# **ISSUE AND POLICY: Oil Diplomacy: American Policy in the Persian Gulf**

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**Highlight**

**ABSTRACT**

In the 1970s, energy security was defined as reducing dependence on imported ***oil***. In today's market environment, however, it is seen as a shared interest between producers and consumers. This study examines Washington's efforts to pursue a long-term ***oil*** strategy. These include the widening gap between production and consumption in the United States, volatility of ***oil*** prices, the potential opening of the upstream ***oil*** sector in Saudi Arabia, the Iranian role in developing energy resources from the Caspian Basin and economic sanctions on Iraq. The main argument is that the prosperity of both the American and the global economy depends on the availability of Gulf ***oil*** in reliable volume and at reasonable prices.

**Text**

**[\*143]** ***OIL* DIPLOMACY: AMERICAN POLICY IN THE PERSIAN GULF**

For more than half a century, ***oil*** has been the world's dominant energy source. In the next few decades, however, ***oil***'s share of the global energy demand is projected to decline slightly from approximately 40 percent to 38 percent. [[1]](#footnote-2)1 Despite this decline, ***oil*** will remain the single largest energy source. Thus, worldwide demand for ***oil*** is expected to increase from 75 million barrels per day (b/d) to 112.4 million b/d in 2020. [[2]](#footnote-3)2 Within this projection, two important facts need to be underscored. First, more than half the growth in ***oil*** consumption in industrialized countries will occur in the United States. Second, despite real and potential increases in ***oil*** production from the North Sea, West Africa and the Caspian **[\*144]** Basin, the world's incremental ***oil*** demand will increasingly be met by Persian Gulf producers.

The historical peak for Persian Gulf exports occurred in 1974, when that region accounted for more than two-thirds of the ***oil*** traded in world markets. After more than a decade of high ***oil*** prices, significant reductions in worldwide petroleum consumption resulted in the most recent historical low for Persian Gulf ***oil*** exports in 1985. Less than 40 percent of the ***oil*** traded in 1985 came from Persian Gulf suppliers. Following the 1985 ***oil*** price collapse, the Persian Gulf export percentage steadily increased. By the year 2020, the Gulf's share of worldwide petroleum export will reach 62 percent. [[3]](#footnote-4)3

This growing global dependence on energy supplies from the Persian Gulf can be explained by at least three factors. First, as a result of its onshore location close to deep water, the size of its ***oil*** fields and their geological formation in which large volumes of crude ***oil*** are pressured by a layer of natural gas, ***oil*** in the Persian Gulf is extremely cheap to extract. [[4]](#footnote-5)4 The marginal costs of production in Iran, Iraq, Saudi Arabia, Kuwait and the United Arab Emirates (UAE) are usually just a fraction of world prices. Second, ***oil*** fields in the Persian Gulf are located along effective and well-developed transport routes and are close to growing markets in both the East and West. Finally, the region holds approximately 64 percent of the world's proven ***oil*** reserves and 33.8 percent [[5]](#footnote-6)5 of its proven natural gas reserves, [[6]](#footnote-7)6 and these figures are constantly being revised upward. Accordingly, the Persian Gulf remains the main energy repository to meet the world's increasing demand both in the short and long term. It is no wonder that ***oil*** consumers have grown more dependent on supplies from the Gulf states in the last two decades. In the United States, for example, the share of Persian Gulf ***oil*** in the overall ***oil*** imports more than doubled from 10.3 percent in 1983 to 21.9 percent in 1998. [[7]](#footnote-8)7

American ***oil*** companies have played a significant role in exploring and developing the Persian Gulf states' hydrocarbon resources for more than half a century. ***Oil*** fields in the Gulf were considered essential for economic recovery in the West in the aftermath of the Second World War and as a supplement to United States reserves. Put differently, the more Gulf ***oil*** was seen as a strategic commodity, the more Washington considered its flow a matter of national security. In the late 1970s and early 1980s the Soviet Union invaded Afghanistan, closely approaching ***oil*** resources in the Gulf. President Carter did not hesitate to respond in what came to be known as the Carter Doctrine which stated that any attempt by an outside force to gain control of the Persian Gulf region would be regarded as an assault on the vital interests of the United States. [[8]](#footnote-9)8 Similarly, in 1987-88 the United States navy escorted reflagged Kuwaiti ***oil*** tankers to protect them from any hostile attack, at the urging of the Kuwaiti government. The Gulf War (1990-91) confirmed the American role in protecting ***oil*** resources in the region. This growing American involvement in the Gulf region reflects a **[\*145]** consensus in the United States and other countries that the prosperity of the global economy depends on the availability of Gulf ***oil*** in reliable volume and at reasonable prices.

The volatility of ***oil*** prices in the last few years has raised concerns in Washington regarding the security of U.S. ***oil*** supplies, and the reliability of its allies in the Persian Gulf. Some members of Congress accused Saudi Arabia and Kuwait of taking part in a "price-fixing conspiracy" and approved a legislation reaffirming President Clinton's authority to cut U.S. arms sales to both countries. [[9]](#footnote-10)9 Meanwhile, Washington's relations with another major Gulf state, Iran, slowly but significantly improved since the election of President Muhammad Khatami in May 1997. Recent developments in both Tehran and Washington might help to end the persistent diplomatic and economic stalemate in place since the Islamic revolution of 1979. Finally, in December 1999 the Clinton administration endorsed the United Nations Security Council Resolution 1284, which, if implemented, will remove the ceiling on the amount of ***oil*** Iraq may sell abroad.

