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GSN

Companies & People

Trouble On The Road To Makkah

Tribal chiefs meeting **Crown Prince Abdallah Bin Abdelaziz** have made a point of showing their allegiance following the Riyadh bombings, and foiled terrorist attempts in the holy cities of Makkah and Medina. Makkah police chief **Saeed Bin Abdallah Al-Qahtani** earned promotion to Lieutenant General as head of national Public Security Department. Soon after, opposition sources said, another shootout in Makkah threatened CPA himself (see page 5).

The exiled opposition **Movement for Islamic Reform's Saad Al-Fagih** claims there was an exchange of gunfire on 19 July between security forces and gunmen, probably Jihadists – although they could have been criminals caught in the dragnet – in Makkah's Al-Khalidiyah area. Elements of CPA's schedule were known that day; he was travelling from Al-Taif to Jeddah via Makkah to attend a function at the Grand Mosque. According to Fagih's version of events – unconfirmed by official sources – shooting started either before the motorcade arrived or as the first outriders came into view. The attackers had no chance to hit CPA, who returned to Taif. The direct Taif-Jeddah route and the road through Makkah were then closed for around 12 hours.

Across The Region

Iraq has taken a significant step in the right direction with the appointment of a new Governing Council that will not be limited to a consultative role – although there is a long way to go before an independent government is in power.

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Though it remains in support of militant elements, Yemen's recent anti-terrorism efforts have won it praise in the US security establishment. President Saleh remains fiercely independent, but the US says Yemen is becoming "one of us".

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To fight terrorism at home and convince international observers it is serious about the task, Saudi Arabia has taken steps to revamp its security structure in the midst of intense politicking when many princes would rather be cooling their heels in more temperate climes.

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It's no longer a secret: contractors are lining up for new work on the USA's Al-Udeid air base in Qatar.

PAGE 6

Significant changes in the Kuwaiti cabinet after the 5 July elections strengthen the hand of the ruling family but also throw notable portfolios to non-royal ministers.

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New Kuwaiti Premier Sheikh Sabah Al-Ahmed Al-Sabah has promised movement on women's political rights, but how quickly this movement comes remains to be seen.

PAGE 9

The signing of a long-delayed Saudi Arabian gas deal with two European oil majors could signal a flow of new deals, and a political shift away from US dominance in the hydrocarbon sector now that Washington has shifted its military focus away from the kingdom as well.

PAGE 13

GSN downgrades Iraq's political risk grade one notch despite the creation of a Governing Council and the death of Saddam Hussein's sons. This assessment is based on continued concerns about the security situation and the slow pace of reconstruction to basic services.

RISK MANAGEMENT REPORT PAGE 14

Kuwait's elections brought new hope for reform, but concerns over political and economic diversification remain. GSN maintains its B-/2 Risk Rating

RISK MANAGEMENT REPORT PAGE 15

GSN's Analysis

The killing of Uday and Qusay Hussein gives President Bush a public relations coup that could prove invaluable as US planners seek new options to reduce their exposure to Iraq. Bush is well advised to bring in the UN and NATO to assume the Iraqi burden.

GSN VIEW, PAGE 2

One year ago, GSN was sure that Saddam Hussein must go, but was wary of the USA's new "pre-emptive" policy towards the Middle East.

PERSPECTIVE, PAGE 2

An influx of pro-government independents to the Kuwaiti Parliament could make speed the road to reform, though economic and business initiatives will almost certainly take precedence over social liberalisation.

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In seeking a restructured security architecture for the Gulf, misperceptions of Arab states' strength and cohesiveness may be leading US decision-makers astray, and could have political costs in the region.

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Washington's perceived mission in the Gulf may preclude handing more responsibility to GCC states, though such an arrangement could be the best option in a region with changing military requirements.

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Even Iranian hard-liners are taking seriously the death of photojournalist Zahra Kazemi, as the event could become another obstacle in Tehran's trade talks with the EU, just as its nuclear programme has become a major issue.

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MIDDLE EAST ENERGY

Despite a 38bn-bbl find of heavy crude reserves this month, Iran is struggling to sign up oil majors to boost its production. Onerous terms have held deals up, but political pressure may see Tehran change its tune.

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MEE Pointers on Iraqi oil and Brazilians in Iran.

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The occupying powers in Iraq have launched a \$1.6bn emergency programme to raise output to pre-war levels of 3bn b/d by April 2004. Iraqi officials remain sceptical.

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Iraqi diesel exports have blossomed since the lifting of UN sanctions.

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The killing in a 22 July shootout in Mosul of Saddam Hussein's sons Uday and Qusay was as a tonic for the US and UK governments, their troops and wavering public opinion. It will help to lift Saddam's spectre from Iraq by shortening the Baath regime's afterlife – a phenomenon so toxic it has threatened to poison the Coalition intervention in Iraq, turning military victory into a political defeat. It helps to compensate for the continued failure to capture Saddam, restore security and essential services, and reassure Western public opinion that war was justified (giving a beleaguered Tony Blair a little more breathing space).

It remains to be seen whether the deaths of Saddam's unlovely children and the creation of a new Governing Council months before US Coalition Provisional Authority head L Paul Bremer III had planned will reverse the negative course of events. Radical Shiite demonstrators in Najaf – a zone of relative peace until mid-July – shouted the 'V' (for Vietnam) word as they confronted US troops. The mounting death toll and cost of the invasion have shaken even US public opinion, and gives impetus for US policy-makers to seek international participation in the occupation to a degree inconceivable only weeks before, when hawks grouped around the Pentagon were happily decrying the United Nations and all its works. A degree of post-conflict "normality" beckons in Iraq's long, turbulent summer; the signs are that normality will be forged from a more multilateral template than Paul Wolfowitz, his boss Donald Rumsfeld and other hawks envisaged as they sought to recast the international order by steamrolling into Baghdad.

Bremer's decision to endow the Governing Council with executive powers, rather than confining it to a consultative role, has allowed it to begin establishing its

own authority, as was reflected when its representatives at a Security Council presentation by UN envoy Sergio Vieira de Mello sought permission to occupy Iraq's UN seat. Iraq does not yet have a sovereign government, so this was not allowed, but the request clearly signalled a new mood. Iraq's new institutional disposition and the credibility of those who occupy office hold the key to further progress at the UN, where there are even suggestions that Russia, France and Germany might eventually send troops. The arrival of big Italian, Polish and Dutch-led contingents has begun to dilute the US/UK domination of the occupation forces.

George W Bush always argued, unconvincingly, that he had assembled a big Coalition to remove Saddam (or, rather, to tackle the threat posed by his alleged ongoing weapons of mass destruction programme). Now, a post-war Coalition is forming. With a huge budget deficit and the feel-bad factor of near daily GI deaths feeding into his worst ever poll ratings, Bush and his politically savvy team led by Karl Rove might feel that as the 2004 elections beckon, a bigger multilateral effort can save the day, helping to reduce the USA's on-the-ground military commitment and share costs.

The US forces' success in finding and killing Uday and Qusay Hussein gives Bush another victory to proclaim: this public relations coup could prove most invaluable in selling a greater UN role to domestic American opinion. Hawks may argue the Uday/Qusay killing shows the USA can handle Iraq on its own, but shrewd politicians like Bush and his more pragmatic advisers may spot the chance to claim a big success and then, from a position of strength, bring in the UN to assume a large part of the Iraqi burden.

Perspective: One Year Ago

Saddam Hussein is, as GSN has described him before, the "dictator's dictator". The Iraqi President has a monstrous record of human rights, staying in power through the use of violence ranging from torture to weapons of mass destruction (WMD). The consequences of his failed invasions have impoverished what was, two decades ago, arguably the Arab world's most vibrant and well-qualified middle class. While professors, doctors and engineers are now focused on scraping a living, they might under more "normal" leadership have formed the nucleus of a pluralist political system to carry the country forward.

The wars with Iran and Kuwait, and massacres of Kurds, Shias and the rest – including old allies and family members – show just how dangerous Saddam can be. Of course, Saddam should go. But governments across the Middle East, Asia and continental Europe are right to be uneasy about the embattled US President George W Bush leading them into war to replace him.

The launching of a "pre-emptive" war against Saddam signals that within two years a Bush presidency that started as isolationist has become "imperial" in its

ambitions – seeking to restructure a turbulent but strategically important Middle East once and for all. Such ideas go down very badly in the Middle East – and Bush might find himself with few real friends even if a US-led "coalition" won the quick victory that Washington hawks talk of with such conviction. The theory of a new imperial America gives substance to the arguments of hardliners in Iran that, after Iraq, Bush is targeting the Islamic Republic. The US President has already, apparently, given up on President Mohammed Khatami's reforms.

But talk of a long-term masterplan for the region is very premature. GSN's canvassing of the DC policy community and Pentagon confirms the impression that extreme uncertainty, rather than a concealed plan for early action, dominates the debate on Iraq... Support for removing Saddam in the near term rests on a very narrow base – civilian hawks at the Department of Defense and their policy advisors – yet the macro trend in US policy suggests that Iraq must be attacked.

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With New Governing Council, Iraq Starts To Shrug Off Provisional Administration

With the installation of a new Governing Council in Baghdad representing all of Iraq's ethnic groups and a diversity of political tendencies, post-conflict "normality" at last beckons for Iraq. With Uday and Qusay Hussein lying on mortuary slabs, an encouraging report from *United Nations* envoy Sergio Vieira de Mello, and talk of a fresh UN resolution that would open the way to a more multi-national military presence and new sources of foreign aid, it is now just possible to glimpse a stable future in which an Iraqi administration is no longer provisional, and includes local actors (see page 2).

Recent weeks have seen a sea change in US plans to re-establish a government that is seen as genuinely Iraqi and accepted across the international community. That point has not yet been reached, but the success of the Coalition Provisional Authority's L Paul Bremer III in persuading a broad range of factions and interest groups to join the new Council has laid the groundwork. The Council has executive powers – rather the merely consultative role originally

proposed by Washington – which have already allowed it to begin establishing its own authority, for example, in deciding that *Baathist* war criminals would eventually be put on trial.

The new Council has 13 Shiite members, five Sunni Arabs, five Kurds, one Christian and a Turkoman (see box below). This reflects the country's demographic blend.

The Kurdish members are real heavyweights in their communities, led by old rivals the *Patriotic Union of Kurdistan's* Jalal Talabani and *Kurdistan Democratic Party (KDP)* leader Massoud Barzani.

The Shiite list includes the Pentagon's preferred exile, *Iraqi National Congress* leader Ahmed Chalabi, and senior *Supreme Council for the Islamic Revolution in Iraq (Sciri)* and *Al-Daawa* members. The future may hinge on other Shiite leaders, but the quality of the line-up says much for the energetic Bremer's powers of persuasion.

For all of Bremer's undoubted commitment to "de-Baathisation" and the preponderance of exiles in the mix, a few Council members held senior jobs before falling out with Saddam Hussein.

