Oxford
ENERGY FORUM

A QUARTERLY JOURNAL FOR DEBATING ENERGY ISSUES AND POLICIES

Issue 75 November 2008

CONTENTS

In the Personal Commentary written for this issue by Andrew Gould the CEO of Schlumberger, the respective roles of services companies and the international oil corporations are insightfully defined. Gould relates his analysis to Mark Moody-Stuart's commentary published in Forum 74 (August 2008) to which readers are referred for a fuller presentation of complementary views. He firmly believes that 'the industry can only satisfy society's needs effectively when all the players clearly communicate their roles and relationships'. The contribution of services companies is in technology and in the provision of first class skills that reflect the high quality of their staff. Trust between them and their customers is the most valuable asset; and this trust arises because competition is not involved in the relationship.

The other articles in this issue are grouped under two themes. The first which is covered by four contributions is the difficult subject of political stability in the Middle East. The importance of this topic for the oil and gas industry is well recognised. At present a large share of world production originates in this region; and the huge reserves held by Middle East countries suggest that their role in supplying the world with oil and gas can only become more critical in the long run.

A host of factors are relevant to the stability problem. There are regional crises such as the Arab–Israeli conflict; international ones such as the dispute over Iran's nuclear ambitions; and internal instability partly caused by foreign military intervention in Iraq. These aspects are addressed by distinguished contributors all of whom have a long experience with, and often a direct involvement in, these matters.

I must add however that the stability issue involves other important elements from domestic political conflicts, frustrations with the state of economies and the lack of political participation, resentment about corruption, the impact of oil revenues on the distribution of income, to name but a few. Some of these may be addressed in future issues of *Forum.*

In a sharp analysis of the continual failure to solve the Arab–Israeli problem, Henri Siegman points out that a country with the overwhelming advantages enjoyed by Israel rarely yields to the demands of a very weak adversary. What is needed is a powerful third party that can restore the balance between Israel

OXFORD INSTITUTE FOR ENERGY STUDIES

and the Palestinians. The failure of many repeated attempts at 'facilitation' by the USA was not due to the lack of ideas but of a more critical lack of political will, in fact to cowardice.

The nuclear issue that has set the USA in association with other UN Security Council Members plus Germany against Iran is analysed by Lakhdar Brahimi, the veteran international mediator and diplomat, and Eric Rouleau, the journalist and sometimes Ambassador who has followed the Middle East for longer than five decades. Both believe that the military option having been swept away by the problems in Iraq and Afghanistan and the financial crisis is now leaving only the 'engagement' policy as an option. Barack Obama's election to the presidency (an event that occurred after the articles were written) suggests that this option will indeed be pursued. This however raises difficult questions about who will set the agenda of the negotiations, what the agenda will consist of, and who will be involved other than the United States and Iran. My own question relates to the risk that Iran may read the US desire to negotiate as a weakness and fail to make concessions. What then?

Internal security in Iraq, a topic addressed by Walid Khadduri, is continually threatened by a long list of factors. The fundamental issue, however, is the failure to forge a social contract between the various population groups. Questions about the future also arise – such as the role of the army, Iraq's reaction to a worsening of the nuclear dispute over Iran and the regional policy of a future Iraqi government.

The second set of articles is about OPEC. This Organisation has come under fierce attack by leaders of OECD countries when oil prices rose during the first half of 2008. Some seem to have forgotten that the reference prices of oil are determined in the futures market, a financial institution, and not by OPEC. Robert Mabro shows that the 'cartel' label consistently and continually pinned on OPEC is only applicable to certain short episodes. For a useful analysis of oil market's behaviour it is important to understand correctly the role that OPEC plays in different times. The blanket use of the term cartel is an obstacle rather than a help to understanding.

Bassam Fattouh describes the relationship between OPEC and the world petroleum market resulting from the recent decision reducing production quotas as a dance in four stages or moves, some of which have already been made, and others are expected in the near future. He also points to cycles in the relationship with the market involving passivity when prices are rising, except when political pressure to intervene with production increases becomes significant, and active responses when prices are too low or falling in a dangerous manner. Even then immediate success is a rare occurrence because of the initial scepticism of markets and the long lags between the implementation of cuts and their impact at final destinations.

Forum is a debating journal. We welcome therefore letters to the Editor. We are publishing two letters here, and we encourage readers to write about the controversial issues addressed in this and other issues.

From time to time Asinus changes its identity and therefore its moods and style. A big thank you is due to Robert (Bob) Sutcliffe who wrote the rubric in a number of recent issues, and welcome to Paul Segal, an Asinus of a younger generation.

Contributors to this issue

Lakhdar Brahimi is a UN mediator and former Foreign Minister of Algeria

Bassam Fattouh is Reader in Finance at the School of Oriental and African Studies and Senior Research Fellow at the OIES

Andrew Gould is Chairman and CEO of Schlumberger

Walid Khadduri is a consultant to the *Middle East Economic Survey*

Robert Mabro is Honorary President of OIES

Eric Rouleau is the former Middle East correspondent of *Le Monde* and French ambassador to Tunisia

Henry Siegman is the director of the US/Middle East Project in New York

Middle East Political Stability

Henry Siegman asks whether the next US President can rescue a two-state solution to the Israel–Palestine conflict

The next occupant of the Oval Office will be the last American president to be able to save the two-state solution to the Israel–Palestine conflict. If he does not pursue and achieve this goal during the first year of his presidency, the two-state 'horizon' that President George W. Bush pursued so ineffectively is likely to disappear for good. But even a quick engagement by the new president will fare no better than previous US peace initiatives – all of which have gotten nowhere – if he and his advisors approach the task believing that some more 'peace processing' or 'confidence-building measures' will achieve the goal that eluded his predecessors.

The Israel–Palestine conflict has defied US 'facilitation' over these many years not because of procedural shortcomings, nor because of a paucity of ideas. The terms of a workable agreement – formulated in the Clinton Parameters and elaborated in the Taba discussions that followed – are well-known, and enjoy near-universal support. What has been missing is the political will to get the parties to act on these parameters – a political and moral failure that has doomed all previous efforts. This failure has not been the result of ignorance, but of cowardice – a willful disregard by successive American administrations and by much of the international community of certain unchanging fundamentals that underlie this conflict. Peace initiatives that ignore these fundamentals and seek an agreement on the cheap cannot succeed.

The following catalogue of past Israeli and European/US failures is not intended to excuse disastrous choices Palestinians have so often made in pursuing their struggle for statehood – from egregious failures at institution-building, to murderous violence against innocent civilians, to the more recent fratricidal warfare between Fatah and Hamas for which Fatah's refusal to accept the democratic choice of the Palestinian people in the parliamentary elections of 2006 deserves most of the blame. Rather, it is intended to say that the difficult measures Palestinians must take to put their house in order will remain beyond their grasp unless they are given a credible and proximate commitment for a Palestinian state alongside of Israel that is 'independent, viable and sovereign' as of right, not Israeli generosity. And because such a state is indeed the right of the Palestinian people, its acknowledgement must precede, not follow, conditions that are set for its implementation. That such a clear commitment has not been made to this day is far more revealing of Israeli intentions and US/European indifference than any number of confidence-building measures that have left entirely unchanged the Palestinians' status as a people under the heel of a crushing and open-ended occupation.

In a recent interview following his resignation as prime minister, Ehud Olmert shocked Israelis by endorsing views associated with Israel's political hard left. Among other startling declarations, he said that the reason Israel was able to reach a peace agreement with Egypt – as opposed to its futile efforts to achieve a peace accord with Arafat or with Syria's two Assad's – was not Sadat's dramatic visit to Jerusalem. The real reason is that well before Sadat's visit, Israel's celebrated chief of staff and foreign minister, Moshe Dayan, at a secret meeting with Sadat's envoy in Morocco, delivered the following message from Prime Minister Menachem Begin: First, Israel is prepared to return every last inch of Egyptian territory under Israeli occupation. Second, now let us negotiate the implementation of that goal. That is something Israel has refused to say to the Palestinians and to the Syrians and that is why all previous negotiations have gotten nowhere.

> "The next occupant of the Oval Office will be the last American president to be able to save the two-state solution to the Israel–Palestine conflict"

Of course, while in office, Olmert not only did nothing consistent with this understanding, but until the very last moment personally approved measures – such as authorising further construction in the settlements and in East Jerusalem – that deepened the despair of Palestinians and made a two-state solution an even more impossible dream.

***

The first and most decisive of the ignored fundamentals is the vast discrepancy of power and influence that defines the Israeli and Palestinian relationship. It is rare for a country with the overwhelming military, diplomatic and economic advantages enjoyed by Israel to yield to demands of a near-impotent adversary without a powerful third-party restoring some balance between the two. The only outside power capable of restoring that balance is the United States, because its support and friendship for Israel are unquestioned by Israelis, and are understood by virtually everyone in Israel to be the country's most important security asset, one they dare not weaken.

Without a determined American insistence that Israel end its occupation and negotiate a peace accord that approximates the international consensus without further delays, no amount of tinkering with negotiating mechanisms or reformulations of permanent status issues, and no amount of 'CBMs' – confidence-building measures – will change the forty-year dynamic of the conflict that has resulted in so extensive an expansion of Israel's population into Palestinian territories as to no longer allow a two-state solution. That Israel's continuing settlement project in East Jerusalem and in the West Bank has reached that point is beyond question. What is not clear is whether these Israeli 'facts on the ground' are still reversible.

Such reversibility depends entirely on the next American president's leaving no doubt about America's resolve to use its leverage to end the conflict on the basis of the existing international consensus while fully supporting – and participating in – measures necessary to enable Israel to deal with security challenges created by a peace accord that conforms to previous agreements and international law. However complicated and costly they are, such arrangements hold far greater promise of protecting Israel's security within its borders – and at lesser material and moral cost – than the perpetuation of Israel's occupation of the West Bank.

A muscular and proactive US diplomacy will be criticised by some as constituting an inappropriate outsiders' imposition of terms for a peace agreement. It is no such thing. The parameters for a permanent status agreement that the next US president must put forward would be based on principles that both Israel and the Palestinians have signed onto when they formally endorsed UN Resolutions 242 and 338, the Oslo Accords, the Road map and the Annapolis understandings. The American president must insist that commitments made by Israel – no less than commitments made by Palestinians – must finally be honoured and implemented, something previous presidents have failed to do.