This study examines American foreign policy with three Gulf states-Saudi Arabia, Iran and Iraq. The focus is on the energy dimension, with particular attention to the volatility of ***oil*** prices, the potential opening to foreign investment of the upstream ***oil*** sector (i.e. exploration and drilling operations) versus the downstream sector (i.e. refining and shipping) in Saudi Arabia and other Gulf monarchies, the Iranian role in developing energy resources from the Caspian Basin (the "pipeline diplomacy") and the economic sanctions against Iraq. The study argues that at the dawn of the new millennium, Washington has a great opportunity to consolidate the stability of ***oil*** supplies from the Gulf region at reasonable prices. This stability would benefit all players in the ***oil*** industry (American consumers, Gulf producers and ***oil*** companies). But first, a discussion of Washington's growing dependence on ***oil*** supplies from the region is in order.

**THE UNITED STATES' GROWING *OIL* DEPENDENCE**

The United States holds about 3percent of the world's proven ***oil*** reserves. Most of these reserves are concentrated primarily in Texas, Alaska, California and the Gulf of Mexico Federal Offshore Region. In spite of these reserves, the United States is the world's largest importer of crude ***oil***. Indeed, Washington's ***oil*** imports have been rising since 1982 and are expected to continue to rise in the future. This projection can be explained by the widening gap between falling production and rising consumption as the following table shows.

**[\*146]** The figures in Table 1 suggest that Washington's dependence on imported ***oil*** is rising. Indeed, the United States Department of Energy projects that the nation's crude ***oil*** production will decline at an average of 0.8 percent a year between 1998 and 2020 even reaching an estimated level of 5.3 million b/d. Consumption will increase by 6.2 million b/d during the same time span. [[10]](#footnote-11)10 Thus, the share of petroleum consumption met by net imports rises from 52 percent in 1998 to 64 percent in 2020. [[11]](#footnote-12)11 Within this context, three interrelated trends deserve highlighting. First, transportation is at the center of the U.S. ***oil*** dependence problem because it is by far the dominant consumer of petroleum products and its demand for ***oil*** is highly inelastic. Second, among developed countries, American consumers are the largest and least-taxed users of gasoline. In 1997, the shares of taxes in the retail gasoline price in the United States, Japan, Germany and France were 27 percent, 56 percent, 72 percent and 78 percent respectively. [[12]](#footnote-13)12 This low level of taxes on transportation fuels in the United States makes domestic prices particularly sensitive to changes in world crude ***oil*** market. In spite of this vulnerability, changes in domestic consumption do not correspond to the fluctuation of global ***oil*** prices. Third, since 1970, energy intensity, measured as energy use per dollar of gross national product (GDP), has improved particularly when energy prices have risen rapidly. Between 1970 and 1986 energy intensity declined at an average rate of 2.3 percent a year as the economy shifted to less energy-intensive industries and more efficient technologies in response to skyrocketing ***oil*** prices. With moderate price increases since the mid-1980s intensity improvements have been flat. Despite the growth in demand for energy services, primary energy intensity on a per capita basis will remain essentially static through 2020, with efficiency improvements in many end-use energy applications making **[\*147]** it possible to provide higher levels of service without significant increases in total energy use per capita. [[13]](#footnote-14)13

**TABLE 1:** The United States ***oil*** production and consumption (1990-98)

| **(thousand barrels per day)** | |  |
| --- | --- | --- |
| **Year** | **Production** | **Consumption** |
| 1990 | 8,915 | 16,305 |
| 1991 | 9,075 | 16,000 |
| 1992 | 8,870 | 16,260 |
| 1993 | 8,585 | 16,470 |
| 1994 | 8,390 | 16,950 |
| 1995 | 8,320 | 16,950 |
| 1996 | 8,295 | 17,470 |
| 1997 | 8,270 | 17,770 |
| 1998 | 7,995 | 17,810 |
|  |  |  |
| SOURCE: BP Amoco, BP Amoco Statistical Review of World Energy, London, | | |
| June 1999, pp. 7 & 10. | | |

This persistent and growing American dependence on imported ***oil*** has made the nation vulnerable to ***oil*** price fluctuations since the early 1970s. In the aftermath of the 1973 Arab-Israeli war, some members of the Organization of Arab Petroleum Exporting Countries (OAPEC) slashed production by twenty five percent, quadrupling prices. In addition, OPEC directed an ***oil*** embargo at the United States and a few other countries to warn them against friendship with Israel. Then United States Secretary of State Henry Kissinger proposed the establishment of the International Energy Agency (IEA) to coordinate the ***oil*** consumers' policies. This idea was accepted by most members of the Paris-based Organization for Economic Cooperation and Development (OECD). [[14]](#footnote-15)14 However, France refused to join claiming that the agency would be confrontational, and instead favored good relations with ***oil*** producers and the Arab world. In spite of this start, the IEA evolved into a leading energy think-tank providing researchers with valuable data and cooperating with other relevant organizations such as the Organization of Petroleum Exporting Countries (OPEC). Given this change, France joined the IEA in 1992.

