SECTION IX

BACKGROUND PAPERS
ON THE WORLD ENERGY MARKET

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MEC International

1 THE GEO-POLITICAL FUTURE OF THE GULF

Formation of the UAE

When the United Arab Emirates was formed over 30 years ago, most experts at the time thought it could not last more than a couple of years. The failure to include Qatar and Bahrain in the project meant that the future of those tiny emirates hardly looked secure either. And I recall taking a bet in the early 1980s with an American diplomat that Kuwait could not survive another 5 years. Yet over the years they have all shown remarkable resilience. Kuwait has survived invasion and occupation, with a little help from her friends, and even internal coups in some of these small states have had no impact on their stability.

Today, all these states face a new set of threats. What are the chances of seeing these largely defenceless monarchies survive into the next decade?

Four key problems

I have identified four key problems the Gulf States now face and which I think will determine their ability to survive. The states are all quite different in character, and even though the threats they face are common, I would not expect them all to tackle them in the same way.

The first and most dangerous threats would come from any increased instability in one or more of the three large neighbours, Iran, Iraq and Saudi Arabia. I will not add to the analyses you have already had about Iraq and Saudi Arabia. On Iraq, the advantages of a successful transfer of power to a single Iraqi state by the Americans would be an enormous boost. In domestic political terms it would vindicate their longstanding close political relations with the West. A democratic and stable Iraq would show their people that the Americans can sometimes practise what they preach and would boost hopes that they might apply the same energies to solving the Palestine issue. Arabia will be watched with the greatest unease. At a

Strategic level, there would also be relief that a strong Iraq would again be a counterweight to Iran, whose shadow looms over all the Gulf states. Only in Kuwait might an American success be received with mixed feelings, since they fear, rightly, that at some stage in the future, when the American protective shield has gone, a single Iraqi state will probably revive its claims to Kuwait.

At the other extreme, American failure, caused by exiting too fast and opening the door for civil war and intervention by Iraq's neighbours would be very dangerous indeed. Interfaith violence could spread, especially in Bahrain with its majority Shia population under a Sunni government. The Ruling Families' links with a discredited US policy will come under increasing fire. And the knock-on effect on Saudi will be appreciable.

Stability in Saudi Arabia is of equal concern. At present Saudi Arabia exercises a generally malign but manageable influence over its small neighbours. It makes clear its dislike of political progress among the neighbours which might show up Saudi in a bad light. When Kuwaitis debate giving women the vote, they look over their shoulder at what the Saudis might think as much as what they themselves want. The Saudis meddle too in border disputes, and keep close links with malcontents in the different monarchies. What I think most of the Gulf States would like to see is continued stability, whether or not it is accompanied by political reform. They would fear most the replacement of the present regime by a more militant Wahhabist regime which sets out to export its hard-line creed to the neighbours. They would also of course fear any internal break-up in Saudi Arabia because of the high risks any regional instability brings. They may not much like Saudi Arabia, and have no faith in its ability to protect them from any threats they might face, but they probably prefer the status quo to anything other than the most gentle pace of change.

Iran poses no immediate threat. Even with the reformists losing out in the last elections, there seems little likelihood of Iran changing its essentially opportunistic policies in the region. It may even be the case that it will be easier for a hard-line regime in Iran to re-establish relations with Washington. We see signs of cooperation with the US – mostly by proxy via the British – over southern Iraq. And internally, if the hardliners fail to deliver economic reform, which essentially means economic liberalisation and opening up to more foreign investment, they could have a revolution on their hands from the increasingly impatient younger generation. What makes the Gulf States nervous is the realisation that if Iran develops the economic and political muscle to go with its population (already more than Iraq and the Arabian peninsula) they will seek to exert their influence over their smaller neighbours in a way which would reduce further their already limited freedom of political manoeuvre.

The second threat

The second threat facing these countries is how to handle their own young people. The two recent reports on Arab Human Development, produced for the UN by Arabs, has drawn attention, among other things, to the acute educational deficit in the Arab world. In a region with massive population growth, where typically half the population will still be at school, demands for employment are going to be huge. In the oil rich states, expectations among the young of the kind of employment to expect, and the kind of salaries and benefits they should command are unrealistically high. Managing these expectations and preparing people for a wider range of jobs within the workforce should be the first priority of all governments in the region. It is simply unsustainable to have high and growing numbers of expatriate workers combined with unemployment among young nationals. In all countries the public sector is saturated with overpaid and underemployed nationals. The private sector will not take on nationals, when they are unsackable, several times the price, and a fraction of the productivity of third country nationals. Qatar is now making a huge effort to tackle this problem, and Bahrain and Oman, with their more limited oil wealth, are also pushing hard. But the others duck the difficult decisions every time the oil price bounces up.

The consequence of allowing this to continue will be increased alienation of the young, leading some to the vices of drink or drugs, but many more towards religious fundamentalism.

Fundamentalism

Fundamentalism is the third of the threats facing the Gulf States. By fundamentalism, I am referring to those groups who wholly reject close relations with the we stand any political, social and even economic reform which they see as western inspired. I do not include Islamist groups which are quite clear about the importance of their country’s religious identity, but see no conflict in working with the rest of the world and are prepared to make pragmatic compromises over modernisation in the wider interests of their country. These are the majority. Fundamentalists are a small minority, and those who would back terrorism a smaller minority still. But they have a disproportionate influence in a region and are a dangerous attraction to the young. It is important to remember that one of their primary targets is always the Ruling Families in the Gulf, generally because of their perceived greed, corruption, decadence or otherwise straying from the fundamentalists own narrow interpretation of Islam. States in the region have generally dealt with them through a mixture of suppression and appeasement. This has kept the lid on the problem, but often at the expense of the state as a whole. In Kuwait, which has a thriving democracy largely ignored by the West because the franchise excludes women, these issues are fiercely debated in the Parliament. Fundamentalists there have successfully blocked decision taking by the Government, usually by raising corruption charges against Ministers, and constantly press for what they see as proper Islamic practice, such as segregated universities (regardless of cost and efficiency) or the full implementation of Sharia law. The Government either gives way, or sets up committees to study the issue further in the hope that the problem will go away. At the same time Kuwait tries to crack down on extremists provoking violence. They were shaken from a certain complacency by a series of attacks on coalition forces in the run up to war last year, and tougher security measures are now a central part of their response to extremism. By contrast, the Amir of Qatar has long believed that fundamentalism is created by suppression. One of his first acts as Ruler was to abolish censorship – indeed he did away completely with the Ministry of Information which in all other Arab States is a key element of internal control. He also funded al Jazeera, the first Arab TV channel not to have state control. Qatar is a very conservative society, closely linked to Saudi Wahhabism. Yet, even with the US having their regional military headquarters based quite openly in Qatar there has been remarkably little dissent, because the people have the safety valve of free speech.

Pressure from the USA

As if this pressure was not enough, the Arab world as a whole is facing equal pressure, as they see it, from the Americans to conform to some American ideal of democracy and to do it fast. This is a threat which is taken more seriously in the region than we might expect. They see that the

US has very powerful levers to use against them. As I have said, the Gulf States cannot defend themselves against any serious external aggression. As Kuwait discovered in 1990, they cannot rely on their Arab neighbours or brothers in time of trouble. Therefore the US has to be the guarantor of their survival (although we can be reasonably sure incidentally, that the US would not have come to Kuwait's aid, unless George Bush senior had not been under intense pressure from Margaret Thatcher to do so). Against this, it would be hard to exaggerate the depth of anti American feeling among ordinary Arabs throughout the region because of what they see as the hypocrisy of US foreign policy. So, keeping the Americans sweet without too obviously rolling over on their backs for them is a challenge all the governments in the region face.

Dilemmas for all Gulf States

So how are the various governments handling these opposing pressures? This is clearly the biggest dilemma in Saudi Arabia, but it also poses problems in Kuwait, for example. Votes for women is the touchstone there, because it is a fundamental issue for both the US and the Islamists in the Parliament. Next time it comes up for a vote I think the Kuwait Government, which genuinely wants it to happen anyway, will have to summon up the courage to make it happen: in their case the perceived pressure from the US is the greater threat. Curiously, when a Parliamentary committee rejected vote for women for municipal elections, the Islamist dominated committee argued that they did so because it did not appear that the government had a serious and coherent strategy for extending the franchise to women. Apart from votes for women, Kuwait is well ahead of the rest of the Gulf on democracy as the vigour of their public debates both in the Parliament and in other fora shows. The back marker is the UAE which has shown not the slightest interest in serious democratic reform and has been under no domestic pressure to move either. But the other states are moving well down the road. In Bahrain this was a necessary move because of the challenge of handling a generally disaffected Shia majority, but in Oman and Qatar reform has been driven from the top at a slow pace, but one which the rulers judge the people and their traditional, tribal way of life can absorb safely. The question now will be whether the Americans can accept this gradualist approach or whether they will demand more radical and faster change to demonstrate the success of their drive for a new democratic order in the Middle East. Gulf rulers already resent the implication that the steps they are now making towards democracy are an American imposition following the call of Washington neoconservatives for the democratisation of the Middle East: all the processes in the Gulf have been around or in gestation for years. And they will I think resist US pressure now to accelerate the process, because too fast a process would threaten stability.

Challenging times ahead

So are the Gulf States well equipped to face these challenging times ahead? Unless we get some of the worst-case scenarios emerging in Iraq and Saudi Arabia, they should manage. The experts have given their views on those two key states already. My own view is that the US just cannot afford the worst case scenario for Iraq to develop. Despite many mistakes they have shown that they can change direction when heading for a brick wall, and I would expect them to be able to contain Iraq's problems with a reasonable degree of success, at least for the next couple of years. That they may fall a long way short of the neo con dream of a pro-western Government, part of an 'axis of good' with Turkey and Israel would probably come as a relief to the rest of the Gulf. A stable Iraq might well push for membership of the Gulf Cooperation Council. The GCC resisted this in the Saddam era, but may find it harder this time, especially if the Americans press the case hard. The need for economic convergence would buy time, but eventually, a GCC embracing both Iraq and Yemen might be a better balanced economic and political grouping than the present GCC.

It is harder to be confident that the House of Saud will get it right. But you have to go with the form book and expect them to muddle through intact, but possibly even more inward looking and awkward as a neighbour than they are today.

Leadership and wealth

Whether the Gulf States do more than just survive, depends on how well they can adjust to the growing demands of their young people. Over the next ten years there is no reason to suppose that demand for oil from the region will dry up. If oil production is at a peak now as some claim, prices may even rise in real terms, allowing the Gulf States to put off the difficult adjustment processes where they lack the leadership to push for uncomfortable change. But in most cases they at least know what they ought to be doing. All are increasing the pace of economic liberalisation; Kuwait is talking about a tax regime; Qatar allows its nationals to be fired for poor performance; and Omanis and Bahrainis are taking on an increasing range of jobs. And everywhere there is a drive towards skills training. Those that adapt fastest will prove the most successful in keeping potentially explosive social problems at bay. Those who can manage the trick of developing the most open societies without abandoning traditional values will have the best chance of handling simultaneously the problems of fundamentalism and an overbearing United States. It is not going to be easy, but it is hardly impossible either given the great wealth in the region and the tiny populations and infrastructure demands they have to cater for. Performance will vary, with leadership rather than wealth being the element that will separate the winners from the losers. But compared with the rest of the Arab world I expect the Gulf States to be looking fairly healthy ten years down the road.

2 CHINA AND OPEC

Summary

The subject of this paper is the relationship of the key oil producers to the future No 1 Pacific Basin Importer - China

Within the context of the political relationship between the Gulf oil and gas producing states and the oil and gas consumers of the Pacific Basin, this paper focuses on China, its people, institutions, markets and commerce and, above all, on the Chinese and Arab governments and their opinions and attitudes.

My underlying premise is that China - with close to one-fifth of the global population - will together with the United States be one of the two key economic drivers in the global system within twenty years and that the Gulf states currently accounting for two-thirds of proven global oil reserves and almost one-third of proven global natural gas reserves will remain the principal key to global political stability, enhanced development and economic growth. So here we have two global economic giants – their evolving relationship will be of considerable significance to the rest of the world and nowhere is it likely to be tested more than in their rivalry to secure access to the oil and natural gas of the Gulf states.

Both China and the six key Gulf members of OPEC (Saudi Arabia, Iran, Iraq, Kuwait, Qatar and the United Arab Emirates) have their own deeply embedded culture which has proved vigorous and robust in the face of an accelerating pace of change and the challenge of western values and technology. China may not appear to have much in common with the lead oil-producers, but it shares many pan-Asian values and can often find problem-solving routes to effective partnership which lie beyond the range of practice in the competitive, highly privatised capitalist economies of North America and Western Europe.

At stake is the fragile and vulnerable symbiosis of interest between the United States and Saudi Arabia which has been used most effectively as an economic regulator in the oil market for the past quarter-century. Whenever

the Americans felt that the oil price was getting too high, Saudi Arabia has been ready to utilise spare capacity, increase production and damp down the price. Conversely, whenever the oil price collapsed, as in 1986 and briefly in 2001, Saudi Arabia has responded to US requests to cut production sharply in order to bring the market back to equilibrium within a tacitly agreed range of price.

China, as explained here, is the new main-player in this global energy market. One thing is certain. China will not be willing to accept the current rules of the game and will thereby change the rules to accommodate its own underlying national interest. Where will this leave the United States and Europe? And where will that leave Saudi Arabia and the rest of the OPEC countries? And how about Japan, that other crucial player in the currently intensifying struggle for access to the cheapest global energy resources?

The China Mega-Economy

Let us start with China, an economic firework display which today none of us can afford to ignore. This is no longer a side-show. It is already at present becoming the second largest economy on earth. Within 25 years, its economy is likely to match that of North America and most probably to be well ahead of Europe and dominant throughout South-East Asia. At that point in 2030 when the mature markets of North America, Japan and Western Europe have reached higher levels of consumer saturation, lower levels of long-term investment and severe constraints in access to natural resources, China, the world's largest market, is likely to be bursting with energy, mobilising effectively its huge population and deriving immense political and trading benefit from a modern economic and industrial infrastructure. It will already be beginning to exploit its competitive advantage by exporting its latest advanced technology.

Today, for example, China is only on the brink of a leap in vehicle numbers on the Chinese roads – about to increase say five-fold, perhaps ten-fold in 25 years as new production plants designed and serviced by western automobile companies come into operation and road construction and improvement keeps pace with the widely expressed desire of the population that each family and working individual should be able to own their own vehicle.

By 2030 China will be on the brink of another massive economic leap forward: its new high-technology, high-volume motor industry will have undercut the dominant truck and automobile exporting manufacturers elsewhere and begun to capture their export markets world-wide one by one. By 2050 the roads of Africa and Latin America, not to mention Eastern Europe and South East Asia, will be filling with Chinese (and hopefully Indian) trucks, service vans and cheap automobiles, all well-adapted to local needs and aspirations, no longer the hand-you-downs of Western affluence and much more appropriately the practical, less sophisticated hand-you-ups of a highly successful sector of the two new leader-states of the developing world, China and India.

A Political Giant in Asia

There is, in my view, relatively little likelihood of China fragmenting or even splitting on a North/South divide: it would be foolish for the rest of the world to plan on that assumption. A federalist internal structure is likely to emerge and new institutions will gradually appear and will help to cement the country together.

Equally, the probability of a debilitating confrontation with another super-power is very slight. Russia no longer poses the main threat and the possibility of a renewed communist-western democracy conflict is steadily diminishing and has probably reached the point of no return.

The rest of South-East Asia is already coming to terms with Chinese political and economic dominance. Concern is expressed widely; yet wiser counsels express great hope for an expanding tidal wave of economic growth and political stability. In my view, the hopes far outweigh the fears.

We are not here faced with a hostile aggressor intent on colonisation, on seizing mineral wealth and other natural resources and enslaving whole populations as cheap labour. This has been repeatedly the model of the past in Asia. It is a model which demonstrates lack of long-term vision, results in intense misery (and early death for) many millions of people and constitutes a vicious stifling of human freedom, inventiveness and creativity. It is also a model which has always failed. Even within the lifetime of the older people of China, the experience of civil war, occupation, revolution and oppression is still keenly felt and transmitted to younger generations. I see therefore no popular support at present for the dominance of the military or for overt plans for acquisition of territory (apart from the recovery of Taiwan).

The Overseas Chinese

We need to look carefully, in addition and by contrast, at the large, stable expatriate Chinese populations some established for many centuries throughout South-East Asia and round the Pacific Rim. The Chinese diaspora has some key features:

- The Chinese way of life and culture has been largely preserved intact;
- Links with the towns and roots of the ancestors in mainland China have been carefully preserved and cherished;
- The Chinese communities have flourished by focussing on local and international trade
- They are generally tolerated and valued by the indigenous population. While here and there their enterprise and affluence arouse envy and provoke expropriation, they only rarely suffer outright expulsion.