Who's Who On Iraq's Governing Council

SHIITES

Ahmed Chalabi, 58: The INC leader is a Pentagon protégé who returned with US forces this year after 45 years abroad.

Abdul Aziz Al-Hakim: *Sciri* Deputy Chair and brother of party leader Ayatollah Mohammed Bakr Al-Hakim was exiled for 23 years in Iran; he commands the armed wing, *Failaq Badr*.

Ibrahim Al-Jafaari, 56: A doctor who speaks for *Al-Daawa*, one of Iraq's oldest parties, he was based in Karbala, before fleeing to Iran and in 1989 to London.

Wael Abdel Latif: Provisional governor of Basra was a judge for 21 years, jailed for a year in 1994.

Eyad Allawi, 57: Surgeon and 1960s *Baathist* who moved to Beirut and London, forming the *Iraqi National Reconciliation Movement*, his party includes many ex-Baathists and military men.

Aqeila Al-Hashimi: Member of the committee now running the Foreign Ministry, where she was previously public relations officer and close to Deputy Premier Tariq Aziz. She headed the Iraqi delegation to a 24 June New York donor meeting.

Hameed Abdul Majid Al-Mousa, 62: Secretary-general of the *Iraqi Communist Party*. his family comes from Babel; he was living in free Iraqi Kurdistan.

Karim Mohammedawi (Abu Hatem), 45: Tribal chief who mounted a guerrilla campaign against Saddam in the southern marshes and helped liberate Amara.

Sheikh Ahmed Al-Burak Al-Bu Sultan: Chair of lawyers association and human rights society in Babel.

Muwafak Al-Rubei: Moderate intellectual, former Al-Daawa member and one of the authors of *The Iraqi Shiite Declaration*.

Ezzeddine Salim: A historian and Daawa movement Chairman in Basra.

Mohammed Baher Al-Oloum, 80: A liberal imam who ran the *Ahl Al-Beit Islamic Centre* in London. He now moves between Baghdad and Najaf.

Rajaa Habin Al-Khuzaeii: Head of the Diwaniyah maternity hospital.

ARAB SUNNIS

Adnan Pachachi, a sprightly 81: Liberal foreign minister in pre-Baathist 1960s,

who later lived in London and the UAE. An advisor on oil to the *Al-Nahayans*, he chairs the *Coalition of Independent Democrats* and is a point man with *OPEC*.

Nasir Kamel Al-Chaderchi, 70: Baghdad lawyer and agricultural company boss. Head of the National Democratic Party, he has always lived in Iraq.

Sheikh Ghazi Al-Yawer: Mosul businessman and grandson of **Sheikh Mohsin Adel Al-Yawer**, the Sunni/Shia Al-Shummar tribe chief, widespread in Iraq, parts of Syria, Jordan and Saudi Arabia. He returned in June after 15 years in Saudi Arabia.

Mohsen Abdelaziz: Secretary-general of the *Hizb Islamiya*, the Iraqi wing of the *Muslim Brotherhood*, established in 1960 but banned the next year.

Samer Mahmoud: Businessman and leader of Northern Baghdad tribe.

KURDS

Jalal Talabani, 67: Sunni leader of the *Patriotic Union of Kurdistan (PUK)*, which he founded after splitting from the KDP in 1975. The PUK controls south-east Kurdistan.

Massoud Barzani, 56: Sunni leader of the KDP, which was founded in 1946 by his father, **Mustafa Barzani**. He took over leadership in 1979 after his father's death. The KDP controls north-west Kurdistan.

Salaheddine Bahaeddine, 53: An Islamist close to the Muslim Brotherhood, in 1991 he founded the *Islamic Federation Party*, the third party in Kurdistan.

Mahmoud Ali Othman, 60: A Suleimaniyah doctor who founded the *Kurdish Socialist Party* in 1975 but later quit party politics, he is based in Irbil.

Dara Nouredine, 50: A Kirkuk judge jailed for three years after criticising a decision taken by Saddam's Revolutionary Command Council, he was released in last year's general amnesty. He presides over a Baghdad court.

CHRISTIAN

Yunadem Youssef Keno, 50: An engineer and founder of the *Democratic Assyrian Movement* based in Kirkuk, he is an ally of the KDP, and held ministerial posts in the Irbil-based autonomous Kurdish government.

TURKOMAN

Shankoul Habib Omar, 35: A sculptor and teacher at Mosul's fine arts faculty, and Kirkuk-based member of the *Iraqi Turkoman Forum*.

Yemen Boosts Security With Tight Focus, US Aid

The Yemen of President **Ali Abdallah Saleh** continues to present an inconsistent public visage, split between support for militant elements in the Gulf and co-operation with Western intelligence and security efforts. But US officials tell *GSN* they are privately pleased with recent steps, and say the relationship between Sanaa and Washington is only growing closer.

Whilst the country is steadily becoming a core US ally in the war against terror, Saleh continues to play up Yemen's fiercely independent stance. **Barbara Bodine**, former US Ambassador to Sanaa at the time of the *USS Cole* attack, described the extraordinary level of individualism and nonconformity in Yemeni culture. It is this dynamic that has driven Saleh to meet with **Hamas** fundraisers, hold talks with President **Mohammad Khatami** of Iran, and vehemently criticise US policy in Iraq this year. At the same time, he has cultivated closer links with the USA.

As one **Federal Bureau of Investigation (FBI)** counter-terrorism official told *GSN*, "Yemen has not turned out to be another Afghanistan. They are coming out of the basement, and are increasingly considered one of us."

June and July saw Yemen score a number of blows in its US-backed counter-terrorism effort, which has also contributed to the government's effort to rehabilitate the country in the eyes of investors and tourist operators.

Throughout the summer, Yemeni government paramilitary forces have been searching a number of mountainous redoubts in pursuit of radical Islamists and **Al Qaeda** elements. In the Jabal Hatat, 120km northwest of Aden, the government launched a major operation in late June, killing six men, including the Islamist militant **Khaled Abdelnabai**, a cell leader associated with the **Aden Abyan Army** and Al Qaeda.

Despite US training provided since 2002 in "hostage negotiation and incident management", the 5 June government assault proceeded along conventional Yemeni lines – the target group was surrounded and offered a chance to surrender through tribal intermediaries, and then bombarded with tank fire, artillery, and multiple-barrel rocket launchers for two hours while Yemeni paramilitary troops positioned for the final assault. This succeeded in its goals, at the cost of one Yemeni officer killed and five soldiers wounded. The operation was prompted by the group's attack on an army medical convoy in June, which left seven wounded.

In addition to such traditionally heavy-handed paramilitary tactics, the government has demonstrated growing effectiveness in intelligence and policing operations. Twenty-seven terrorism

suspects have been apprehended since June in snatch operations, bringing the total number of terrorism-related arrests this year to 195. On 18 July, the government announced that it was holding 292 prisoners related to terrorism charges, including 92 core suspects and 200 Islamist sympathisers.

Washington Institute for Near East Policy counter-terrorism expert **Jonathan Schanzer** told *GSN* that these figures compared very favourably with Egypt, where an estimated 16,000 terrorism-related prisoners are under detention. This difference in scale is an indication that counter-terrorism in Yemen is tightly focused on containing militant radicals rather than secular suppression of a whole segment of society. According to Schanzer, recently returned from secondment to the Yemeni Interior Ministry, the Yemeni security services are now focused on as few as a dozen major Islamist terrorists and 100-200 identified low-priority supporters and sympathisers who are still at large.

INTO THE BIG LEAGUE

Despite some of Saleh's rhetoric, tighter co-operation and increasing integration between Yemeni and US security has contributed much to recent successes.

At the investigative and intelligence-gathering level, Yemen has benefited from high levels of US State Department Anti-Terrorism Assistance to the country, which reached \$827,000 in FY2002 and has been budgeted for \$915,000 in FY2003. This money has allowed Yemeni personnel to receive US training in surveillance and rural border patrol techniques from US advisors, among other things.

Further funding is also available to buy (or at least rent) tribal loyalty through the **Central Intelligence Agency's (CIA)**'s close liaison with the Yemeni **National Security Council**, which was established in August 2002 to allow a closer central point of contact with foreign intelligence services.

US counter-terrorism advisors tell *GSN* that **Abdelhadi Hamdani** political advisor to President Saleh, is the key point of contact between the CIA and the Interior Ministry. President Saleh's formal advisor on counter-terrorism is **Salem Saleh Mohammed**, a senior **Al-Islah** politician.

The FBI has considerably aided Yemeni counter-terrorism efforts following a rapid improvement of relations since the angry fracas that followed the *USS Cole* bombing investigations in 2000-01.

FBI Director **Robert Mueller** recently completed his third visit to Yemen since 9/11, and the FBI has quietly expanded its low-profile "legal office" in Yemen to full bureau status. This important step means that Sanaa has finally

entered the big league of US partners in the war on terror, alongside **Jordan**, Egypt and **Saudi Arabia**.

On the military side, Yemen looks set to receive up to \$1m worth of US International Military Education and Training and a massive \$15m worth of Foreign Military Financing, including support to buy reconditioned US equipment. This aid will support the development of mobile rapid reaction forces and improved coast guard capabilities.

Yemen has already invested up to \$55m of budgeted spending in ten patrol boats, purchased from **Australian** firm *Austal Ships*. US special forces and Marines are meanwhile touring the country, training government internal security and rapid response forces in each province, most recently in Marib.

According to *GSN's* soundings, Yemeni counter-terrorism officials are notably upbeat on the fruits of closer co-operation with Saudi Arabia's large-scale security apparatus. Following June's co-operation agreement between Interior Minister **Rashid Mohammed Al-Aleimi** and his Saudi counterpart **Prince Nayef Bin Abdelaziz**, high-level

delegations from both countries attended the 15th *Yemeni-Saudi Co-ordination Council* in Sanaa to discuss border security in early July. The agreement has already yielded tangible benefits, with Yemen transferring five suspects to Saudi Arabia, and Riyadh extraditing eight suspects to Yemen, including three linked to the attack on the **French**-flagged tanker *Limburg* in October 2002.

These three will be tried this summer for their alleged role in the attack. Their trials are among a raft of proceedings Yemen will initiate in coming months, partly in hopes of displaying further tangible evidence that counter-terrorism within the country is bearing fruit.

Some of the damage caused by the April escape of ten suspects linked to the October 2000 bombing of the *USS Cole* will be repaired by the trials of eight suspects, three *in absentia*, this summer. Nineteen suspects, two *in absentia*, will also be tried for involvement in the December 2002 killing of three US missionaries in southern Yemen, plus the murder of Socialist Party Deputy Secretary General **Jarallah Omar** (*GSN 710/6, 701/5*).