For such a new initiative to be credible and effective, the next administration must reaffirm the foundational principle of the Road Map and of previous agreements, which is that while some changes from the pre-1967 situation may be inevitable, they will not receive US and international support or recognition if made unilaterally by either party. It is a principle that President Bush and Secretary of State Condoleezza Rice repeatedly affirmed rhetorically, but never acted upon.

> "So far, it is only Palestinians who have made painful concessions"

At a press conference following her February 2006 meeting in Washington with Israel's Tzipi Livni, Secretary Rice said that 'the United States position on [Israel's unilateralism] is very clear and remains the same. No one should try and unilaterally predetermine the outcome of a final status agreement. That's to be done at final status.' Rice added that President Bush's letter to Prime Minister Ariel Sharon endorsing the need to take into consideration 'new population centers' in the West Bank does not provide a licence for anyone to 'try and do that in a preemptive or predetermined way, because these are issues for negotiation at final status.' Yet both Bush and Rice repeatedly prevented efforts by members of the Security Council to censure Israel for doing precisely that – 'unilaterally predetermining the outcome of a final status agreement'.

***

Particularly misguided and damaging has been the oft-repeated demand that Palestinians offer territorial concessions that match the 'painful concessions' Israel's leaders have said they are prepared to make. It is a formulation that reveals a profound misunderstanding or deliberate distortion of the history of this conflict, and must produce a one-sided outcome that is unjust and untenable. For Palestinians have not asked Israel to make territorial concessions, i.e. give up any of the territory Israel has controlled since the armistice agreement of 1949, nor has Israel ever indicated it would under any circumstances consider doing so. What Palestinians have asked is that Israel return Palestinian territory on which Israel has illegally established settlements and to which it has transferred its own population, in violation of treaty obligations and international law.

So far, it is only Palestinians who have made painful concessions. This they have done when, as a condition for Israel's acceptance of the Oslo Accords, the PLO formally agreed to recognise the legitimacy of territory acquired by Israel in the war of 1948. It is a concession that reduced by fully one-half the territory originally assigned to the Arab population of Palestine by the United Nations in the Partition Plan of 1947. Given that major Palestinian territorial concession, any new initiative that does not provide that negotiations begin at the pre-1967 armistice line and requires Palestinians to relinquish even more of the 22 percent of the territory that has been left them (other than in equal land swaps) will be stillborn.

The United States and the international community must finally reject the unspoken but long-dominant notion that if the parties do not reach a peace accord, the 'default setting' of UN Resolutions 242 and 338 is a continuation of Israel's occupation. If this is what the resolutions intended, they would have provided a powerful incentive for the occupying power to resist a peace agreement indefinitely. Clearly, this was not their intention. The USA and the international community must therefore finally act on the resolutions' plain logic that their default setting is a return to the status quo ante – without territorial and other changes that negotiations and a peace agreement might have produced. It is a default setting that should have kicked in long ago.

The cessation of violence by both sides is a reasonable and necessary condition for successful peace negotiations. But it is not an achievable goal absent an independent and empowered international mechanism that monitors violations by either side. If the occupying power – with its guns trained on the occupied population – continues to serve as judge, jury and executioner as it has for the past forty years, violence is inevitable and peacemaking will remain out of reach.

It is these fundamentals that must inform what will surely be the last US opportunity to salvage a two-state solution. Losing this opportunity will spell the end of Israel as a democratic or Jewish state; given the emerging non-Jewish majority in the territories under Israel's control, it can no longer be both. It is difficult to understand why any head of state would believe that supporting or acquiescing to that kind of an outcome might be an act of friendship to the State of Israel or to the Jewish people.

A US initiative that goes beyond the failed 'facilitation' of previous administrations to vigorous and determined diplomacy can still produce a two-state solution, but only a president whose political and moral horizon extends beyond the next Congressional elections – and understands that by the time those elections occur, the two-state solution will have disappeared – can hope to bring this multi-generational tragedy to an end.

Lakhdar Brahimi discusses Iran – war or peace in the Middle East?

Surely, the last belligerent neo-conservative voices calling for military action against Iran before the Bush–Cheney administration leaves office must have been definitively silenced by the financial crisis. The field is now free for all kinds of Think Tanks, Universities and Ad Hoc groups to send in their policy papers to the Presidential candidates in the hope of influencing future US policies towards Iran. Most of these policy papers recommend engagement, rather than containment, and if some do speak of *'not taking the use of force off the table'*, no serious party contemplates an immediate recourse to military action against Tehran. Unless the Israelis prove as reckless and as irresponsible as the Georgians were this past summer …

If, however, our assumption is right and the Bush–Cheney administration leaves office without using force against Iran, it is fairly safe to predict that an Obama administration would offer to open negotiations with Tehran at a very early stage whereas McCain may take somewhat longer to break away from the Bush–Cheney Neo-Con rhetoric he largely espoused during the campaign.

This is very good news for Iran and the Middle East as well as for the rest of the world including, naturally, the United States itself. For all of us, the Iraq disaster with its dire consequences is more than enough. But the willingness of the United States to put aside the military option in its dealings with Iran and to express readiness to engage Tehran is just the beginning of a long march in which success will not be achieved easily or soon.

Many questions need to be satisfactorily answered before any meaningful negotiation can even start. Amongst these questions I note the following: What will the Agenda of such a negotiation be and who will set it? Who else, if any, apart from Iran and the USA, would participate in the negotiations?

The natural tendency in Washington is to unilaterally set the agenda, establish the list of participants, and even define the outcome of the negotiation. Such an inclination to dictate rather than discuss comes naturally to the Americans. It has been taken to extremes by the present administration but it was there before George W. Bush and Dick Cheney entered the scene. This tendency is unlikely to disappear with the end of this administration. But Iran will not accept to simply play the role assigned to it by the new US administration of either Mr Obama, or Mr McCain. They think they have strong cards to play, and will demand to be treated with respect, and be accepted as a much more proactive partner in any negotiation.

Iran is a major power in the Middle East. It was so under the Shah and it did not lose its status after the triumph of Ayatollah Khomeini in 1979, despite the turmoil provoked by the Islamic revolution, the disastrous war with Iraq, and the hostility of the United Sates and much of the Western world. If anything, its standing in the region and the world has been significantly enhanced these past few years.

Today, Iran claims for itself the status of *the* regional superpower by virtue of its population, its natural resources, and its strategic position and fast growing influence in the region. In terms of population, only Egypt and Turkey come anywhere near Iran with its 80 million inhabitants, but neither has its natural resources. Only Turkey has military forces and an industrial base that are in the same league as Iran's. Only Saudi Arabia has more oil reserves but it has neither the population nor the military might or the economic base that Iran has.

More generally, no other country has worked so persistently and so effectively to enhance its strategic assets in the region – from Lebanon to Afghanistan, Tajikistan, and Central Asia – and beyond.

Iran invested patiently in Syria, in Lebanon and with the Palestinians. With Damascus, a solid political alliance and a diversified economic and cultural cooperation were built during the ruinous eight-year long Iraq–Iran war. Co-operation with Syria opened for Iran the way to Lebanon, where it helped build a formidable militant machine – Hezbollah – which is all at once an armed militia, a political party and a social organisation providing services to the Shia, the largest and most deprived community in the country. Now Iran has extended its reach – through Hezbollah – even to important Christian groups such as the one led by the populist leader General Michel Aoun. At the same time, Hezbollah itself is fast becoming a central political force in Lebanon.

Amongst the Palestinians, the organisation of the late Yasser Arafat, Fatah, used to be particularly popular in Iran and close to the Iranian leadership both in Tehran and Qom. But since the Oslo Agreement between Israel and the PLO in the early nineties, the two parties have slowly drifted apart and it is now Hamas and other radical Palestinian movements who enjoy intimate relations with Tehran. The United States, Israel and others in the West may call Hezbollah and Hamas '*terrorist organisations*' as much as they wish; what is important in the region is that both organisations enjoy widespread support in their respective communities and growing – indeed overwhelming – sympathy throughout the Arab and Muslim world.

Iran invested also patiently in Tajikistan, Afghanistan and the rest of Central Asia. It openly supported the Islamist rebellion in Tajikistan soon after the break-up of the Soviet Union in the early 1990s and played a key role in the return of stability to that country.

In Afghanistan, Tehran supported the resistance of the 'Mujahedeen' against Soviet occupation in the 1980s and the Northern Alliance – along with India and Russia – against the Taliban in the 1990s. Their Afghan allies lost roundly to the Taliban, but then came 9/11, and both suddenly found themselves on the winning side, in the context of the US military intervention in Afghanistan.

And last but not least, there is Iraq, the trump card in Iran's hand these days – a card received free of charge from the Great Satan itself, the arch enemy whose president stigmatised Iran in February 2002 as a member of the 'Axis of Evil' along with Saddam Hussein's Iraq and Kim Ill Jung's North Korea. And, just 13 months later, the USA invaded Iraq, toppled down Saddam Hussein, the bitter enemy of Iran, disbanded the Iraqi Army, dissolved the Baath Party and in the process completely destroyed the Iraqi State. To rebuild Iraq and its institutions, the Americans put in charge Iran's closest and most trusted allies among the Iraqi expatriates who returned home with the invading armies.

As a result, many observers in the Middle East and in the USA itself comment somewhat unkindly that the Bush–Cheney administration suffered the death of more than 4000 of their soldiers, spent billions every month and is maintaining 150,000 troops in Iraq to keep the place safe for the sole benefit of Iran! This is perhaps a simplified, caricatural way of putting it, but it is not far from the truth. Iran, at present, exercises infinitely more influence in Baghdad and most of the rest of the country than the United States or any other country or group of countries; at the same time, it has established the strongest, most diversified economic ties that Iraq has with any country in the region or in the world at large.

"The natural tendency in Washington is to unilaterally set the agenda, establish the list of participants, and even define the outcome of the negotiation"

If proof were needed to show how extensive is Iran's influence in Iraq, one needs only to look at the painstaking negotiation of a 'Status of Forces Agreement' between the USA and the Iraqi government. There is no doubt in any one's mind that the Maliki government will not sign anything without securing previous approval from Iran. One has the impression that even the Bush administration is resigned to the fact that Iran has veto rights these days in Baghdad and no Agreement will be completed if Teheran does not give its seal of approval: even if Washington, with help from Kurdish leaders in the government, were to succeed in forcing the hand of Prime Minister Maliki, Iran's weight will shift to Parliament where they most likely can muster enough support to defeat any agreement they dislike.