This network of Chinese expatriate communities with its highly-developed family inter-communication stimulates much trade between the various centres. As mainland China emerges more and more from self-imposed isolation, the expatriate communities are likely to be a source of considerable strength and a new vehicle for extending trading influence throughout the region. Already the flow of investment in Mainland China from Taiwan and other expatriate Chinese business interests has been a significant factor in sustaining high economic growth over a long period. “Buy your second home in this province!” is an advertisement greeting the thousands of overseas Chinese visitors on their arrival, many now for the first time, at the airport in Mainland China.

The Lessons of the Spratlys

The Spratly Islands lie just about at the centre of the South China Sea. The states of Vietnam, Thailand, Cambodia, Malaysia, Brunei and the Philippines as well as China have a strong interest in the freedom of navigation in these waters, which also embrace significant oil and gas offshore (and onshore coastal) development and production.

The recent Chinese military occupation of these tiny deserted islands, hitherto only inhabited from time to time by mainly Philippino and Vietnamese fishermen, set off alarm bells all around the South China Sea. The new China mega-state was clearly flexing its muscles and testing the reactions of its neighbours. Yet the latest developments also carry a clear message. China and the Philippines have signed quite amicably an extensive inter-government agreement on the joint administration of the Spratlys. China is now signalling thereby both its wish and need to be involved in the whole region, but also its friendly and peaceful intentions.

I will not be surprised if the psychology and motivation behind these actions is not in due course applied to the leading oil and gas producers of the Gulf and I suspect that the depth and subtlety of the ensuing collaboration may come as something of a surprise to the USA and Europe.

Coal in China

One question-mark in this mainly optimistic vision of the future is where and how is China going to obtain adequate energy to fuel this buoyant and sustained economic growth.

China is still essentially a coal economy. In 1960 coal accounted for 95% of China's needs for primary energy. It still accounts for almost 70% of the energy mix today and this share will only decline quite slowly. Mainly of poor quality and highly sulphurous, and with mining mainly concentrated far from the high-growth areas of the country, the Chinese coal industry presents formidable transportation and environmental challenges.

China's coal production is 29.5% of the global total; coal consumption is 27.9% of the global total. The indigenous resource is abundant: 11.6% of the global total of proved coal reserves, giving a reserve/production ratio of 82 years. Moreover there are further ample and cheaply produced resources available in the Pacific Basin area, most notably in Australia, Indonesia and the Eastern Siberia region of Russia.

The profile of recent coal production in China is curious. It built up strongly year-by-year to 1996. Then under environmental pressure and Government determination to close down inefficient fields and regions, production fell by almost one-third in three years. However, production then rose sharply and surpassed the 1996 peak in 2002, while consumption in the same year was over 40% higher than two years previously. These massive swings have been examined by the International Energy Agency, the World Bank and others and it appears that some of the statistics for 1997-2000 may have been exaggerated by including government targets rather than the hard statistics of production output. In any case, the conclusion is clear: China cannot do much without a lot of coal.

Coal is two-and-a-half times the weight of oil in the Chinese energy mix. No other leading state has such a high dependence on coal. Coal therefore remains central to the energy strategy of the government and presents large-scale challenges in the mobilisation of adequate investment in mining and transportation infrastructure.

Oil Production Successes

The economic awakening of China is generally dated from the accession of Deng Xiaoping in 1979. Like most developing countries, China began by liberalising other sectors of the economy first and by keeping tight hold of almost all parts of the oil industry. As a net exporter of oil into world markets, the Chinese output generated significant volumes of hard currency, otherwise at that time in very short supply.

China at that time knew that it had adequate reserves of oil to remain self-sufficient but it failed to calculate the impacts of very high rates of economic growth. Demand for oil rose faster than production and by 1993 China had become a net importer of oil.

Considerable effort was expended to boost domestic production; when this failed to meet the government targets, there was in 1994 a distinct change of direction. Major multinationals were encouraged to invest and bring with them the latest technology. This process had only mixed results as some of the companies were disappointed with the terms of the contracts proposed and the low prospectivity of the fields offered to them.

Oil production continued to rise until it peaked in 2000-2003 at 3.4 mbd, putting China into the No.6 ranking in global oil production.

This looks like the limit of production growth and China is unlikely to displace Iran and Mexico to reach No. 4 ranking behind the three oil production giants, Russia (9.0mbd); USA and Saudi Arabia (both 7.8 mbd). Indeed China will find it hard work to replace many old depleting fields with oil from new fields to maintain the present level of production.(Table 1).

Table 1: Oil Consumption and Production in 2002 (mbd)

	Consumption	Production	Shortfall(-) / Surplus (+)
USA	19.7	7.7	-12.0
China	5.7	3.4	- 2.3
Japan	5.3	-	-5.3
Saudi Arabia	1.4	8.7	+7.3
Iran	1.1	3.4	+2.3

Oil Consumption – Sustained Growth Likely

In terms of national oil consumption, China at 5.7 mbd has already displaced Japan (5.2 mbd) as the second largest oil consumer in the world. Although well behind the United States (20.3 mbd), China is expected to gradually close the gap as the Chinese economy continues to expand vigorously (Table 1).

Oil Imports - Increasing relentlessly

With oil consumption rising strongly and oil production expected to be flat or in slow decline, oil imports are rising fast. Currently ranked at No.5 among global importers of oil, China (2.4 mbd in 2004) is now expected to displace South Korea (2.3 mbd) this year, Germany (2.6 mbd) next year and Japan (5.2 mbd) by 2010.

Table 2: PTA estimates of global oil trade in 2025 (mbd)

Major Net Importers		Major Net Exporters	
USA	15-22	**Gulf**	21-24
Europe	15-18	**FSU**	7-9
Japan	7-9	**West Africa**	5-7
China	10-18	**Mexico/Venezuela**	6-7

In the period to 2030, oil demand in the United States and China is expected by the IEA and World Bank to increase by about 10 mbd each. In each case it can only be satisfied by increased imports. The IEA wording for Chinese imports is “up to 10 mbd”, reflecting Chinese political sensitivities, but their numbers and economic analysis point to a higher number.

Where will the incremental oil come from?

In global terms, incremental demand for oil has to come mainly from the Gulf states, where two thirds of global proven oil reserves are located. The IEA's expectation that Gulf output will double to satisfy this incremental demand and compensate for depleting production elsewhere looks highly dubious. Continuing political turbulence in the Middle East is likely to continue to deter investment and a tightening market will deliver higher prices and enhanced government revenue to the producers, without having to go to the trouble of mobilising vast new investment funds both internally and by drawing on the global capital market.

China and the USA as oil import rivals

The US complacency in this matter is based on the assumption that the economic weight of the US (25% of global energy consumption) operating in an open world market for oil will ensure that it can outbid its competitors for available supply. The US also has a wider strategy to protect its national interest: its Strategic Petroleum Reserve can be used to meet any temporary shortfall and a strong naval and military presence in the Gulf will be ready to restore any interruption to supply and to redirect the remaining supply as needed.

The US may find, however that China has cemented its relations with the Gulf states in a manner which will virtually guarantee adequate oil supply to China. One aspect of this for example, lies in the latest Liquefied Natural Gas (LNG) contracts currently under negotiation. Unlike crude oil and product which is fungible and freely tradable on world markets once it is loaded and on the high seas, LNG supply depends on long-term take-or-pay contracts with specific consumers who are in control of adequate supply networks to power stations, to industrial and commercial consumers as well as to the domestic sector. The gas producer and consumer are locked in by contract to a bilateral arrangement over a period of 15-20 years at a time. China and other Asia Pacific gas consumers are actively exploring how to extend this relationship to guarantee at least part of their oil supply.

Chinese Relations with OPEC

So far as I am aware, China has made very little impact so far on the OPEC Secretariat in Vienna. Unlike Russia and Japan, who keep a close eye on what is going on, coverage by China at the diplomatic and press level is limited. The main thrust of China's interest in supply from the West has been directed at Kazakhstan and other Central Asian/Caspian states and at Saudi Arabia and Iran.

Of the non-Gulf OPEC members, China has very strong interests in Indonesia, quite strong interests in Algeria, Libya and Nigeria and less strong interests in Venezuela.

Among the Gulf OPEC members, relations with Iran are close including agreements to share nuclear and weapons technology. Iraq today has become a major opportunity for China but so far in the hand-over transition phase, there is little evidence apart from increasing flows of Chinese goods into the blossoming Iraqi market. Kuwait and UAE rank China high in the list of imported manufactures and both have offered the Chinese opportunities to invest in equity in the oil and gas sector. In Qatar there is lively interest by China in new LNG contracts. A 51-person Chinese delegation visited Qatar in December 2003 to view the new Qatar LNG export facilities.

All this does not add up to very much compared with Saudi Arabia where the China-Saudi Joint Commission is well-established under the joint chairmanship of Ali Naimi, Saudi Minister of Energy (and former President of Saudi Aramco, the largest oil-producing company in the world) and Dr Wang Tao, Adviser to the Council of Ministers (and former President of China National Petroleum Corporation which at that time had a total work-force numbering 1.7 million).

3 EGYPT – A PROMISE YET TO BE FULFILLED.

Introduction - Political and economic overview

Egypt commands attention for many reasons. It occupies over a million square kilometres at the vital strategic junction where Europe, Asia and Africa meet, the land bridge between Africa and the rest of the Eastern Hemisphere. It owns the Suez Canal, which also brings substantial regular income. Cairo's population of over 17 million makes it the largest city in Africa.

Egypt is the centre of the Arab world, geographically as well as culturally and politically. It has awkward neighbours: Libya to the West, Sudan to the South and the Occupied Territories, Israel and the Red Sea to the East. Its population of nearly 70 million makes it the largest Arab country: every third Arab is an Egyptian. Egypt sends skilled professionals to work throughout the region, and plays a central role in Arab media and cultural life: its film industry supplies the entire Arab world.

In religious terms. It is a leading Muslim (mostly Sunni) country, having become progressively Islamized since the Arab invasion of the seventh century, though a Coptic Christian community some 5 million strong still survives. The Al-Azhar mosque and university is an internationally respected centre of Sunni Islamic orthodoxy, which is traditionally moderate, tolerant and non-threatening in colour.

If all that is not enough, it also has 7000 years of civilisation behind it, and is one of the world's most attractive tourist destinations. The largest annual contingent of tourists normally comes from the UK: some 368,000 British nationals visited Egypt in 2003, about 10% of the total.

Politically, Egypt's regional weight, gateway role to the oil-rich Arab countries, consistently moderate policies amid the tensions of this particularly tense region and not least its rank as a leading Islamic power make it a key partner both for its neighbours and for the international community at large, notably the United States and the member states of the European Union.

History

The regime was autocratic (Pharaonic) from the fourth to the first millennium BC. Then came the Persians, the Greeks, Romans and Byzantines. By 641 AD, the Muslim Arabs had conquered the whole country. The Fatimids from Morocco invaded in 969 AD, founding the city of Cairo (Al-Qahira – the Conqueror) and establishing the Al-Azhar University. Subsequent rule by Salah Al-Din (Saladin) and the Mamluk Sultans was ended by the Ottoman occupation of 1517 AD.

In the mid-19th century, Muhammad Ali’s dynasty oversaw the westernisation of Egypt, the building of the Suez Canal and the colonisation of the Sudan. In 1882, British forces occupied Cairo and the British Consul-General became the effective ruler. Egypt profited from the two World Wars. Britain recognized Egyptian independence in 1936. But Arab nationalism and defeat in the 1948 Arab-Israeli war discredited the (Ottoman-descended) monarchy, and on 23 July 1952 the Free Officers seized power, sending King Farouk into exile.

First, briefly, Neguib, and then Nasser took over, the latter soon becoming an iconic figure of Arab nationalism. Israel, Britain and France launched their ill-fated 1956 attempt to seize the Suez Canal; Egypt and Syria enjoyed a short-lived union, the United Arab Republic (1958-61); and after the disastrous Arab-Israeli War of June 1967, Israel occupied the entire Sinai. Yet Nasser’s death in 1970 was mourned throughout the Arab countries.

His successor, Anwar al-Sadat, expelled the 15,000 Soviet military advisers (1972); launched the October 1973 War (a partial triumph for Egypt) and the economic Infitah (or opening up); promoted improved relations with the USA; and made a bilateral peace with Israel following US-brokered talks at Camp David. This in turn caused Egypt's expulsion from the Arab League and on 6 October 1981 Islamists assassinated Sadat at a military parade.

Vice-President Hosni Mubarak took over as president. He abandoned many of the unpopular features of Sadat's domestic policies, condemning privilege, ostentation and profiteering, and placing new emphasis on economic reform (but see below).

The current situation

Since his accession, Mubarak's Egypt has played a pivotal role in the Middle East Peace Process, and has been rewarded for this by substantial international support, mainly from the US. Mubarak oversaw the return of Egypt to the Arab League in 1991. In the same year, Egypt joined the international coalition which drove Iraqi occupying forces out of Kuwait. The Peace Process is now apparently in serious crisis: but this is not for lack of Egyptian goodwill and effort. Internally, Mubarak is unchallenged, and on 26 September 1999 was re-elected for a fourth six-year presidential term, the constitution having twice been specially amended to allow this to happen.

The internal political and economic scene is less positive. Political stagnation, lack of democracy and occasional low-level violence have led to loss of direction and a sense of stagnation. Against a background of continuing rapid population growth, poverty and inadequate public services, poor political and economic management and excessive bureaucracy have allowed social problems to accumulate and multiply and have failed to allow the economy to develop or to deliver adequate improvements in living standards.

The Egyptian Parliament is bicameral: the People's Assembly (PA) is the main legislative body with the Shura Council (SC) providing an oversight mechanism. Egyptian democracy has long been paralysed by a sclerotic system of patronage and client networks, which serves the regime and has worked until now as a factor for stability and continuity. The ruling National Democratic Party (NDP) dominates the PA, holding over 80% of the seats. Disaffection with its performance, has however been increasing, particularly amongst the young, making political reform a key requirement for Egypt's further development.

Formally, the People's Assembly has important powers. Elections are held every five years: 444 deputies are elected and 10 more appointed by the President. The Shura Council has 176 elected members and 88 presidential appointees. But the influence of the Parliament in Egyptian political life should not be over-estimated. Key regime interests are 'off limits' to deputies. The National Democratic Party (NDP) has however been in nominal power since its formation by President Sadat in 1978 and still dominates the People's Assembly. At present, since the elections of 2000, the NDP holds 388 seats, independent candidates 20, the Muslim

Brotherhood 17 (nominally as independents) and 4 assorted opposition parties between them the remaining 17. The NDP's majority conceals the fact that in the elections, only 178 official NDP candidates won an Assembly seat under the NDP banner. Their numbers were boosted by 210 “independents” who then joined the party. The electoral process in Egypt is clearly subject to considerable outside influence. But it was interesting that the regime failed to prevent the 17 Muslim Brotherhood deputies from winning their seats, despite harassment of candidates and manipulation of the voting process.

Spurred on by its poor performance in 2000, the NDP has since embraced wide-reaching personnel and structural changes and adopted a number of key policy papers – on Education, Healthcare, Economic Policy, Youth, Women and Foreign Policy. Leading old guard figures were sidelined, and Gamal Mubarak – the President’s younger son - appointed Secretary for Political Affairs, a new post giving him effective day-to-day control of NDP policy formulation. This shifted the balance of power in favour of Gamal’s progressive/reformist group, and he is said to be well placed (though far from certain) to succeed his father one day.

But in reality, if not constitutionally, the power of the President is supreme. President Husni Mubarak, who succeeded President Sadat in October 1981, began a fourth term in October 1999 after 93.97% of voters nominally approved his candidacy. In practice he relies on his control of the power-broking elite, including mainly the military and security apparatus. There is no obvious successor to President Mubarak, not least because he has continually refused to appoint a vice-president who could take over his post if and when he left. Whoever does succeed him will be chosen on the basis of his acceptability to the military and security, presumably on their view of his ability to maintain stability in the country.

Reform must therefore come from the top down, and there are some limited signs that this is happening. The NDP held its first ever Annual Conference (one of the structural reforms agreed at a 2002 General Congress) in Cairo on 26-28 September 2003, under the slogan "New Thinking and Citizens' Rights”. In his speech, President Mubarak announced the abolition of military decrees, except those relating to national security, which had been issued under the State of Emergency, now in force for over 20 years.