Saudi Leaders Discuss Reform Amid Summer Shoot-outs, US Charges

With highly critical testimony in Congress fanning the flames of anti-Saudi feeling in the USA, senior princes have spent the early summer rebuilding confidence at home and hoping to convince international observers that the Kingdom really is committed to tackling "Islamic terrorism" – rather than acting as a conduit for funding and a fertile recruiting ground for *Al-Qaeda's* foot soldiers, as critics claim.

With temperatures soaring, many princes have yet to escape to cooler climes. Summer politicking has been intense, with a level of calls for significant reforms unprecedented in three decades. This has even forced Al-Saud conservatives like Second Deputy Prime Minister, Defence and Aviation Minister **Prince Sultan Bin Abdelaziz** to consider the merits of reform, and has led to shifts within the senior security apparatus that could spell a new willingness in the Kingdom to grapple with the roots of terrorism at home.

The summer has also brought reports of more violent deaths in shoot-outs between Jihadist militants and security men. These include an unconfirmed report of an attack on or near **Crown Prince Abdallah Bin Abdelaziz** during his July tour of the Kingdom to meet tribal leaders and other notables (*see page 1*).

The alleged attack on Crown Prince Abdallah's motorcade took place on 19 July, according to the widely monitored – and highly partisan – *Movement for Islamic Reform (MIRA)* website,

run by the exiled **Saad Al-Fagih**. MIRA said an exchange of fire took place between security forces and gunmen in Makkah's Al-Khalidiyah area at the time CPA's motorcade was supposed to arrive from Al-Taif; the report said five people were arrested, probably members of the Jihadist movement.

MIRA has also reported more clashes involving security forces and tribal groups, including a mid-July incident involving the Al-Rawlah tribe in Hadib, where a mosque was bombed at Suwayr.

EVERYONE'S A REFORMIST

With the Jihadist movement under pressure, the Al-Sauds are putting efforts into promoting other groups, including the reformists courted by CPA (*GSN 713/10*). They are also seeking to reduce Wahhabi influence over education, mosques and charitable donations (*GSN 712/4; 710/5*).

On 13 July, the Shura Council approved a much-anticipated bill setting up a new body to oversee Islamic charities and create the *Supreme Saudi Relief and Charity Foundation* to control and regulate the raising and spending of funds and appoint external auditors.

Prince Sultan Bin Abdelaziz has made a point of meeting reformist notables recently, after having been criticised in the West for helping to fund aggressively Islamist Wahhabi tracts and named, along with many other prominent Saudis, in post-9/11 litigation in the US for his alleged support of underground groups (*GSN 712/5*).

Sultan's new interest in reform indicates which way the wind is blowing in the Kingdom – and could also represent a new bout of coalition-building, as Sultan seeks to secure, at the very least, the title of Crown Prince when **King Fahd** is finally pronounced dead.

On 20 July, the liberal daily *Al-Watan* reported that Sultan had welcomed some 30 intellectuals “representing different backgrounds of Saudi society”, and asked them to present their ideas on the next stage and nature of the political, economic and educational reforms. Sultan told the group that political reforms were “under study”.

Sultan was also present in Jeddah on 19 July when CPA met princes, officials and citizens following his tours of Al-Taif and Makkah provinces. This included separate meetings with leaders of Rabegh province and delegations from the Guraish, Harb, Al-Talhan, and Bani Al-Harith tribes. Terrorist attacks and appeals for national unity behind the Al-Sauds were on the agenda – as they were during the earlier Taif leg of the tour when CPA had audiences with *shioukh* (tribal leaders) from Al-Taif and Asir governorates.

Sultan's ambitious younger brother, Interior Minister **Prince Nayef Bin Abdelaziz** – the Sudairi prince most associated in the public mind with support for hard-line Wahhabi causes – seems to have recovered sufficiently from illness to lead the ongoing round-up of suspected “terrorist” groups. On 21 July, he announced the arrests of 16 more suspects who “belonged to the Al-Qaeda organisation”.

He also took the opportunity to regret coverage of an upcoming US Special Congressional Committee report that alleged links between Saudi agents and the 11 September 2001 attacks, and he denied a report in US magazine *Newsweek* that referred to an alleged link between one **Umar Al-Bayyumi**, whom the magazine said was probably an agent for the Saudi government, and 9/11 hijackers **Khalid Al-Mihdar** and **Nawwaf Al-Hazimi**.

NEW APPOINTMENTS, CONTINUED CRACKDOWN

Crown Prince Abdallah's mid-July tour was accompanied by his close ally, General Intelligence head **Prince Nawwaf Bin Abdelaziz**. Also on the trip was **Prince Faisal Bin Abdallah Bin Mohammed Al-Saud**, appointed by a Royal Decree reported on 1 July as Assistant Chief of the General Intelligence. His previous jobs have included Undersecretary of the National Guard for the Western sector – which would place him close to Crown Prince Abdallah. Prince Faisal seems to be one of the most senior members of the Al-Saud Al-Kabir branch of the ruling family, which is well represented in the armed forces.

There have been other substantial changes within the security establishment, with Mecca police chief **Saeed Bin Abdallah Al-Qahtani** promoted to Lieutenant General and head the

national Public Security Department following successful raids on alleged terrorist hideouts in the city.

As expected, the authorities have cracked down on dissident preachers and the Jihadist underground in the past month (*GSN 710/3*). If CPA's motorcade was attacked, or if there was (more likely) another shoot-out with security forces at the time of his arrival in the Makkah area, it was probably a signal that the Jihadists fight on, however successful Qahtani's recent campaign to eradicate the underground in the Makkah area has been.

Qahtani graduated from **King Fahd Security College** in 1969 and has worked in security ever since. His predecessor, Lieutenant General **Asaad Bin Abdelkarim Al-Fraih**, was appointed as a consultant in Prince Nayef's office. He has said his move had nothing to do with the criticism that followed the mid-May bombings.

The security crackdown is expected to continue. Nayef claimed the group of 16 arrested in mid-July planned terrorist operations against “vital installations”, and were members of cells based in Riyadh, Al-Qasim and Eastern Province. According to a report in the Saudi-owned pan-Arab daily *Al-Hayat*, the group had hidden tonnes of chemicals for making explosives in underground stores. This guerrilla treasure trove also apparently yielded a range of weapons and shells; 72kg of RDX high explosive, fuses, electric detonators, machineguns, ammunition, 18 RPGs with five launchers, night-vision goggles, communications equipment, monitoring cameras, bullet-proof vests and other equipment, forged passports and documents, SAR300,000 in cash, and vehicles which the report said “were ready for use in terrorist actions”.

The arrests brought to 140 the number of people held on terrorist charges since 17 May. Ten of those wanted as members of the gang that attacked three residential areas in Riyadh on 12 May are still on the run.

Everyone Wants a Piece Of The Qatar Base Action

It was still a secret when *GSN* first wrote about Al-Udeid air base and its potential to become the dominant US facility in the Gulf. Then came the war in **Iraq** and everyone knows about US Central Command's key facility. Not surprising then that 78 contractors have registered for the **US Army Corps of Engineers (USACE)** Millennium Village project, valued at \$60m-95m, to accommodate US troops redeployed from **Saudi Arabia**. A bid closing date – which could be extended – has been set at 20 August.

The majority of the expressions of interest came from US firms – who have an advantage under US military bidding rules as they do not have to pay the 20% of bid value surcharge imposed on foreign firms. Expressions of interest have also come from 16 local firms, three contractors from Saudi Arabia, three from **Turkey** and two from **Kuwait**. Italian company **Rizzani de Eccher**, which is already working on the base, is also included on the list.

New Kuwait Assembly Could Open Door To Reform

Economic reform looks set to dominate the early agenda for Kuwait's revamped government leadership as newly appointed Prime Minister **Sheikh Sabah Al-Ahmed Al-Sabah** considers how best to exploit post-election goodwill among parliamentarians. Early indications are that despite losses by liberal factions in Parliament, the 5 July elections have produced a National Assembly that seems readier than its predecessor to open the door to private investment – and even, perhaps, to the participation of foreign majors in the proposed \$7bn revamp of the northern oilfields.

The reshuffled cabinet includes six new faces, but the novelty of personnel changes will soon wear off. Sheikh Sabah – now appointed Premier in his own right, rather than simply standing in for ailing **Crown Prince Sheikh Saad Al-Abdallah Al-Sabah** – is under public pressure to maintain the momentum through a decisive policy lead (*GSN 714/6*).

With liberals and the *Islamic Constitutional Movement (ICM)* suffering heavy election losses, Parliament has seen an influx of pro-government independents. But the honeymoon period will be limited, and Sheikh Sabah is likely to focus at first on measures that have a good chance of winning the support of MPs and laying the basis for a constructive relationship between the assembly and the government.

Setting out the new government's programme in the inaugural Emiri address to Parliament on 19 July, Sheikh Sabah laid a heavy stress on combating terrorism and the need to "enhance positive values among the young". This provided the context for the new Premier to push a slate of economic liberalisation, bolstering the private sector and attracting foreign investment.

Although not plainly expressed, his presentation effectively left MPs to conclude that job-creating economic reform was a key tool in dispelling youthful anger and thus combating extremism. On social issues, the conservatives and Islamists will have a strong hand, dominating key parliamentary committees. While the ICM's official representation has been slashed to two members, the number of independent and tribal MPs with a traditional religious and social outlook has risen significantly. Sheikh Sabah appears in no hurry to confront conservative elements with a revived effort to grant full political rights to women (*see below*).

But when it comes to economic issues, the balance of parliamentary views is less sceptical of reform and liberalisation – and the pattern of election results for key parliamentary committees reflects this fact. While the Islamist camp has four of

the five seats on the Education, Culture and Guidance Committee and dominates the Human Rights Committee, the liberal **Abdelwahab Al-Haroun** remains chair of the Finance and Economic Affairs Committee and his allies hold five of the six remaining seats. Liberals also retained control of Foreign Affairs, with **Mohammed Al-Saqr** re-elected as Chair.

Many Islamists are sympathetic to the need for an increased private sector role in the economy, especially to generate more jobs for young people. At present, some 93% of Kuwaitis work in the public sector. But it is already well-staffed and there is little scope for recruitment.

OIL INVESTMENT POTENTIAL

There is widespread recognition of the need for increased foreign investment, even in oil, although the constitution formally bars foreigners from taking control of this key national resource. The prominent ICM parliamentarian **Dr Nasser Al-Sane** last year told *GSN* that he was not, in principal, opposed to foreign participation in the northern fields – but the details had to be right.

Energy Minister **Sheikh Ahmed Al-Fahd Al-Sabah** – whose oil portfolio has now been broadened to include electricity, itself a likely priority for privatisation or foreign investment – appears confident that international companies will soon be brought in.

Recent events back him up. In London this month, **Kuwait Petroleum Corporation (KPC)** has been holding talks with **ExxonMobil**, **BP**, **ChevronTexaco**, **Shell**, **ConocoPhillips**, **Total** and **Occidental** – all potential consortium members.

