enthusiastic about participating in the industrialization effort than Mobil is.

The position of the oil producing countries

One might argue that, after all, differences between companies simply reflect the different policies of the producing countries in which they operate. Had BP been present in Saudi Arabia...

Of course there is a large amount of truth in this argument, but it misses some important points. It does not explain the differences in present behaviour: e.g. why is Shell trying to get into Saudi Arabia while BP or Gulf are not? Why is Mobil investing more heavily in Saudi Arabian downstream industrialization than her former Aramco partners? Why has BP a totally different attitude towards Abu Dhabi than CFP?

Governments of Arab oil producing countries have widely different oil policies: however, close scrutiny yields the impression that these differences may be decreasing.

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A clear distinction must be drawn between the minor and the larger producing countries; the former countries include both relatively "new" producers such as Egypt and Oman and declining producers such as Bahrein. The "new" producers have a strong interest in exploration, and tend to rely on international oil companies to find oil and increase production. The declining producers are interested in making as much money as possible out of the oil they produce, and in stretching production for the longest period of time. Their behaviour closely resembles that of the classic monopolist, and points to the vertical disintegration scenario.

However it is the major producers that make the difference. In the past some of them took a strongly conflictual stance against the oil companies, while others have always maintained some relationship. Iraq is the clearest example of long-lasting and bitter conflict; however, the role of the companies was drastically if less traumatically reduced in Kuwait and to a large extent in Abu Dhabi as well. It is only in Saudi Arabia that serious conflict never arose, which is only in part a consequence of Saudi Arabian moderation, it is just as much a consequence of the fact that it was always utterly clear to the companies involved that they would be lost without Saudi Arabia.

If in the past Saudi Arabia was the laggard in the drive towards vertical disintegration, she is today the leader in the drive towards vertical reintegration. This drive is however not confined to Saudi Arabia. Although it is difficult to forget about past conflicts, both speculative and factual evidence points in the direction of gradual reintegration in the coming years. The key to the process of reintegration is in downstream industrialization. Of course this would succeed only if companies were interested in cooperating. The example of Kuwait shows that a refusal to cooperate in downstream integration may be the source of conflict and the cause for disintegration. When this happens the process of reintegration is still a possibility, as it is shown again by Kuwait, however conditions are much more complex. The Kuwaiti government reacted to the negative attitude of BP and Gulf by creating national companies to develop petrochemical refining and gas exports. These companies are now establishing ties with foreign companies other than BP and Gulf and are beginning to invest in joint ventures abroad (mainly in Asia).

On the other hand, Saudi policy, which is based on allocating certain quantities of crude oil in proportion to the investment of individual companies in the downstream industry in the country, does not exclude the former Aramco partners but goes beyond them. It is clear

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that by cooperating in Saudi Arabian industrialization even companies that are not in the oil business, such as Dow, or companies that did not have a foothold in the country, such as Shell, will have guaranteed access to Saudi oil. Also the relative shares of the Aramco partners will be changed to the benefit of Mobil. Figures on the quantities of oil which are allocated to each partner are available only in part (table 4). This oil would most likely be subtracted from the "normal allocation" of the former Aramco partners; considering that they would also be beneficiaries, the net result would be a loss of 200,000 b/d for each of Exxon, Socal and Texaco, while Mobil would gain some 130,000 b/d. It might help to recall here, to give a degree of measure, that a project to extract oil from shale in Colorado which is being undertaken by Exxon is expected to cost 3.5 bn dollars for a capacity of 50,000 b/d.

Political impact of the reintegration tendencies

Although not all companies are willing to cooperate with the major Arab oil producing countries in order to lay the basis for a process of vertical reintegration, the number of companies which appear to be willing is sufficiently high to conclude that there is a chance for a development in this direction.

The political implications of such a trend would be far ranging. The overcoming of a conflictual climate would certainly increase the perception of security of supply with reasonably stable price conditions. Companies which have enormously increased their stocks of crude partly as a reaction to greater instability caused by market disintegration, might be less inclined to scramble for supplies in periods of tight overall conditions.