In compliance with IEA recommendations and in an attempt to enhance its ***oil*** security, the United States government established the Strategic Petroleum Reserve (SPR) in December 1975 when President Ford signed the Energy Policy and Conservation Act (EPCA). [[15]](#footnote-16)15 In 1977, the SPR fill rate began with imported crude ***oil*** and by 1994, the reserve had reached its maximum storage of 592 million barrels. The United States has held two public sales of crude ***oil*** from the SPR in 1990/91 and 1996/97. The first sale was intended to stabilize the price of crude ***oil*** during the Gulf War and the second sale was intended to finance the SPR's operations. Currently, the Reserve storage level hovers at 563 million barrels of crude--about 63 days of net U.S. petroleum imports. [[16]](#footnote-17)16

Ironically, the ***oil*** industry in the United States did not see the collapse of ***oil*** prices of 1997-98 as a blessing. The nation's drilling activity peaked in December 1981, with an average of 4,521 rigs in operation. Since the ***oil*** price collapse of late 1997, the number of rigs fell sharply, reaching 588 in January 1999, the lowest level since 1950. [[17]](#footnote-18)17 According to the U.S. government statistics, 29,300 jobs were lost in the petroleum industry in 1998 [[18]](#footnote-19)18 and hundreds of wells were abandoned. [[19]](#footnote-20)19 These downsizings and lay-offs reflect the relatively high cost of ***oil*** production in the United States in comparison with the rest of the world. Put differently, low global ***oil*** prices make it unprofitable to explore and develop American ***oil*** resources. Finally, this drop in rigs drilling for ***oil*** and the abandonment of many wells led to the fall of crude reserves. According to the Department of Energy of the United States, proven ***oil*** reserves fell seven percent in 1998, the largest percentage decline in over 50 years. [[20]](#footnote-21)20

**[\*148]** Nevertheless, the climb of ***oil*** prices since March 1999 has not boosted the American economy. Indeed, a different set of problems has hit American consumers and both the Administration and Congress have felt pressure to take some action. In the early months of the year 2000, the Clinton administration took steps to provide relief from high ***oil*** prices particularly for low-income people in the northeast states. These included the temporarily halting of ***oil*** purchases for the SPR and the authorization of an early release of U.S. $ 45 million of previously budgeted federal money to state governments to subsidize heating bills for poor families. [[21]](#footnote-22)21 Meanwhile, in November 1999 Senators Susan Collins (R-Maine) and Charles Schumer (D-New York) introduced Senate Bill 1951, called the ***Oil*** Price Protection Act. [[22]](#footnote-23)22 The bill would give the Secretary of Energy authority to draw down the SPR when ***oil*** and gas prices in the United States rise sharply because of "anticompetitive activity." It also would require the President, through the Secretary of Energy, to consult with Congress regarding the sale of ***oil*** from the SPR. [[23]](#footnote-24)23 The administration has balked at using the reserve, because it is designed to soften the blow of another ***oil*** embargo or similar energy crisis, not to control market prices. Still, President Clinton has not completely ruled out this option. In fact, in the beginning of 2000 the Clinton administration considered a special arrangement called "swaps." Under a system of swaps, a company would take ***oil*** out of the SPR and sell it at current prices. The extra ***oil*** on the market would help drive prices down. Later, the company would return a somewhat larger amount of ***oil*** to the reserve. The incentive for the companies is that they would earn a profit from selling the reserve ***oil*** at today's high prices and replace it later with cheaper ***oil*** when prices have fallen. [[24]](#footnote-25)24

These efforts by the United States to ensure and enhance its energy security lead to two important conclusions. First, over the last three decades the American economy has suffered from both extremely low and extremely high ***oil*** prices. Stable prices at a reasonable level are in the best interest of consumers in the United States and worldwide. The challenge is that no consensus has arisen on what is "a reasonable level" and how to reach and maintain it. Second, access to overseas energy resources is a cornerstone of U.S. economic prosperity, and access to the Persian Gulf ***oil*** supplies remains a key component of this objective. The challenge is balancing these geo-economic interests with geo-strategic ones (i.e. promoting civil liberties and human rights, the non-proliferation of weapons of mass destruction, containing terrorism and maintaining peace and stability). The United States' ambiguous policy toward Saudi Arabia and other Gulf monarchies, Iran and Iraq reflects this competition between economic and strategic interests.

**[\*149]** **SAUDI ARABIA AND THE UNITED STATES**

In spite of calls from some members in the United States Congress to punish ***oil*** producing countries for their deliberate policy of raising ***oil*** prices, the Clinton administration has chosen to use quiet diplomacy to "convince" the leaders of major energy producers to take some action to stabilize the market. After a visit to Saudi Arabia by the United States Secretary of Energy Bill Richardson in late February 2000 the two sides issued a statement in which the Secretary underscored the "strategic importance of the kingdom as a dependable, reliable and secure ***oil*** supplier of the U.S and to world markets." [[25]](#footnote-26)25 Furthermore, Riyadh vowed to "review the ***oil*** supply and demand levels to ensure market stability, prevent ***oil*** price volatility and avoid harming the world economy." [[26]](#footnote-27)26 This statement reflects the close economic and strategic cooperation between the two sides, which has been in place for more than half a century. The United States, the world's largest ***oil*** importer, and Saudi Arabia, the world's largest ***oil*** exporter, share common interests in ensuring stability for the global energy market. Two areas illustrate these common goals: preventing ***oil*** price volatility and inviting American and other international ***oil*** companies back into the upstream sector in Saudi Arabia.