Early Moves Could Address Sensitive Issue

One interesting test of the government's nerve, and parliamentary attitudes, will come with the delicate question of the bidun – long-term Arab residents of **Kuwait** who have not so far qualified for full citizenship and its associated rights. In the Emiri address, the government listed the bidun issue among its ten initial priorities. This is an intensely sensitive subject for Kuwaitis of all political colours, arousing bitter arguments over whether and how many bidun should be accorded full nationality.

But in the debate following the Emiri address, newly elected liberal Shia MP **Dr Youssef Al-Zalzalah** nevertheless opted to raise the issue again. A specialist in education and training, he pointed out the extent to which the bidun issue is featured in international human rights reports on Kuwait. At a time when Kuwait is seeking to revive its international profile and political standing among other Arab states, this argument could carry some weight in parliamentary argument for addressing the issue early on. Interestingly, one of the Salafi Islamist MPs, **Abdallah Aqash**, has

Sheikh Ahmed and KPC believe they might be able to bring in the companies under “service agreements”, which would not infringe constitutional rules on control of natural resources. These might not require formal parliamentary approval, although it could make political sense to get the endorsement of MPs if the government wants to retain parliament’s goodwill towards the rest of its programme.

For the National Assembly, economic issues probably offer the best chance of putting forward a unified face and avoiding the stalemates and bitter wrangling that had come to characterise the last Parliament and led to alienation among voters, who dealt surprising defeats to both liberals and conservatives on 5 July.

Even so, it will not all be plain sailing. Persuading Kuwaiti voters to accept foreign investment is one thing, but inducing them to accept a reduction in

massive housing subsidies and other welfare benefits is quite another, as ministers in the last administration found out. Sheikh Sabah may well leave that thorny issue until later.

In the last assembly, the strongest opposition to economic liberalisation came from the populist former speaker **Ahmed Saadoun**. But his confrontational approach, particularly in challenging then-Finance Minister **Youssef Al-Ibrahim**, did not go down well with voters.

Saadoun came close to losing his seat on 5 July and is weakened as a political force. He had been expected to make a new bid for the speakership, but the consensus-building, pro-government incumbent **Jassem Al-Khorafi** was re-elected to the post unopposed. The shift in mood away from Saadoun’s confrontational approach is reflected in the fact that liberals or government supporters hold all but one Protection of Public Funds, a natural springboard

Reshaped Government May Spell Reforms For Kuwait

With the formation of the New national Assembly after the 5 July elections, non-royals have seen their representation significantly expanded as Kuwait’s new Premier has set about reshaping the government, sometimes in surprising fashion.

Committee chairmanships and cabinet posts point to greater accountability and a real chance to move reform measures ahead at home, including new oil deals in the North Kuwait project. But they may also indicate major moves in the foreign relations arena may be put on hold.

Strengthening the hand of non-royals are **Mohammed Dhaifallah Sharar**, appointed one of three deputy prime ministers, and long-serving ambassador to the *United Nations* **Mohammed Abulhassan**, who returns home to take over the Information Ministry.

The formal accountability of the government has been enhanced by the separation of the posts of Crown Prince and Prime Minister (*GSN 714/6*). **Sheikh Saad Al-Abdallah Al-Salem Al-Sabah**, holding both posts, was above formal parliamentary rebuke, because of his status as Crown Prince. New Prime Minister **Sheikh Sabah Al-Ahmed Al-Jaber Al-Sabah** is answerable for his performance.

In making his personnel selections, Sheikh Sabah – aware of the need to dispel popular disenchantment and transform Kuwait’s economic competitiveness – has paid little heed to traditional tribal, sectarian or ruling family balances. He has notably not “compensated” the Salem branch of the Al-Sabah for losing the premiership.

But members of the ruling Al-Sabah family retain most of the top posts, with **Sheikh Nawaf Al-Ahmad Al-Jaber Al-Sabah** returning to government as

Interior Minister and **Sheikh Ahmed Al-Fahd Al-Sabah** abandoning the Information portfolio to take on full-time responsibility for Energy.

Most royal ministers are from the ruling Jaber branch of the family. Sheikh Sabah himself is a brother of Emir **Sheikh Jaber Al-Ahmed Al-Jaber Al-Sabah**, while Sheikh Nawaf is the Emir’s other brother. Sheikh Ahmed Al-Fahd is a nephew of the Emir and Communications, Planning and Administration Minister, **Sheikh Ahmad Abdullah Al-Ahmad Al-Sabah** is also from the Jaber branch.

The only representative of the Salem branch is **Sheikh Mohammed Sabah Al-Salem Al-Sabah** (Foreign Affairs). Defence Minister **Sheikh Jaber Mubarak Al-Hamad Al-Sabah** is from neither branch. Six fresh faces have joined the cabinet, but Kuwaiti commentators seem divided over the new team’s capacity to set a dynamic tone in favour of reform. The real test will lie in their ability to achieve steady if unspectacular progress in modernisation.

A FASTER TRACK AT HOME

The new cabinet may have a smoother road ahead of it not only because of its make-up but because some much-needed steps have been taken to rationalise the government workload.

For more than a year following the Q2 02 resignation of Oil Minister **Adel Al-Subaih**, the then-Information Minister Sheikh Ahmed Al-Fahd looked after the key oil portfolio on an acting basis. But parliamentary arithmetic at the time precluded further progress on efforts to bring foreign majors into the North Kuwait project, so Sheikh Ahmed’s split attention probably made little difference.

Now that the new parliamentary climate is more favourable to this key scheme, he will concentrate

full time on the Energy portfolio – which has been widened to include electricity. His assiduous cultivation of links in tribal circles could prove useful in persuading some of the more traditional members of the national assembly to accept the entry of foreign firms into the oil and power sectors.

The Finance Ministry has been entrusted to **Kuwait Public Transport Company** Managing Director **Mahmoud Abdelkhalig Al-Nouri**. As an adviser to the Finance Committee during the last Parliament, he should be well placed to develop a good working relationship with the committee's liberal reformist Chairman **Abdelwahab Al-Haroun**. His experience of transport – which has already seen a measure of deregulation, in the bus market – may prove useful as he prepares privatisation moves.

As was widely expected, Sheikh Mohammed Sabah Al-Salem now takes on the full-status Foreign Minister's post. He had hitherto been officially only deputy, doing the job on an acting basis because the titular holder of the portfolio, Sheikh Sabah, was himself busy elsewhere, acting as premier, due to the illness of Sheikh Saad.

In recent months Sheikh Mohammed had also become acting Finance Minister, following the resignation of **Youssef Al-Ibrahim**. He has managed to unload that supplementary responsibility, but

only to find himself landed with the prickly Social Affairs and Labour portfolio on an acting basis.

This is a curious domestic assignment for a minister who has to travel a lot and whose domestic political base is regarded as relatively weak, thanks to his years in academic life and a stint abroad as ambassador in Washington. It suggests Sheikh Sabah has decided to postpone unpopular reforms in this difficult area until the government is more solidly bedded down.

Three ministers have been accorded the formal status of Deputy Premiers – Sheikh Jaber Mubarak, Sheikh Nawaf and Mohammed Dhaifallah, whose role as Cabinet and National Assembly Affairs Minister will be vital in mobilising parliamentary support for key reforms.

Sheikh Nawaf returns to government after 11 years away. His last post was as defence minister; he left in 1992 to become deputy commander of the National Guard.

The Salafi Islamist **Ahmed Yacoub Baqer Al-Abdallah** (Justice) is the only MP to be appointed a minister. The law requires that at least one parliamentarian is included in the government. In the last government – when Baqer held the Awqaf and Religious Affairs portfolio – he was one of four MP ministers. But some commentators feel that this did not work well.

Kuwaiti Women's Rights Again In Play

New Kuwaiti Prime Minister **Sheikh Sabah Al-Ahmed Al-Sabah** hurried to reassure campaigners that he would once again bring forward legislation granting women the right to vote in national elections and stand for government office. But in responding to media criticism after his appointment in the wake of the 5 July parliamentary elections, Sheikh Sabah failed to say whether a bill would be put before the first session of the new Assembly or whether it would have to wait until later in the four-year term.

Although the path ahead is far from clear, the momentum appears to be slowly shifting in favour of change. Kuwaitis are increasingly aware of the damage to their international image that is caused by excluding women from national politics. The government is under **US** pressure to push reform (*GSN 712/2*). There are even some conservative Sunni Islamists who support women's political rights, while many of those who oppose women's voting do so on social rather than religious grounds. Some have even suggested it would be acceptable, provided women had separate polling stations.

Though they do not yet have the franchise, women are not being ignored by politicians. Some candidates in the last election arranged relay microphone links for women to listen to their campaign speeches in seating areas separated from the male voters they were addressing.

Still, the road ahead will not be easy. The failure to include women's political rights among the priorities outlined in Sheikh Sabah's 19 July Emiri address to Parliament led liberal columnist **Ahmed Dien** to complain that the government was not serious about the issue. Indeed, many reform supporters argue that Sheikh Sabah could have got it through the last Parliament if he had exerted the powers of persuasion and leverage that were brought to bear on MPs over some other matters.

The portents this time are mixed. The strengthened parliamentary position of independents backed by Islamist or traditional tribal

interests appears to pose obstacles to reform. Among the Islamist factions, it is the hard-line Salafi led by **Walid Tabtabai** who have gained seats. The **Islamic Constitutional Movement (ICM)**, which was slowly becoming more open to women's rights, lost three of its five seats.

Even liberals argue that it probably makes sense for the government to concentrate initially on economic measures that can more easily command a majority in the assembly, moving on to women's rights later, once its support is consolidated. But a shadow women's election, organised by Kuwaiti journalists on polling day, captured a fair bit of attention. Unsurprisingly, it was liberals such as former Information Minister **Saad Al-Ajmi** who were favoured by the students and middle class women casting their symbolic ballots.

KEY FIGURES IN THE DEBATE

Parliamentary Speaker **Jassem Al-Khorafi** – who famously opposed reform in the last Parliament – has refrained from committing himself on his future stance. Talking to foreign journalists as Kuwaitis queued at the polls on 5 July, he complained that women had not chosen wisely in the institutions where they already have the vote. But he also commented that it was possible they would be voting in the 2007 election. He argued that while the reform had been imposed by decree in some countries, in Kuwait it would have to secure the approval of democratic institutions.

When the government does finally bring forward proposals for women's political rights, much may depend on the attitude taken by **Abdullah Al-Roumi**, the conservative MP for Deiyah, who chairs the National Assembly's Legislative and Judicial Committee. This seven-member committee has a crucial influence in deciding the priorities for parliamentary business. It has three liberal members, and three Islamists. So Roumi's view could well be decisive. Roumi is backed by the Islamists of ICM, but the liberals also feel he has sympathies for some of their policies. If the government is serious about

Restructuring Gulf Security Architecture: US Misperceptions Point To Shaky Foundation

Even before the fall of the *Baathist* régime in Iraq, US government, military and think-tank analysts were preparing themselves for a major reorientation of the Gulf region's security architecture. But the view from Washington may not be as clear as the experts would like to believe. In misinterpreting *Gulf Co-operation Council* military capabilities and perhaps over-estimating GCC cohesiveness, Washington analysts may be basing imminent decisions on a set of faulty assumptions that could have important consequences for future security architectures.