The process of industrialization of the oil producing countries also favours the development of regional cooperation in a way not justified by the vertical disintegration scenario. It would create the need to regulate migration and to coordinate investment plans in order to avoid overcapacity and other possible mistakes. Moreover, while the market for crude oil is global, the market for oil derivatives is far less so. A drive towards industrialization in the Arab Gulf countries thus necessarily increases the importance of access to the European market.

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Table 4

Future incentive crude supplies from Saudi Arabia

Company	Quantity	Source of information
Shell	260.000	Mees 4/5/81 p.5
Mobil	225.000	Mees 15/12/80 p.9
Exxon	74.000	Mees 12/1/81 p.4
Texaco, Socal	75.000 (e)	Mees 13/4/81 p.10
Dow	110.000	PIW 1/6/81 p.11
SPDC	110.000	PIW 1/6/81 p.11
SSMC	19.000	Mees 22/12/80 p.7
Calanese, Texas Eastern	25.000 (e)	Mees 9/2/81 p.5
TOTAL	898.000	

II Of shortages and gluts

The oil importing countries' reaction to the price increases of 1979-80 was very different from their 1974-75 reaction. Today, forecasts on future oil demand point to a future of relative oil abundance; The data in table 5 summarize the latest Exxon predictions. There is evidence that within Opec there is growing concern that substitution of oil as an energy source may go too far too fast. This preoccupation is not voiced only by Saudi Arabia; as an example we may

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Table 5

Exxon's projections on world oil supply and demand

(In million barrels daily)

Demand	1979	1990	2000
Non-Communist World	53	55	61
United States	18	16	15
Europe	15	13	13
Japan	5	5	5
Other Industrial Countries	4	4	4
Developing Countries	11	17	24
Centrally Planned Economies	13	15	16
WORLD TOTAL	66	70	77

Supply	1979	1990	2000
Non-Communist World	52	53	55
U.S. & Canada	12	9	9
Europe	2	4	4
Other Non-Opec	6	10	13
OPEC	32	30	29
Centrally Planned Economies	14	15	16
Synthetics & Very Heavy Oil	--	2	6
WORLD TOTAL	66	70	77

Source: PIW. December 22, 1980

quote from a recent speech of Fadil Al Chalabi, Deputy Secretary General of Opec. Chalabi is preoccupied that industrial countries will be able to resort to other energy sources sonner than oil exporting countries will be able to industrialize. "In oil producing countries development is virtually totally dependent on oil exports to the world markets. This dependence will continue until sufficient structural changes in their economies are achieved and oil revenues come to play a less predominant role in their development as diversified sources of income are created. Although oil producing countries differ in economic and social structures, it is nevertheless fair to estimate that the time horizon needed for achieving such structural changes in their economies will be generally longer than that envisaged for the energy transition". "Substantiallly higher prices in real terms in the future would no doubt accelerate the pace of transition and hence speedily reduce Opec's share in the total energy requirement. Lower real prices would serve to reduce the speed of energy transition, and hence widen its horizon". (1)

The existence of conditions of potentially abundant supply does not however allow any firm conclusion on prices and security implications. Indeed such conditions have normally existed throughout the seventies except for two short periods and the latter were all that was needed to cause a jump in prices. From this point of view flexibility of supply appears to be more important than an actual glut.

Continuing conditions of excess supply cannot be maintained for a long time. At the same time there is no reason to believe that nominal prices will be reduced. Even real prices are unlikely to decline more than marginally.

Given this outlook the equilibria of international oil supply and demand appear to be conditional upon two main questions: (1) when and to what extent will Iran and Iraq restore their production levels; (2) when and to what extent will Saudi Arabia reduce her production level. The two aspects are obviously linked.

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(1) Al Chalabi "Problems of World Energy Transition: A Producer's Point of view", Seminar on "Development Through Cooperation", Rome, April 7-9, 1981. This text is reproduced in MEES, April 20, 1981, Supplement.