The main, though still limited, real opposition to the Government comes from the Muslim Brotherhood, which has spent 50 years promoting its agenda of islamising politics through peaceful means. It has 17 PA seats and growing support – thousands of supporters attended the funeral in Cairo of the Brotherhood's Supreme Guide in January 2004. Its non-political work (e.g. in parallel social services such as subsidising schools and hospitals) is also popular. But like other opposition parties, its activities are closely monitored and controlled by the Government, which has a deep aversion against legitimising any form of "political Islam".

The Islamic factor

Formally, the Muslim Brotherhood and other Islamist organisations are banned. But as already noted, they are a factor to be reckoned with. The Egyptian government also faces a sporadic threat from Islamic extremism. Since 1992 the Egyptian authorities and militant Islamic groups have continued a low intensity conflict against each other, mainly in Upper Egypt. Islamic militants have targeted foreigners, killing several foreign tourists (including eight Britons).The worst attack, on 17 November 1997, was in the hitherto relatively unaffected area of Luxor, when 58 tourists, six of them British, were murdered. UK official travel advice currently warns travellers to be vigilant and respect any advice from the local security authorities: but tourism continues on a large scale, carefully protected by the authorities.

Over the past decade, hundreds of suspected militants and police have been killed and there have even been assassination attempts on President Mubarak (most recently in September 1999 in Port Said) and key Ministers. The authorities have contained the threat but have yet to eradicate it. Human rights organisations, including the United Nations, have accused the security forces of human rights violations in their response.

Human Rights

Egypt has ratified the six core UN human rights conventions and guarantees certain basic human rights (e.g. religious freedom) in its constitution. But there are concerns about individual cases of human rights abuse, but also positive developments in recent years in Egypt's human rights record. For example, where outsiders have had concerns about alleged widespread use of torture by the Egyptian security forces, the authorities have taken steps to clamp down and a number of police officers have been convicted for torture offences.

Human rights is naturally a sensitive area for the Egyptians, as for other North Africans. They see policing/security issues as a domestic matter integral to their fight against terrorism. However, on 19 January 2004, the Egyptian Parliament approved the establishment of a 26 member National Council for Human Rights (headed by the former UN Secretary-General Boutros Boutros Ghali) and abolished seven of the eleven military decrees issued since the State of Emergency was declared in 1981.

Economy

Basic statistics:

- GDP: $268 billion (2002, est.)
- GDP per head: $3900 (2002 est.)
- Inflation: 4.3% (2002)
- Major Industries: Agriculture, Manufacturing, Services
- Major trading partners: EU, Middle East, USA
- £1 = 9.75 Egyptian pounds $1 = 6.22 Egyptian pounds)

The performance of the Egyptian economy has fallen well below its potential. The regional tensions and conflicts of the past fifty years (notably Suez 1956, Sinai 1967 and the October war of 1973) have made things difficult. Egypt has advantages: regular hard-currency earnings from Suez Canal dues, tourism (terrorism permitting), US subsidies as part of their financial support of Israel, other foreign contributions, increasing oil revenues, foreign investment, a large internal market and a thriving and dynamic entrepreneurial class, many of outstanding ability. and a large, willing and reasonably educated workforce.

The government led by Prime Minister Mr Atef Obeid (since 5 October 1999) is considered liberal and business-oriented. The Minister of Economy, the Coptic Dr Yousuf Boutros-Ghali, formerly of the IMF, is a star economist by any standards.The Egyptian Government is addressing the need for economic reform to address some of the underlying causes of extremism, with measures to privatise some of the large public sector and attract foreign investment. A stand-by agreement has been agreed with the International Monetary Fund and the stock market has grown impressively.

But political reform has been slower in coming. The existing political and economic systems, dominated by security concerns and characterised by heavy central controls, have so far not allowed the country free rein to develop. The current Western occupation of Iraq and the international efforts to contain terrorism are complicating factors. The principal obstacle to progress lies however in the persistent stresses of the Arab/Israel dispute. A settlement of that conflict would revolutionise the economic prospects for the whole region.

In trade, Egypt is heavily import-dependent. Exports include oil/petroleum, cotton and textiles. A significant proportion of foreign currency earnings come from service industries, mainly tourism, and migrant workers' remittances. But economic policy often has to be subordinated to social issues such as poverty and inequality. The government's tight monetary stance makes its aim of 7% annual growth unlikely in the short term.

The prospects for the medium-term, supported by the regular sources of external income and other assets mentioned above, seem however more promising. The UK is at present the largest Western investor in Egypt, ahead of the US and all other EU member states: only Saudi Arabia and perhaps Kuwait have a larger stake in Egypt. UK investments are currently estimated at $18 billion, with a further $7 billion due in next 5 years from BP Shell and British Gas. Other UK investments in Egypt are in financial and business services, tourism, pharmaceuticals, textiles and consumer goods.

Conclusion

Like other countries of this region, Egypt is much more than the sum of its current political and economic policies and problems. In this part of the world, culture and identity, education and religion, human attributes, must all be taken into account. Human contacts are often decisive in business success. Personal attributes and traditional behaviour patterns, including such qualities as entrepreneurial flair, profound tolerance, work discipline, ability to confront and surmount problems and readiness to welcome and work with foreigners, (all extensively tested over the past two centuries and more) mean that Egyptians are likely to be co-operative and reliable partners in business ventures in the Middle eastern region. As the title of this session implies, Egypt is a promise waiting to be fulfilled.

4 EGYPT'S RACE FOR GAS EXPORT MARKETS

Introduction

Following strong growth in the late 1990's, Egypt's economic growth has slowed in recent years. Real GDP growth registered just 3.2% in 2002, compared with 5.9% in 2000. Nevertheless attempts to stabilise inflation have been successful with average annual inflation of 2.4% in 2002, down from 7.3% in 1996.

The price of consumer imports, along with staples like bread, rice and sugar, soared after the government moved in January 2003 from fixed exchange rates to a free float against the dollar, which led to a 26% devaluation of the Egyptian pound. Mindful of past bread riots, the government boosted subsidies, but at a heavy cost to the budget. The devaluation increased export earnings, but not enough to cover foreign exchange shortages, sparking a request in March 2003 for a $1.5 bn World Bank loan.

Table One – Key economic indicators.

	1996	1997	1998	1999	2000	2001	2002
Real GDP Growth (%)	5.0	5.3	4.1	5.4	5.9	3.4	3.2
Average annual inflation (%)	7.3	6.2	3.8	3.8	2.8	2.4	2.4
Unemployment rate (%)	9.2	8.8	8.8	8.1	7.7	8.3	9.0
Fiscal deficit (% of GDP)	1.3	0.9	1.0	3.0	3.9	5.5	5.8
Current account (% of GDP)	(0.3)	0.2	(2.9)	(1.9)	(1.2)	(0.04)	(0.01)
Foreign debt (% of GDP)	45.9	36.7	33.2	31.2	28.2	28.5	32.6
Total debt (% of exports)	203.6	173.5	180.2	182.4	156.0	141.5	176.3
Exports							
Petroleum (US$m)	2,226	2,578	1,728	1,000	2,273	2,632	1,904
Other exports (US$m)	2,383	2,768	3,400	3,445	4,115	4,446	4,740
Sectoral Output							
Petroleum products (% of GDP)	6.9	7.1	6.1	6.0	5.5	5.3	5.2

Investments							
Petroleum products (%)	-	14.8	10.4	12.9	10.4	11.6	11.7
GDP per capita (US$)	1,116	1,274	1,392	1,431	1,550	1,250	1,276

Source: Egyptian Ministry of Finance, Ministry of Planning, Central Bank of Egypt as at 31 December 2002.

Egypt's sources of hard currency, particularly tourism, have been negatively affected by increased regional tensions and fears of war and terrorism. Notably Egypt's other main sources of hard currency have also been affected, chiefly oil exports and Suez Canal revenues. In the longer term, macro-economic prospects are more favourable although it is clear that structural reforms are a necessity. The principle challenge lies with employment, where unofficial figures put the unemployment rate at approximately 20.0%, double the official unemployment rate quoted above. As a result Egypt is seeking foreign investment in order to maintain a high GDP growth rate and satisfy the annual increase in demand for jobs.

In order to achieve this the government intends to accelerate its privatisation programme, though restrictive labour laws are seen as prohibitive. Notably while petroleum products represented just 5.2% of GDP in 2002 investment into the sector lies at 11.7% of total investment. In the coming years the government intends to target the telecommunications and utilities sectors for privatisation, though there are is no intention to privatise the Egyptian General Petroleum Corporation (EGPC) or the new natural gas entity Egypt Gas (EGAS). It is here that Egypt's future lies. While oil exports have been declining as production at mature fields continues to fall and domestic demand continues to increase; natural gas exports are expected to become a major source of hard currency revenues over the next decade.

Egypt's oil industry

Sameh Fahmi, Egypt's Petroleum Minister, is responsible for implementing Egypt's new integrated petroleum strategy to the year 2020. He was one of the experts behind the previous strategy for natural gas to 2017. Immediately as he became minister, he got the government to endorse plans to export gas in LNG form and by pipeline and in January 2000 submitted to President Mubarak a new plan to 2020 which was much bolder and focused on natural gas exports. Egypt’s oil production during 2002 was approximately 631,00 bbl/d, down from 748,000 bbl/d in 2000 and 922,000 bbl/d from its peak in 1996.

Demand for petroleum products has declined slightly since 1998 after rapid growth in the previous 5-years, as a result of the removal of state subsides and an increase in the use of compressed natural gas. Egypt hopes that exploration activity, particularly in virgin territories, will discover sufficient oil to slow the decline in output. Egypt's consumption of primary energy has risen from less than 22m tons/year of oil equivalent in the early 1980s to over 50.7m t/y in 2003. The government has been focusing on accelerated efforts since the late 1990s to curb local oil demand and boost gas consumption. Oil consumption now is limited to 575,000 b/d, having risen moderately from 440,000 b/d in 1988. Gasoline consumption is 3.2m t/y compared to 2.08m t/y in 1997.

Egypt's oil production has been falling steadily since the third quarter of 1995 when it peaked at 950,000 b/d. Output recently has been approximately 700,000 b/d, but it is expected to fall in the coming months and the 2004 average might be as little as 650,000 b/d. Most of Egypt's oilfields are declining due to reserves depletion and a resultant fall in reservoir pressure.

Egypt’s oil production currently come from four key areas, the Gulf of Suez, the Western Desert, the Eastern Desert and the Sinai Peninsula. Oil from the Gulf of Suez basin is produced mainly by Gupco (Gulf of Suez Petroleum Company), a joint venture between BP and the Egyptian General Petroleum Corporation. Production in the Gupco fields, with most wells in operation since the 1960s and 1970s, has fallen in recent years. Gupco is attempting to slow the natural decline in its fields through significant investments in enhanced oil recovery as well as increased exploration. BP is undertaking a program to invest $450m over six years (starting in 1999) in technology to prolong the productive life of Gulf of Suez fields.

The Gulf of Suez Petroleum Co. (GUPCO), a 50-50 JV between EGPC and BP with the latter being the operator, is Egypt's biggest oil producer. But its GOS output has fallen to 215,000 b/d, compared to 280,000 b/d in early 2000, 310,000 b/d in early 1998, 430,000 b/d in 1992 and 500,000 b/d in the 1980s. GUPCO's crude oils make up the Suez Blend, 32 deg. API which is Egypt's main export crude oil. Its output in the Western Desert has declined to 20,000 b/d. But GUPCO's GOS output is to rise in the coming months with the development of oilfields found in the past two years. GUPCO has more than 38 offshore fields in the GOS, which include Morgan, July, October, Ramadan, Ras Shukheir, Sidki, Shoab Ali, Badri and East Tanka Asl. From 1990, Amoco acquired additional blocks in the GOS, because its fields then were 25-37 years old and most of them were declining. Since its absorption of Amoco, BP has acquired several other blocks in the region. The latest were four blocks which BP got in April 2003, three in the GOS - East Morgan Block 2, North Ghara Block 4 and East Warda Block 35 - and one in the northern Red Sea covering Blocks 12/13.

Morgan, a giant and Amoco's first oil find in 1965, has been in decline since the late 1980s. Despite the tie-in of small fields later found nearby, Morgan's capacity now is less than 40,000 b/d, compared to 120,000 b/d in late 1995. Morgan's life was extended by 30 years, but at a relatively low capacity, with the completion of a water injection system in May 1997. The field's remaining recoverable reserves were thus doubled to 230m barrels. Before work on the $450m modernisation programme began in late 1999, the field had 160 production and water injection wells hooked up to 24 platforms.

October, found in 1978, is BP's biggest field with extensions discovered in recent years, including one in 1994. October and its satellites, including major northern extensions developed in the late 1980s and early 1990s, now produce 85,000 b/d, compared to 180,000 b/d in late 1995. Ramadan, Amoco's third major discovery in 1974, and satellite fields produce 20,000 b/d of 30-31.7 deg. oils from the Lower Cretaceous at a depth of 11,400 ft, down from 40,000 b/d in early 1998.

Egypt's second largest oil producer is Petrobel, which is a joint venture between EGPC and Agip of Italy. Petrobel operates the Belayim fields near the Gulf of Suez, and is similarly undertaking an upgrade program to stem declining production. GOS/South Sinai - Belayim Petroleum Co. (Petrobel), EGPC-Agip (locally known as Int'l Egyptian Oil Co. - IEOC), is Egypt's second largest oil producer and for many years has been the biggest gas producer operating both in Sinai and the GOS. Its main gas production is in the Nile Delta and the Mediterranean.

Petrobel's oil output has fallen to less than 190,000 b/d, compared to 210,000 b/d in early 1998 and a peak of 240,000 b/d in 1993. Petrobel has several fields, including the onshore/offshore Belayim system consisting of

Belayim Marine and Belayim Land in Sinai and Ras Gharrah in the GOS. After an agreement in early May 2000 with EGPC, IEOC launched a $450m programme to stabilise its oil production at 200,000 b/d over a five-year period. But since then the fields have declined at a rapid rate and Petrobel's production has fallen, despite several discoveries.

Other major companies in the Egyptian oil industry include Badr el-Din Petroleum Company (EGPC and Shell); Suez Oil Company (EGPC and Deminex); and El Zaafarana Oil Company (EGPC and British Gas - BG).

While production from these joint ventures has been steadily declining, new output from independent producers such as Apache has helped to slow the decline. Many of these fields are located in the Western Desert and Upper Egypt. Crude oil production in the Qarun block in southern Egypt reached around 60,000 bbl/d by early 2000, but has since fallen to 36,000 bbl/d. Apache has developed the Beni Suef IX field in the East Beni Suef concession in Upper Egypt, which produces over 5,000 bbl/d. The field is said to contain around 100m barrels of crude oil. A joint venture between EGPC and Agip also is producing about 50,000 bbl/d from an area in the Qattara Depression in the Western Desert, in the Meleiha and West Razzaq blocks.

Tanganyika Oil announced its scheduled work program for the West Gharib Block in Egypt in February 2004. The West Gharib Block in Egypt is a 1,898 sq.km concession flanking the Gulf of Suez. The block contains the producing Hana field as well as numerous exploration prospects. Production from the Hana field in Egypt has remained steady due to regular and ongoing well workover and water shutoff programs throughout the year. Tanganyika has a 70% participating interest in the West Gharib block and is the operator.

Offshore oil production is a possibility with the largest concession awarded to Shell, in February 1999, for a large deepwater area off Egypt's Mediterranean coast. BP Amoco and TotalFinaElf were also awarded a large offshore block in the same bidding round. A smaller offshore concession was awarded to Italy's ENI-Agip. While most discoveries offshore from the Nile Delta have been natural gas, it is believed that there may also be large quantities of oil in the area. Shell reportedly is optimistic about the prospects for its North East Mediterranean Deepwater (NEMED) concession.

Suez Canal / Sumed Pipeline

Egypt's role within the oil industry is more significant for its operation of the Suez Canal and the Suez-Mediterranean Pipeline, and therefore its partial control over the export of Persian Gulf oil. Nevertheless revenues have been declining over the last ten-years due to increased competition from alternative routes. To try and offset this decline the Suez Canal Authority (SCA) published a new tariff in 1999, offering a 35% discount to both oil and LNG tankers.

To accommodate the very large crude carriers (VLCC's) and LNG tankers the SCA continues to enhance and enlarge the canal. The SCA currently offers incentives for tankers to off-load a portion of its cargo through the Sumed, allowing for passage through the canal, and reloading at the other end of the pipeline.

The Sumed pipeline is an alternative to the Suez Canal for transporting oil from the Persian Gulf region to the Mediterranean. The 200-mile pipeline runs from Ain Sukhna on the Gulf of Suez to Sidi Kerir on the Mediterranean. The Sumed's original capacity was 1.6m bbl/d, but with completion of additional pumping stations, capacity has increased to 2.5m bbl/d. The pipeline is owned by the Arab Petroleum Pipeline Company (APP), a joint venture between Egypt (50%), Saudi Arabia (15%), Kuwait (15%), the UAE (15%), and Qatar (5%) .