Most importantly, the USA is in danger of overestimating the numbers of forward-deployed US forces needed to maintain the local military balance, leading Washington to construct an unnecessarily heavy security architecture that is ultimately built on sand.

As well as imposing unnecessary financial costs and the strains of constant readiness on the US, a heavy-handed force posture in the Gulf could cause internal problems for the GCC monarchies (see *story below*). The presence of a large US force in the Gulf could raise the potential for domestic unrest and terrorism, and GCC governments could feel less capable of making the political and economic reforms expected by the USA while simultaneously accommodating US military basing requirements.

One of Saudi Arabia's Crown Prince Abdallah's motives for scaling down the US presence in the Kingdom was to demonstrate independence from US policy, and thereby win political elbow room to undertake painful reforms that will inevitably draw opposition from conservatives.

The USA is also in danger of overestimating GCC cohesiveness. As border disputes have increasingly been referred to arbitration or otherwise defused, the USA has increasingly come to see the GCC states as a homogeneous bloc. Gulf security models now emerging stress the potential of collective defence arrangements in which the GCC acts as a bloc. Yet trends in the region suggest that competition or even conflict is a more likely form of relationship than co-operation between GCC states.

As *Brookings Institution* fellow and former *Central Intelligence Agency* analyst Kenneth Pollack recently noted, Washington analysts have identified two basic security frameworks that could facilitate a lighter US military presence in the Gulf.

The first is a Gulf Arab version of *NATO* – a successor to the 1954 Baghdad pact (which linked

Iran, Iraq, Pakistan, the US and the UK) or the 1958 CENTO pact (which included Iran, Pakistan, the USA and the UK but omitted Iraq). The probable aim, Pollack told *GSN*, would be to keep “Americans in, Iranians out, and Iraq down”.

The second model for Gulf security being considered in Washington would establish a “regional security condominium” that would more closely resemble the processes undertaken by NATO and the Warsaw pact at the end of the Cold War – things like the *Treaty on Conventional Forces in Europe*, the Commission on Security and Co-operation in Europe, and the Mutual and Balanced Force Reduction measures.

This model of Gulf security would be far more inclusive than a NATO-style alliance, including states such as Iran and Yemen instead of identifying them as the threatening adversary required to provide a central mission for the organisation.

A Gulf security condominium would focus on engagement and confidence-building measures such as notification of exercises and exchange of observer personnel. Arms control measures might include demilitarised zones, the balancing of defensive forces, and moratoria on destabilising arms and eventually weapons of mass destruction (WMD), perhaps even creating a sub-regional Gulf WMD-free zone. But these models indicate the US security establishment has very little faith that Gulf states will develop a stable military balance if left to their own devices.

In the early 1990s, the USA still believed that capacity-building could make GCC states able to defend themselves individually, and then allow them to develop a collective defence structure, giving them a degree of independence from Western security guarantees. In the mid-1990s, however, the USA came to believe that it was easier and perhaps cheaper to develop its own military presence and deterrent capability in the region than it was to develop indigenous GCC capabilities.

The neutralisation of any military threat posed by Iraq arguably occurred in the mid-1990s, and is now undeniably a reality “for the next five to 15 years,” according to Pollack. That being the case, the US government will find it harder to justify the deployment of major forces in the Gulf for prolonged periods.

Though some additional costs are incurred by maintaining forces in the Gulf rather than elsewhere, the real incentive to reduce forward presence will be the human costs. Military planners

will seek to ease the deployment burden on US personnel and their families, making the use of US forces to substitute for regional militaries a less sustainable option.

DISCOUNTING REGIONAL MILITARIES

Unfavourable perceptions of GCC military capabilities have ossified in US political and military decision-making circles, based on the image of Gulf Arabs as effete and incompetent in military force design and maintenance, and in operational planning and execution. But a more realistic assessment finds that Gulf forces are more evenly balanced than might be expected.

New military capabilities in the GCC are slowly building, whether Washington notices it or not. GCC militaries have not have completely mirrored the advanced "system of systems" being designed in the West. US analysts have often judged the GCC states against this benchmark, projecting their own requirements onto Gulf militaries. A more realistic appraisal of regional militaries would note that capabilities are growing rapidly in a number of fields. With new capabilities comes the impetus to develop plans, and with plans come options. Each of the GCC states has quietly increased its military options throughout the 1990s and will continue to do so.

The US assessment of the Gulf military balance has also been overly land-centric and somewhat conventional since the 1990s, focusing on elements such as Iraqi armoured divisions and other threats that have either palpably dissolved or are now less likely to come into play. A new assessment of the military balance could focus on more plausible conflict scenarios such as coercive strikes on oil export infrastructure during periods of diplomatic crisis or other such unconventional uses of force.

In this kind of military planning, simply adding up numbers of weapons and men becomes considerably less important. A careful analysis shows that the playing field is far more level than might be anticipated among Iran, Saudi Arabia, and individual small GCC states.

Completed and planned purchases of anti-shiping cruise missiles, advanced long-range strike aircraft, and mine-laying equipment give even the smallest states an ability to launch heavy strikes against oil infrastructure and other targets.

The proliferation of satellite-guided weapons now beginning in the Gulf suggests that fixed oil infrastructure will be vulnerable to strikes from even the smallest adversary. With oil, insurance and shipping markets highly sensitive to any threat to free navigation of the Gulf, even small states can now cause major market repercussions with their indigenous military capabilities, creating a degree of mutual threat or deterrence that never existed before in the Gulf.

Among notable developments, **Bahrain** has advanced highly accurate surface-to-surface

missile systems capable of filling any football stadium-sized area with explosive bomblets without warning. Even a small state like **Qatar** has invested in advanced long-range strike capability through its Mirage 2000-5 fleet, which can safely lob air-launched 150km **Matra** Black Pearl cruise missiles at fixed targets on the Gulf coasts of Bahrain, Saudi Arabia or Iran, or fire Exocet missiles at their tankers.

OVER-ESTIMATING GCC COHESION

Washington has long identified three political poles in the Gulf – Iran, Iraq and the GCC, which it has treated as a cohesive unit. But ambitious GCC states like the **UAE**, **Oman** and **Qatar** are developing more independent economic and political policies that have begun to lift them out from beneath the shadow of Saudi hegemony. The motives and intentions of these states may not be as easy to predict as they were in the past.

The UAE, for instance, has a major interest in maintaining stability in the region, including its trade with Iran. Yet it is building amphibious and air forces that will give it the capability to recover the Iranian-occupied Abu Musa and Tunbs islands by the end of the decade with a high degree of confidence. Will this capability modify previously peaceful UAE intentions? Will the UAE use this issue to underline its growing profile in the region?

Similarly, could Qatar's maverick foreign policy one day include military posturing over the disputed areas on its border with Saudi Arabia?

Such prospects are not lost on the defence business community in Washington, who are looking at breaking the more moderate GCC states away from Saudi association, and are basing their long-term marketing efforts on the concept of the "GCC minus one" – that one being Saudi Arabia. By convincing the US Congress that the smaller GCC states do not present the same terrorist or Islamist risk as Saudi Arabia, they hope to lift barriers to future arms sales, creating a new perception of "moderate Gulf Arab states".

In many ways, such defence contractors are closer to the smaller GCC states' views on security than is the US government. GCC states have shown a preference in recent years for the quiet development of real airpower-led capabilities and for bilateral security agreements with the USA and other security guarantors.

The reason, put simply, is that they do not share a common threat assessment or entirely complementary economic goals, and do not trust each other or the concept of regional collective security. This will make the development of a Gulf Arab 'NATO' very difficult, and indeed the concept is not popular among GCC decision-makers, according to *GSN's* soundings of Washington military attaches. Equally, the diverse views of GCC states will complicate the development of an inclusive GCC security condominium that must, by its nature, include Iran.

Washington's Mission And The Balance Of Power

As US military and government analysts begin to address developments in Gulf security, they will be weighing the military and non-military threats throughout the region against the mission the USA imagines for itself in the Gulf. For the time being, the USA will be unlikely to scale back its military presence without some development it perceives as counter-balancing such a move. But the military and political relationships among the Gulf states – as well as non-traditional threats such as terrorism and radical Islam – present a complex picture that Washington's stark view of the region may be hard-pressed to take into account.

As democratic civil society develops, the political environment in the GCC region has grown more complex. History suggests the process of reshaping the region's states will be accompanied by nationalistic tensions, posturing and inter-state clashes. Although issue resolution through arbitration and negotiation has enjoyed some success, there is ample evidence that once issues become politicised, they quickly become resistant to non-violent resolution (as with the Iranian-occupied Tunbs islands and Abu Musa). In such cases, the military balance of power represents a key bargaining chip.

Regional military balances are dynamic, based as much in perception as reality, and require constant attention. The perceived capabilities and intentions of one actor may affect the ambitions and fears of another in a classic security dilemma.

The fluid, incrementally changing balance of power in the Gulf, particularly within the GCC, also involves long-term shifts of perception in identifying regional leaders, influenced by issues such as the contribution of forces during the resolution of crises and the relative willingness of certain states to back their words with actions. When measuring military capabilities, the devil is in the detail, and gaining an accurate insight into capabilities is complicated by the sensitive nature of the information and the tendency of regional actors to either exaggerate (Iran) or downplay (the GCC) their capabilities. Yet while the military balance may be difficult to measure, although currently stable, the USA and other Western security guarantors would be well advised to carefully watch for emerging imbalances that could destabilise the area.

Even casual observers are now aware that non-military threats to national security have gained prominence and effectiveness. Environmental and internal security is now threatened by illegal immigration, maritime incidents, terrorism, radical Islam, and popular dissatisfaction caused by political and economic stagnation.

Against this background, many analyses have argued that traditional military threats to Gulf

states and to Western business, security, and political interests there have receded. Though correct in relative terms, this view understates the importance and difficulty of maintaining a stable military balance, thereby preventing further military adventurism by powers great and small.

How Washington addresses the question of maintaining military balance in the Gulf remains to be seen, but decision-makers and analysts do seem to have reached consensus on one issue: that the region's stability remains a vital US national security interest, that Washington will be loath to leave in what it sees as unqualified hands.

Despite growing concern about an over-extended military, senior National Security Council decision-makers told GSN a withdrawal of US troops from the Gulf would leave a security vacuum that Washington is not willing to tolerate.

They noted that while the UK could withdraw from the Gulf in the early 1970s secure in the knowledge that the USA would step in, there was no such expectation that a friendly power would fill the vacuum a US withdrawal would leave.