For many years, ***oil*** producing countries in the Persian Gulf have switched between two strategies: maximizing profit and maximizing market-share. Prices that are too high encourage investment either in other regions (i.e. the North Sea or the Caspian Basin), threatening their market share, or in alternative energy sources, threatening the whole industry. On the other side, prices that are too low mean low revenues that restrain the Gulf governments' ability to maintain their socio-economic development plans. For the last few years, ***oil*** producers, led by Saudi Arabia, have sought to figure out the "right" price to balance between these two strategies.

In November 1997, OPEC ministers met in Jakarta, Indonesia and decided to raise production from 25 million b/d to 27 million b/d. This decision, in conjunction with other developments, led to the collapse of ***oil*** prices to a level not seen since the early 1970s. In response, the kingdom, in consultation with other OPEC members and non-OPEC producers (i.e. Mexico, Norway, Russia and Oman), took several initiatives to raise prices. In March 1998 the ***oil*** ministers of Saudi Arabia, Venezuela and Mexico met in Riyadh and announced a commitment from most of the OPEC members to boost ***oil*** prices by removing up to 1.6 million b/d from the market. Another cut was announced in June 1998. Still, these two attempts failed to impress the market and prices continued to drop. Finally, in March 1999, ***oil*** ministers from Saudi Arabia, Iran and Venezuela reached an agreement, endorsed by other OPEC members, to further **[\*150]** cut production by 1.7 million b/d. [[27]](#footnote-28)27 In a separate accord, the non-OPEC producers Mexico, Norway, Russia and Oman made a commitment to cut 388,000 b/d. [[28]](#footnote-29)28 The agreement was effective for one year (April 1, 1999 to March 31, 2000). Given this substantial production reduction and the unprecedented cooperation between OPEC members and non-members as well as the rare high level of compliance to the agreements by most producers, ***oil*** prices skyrocketed.

In response to this volatility in ***oil*** prices, the ***oil*** ministers of Saudi Arabia, Venezuela and Mexico met in Caracas where they floated ideas about how to stabilize prices in the future, including a proposal by Venezuela that called for an automatic mechanism to manage ***oil*** supply and keep prices within a special range. This essentially would create a production quota system linked to a price range. When prices rise above a certain ceiling, a country should produce more, and when they fall below a predetermined floor, it should produce less. The proposal is initially to set the band at a fairly wide range of U.S. $ 16 to U.S. $ 20 per barrel for world benchmark grade North Sea Brent, and narrow it over time. [[29]](#footnote-30)29 Riyadh has neither accepted nor rejected this idea. Still, recent statements by Saudi officials indicate a desire to find a way to stabilize prices. Recently the Saudi ***Oil*** Minister Ali al-Naimi said,

In the period up to the early seventies, the international ***oil*** majors managed the market and set prices at the optimum level from their perspective. Unfortunately, that level was too low for the producing governments to generate adequate revenues for development. Then OPEC took control and managed the market at relatively higher prices until the mid-eighties. These higher prices resulted in declining demand and increasing supply. The new market environment necessitates finding new tools to point it in the desired directions. [[30]](#footnote-31)30

This idea of a price band was approved in OPEC's meeting in Vienna last March in which the cartel decided to raise output by 1.7 million barrels per day. [[31]](#footnote-32)31 In addition, the members agreed to defend a price range of U.S. $ 22-28 per barrel. According to Venezuelan Energy Minister and OPEC President Ali Rodriguez, "OPEC would raise or cut production by 500,000 b/d on a pro-rata basis if prices moved outside the band for more than 20 trading days." [[32]](#footnote-33)32 President Clinton stated that OPEC's decision to raise production was "good news for the economy and for the American consumer." [[33]](#footnote-34)33

In addition to this common desire between Washington and Riyadh to stabilize ***oil*** prices at a reasonable level, there are signs of increasing cooperation to further expand and develop the kingdom's upstream ***oil*** sector. In 1933, King Ibn Saud granted a concession to the Arabian American ***Oil*** Company (Aramco). Aramco was the operating company for Standard ***Oil*** of California and Texaco, which were joined by Socony Mobil and Jersey Standard in 1948. [[34]](#footnote-35)34 In the mid-1970s, however, Riyadh, after long negotiations, ended concessions and nationalized its ***oil*** industry. **[\*151]** Since then foreign investors have only been allowed to participate in downstream operations such as refining and shipping and have been awarded minor concessions in the Neutral Zone shared by Kuwait and Saudi Arabia.

The kingdom's adherence to this state-control policy, however, came into question in September 1998 when Crown Prince Abdullah met in Washington D.C. with senior executives from seven American ***oil*** companies: Chevron, Exxon, Mobil, Texaco, Arco, Conoco and Philips Petroleum. [[35]](#footnote-36)35 The Crown Prince asked the executives to submit directly to him recommendations and suggestions about the role their companies could play in the exploration and development of both existing and new ***oil*** and gas fields. [[36]](#footnote-37)36 This invitation provoked an intense debate among U.S. executives about Riyadh's motives for a potential change in its ***oil*** policy.