Egypt's natural gas industry

In the last few years natural gas has become the most likely source of revenue for Egypt's energy sector. Active exploration led by foreign oil companies has led to major recent discoveries and a steady increase in Egypt's total recoverable natural gas reserves. Significant natural gas deposits have been discovered in the Nile Delta and in the Western Desert. Major foreign companies involved in natural gas exploration and production in Egypt include BG, BP, Eni, and Shell. Apache also produces gas from its concessions in the Western Desert.

As a consequence of these discoveries Egypt's natural gas industry is expanding rapidly with production having doubled between 1999 and 2002. Natural gas production in Egypt stood at about 3.0 bcf/d in late 2002, and is expected to rise to around 5.0 bcf/d by 2007, with much of the increased volume being exported as LNG. The Egyptian government formed a new state-owned entity in 2001 to manage the natural gas sector, Egyptian Natural Gas Holding Company (EGAS), separating those assets out from EGPC.

Under the terms of Egyptian production sharing agreements, EGAS has the right to acquire gas for its domestic network, which is being expanded to cope with rising domestic demand for feedstock power generation and industrial use. The two liquefied natural gas (LNG) plants being developed at Idku and Damietta are also driving the impetus for gas exploration, as is the Egypt-Jordan regional gas pipeline, for which the second phase of expansion has been launched. However, government guidelines rule that export commitments cannot exceed a third of proven gas reserves.

Estimates of proven natural has reserves are currently in the region of 58Tcf, though probable reserves are likely to be double this figure. The Nile Delta in particular has emerged as a world-class natural gas basin, with recent offshore field developments including Port Fuad, South Temsah, and Wakah. In the Western Desert, the Obeiyed Field is an important natural gas area currently under development.

The International Egyptian Oil Company (IEOC), a subsidiary of Italy's Eni, is presently Egypt's leading natural gas producer, operating in the Gulf of Suez, the Nile Delta, and the Western Desert regions. In co-operation with BP Amoco, IEOC has been concentrating its natural gas exploration and development efforts in the Nile Delta region.

On November 4, 1997, BP (along with its partners EGPC and IEOC) announced plans to develop the giant Ha'py gas field in the Ras el-Barr concession of the Nile Delta region at an estimated cost of $248m. The field came onstream in February 2000, and has reached an output of 280 mcf/d. In September 1997, IEOC tested the Temsah gas field (located offshore from the Nile Delta) at 11.6 mcf/d. In October 1998, BP (25% owner) and Eni signed a natural gas sales agreement with EGPC (50% owner) and IEOC (25% owner) for Temsah. Temsah's gas reserves are estimated at 3.9 Tcf, and the gas sales agreement was for 35 mcf/d initially in 2000, increasing to 480 mcf/d by 2003.

Eni reported another find in its East Delta Deep Marine concession, which may hold as much as 1 Tcf of additional reserves. Canadian independent Centurion Energy reported a new discovery in the El Manzala concession, onshore in the Nile Delta, in August 2001. Centurion signed a contract in October 2002 with the Egyptian government to begin natural gas deliveries from El Manzala of 35 mcf/d in mid-2003.

Two areas in the Western Desert, Obeiyed and Khalda, have shown great potential for increasing Egypt's natural gas production in the near future. Obeiyed is producing 300 mcf/d, after the completion of a pipeline linking it to Alexandria. Production in the Khalda concession is currently around 200 mcf/d. Apache reported another gas discovery at Khalda in August 2001. Output from Obeiyed and Khalda is transported to Alexandria by a 180-mile pipeline.

Several major new natural gas finds are currently under development in the Nile Delta region. In May 1999, the Italian firm Edison and the BG Group made a large find (Scarab/Saffron) in their West Delta Deep Marine concession, which tested at 45 mcf/d, followed by another (Simian) which tested at 44 mcf/d in October 1999. The two companies announced in July 2000 that their second and third wells at the field also had tested successfully at a similar flow rate, which was constrained by the capacity of the equipment.

The Scarab/Saffron finds are currently under development, with commercial production of 600 mcf/d to begin in 2003. Bids were solicited in November 2002 for the development of the Simian field, which is to link into the same pipeline to the Egyptian coast as the Scarab/Saffron fields. BP Amoco and Shell also have concessions offshore from the Nile Delta, and initial seismic survey work and exploratory drilling has indicated significant probable reserves. Shell has announced that probable reserves in its Northeast Mediterranean (NEMED) concession are 15 Tcf. ExxonMobil also holds a 25% stake in this concession. BP and the IEOC also are preparing to bring several fields off the Nile Delta coast into production. BP reported a new find estimated at 500 Bcf in the offshore North Alexandria Concession Area in July 2001.

Formed in 1997 to develop and market gas from the offshore Rosetta block, Rashpetco is a JV of ENGHC (50%), British Gas (operator with 20%), Shell Egypt (10.2%), Shell Austria (9.8%) and Edison Int'l (10%). Edison is a US unit of Italy's Montedison chemical group. Rosetta block, north of the Delta town of Rasheed, lies between Abu Qir to the west and Baltim to the east and has a giant gas field found in April 1997 with important extensions found subsequently and proven reserves estimated at 2 TCF. The first find was in 200 ft of water 48 km north-east of Alexandria in three net gas zones of over 460 ft of sandstone at about 6,000 ft and tested 60 MCF/d. The second, Rosetta 5, in Nov. 1997 tested over 90 MCF/d which was the highest rate in any gas find made in Egypt. Also in Nov. 1997 Rosetta 6 tested 40 MCF/d. These and subsequent finds in Rosetta went on stream on Jan. 31, 2001. BG says the Rosetta gas is of very high quality with less than 0.5% impurities.

In Oct. 1997 Rashpetco signed with EGPC a 20-year take-or-pay contract whereby EGPC (now ENGHC) was committed to buy 250 MCF/d of Rosetta. The field now produces 275 MCF/d. The $330m field development consists of six wells tied to a platform with a 66 km gas/condensate pipeline to an onshore terminal near Idku, about 50 km east of Alexandria. After processing at an onshore plant, the gas is delivered to the national grid. The condensate is exported by pipeline to a gathering centre at Abu Qir, 15 km east of Alexandria.

Shell announced two ultra-deepwater hydrocarbon discoveries in the company's North East Mediterranean Deepwater Concession (NEMED) off the Egyptian coast in February 2004. Shell stated that the discoveries in two locations in the south-west part of the concession have demonstrated that the concession is a rich hydrocarbon province. Shell and its partners, Petronas Carigali Overseas and the Egyptian Natural Gas Holding Company, will now evaluate the data before moving forward with phase two of the exploration project ahead of commercialising the finds.

Bids are due on 15 April 2004 for six offshore blocks in the Mediterranean covering a total area of 7,250 sq.km. As part of the same bid round, Egyptian Natural Gas Company (EGAS) in late January 2004 received bids for two onshore concessions in the Nile Delta area, the 1,928 sq.km West El-Manzala block and the 1,294 sq.km West El-Qantara block. A further bid round has also been muted for later in 2004. Five of the new offshore blocks, El-Burg, North El-Burg, Burullus, West Burullus and Northwest Sapphire, are 1,250-1,450 sq.km in size, while the West El-Tabya block covers 581 sq.km.

The new acreage is expected to draw a strong response from international oil companies due to the quantity and high quality of 3D seismic data gathered by the government since 1992, which has meant that the Mediterranean and Nile Delta regions have enjoyed a high exploration success rate. The last five years of exploration have resulted in the discovery of at least 33 major fields.

Domestic demand for natural gas

Under the terms of Egyptian production sharing agreements, EGAS has the right to acquire gas for its domestic network, which is being expanded to cope with rising domestic demand for feedstock power generation and industrial use. The two liquefied natural gas (LNG) plants being developed at Idku and Damietta are also driving the impetus for gas exploration, as is the Egypt-Jordan regional gas pipeline, for which the second phase of expansion has been launched. However, government guidelines rule that export commitments cannot exceed a third of proven gas reserves.

Natural gas demand has grown rapidly in Egypt as thermal power plants, which account for about 65% of Egypt's total gas consumption, have switched from oil to gas. Domestic natural gas consumers are to be served by several private distributors, franchises which were awarded in late 1998. One of the franchises, awarded to a team headed by BG and including the Egyptian construction firm Orascom and Edison of Italy, is developing distribution infrastructure in Upper Egypt as far south as Asyut, where no piped natural gas had been available. After the initial phase, valued at $220m, a possible later phase may extend the natural gas grid south to Aswan.

Gas consumption has risen to 3,800 mcf/d, compared to 2,300 mcf/d in early 2000. Marketed gas production has risen to about 4,000 mcf/d from 1,700 mcf/d in early 1998, compared to 1,600 mcf/day in mid-1996, 1,500 mcf/day in late 1995 and a mere 4.5 mcf/d in 1974.

Natural gas exports

The rapid rise in natural gas reserves has led to a search for export options, which has become particularly important to Egypt's future international balance of payments due to the decline in oil exports. In late 1999, the Egyptian government stated that natural gas reserves were more than sufficient for domestic needs, and that foreign firms producing gas in Egypt should seek export customers. In early 2000, the government announced a moratorium on new purchase agreements by EGPC for domestic consumption, as previously signed agreements will meet projected demand over the next several years. It also announced in September 2000 a new pricing policy which includes ceiling and floor prices, designed to protect both consumers and producers from the risks of prices indexed to oil.

The idea of exporting natural gas to Israel has been under discussion for several years, but appeared by mid-2001 to have been sidelined for the time being by the deterioration in Egyptian-Israeli relations as a result of renewed violence between the Palestinians and Israel. The most ambitious version of the scheme would have involved the construction of an offshore pipeline from El-Arish in Sinai up the coast of Israel, with a possible extension onward to Turkey. The East Mediterranean Gas Company (a consortium of EGPC, Merhav of Israel, and Egyptian businessman Hussein Salem) had been set up to pursue the project. ENI completed a pipeline up Egypt's Mediterranean coast to El-Arish, which could have served as a starting point for the export pipeline.

Egas, as part of the East Mediterranean Gas (EMG) consortium is continuing discussions with state Israel Electric Corp. over supplying 1.7 bcm/yr over 15 years. Israel selected EMG, backed also by private Egyptian investors and Israel's Merhav Group, as a second gas supplier in August 2003. But controversy over a $200-300m bank guarantee demanded by the Egyptian government to cover the cost of financing a pipeline from Egypt to the Israeli border threatens to delay a final deal. Although Israel Electric reportedly agreed to provide the bank guarantee, its board refused to approve such terms.

A smaller export pipeline to Jordan has been constructed from a pre-existing pipeline terminus at El-Arish to Aqaba in Jordan, with a sub-sea section in the Gulf of Aqaba bypassing Israeli waters. First gas from the Arab Gas Pipeline started flowing from El Arish in Egypt to a power station in Aqaba, Jordan, in August 2003, and in January 2004 interested parties agreed to extend the pipeline 370 km north to a second power station in Jordan. The 370-km pipeline from Aqaba to northern Jordan is to be built in 30 months. Construction is to begin shortly. The gas will fuel other power plants and industry in Jordan. The $250m pipeline will be built on BOOT for an Egyptian group called EPEG comprising Egas, Gasco, pipeline contractor and EGPC/Egas affiliate Petrojet, and EPC contractor Engineering for the Petroleum & Process Industries (Enppi) which is another affiliate of EGPC and Egas.

Egypt, Jordan, and Syria agreed in principle in early 2001 to extend the pipeline into Syria, with eventual natural gas exports to Turkey, Lebanon, and possibly Cyprus. The feasibility of this option is questionable, though, as Turkish demand probably would not support another source of piped gas (beyond existing agreements in place with Russia, Azerbaijan, Iran and Iraq).

The Palestinian Authority is reportedly due to sign an agreement with Egypt for the purchase of 300 mcm/y of natural gas. The gas will be delivered by pipeline and used to fuel a power plant in the Gaza Strip. Al-Shawa said the pipeline would be constructed at an estimated cost of $15-20m. The pipeline would be financed by the Palestinian Investment Fund. The Palestinian Authority had hoped to fuel the plant on gas from the Marine field, off the Mediterranean coast of the Gaza Strip, but the UK's BG Group failed to reach a supply agreement with Israel making development of the field unfeasible.

Egyptian LNG

Egypt's other option for exports is LNG. Two LNG projects are currently underway. The Spanish firm Union Fenosa is building a two-train liquefaction facility at Damietta, which is scheduled to begin commercial production in late 2004. Unlike most previous LNG projects, this one is not tied in directly with upstream natural gas production. Union Fenosa has contracted with EGAS for the supply of natural gas from its distribution grid, and will take all of the LNG output itself for use at the company's power plants and distribution to other users in Spain and elsewhere in Europe. Eni also has become involved in the project recently, having purchased a 50% stake in Union Fenosa's natural gas business in December 2002.

With several projects now ongoing, state Egyptian Natural Gas Holding Co. (Egas), established in late 2001, is emerging as a gas seller in its own right. Egas is marketing LNG expected late 2004 from Spanish Egyptian Gas Co.'s (Segas) first train, which at 7.6 bcm/y will briefly be the world's largest. Segas is 80% owned by Spain's Union Fenosa Gas -- itself 50% owned by Italy's Eni -- and 20% by state Egyptian General Petroleum Corp. and Egas.

The second LNG export project, at Idku, is to be built by BG in partnership with Edison of Italy. The project is tied in to natural gas reserves from BG's Simian/Sienna offshore fields, and is scheduled to begin production in 2005. Gaz de France is to be the main off -taker for the Idku LNG project, having signed a contract in October 2002 for 127 Bcf per year beginning in 2005.

BG Group, having made the biggest gas discoveries in Egypt since 1996, is to turn Idku (just east of Alexandria) into one of five gas hubs it is developing around the world. BG is aiming to turn itself into an integrated energy giant delivering gas and power directly to customers. It is targeting attractive markets in southern Europe, America, and Asia.

BG signed the final deal for the Idku LNG venture, called Egyptian LNG (ELNG), with EGPC (now Egas) in April 2001. The first of its LNG trains will on stream in September 2005 with a capacity of 3.6m t/y. The second 3.6m t/y train will be on stream in April 2006. Now BG and its partners are discussing a third train. Idku, meanwhile, is being developed to site six LNG trains which, in BG's impressive model, could catapult Egypt into the top rank of world LNG exporters. Each train will have its own venture company, with a different ownership structure from the others as it will include a main buyer of the liquefied methane.

The Idku liquefaction centre is being modelled after Atlantic LNG of Trinidad & Tobago in which BG is the leader and largest shareholder (26%). Like that plant and its three additional trains, Egyptian LNG will use the optimised cascade process developed by Phillips Petroleum of the US (now ConocoPhillips). The FEED work for ELNG has been done by Bechtel which has the $900m EPC contract for Train 1 and the $550m EPC job for Train 2. Bechtel, the main contractor for the Atlantic LNG venture, has been part of the project management team for the development of the Scarab/Saffron fields in the WDDM block.

On September 25th, 2003, the Train 2 partners signed the sale and purchase agreements (SPAs) for the sale of the entire 3.6m t/y output of Train 2 to BG Gas Marketing. This will be supplied from April 2006 to BG LNG Service for the Lake Charles import terminal in Louisiana. The SPAs provide for LNG volumes to be switched in 2007 to a 6m t/y import terminal in Brindisi (Italy) on the Adriatic which is being built as a 50-50 venture for BG and the Italian power utility Enel. BG now is on the look out for firm buyers to take LNG from the third train. The Italian market will need 30 bcm/y of additional gas within the next eight years.

British Petroleum, for years the biggest oil producer in Egypt and the second biggest gas producer next Agip of ENI group, was until a few years ago leading the first LNG project ever to be conceived in Egypt. But this project has been stalled for lack of sufficient gas being produced by the major for export. BP's planned gas production of 1,200 MCF/d in 2004 is locked into Egypt's domestic market. It may take a few more years for BP to revive the LNG project. (BP is the main investor in Egypt's petroleum sector, with most of the money having been spent over the past 42 years by Amoco, the biggest oil producer in Egypt which was absorbed by BP in 1999).

Each of BP, ENI (through its local unit IEOC) and Gasco has a third share in a two-train NGL plant being built in Damietta which will cost more than \$310m. To be on stream in the third quarter of 2004, the plant will process 1,100 MCF/d of gas to produce 330,000 t/y of LPG, 280,000 t/y of propane and 1m t/y of condensates. Most of the gas liquids will be consumed locally, where demand for LPG and other liquids has risen rapidly. In late January 2001, when the JV agreement for this plant was signed, it was reported that Egypt was importing 800,000 t/y of LPG at the cost of \$200m per annum.