It is against this background that the whole nuclear issue must be looked at. Is Iran cheating as much as the Americans, the Israelis and most Europeans say, and many others suspect they are? Are they just a couple of years away from actually producing a bomb, or are they still five to ten years away from this outcome? Or have they chosen the so-called 'Japanese option'?

And what if, after all, the Iranians are telling the truth, and are only, strictly and honestly exercising their 'inalienable rights' under the International Atomic Energy Agency (IAEA) rules and regulations? Mohamed Al-Baradei, the Director General of the IAEA says emphatically that his inspectors did not see any sign that Iran was acting outside of those rules and regulations even if it did not always fully disclose all its activities 'in full and on time'.

In the Middle East, there is a stark contrast between the attitude of governments and the reaction of the public. At the official level, all capitals strongly suspect that Iran is determined to produce its own nuclear armament and they do not like that. The public, on the other hand, both the common man in the street and the elite – journalists, academics and intellectuals – have no problem with Iran's alleged nuclear ambitions. Even those who mistrust Iran in all sorts of ways, say they can live with a nuclear armed Iran. This, obviously, has much to do with the fact that Israel is sitting, some say, on a significant number of nuclear bombs. If Israel can be trusted with atomic weapons, why can't Iran be?

The legal nuances of who is a signatory of the Non-Proliferation Treaty (NPT) – Iran – and who is not – Israel – are of course lost on the people of the region. For them the central argument that wins the day, legally and politically, is that the NPT was an explicit bargain between the original members of the nuclear club and the rest of the international community. The latter undertake not to go nuclear while the former would progressively reduce and ultimately totally eliminate their respective nuclear arsenals. The Major Powers did not keep their side of the bargain. Why should other countries keep theirs? And look at

North Korea: it has defied the ban and it is being rewarded for it. Look at India, too. They never signed on to the NTP, acquired the bomb and now they are practically accepted as a new member of the nuclear club. If India, why not Iran tomorrow, Turkey the day after and whoever else has the will and the cash to follow suit?

Be that as it may, the fact is that, as we said earlier, Iran has a winning hand. Tehran has almost exclusive influence in Iraq; it has also a presence in Afghanistan and may, at the very least be a dangerous spoiler there. In addition, they have a huge inflence in Lebanon, a solid alliance with Syria and strong relations with Hamas – arguably the most important organisation amongst the Palestinians. Furthermore, they are a major oil producer and an influential member of OPEC. And they enjoy much sympathy and support in the Muslim world in particular and in the Third World in general.

"Only Iran can help the USA disentangle itself from the Iraqi mess"

The political elite outside the Bush–Cheney administration and the neo-con circles in Washington are very much aware of these realities. They know that Iran is deeply conscious of its strength and believes it is in a position to go to any negotiation on its own terms. Self-confidence in Tehran has reached such a high level that the media there writes quite openly that they are now *the* regional superpower and that what is needed is for the United States and Iran to get together, alone, to discuss and agree on the future shape of things in the entire region.

A few voices in the United States are starting to say 'and why not?' particularly with regard to Iraq. In that country, it is indeed true that Iran has decisive influence and the fact that this is due to massive blunders made by the USA itself does not change this reality. Besides, the Arab neighbours of Iraq have been wringing their hands and looking the other way while Iran was pushing its advantage day after day, inch by inch. Only Iran can help the USA disentangle itself from the Iraqi mess. And for that, the United States must accept to pay a price.

Others in the US capital have more nuanced views. Iran does have a strong hand, they say. It does not mean they can dictate their conditions and unilaterally set the agenda of a future negotiation. They see in the Report of the Study Group co-chaired by James Baker and Lee Hamilton a valid road-map for a big Middle East bargain, in which Iran will no doubt occupy a very important place, but not an exclusive one. Indeed, the USA cannot even put itself in an exclusive position. To begin with, on Iraq, neither the USA alone nor Iran together with the USA can decide what the future of the people of Iraq should be in their absence. They have to occupy centre stage in any discussion concerning their country.

Furthermore, the other countries in the region may have done little so far, but that does not mean that Turkey, Saudi Arabia, Egypt, Syria and all the others will accept to leave so many issues that so vitally affect their interests in the sole hands of Iran and the United States. There are of course many issues that are of a bilateral nature. Those need to be identified and taken up by the United States and Iran alone. But regional issues need to be addressed within regional frameworks; and some of them require the involvement of international actors such as the other Permanent Members of the Security Council, the European Union, Japan and India (as well as Pakistan if Afghanistan is also on the agenda), the Arab League and the Islamic Conference.

As the US presidential election moves closer, many voices are heard in Washington saying that the future president will inherit more serious problems than any of his predecessors in a long time, perhaps ever. The problems of the Middle East have been on the table ever since the end of the Second World War. They seldom made it very high on the priority list of any US president. Quite often, these problems have been largely neglected. In this regard, the Bush–Cheney administration has established a record: for seven years, they not only neglected the region and its problems; they ignored them. It is doubtful that the next president will be able to focus on all the Middle Eastern problems in his first year of office. But it is fairly certain that Iran will be an immediate and serious preoccupation for the future new White House. And if the Iranian issues are approached properly, there is some hope that the other problems in the Middle East will also be addressed.

Eric Rouleau assesses the Iranian nuclear threat

What about the Iranian nuclear threat? It is not at all certain that Arabs, Sunnites or not, do believe that this threat is real, or that it is imminent. Some recent intelligence reports estimate that Iran would be unable to build its first nuclear weapon within the next ten years.

In any case, many political observers of the region are convinced that Arab public opinion (excluding governments) would not mind, or may even welcome Iran becoming a nuclear power. They perceive the Islamic Republic as a potential counterweight to American hegemony and to Israel's military superiority. Optimists are even convinced that a nuclear Iran, having established a more favourable balance of power, might open the way to a settlement between Israel and the Arabs, in the same way that the fear of a nuclear war maintained peace between the Soviet Union and the United States for nearly half a century.

Middle Eastern rulers are plainly sceptical about the anti-Iranian campaign which has moved from stage to stage without apparent success. Either they do not believe that Iran is a potential and imminent threat, or more likely they are in favour of a negotiated settlement between the Islamic Republic and Western Powers, rather than in a confrontation over the nuclear issue.

Is it not striking that the Islamic Republic far from being isolated in the region has been able to develop good and fruitful relations with a number of neighbouring countries, all of which are either friendly with, or allies of, the United States? These include Saudi Arabia, other Gulf countries, Afghanistan, Turkey, India and even Iraq. All these countries are being insistently warned by Washington that Iran represents a threat to their security.

The US efforts to include regional countries in a coalition against Iran have not borne fruit. President George W Bush has been trying to follow the example of his father who, in 1990–91, was able to set up a vast coalition of states, including Arab countries, before launching an attack on Iraqi forces occupying Kuwait. George W hoped to forge a similar alliance, but now of Sunni states against Shiite Iran. This was not a realistic endeavour.

In contrast, the United States succeeded in convincing the permanent members of the UN Security Council plus Germany to adopt a number of resolutions that imposed essentially economic sanctions on Iran. This was undoubtedly a major success of American diplomacy, taking into consideration the fact that Russia, China and European powers have agreed to vote in favour of measures that affect their own interests. These countries, since the break of all relations between the United States and Tehran in 1979, had developed economic and commercial relations with Iran.

Do these countries realise that should the sanctions fail the following step could well be military intervention? President Bush has repeatedly stated that all options remain on the table although a peaceful solution is still preferred.

Until recently, the question was: will the United States attack Iran, and if so will it go about it on its own or with a 'coalition of the willing' as in the interventions against Saddam Hussein and his regime? Although the question was regularly asked at least in the US and European media no definite answer was provided.

Those who believed that President Bush will not take risks pointed to various catastrophic consequences that may follow. Some American and civilian analysts mentioned that Iran possesses long-range missiles that could reach as far as Israel. An Iranian retaliation would most probably target oil tankers in the Gulf and the Straits of Hormuz. The oil price will explode. The initial fear was that an economic crisis will ensue. Now that we are in such a crisis a military intervention in Iran will worsen the situation.

“many political observers of the region are convinced that Arab public opinion … would not mind, or may even welcome Iran becoming a nuclear power”

The political consequences of the conflict may be as serious. Not only Shiite populations, most of which are sitting on the richest oil fields of the region, but also Sunnite would probably consider Washington's military attack as an aggression against a brotherly Muslim country. Pro-Iranian Hezbollah in Lebanon and Hamas in Palestine will not remain with their arms folded. In which way they will try to hit American interests remains to be seen. It is however practically certain that the present Iraqi government will either turn against the United States or collapse to the benefit of anti-American forces.

The warmongers thought that President Bush had no choice but to attack Iran in a way that is supposed to reduce the risks of retaliation. The Islamic Republic will not be invaded; selective targets will be bombed on and off. These so-called surgical strikes would not need the approval of Congress since they are not considered to constitute an all-out war.

The hawks believe that such strikes will have a double effect: reduce Iran's military capabilities and weaken the regime sufficiently to cause its eventual demise. Yet some US intelligence reports have argued that the overthrow of the regime will not be possible in the foreseeable future. On the contrary, military strikes will provoke a patriotic upsurge in favour of the regime.

The threat to the Iranian regime may come from another direction: the difficulties due to the mismanagement of the economy and a galloping demography that brings big cohorts of young persons into the labour market every year chasing very few new jobs. Otherwise the regime is stable. There is no alternative political force that can come to power. The reformers have a certain influence but are not well organised and are discriminated against in elections by laws that enable the regime to reject candidates wishing to contest parliamentary seats. In fact, the press campaign against Iran over the nuclear issue and the threats recently made by some Israeli leaders can only reinforce nationalistic feelings in the country and bring the Iranian people in closer support to the regime.

President Bush did not in the end send cruise missiles and war planes against Iran. The US army was opposed to the idea. The other countries of the group of 'five permanent UN Security Council members plus one' – Russia, China, France, Germany and even the UK – would not be inclined to support military action. And President Bush has too much on his plate from Iraq to Afghanistan and now a major financial and economic crisis. President Obama will definitely engage with Iran, as he stated during his campaign. The difficulties however will be in defining the agenda for negotiations and to obtain meaningful concessions from Iran.

Walid Khadduri looks at concerns over the future of Iraq and regional implications

There are serious concerns about the future security of Iraq. These stem mainly from the inability of the occupying forces, five years after the 2003 invasion, to forge a new Social Contract among the population. Other factors include:

a) the strength of terrorist groups despite their recent defeats,
b) sectarian violence,
c) the rise of criminal gangs, the widespread corruption and the smuggling of petroleum products,
d) the increasing ethnic conflict between Arabs and Kurds,
e) the formation of the new army – its new composition and the uncertain role it would play in the political decision-making process,
f) the rising influence and meddling of neighbouring states In Iraqi politics.