Several economic and strategic rationales have been advanced in favor of foreign investment in the kingdom's upstream ***oil*** sector. Saudi Arabia today is much poorer than it was in the 1970s. Over the past three decades Saudi economic growth has failed to keep pace with population growth, resulting in decreased per capita income. Accordingly, the government accepted the need to reduce its involvement in the economic system and to open the door to private sector and foreign investment. The presence of several international companies will create a competitive environment and eventually lead to a more effective utilization of the country's hydrocarbon resources than the current monopoly by the national company, Saudi Aramco. At the same time, the potential opening of Saudi Arabia's ***oil*** industry to foreign participation would divert investment to the kingdom, thereby reducing the flow of capital going to other producing regions. In short, a barrel that is developed in Saudi Arabia by international ***oil*** companies is a barrel that is not developed in other areas. [[37]](#footnote-38)37 Meanwhile, the Crown Prince's initiative can be seen as part of a Saudi foreign policy agenda to further consolidate U.S. geo-political and geo-economic interests in the security of the kingdom. [[38]](#footnote-39)38 Put differently, the Saudis are concerned about losing some of their country's strategic importance as the Americans rely more and more on ***oil*** from countries closer to home such as Canada, Mexico and Venezuela.

In spite of these economic and strategic advantages of a potential return of the international ***oil*** companies to the Saudi ***oil*** industry, another element of the internal Saudi debate has sought to portray any foreign investment in the kingdom's ***oil*** upstream sector as unnecessary and undesirable. Saudi Aramco is among the most technologically competent in the world, and already knows the locations of its ***oil*** and gas. It can produce them at a cost similar or less than a foreign ***oil*** company can. Furthermore, the kingdom already has roughly 3 million b/d of spare production capacity, the largest in the world. [[39]](#footnote-40)39 The London-based Center for Global Energy Studies estimates the cost to Saudi Arabia of maintaining this idle capacity at U.S. $ 500 million each year. [[40]](#footnote-41)40

**[\*152]** The Saudi ***Oil*** Minister Ali al-Naimi is known to be cautious in his stand on the issue of foreign investment in the upstream ***oil*** sector. In several statements, al-Naimi underscored the fact that the Kingdom is not opposed, in principle, to the return of the international companies to the country's ***oil*** industry but currently there is no need for this step. Instead, the Saudi ***oil*** minister has invited foreign investors to participate in developing the industrial base of the kingdom. In spite of this controversy over opening the door to foreign investors, several international ***oil*** companies have already submitted proposals and expressed interest in investing in the kingdom. These include Exxon/Mobil, Royal Dutch/Shell Group, BP Amoco, Philips Petroleum, Conoco, Texaco, the ENI of Italy and Total/Fina of France. [[41]](#footnote-42)41 In 2000, a ministerial committee had been set up to examine these proposals and negotiate with the international companies. According to Crown Prince Abdullah, if all the proposals go ahead, the financing would be worth more than U.S. $ 100 billion. [[42]](#footnote-43)42 These signs regarding the potential opening of the kingdom's upstream ***oil*** sector are in line with a new foreign investment law, approved by the Saudi cabinet in early April. The new law gives foreign investors the same privileges, incentives and rights as nationals. [[43]](#footnote-44)43

To sum up, for almost seven decades the United States and Saudi Arabia have been engaged in a strategic and economic cooperation to ensure the non-interruption of ***oil*** supplies from the Persian Gulf at a "reasonable" level. Like any relationship, American-Saudi close cooperation has had its own ups and downs, but their alliance has survived many storms. For the foreseeable future, American and Saudi interests in promoting market stability and the leading role American companies have played in developing the kingdom's hydrocarbon resources will foster their cooperation. Ironically, for more than two decades Washington has had stormy relations with OPEC's second largest ***oil*** producer--Iran.

**IRAN AND THE UNITED STATES**

The Islamic Republic of Iran occupies a strategic location between the Persian Gulf and the Caspian Sea. It holds nine percent of the world's ***oil*** reserves and 15 percent of its gas reserves. [[44]](#footnote-45)44 These vast resources and the strategic location make Tehran a crucial player in both regions as well as in the world energy market. However, for the last two decades, Iran has presented the United States government with a difficult dilemma, leading to two conflicting pillars in American foreign policy: a desire to promote Washington's economic interests around the world and a determination to exert pressure on Tehran to change its behavior on certain foreign policy issues with respect to the Middle East peace process, the sponsoring of international terrorism and attempts to acquire and develop weapons of mass destruction. In order to deprive Iran of the financial resources to pursue these strategic objectives, Washington has **[\*153]** imposed several restrictions on investment in the Islamic Republic's energy sector--the primary source of national income. These include the 1995 executive order that made it illegal for American ***oil*** companies to operate in Iran. [[45]](#footnote-46)45 Another important step was the 1996 Iran-Libya Sanctions Act (ILSA) which imposed sanctions on any foreign corporation that invested U.S. $ 20 million or more in the Iranian energy sector.

This American policy of trying to limit foreign investment in the Iranian energy sector has been partially successful. Both domestic political chaos in the late 1970s and the war with Iraq in the 1980s left very few resources, if any, to upgrade and expand the economic infrastructure. Consequently, since the early 1990s, Tehran has sought to resist the American sanctions and to attract investment from other sources. An important impediment, however, is the fact that the Iranian constitution does not allow for concessions to foreign entities in the energy sector. Subsequently, the Iranian government has developed an arrangement called 'buy-back' that allows firms to finance projects for repayment in production. These efforts recently succeeded in breaking the wall of economic isolation and to the signing of several agreements with non-American ***oil*** and gas companies. The list includes France's Total and EIF Aquitaie, Italy's ENI, Canada's Bow Valley, Russia's Gazprom, Malaysia's Petronas, Britain's Lasmo and in late 1999 Royal Dutch/Shell, among others.