Table 6 contains the latest available data on Opec production. The total of 25 m. b/d is low compared to the Exxon estimate of 30 m. b/d by 1990; at the same time a common estimate puts excess supply from Opec at around 2 m. b/d. Given that forecasts on Oecd growth are grim, we may reasonably assume that the figure of 25 m. b/d for total Opec production is not exceptionally low and will not change very much in the first half of the 1980's.

Table 6

Monthly Opec oil production

	---- March -----		Previous Two Months		--Jan-March ---		Output
	Volume (1,000 b/d)	% Chg v'80	February (Volumes in	January 1,000 b/d)	Volume (1,000 b/d)	% Chg v'80	Capacity (1,000 b/d)
Saudi Arabia°	*9,850.0	+3.7	10,000.0	10,000.0	9,948.3	+4.7	11,000
Iran	*1,800.0	-10.0	1,500.0	*1,200.0	1,500.0	-33.7	3,000
Iraq	*960.0	-72.6	*700.0	400.0	686.2	-80.4	4,000
Kuwait°	*1,300.0	-26.6	*1,300.0	*1,500.0	1,368.9	-27.4	2,500
UAE, Abu Dhabi	1,239.4	-7.2	1,246.5	1,249.3	1,245.0	-8.8	2,100
UAE, Dubai	362.0	+3.6	350.9	362.4	358.7	+3.6	370
UAE, Sharjah	7.7	-33.1	8.0	8.3	8.0	-34.7	15
Qatar	506.9	+1.8	482.3	507.1	499.3	+3.1	650
Neutral Zone+	521.6	-8.8	525.6	528.4	525.2	-7.9	600
MIDEAST OPEC	16,547.6	-15.3	16,113.3	15,755.5	16,139.6	-19.0	24,235
Other OPEC:							
Venezuela	2,240.0	+12.2	2,195.0	2,218.0	2,218.4	+2.8	2,400
Nigeria	1,867.6	-13.4	1,942.7	2,091.8	1,968.2	-8.6	2,400
Libya	*1,600.0	-20.0	*1,650.0	*1,600.0	1,615.6	-21.8	2,100
Indonesia	1,633.4	+3.7	1,620.7	1,631.2	1,610.8	+3.0	1,600
Algeria	*900.0	-10.0	*900.0	*900.0	900.0	-10.0	1,200
Gabon	175.0	-4.7	165.0	165.0	168.4	-10.1	250
Ecuador	230.0	+21.5	235.0	230.0	231.6	+6.7	250
Total OPEC	25,193.6	-12.6	24,821.7	24,591.5	24,852.6		34,435

° Excluding share of Neutral Zone.

+ Capacity and production shared about equally between Saudi Arabia and Kuwait.

* Estimate Source: PIW, May 25, 1981, p.11

On the other hand, both Iran and Iraq are increasing production. Barring a new escalation in hostilities, Iraq and Iran might very well be producing 3.5 and 3 m. b/d respectively by the end of 1982. This means a net addition of close to 4 m. b/d to Opec production, which will have to be compensated by cuts from other producers.

It is unlikely that Opec countries other than Saudi Arabia will be willing to cut much of their already depressed production levels. An estimate of 1 m. b/d shaved here and there is probably on the high side, and still leaves us with a necessary Saudi Arabian cut of around 3 m. b/d bringing production in the 6 to 7 m. b/d range. (1)

Is such a large cut in Saudi Arabian production at all likely? Without pretending to give a firm answer to this question, let me point to some consequences that this development would entail.

A. If Saudi Arabia were to reduce her production to the level envisaged, flexibility in the international oil supply system would be greatly increased. The unutilized production capacity of Saudi Arabia could be called upon to compensate the total loss of production of any other country. What is even more important, existing unused capacity elsewhere in the world could be called upon to compensate an eventual total loss of Saudi Arabian production. Indeed, assuming total Opec production at 25 m. b/d, Iraqi production at 3.5 m. b/d, Iran at 3 m. b/d, and Saudi Arabia at 6 m. b/d, readily available unused capacity in Opec countries other than Saudi Arabian would total around 5 m. b/d.