Last, but not least, is the Status of Armed Forces Agreement (SAFA), scheduled to be concluded between Baghdad and Washington before end-2008.

While each one of these factors impacts the security of the state, they also have regional implications. The experience of Iraq during the past quarter of a century (the Iraq–Iran war, the invasion of Kuwait, the international sanctions and the 2003 US occupation) has shown very clearly the strong relationship between the stability of the country's oil exports, its internal security, and the existence of appropriate and stable relations with the neighbouring states. Iraq, with its semi land-locked borders, needs friendly relations with neighbouring countries to enable it to export crude oil in cross-border pipelines. In this important respect Iraq is different from all other oil-exporting countries of the Middle East and North Africa.

The controversies that surrounded the drafting of the 2005 constitution are an example of the many problems that will continue to haunt Iraq in the near future. Differences arose over a definition of the identity of the country, the extent of the writ of the federal government, the division of power between central authorities in Baghdad and the provinces, the distribution of the oil wealth, and over the status of oil-rich Kirkuk and other disputed regions. On this latter point the issue was whether these parts of Iraq should be included in the domain of the Kurdistan Region.

The constitution was drafted almost exclusively by the Kurdish and Shi'a parties. At that time, the Sunni Arabs had boycotted the political process. As a result, they had no meaningful input in it. However, the Kurdish parties, the most active group in support of federalism, had a clear agenda of what goals they wanted to achieve. They knew exactly what federalism meant to them. This included their full participation in the political process in Baghdad combined at the same time with as much independence from Baghdad as possible. The Kurds interpreted federalism as a framework that enables them to go it alone, and at the same time providing them, through their pivotal role in the new regime, with opportunities to maximise their goals, interests and territory. They also wanted to make sure that the Baghdad authorities would never regain enough strength and instruments of power to be able to repress them, as had happened under the previous regimes.

The Shi'a parties agreed at that stage to support the Kurds in their demands, hoping that they would benefit one day from the concessions obtained by the Kurds. However, these hopes were short lived, and major differences surfaced soon after over the Hydrocarbon Law, the status of Kirkuk, the role of the army in relation to that of the armed forces of the Regions, and the ethnic and sect composition of the officer corps. The question is: How to distribute between Sunni Arab, Shi'a and Kurds the top positions in the army?

There was also a dispute between the Maliki government and the Kurdistan Regional government over the security of the cities of Khanaqin and Jalwla located in the north central part of the country, not very far from the Iranian border. The question was whether they should remain under the authority of Kurdish Peshmerga forces or the Iraqi army.

The Kurdish Regional authorities, without the acquiescence or approval of the Baghdad authorities, hosted Turkish insurgents of the Kurdistan PKK, a move which Turkey treated as an aggression, and accordingly sent its armed forces into Iraqi Kurdistan. The Turkish air force carried out strikes against several towns in northern Iraq, causing much destruction. The Kurdish–Turkish dispute goes much deeper than the presence of PKK fighters in Iraqi Kurdistan. Turkey has publicly supported and hosted Iraqi Turkomen parties; and this raised Iraqi fears about Ankara's ambitions on Kirkuk.

> "The Kurds interpreted federalism as a framework that enables them to go it alone"

The Kurdish parties have also opposed the Hydrocarbon Law that was tabled by the government in parliament in February 2007, while at the same time going ahead and concluding over twenty production-sharing contracts with international oil firms. They did not inform Baghdad about the text of the agreements and did not seek its approval. Baghdad then announced that international oil companies operating in the Kurdish Region will not be permitted to work in the rest of the country. Furthermore, oil produced in Kurdistan is not allowed to be exported through Iraqi territory. It appears, so far, that Kurdish oil cannot be exported through Turkish or Iranian territory either. There are however reports that some of the Kurdish oil is being smuggled by trucks to Iran, but the volumes involved, if these reports happen to be correct, can only be very small.

The USA, as a result of the 2003

invasion, has, unwittingly or not, allowed Iranian influence to establish itself in Iraq. US complaints of the Iranian role in the country, particularly the assertions concerning the export of terrorism, baffle most Iraqis. Major Shi'a parties that had sought asylum in Iran and built close and cordial relations with various Iranian political institutions, including the Revolutionary Guards, returned to Iraq after 2003. Some of their members have assumed senior positions in the post-2003 governments.

Moreover, the USA decided to make Iraq a major theatre of war against al-Qa'eda. The presence of these extremist groups accentuated the sectarian conflict in the country, particularly in 2004 and 2005, leading to much bloodshed and communal strife. At the same time, Iraq witnessed the rise of local resistance forces against the US occupation.

The United States tried and did succeed in winning the support of some of the Iraqi opposition groups which – together with the Iraqi armed forces – have been able to deal major blows to terrorist and sectarian forces throughout the country, particularly in Baghdad, Basra and Mosul. Yet, the military victories have not stopped the daily carnage that is bleeding the country. There is now a fragile peace, and it is expected that any of the groups mentioned above will wait for the opportune time to resurface again, most probably with assistance from neighbouring states.

Much of Iraq's future security will depend on the SAFA agreement being negotiated between Washington and Baghdad. There are many issues under discussion: How many US troops will remain in Iraq? What will be their functions? To ensure security throughout the country, as they are doing now, to provide training to the Iraqi army or to remain idly in some military bases?

Other important questions concerning Iraqi security and relations with neighbours also arise. How is the USA or Israel going to deal in the future with the Iranian nuclear issue? What would Iraq's role be should a military confrontation take place? How would such a conflict impact Iraqi political parties, particularly in the oil-rich southern part of the country? Would there arise in Iraq a disciplined party loyal to Iran, similar to Hizbollah in Lebanon, a party that would act as a proxy to Tehran while occupying at the same time a significant place in the country's political system?

Finally, what role would the new Iraqi army play in the country's political system? The USA since 2003 has definitely introduced substantial structural transformations in the organisation of the armed forces. The system introduced by the British during the mandate in the 1920s has been changed. We do not expect the new senior officers to be aligned or sympathetic to Arab nationalism, as was the case in the past. Most of the new officers are either Shi'a or Kurds, who have different allegiances and political sympathies than the Sunni Arabs who monopolised the top military positions under previous regimes.

Having said that, one can still assume that the newly formed Iraqi army would interfere once more in domestic politics, as happens in many Third World countries. One may wonder about the alliances with neighbouring states that the officers may want to establish; and about the reactions of these states to the creation of military regimes (or political regimes strongly influenced, albeit indirectly, by the army). Would they allow Iraq to create new political systems in the region?

It is doubtful that Iraq's neighbours will look on passively if Iraq were to forge alliances with Iran or Syria. Such alliances would adversely affect Iraq since both these countries exert much influence within Iraq. They represent a threat to its sovereignty. And there will be opposition from other neighbouring states.

Moreover, Iraq's economic security in the future depends very much on maintaining a more cordial, or at least much less hostile attitude, towards neighbours than was sometimes the case in the past. The bitter experience of the past three decades amply demonstrated that because Iraq is almost land-locked its oil exports could fall to a very low level in the absence of good and peaceful relations with the surrounding states. And this outcome will be obtained despite the huge proven oil reserves that the country possesses.

Whither OPEC?

Robert Mabro asks when OPEC is a cartel and when it is not

Since 1973, the year of the first oil price hike imposed unilaterally by OPEC, this organisation of oil-exporting countries has been continually labelled a 'cartel'. The *Financial Times*, for example, systematically follows every mention of the word OPEC in articles or reports with the clause, the oil-exporting countries cartel.

The trouble with labels is that they seem to impart full information about the entity to which they are attached albeit in a short-hand form. In reality, they conceal as much as, if not more than, they reveal. Most people do believe that they know perfectly well what the label means. It is obvious, isn't it?

What at first appears to be obvious often turns out not to be obvious at all. Once a label is stuck on a person, an institution or a phenomenon the need to enquire about the real person, the true nature of the institution or the phenomenon at hand fails to emerge. There is no need for that need. In short, labels are the enemies of research, of serious attempts for better understanding.

It is important to know the exact nature of OPEC – is it a cartel or something else? There are several types of cartels, in the same way as there are different types of oligopolies. They do not, all of them, operate in the same manner. How does OPEC operate? And did the nature of OPEC change from one episode to another of its 48-year history? Finally, how significant are the discrepancies between the OPEC reality and the perceptions of an outside world shaped by this 'cartel' label that fails to tell us anything of interest.

My first point is that the changing nature of OPEC related to the specific structure of the world petroleum market that obtained in each particular period. When OPEC was founded in 1960 its Member Countries (Iraq, Iran, Kuwait, Saudi Arabia and Venezuela) had no direct involvement in the exploration, production and exports of crude oil. These operations were entirely performed by a small group of international major oil companies under long-term concession agreements. The companies paid to the host country a royalty and a notional income tax per barrel produced. This system continued when other nations joined OPEC later in the 1960s and the beginning of the 1970s.

OPEC countries depended financially on the payments made by the concessionaires, and these revenues were a simple function of tax-cum-royalty per barrel and the number of barrels produced.

OPEC during this period was akin to a trade-union always engaged collectively in negotiations with the revenue provider for increases of per barrel income (the wage). Some members, as was the case with Iran under the Shah, will also repeatedly ask the companies to increase the volumes produced on their territory. The companies did not always oblige. The collective bargaining involved solidarity which would be weakened if individual attempts to increase market share at the expense of other members turned out to be successful.

The 'trade union' managed to obtain small concessions from the companies such as the expensing of royalties. The more important result of the establishment of OPEC, however, was that the companies from then on never reduced the posted price which they fixed unilaterally. The posted price determined, given other parameters such as the tax and royalty rate and the nominal cost of producing a barrel, the per barrel take.

The very weak bargaining position of the 'trade union' characterised the relationship between governments and companies throughout the 1960s. OPEC's position became stronger at the end of that decade. A member country, in that instance Libya, taking advantage among many factors of favourable market conditions in the Mediterranean, managed to obtain increases in the posted price. This success was achieved by a member acting on its own, not by the collective action of the trade union.

The Gulf members of OPEC then obtained similar price increases thanks to a simple clause in the concession agreements which one often finds in bilateral trade treaties. This is the 'most-favoured nation clause'. Every country signatory of an oil concession contract must obtain all the advantages secured by another country. This led to the so-called Tripoli–Tehran–Tripoli agreement of the early 1970s. At that time, I quipped that OPEC was redundant. Favourable market conditions enjoyed by any individual country coupled with a most-favoured nation clause are all that is needed to secure generalised concessions from oil companies.