The gas for this plant will be produced by the Mediterranean Gas Co. (MGC) which was formed in 1997 as a joint venture between EGPC (now Egas), Agip (IEOC) and BP to develop big gas fields in four offshore blocks: Temsah and East Delta Deep Marine blocs operated by Agip (IEOC), and Baltim and Ras El Barr blocks operated by BP. Gas production from the four blocks will reach more than 1,200 MCF/d by end-2004. BP-led GUPCO operates a \$138m LPG plant in Ras Shukhair which went on stream in October 2001. This is processing 280 MCF/d of gas to produce over a 15-year period 1.1m tons of LPG, 3.9m tons of propane and 14m barrels of condensate, with the liquids also being consumed by the local market.

Petrochemicals

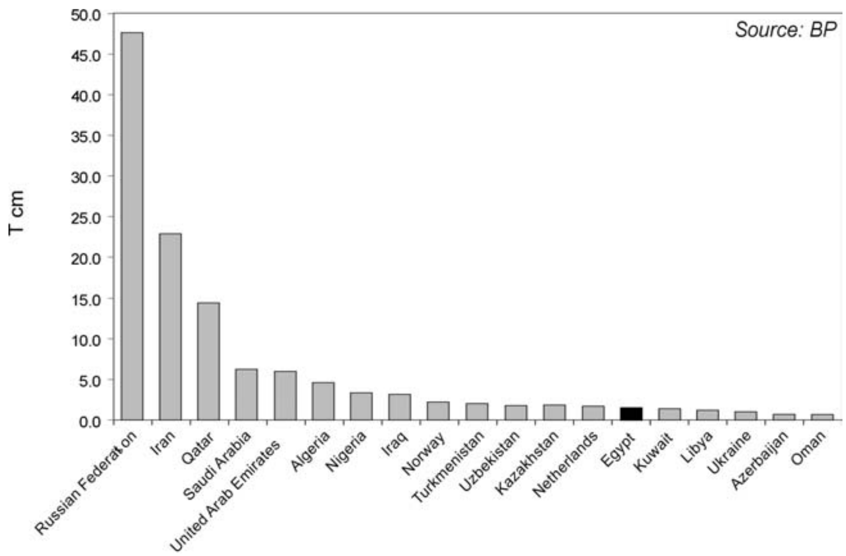
The petrochemical sector in Egypt, having grown rapidly in recent years, has been elevated to the top tier of the industrial hierarchy. The state entity in charge of this is the Egyptian Petrochemicals Holding Co. (Echem) which, as one of three strategic pillars in parallel with the Egyptian General Petroleum Corp. (EGPC) and the Egyptian Natural Gas Holding Co. (Egas), are answering directly to the Ministry of Petroleum. Echem is executing a 20-year, \$10 bn Petrochemical Master Plan (PMP) to 2020, adopted in late 2000, to raise the country's production of petrochemicals to 15 million tons per annum for the local market and for export, with new ventures to involve both the private sector and state companies of strategic importance.

The increasing availability of natural gas has been the key factor behind the expansions and the PMP. Based mostly on recommendations made in September 2000 by Chem Systems, the plan calls for 24 petrochemical complexes to be built in big industrial zones along the Mediterranean and Suez/Red Sea coastlines. They will create 100,000 new jobs.

The future for Egypt's gas industry

Recent discoveries and burgeoning reserves mean Egypt's already well-developed gas programme will soon get bigger. The current speculation is an indication of how far the local gas industry has come in such a short space of time. The gas industry has proved to be the silver lining to the cloud that has hung over the Egyptian economy over the past four years. Egypt's proven reserves of natural gas have been estimated at 60 tcf, ranking them 18th in the world in terms of natural gas reserves, worth \$232bn and proven reserves of crude oil was set at 3.7bn barrels worth \$97bn.

Chart One. Egypt's natural gas reserves relative to key competitors.

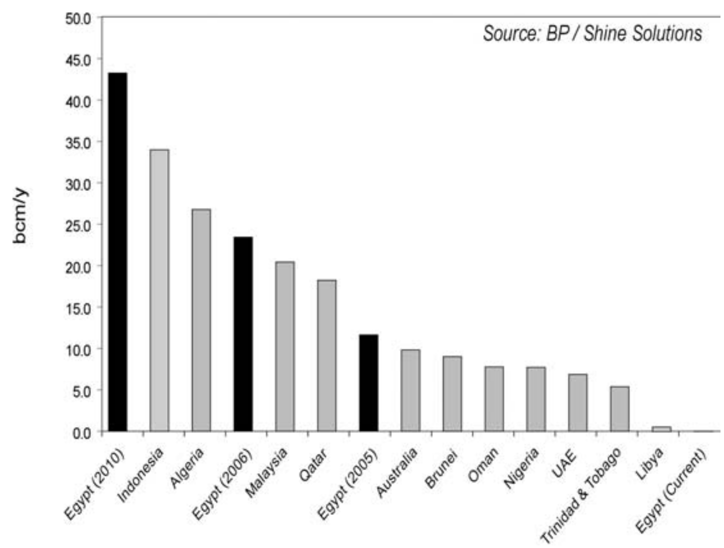


Due to its diverse industrial base and the rapid expansion of local power production capacity, Egypt already boasts one of the most extensive gas distribution networks in the region. The local market for natural gas will continue to growth at a rapid pace in the coming years. In 1997, the transport and distribution of gas were opened up to the private sector under Investments and Incentives Law No. 8. But the overwhelming impetus behind the development of the gas industry remains the government's hunger for export revenues. Egypt is already exporting natural gas by pipeline to Jordan, and further increases in capacity are expected when the regional network is expanded to Syria.

The chief focus is now on liquefied natural gas (LNG) projects. BP's announcement in early November 2003 that it had made another major gas find in its West Mediterranean offshore concession triggered fresh speculation in the industry about a possible revival of the country's third LNG complex, which has been on hold since it was licensed in 2000. Any revival of the scheme is likely to wait on an assessment of market conditions after the two existing projects, at Damietta and Idku, come on stream in November 2004 and in late 2005 respectively.

The signing in late December of the $950 million debt financing for the first train of the Egyptian LNG project at Idku - the largest ever project financing in Egypt - indicates the confidence that has been placed by foreign investors in the local gas industry and its prospects. Plans for a second train are well advanced, with Bechtel of the US mandated to conduct an early works programme, and marketing for a third train in its early stages.

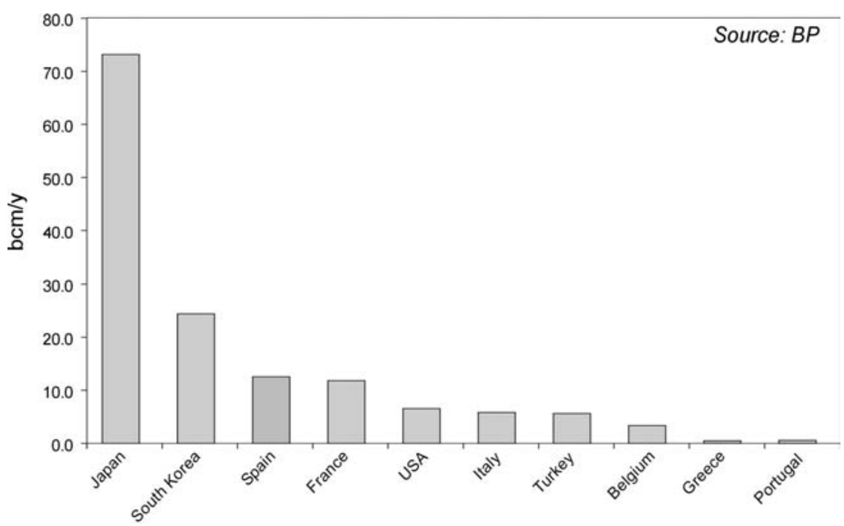
Chart Two. Egyptian LNG exports and key competitors.



The biggest challenge for Egypt would seem not to be a lack of gas reserves, but the fierce competition which it faces from other established gas producers in delivering its gas to consumers. The lucrative market of Turkey had been suggested but this already appears over-subscribed. Initial gas sales agreements with Spain and France appear to be encouraging but once again there is fierce competition from Libya and Algeria for piped gas and Qatar, Oman and Algeria for LNG. The chart above indicates the expected level of Egyptian LNG exports in 2005 and 2008.

LNG exports will increase rapidly by 2008 as BG's two-train 7.2bcm/y plant at Ikdu comes onstream. Similarly Union Fenosa's plant at Damietta will add an additional 15.2 bcm/y to capacity by 2007-2008. Nevertheless the key for Egypt lies in BG's ambitious plans to make Egypt one of five natural gas hubs it is planning around the world. A third train is already under discussion with the Ikdu site expected ultimately to deliver six LNG trains. Significantly these plans are dependent on finding consumers for Egypt's natural gas. What is clear is that Algeria and Nigeria, both of whom have expansion plans of their own, already have established sales and marketing channels with European gas consumers.

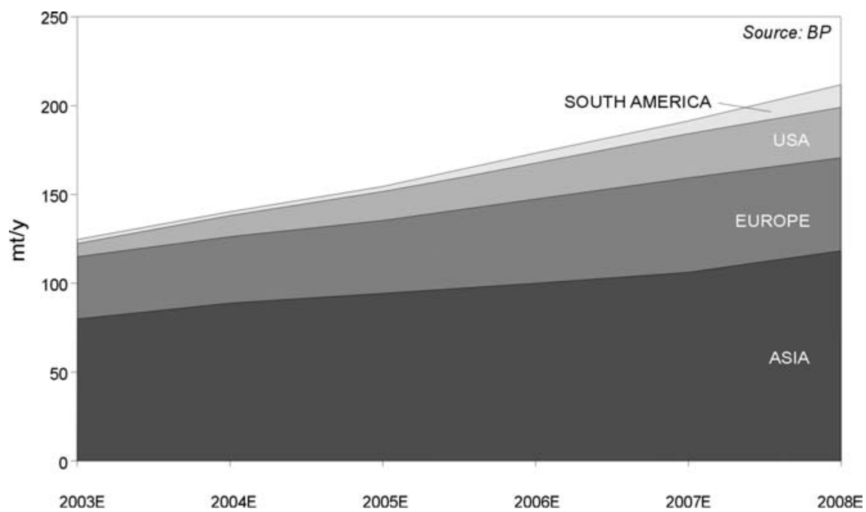
Chart Three. LNG imports by country.



It is clear that Egypt faces fierce competition in its race to market its gas reserves. The Asian market is already over-subscribed, with LNG imports from Indonesia, Malaysia, Australia, Brunei, Oman and Qatar. Nevertheless there is considerable expected demand growth in Spain, France, Italy, UK and US, and it is these markets that the Egyptian authorities should be targeting.

The chart below illustrates the current magnitude of the LNG market by region. While Asia dominates the import of LNG, it is not here that the fastest growth is anticipated. On a global basis the global LNG market is expected to grow by 10% to 2008. However, it is the US market which appears set to be the most lucrative for LNG exporters, with anticipated growth of 28% over the period to 2008.

Chart Four. Global LNG growth (2003-2008).



Notwithstanding the pressures faced by the Egyptian authorities in seizing market share, LNG exports are set to grow. This will have a positive impact on Egypt's economy from 2005, though given continued difficulties it is unlikely to be dramatic. Real GDP is expected to grow at 2.9% in fiscal 2004, up from an estimated 1.9% in fiscal 2003. The pick-up in growth during 2004 will be led by exports of goods and services. Tourism, by far Egypt 's most important export industry, has recovered extremely strongly since the downturn caused by the US-led attack on Iraq, partly because of government support and partly because of the depreciation of the pound, which allows Egypt to undercut regional rivals in terms of price.

Table Two. Economic forecasts to 2008.

	2003F	2004F	2005F	2006F	2007F	2008F
Real GDP growth (%)	1.9	2.9	3.7	4.3	4.9	5.2
Consumer price inflation (%)	4.4	5.1	4.1	3.4	3.1	3.3
Budget balance (as % of GDP)	-6.4	-7.3	-6.9	-5.8	-5.4	-5.4
Current account balance (as % of GDP)	4.3	2.5	1.0	0.7	-0.8	-1.4

Source: Shine Solutions / World Bank.

By fiscal 2005 , Egypt will benefit from increased revenues from LNG exports, leading to real GDP growth of approximately 3.7%. While LNG exports are set to diversify Egypt's economy, oil export revenues are likely to fall as a consequence of an anticipated fall in oil prices from their current highs. As a consequence by 2005 the current-account surplus will likely fall to about 1.0% of GDP, due largely to a growth in imports.

By 2007-2008 LNG revenues will be significant and have a greater impact on real GDP growth. However LNG exports of c.22 bcm/y will not catapult Egypt into the world's elite. However, the government's ultimate ambition to export 50 bcm/y by 2015 could significantly impact the economic situation in Egypt. What remains to be seen is in the face of the fierce competition, whether Egypt can deliver on its bold plan.

5 SAUDI ARABIA

Introduction

The Kingdom of Saudi Arabia has just undergone two of its two most tumultuous years in which its international relations have been threatened with radical change by one of its closest allies and the domestic scene has suffered violent disruption, whilst its economy has continued to be highly sluggish, despite of the success of its oil price policies within Pectin part, of course, these events reflect the new international agenda of the Bush administration, although this is not as radical a departure from American policy as it appears to be. And, of course, the more extreme rhetoric of the post-September 11, 2001 period has now been tempered in Washington by a more sober realisation of the underlying strengths and importance of the alliance.

They also reflect, however, the culmination of internal contradictions inside the Saudi system that can no longer be ignored. In short, the old implicit contract between ruler and ruled, whereby authority was bargained against benefit is being called into serious question and now faces an independent ideological challenge. The same is true of the three century-old normative relationship between the Wahhabi movement and the al-Saud family, for that is under challenge from the al-Islah reform movement, a challenge that might enjoy some tacit support from within the ruling family itself.

Indeed, all these factors have been intensified by the fact that the leadership of the state continues to be in an ambiguous condition because of the incapacity of the king. The result of this is that Crown Prince Abdullah, now in effect, in charge of government, is not able to exercise his authority without a constant awareness that the Sudairi Seven – his half brothers – can always exercise a restraining influence upon him by recourse to the vestigial authority of the king himself. This has been significant until recently, for it has meant that the bolder initiatives that the Crown Prince might have wished to introduce have been hampered by the conservatism of his normative partners in power. He appears, however, to have successfully exploited the new crises that the Kingdom faces to force through radical initiatives – of a kind that the al-Islah movement would approve – that were not possible before, although recent arrests have called his apparent achievement into question.

The Key Relationship

Saudi Arabia's relationship with the United States continues to be the essential bedrock upon which the Kingdom's foreign policy rests, despite the vicissitudes of the past two years. That relationship has been profoundly threatened by a series of factors but, despite that, continues to be essential to both partners. Despite the abuse heaped upon the Kingdom in the United States – which has had a real effect on the relationship, with Congress now holding up a contract, worth nearly $1 billion to re-supply the Saudi National Guard, as part of a wider programme to modernise the defence forces, and threatening an accountability act of the kind recently passed against Syria – Washington knows that the Kingdom is essential to its plans to ensure moderation in oil prices and continuity of oil supply.

The problems in the relationship go back to September 11, 2001, when it was revealed that 15 of the 19 hijackers responsible for the attacks on the World Trade Centre and the Pentagon were Saudi nationals. The following year, families of the victims of the destruction of the World Trade Centre sued both the leaders of the *al-Qa'ida* organisation and leading Saudi officials within the Royal family, including Turki al-Faisal, Sultan bin Abdelaziz and Muhammad al-Faisal, in addition to leading charities and banks, for $1 trillion because of their alleged involvement in the incident. The Bush administration formally disavowed such attacks against Saudi Arabia but did little to assert its alliance with the Kingdom.

The apogee was reached on July 10, 2002 when a Rand analyst of French origin with links to the Larouche organisation who had previously worked for the French Ministry of Defence, Laurent Murawiec, launched a bitter attack against Saudi Arabia at a semi-private meeting organised by the Defense Policy Board at the Pentagon. In contradistinction to the conventional view, Saudi Arabia was portrayed as a threat to American security because of its clandestine involvement with Islamic terrorism, "active at every level of the terror chain". Saudi Arabia should be told to eliminate its links with terrorism or face the annexation of its oil fields, the analyst proposed.