B. Saudi Arabian bargaining power within Opec essentially depends on her ability to threaten to increase production and undercut other producers. It is only at times of confrontation within Opec, as today, that Saudi Arabia actually needs to produce much in order to impose her view on prices. Once this is achieved a large unutilized capacity in Saudi Arabia would be even more effective in imposing her leadership. The political strength of Saudi Arabia within Opec would be enormously increased by a reduction of her production. We are assuming of course

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(1) This would still be well above the level of between 5 and 6 m. b/d that the Saudi Minister for Economic Planning, Nazir, believes to be sufficient to cover the country's financial needs and advocated more than once. A recent projection effort by Solomon Brothers led to conclusions strongly similar to those sketched above. In the event of total Opec supply of 24.6 m. b/d, and production from Iraq to Iran of 6 m. b/d, the "needed" Saudi oil output is put at 6.1 m. b/d (PIW, June 2, 1981, p. 6)

that Saudi Arabia would continue to be essentially in favour of moderation in prices. This assumption is indeed strenghtened if Saudi Arabian levels of production are reduced because this stretches the time horizon of oil policy decision makers; also it essentially deprives critics of any alternative proposal (today they can preach lowering production and increasing prices). It is worth noting that Iraqi reserves are such that Saudi Arabia will not be alone in worrying about the long-term economic value of oil.

C. A corollary of the above is that domestic stability in Saudi Arabia becomes less important to global oil equilibria, because a new regime would not be likely to change the oil policy. Feelings on this point are perhaps excessively influenced by the experience of Libya and Iran: in both cases a change in government led to decreases in production. However, conservationist policies have also been adopted by stable and conservative governments (Kuwait), while a "radical" country such as Iraq has consistently adopted a policy of maximizing production. In the end, objective conditions seem to carry more weight than government ideology: the revolutionary governments in Libya and Iran reduced production because this was the sensible thing to do in light of reserves; in Kuwait a conservative government reached the same conclusion, while in Iraq a "radical" government sees no point in restraining production given the likely size of reserves. Thus, while we may expect that the overthrow of the House of Saud would lead to a reduction in Saudi production if it happened today, once production were reduced to 5 - 7 million b/d it would become essentially stable even in the event of domestic political change. In such a situation one wonders what price the United States or other European countries would put on the political stability of Saudi Arabia, even if the country would still command a very large unutilized capacity of great importance in the price making process.

D. At present, Saudi Arabian oil sales may be subdivided into three groups: government-to-government agreements, oil allocations linked to industrial investment, and oil sold to the former Aramco partners. The latters' share is today by far the largest; but, as was pointed out earlier, it is bound to decline to leave room for the growth of the other two groups. If overall production were sharply reduced and assuming that the first two groups would remain unaffected by such a change, then oil available to the four former Aramco partners would be reduced to a trickle - indeed, if total production were reduced to 6 m. b/d their share might well disappear by the end of the current decade. If we simply extrapolate into the future the current behaviour

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of the individual companies involved, we reach the conclusion that Mobil might keep most of her crude supplies because of the high level of involvement in Saudi Arabian industrialization, while Exxon, Texaco and Socal would lose very heavily. Given the very high degree of dependence of the last two companies on Saudi crude, their size in terms of available crude might well be halved by 1990.

It is interesting to speculate on how these four developments might affect in particular American perceptions of Middle East security. The answer very much depends on Washington's implicit or explicit attitude towards Middle East oil supplies. If the view prevails that East-West considerations impose US independence from Middle East oil supplies; and that this must be reached through market mechanisms; then the US government would end up favouring relatively high oil prices, to contain demand and stimulate development of alternative resources. By the same token, they would be happy to see Saudi Arabia reduce her production and they would not be very worried by the loss of supplies affecting Exxon, Texaco and Socal. Exxon (which is pushing synthetics) and Socal (which is very successful in domestic exploration) would be in the political mainstream anyway, and they might not even complain about the turn of events in Saudi Arabia. Mobil might find herself politically isolated, and it would be interesting to speculate on her eventual reactions.