The power of the 'trade union' increased significantly in the early 1970s. This was largely due to two major factors: the very rapid growth of global oil demand that began to tighten the supply/demand balance in the world petroleum market, and a new rise of nationalism in most OPEC countries. There were threats of nationalisation of oil assets by some countries, and milder demands of equity participation in the investments of the concessionaires by some others including the politically moderate Saudi Arabia. Higher posted prices, tax and royalty rates were obtained. The strength of a trade union depends on the state of the relevant market and on the ability to strike.

No cartel up to this point.

Things did change in 1973. The negotiations between the 'trade union' and the companies broke down. The petroleum market had become very tight. A number of market indicators – tanker freight rates, product price realisations and crude oil spot prices – were rising. The prices of all primary commodities were rising between three to five fold. The companies knew that oil prices must be significantly raised. They did not want to be part of such a decision however. They would run into trouble with the governments, the media, and public opinion of oil-importing countries. They asked for a long pause in the negotiations. This was unacceptable to their OPEC counterparts. Furthermore, the October war had broken out in the Middle East. A few days later, Arab oil-exporting countries (but not OPEC) meeting in Kuwait decided on an embargo against the USA and Holland, and production cuts across the board to make the embargo effective.

In this context OPEC no longer negotiated over prices with the companies. It decided to administer the prices on its own. It raised twice the official price (the replacement of the price previously posted by the companies), once in October and once at the end of December 1973.

This development was labelled the 'oil price shock' in importing countries. However this was not the most important event. The economic impact of this shock did not last for very long, at least in OECD countries. The significant event with long-term implications was a structural transformation of the petroleum system. The major oil companies gradually ceased to move oil produced by them in OPEC countries through their internal channels. Now, they bought it arm's length from the various exporting countries. The previously integrated structure had become de-integrated.

The two major consequences were as follows:

First, OPEC became the administrator of the oil price. Between 1973 and 1985

OPEC used to determine the price of Arabian Light 34°API as the reference for transactions in international trade.

Secondly, de-integration caused the emergence of an open market for international oil. And markets always diversify over time. We thus saw the emergence, besides long-term contract transactions between companies and countries, of trades between companies, an expanding spot market, the famous 15-day Brent forward physical market, and sometime later futures exchanges in New York and London. This final development gave rise to an explosion of different types of derivatives many of which are traded over the counter.

A price administrator is not necessarily a cartel. Nobody accuses the monetary committees of the Bank of England, the US Fed or the European Central Bank, those who administer the interest rate which is after all the price of money, of being cartels. So long as OPEC fixed the reference price of oil and passively accepted the impact on the demand for its oil it was not acting as a cartel because it did not curtail production to support the price. It was a price maker and a volume taker. This was the case until 1982.

The structural transformation of the mid-1970s simply meant that OPEC has been facing complex markets, never fully transparent, instead of the small group of oil companies with whom it used to negotiate. Solidarity was more easily achieved in the former state of the oil world, even if some members of the 'trade union' made tougher demands than other members.

In 1979–81, a tight oil supply/demand balance pushed market prices above those fixed by OPEC. The market was leading, and the administrator lagged behind. OPEC was universally blamed for this second price shock. The important point that is missed when one rushes to the accusation that OPEC is responsible whenever oil prices rise is that the actual market may have played a role. Supply tightness due to the fall in Iranian production, the scrambling of consumer countries, particularly Japan and some European ones, in search for additional import volumes caused prices to skyrocket.

The paradox is that a price rise leads to the view that OPEC in such circumstances is strong. The truth is that when the market leads OPEC is in reality weak if it does not then have the means to rein in market forces.

And the symmetrical proposition is that often OPEC is *potentially* strong when it is generally perceived as weak because of stagnant prices. This is the only type of situation when it could, if it so wished, effectively intervene.

> "So long as OPEC fixed the reference price of oil and passively accepted the impact on the demand for its oil it was not acting as a cartel"

"So long as OPEC fixed the reference price of oil and passively accepted the impact on the demand for its oil it was not acting as a cartel"

The first episode when OPEC tried to act as a cartel, that is to restrict production in order to support prices, was in the period 1982–85. It introduced production quotas, but the fall in the demand for OPEC oil from 30 million barrels per day in 1981 to just above 16 million barrels per day in 1985 (due to considerable increases in non-OPEC production and a fall in world oil demand) was too big. No entity, however strong or sophisticated could cope with it. Agreements on quotas were not well implemented. Saudi Arabia took the brunt of the shock in its attempt to defend the OPEC price; its production fell over four or five years from more than 10 million barrels per day to just above 3 million barrels per day. This was unsustainable. Saudi engaged in an undeclared price war against both OPEC members and other exporting countries with the introduction of a devastating weapon, the netback pricing system.

Paradoxically, this is when OPEC was acting as a cartel because only cartel members engage in price wars to discipline other members.

OPEC took the view after the catastrophic 1986 events that it could no longer administer the oil price. It will instead follow the market by using market-related formulae to price its oil in exports. This is where we are now.

As well explained by Bassam Fattouh in this issue, OPEC cannot directly get the market to deliver its preferred price. It is essentially a price taker who tries to signal to the market to stop a price decline or to raise current levels when prices are either falling or deemed to be too low. The only signal it can use is the decision to reduce production quotas. Markets can receive the signal and act upon it or simply ignore it and indulge in scepticism. There are so many negative views about OPEC that can easily feed this scepticism. A market positive response to an OPEC decision on production cuts can be delayed because of long time lags between a decision and the actual changes in oil flows in the final market. Oil travels for a long time toward destinations and it then needs to be refined and distributed in product markets.

To the extent to which OPEC uses production as an instrument to influence prices, the cartel characterisation applies. But the episodes when this behaviour has been effective were rare and usually of short duration. Once again OPEC was indeed a cartel in 1998 when prices were brought down through a price war launched by Gulf countries against other members.

Finally, OPEC has been more often passive than in the instances mentioned by Fattouh – the situation when markets push prices up and up. It behaved passively on many occasions in the late 1980s and in the 1990s despite the fact that prices then were low.

At that time many commentators prepared OPEC obituaries. But OPEC is still alive.

To quote Mark Twain, OPEC could say 'The reports of my death are greatly exaggerated'.

In short, things are not as they appear to be. Simplifications and labels lead to gross misunderstandings. An oil price rise is not a proof that a cartel is in operation. Gordon Brown was misled by this wrong criterion when he accused OPEC of causing the price explosion of the first half of 2008.

A price fall due to a price war is an unmistakable sign that a cartel is in existence. And one always needs to remember that the market plays a major role, and that it is strong when it is considered weak and weak when it is believed to be strong.

Bassam Fattouh describes OPEC's dance with the market

Introduction

In its emergency meeting on the 24th October, 2008 OPEC decided to cut oil output by 1.5 million barrels per day (bpd) from existing quotas. This reduction amounts to around 1.8 million bpd as some members were already producing above their quotas. After the meeting, OPEC president, the Algerian oil minister, announced that the cut will be '100 percent effective' in stabilising prices. The immediate response from the market was negative: WTI prices tumbled to a low of $62.65 on the OPEC announcement but then settled at $64.15 by the end of the trading day. But this reaction may still prove to be at odds with future responses.

The OPEC communiqué revealed deep concerns about the fall in oil prices describing them as 'unprecedented in speed and magnitude'. It added that the 'slowdown in oil demand is serving to exacerbate the situation in a market which has been over-supplied with crude for some time'. The communiqué sent a warning to oil importers that falling oil prices 'may put at jeopardy many existing oil projects and lead to the cancellation or delay of others, possibly resulting in a medium-term supply shortage'. It also sent a clear message to non-OPEC suppliers that 'OPEC cannot be expected to bear alone the burden of restoring equilibrium' and it called on non-OPEC producers/exporters to contribute to efforts to restore prices to reasonable levels and eliminate harmful and unnecessary fluctuations. Finally, OPEC sent a signal to the market that it means business by 'strongly emphasizing their firm commitment to ensuring that the volumes they supply to the market are reduced by the individually agreed amounts'.

The decision that OPEC would cut output was widely expected though some media reports were interpreting Saudi Arabia's silence before the meeting as an unwillingness to reduce its production. Whether these output cuts will succeed in preventing oil prices from falling in the short term is a separate matter altogether. As argued below, the shift to the futures markets for price determination that occurred in the early 1990s means that OPEC's influence on prices does not depend only on the signal sent about its intention to reduce production but on how market participants interpret the signal.

This does not mean that OPEC is irrelevant to oil prices in the current context. Since the early 1970s, the organisation's role has been central to understanding the dynamics of oil prices. With the shift to the futures market for oil price determination, OPEC maintained its influence although its interaction with the market has changed in nature. The events of the past four years or so portray an evolving and dynamic OPEC behaviour.

The OPEC Cycles

It is best to describe OPEC's behaviour in terms of cycles. Interestingly, the role of OPEC changes cyclically from being an active player to a passive one. As argued by this author elsewhere,

> OPEC's response to changes in oil prices is asymmetric. In a rising market, there is a tendency towards adopting the more passive approach of supplying upon demand. On the other hand, in a declining market, there is a strong bias towards cutting supplies regardless of the context. This asymmetry in response implies that the perceived risks associated with a potential collapse in the oil price are too high for any of the members to be willing to bear and seem to outweigh any economic or political risks of adopting a more active strategy of cutting output.

In what follows, we analyse OPEC behaviour for the period 2004–2008.

2004–2006: OPEC the Passive Player in a Rising Market

One of the most defining features of the recent behaviour of oil prices has been that expectations about the long-term price have been unlocked. This is reflected in the parallel shift of the back end of the futures oil price curve. While the back end of these curves very rarely strayed outside the $20–$22 range for all of the 1990s and early 2000s, this anchor has been lost since 2004. In fact, in the past few months the back end of the curve exhibited high volatility almost matching the volatility observed at the front end.