The 1990 invasion of Kuwait was deemed to have shown that an "over-the-horizon" military presence could not deter determined regional aggressors. With most of the costs of developing basing infrastructure paid, and relatively minor costs incurred by keeping bases "warm" and ready for rapid reinforcement, a US military presence in the Gulf is a *"sine qua non"*, in the words of a recent RAND Corporation issue paper.

The subject under consideration in Washington is instead how US forces' presence and visibility, the strains on personnel and costs of deployment, can be reduced, while maintaining an acceptable and stable regional military balance (see above).

The USA is unlikely to scale back until a satisfactory new security arrangement is found. The most obvious answer may be the one least obvious to government analysts: continue on the present path, retain faith in building individual GCC states' self-defensive capabilities and maintain the bilateral security guarantees popular with Gulf leaderships.

If the US presence is to be reduced in favour of a GCC-centric security structure, this approach would require a shift away from risk avoidance strategies that call for a major forward presence and other deterrent capabilities. A new outlook for managing military risk would place more emphasis on GCC forces, and would require a reassessment of the regional military balance that considers more plausible conflict scenarios, rather than the medium-theatre war scenarios that dominated US Central Command thinking throughout the 1990s. Though it would take some significant shifts in perception to achieve, this more delicate balance might be the best option in a region that arguably no longer boasts any excessively acquisitive or irrational aggressor states.

Saudi Gas Deals Start Flowing In Wake Of Geopolitical Moves

Denuded of the messy downstream baggage, the surprise deal patched up between **Royal Dutch/Shell, Total** and **Saudi Aramco** in mid-July on the Rub Al-Khali (Empty Quarter) field could spell a new round of oil and gas deals in the Kingdom. The move caps five years of lamentable stop-start "progress" on the \$25bn core ventures (CV) project, and was followed by a meeting with London of 41 international oil companies (IOCs) to peruse a hastily repackaged series of Saudi assets salvaged from the unbid portions of the South Ghawar (CV1) and Red Sea (CV2) projects.

Details of the proposals had not yet emerged as *GSN* went to press, but the mood music, for once, appears positive. Three specific gas projects, each with an area covering 30,000-50,000km², will be offered in the Kingdom's first-ever licensing round, said Oil Minister **Ali Al-Naimi** on 21 July, with more to follow in future. Rates of return, he teased, would be "high".

Despite the failure of the core ventures project as envisaged at its inception five years ago, Naimi has demonstrated a renewed urgency to start divvying up exploration packages. The timing of the licensing round is hasty, at least by Saudi standards. Normally the summer months afford the Saudis an opportunity for lengthy R&R exploits in more temperate climes. This August will be different. Bid packages, consisting of draft agreements and other fiscal terms, will be disbursed to companies over the next two months, with a mid-September deadline.

STYLE AND SUBSTANCE – OR JUST POLITICS?

The Empty Quarter deal – basically the upstream portion of the former Shaybah CV3 – granted the two European majors a vital toehold in the vaunted Saudi upstream, to the undoubted chagrin of **US** giants formerly in the chase, including **ExxonMobil, ChevronTexaco, ConocoPhillips** and **Marathon Oil Company**, who have now been left out in the cold.

The symbolic significance of two non-**US** majors striking the first upstream hydrocarbons deals in the Kingdom for more than 30 years will not pass unnoticed in Washington or Riyadh. The timing of ConocoPhillips' massive \$5bn **Qatar** liquefied natural gas deal is doubly telling. The USA has shifted its military operations to Qatar; coincidence or not, its major corporate standard bearers now appear to be following suit.

Senior analyst at the Washington-based **PFC Energy Fared Mohammedi** detected a souring in US/Saudi corporate relations behind the US majors' absence, pointing to friction in "style and substance" even if it might not be geopolitical in nature.

Naimi – in his new guise as an energy reformist in the mould of **Algeria's Chakib Khelil** – remains convinced that his newly spliced and diced gas initiative package is an attractive one. The 41 companies attending the London roadshow on 21-23 July may need more time to digest the details before they concur.

Deals in the pocket, **Shell** and **Total** have a head start over the rest of the herd – though **Total Gulf** chief **Alain Lechevalier** was present at the London meetings, suggesting the **French** company still has the scent of more Saudi assets in its nostrils. **Shell** looks to be sated by its exposure, however. **Shell's** Saudi country chairman **Floris Ansingh**, one of the more prominent movers and shakers behind the gas initiative in the past three

years, told reporters at the London event that it would likely not bid on the assets on display there.

OPENING PANDORA'S BOX

The new gas projects on offer are considerably more straightforward than past deals, peeling off the utility and petrochemical elements that the majors balked at first time around. Gas-to-infrastructure, to the IOCs' relief, is out. Condensates will be included in the new projects, Naimi said, though natural gas liquids (NGLs) will be prioritised for domestic use. This may prove a long-term tempter for IOCs, as Naimi suggested the winning bidder may eventually be allowed to export their gas – a tantalising prospect given the likely scale of untapped gas reserves. The prospect of a gas-rich kingdom following Qatar's export-led route is one that will whet the appetites of many an IOC.

For now, gas prices will make few new millionaires. Naimi confirmed that prices would remain at the state subsidised \$0.75/m Btu level – highly uncompetitive by global standards. But if the Saudis abide by their promise to lift the shackles imposed on NGL exports such as naphtha, propane and butane, such concerns would be no doubt be put on the back burner.

The landmark July deal sees **Shell** taking a 40% stake in the pure exploration contract covering 200,000km² of the Rub Al-Khali, with the remaining interest held equally by **Total** and **Aramco**. The current deal is a shadow of the ambitious \$5bn Shaybah CV, both in terms of value and scale, having been stripped bare of the water, power and petrochemicals plants.

But this will not perturb shareholders at the two majors – if anything, the contrary. Hiving off the downstream components will have sweetened the pill for investors. That the deal is not the same one thrust on a reluctant **Shell** in September 2002 – when it evoked a lukewarm response to the uncompetitive rates of return on offer – is all to the good for the foreign partners. While it's unlikely that the rates of return are that much better this time around – lips remain tightly sealed on this count – shareholders will be prepared to take a one-off hit if it succeeds in prising open the Pandora's box that is Saudi hydrocarbons.

CONOCOPHILLIPS PREFERS QATAR

The concern on internal rates of return (IRRs) may have played a part in ConocoPhillips' surprise decision to back out of the deal. The US major is understood to have withdrawn at the eleventh hour, precipitating **Aramco's** hasty entry to the project. Speculation has been rife over the reasons for ConocoPhillips' departing the fray, with its \$5bn commitment in Qatar's LNG project possibly a major factor. But like **ExxonMobil**, ConocoPhillips chiefs also took a hard line on rates of return.

The consensus among analysts is that the Saudis were offering below 12%, which is well below the normal IRRs sought by oil companies on a venture of this kind. Political risk worries will also have come into play – though Saudi negotiators and IOCs are sticking to the line that the deals stand or fall on the economics, Riyadh bombings or not.

GSN Risk Grade – D-/3: Security concerns hurt political outlook, undermine reconstruction

Political And Social Developments

Overview: The security situation remains tense. Sporadic violence from “Saddam loyalists” has not waned as the USA had hoped, despite the capture of around 36 of the regime’s top officials. The killing of Saddam’s sons Uday and Qusay will renew such hopes. The UN has proposed areas where it can help but has reiterated the occupiers’ responsibility for civil order and administration until a new government is in place. Despite the creation of a broadly representative Governing Council, the security situation has prompted GSN to downgrade Iraq’s political Risk Grade to D-.

Government: The 25-member interim Governing Council is involved in all major decisions, although the Coalition retains the right of veto. One of its first tasks will be to appoint a Constitutional Council to draw up a constitution and propose a date for democratic elections. The Governing Council will help name new ministers and determine the budget for 2004.

Political splits: There are signs of a Shiite mass movement developing, countered by divisions between key leaders such as Supreme Council for Islamic Revolution in Iraq leader Ayatollah Mohammed Bakr Al-Hakim and Muktada Al-Sadr, whose unruly supporters have confronted US troops in Najaf.

UN/NATO role: UN Secretary General Kofi Annan has urged the Coalition to publish a timetable for democracy and has produced a blueprint for UN support; areas include the constitutional process, judicial and legal reform, police training, demobilisation of the armed forces, public administration, economic reconstruction, sustainable development and advisory services to Iraqi ministries. A 300-strong UN Assistance Mission will help. NATO is providing technical and logistical support to a 9,200-strong multinational force led by Poland that will operate in central and southern Iraq from 1 September.

Weight of evidence: The USA and UK are under pressure to show concrete evidence of Iraqi weapons of mass destruction, with awkward questions being asked about the legitimacy of intelligence assessments and David Kelly’s death prompting a new political crisis in the UK. Evidence of huge human rights abuses have been found, but this was not the *casus belli* behind the invasion.

Economic Outlook

Overview: Oil revenues and aid are expected to see Iraq through 2003-04, but basic reconstruction issues must be resolved. An initial \$1bn Development Fund will be fed by hydrocarbon revenues. Independent public accountants will act as auditors, with advisory and monitoring board including representatives of UN, IMF and World Bank. Oil production still low. Creditors busy collecting data on estimated \$100bn-\$200bn debts (excluding reparations). Such unresolved issues lead GSN to hold Iraq’s economic risk grade at 3

Financial restructuring: Priorities include unification of Iraq’s dual exchange rates, restoration of the banking system, and tackling inflation (60% pre-war). A fully dollarised economy has been rejected; new Iraqi dinar banknotes will be available in October. The IMF says it will initially provide technical assistance and advice for priority areas such as core economic systems (basic budget planning and execution, central banking and payments systems), monetary policy options, a macroeconomic policy framework for stability and growth, and diagnostic studies for financial sector institutions.

Oil industry: Oil production hit 1m b/d in mid-July. The US Energy Department forecasts production of 1.5m b/d in the fourth quarter, but a return to 1990 output levels of 3.5m b/d may take two years. Oil is being sold on spot tenders. The move to term contracts will require production sustainability, itself dependent on power supply levels; emergency generators are to be installed at the Basra refinery. Around 6m bbls of crude has so far been exported from southern Gulf terminals. Control of Iraqi oil is a thorny, unresolved issue. Former Shell Oil chief executive Philip Carroll heads a coalition oil advisory team, including members drawn from former Iraqi officials.

Debt and compensation: Paris Club government creditors don’t expect repayments before end 2004, and estimate total public debt to its members at \$21bn in principal plus a similar amount of accrued interest. A moratorium has been declared on all claims relating to the hydrocarbons sector until the end of 2007. Iraq has about \$82m in debt to the World Bank, and a technical debt to the IMF of around \$72m in Special Drawing Rights. IMF collecting data from non-Paris Club creditors and sent a fact-finding mission to Baghdad in June.