With the advent of the war against Iraq in March 2003, Saudi Arabia once again became important to American strategy because of the facilities established there in the wake of the 1991 war against Iraq after its occupation of Kuwait. Although the Kingdom, because of domestic opinion, was not prepared to openly participate in the operation or to formally allow American commanders to use the command-and-control facilities or the airfields on its territory, it quietly did nothing to prevent their use in practice. Nevertheless, in the wake of the war, one of the major bones of contention between the two states –the American military presence since the end of the war against Iraq in Kuwait in 1991 – was removed when the United States announced that it would re-base its forces at Camp Doha in Qatar.

In reality, the United States cannot abandon its links with Saudi Arabia which now go back to the period immediately before the Second World War and are predicated on its influence over the Kingdom and interests in the Saudi oil industry. Saudi Arabia produces 36 per cent of Opec output and 12 per cent of global output. In 1997 it generated 18.6 per cent of America's imported oil and, in August 2003, it was still generating 14.5 per cent of American imports. It has been a loyal American ally inside Opec for many years, despite the events of 1973 and its nationalisation of Aramco at that time. It has ensured oil price stability in recent years and, despite the resentments of the neo-conservative wing in the United States, this role has been appreciated by subsequent administrations. Indeed, the Kingdom has been vital to the longstanding American dream of controlling the Gulf region, a concern that goes back to 1945, when it was first articulated in a State Department report.

It has also, since 1990, been the main bulwark of American interests in the Gulf region, despite its obvious misgivings about the implications of American policy elsewhere – over the Palestinian issue, for example, where Crown Prince Abdullah initiated a separate initiative at the Arab League in March 2002, or over Iran, where Saudi Arabia has enjoyed good relations and cooperation within Opec since 1998. In short, despite American suspicions, the relationship continues to be essential to both parties and, since the defeat of Iraq and the transfer of American forces to Qatar, the relationship has been publicly reinforced. However, outside the formal diplomatic sphere, suspicions still remain, within Congress and in the domain of public opinion in the United States. Nor, indeed, have the key Administration concerns been forgotten.

Insurgency?

These revolve around the role of the Kingdom within the activities of trans-national terrorism, particularly that connected with Usama Bin Ladin and the *al-Qa'ida* organisation and thus the role it can play within the "war on terror". There are some rather rich ironies in this for the current wave of terrorism results from a Saudi decision, with American support, to fund and provide personnel to the Afghan *mujahidin* at the beginning of the 1980s. America provided material support from 1984 onwards, so that the *al-Qa'ida* phenomenon finds its origins in American geo-strategy, supported by Saudi Arabia, at that time.

Furthermore, once Usama Bin Ladin had been dispossessed of his citizenship in 1991 and his personal funds had been blocked in 1994, funding sources for the movement, which had received official support up to 1991, inevitably depended on those of like mind – in Saudi Arabia, Kuwait and the UAE – who accepted the concept of *jihad* developed by Abdullah Azzam in Peshawar in the late 1970s and popularised by the *mujahidin* during the 1980s, resulting in the "nomadic *jihad*" of the 1990s in Bosnia, Kosovo and Chechniya. They, for ideological reasons connected with the radical interpretation of Islam developed during the Afghan war, were prepared to fund the new trans-national movements, a procedure which, until the United States became the victim of terrorism in the late 1990s, had been internationally acceptable, particularly where charities were concerned .

In effect, therefore, the Kingdom was condemned for not having anticipated this development or being aware of the close links between Wahhabism and the neo-Salifiya movement that informed the trans-national terrorist movements. This was compounded by the refusal of the Royal Family to recognise that the United States had determined a close linkage between the funding of Islamic charities and *al-Qa'ida* and considered the Saudi insouciance over the issue as being close to formal culpability. This was intensified by the refusal of the Kingdom to accept that terrorist networks existed within the Kingdom, formed from disaffected Saudi nationals.

The ultimate irony is that it was only when the Kingdom suddenly realised the degree of alienation within the population and the potential danger that the Saudi system faced in May 2003, that formal relations with the United States government improved, even if relations with Congress remained tense, as the Congressional report on September 11, 2001 demonstrated last September. Cooperation over intelligence-sharing dramatically increased as the Saudi authorities rounded up over 300 people accused of involvement with *al-Qa'ida* and similar groups, as they had to deal with two major bombings of domestic compounds in Riyadh –in May and November – and repeated discoveries of arms and explosives caches, often involving pitched battles with hostile groups. Over 12,000 nationals are said to have been interrogated by the authorities in connection with the violence

One consequence of this has been a willingness to clamp down on private funding for suspect Islamic charities and another has been to recognise the role of radical *'ulama* and other religious figures in promoting support for the neo-Salafiyyists, now often referred to as the *salafi-jihadi* movement. As a result, after a *fatwa* condemning the violence was issued in mid-August, the most outspoken members of this group – up to 700 in number – have been dismissed, whilst a further 1,500 have been banned from preaching and an additional 500 have been called in for re-education. In addition, much more care has been exercised in controlling the weekly Friday *khutba*. The Family is now in no doubt about the problem it faces, not just from the violent extremists, feeding on unemployment and declining living standards, but also from the growing alienation of the professional classes, not to speak of the wider population, as average incomes fell from close to $20,000 per year in the 1980s to around $7,000 today and the consequent increase in support for the *al-Islah* movement. The ruling elite has reacted to this, not just by repression but also by being willing, albeit reluctantly, to contemplate reform.

The Reform Programme

It is clear that Crown Prince Abdullah has been prepared to take advantage of the current crisis, both in relations with the United States and within the Kingdom, to persuade his more conservative fellows within the family, particularly within the Sudairi Seven, to accept that change was inevitable. He signalled the way as early as January 2003, with his "Arab covenant" proposal. The domestic political crisis has been one driver for this view, the worsening employment situation for Saudi nationals has been another. Perhaps the most intractable has been the deplorable state of the Saudi educational system, for here reform would touch upon religious sensibilities and interests. The problem is that it is not clear that these issues can be effectively addressed because of the essentially conservative nature of Saudi society, particularly in the religious and political elites. The encouraging feature is that an attempt to achieve change is really under way.

As far as liberalisation is concerned, three petitions have been presented to the King, the last of them being signed by 300 persons, including 50 women – an unprecedented event. Indeed, in the light of the way in which earlier petitioners were treated – they were arrested – the fact that three petitions in as many months should have been presented without the repression of those involved is a sure pointer towards the willingness of the authorities to listen to constructive protest. There are, however, strict limits to this, for a demonstration in Riyadh in mid-October, coinciding with the first human rights conference held in the country, was suppressed by police with 50 of the 200 demonstrators being arrested. Demonstrations called for the next week end in Jiddah, Dammam and elsewhere were foiled by widespread arrests.

Quite apart from the fact that the demonstrations were amongst the first signs of peaceful protest ever seen in Saudi Arabian cities, they were probably also suppressed because of their provenance. They had been called by the exiled, London-based *Harakat al-Islamiyyah li'l-Islah* (the Islamic Movement for Reform).This movement is run by Sa'd al-Faqih who originally participated in the *Committee for Legitimate Rights* (*Lajnat Difa''an al-Huquq al-Shar'ia*) in the mid-1990s – a movement inspired by moderate Islamist archetypes and linked to the two petitions presented to the King in 1993 and 1994. He had originally been a close collaborator with Dr Muhamad al-Mas'ari but, after a split engineered by the Saudi embassy in London, Sa'd Faqih continued alone. It is clear, however, that the authorities in Riyadh, whilst prepared to contemplate change, will not entertain contacts with what they feel is a discredited exiled opposition.

Ironically enough, five days before the demonstrations took place, the Saudi cabinet announced the first cautious steps towards political reform. At some point in the future, half the seats on the recently restructured fourteen municipal councils are going to be open to election. Nor has the basis of the electoral franchise been made public, although the fact that the announcement referred to voters as "citizens" lends credence to the view that women may also benefit from the franchise. Many commentators inside the Kingdom believe that the elections will take place before 2010 and some hope that they could occur as early as 2005. Indeed, the government has suggested that partial municipal elections could take place even earlier, with a census to precede them and to provide the basis for electoral lists. The caution is quite typical and reflects both the need to achieve consensus within the elites –particularly in persuading the religious Wahhabi elite to fall into line – and anxieties about too precipitate an electoral process which might give rein to tendencies within the population that the authorities wish to exclude.

Eventually, of course, the electoral process, if successful, will extend to include a directly elected Consultative Council (*majlis ash-shura*).This would then bring Saudi Arabia to a position between the radical liberalisation seen in Bahrain, for example, or the practice in Kuwait, where the elected assemblies have direct executive power and the conservatism of the Kingdom itself in the past where the Council only ever exercised a consultative role. Interestingly enough, many Council members increasingly feel that they have a *de facto* executive role as they are brought into a consultative process with government and can see concrete evidence of their suggestions within legislation and executive practice.

There is no doubt that the reforms announced by the Saudi authorities have gone a long way to calming official American suspicions, even if popular and Congressional suspicion remains. There are still, however, many uncertainties about the way ahead, although the evidence suggests that the proposed reforms are quite genuine and are intended to mark the beginning of a genuinely liberalising process. Given the dimensions of the domestic political crisis facing the regime, it could be argued that the caution exhibited in planning the reform programme and the slow rate on introduction could vitiate the attempt. Then again, it is not clear to what degree, if any, the House of Saud will implicate itself within the liberalising process.

The greatest challenge, however, is what is to be done about the Saudi education system, for it is here that the malaise that has struck the Kingdom is in large part located. Up to 30 per cent of young Saudis are unemployable in the modern economy that Saudi Arabia has been trying to create, largely because of the way in which they have been educated, for educational system lays greater weight on conformity with Wahhabi doctrine than with international standards of intellectual competence. This has meant that many Saudis simply cannot compete within the private sector and thus plans for the Saudisation of the economy, with a consequent reduction of dependence on immigrant expertise are already facing difficulties. This, incidentally, is nothing new, other countries in the Gulf region that have tried to indigenise their labour forces have also discovered that legislation cannot compensate for inappropriate educational systems.

The real danger, however, is that a marginalised and discontented youth, educated within the tenets of Wahhabism with its implicit critique of temporal authority, may become disaffected from the regime and turn to more radical alternatives. Indeed, this has probably already happened, given the surprisingly wide range of opposition that the Saudi government is now facing, with armed clashes occurring all over the country as police investigations continue. The problem is, however, quite how educational reforms can be carried out, given the sensitivity of the religious authorities about its implications and the widespread conservatism of Saudi society. This is a crucial concern because one aspect of educational reform will involve dealing with the status of women, both within the economy and within society. So far, no details have emerged as to what will be included in any reform programme but the Saudi authorities are fully aware that the United States has its own reform agenda for the Middle East, not least over the question of educational reform and the emancipation and empowerment of women.

The Saudi government, therefore, faces a major problem of how it can reconcile competing pressures over educational reform. On the one hand, it may outrage American concerns by being too cautious and conservative. On the other, there is the danger of conservative religious opposition within the Wahhabi elite. Then there are the aspirations of the moderate reform groups, as well as competing pressures from more extreme *salafi-jihadi* circles. Finally the more secular professional groups look for rapid liberalisation and access to the economy, including the empowerment of women. It is extremely difficult to see how the Family will cope with these competing pressures, although it is aware of the general direction that reform will have to take. Indeed, the recent arrests of eight intellectuals involved in the petition movement is a depressing reminder of the intense conservatism of leading figures in government, particularly amongst the Sudairi Seven, with the defence minister, Prince Sultan and the interior minister, Prince Nayyaf, in the lead It is, however, an unavoidable issue that can no longer be postponed because of the implications it has for economic development as well as political stability.

The Economy

With population growth at 3.3 per cent per year and 45 per cent of the population under 14 years old, the Saudi government cannot afford to allow its economy to stagnate in the way in which it has for the past decade. The simple result of that has been massive unemployment amongst Saudi nationals – partly because of inappropriate educational policies – and a significant decline in per capita incomes. It is calculated that, today, average per capita income is around $7,000, compared with levels close to $20,000 in the 1980s. The consequence of that has been a growing disaffection with the Saudi regime, particularly with the 5,000-to-8,000-strong privileged royal family. The old system whereby political acquiescence was bought through public munificence and a complex system of patronage no longer guarantees the social peace of the past, even when supported by judicious, albeit ruthless repression.

Oil continues to be the driver of the Saudi economy, generating 90 per cent of export revenues and contributing 30 per cent to GDP. Since the low point of 1998, in the wake of the Asian economic crisis, Saudi Arabia's cooperation in Opec's policies of sustaining oil prices within a band of between $22 and $28 per barrel has ensured stable oil income. Indeed, this has been buttressed by the continuing uncertainties in Iraqi oil exports as a result of the war in early 2003 and the continuing crisis inside the country ever since which, through persistent sabotages, has effectively removed Iraq from the oil export scene – a situation which is likely to persist into 2004. However, the consequent high oil prices, which reached $32 per barrel in the first quarter of 2003, is unlikely to persist and prices are expected to resume their secular decline next year, despite the Kingdom's willingness to cut back production from an average of 8.6 million b/d (7.9 million b/d in 2001 and 7.5 million b/d in 2002) to below its new quota of 7.96 million b/d from the start of November 2003.

Nonetheless, the prolonged period of high oil prices has created a much more encouraging picture for the Saudi economy over the past year.

Exports rose by a striking 21 per cent in 2003 to $94 billion, far outstripping the budget predictions of $32.8 billion and guaranteeing a trade surplus of $56.8 billion. Even though exports will decline somewhat next year and imports will rise to around $39.8 billion, there should still be a comfortable trade surplus. And, now that the first upstream gas development contracts have been awarded to Royal Dutch Shell in the Rub al-Khali, gas will soon begin to buttress oil revenues through its contribution to the petrochemicals sector. These developments, however, cannot conceal the fact that oil still dominates the Saudi economy, with the non-oil economy, for example, only contributing $12 billion (SR45 billion) to budget revenues, compared with the massive $48 billion – 80 per cent of the total – that is generated by oil. And oil and gas do not generate employment!

The windfall in oil revenues, however, has meant that Saudi Arabia has generated its first budget surplus for the past decade, alongside a current account surplus expected to be equivalent to 10 per cent of GDP. Although small at an expected $3 billion (1.5 per cent of GDP), it should be compared with the government's prediction of a $10 billion deficit, equivalent to 5.6 per cent of GDP. It should also be borne in mind that the habitual budget deficits of the past have been borne by an increase in domestic debt, now about 100 per cent of GDP (an expected 91.5 per cent in 2003) .Ironically enough, the government actually controls its own debt for those institutions which fund the budget debt are largely effectively controlled by government! It can, therefore, easily roll over debt, a facility that discourages basic reform. The public sector continues to dominate the economy with the private sector contributing only 30 per cent to GDP – a level that has remained unchanged for years, despite all official attempts to stimulate its growth. Now the Kingdom is to join the World Trade Organisation in the hope that this will stimulate both non-oil trade and private sector growth. It has up to the end of 2005 to complete the process but must still pass a series of trade-related laws to comply with the Organisation's basic requirements.

Indeed, it could be argued that the Kingdom might do better to promote its relations with its neighbours inside the Gulf Cooperation Council, where it is the dominant economy and can now benefit from the new unified tariff structures that have come into operation after years of discord, with the Kingdom reducing its external tariff from 12 to 5 per cent last year. Otherwise it should look to improving its relations with the European

Union, its major trader partner, despite American offers of a free trade area agreement – in return for educational reform, empowerment of women and democratic government – which could not come into operation until 2005 at the earliest. These measures, however, will only improve the macro-economy and will do little to deal with the most pressing demand, the need to create employment opportunities for the burgeoning population.

In the meantime, Saudi Arabia will have to prepare itself for less advantageous conditions in the future, as oil prices come under sustained pressure when the Iraqi oil industry recovers from the years of sanctions and the recent war. Then the anticipated 4 per cent growth in the Saudi economy this year will be replaced by far lower levels of growth, so that budget deficits return and current account surpluses decline, with consequent lower returns to the Kingdom's foreign currency reserves. Commentators expect GDP growth to drop to around 2.5 per cent per year up to the middle of the decade, compared with an average of 3.3 per cent for the first three years of the new century – solely as a result of stable and high oil prices. Ironically enough, it will be the private sector that will suffer most, largely because of regional uncertainties, and is expected to show growth of only 2 per cent this year, compared with over 4 per cent last year.

In other words, Saudi Arabia has still not resolved the three major problems facing its economic future – employment generation for the national population, diversification away from oil and gas, and expansion of the private sector. In part, this is a consequence of its massive oil and gas reserves, for the difficulties created by "oil curse" are peculiarly intractable. However, government must also bear much of the responsibility. For the decade of the 1990s, it fuelled growth through defence spending at 33 per cent of budget expenditure and spending on human resources (27.5 per cent) and health (11 per cent).It has also prioritised spending on social provision recently –these sectors saw expenditure on them rise by 22 per cent last year – and cut back on public administration. The problem is not, however, how much it spends on these essential demands but how it spends it – and that is an issue which, for domestic political reasons, it has only just begun to address.