The conventional framework that dominated the thinking about oil prices was based on the belief that there are strong feedbacks from oil prices to oil demand and supplies. High oil prices would have an adverse impact on oil demand and economic growth, reducing global oil demand or slowing down its growth. High oil prices would also create feedbacks through supply and investment responses in non-OPEC countries. It would encourage inter-fuel substitution at the margin, although with a long time lag. An important part of this conventional wisdom of the early 2000s was that OPEC in response to price rises will have a ceiling in order to avoid demand destruction for its oil in the long term, and to limit the entry of substitutes such as tar sands and ethanol. This view was supported by an OPEC decision to introduce a price band which involved production adjustments if the OPEC basket price moved above $28 per barrel for 20 consecutive trading days or below $22 per barrel for 10 consecutive trading days.

The conventional framework had profound implications on the behaviour of oil prices. It resulted in a high degree of determinacy in the long-term oil price relating to supply/demand 'fundamentals', and it anchored the back end of the crude oil futures curve at around the $20–$22 range. Governments and financial markets thought in terms of that range, and for most of the 1990s no one questioned the validity of this framework, especially at times when spare capacity was sufficiently big to provide a cushion against adverse geopolitical supply shocks.

While there is a current debate about the size of demand and supply feedbacks, and the time lags involved, and on whether the current demand feedbacks resulted from the credit crunch, high oil prices or both, there was an interesting observation which is not widely recognised by oil markets commentators. This relates to the asymmetry of OPEC response to oil price movements. Specifically, the boom of late 2007 and first half of 2008 showed that the main OPEC objective is to defend oil prices from falling below some level deemed unacceptable by its members. OPEC's role is not to prevent oil prices from rising. More accurately, OPEC assumes a passive role in a rising market. It is reluctant to reduce oil prices by auctioning part of the available spare capacity or to engage in heavy discounting of its heavy crude oil. OPEC does not have an official mechanism to perform the role of reducing prices. Early on in the boom, it has become clear that a price ceiling in a band was never relevant. Yet, at times, the perception that OPEC would respond to limit price rises has been important for anchoring long-term expectations about oil prices.

The latest cycle has raised various hypotheses about OPEC behaviour. Some argue that OPEC has realised that higher oil prices did not have adverse effects on the growth of the global economy and/or inflation, and that oil demand is more price inelastic than they originally thought. The world economy has proved fairly resilient to high oil prices. More sceptical observers argue that OPEC is not concerned about long-term effects on global oil demand given that there is no sign of an urgent or serious political economic response by OECD countries, and that the climate change agenda is unlikely to seriously undermine demand for oil in the absence of alternative transport fuels. Others have noted that OPEC is concerned about high oil prices but that influencing oil prices is beyond its ability especially since the market perceives that OPEC spare capacity is less than the figure announced and not of the right quality. Yet others have argued that OPEC is concerned about high oil prices and has the ability to influence oil prices but is politically constrained as actions to reduce the price of oil by any one of its members are likely to be met with criticisms from the local population and other members. There are also fears that any action of OPEC may induce a downward spiral of oil prices which the organisation may not be able to control.

> "One of the most defining features of the recent behaviour of oil prices has been that expectations about the long-term price have been unlocked"

Early 2007: OPEC the Active Player

OPEC's passive behaviour was interrupted in 2007 when it became highly concerned about the rapid accumulation of inventories. The organisation feared that high inventory levels can induce sharp falls in oil prices if physical traders decide to unwind their position and flood the market with supplies in response to a change in market sentiment. OPEC responded by cutting supplies. Although in 2007 the growth in global oil demand was positive, the growth of oil supply turned out to be negative, mainly because of a reduction in OPEC output. This meant that oil-importing countries had to tap into their oil stocks, reducing the level of crude oil inventories. This caused the spot price to rise and changed the shape of the futures curve from contango into backwardation.

The First Half of 2008: OPEC the Passive Player

For most of the first half of 2008, when oil prices began to rise sharply, OPEC resumed a passive role supplying the market upon demand at oil prices 'determined by the market'. It did not attempt to bring down prices by auctioning its spare capacity or offer discounts for refineries to lift its heavy sour crude. In a way, OPEC was comfortable with its position. A market in backwardation meant that there was no incentive for oil importers to accumulate inventories. At the same time, spot prices kept rising as the market perceived low stocks as an indicator of low oil supplies. Furthermore, concerns about long-term supplies intensified. Although there were clear signs of weakening demand in OECD countries, excess supplies did not manifest themselves because OPEC passively adjusted its output in line with the demand for its oil.

The Jeddah Meeting: A Concerned Saudi Arabia

The sharp rise in oil prices during the first half of 2008 created serious concerns about the potential impact of oil prices on OECD economies which were already showing signs of a slowdown and potential financial problems. The data on US oil demand released by the EIA were pointing towards a sharp contraction. The year-on-year change in US oil demand turned negative in August 2007 and has remained negative since then. This, however, did not dent the rise in oil prices as oil traders continued to condition their decisions on the weak dollar. Amidst rapid rises and sharp volatility in oil prices, Saudi Arabia called for a meeting in Jeddah in June and announced that it would increase its output by an additional 500,000 bpd outside OPEC quotas in an attempt to calm the oil market. This decision was made despite Saudi Arabia's repeated statements that the 'market is well supplied'.

The decision to add 500,000 barrels per day can be considered as a change in the supply-upon-demand policy towards a more active approach aimed at curbing the rise in oil prices. Whether this additional output was taken by the market and whether it was responsible for the subsequent decline in oil prices is highly debatable. Oil prices reached their highest levels after the Jeddah meeting and there was not a rapid rise in inventories despite the slowdown in the growth of global oil demand. The more plausible story is that once market sentiments turned negative, news about the extent of the decline in US demand intensified. The fall in oil demand became the main public signal on which traders started coordinating their decisions. In any case, this experiment to put a ceiling on oil prices was very short-lived and by September Saudi Arabia was back on its passive policy of supplying 'whatever the customers want'.

OPEC Dancing with the Market

The organisation's latest decision can be best described as 'OPEC dancing with the market'. This involves a series of moves, some that have already been made and others that are expected in the future.

In the first step, traders talk about the amount that needs to be cut. Anything below that amount is considered as 'worthless' or 'not enough' to alter price expectations. It is very difficult to explain how certain numbers come to dominate the market's psyche. But the number of 'more than 1 million bpd', later raised to 2 million bpd, became the barometer to test whether OPEC's output cut is big enough.

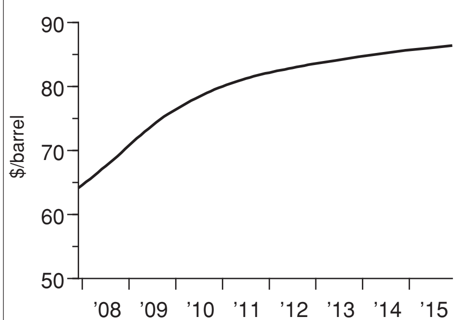
In the second move, OPEC responds by announcing cuts of more than 1 million bpd. If the signal is successful in stabilising expectations, OPEC will not to have to resort to output cuts. Instead, it will continue to supply upon demand at a price that the organisation is comfortable with given current market conditions. However, OPEC signals are rarely successful in stabilising short-term expectations in a falling market.

As expected, this latest decision has had a limited impact on oil prices so far. As discussed above, one major feature of the current oil markets is that prices have entered a phase of indeterminacy where market participants including oil companies and oil producers do not know where to anchor the oil price that balances supply and demand in the long run. This is affecting the behaviour of short-term prices as long-run and short-term prices seem to be co-determined. This has become apparent in recent price behaviour when both short- and long-term prices rose and declined simultaneously (although the falls were less pronounced at the back end of the curve).

In such a market, traders watch public signals. Even if news does not convey accurate information about the fundamentals of supply and demand, they tend to be misinterpreted, causing oil prices to overreact to news in either direction. As there is an abundance of news and information, traders will limit their attention to few signals that they think other market participants would also consider as relevant at every particular point in time. Until July 2008 traders conditioned their decisions on news about inventories, potential supply disruptions, and the weak dollar. The situation has now changed and the market has switched to coordinating on public signals about the demand for oil and health of the world economy. In these current circumstances, OPEC signals about output cuts are likely to be washed out by news about the depth of the recession, the decoupling of Asia, and the impact that these have on global oil demand. This is likely to keep a downward pressure on oil prices in the near term.

The extent of undershooting will be affected by the term-structure of futures prices. While both the front end and the back end of the oil price curve have seen sharp declines in the past two months, long-term oil prices have fallen more slowly. This may be due to concerns about long-term supplies as the market expects that the current crisis will induce a slowdown in investment and tighter oil market conditions in the future. Alternatively, this behaviour may be unrelated to long-term expectations about supply and demand and is due to the current weakness of the market in the short term where the bulk of the trading activity is concentrated. Either way, the term-structure has shifted to contango with the price of the first month futures contract falling below the prices of subsequent contracts for each maturity as shown in the figure below. A steeper contango could result in an accumulation of inventories leading to further falls in oil prices as high inventory levels are usually interpreted as reflecting a supply glut.

Figure 1: WTI Forward Curve as of 27 October 2008



Source: NYMEX Website

In the third move, traders demand to see actual cuts in productions. After all, OPEC signals do not involve a cost and are often perceived by the market as not credible. Traders think that OPEC signals in a falling market are some sort of cheap talk that they could ignore. This is the phase when the market starts doubting the viability of OPEC. In the past, OPEC's announcements of output cuts and the phrase 'the death of OPEC' went hand in hand. For instance, in 1998, when the Dubai price approached $10 per barrel, many observers claimed that OPEC had lost its ability to defend oil prices with many observers predicting its demise. This time is no different. Many commentators are questioning whether OPEC will be able to implement these cuts given the 'divisions' within OPEC, the different needs of their members, and the difficulty of sustaining an unanimous production decision in face of falling demand.

In the fourth move, as oil prices

continue to fall, OPEC will succeed in implementing production cuts. Despite their divergent needs and interests, the source of the pain (falling oil revenues) is the same. Some members may be more able to withstand the fall in revenues than others, but eventually as oil prices fall, all oil-exporting countries (including non-OPEC) will feel the pain. The main difference from the 1998 situation is that the oil price that OPEC wishes to defend is much higher now than it was ten years ago. This may affect OPEC's resolve to act swiftly, and in the current context it may take a long time before Member Countries adhere to their quotas. However, falling oil prices will eventually induce OPEC members to react, and more often to overreact, by implementing excessive cuts for traders to take them seriously. Since these cuts take time to feed through to the system, there is a risk that they will tighten supplies at a time when the global economy is about to bounce back from recession. This would worsen the global economic outlook.