It is perhaps even more interesting to speculate on how the Saudi regime might react to these possible developments. If Saudi domestic stability were to become less important to the US, will the House increasingly seek legitimation in her regional or Islamic role? Or will it try to resist this turn of events, e.g. by refusing to lower production and aggressively pursuing a reduction of oil prices in real terms, in order to increase the political cost to the US of achieving independence from Middle East oil? Is this what Yamani is already doing now?

We leave these questions unanswered because they depend on a number of important and open issues e.g.

- The hypothesis of a growing importance of regional legitimation is in line with the creation of the Gulf Council.
- This samehypothesis appears plausible if one believes that the Saudi regime may somehow evolve, or "modernize".
- One might argue that the present drive to acquire AWACS planes is an attempt to create a strong US interest in Saudi domestic stability that would survive a reduction in oil production levels.

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III The oil transportation system

The Iran-Iraq war brought the strait of Hormuz to front page attention around the world. To the decision makers in the Gulf area, the extreme fragility of the international oil transportation system had been evident for quite some time, and a few steps had been taken to gain flexibility. A tendency in this direction is now strenghtening.

Indeed, one may wonder how strategic planners could have let the strait of Hormuz acquire such enormous importance. Ex post this development appears as a major mistake; historically, it was only a second best solution made necessary by the difficulty of transporting oil overland to the Mediterranean. Most of the responsibility for this falls on the Arab-Israeli conflict, which caused the permanent abandonment of certain pipeline trunks which had been built before the war, recurrent interruption of the Tapline, and closure of the Suez Canal. Economic and political conflict, e.g. between Syria and Iraq, also played a role. That this issue is perceived as a political priority by Gulf states is confirmed by the fact that one of the three pillars of the recently created Gulf Cooperation Council's strategy for increasing Gulf security is the construction of strategic pipelines to bypass the straits of Hormuz. (1)

Iraq has been in the avantgarde in the effort to develop a pipeline system that would allow her to switch from Gulf to Mediterranean loadings and vice-versa. The Iraqi system is based on the so-called "strategic pipeline" connecting the Basrah to the Kirkuk fields, and capable of operating in both directions. The Northern fields are connected to the Mediterranean through two pipeline systems, the first one crossing Syria and leading to Banias and Tripoli (Lebanon), the second crossing Turkey and leading to Ceyhan. After the outbreak of the Iran-Iraq conflict, both systems were damaged by war activities, but could be restored relatively quickly. The Turkish pipeline was interrupted a few days after the beginning of hostilities, but was back in opeation on November 20, 1980.

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(1) Interview with Dr. Mana Saeed al-Otaiba, Minister of Petroleum of the UAE, in the Observer, Feb. 15, 1981; also MEES Feb. 23, 1981.

It was again interrupted on December 10-11, and put back in operation on December 26. (1) The line presently has a maximum throughput of 650,000 b/d, but on December 26 Iraq and Turkey signed a protocol which envisages increasing its capacity to 900,000 or 1 million b/d.(2)

The pipeline to Banias and Tripoli theoretically has a maximum throughput of 1.4 million b/d, but "a great deal of maintenance work on the pumping stations and export terminals would be required to reach this level". (3)

The line was closed for two months because of Iranian air attacks but resumed operation from Banias in March 1981 (4) and from Tripoli in April.

The Tapline connecting Saudi Arabia to Lebanon (Zahrani) has more or less been mothballed since 1975 (5), being used only sporadically to supply crude to Jordan and Lebanon. Yet in April Saudi Arabia took over a 50% interest in the line (6), which was still fully owned by the Aramco partners, in a move that signals some interest. The largest Saudi Arabian effort is however the East-West pipeline connecting Abqaiq and Ghawar to Yanbu on the Red Sea. Crude will be available at Yanbu starting July 1, 1981, at an initial rate of 500,000 b/d. The initial full capacity of this line is set at 1.85 million b/d, but could be expanded to 3.7 million b/d (7). The crude pipeline is paralleled by a NGL pipeline which will deliver up to 270.000 b/d later in 1981 or early in 1982 (8)

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(1) MEES, January 5, 1981

(2) Ibidem, the protocol also provides for the construction of a natural gas pipeline between the countries. The importance Iraq attaches to the Turkish connection is confirmed by the negotiations to raise the pipeline transit fee from $ 0.38 per barrel to some $ 1.00/barrel. MEES 30/3/1981.