Conclusion

Despite the hackneyed quality of the phrase, the Kingdom really does now stand at a cross-road. The problems of the economy, now reaching back for three decades, still remain to be resolved as the Kingdom's dependence on oil begins to create a political and social resonance. The declines in per capita income have destroyed the old political and social consensus in what has always been a conservative society. Behind this lies the frustration of an increasingly young society as unemployment mounts and immigrants drain off available jobs, largely because of a religiously and politically correct but economically and socially inappropriate educational system. The emergence of a dynamic ideological alternative threatens the Saudi-Wahhabi political hegemony, whilst the growth of domestic violence can now no longer be denied.

Coupled to this has been a massively disrupting and disruptive relationship with the Kingdom's major international ally, the United States. Despite the fact that the neo-conservative ideology of the Bush administration, coupled with the implications of the events of September 11, 2001 for the Kingdom, precipitated the crisis, the underlying factors had had a long gestation and would eventually have risen to the surface. The United States would eventually have lost patience with the Kingdom's refusal to recognise the involvement of its nationals in the new wave of trans-national terrorism and would have had to redeploy its forces because of the deteriorating relationship over their presence in the Kingdom. Similarly, increasing American reliance on energy imports was bound to encourage increasing diversification. In other words, the specific role of the neo-conservatives in Washington merely accelerated existing tendencies.

The explosion of violence inside the Kingdom has now forced the royal family to reconsider its status and legitimacy. Despite the normative and traditional reliance on the Wahhabi connection, new ways of authenticating its leadership role is now necessary – hence the very cautious steps towards reform. If the reforms are carried through – and here Crown Prince Abdullah seems sincere and appears to have the reluctant support of his colleagues in government and in the family – they will certainly recover the waning support of the professional groups inside the Kingdom. They will not, of themselves, however, deal with the far greater gap between the massive of disadvantaged Saudis, now aware of their disadvantage and of the alternatives offered to them, which they may reject for its violence but accept in terms of its critique.

Their support can only be recovered if they can be fully integrated into the economic life of the Kingdom and into the cultural mainstream of the Middle East. The two problems are linked through the issue of education and it is here that real long-term reform is essential. Without a dramatic change in the Saudi educational system, so that it can produce young Saudis equipped to deal with a modern, technological and globalised world, the alienation and marginalisation of the population will increase and vitiate reform in all other sectors. And, without a restructuring of the economy away from oil dependence and towards job creation, the marginalisation will persist, even if educational reform is successful. The problem is that such reforms touch at the very heart of the Saudi-Wahhabi bargain and it is not yet clear that those involved are prepared for its own transformation!

6 SAUDI SOCIETY

Introduction

The current state, formed by conquest in the early 20th century, is the third Saudi realm. The first Saudi Kingdom was established in the mid 18th century and was built on an alliance between the Al Sa'ud family and Muhammad Abdul Wahab, the founder of the *Wahabi* school of Islam. The Al Sa'ud were able to mobilise tribal power inspired by the puritanical and fundamentalist teachings of Abdul Wahab to conquer much of the Najd region in central Arabia and set up a state that lasted until the early 19th century when it declined in the face of internal rivalries and Ottoman power. The second Saudi Kingdom (sometimes called the Golden Era) was set up on similar lines in the mid 19th century until it too fell away towards the end of the century.

Modern Saudi Arabia was the creation of King Abdul Aziz Ibn Sa'ud who from exile in Kuwait in 1899 took over the Najdi capital and quickly established his control over the Najd and adjoining areas of Qasim and Hail. He conquered Hasa (the Eastern Province) and annexed Jauf in the north and then Asir in the south on the border with Yemen. In the 1920s he took over the Kingdom of the Hijaz, which included Mecca, Medina and Jeddah. The country became known as Saudi Arabia in 1932 and acquired more territory in war with Yemen in the early 1930s and has since remained within its current borders. The Al Sa'ud gradually consolidated their rule and was able to exploit their control of the country's oil wealth from the 1950s onwards to centralise the state and greatly extend their own powers.

Saudi society is thus heavily influenced by regional, Islamic and tribal factors and the changes forced through the modernisation of the state.

Regional Factors

The ***Al Sa'ud*** were a Najdi family who first imposed their dominance on tribes in their own region and gradually extended this to other parts of the peninsula, which had not previously been under Saudi or Wahabi influence. The Al Sa'ud used largely Najdi tribal soldiers and then Najdi officials to run their government and even today Najdis are a majority of the senior ministers, civil servants and military officers. Some Saudis even refer to the process of governing as Najdasation of the rest of Saudi Arabia.

The key regions are:

- The old Hijaz. This had been a semi-independent state for centuries and had a more open and international attitude than the Najdis. The Hashemite rulers of the Hijaz had been protectors of the holy places of Mecca and Medina and had organised the Hajj. Hijazis regarded themselves as more liberal and sophisticated than the Najdis. Even today there is a distinct difference in the atmosphere between Riyadh and Jeddah. Hijazis will complain about some discrimination against them and are more critical of government policies.
- The Eastern Province (Hasa or Ahsa), too, has a more liberal tradition and is the home of the country's *Shi'a* minority. It has much more in common with other Gulf States and the long-term presence of Aramco has helped foster greater openness. We will discuss the Shi'a issues later.
- The Asir in the south west has more in common with Yemen than Najd. Resentment of Saudi rule is strongest here - which is also one of the poorest parts of Saudi Arabia. Many young Asiris were attracted to Osama bin Laden.
- Qasim and Hail were early conquests of Ibn Saud from his main tribal rivals and quickly became ardent Wahabis. But Qasim, in particular, has not benefited from Saudi rule in the same way as Najd and there is considerable poverty here. Islamic extremism is stronger there than elsewhere.

- Jauf, which has much in common with southern Jordan, has a strong tribal tradition and the rule of the Al Sa'ud is exercised lightly though the Sudeiri branch of the family.

Regionalism is not normally a problem and there are no separatist movements. But it is there beneath the surface: for the last year, for example, in London Hijazis have been producing their own journal which is highly critical of the regime. It can be a factor in the approach to certain markets – with different arrangements in Riyadh, Jeddah and the Al Khobar/Dammam/Dhahran region.

The Wahabi movement

The Wahabi movement helped inspire the previously warring tribes of the Najd region of Saudi Arabia to unite under the Al Sa'ud. The Al Sa'ud have always been dominant and, for example, were able to break up the Ikhwan – the fanatical tribal troops in the 1930s – used in the conquest of the other regions. The relationship between the Al Sa'ud and the Wahabi Ulama (senior clerics) is crucial to the Saudi state.

There are several elements to this:

(a) The King as Imam appoints the top Ulama who come together in the Council of Senior Ulama. Though the influence of the Al Shaikh family has declined the Ulama remain amenable to the wishes of the King/Crown prince. Indeed they are often regarded as apologists for the regime. The understanding is that the Al Sa'ud put Wahabi tenets at the heart of the state and take into account the views of the Ulama when making decisions. He usually does so. The country remains deeply Islamic and conservative.

(b) The Council for the Preservation of Virtue and the Suppression of Vice (which controls the religious police) has had offices or people since the 1920s in all settlements. It has helped keep the Wahabi message pristine and prevented the evolution of more tolerant and less fanatical views.

(c) Much of Saudi Arabia before the 1920s was not Wahabi or even Hanbali (the most puritanical of the four schools of Islam from which Wahabism derived)). The Al Sa'ud imposed wahabism on the conquered regions such as the Hijaz. Even today nearly all mosque officials are wahabis from the Najd. Hijazis sometimes claim, for example, that there is not a single Hijazi mosque official.

(d) For decades the Al Shaikh and the senior Ulama controlled the ministry of education and thus the curricula and text books. Even in the 1980s and 1990s the major Islamic universities expanded at three times the rate of secular universities and still have greater resources per student.

Whilst the senior Ulama may be responsive to the commands of the Al Sa'ud there is a large body of Islamic opinion that the Al Sa'ud must take into account in policy and decision making. In recent years it has become clear that there are significant gaps between the senior Ulama and a large section of Wahabi Islam. There are some 58,000 mosques in Saudi Arabia and probably around 100,000 clerics of one sort of another. There is no formal hierarchy and until very recently little control of what went on in mosques and what clerics preached. This gap was shown in 1979 when a group of fanatics seized the Grand Mosque in Mecca and held it for some weeks until it was retaken with considerable loss of life.

The response was for the regime and the Ulama to adopt more extreme positions. Combined with the Soviet invasion of Afghanistan and the Iranian revolution in the 1970s there was also a great upsurge in the flow of Saudi money and clerics to Islamic institutions abroad and of course the fight against the Russians which helped breed Osama bin Laden. Many of the problems of the 1990s and today are a result of these developments in the late 1970s.

Since 9/11 and more particularly since 5/12 (the day of the attacks in 2003 on the three compounds in Riyadh the Saudis have taken a number of measures to eliminate what they call extremism:

(e) A number of the senior Ulama have been replaced

(f) There have been efforts to control mosques by dismissing and re-educating some 3 -4 per cent of mosque officials, seeking to impose standard sermons and by fostering moderation.

(g) The curricula of universities and schools have been revised as have text books.

(h) Restrictions have been placed on the religious police.

(i) Encouragement of a national dialogue which has so far concentrated on recommending other measures to foster moderation

It will take time for these measures to work. There is a reaction. University lecturers talk about dissident students retreating to certain mosques and private houses or even going off into the desert. The caution over the reform programme and the careful construction of government statements and action show that the regime remains deeply concerned. There are almost weekly examples of the government reacting first to a need for reform and then the need to placate the Ulama.

Tribal Factors

Much of Arabian society was based on tribes and the major tribes remain important. Educated liberal Saudis will today deny the existence of tribalism but the evidence outside the major towns does not support this. King Abdul Aziz pursued a policy of inducing tribal leaders to support his cause in exchange for government funds and favours. He consolidated this through marriage - he married into many of the main tribal families - and binding them into the regime in other ways. This continued under his successors and today in the more remote areas the government often acts through tribal leaders in handling local affairs. Tribal elements provide the basis of the Saudi National Guard. This defends the regime whilst the army defends the borders – it should be noted that the army is deployed well away from the main urban centres of Saudi Arabia whilst the National Guard is located close to the cities. Tribal factors are particularly important in the Najd and in the north where there are large tribes like the Shammar that have significant territories, people and influence in Iraq, Jordan and Syria. One interesting recent development since the 12th May attack on three western compounds is a move by the Al Sa'ud to cultivate tribal leaders much more openly than normal. If tribal factors have declined Saudi society remains based on the extended family – with the Al Sa'ud being a prime example.

Elites

The large Najd families and their allies are the backbone of support for the regime and today they play the dominant role. Although families from the old Hijaz and Ahsa resent the Najdi dominance they also have much in common in subscribing to a moderate reformist agenda and the further modernisation of Saudi society.

These groups have vested interests in the status quo as they have largely benefited from the inflow of oil wealth, the spread of education and the opportunities for employment in the government, Aramco and the military. Today they provide the ministers, members of the Consultative Council, civil servants and military leaders. They make up the bulk of the business community, which is still largely organised in family firms. These people are usually associated with the modernising and liberal establishment in Saudi Arabia but this can be misleading. Important religious figures are also drawn from the same group – though largely *Wahabi* families from the Najd. It is unwise to assume that the wealthy Saudi families and businessmen are all liberals and modernists – far from it.

The poorer Saudis

There are no reliable statistics to measure the degree of poverty or relative poverty. Poverty is visible in areas like Asir in the south west, towns and villages in parts of Jauf and Qassim as well as districts of the major cities. The Shia in the Eastern province suffers both from poverty and discrimination. Poverty is eased by the cradle to grave welfare system and a range of subsidies on food, utilities and internal transport. But Saudis outside the elites, which are very small group, feel they are getting poorer. The few studies that have been done tend to support this conclusion. Research shows that the young do not expect to achieve the same living standards as their parents. There is growing resentment of the differences in wealth, the claims of corruption and the Al Sa'ud. University lectures note that though many of the middle class Saudis are politically apathetic there is a sense of growing disenchantment. It is unorganised and inchoate but it no doubt fuels the appeal of extremist ideas to some. It will get worse. The Saudi government understands that it must eliminate the causes of social alienation as part of the counter-terrorist strategy but, as the section on the economy will show, there is a very long way to go and progress so far has been at best fitful.

The Economy

The Saudi regime must greatly increase GDP growth over the next ten years to provide the jobs for its youthful population sustain expectations of living standards and enhance and develop its infrastructure. On the face of it the economy has been doing well recently with high rates of growth, the start of an ambitious reform programme and good marks from the rating agencies. But the economy is too dependent on oil and gas which contribute 90%-95% of total Saudi export earnings, 70% of state revenues, and around 35%-40% of GDP, more if the downstream petrochemical sector is counted. It has the capacity to produce around 10.5 million b/d but normally keeps production to around 8 million b/d – although it has been well over 8 million b/d since the start of the Iraq crisis. GDP growth and government income thus depend very largely on the oil price and the quota. It has not yet built up other sources of income.

Saudi Arabia usually struggles to keep its budget out of deficit. As a rough rule of thumb; Saudi Arabia needs an oil price of around $25 per barrel from just over 8 million b/d of oil to meet its current consumption and investment needs. It is earning over that currently but very few believe that this price level can be sustained. In addition to this it will need substantial sums to invest to repair and update its infrastructure. One economist has estimated that Saudi Arabia will need at least $200 billion to finance its needs for power and water over the next 20 years. Rate of capital formation of the economy at present suggests that this will be a formidable task.

Government economists believe that the economy has a potential growth rate of over 7 per cent but this requires measures to persuade Saudi businessmen to invest in their country (estimates of the amount held by Saudi private investors abroad range from $200 billion to $600 billion), persuade foreign companies to invest and find ways of employing male Saudis and engaging more of the female population in the work force. It must remove the many internal obstacles to growth such as the bureaucratic procedures and lack of incentives, ensure greater competition and increase transparency. Thus most private economists assume a maximum growth rate of 2-3 per cent – that is not enough.

In the early 1980s Saudi GDP was over US$17,000 per capita. It is now under US$8,000. It may well fall further.

- Population growth in Saudi Arabia is very high: some 50 per cent of Saudis are under 18.
- Around 58 per cent of the population is in the economically active age group of 15-64 but only 33 per cent of Saudis actually work – which creates a very high dependency ratio.

- There is a cradle to grave welfare system and a range of subsidies on food, utilities and internal transport
- There is no income tax
- Heavy defence needs – defence and security absorb around 40 per cent of government revenue.
- A very large state sector (60 per cent of the budget goes on wages and salaries).

There is an urgent need to create jobs to meet the rising number of new entrants to the labour market each year: some 100, 000 at present. Unemployment among Saudis is well over 10 per cent and is rising rapidly particularly among people in their early 20s. The educational system is not able to produce sufficient qualified graduates, nor can the secondary schools. In the period 1980-2000 the number of engineering graduates has increased by 20 per cent and the number of graduates in Islamic-related subjects by 300 per cent.

The high dependency ratio is putting heavy demands on services and increasing the cost of subsidies. Saudi Arabia has thus experienced budget deficits in most of the last ten years, which it has covered through domestic borrowing. Domestic debt is close to 100 per cent of GDP – and in the 1990s grew faster than GDP. Saudi Arabia has not borrowed abroad – it has always rejected the concept of sovereign debt and of opening up its books to ratings agencies and the like – but the Saudi institutions and banks covering the debt have been forced to draw on their foreign deposits to meet it, with a significant impact on the Saudi balance of payments.

Oil and gas

The main lines of Saudi Arabia's oil policy have not changed recently and can be summarised as follows:

- Managing where possible the price of oil through OPEC. Saudi Arabia has played a key role in seeking consensus among OPEC members and the Oil Minister has played the central role in this;
- Understanding and acting to assist the needs of the market – the USA in particular.

- Maintaining sufficient capacity to be able to cope with a short-term need to increase production;
- Keeping foreign oil companies out of upstream oil;
- Using gas for domestic energy needs and encouraging foreign companies to explore for gas
- Development of the downstream to produce jobs for the Saudi economy;
- Downstream investments abroad to get the most out of Saudi oil income.