Three important factors explain this global interest in investing in the Iranian energy sector. The first of these is the country's well-known huge ***oil*** and gas reserves which means that there is low risk in the exploration and development of these resources. Second, the fact that with the exception of the United States, the rest of the world does not subscribe to the policy of containing and isolating Iran. The European Union has pursued a policy of accommodation and dialogue with Iran. It is important to point out that under European pressure the Clinton administration decided in May 1998 to wave the provisions of ILSA against a consortium of French, Russian and Malaysian companies that signed a U.S. $ 2 billion agreement to develop Iranian gas fields. Third, the election of President Muhammad Khatami in 1997 and his efforts to introduce economic and political reform have convinced many foreign leaders that the Iran of the 1990s and 2000s is different from that of the 1970s and 1980s. The February 2000 parliamentary election demonstrates this change in Tehran. Following this election, the Clinton administration lifted some of the economic sanctions. However, the ban on American investment in the Iranian energy sector is still in place. A policy of accommodation might accelerate and consolidate this shift toward moderation. Thus, for the foreseeable future it is likely that Iran will continue to attract foreign investment, particularly if the Khatami administration succeeds in offering more incentives for international ***oil*** companies to develop the country's massive energy resources and if the United States continues to show a benign opposition to such **[\*154]** investments. In contrast, Washington has expressed strong opposition to Tehran's efforts to become a major player in the Caspian Basin.

The ***oil*** and gas pipeline systems of Central Asia and the Caucasus were originally designed and built to serve the needs of the Soviet Union. As such, they cross borders of many former Soviet successor states. All ***oil*** and gas export pipelines inherited from the Soviet period pass through Russia. Russia's ***oil*** and gas operators, facing capacity constraints due to lack of maintenance and other technical problems, have capped exports from the region. Meanwhile, the countries whose transit routes are eventually chosen will benefit not only from heavy capital inflows in terms of investment and transit fees, but more importantly, will gain considerable influence throughout the region in particular and tremendous leverage in the global energy market in general. In other words, the choice of export routes has economic and strategic implications. Not surprisingly, many players--transit states, importing countries, international ***oil*** companies and the Caspian producers--have proposed a variety of competing routes.

Since the mid-1990s, the United States has been firmly committed to the pipeline from Baku, Azerbaijan to Ceyhan, Turkey. This route, in bypassing both Russia and Iran, would accomplish three American foreign policy goals: it would strengthen the independence of the Caspian states by reducing their dependence on Russia for energy exports, exclude Iran from any possible financial benefits (i.e. transit fees and foreign investment) as well as from any potential leverage, and solidify ties with Turkey, a NATO member. An important step in this direction was taken during a summit meeting of the Organization for Security and Cooperation in Europe (OSCE) held in Istanbul, Turkey, in November 1999 when the presidents of Azerbaijan, Georgia, Kazakhstan and Turkey signed a series of agreements to build the Baku-Ceyhan pipeline. President Clinton, who attended the ceremony, stated, "These pipelines will be an insurance policy for the entire world by helping to ensure our energy resources pass through multiple routes instead of a single chokepoint." [[46]](#footnote-47)46

In spite of this strong American support for the Turkish route, there remain important obstacles. First, many industry analysts argue that this proposed pipeline would need to see ***oil*** production double to around 2,000,000 b/d to make it commercially viable. Furthermore, the Baku-Ceyhan scheme faces competition from another pipeline, the one between Baku and Supsa, Georgia, which began operation in April 1999. In September 1999, the Azerbaijan International Operating Company (AIOC) announced plans to triple the capacity of this line to 300,000 b/d by laying a parallel line and to boost production commensurately by 2002. [[47]](#footnote-48)47 Second, the Baku-Ceyhan is the most expensive proposed pipeline. The Clinton administration has not pledged any money for the project beyond U.S. $ 500 million in loan guarantees from the Overseas Private Investment Corporation and the Export-Import Bank. [[48]](#footnote-49)48 **[\*155]** Finally, the Baku-Ceyhan pipeline travels through two trouble spots in the Caucasus: Abkhazia and Nogorno-Karabakh where ethnic wars, put on hold by fragile cease-fires, can re-start at any moment.

Given these problems, many analysts consider the route south through Iran the most attractive option. Iran already has a well-developed hydrocarbon infrastructure and by almost all estimates the Iranian route is the cheapest proposed pipeline. Many international ***oil*** companies, including American ones, have expressed interest in a pipeline through Iran. The major problem preventing the full utilization of the Iranian option, however, is the strong opposition by the Clinton administration. In spite of wavering sanctions against foreign companies investing in the Iranian energy sector, the United States government has shown strong determination to oppose the transportation of the Caspian's ***oil*** and gas through Iran. According to Madeleine Albright, the U.S. Secretary of State, "Washington remains strongly opposed to ***oil*** and gas pipelines which transit Iran, and, as a policy matter, we will continue to encourage alternative routes for the transport of Caspian energy resources." [[49]](#footnote-50)49 In spite of this strong American opposition, a pipeline has already been constructed from Korpedzhe in southeastern Turkmenistan to Kurt-Kui in north-central Iran. In addition, the British Monument ***Oil*** and Gas Company already exports Caspian crude through Iran under swap arrangements. Under this agreement, Monument supplies crude to northern Iran to be refined and consumed locally. Iran, in turn, supplies crude to Monument at its southern port of Kharg Island on the Persian Gulf, effectively allowing crude to transit Iran without the need for a pipeline at all. In spite of Monument's success in exporting the Caspian's crude through Iran under the swap arrangement, the Clinton administration rejected applications by two American companies, Optimarket and Mobil, to engage in ***oil***-swap deals with Iran. Thus British firms enjoy an advantage over American ***oil*** companies.