IRAQ: Key Projects

OIL SECTOR: US Army Corps of Engineers overseeing rehabilitation. Some estimates place long-term rehabilitation costs at \$20bn. USACE says at least \$1.7bn required to return production to pre-war levels. Bids expected mid-August for two \$500m hydrocarbons infrastructure contracts in the north and south of Iraq. These will replace an emergency management contract controversially awarded to Kellogg Brown & Root in March.

WEST QURNA OIL FIELD: Russia’s Lukoil has 68.5% stake in the second stage development of the giant field (partners include Zarubezhneft, Machinoimport and Iraqi Oil Ministry). The USA has questioned the validity of the contract (which terminates in 2020) but UN envoys suggest that the terms of Security Council Resolution 1483 mean long-term oil contracts can only be renegotiated when a permanent Iraqi government is in place.

ELECTRICITY: USAID estimates post-war generation capacity of 2,000MW vs 5,000MW before the war. Bechtel is responsible for rehabilitation. Transmission and distribution are priorities. USAID’s contract requires restoration of power to 75% of pre-1991 levels (around 9,000MW) through rehabilitation of 10 power plants. An estimated 6,000MW of new capacity will be required over the next three years.

MOBILE TELECOMS: A request for proposals is due 27 July for three mobile telecom licences covering south-east, central, and northern Iraq. Licences are for installation and operation over initial 24-months, with option to become full national licences at a later date.

GSN Risk Grades

The GSN Risk Grading is based on GSN’s assessment of the outlook for political and payments stability. The political outlook is reflected by a letter rating, where A is most stable and E least. Payments conditions are represented by a number: 1 is most favourable and 5 least. + or - represents a slightly higher or lower than average score.

IRAQ: Selected Economic Indicators

(\$ m unless otherwise stated)	1998	1999	2000	2001
Domestic economy & finance				
GDP (ID bn)	1,391.8	1,925.0	2,290.8	–
Total consumption (ID bn)	1,133.6	1,561.8	1,768.2	–
External situation				
Current account balance	–	2,018	–	1,031
Exports fob	7,417	12,750	20,603	15,905
of which: oil	7,063	12,143	19,622	15,148
Crude exports (‘000 b/d)	1,795	2,203	2,243	2,030
Imports	3,991	6,886	11,153	11,000
Trade balance	3,426	5,864	9,450	4,905
Current account/GDP (%)	–	9	–	4

Source: Arab Monetary Fund (domestic); World Bank (external).

GSN Risk Grade — B-/2: With reshaped government, new PM holds hope for reform even for oil

Political And Social Developments

Overview: There is new hope of reform following the 5 July national assembly elections and changes in government, most notably the appointment of former Foreign Minister Sheikh Sabah Al-Ahmed Al-Jaber Al-Sabah as Prime Minister. The government says it will prioritise the economy and the fight against terrorism while Sheikh Sabah has confirmed that a bill will be sent to parliament dealing with women's political rights. Increased levels of co-operation from the new national assembly will be vital to prevent the kind of impasse suffered during the last parliament. The ruling Al-Sabahs appear the biggest winners of the elections, but many Kuwaitis have expressed disappointment that the new government does not include more non-family technocrats, leading GSN to hold Kuwait's political risk grade at B-.

Government: Sheikh Sabah's elevation to premier split the function from the role of the Crown Prince and formalised a job he has effectively been doing for the last couple of years due to Crown Prince Sheikh Saad's ill health. Notable changes include Sheikh Nawaf Al-Ahmed Al-Sabah's appointment as Interior Minister, while the Oil Ministry has been merged with the Ministry of Electricity and Water and entrusted to Sheikh Ahmed Al-Fahd Al-Ahmed Al-Sabah, the previous information minister and acting oil minister. Of the major portfolios, only Finance Minister Mahmoud Al-Nouri is a non-Sabah.

Parliament: Estimates are that the number of pro-government MPs has risen to 30 (out of a possible 50), from just 15 in the outgoing parliament. The biggest losers were liberals, victims of obvious voter dissatisfaction. Almost half of the incumbent MPs failed to be re-elected while turnout was only 45%. The Sunni Islamic Constitutional Movement also lost seats, although overall, Islamists fared well. Jassem Mohammad Al-Khorafi has been re-appointed speaker, with Mishari Al-Anjari his deputy.

Security: The government has pledged to continue the fight against terrorism, while a stable and prosperous Iraq is seen as important for future security. Security services continue to be very vigilant and the justice system has processed those accused of terrorist links very quickly. In June Sami Al-Mutairi was handed a death sentence for shooting two US civilian contractors in January.

Economic Outlook

Overview: New Prime Minister Sheikh Sabah has pledged to prioritise economic issues such as private sector development and foreign investment. New privatisation efforts are expected. Project Kuwait, the much delayed development of the northern oil fields with foreign equity participation from IOCs, should be a priority. A new relationship with Iraq is expected to bring economic benefits, and some hope of eventual repayment of \$10-20bn in debts. While macro position remains strong, concerns remain over housing and unemployment, and non-oil sector growth needs to be addressed. Concerns have also been expressed about state fraud and bad loans in the banking sector. All this leads GSN to hold Kuwait's economic risk grade at 2.

Finances: The 2003/04 budget passed in late June is based on a very conservative oil price of \$15/barrel and envisages a deficit of KD2.27bn (\$7.578bn), with revenues of KD3.55bn and expenditure of KD5.8bn. The National Bank of Kuwait predicts, however, that higher oil prices would push revenues to KD5bn-6bn and could even produce a small budget surplus. The Kuwait Stock Exchange is still performing well despite signs that a correction is on the way. Traders say the index has fluctuated heavily over the last few weeks during daily trading. It peaked at around 4,000 points on 21 June.

Iraq: A task force of top officials headed by Foreign Minister Sheikh Mohammed Sabah Al-Salem Al-Sabah has been formed develop relations with Iraq, including of economic links. Task force members include representatives of the Kuwait Investment Authority (KIA), Kuwait Petroleum Company and the Kuwaiti Fund for Development. The task force is expected to initially focus on practical issues such as border/customs issues and development aid. Government sources have stressed that recouping Iraq's debt to Kuwait (officially put at \$11.5bn but possibly higher) is not an immediate priority.

Liberalisation: A new four-year plan, privatisation bill, subsidy cuts, service fee increases and sales tax have been mooted as goals for H2 03/Q1 04. Development of the relationship between the government and national assembly over the next few months will be crucial in determining the pace of change. The KIA announced in early July that it is postponing indefinitely the sale of the state's 35% stake in Kuwait Cement.

CO-OPERATION OR CONFRONTATION?: The new government should have a honeymoon period of around six months in its relationship with the National Assembly and will need to exploit this time well. While the Assembly is considered to be more pro-government than the previous one, which proved no friend of reform, the absence of political parties and cohesive voting blocs means its true nature will only be revealed in time. Both liberal and Islamist blocs claim the support of a number of "independent" MPs.

KUWAIT: Selected Economic Indicators

(KD billion)	2000	2001	2002	2003p ¹
Exports	5,962.7	4,969.7	4,683.2	4,680.4
Of which oil and oil products	5,578.3	4,590.8	4,276.7	4,286.9
Imports	2,195.4	2,413.3	2,720.0	2,296.8
Trade balance	3,767.3	2,556.5	1,963.2	2,383.6
Current account	4,501.0	2,553.0	1,282.0	1,841.8
Real GDP (% change)	1.4	-1.1	-0.9e	2.0
Consumer price index (annual % change)	1.02	1.02	1.01	-

p – projection e – estimate

1\$ =0.332 Kuwaiti Dinars

Source: Central Bank of Kuwait, IMF.

Kuwait: Key Projects

PROJECT KUWAIT: The \$7bn scheme to develop oil fields near the Iraqi border is much delayed but a renewed push is expected from the new government. In anticipation, Kuwait Petroleum has invited eight international oil companies to submit proposals by 1 September. The project is an integral part of plans to raise oil capacity to 4m b/d (from 2.4m-2.7m b/d).

GAS PIPELINES: Finalisation is awaited for two gas import pipelines, one from Iran to supply 15m ft³/d over 25 years and one supplying an initial 750m ft³/d volume (rising to 1.4bn ft³) of Qatari North Field gas to local power stations from 2005-06. The Qatari gas pipeline has been delayed by the need for formal approval to pass through Saudi waters.

OLEFINS II: Petrochemical Industries Co. and Dow Chemical Co. announced plans for a new ethylene and derivatives complex at Shuaiba in May. It will have an 850,000 t/yr ethane cracker and 600,000 t/yr ethylene oxide/ethylene glycol plant, for start-up in 2007. A 300,000 t/yr ethylbenzene/styrene unit is planned using ethylene from Olefins II and benzene from PIC's aromatics facility.

POWER STATIONS: Siemens Power Generation Group was awarded a E280m turnkey contract in May to construct a 1,000MW gas-fired plant adjacent to the existing Al-Zour South plant. Completion scheduled for 2005. Progress expected soon on Al-Zour North project, with Parsons Brinckerhoff as consultant. Energy Ministry has long seen developing the 2,500MW, 125m g/d desal plant with private equity as a build-operate-transfer project.

MIDDLE EAST ENERGY

POLICY, RISK AND PROJECTS IN THE GULF AND LEVANT

IRAQ: New Oil Minister?

Officials representing the new Governing Council hinted that a new oil minister could be appointed in the coming weeks, along with a number of other senior ministers. **Adnan Pachachi**, the Sunni former foreign minister who headed the three-member delegation which visited the *UN* on July 22, said various ministers including the oil minister would be named. Acting oil minister **Thamer Ghadhban** is not tipped by insiders to stay in the top job, who say his *Baathist* credentials will ultimately weigh against him.

IRAQ: SOMO's First Term

Iraq's *State Oil Marketing Organisation (SOMO)* said on July 22 it was negotiating its first term oil contracts with end-users since its invasion of **Kuwait** in 1990, but at lower volumes than expected given the failure to reach pre-war production levels. SOMO said it was negotiating Basrah Light term contracts with refiners for the period 1 August to 31 December, an indication Iraq's oil managers were confident export volumes of Basrah Light crude would be generated over the next few months. SOMO has only issued two crude tenders since the war, one in June for 8m barrels held in storage during the conflict and one in early July for 8m bbls of post-war production from the southern Rumaila field. Current output stands at around 800,000 b/d. Exports from the northern Kirkuk fields have been curtailed because of urgent repairs to the pipeline carrying crude to the Ceyhan export terminal in **Turkey**.

IRAN: Brazilians Line Up For Upstream Deals

Petrobras, Brazil's state oil company, is to take part in license offerings organised by the *National Iranian Oil Company*, adding another market entrant to the Iranian oil upstream. Petrobras has already bought a seismic data package for the onshore oil areas. Previously, it had said it would only consider development of oil fields in partnership with other companies.

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Iran Feels The Summer Heat As Attractions Wane

Under pressure from the USA on its nuclear programme and from IOCs on unattractive contract terms, Iran is struggling to develop existing fields and new finds without making too many strategic compromises.