Economic reform

Prince Abdullah has been pushing hard for reform since 1995 and has made some headway through:

- Establishing rigorous control on spending via the tough and able Finance Minister
- Re-organising decision-making in the economic sector so that the *Crown Prince* can drive it through the Supreme Economic Council which he chairs;
- Setting up the Saudi Arabia General Investment Authority (SAGIA*)* to act as a one-stop shop and general supporter of investment. This, in turn, has been run by an able and energetic Saudi Prince fully committed to opening up the country;
- Bringing incentives to investing in Saudi Arabia to be competitive with other similar economies;
- Opening up state sector to private capital mainly through allowing private companies to take over the management of ports, for example, and providing services;
- Indicating that it will privatise some state corporations;
- Launching the gas initiative;
- Reorganising the power sector and paving the way for private financing of power projects;
- Saudi Arabia should join the WTO in late 2004.
- However, there is always opposition from:

- Vested interests within the Al Saud. A large slice of Saudi income is "off budget" and is used to finance some military spending and spending on security and intelligence. An unknown slice of it goes into providing stipends for virtually all the male Princes. Many of the senior Princes are involved in business. An absence of transparency.
- The deep conservatism within the state structures.
- The social costs of reducing subsidies and welfare benefits at a time of rising unemployment are unacceptable;
- Resistance to the changes e.g. Aramco's attitude to the upstream gas initiative.

There has been a noted change of pace and urgency since 9/11. There has been a great deal of intense discussion about the need to increase Saudisation and provide jobs for the growing army of young men. It is recognised now that greater resources must be devoted to secular and skills education. This needs to be combined with reforms that will eventually reduce the number of Islamic graduates. Much more needs to be done to attract back Saudi private funds and bring in external funds.

There is still much more talk than action. This is partly because the decision-making process – or the consensus building process – is slow and cumbersome. Apologists for the system will say Saudi Arabia has always been like this. The process goes through the increasingly over crowded programme of the Majlis al Shoura and then through cabinet. The general trends are clear but there is too much hype. There is no doubt that the Crown Prince and his allies want to get across the message that reform is now unstoppable. In particular they have talked up the following:

- Expanding the list of sectors that are open to foreign investment.
- Pushing through a new capital markets law and an insurance law. A labour law will follow
- Opening up the electricity, telecom and other sectors to private capital.
- Introducing income tax for foreigners.
- Introducing the new laws that will provide the legislative framework to give investors confidence in the country.

- Introducing more technology and IT courses into the Islamic Universities - i.e. changing them from within.
- Greater transparency in decision-making.
- Steps to bring about clarity over dispute settlement

Regulators have been appointed to the electricity and telecoms sectors and moves are being made to find ways of bringing private capital into power generation. However, it is important to recognise that much of this is still at the proposal stage and that implementation will take a lot longer than the government would like westerners to believe. There is no doubt that the Crown Prince is committed but the need is to balance against these claims the following factors:

- Look at the gas negotiations. The oil companies are getting increasingly frustrated and there is a rumour that one may pull out.
- Educational reform has started but is not going fast enough. The Ulama no longer have control of the ministry. Islamic Universities are now teaching a few more technical subjects. There are plans to set up private universities. It will take time to introduce the facilities to increase the technical and engineering content. It will happen but not yet.
- Progress on every key reform is painfully slow.
- Resignation last week of the Head of SAGIA – frustrated at the difficulties in getting the system to respond.

There have been moves over the last ten years to reduce the cost of the subsidies to the Ministry of Finance. Electricity and water prices have been increased, as have domestic airfares. But this has not yet been harsh enough to cause any difficulties. There is no talk of introducing income tax or of paying for education and health. It is highly unlikely anything will be done in these areas in the short term – the government is clearly worried about the impact on domestic opinion. It thus seems unlikely that there will be serious action to tackle the issue of subsidies.

There are at least four million expatriate workers in Saudi Arabia – and thus in theory four million jobs that the Saudis could take. The government is committed to Saudisation. It has now barred non-Saudis from taking some jobs. It has set targets for some sectors and made it more difficult for companies to employ foreigners. There is no doubt that this pressure will increase. In March the Saudi travel industry was virtually brought to a halt as the government tried to enforce it to Saudise.

Conclusions

There has been a distinct change of pace since 9/11 but it still lacks the sense of urgency that the growing problems demand. As one of the leading Saudi economists said recently that it might take "greater social problems" before the urgency will be injected. The old men at the top – as is the wont of old men – do make haste slowly. Saudi problems may not wait for them but they have to get worse before drastic action will be taken. The time available to the regime is running out. It has not used the last ten years to good effect. The reform process is gathering momentum but is still moving far too slowly. Saudi Arabia will remain dependent on oil prices and output for most of the next ten years. Although Saudisation will help absorb new entrants to the labour market the signs are that demographic growth will continue to outstrip GDP growth for the next ten years. This will almost certainly mean that poverty in places like Asir and Qasim where most radicals are bred will not be alleviated significantly. Political apathy among the young will change quickly when they cannot afford to get married, get a house or build a middle class life.

The key to Saudi stability lies in how the leadership can bring the various elements of Saudi society into a consensus for reform – economic followed by political. Octogenarians are not the ideal people to do this. Much will depend on how soon the country moves to a newer generation of leaders who have the vision, energy and personality to tackle the problems. Benign neglect will no longer suffice.

7 CENTRAL ASIA AND THE CASPIAN BASIN

Relations with Russia and Opec

Summary

In 50 years' time, statesmen and businessmen may well look at a much more highly integrated global market for goods and services and ask themselves why the integration of energy supply has lagged behind and placed a brake on economic growth.

Once the expanded network of oil and gas pipelines and electricity connections has begun to deliver enhanced energy supply security through the entire Euro-Asian region and the benefits of much larger economies of scale and load-sharing are apparent, the Central Asian and Caspian states will be at the heart of the system and in a strong position to stimulate the development of their own limited resources for export and domestic use. Until then, we are likely to witness a prolonged competitive squabble with much more damaging intervention from outsiders.

This paper looks first at the current levels of production within the four leading states of the Central Asian and Caspian area in the light of their resource base and domestic needs. It then considers the underlying economic and political interests of Russia to the North and the Gulf oil and gas producers to the South, and also reviews the aspirations of Europe to the West and China to the east – a likely source of unending rivalry and conflict. In this diplomatic global game of energy chess, the Central Asian states and the Caspian Basin states are at present no more than pawns with little weight of their own. The reason why they attract so much attention, is the central ground which they occupy and their own policy priorities in transport infrastructure to enable their energy surpluses to access hard-currency markets.

Will China outwit the United States in the global race for incremental oil and gas from the Gulf? – probably! Will the West be able to play Russia

off against OPEC as global oil supply begins to tighten? – probably not! The Central Asian and Caspian states may be a long way down in the production league tables but this does not mean that they will be able to keep out of the broader, long-term economic war going on all around them.

Small populations in a vast area

The area of the four lead-states under review is 14% larger (Table 1) than that of India whose population is fourteen times that of the four states. Translated into population density statistics, these are some of the emptiest states on earth. Kazakhstan has roughly 17 people per square mile strung across a state which is 1800 miles from West to East and 900 miles from North to South: compare this with India which has 788 inhabitants per square mile or China with 965.

Table 1: Population Density

	Population *Million*	**Area** *Square Miles*	**Population Density** *Persons per square mile*
Azerbaijan	9	33,000	272
Kazakhstan	18	1,049,000	17
Turkmenistan	4	188,000	21
Uzbekistan	25	173,000	145
Total	**76**	**1,443,000**	**53**

Source: Times World Atlas, 1995

NOTE ON THE TABLES: The individual country numbers are rounded to one point of decimals. The totals here are merely the totals of these roundings. If you wish to have more accurate figures and roundings, take the numbers in the BP Statistical Review, apply all the appropriate conversion factors listed on the inside back cover and calculate the precise totals.

It is not surprising therefore that aggregate domestic energy demand for the four states is very low (Table 2), about 1% of global energy demand and over half of that is accounted for by gas in Uzbekistan and coal in Kazakhstan.

Table 2: Consumption of Primary Energy, 2002 (Mbdoe)

	Oil	Gas	Coal	Nuclear	Hydro	Total
Azerbaijan	0.1	0.1	-	-	0.1	0.3
Kazakhstan	0.1	.02	0.4	-	-	0.7
Turkmenistan	0.1	0.2	-	-	-	0.3
Uzbekistan	0.1	0.9	-	-	-	1.0
Total	**0.4**	**1.4**	**0.4**	**-**	**0.1**	**2.3**

Source: BP Statistical Review of World Energy, June 2003

The four states produce just about double the energy they need (Table 3). The three main export surpluses are Kazakh oil (0.9 mbdoe) and coal (0.4 mbdoe) and Turkmenistan gas (0.7 mbdoe). In total energy production they account for 2.5% of the global total (188 mbdoe). The great success story in this picture is Kazakh oil production which doubled between 1997 and 2002 to reach close to 1mbd (Table 4).

Table 3: Production of Primary Energy, 2002 (Mbdoe)

	Oil	Gas	Coal	Nuclear	Hydro	Total
Azerbaijan	0.3	0.1	-	-	0.1	0.5
Kazakhstan	1.0	0.2	0.8	-	-	2.0
Turkmenistan	0.2	0.9	-	-	-	1.1
Uzbekistan	0.2	1.0	-	-	-	1.2
Total	**1.7**	**2.2**	**0.8**	**-**	**0.1**	**4.8**

Source: BP Statistical Review of World Energy, June 2003

Table 4: Oil Production 1992-2002 (Mbdoe)

	1992	1997	2002
Azerbaijan	0.2	0.2	0.3
Kazakhstan	0.5	0.5	1.0
Turkmenistan	0.1	0.1	0.2
Uzbekistan	0.1	0.2	0.2
Total	**0.9**	**1.0**	**1.7**

Source: BP Statistical Review of World Energy, June 2003

For the scale of production and consumption, the four states have ample proven resources in aggregate (Table 5), but varying reserve/production ratios for the individual states. In the oil sector they range from a very high 62.5 years in Azerbaijan to rather low ratios in Turkmenistan (8.3 years) and Uzbekistan (11.3 years).

Table 5: Share of Global oil, gas and coal reserves, 2002

	Oil Reserves	Gas Reserves	Coal Reserves
Azerbaijan	0.7%	0.5%	-
Kazakhstan	0.9%	1.2%	3.5%
Turkmenistan	0.1%	1.3%	-
Uzbekistan	0.1%	1.2%	-
Total	**1.8%**	**4.2%**	**3.5%**

Source: BP Statistical Review of World Energy, June 2003

Global politics repeatedly intrude

The Central Asian and Caspian Basin states face many obstacles in attempting to secure access to the rich, hard-currency markets of Europe:

All the states have inherited the dilapidated remnants of the integrated Soviet Energy System designed, constructed and run with the interests of Russia/ The Soviet Union in mind and not for the benefit of individual states.

The Soviet system pointed energy exports to markets within the Former Soviet Union, not towards Europe or China or Southwards towards Turkey or Iran or India or Pakistan.

The energy system in the area has been very slow to change.

Many of the former Communist governments and ministers are still in power and have no intention of handing the energy sector over to free market forces.

As an example, when I was over there recently trying to work out why some energy transfers from certain producer states to neighbours, originally part of the Soviet economic plans, had become so sluggish, a friendly minister took me quietly on one side:

"*You do realise, Paul,*" he said, "*No one has ever paid cash for that exported gas and electricity for years and years. They would not know* how *to do it.*"

So, as everywhere in the Former Soviet Union, you discover running beneath the surface, a secret submerged system based on extremely inefficient ad hoc barter – gas for agricultural produce, oil for arms, coal for cotton etc – trades which are firmly in the hands of powerful trans-border mafia groups, some brand-new, some which have been prospering continuously for fifty years without a single published annual report to show for it.

On the surface you have national taxation laws and inter-government trade contracts perfectly formulated by some passing World Bank mission, excellent legislation drafted by a bevy of Wall Street and Cheapside lawyers, and glossy PR from the Ministry of Foreign Affairs. But the reassuring clink of real coin in the coffers of the Ministry of Finance is often characterised by its complete absence. This is why the so-called new "free" market economies frequently fail to produce what the economy needs or what the population wants. At its worst, the distribution policy is simply to take all surpluses at knock-down prices and dump them on the public or that of neighbouring states at inflated prices – whatever the market will bear. How the profits of this trade are raked off is not always clear but a small number of entrepreneurs rapidly become multi-millionaires.

Various large Western companies have rushed in to offer to build new oil and gas production facilities and pipelines, always with an eye to ultimate link-up with the European energy market. They have usually run immediately into collision with state-promoted resource-based energy industry projects, whose enthusiasm for cash injections of any kind are sometimes dampened only by their unwillingness to accept independent auditors or complete transparency of pricing or outside managerial control of the new technology. Production Sharing Agreements on the model popular in the Russian Federation were until quite recently supposed to have got round these inhibitions and anomalies but many of these joint operations have proved hopelessly uncompetitive and in need of further injections of government subsidies or capital mobilised by the international agencies.

Russia resists

In the case of the major planned pipeline outlets to Europe and China, all essential decision-making rests with governments and the process of agreement is highly politicised. Russia is determined not to lose influence in any part of the Former Soviet Union and talks to a listening Russian electorate of re-establishing effective control and thereby eliminating the rebels as in Chechnya. The USA, now with a commercial and industrial foothold in the Caspian area and a military foothold in Uzbekistan and Tajikistan, based on supply routes to Afghanistan, also will not give up easily.

The interests of the Gulf

Today, attention turns towards Iraq and the Gulf states. If Iraqi oil production recovers quickly or new Western technology rescues many of the depleting older fields in Iran, we are likely to see oil prices falling and less interest in Caspian oil and gas, where external investment can only be attracted in a high-price and/or supply interruption environment.

Conversely, if the oil market becomes preoccupied with the political instability of Iraq and Saudi Arabia, it will be clutching at straws of comfort in the Caspian. In this global market, accelerated Caspian production might just tip the balance whereas it is difficult to see the other central Asian states making much difference.

What is of greater relevance is the stance of Saudi Arabia and Iran operating through the OPEC quota mechanism. We need to ask ourselves what are the long-term and short-term interests of OPEC.

In the short-term, OPEC looks for the highest price (and therefore oil export revenue) for its members which is compatible with maintaining market-share. The lesson of the seventies, when the two big oil-price hikes of 1973/4 and 1979/80 greatly stimulated the development of the North Sea and other non-OPEC sources of energy and in the eighties led to a collapse of OPEC market-share and of revenue has not been lost on OPEC. The question is frequently asked, particularly in the USA, whether the Caspian might be the new North Sea and a new means of restraining OPEC power and influence in the market-place. It is an attractive hypothesis for Pentagon strategists, who have their own agenda in Central Asia, but carries little serious weight within the global oil and gas industry.

OPEC's long-term strategy is to hold on to the centre-stage in global supply and demand. This embraces tacit agreement with the key consumers on what range of price the oil market can bear. Within this broader horizon, there is little OPEC enthusiasm and no OPEC capital available for helping neighbouring supply competitors such as the Caspian states.

In political terms, the OPEC interest is in economic and trading stability – containing dissent within their own economies and minimising external interference and threat. They need secure supply lines to their lead customers and recognise that they are dependant on others, particularly the United States and Japan to police the choke points such as the Straits of Hormuz and the Straits of Malacca and to keep piracy and terrorism in check.

Only in the very long-term is OPEC aware that oil and gas pipeline access from the Gulf to Europe (as in the pre-1979 Iranian IGAT 2 project) would be of immense benefit to Gulf producers and could give them even more leverage in the market. The same visionaries see similar benefits in Gulf oil and gas being added to the planned gas and oil lines from Central Asia to China and to supply Japan.

Russia and OPEC

One major recent strategic alliance has attracted the attention of OPEC. The recent buoyancy of Russian oil production, recapturing the global lead position from Saudi Arabia and the US President's enthusiasm for projects to bring new Russian oil exports to the US raises the question of whether the USA can use Russia as a counterweight to OPEC

OPEC has, of course, in the late eighties courted Russia to become a member. Indeed an association of sympathetic non-OPEC producers, IPEC, the Independent Petroleum Exporting Countries, led by Russia and supported by Norway, Malaysia and Mexico emerged for a short while at that time before it dawned on these governments that they could reap the economic benefits of OPEC confrontation with western consumers without the political opprobrium of being seen to break ranks with their OECD partners. Support for Russia quickly evaporated.

Neither the oil and gas industry multinationals nor the lead-western governments can keep up with the current helter-skelter of Russian economic and industrial restructuring. Russia has proved extremely unpredictable as an economic ally. In any contingency positioning to absorb the next set of surprises from the Middle East in the light of the transition in Iraq to Iraqi democratic government, the mood is one of caution and wait-and-see.

Summary

Russia, at the end of the day, is so politically different from Wahabi Saudi Arabia and fundamentalist Iran that it is very hard to see those three forming an effective alliance and it is equally unlikely that the USA will be able to manipulate Russian oil policy to diminish OPEC power in the market.