(3) MEES, March 2, 1981

(4) MEES, March 16, 1981; March 30, 1981

(5) MEES, February 21, 1975

(6) MEES, April 13, 1981

(7) MEES, April 27, 1981

(8) MEES, April 6, 1981

The new Red Sea orientation of the Saudi transportation System will increase traffic through the Suez Canal, which has been enlarged since December 1980. Becuase of the enlargement, the traffic through the canal is already growing at a fast pace and the daily tonnage in March was 30% higher than in December (1).

What these developments prove is that the importance of Hormuz or the Indian Ocean as a waterway for oil trasnportation can be drastically reduced in a relatively short time, provided there is a determination to do so. Expanding this pipeline network is not much more difficult than setting up a credible RDF.

Development of the oil transportation system along these lines carries with it a series of important political implications which we may briefly mention.

- The strategic importance of Turkey as the land bridge between Western Europe and the Mediterranean on one side, and both Iran and the Arab Gulf countries on the other, is greatly enhanced, at a time when her importance as a forward land base for possible military operations in the region is also increasingly clear.
- The importance of Egypt to Saudi Arabia is also heightened, even if strong American interest may be more than enough to guarantee freedom of movement from Yanbu to the Mediterranean through either the Canal or an enlarged Su-Med.
- Syria also gains an important bargaining card in the Arab contest. However, it seems that the Syrians do not intend to play this card right now, because for the moment they need the revenue too badly.
- The costs of continuing Arab-Israeli confrontation in terms of the East-West balance in the region are also heightened.
- More generally, pipelines - similarly to downstream integration; and in conjunction with it - create closer regional interdependence and hence a greater need for regional cooperation.
- The need to add flexibility to the oil transportation system will tend to reverse the common perception that the Middle East should be considered as part of the Indian Ocean geopolitical system. From any point of view there is nothing in common between the PDRY and Mozambique, except

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(1) MEES, April 20, 1981

Soviet presence and the routes of the VLCC's. As the importance of the latter decreases, we will increasingly find that we are faced with two distinct problems: on the one hand, the problem of defending the Gulf, and on the other the problem of relations with the South African countries.

Concluding remarks

The fact that European and American vital interests are at stake in the Gulf is so often repeated that no one seems to worry about defining exactly where this vital interest lies.

As a matter of fact, a great deal of the feeling of insecurity is connected to economic elements: prices have gone up, production down. The vertical integration that used to guarantee the smooth working of the system no longer exists. However, at no point in time has a serious military threat been levelled at oil supplies. Even in the case of the war between Iran and Iraq the only possible danger was a further increase in prices resulting from a refusal to make up for Iranian and Iraqi production from other sources.

The decrease in production is connected with conservationist choices which have been made by "conservative" as well as "radical" governments; and were rejected by "radical" as well as "conservative" governments, depending on objective conditions (mainly on the reserves to output ratio).

The trend toward vertical disintegration may now give way to a process of vertical reintegration, provided European governments and the US Administration do not actively work against it. And while I am ready to admit that a downfall of the House of Saud may be a serious threat today, it may not be perceived as a threat at all in a relatively short time. Moreover, it is debatable whether greater Western military presence in the Indian Ocean would enhance Saudi stability.

Is there a Soviet threat menacing our oil supplies? Perhaps; however we must ask ourselves what form this threat might take. We may picture the Red Army rolling over all the fields in the Northern Gulf area - however such action would hardly be any different from it rolling over Hamburg, and something like the RDF would not make much difference. Or we may think of something more subtle - a combination of internal destabilization of some countries and stirring up of regional conflicts. Vulnerability to this kind of action is a consequence of the rigidity in production and transportation systems, and will cease to be a concern once sufficient investment in flexibility is made. At that point in time - which could be as near as two or three years - diplomacy could be trusted to keep Soviet influence in the Arab world well within bounds. Afganistan, after all, is not a success story.