With the Islamic Republic making international headlines for all the wrong reasons this summer, the Iranian government is keen to take the heat off by pressing ahead with new oil and gas deals with international oil companies (IOCs). One industry source suggests two major deals may soon be inked. But without improved terms, Tehran will find it difficult to make much headline-grabbing progress, according to Western oil executives interested in Iran.

A dramatic new reserves find will steel the Oil Ministry's nerves. *National Iranian Oil Company* subsidiary *Iran Oil Development and Engineering Company* announced a major new discovery in mid-July consisting of three fields with reserve estimates of a total 38bn barrels of heavy sour crude.

The discovery has given a fillip to the oil sector, which has seen the rapid exploitation of Gulf gas reserves steal the limelight in recent years. But it remains to be seen how quickly Tehran will be able to turn the find to its advantage.

Most IOCs find Iran's current terms for development deals onerous. But US political pressure on Tehran could be just the leverage IOCs need to prompt a change in the ground rules under which the Iranian authorities are

willing to do business.

The USA stepped up diplomatic pressure on the Islamic Republic after the crackdown on recent large-scale anti-government demonstrations, the release of a highly critical report by the *International Atomic Energy Agency* on the country's nuclear programme, and Tehran's admission in early July that it had test-fired the long-range Shihab-3 ballistic missile.

US lobbying in Tokyo is also understood to have put pressure on Iran. A **Japanese** consortium considering participation in the development of Iran's giant Azedagan onshore field recently failed to confirm its participation in the project. The USA is said to have had a hand in this decision.

One industry insider said he still believed the deal would eventually go ahead, though the Japanese government, with its own concerns about **North Korea's** nuclear and missile programmes, may need further convincing that Iran is not developing new and deadlier weapons. The Azedagan field is one of the world's largest undeveloped oilfields, with reserves of 3bn-6bn bbls.

Iran is also still subject to the *Iran-Libya Sanctions Act* passed by Congress in the mid-1990s. Its effect, however, has been simply to bar US companies and

discourage non-US companies that have a major presence in the US market. **French, Italian, Russian** and Asian majors have struck a number of deals with Iran since 1997. The main IOCs in the country are now **Total, Eni** and **Shell** in oil, and **Total, Malaysia's Petronas**, Russia's **Gasprom** and **Statoil** in gas.

The IOCs' main gripe is the standard terms of current agreements. Iran deals on a buy-back basis under which IOCs bid a development cost and a profit margin on proven reserves. This, according to a recent **Deutsche Bank** report, generally results in a return of 15% to the companies, compared with a global average of over 20%, and nearly 25% in **Libya**.

Furthermore, the companies do not own the reserves and are paid out of production proceeds. The other major drawback is that agreements tend to last only seven to eight years rather than the 15- to 20-year industry norm, resulting in the need to constantly negotiate new agreements to maintain revenue streams. Companies have invested, however, on terms that in other countries would be considered uneconomic with the view to establishing a relationship that will pay dividends in the longer term.

"It's a style of contract that hasn't worked well," one Western upstream consultant told **MEE**. "They have not been fantastically attractive to foreign investors. There are, however, murmurings that one or two big deals are about to be signed on the **Bangestan** and **Azedagan** fields."

TOPPING UP

The Iranian government is said to be in a rush to sign new deals as evidence grows of depletion in existing oilfields and a pressing need to develop its vast gas reserves in the **South Pars** field it shares with neighbouring **Qatar**, where it is known as the **North Field**.

The new find may change the picture somewhat, giving **Tehran** new opportunities for development deals and perhaps new leverage. But enthusiasm will be tempered by the density of the crude, which makes it less valuable on world markets than most of Iran's 90bn bbls of proven reserves. Commercially recoverable reserves will also be much less than the 38bn bbls in place.

The three fields are located in the south of the country near **Bushehr**. They comprise **Ferdowsi**, (with estimated reserves of 30.6bn bbls), **Mound** (6.6bn bbls) and **Zagheh** (1.3bn bbls).

While **Tehran** puts the country's oil production capacity at 4m b/d, compared with an **OPEC** quota of 3.6m b/d, some industry observers suggest capacity is nearer 3.6 b/d and could fall to around 3m b/d unless new production comes on-stream.

The signing of an agreement on the **Azedagan** field would be critical. US pressure could prompt Iran to grant more favourable terms to the Japanese-led consortium, consisting of **Japan National Oil Company, Indonesia Petroleum,**

Japan Petroleum Exploration Company and **Japan's Tomen Corporation**, as well as possible involvement by **Shell**.

Negotiations on the **Bangestan** project (with 600m bbl reserves) have also run into trouble and appear no further advanced than they were in Q1 03. **Royal Dutch/Shell, Total** and **BP** all submitted bids to develop the blocks on offer.

BP's participation is seen by some as a key test of the government's commitment. While BP played a key historical role in the development of Iran's oil industry, its large presence in the US market has in recent years made it wary of attracting criticism in Washington. Its return to the Iranian scene should enhance the country's position *vis-à-vis* potential long-term customers.

The three companies are reported to have been given provisional agreements but – surprisingly – no deadlines to submit responses. This is a clear sign that gas, rather than oil, is the government's top priority, say some oil industry sources.

THE LNG RACE

In gas, **Qatar** has been pulling ahead with production and export marketing deals (**GSN 714/16**) and Iran is clearly worried about being left behind in the hunt for long-term creditworthy export customers. **Doha's** liquefied natural gas (LNG) push will see exports hit 14m t/yr this year, almost doubling to 25m t/yr by 2005.

Iran is reportedly negotiating new LNG agreements with **BG, BP, Repsol, Shell** and **Total** for the **South Pars** phases 9-12, which will require an estimated capital investment of \$3bn. **Total** has said it aims to market the gas in the Far East. A recently announced gas deal between **Tehran** and **Delhi** for the supply of natural gas appears to have put the **BP, BG** and **Shell-led** consortia in a strong position. **BP** has teamed up with **India's Reliance**

Gulf Currency Box

	\$	£	€
Bahrain	0.3770	0.6020	0.4269
Iran	8230.0	12,968.2	8984.61
Iraq	0.3110	0.4998	0.3559
Jordan	0.7090	1.1393	0.8113
Kuwait	0.2998	0.4818	0.3431
Oman	0.3850	0.6188	0.4243
Qatar	3.6400	5.8491	4.1654
Saudi Arabia	3.7502	6.0262	4.2915
Syria	46.000	73.9174	52.6378
UAE	3.6730	5.9021	4.2032
Yemen	178.005	286.036	203.691

Source: Financial Times.

group and BG claims to have the marketing agreements already worked out.

A major drawback with the **Indian** option is that finance may be more difficult to obtain due to India's default on a sovereign guarantee on the **Enron**-owned electricity generating plant in the state of Maharashtra two years ago.

Another sticking point has been the determination of the IOCs (with the exception of BG) to link downstream proposals with upstream projects, which they say will result in major savings. So far, the Iranian side has suggested only limited integration, such as upstream work and on-site utilities. The IOCs say this is not enough.

In their negotiations on Iranian gas, the IOCs look to have a strong hand. Not only is Qatar securing the contracts, its extraction of gas from its own share in the South Pars/North Field reserves is depleting Iranian reserves.

One Gulf-based lawyer who has represented an IOC in Iran puts it bluntly: "Qatar is simply a better place to do business." Iran's long-awaited *Law on Foreign Investment Promotion and Protection* of 2002 was "a damp squib," he says. "The original draft was far more investor-friendly, but it was constantly referred back to the Council

of Guardians [Iran's supreme constitutional body] and was considerably watered down."

Another source of irritation is the Iranians' insistence on being directly involved in the marketing of all products. One Western company saw its draft joint venture agreement sent back by the Iranian side, "with its standard terms reversed". The result? No deal.

And while the Iranians claim that Russian companies can fill the gap left by reluctant Western IOCs, there are considerable doubts that the Russians have the track record to secure customers in such areas as gas-to-liquid, for which much of the recently announced investment in Qatar is earmarked.

The key political development to watch is the nuclear question. Now that the question of North Korea's military nuclear programme has again begun to assume an international dimension, and with signs that the **European Union** may be inclined to back a tough US stance, Iran may find it needs to compromise at least in public before it can attract the significant foreign investment required to resuscitate the energy projects already on the table and move on to develop new resources.

Iraq Output Gloom Prompts Action

The failure to revive crude production has prompted Iraq's occupation powers to sanction a \$1.6bn emergency plan to lift output almost threefold by April 2004. A confidential report obtained in July by the *Middle East Economic Survey (MEES)* says the authorities aim to reach 2.8m b/d by April, close to the country's pre-war level, as well as repairing refineries and pumping stations.

According to the report, the US government is to provide more than \$1bn of the new funds through a private sector contractor, with Iraq paying the remainder. The US Army Corps of Engineers (USACE) invited companies in early July to bid by mid-August for up to \$1bn of business to replace the contract currently held by **Halliburton** to repair the oil infrastructure.

At a meeting in Dallas on July 21, the USACE told executives from Halliburton, **Fluor Corporation** and other major oil services firms that the government hoped to award contracts by mid-October aimed at restoring Iraqi oil production to its pre-war level of 3m b/d.

Halliburton unit **Kellogg Brown & Root** has already spent some \$300m on repairs, but has been unable to stretch production beyond 800,000 b/d in the past two months. Sabotage and looting are seen as the major culprits behind dashed production targets. According to the *MEES* report, US officials are targeting 2m b/d production by year-end, although Iraqi officials' own forecast is

for a maximum 1.5m b/d capacity by that time – which is itself looking a tall order given the parlous security situation and general atmosphere of chaos.

Iraq Revs Up Diesel Exports

One area that has flourished is the market for Iraqi diesel. Reports suggest that Iraqi diesel exports in the Gulf have blossomed since the lifting of **UN** sanctions. Reports are that the sudden jump in the Iraqi diesel supply business has raised demand for 4,000-5,000 DWT shipping vessels to transport the products.

UAE diesel transporters use cargo vessels to take cars and other commodities from the **UAE** and bring back diesel. The competitive price of Iraqi diesel is the major attraction for local buyers. A major portion of Iraqi diesel is used for blending purposes, according to reports.

Some local companies based in various Emirates use Iraqi diesel for blending, and the final product goes to the market through private channels. The removal of UN sanctions has been a major blessing for operators, who no longer face as many security-related problems on the sea route.

Prior to the war, a high proportion of Iraqi refined products were smuggled out of the country. **Turkey** was thought to be lifting as much as 150,000 b/d of mainly fuel oil. Pre-war Iraqi refining capacity was around 400,000 b/d. Recent weeks have seen a restoration of refining operations, alleviating the immediate oil products crisis that followed the end of the war. Most refineries are now back at something near full capacity, though ordinary Iraqis continue to complain of lengthy waits at filling stations.

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