Another Missed Opportunity

The recent behaviour of oil prices has raised the issue of whether policy via the oil importer–oil exporter dialogue should seek to establish a stable medium-term expectation of the oil price that can help dampen the cycles. Unfortunately, this is not likely to work as the interests of the two groups remain highly misaligned. In a rising market, OPEC switches to a passive mode. In a falling market, oil consumers switch from an active to a passive mode. This is clearly reflected in Mr Gordon Brown's recent plans to downgrade the international oil summit (to be held later in December 2008) to ministerial level as the 'most worrying situation in the world' a few months ago (i.e. high oil prices) is no longer a pressing issue. The current cycle has confirmed once more that oil producers and consumers cannot agree on a 'fair' oil price that satisfies the needs of both parties and that oil price cycles which have always been the defining feature of the oil market in the past will continue to prevail.

Letters

Dear Editor,

The Oil Price Conundrum: A comment

Robert Mabro provocatively raises the question as to whether oil prices can safely be left to the market, concluding that they cannot. He suggests a new regime involving an agreement between large importers and exporters involving a system of price administration consisting of a committee to examine and comment on the fundamentals and which would 'define a reference price at regular intervals'. The system would need to be backed up by the physical capacity to intervene. Effectively, Robert Mabro is calling for the reestablishment of the consumer/producer dialogue with a cooperative research and intervention mechanism on top. He rightly notes that 'political vision and much goodwill' would be required!

There is always a temptation to intervene, often in a heavy handed way, to control prices which are too important to leave to the market. But the history is not favourable. Domestic agricultural protection, on just these grounds, is a sorry tale. Commodity agreements have come and gone. International attempts to manage exchange rates – such as target zones – have proved fragile at best. Why should oil markets be any different?

The answer, according to the article, is that the oil market is not fit for purpose. Avoiding the loosely used term 'speculation', the suggestion is that financial markets (including the trading arms of oil companies) play an undue role in the determination of the oil price. Drifts or 'bubbles' may lead to overshoots (in either direction) and extreme volatility – which is damaging to investment and supply capacity and to producer and consumer countries alike. A system which gives a greater role to the 'fundamentals' (including institutional help in determining what they are!) would be of benefit to all.

I see the situation rather differently. What appears to have happened since 2004 is that the market became detached from any idea of what the longer-term fundamentals actually are. The whole futures curve moves up and down in parallel fashion. With no anchor in the future, the oil price, within wide (and apparently ever wider) limits, driven by small pieces of news, can be almost anywhere. The system is close to indeterminacy.

An explanation for this recent volatility is the *lack* of feedbacks in the international oil market. Famously, demand and supply elasticities are very low in the short run. Increasingly, they appear low in the longer run as well. (For example, non-OPEC supplies have been disappointing despite high prices; investment, for all sorts of reasons, cannot or does not respond). Much of this is not new, though the extent of non-response has surprised analysts. What is new is the *lack* of response to high oil prices via the world economy. In OECD countries, the recent impact, larger than the great oil shocks of the 1970s, has not led to the expected inflationary recession that was widely anticipated. (The credit crunch is another matter). This is startling. First, it means that demand does not fall nearly as much when oil prices go up as previously anticipated. Second, indirectly, producers and particularly OPEC, have learned that this is so and market operators see that this is so. So the potential feedback via market perceptions that OPEC would limit price rises for fear of longer-term 'demand destruction', has also gone out of the market. Add to this the fact that any expectation that the Strategic Petroleum Reserve (SPR) would be used to lower oil prices (or to quell a rise) has gone, since, surprisingly, this policy weapon has not been used, even as a threat. Finally, on a longer time scale, the fear that high oil prices would trigger political initiatives, for example on climate change or security, and thus lower future oil demand, has greatly attenuated.

If the story of near indeterminacy is right – that quite large changes in prices don't have very much effect any more – what are the implications? The first is that there is extreme uncertainty about the future oil price. This is both a cause and a consequence of the way the market functions. It would be quite wrong to blame finance or financial operators for this. The industry is just as uncertain about future oil prices and the 'fundamentals' as financial operators. A second is that the market is likely to 'coordinate' on apparently small or even irrelevant public signals. Everyone is trying to out guess everyone else. Or, in Keynes's famous words: 'We have reached the third degree where we devote our intelligences to anticipating what average opinion expects average opinion to be'. The third is that anything that helped to establish a market view of what the 'fundamentals' are (or to limit the range of uncertainty) would help the market to function in a better way.

What kinds of intervention or political change would help? Some aspects of the Mabro Scheme fit directly within this framework. The idea that better public research and analysis of the 'fundamentals' would be helpful is straightforward: it is a public good. What is needed, however, is that markets should coordinate their medium-term perceptions on the results of such research – which might be problematic given the genuine uncertainties. (The Mabro response is a reference price backed up by the capacity to intervene.)

My view is that the key lies elsewhere – in an essentially political commitment to support a broadly agreed range of policies and prices for the future. The political commitment itself is the factor that should stabilise market perceptions. The mechanisms to police the policy could be relatively informal – stopping short, for example of target ranges and intervention arrangements. In other important markets, such as for the dollar in the 1980s, policies of 'benign neglect' have led to serious instabilities which have been reversed as policy changed.

Oil markets have been through a period of 'benign neglect', or, more accurately, something worse – a stand off between producers and consumers (what Mabro calls the blame game). Clearly the establishment of a credible set of international policies towards oil markets is going to be very difficult. For obvious reasons, OPEC finds it politically difficult (even if they have the capacity) to stem a price rise. Moreover there are fears that price falls would get out of control. On the other side, the United States has proved very reluctant to use the SPR, for fear that it would not work.

Any credible framework must involve at least the recognition that prices can be too high, for both parties, and too low, for both parties. In practice, a commitment by consumer countries (especially the USA) to help prevent oil prices falling below some level (say $60), e.g. by building up the SPR, would have a large effect on the prospects for cooperation. Moreover, given concerns over other agendas, such as security and climate change, it would not be hard to make the case for a lower bound – in the interest of consumer countries. With that in place, help from OPEC to prevent price rises beyond a reasonable view of the longer-term fundamentals would also be much more likely to be forthcoming.

Given the recent volatility of oil markets, it is quite possible that even the start of such a constructive dialogue – the end of the blame game and the search for common ground – would make a big difference to the dynamics of the oil market. What is needed is for market operators to start thinking about what kind of regime will be in place in the medium term – which hopefully would start to stabilise short-term prices as well.

Christopher Allsopp

christopher.allsopp@oxfordenergy.org

Dear Sir,

Regarding Peter Fox-Penner and Matthew McCaffrees 'The Oil Climate Bargain: How Fuel Economy Standards May Help Global Climate Policies' (*Oxford Energy Forum* 74, August 2008, pp. 14–17), I agree with the authors' claim that it is in the interest of the United States to reduce domestic oil consumption, and I find the idea of a concomitant 'climate bargain' with the developing world intriguing, but probably slightly unrealistic. Its potential really depends solely on the relative pricing of coal and oil after the US induced price reductions suggested by the authors:

> *Oil and, more specifically, gasoline-saving-policies can have a very large and direct impact on prices... Lower oil prices will carry even greater benefits for the economies of emerging nations*. (pp. 15 and 16)

In other words, if the price of oil makes this fuel more economic than coal, then developing countries will be experiencing a dash for oil without the need for an explicit 'bargain'.

If oil remains more expensive than coal, then it is unlikely that developing countries will be willing to pay for the incremental mitigation costs. However, the situation is not as bleak as might seem, for there are many ways in which mitigation in developing countries could be financed short of bothering the much beleaguered treasuries of the North, such as the Clean Development Mechanism and other (win-win) private sector initiatives.

Yours sincerely

Dr Benito Müller

benito.mueller@philosphy.ox.ac.uk

Personal Commentary

Andrew Gould

Although I write at a time of great concern over the global economy, I think it important to begin by saying that the global oil and gas industry has a critical role to play as an effective and reliable partner in providing energy at reasonable cost both in the short and long term. Within that context, I would like to focus my remarks on the role of the service company as a technology supplier to the exploration and production industry. Naturally, I write from my own perspective at Schlumberger, but in the spirit of the debate that the *Forum* seeks to foster, I will build on the insights on the roles and relationships of the industry players that were presented by Mark Moody-Stuart in August 2008.

There have been many studies analysing the correlations between economic growth and the demand for oil and gas that have included some excellent work on the demand side by the International Energy Agency (IEA), especially the last World Energy Outlook (WEO) focusing on China and India. On the supply side, the IEA acknowledged the importance of future energy supplies to economic growth in the 2001 WEO subtitled 'Assessing Today's Supplies to Fuel Tomorrow's Growth'. This was followed in 2003 by an estimate of the cumulative investment required to provide the necessary oil and gas to meet demand over the period 2001–2030. This figure totalled $6.2 trillion (in year 2000 dollars) for upstream-, downstream- and transportation-related investment. Four years later this figure was increased to $9.6 trillion (in year 2006 dollars) over the shorter period of 2006–2030. While this amount of capital may appear large, the economic value of the fuel produced is certainly very much higher.

Turning now to the impact of oil prices on economic growth, there have been several studies that link the recessions of the last few decades to oil price shocks. In 2000, a study by Oak Ridge National Laboratory, estimated the costs to the US economy of the oil market upheavals over the period 1970–1999 at $7 trillion (present value 1998 dollars). Indeed in the final write-up of the events leading up to the current economic gloom and inevitable recession, I would be surprised if the volatility of oil prices escaped at least part of the blame for the impending recession.

Where does this lead us? The value of a well functioning oil and gas industry is critical to the wellbeing of the people on this planet. The benefits of oil and gas exploration and production (E&P) are measured in trillions of dollars, as are the global economic costs of inadequate supplies that lead to oil price shocks. One would think that this would provide ample incentive for all companies involved in the oil and gas industry, as well as the major resource holders, to invest in providing adequate oil supplies at a reasonable cost. If consumers are also reassured over the security of future oil supplies as well as a reduction of oil price volatility, then there is significant additional value for global economic growth prospects.

Within this sphere lie the roles and relationships of the oil and gas companies and the oilfield service providers. In order for these companies to clearly communicate their position to stakeholders, whether they are employees, customers, host governments or investors, it is important for them to define the guiding principles of their business. As well as statements on corporate governance ethics and values, the Schlumberger guiding principles include a commitment to our customers, the oil companies. As Mark pointed out, the Schlumberger position on equity has not changed since that position was first formulated. Stated simply, 'Schlumberger is committed to excellence in everything we seek to do. We aim to do business in a consistent and transparent way with all our clients and do not hold equity stakes in our customers' assets. Customers place a great deal of trust in us, particularly when it comes to handling sensitive and confidential information. Our reputation for integrity and fair dealing is vitally important in winning and retaining this trust.'