Finally, Iran is seeking financing for a pipeline to carry crude ***oil*** from its Caspian Seaport of Neka to Tehran. In late 1999, a partnership between China National Petroleum Company (CNPC), Sinoped and two other Chinese firms have opened negotiations with the National Iranian ***Oil*** Company (NIOC) for construction of the pipeline. The talks follow the failure of the local Iran Power Plant Projects Management Company, which had put in the winning bid in December 1998, to raise the necessary capital. [[50]](#footnote-51)50

In spite of these deteriorating relations between Washington and Tehran for more than two decades, there have been signs of a desire to reduce tension between them since the election of President Khatami in 1997. Following the Iranian parliamentary elections in February 2000, President Clinton said that he was seeking a "constructive partnership" with Iran. [[51]](#footnote-52)51 Still, given the American presidential elections and the fact that the ILSA will not expire until 2001, the United States' opposition to foreign investment in Iran's energy sector and to **[\*156]** pipelines through the Islamic Republic is not likely to end until a new president takes office in Washington. The new president will also have to decide on relations with another Gulf state--Iraq.

**IRAQ AND THE UNITED STATES**

Iraq contains 112 billion barrels of proven ***oil*** reserves, second only to Saudi Arabia, along with roughly 215 billion barrels of probable and possible resources. [[52]](#footnote-53)52 Iraq's true resource potential may be understated, as deeper ***oil***-bearing formations located mainly in the Western Desert region could yield additional resources, but have not been explored. In spite of these huge resources, the country's hydrocarbon wealth is substantially under-developed and under-utilized. The reason is continuous political crises as the following table demonstrates.

Table 2 illustrates the impact of wars and political problems on Iraqi ***oil*** production. The huge drop in 1981 was in response to the break out of the war with Iran in which the two sides attacked each other's ***oil*** installations. The substantial increase in production in 1989 coincides with the only year in the 1980s when Iraq was not at war with any of its neighbors. This relative peace, however, did not last for long. The Gulf War and economic sanctions took a heavy toll on Baghdad's ***oil*** industry. Both upstream and downstream installations were among the main targets for the international alliance's missiles and bombs. Furthermore, since ***oil*** was the main source of foreign currency revenue, it became the main focus of the sanctions. Iraqi ***oil*** exports were restricted to supplying Jordan with limited quantities. The rise in production in 1997 was a result of the United Nations Security **[\*157]** Council Resolution 687 ("***oil*** for food") which authorized Iraq to sell more of its ***oil*** in order to meet its humanitarian needs of food and medicine.

**TABLE 2:** Iraqi ***Oil*** Production 1979-1999

| **(Thousand Barrels per Day)** | | | | | |
| --- | --- | --- | --- | --- | --- |
| **Year** | **Production** | **Year** | **Production** | **Year** | **Production** |
| 1979 | 3,477 | 1986 | 1,690 | 1993 | 0,512 |
| 1980 | 2,514 | 1987 | 2,079 | 1994 | 0,553 |
| 1981 | 1,000 | 1988 | 2,685 | 1995 | 0,560 |
| 1982 | 1,012 | 1989 | 2,897 | 1996 | 0,579 |
| 1983 | 1,005 | 1990 | 2,040 | 1997 | 1,187 |
| 1984 | 1,209 | 1991 | 0,305 | 1998 | 2,000 |
| 1985 | 1,433 | 1992 | 0,425 | 1999 | 2,600 |
|  |  |  |  |  |  |
| SOURCE: Energy Information Administration, United States Department of | | | | | |
| Energy, International Petroleum Statistics Report, Washington, D.C.: United | | | | | |
| States Government Printing Office, February 2000, p.38. | | | | | |

These two decades of continuous political crises allowed only very limited financial resources to renew and update the country's energy infrastructure. Worse, the degree to which wars and sanctions damaged the ***oil*** wells is uncertain. A recent study commissioned by the United Nations estimates that "as many as one-fifth of Iraq's ***oil*** wells might be irreparably damaged." [[53]](#footnote-54)53 In 1999 Iraq had been able to increase its ***oil*** production through use of short-term techniques not generally considered acceptable in the ***oil*** industry. These additional supplies are in line with the United Nations Security Council resolutions. In February 1998, the Council voted unanimously to more than double from U.S. $ 2 billion to U.S. $ 5.26 billion the amount of ***oil*** Iraq can sell over six-month periods. The Security Council also approved a resolution allowing Iraq to purchase U.S. $ 300 million worth of equipment for its ***oil*** industry. In late 1999, the Security Council raised the revenue cap to U.S. $ 8.3 billion for a one-time six monthperiod. In December 1999, the Council adopted Resolution 1284, which, among other things, lifts the cap on the volume of ***oil*** Iraq can sell. Finally, in late March 2000 all 15 members of the United Nations Security Council voted in favor of a U.S.-sponsored resolution that doubles the amount of money Iraq can spend on spare parts to repair its ailing ***oil*** industry. These developments suggest that almost ten years after the Gulf War, Iraq is vigorously resuming its position in the international ***oil*** market.