This is a very clear position. I firmly believe that the industry can only satisfy society's needs effectively when all the players clearly communicate their roles and relationships. Each player must understand and fulfill their role in order for the industry to function. We have a clear understanding of our role as a service company, which does not seek to compete with its customers for equity in oil and gas assets. We provide services and technologies that help our customers improve the performance and reduce the risk of producing oil and gas, and investors value us on our ability to do this. This is quite distinct from the valuation of an oil company, which is based on its production and its reserves.

One of the most important characteristics of any service company is the quality of its people. It will come as little surprise to know that we attract our staff by offering exciting and varied careers, equal opportunities, outstanding training and competitive salaries. However, the ability to attract the best is made harder by unstable E&P spending. This affects all industry players, but the service company is less protected than the oil company because it is measured by the financial performance of its current operations rather than by the quality of its oil and gas assets. Consequently, the service company must react rapidly to the changing spending patterns of its customers. While oil companies can adjust E&P spending levels up and down depending on their perception of supply, demand and price, the service sector has to respond with increasing or decreasing resources. Hence we are heavily reliant on the forecasting ability of our customers, and volatility of their investment plans. This also explains why oilfield cost inflation appears when activity increases after periods of under-investment.

I doubt if anyone would disagree that attracting the best people into the oil and gas industry is a productive use of the world's human capital. By working together, international and national oil companies, service companies and the major resource holding countries can attract the best talent to the business and deliver reliable, cost-efficient supplies of oil and gas. In doing so, we compete with other sectors but at the moment it's reasonably safe to say that a technical career in oil and gas is probably a better use of talent than devising complex products in the financial sector.

I would now like to turn to the importance of technology. This forms a fundamental part of our company's values and vision since its inception. Schlumberger firmly believes that the service sector has a fundamental role to play in the research, development and deployment of upstream technology and that is why we reinvested over 14 percent of our net income in R&D in 2007. For comparison, the corresponding figure for the world's largest international oil company was 2 percent. We firmly believe that the need for upstream technology development to find and produce more oil and gas has never been greater. We also recognise that there are technology opportunities in other parts of the oil and gas value chain, where Schlumberger has no participation and which are most suited to oil companies.

One of the best examples of the effect of technology lies in production of natural gas in North America. With many conventional reserves well depleted, the North American exploration and production industry has turned more and more to unconventional reserves to meet demand. The geological and production characteristics of these reserves have demanded new technologies able to improve production for satisfactory economic return. Well placement, natural fracture identification, pressure pumping stimulation and completion design have all had to make advances, and have all had to become closely integrated for the performance to unconventional gas wells to become acceptable. The service industry has met that challenge – one that lies firmly within its remit.

But surface seismic acquisition and processing has also changed dramatically through research and development investment by the service sector. Long seen as a commodity service by the oil companies, who added their own differentiation versus their competitors through processing and interpretation, the latest generation single-sensor technology requires a certain acceptance of technology at the black-box level. It is not realistic to expect the service company to develop the technology and then not receive the return of the required investment. Yet our industry is really no different to any other technology-based industry. After all, oil and gas exploration and production is an engineering business and there is no reason for the same transformation that has led to significant progress in the aerospace, automotive and biomedical industries not to apply to oil and gas development.

The technology development landscape is not limited to hardware and data acquisition. It also extends to information technology and data conditioning, processing and interpretation. Workflow process software has made dramatic strides thanks to the engineering efforts of the service sector. Workstation, visualisation and simulation capabilities have extended far beyond the impressive efforts of just ten years ago. The shared earth model, the meeting place of geologists, geophysicists and engineers has enabled incredible progress to be made in the management of one of the most vital energy assets we cannot see for ourselves – the hydrocarbon reservoir. The development of high-performance software platforms to manage all of this has, in the last twenty years, moved from being an activity internal to the large oil companies to a competitive market of third-party software vendors.

I would now like to try to draw some coherence between the roles of the industry players. Economic growth depends upon reliable and reasonably priced oil and gas supplies. If the oil and gas industry and its major resource holders are unable to deliver increasing supplies of oil, then governments will investigate whether the market is correctly functioning and whether higher oil prices are resulting in increased investment in exploration and production. If oil companies prefer to find other uses for the money generated by the sale of oil and gas, then governments may well feel justified in using taxation to obtain capital that can then be reinvested in E&P. But who really has the knowledge to reinvest if not the oil companies themselves?

There are of course fundamental differences between oil companies and service companies. Oil companies have traditionally been valued on their exposure to ownership of oil as a proxy for exposure to oil price and geological risk, or in the case of the national oil companies their capacity to contribute to the nation's wealth. Even if the internationals are increasingly accepting contracts that reflect more a service model than an equity model, it is likely that they will continue to be valued on the net present value of the quantity of the commodity they can find, produce and sell. Service companies on the other hand are typically valued on the earnings power of their technology portfolio applied to a probable activity scenario and they are tributary to the oil companies' desire to spend on exploration and production. In fact, I would suggest that today's service companies are probably wrongly named – a more correct description would be technology suppliers as is the norm in many other engineering industries.

The risk profile and appetite of the oil companies and service companies remains fundamentally different. Most oil companies typically cover more of the E&P value chain than any service company. The service companies remain suppliers of technology products and services to the oil companies whatever their form – national, international, small or large, oil, gas, or of any other variety and believe me there are many. Such companies would, in my opinion, remain well advised not to cross the divide and begin to take equity. A consistent relationship with all customers is vital to a clear distinction of the roles of each of the players.

In closing, I agree with Mark that technical and operational excellence is key for all the players in the oil and gas industry. However, I propose that to achieve this excellence a company has to be clearly focused on its role in the industry and structured accordingly. It is simply unrealistic to expect that any company can effectively fulfil both roles. We at Schlumberger have made our choice.

Asinus Muses

Credit where it's Due

As credit gets ever crunchier, Asinus has been counting his blessings. In his current incarnation he is an ass with no assets: no shares, no houses, no collateralised debt obligations. He has never been sold a SIV by a spiv. And for the first time in a long time, having no assets appears to be the only way to avoid becoming poorer. Should Asinus celebrate his out-performing the market?

Contra the old saying about love, behavioural research finds that when it comes to money, humans prefer never to have had than to have and to lose. Soros, who knows a thing or two about having and losing, has confirmed that there is greater sorrow in losing a billion than joy in gaining it.

If losing a billion hurts, pity the poor souls who used to be CEOs of US investment banks. With little to cushion their landing but their nest beds of a few hundred million bucks, these fellows have lost everything: their jobs, their reputations, and the right to gamble with the wealth of people poorer than them. Still, losing tens of billions of other people's money is probably preferable to losing a billion of your own.

One of the more amusing sideshows of the crisis has been the sight of free market cheerleaders begging for bailouts. It should probably be no surprise that Hank Paulson, US Treasury Secretary and former Chair and CEO of Goldman Sachs, supports welfare for bankers. Paul Volker, former head of the US Fed, has also called for a public body to take over the bad debts littering the financial system. His main claim to fame is having caused the Latin American debt crisis of 1982, so I suppose we can at least say he is experienced in these matters.

Left Holding the Baby

It seems the only people left holding anything of value are our old friends the oil producers. But even the effervescent oil price has lost some of its fizz. Asinus is not, however, so foolish as to assume that it will not double, or indeed halve, in between this being written and being printed. Indeed, the best metaphor that I have heard for the oil price is Paul Horsnell's image of a naughty toddler wandering in random directions until he collides with something.

This suggests that what the oil market needs is adult supervision, which is essentially what our own Robert Mabro has called for: internationally-coordinated public intervention to stabilise oil prices, led by the biggest importers and exporters. Such a proposal would have been terribly unfashionable until recently. But post Fannie Mae, Freddie Mac, AIG, Bradford and Bingley, and so on and so forth, it seems that public intervention in markets is back in style. Evidently Mabro was simply at the forefront of the new wave of retro chic. But while I would be delighted to see the Americans and Saudis leading a new multilateralism, I am not holding my breath.

Mohamed ElBaradei apparently has more faith. He has been arguing for international coordination in setting up a truly international energy agency to represent all stakeholders. According to ElBaradei, OPEC, the IEA, and UN-Energy don't cause enough trouble on their own. Asinus is reminded of the comment made by Lord Palmerston, Prime Minister of Great Britain, to Queen Victoria: 'Change? Change? Why do we need change? Things are quite bad enough already.'

Winds of Change

Speaking of changes, clean energy's newest and least likely advocate is oil's best-named personage, T. Boone Pickens. (Asinus cannot read his name without picturing Boss Hogg from the Dukes of Hazzard, elbow-deep in a platter of porterhouse steaks.) Pickens plans to invest several billion dollars in building wind farms in Texas. In addition to making a bundle, he wants to reduce oil imports to the USA. He declares: 'We are now transferring $600 billion [a year] out of the United States to a few friends and a hell of a bunch of enemies. I can tell you, we are paying for the war against ourselves.' Oilman to green is thus explained. But Asinus wonders if the difference in skill sets between the oilman and the diplomat might help to explain how the world got into its current geopolitical pickle in the first place.

Man and his Ass

Asinus has discovered that his equine cousins are barred from the famous Inca Trail to Machu Picchu, Peru's recently-anointed Wonder of the World. Pack animals are judged to be a danger to the route and the priceless artefacts at the end of it. Curiously, tourists are not thereby induced to dispense with pack-carriers but outsource, instead, to other humans. These very fit human specimens are known as *portadores*. Even more curiously, some tourists nonetheless have more trouble carrying their own unladen asses up the trail than their ass-like employees have in carrying their loads. (Loyal readers may notice that Asinus's views on the fat-thin debate are experiencing a secular shift.)

Oxford Energy Forum. ISSN 0959-7727. Published by Oxford Institute for Energy Studies, 57 Woodstock Road, Oxford OX2 6FA, United Kingdom. Registered Charity 286084. Tel: (0)1865 311377. Fax: (0)1865 310527. E-Mail: forum@oxfordenergy.org EDITOR: Robert Mabro. Annual Subscription (four issues) £45/$85/€65.

Indexing/Abstracting: The Oxford Energy Forum is indexed and/or abstracted in PAIS International, ABI/INFORM, Fuel and Energy Abstracts, Environment Abstracts, ETDE and CSA Human Population and the Environment