As a permanent member of the United Nations Security Council, the United States endorsed all the previous resolutions regarding Iraq's ***oil*** policy. Indeed, since the Iraqi invasion of Kuwait in August 1990, Washington has taken the lead in imposing and maintaining economic sanctions on Baghdad. The stated American objective is to neutralize the threat the Iraqi regime poses to the peace and security of a region of vital national interest to the United States. In order to achieve this goal, Washington has employed political, economic and military methods (i.e. sanctions, supporting opposition groups and missile strikes). These measures aim at creating the conditions that would permit a successful change of the regime locally and keep Iraq isolated internationally.

Two important developments regarding the American approach towards Iraq need to be underscored. First, in the late 1990s, the American goal changed from containing the regime in Baghdad to attempting to topple it. In December 1998, Secretary of State Madeleine Albright said that the American policy of containment of Iraq had changed to one of "containment plus regime change." [[54]](#footnote-55)54 Second, ten years after imposing sanctions on Iraq, the country remains isolated, yet the isolation barrier has holes. The international community's determination to maintain sanctions is waning, described by some analysts as "sanction fatigue." In other words, as memories of the Gulf War fade, it is harder and harder to sustain support **[\*158]** for sanctions. One illustration of "sanction fatigue" took place in September 1999 when more than 50 foreign companies attended an ***oil*** and gas technology exhibition in Baghdad, the first such gathering in 10 years. Most of the firms were from Russia, China, Canada, France, Italy and the United Kingdom. No United States firms attended the exhibition. [[55]](#footnote-56)55

In order to break the wall of isolation, Baghdad has sought to use its ***oil*** resources as a carrot in order to influence the positions of other governments in the Security Council. A large proportion of the Iraqi ***oil*** is sold to Russian, Chinese and French firms. More importantly, Baghdad has offered these three permanent members of the Security Council attractive terms to explore and develop its ***oil*** fields. Over the last few years Iraq has signed production sharing contracts (PSCs) with China National Petroleum Corporation, Russia's Lukoil and France's Elf Aquitaine, and Total, among others, to develop al-Ahdab, West Qurna, Majnoon and other ***oil*** fields once the U.N. sanctions are lifted. Zarubezhneft, a Russian ***oil*** company, has already started drilling scores of ***oil*** wells in the Kirkuk field in north Iraq, considered by some officials to be part of Kurdistan. [[56]](#footnote-57)56 As of March 2000, American ***oil*** companies are not known to have signed any deal with Iraq.

These agreements between the Iraqi government and several international ***oil*** companies are in line with two publicly stated objectives by the government in Baghdad. First, for the last several years Iraq has indicated a desire to expand its production capacity aggressively to about 6,000,000 b/d when the United Nations sanctions are lifted. Given the country's burdensome foreign debt and the poor status of its ***oil*** installations, foreign investment is a necessity. Second, in a speech marking the 79th anniversary of the founding of Iraq's armed forces, President Saddam Hussein said, "We have said with certainty that the embargo will not be lifted by a Security Council resolution, but will corrode by itself." [[57]](#footnote-58)57 The Iraqi leaders believe that the United States will not accept lifting the sanctions as long as they are in power.

For the foreseeable future, it is very hard to forecast any rapprochement between Washington and Baghdad while President Saddam Hussein is in office. Iraqi ***oil*** is already back in the international market in increasing quantities. American diplomatic and economic pressure on the Iraqi government to accept the Security Council resolutions are likely to continue. Meanwhile, American ***oil*** companies cannot be expected to play a role in developing Iraq's hydrocarbon resources without a fundamental change in the political system in Baghdad.

**CONCLUSIONS**

Three conclusions can be drawn from the preceding discussion of the United States ***oil*** diplomacy in the Persian Gulf. First, unlike most other commodities, ***oil*** **[\*159]** markets have never been driven by economic factors alone. Strategic considerations have always shaped ***oil*** supplies and prices. The United States has the largest economy in the world and, at the same time, is the only remaining superpower. Washington's ***oil*** diplomacy reflects both its economic and strategic interests. Occasionally, as the experience with Iran suggests, the preferred approaches of private American ***oil*** companies do not correspond with the objectives and strategies of the United States government. Second, the globalization of the ***oil*** market has made the question of who buys and who sells a particular barrel of ***oil*** less and less relevant. It is true that the United States is less dependent on ***oil*** supplies from the Persian Gulf than are Europe and Japan. It is also true that any disruption of supplies from the Gulf region will have a negative impact on the global economy including the United States. In other words, all major powers should find a way to ensure the stability of the energy market. American ***oil*** security cannot be achieved without a stable global ***oil*** market. Third, the possibility of inviting foreign investment back to the ***oil*** industry in the Persian Gulf states as well as the recent political changes in Iran provide Washington with a significant opportunity to contribute to economic and political reform in the region. This opportunity should not be missed. Furthermore, at some point in the future, the situation in Iraq will settle down. Given its tremendous hydrocarbon resources, Baghdad will remain a major player in the ***oil*** industry. The re-integration of Iraq into the global system will add to the stability of the international energy market. In short, ***oil*** diplomacy is not a zero-sum game. In the energy industry, all players, including the United States government, American ***oil*** companies and Gulf producers, can win.

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