

# U.S. Policy and Iraqi Oil:

## The Challenges Ahead

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### ABOUT THE AUTHORS



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### Brief Analysis

**T**his Thursday, the Organization of the Petroleum Exporting Countries (OPEC) -- the oil producers' cartel of which Iraq is a founding member -- meets in Vienna to discuss production cuts intended to maintain the current, relatively high price of oil. The United States is not expected to send a representative for Iraq, although one or more among the plethora of political groups in the liberated country may send a would-be representative, unlikely to be seated. While ignoring the meeting, Washington still needs to make clear how it will reconstruct the Iraqi oil industry and utilize the nation's huge oil reserves, second in size only to those of Saudi Arabia.

### Garner's Vision

A week ago, retired lieutenant general Jay Garner, incoming director of the Office of Reconstruction and Humanitarian Assistance for Postwar Iraq, told the New York Times that revenues from Iraq's rejuvenated oil production would be used for "reconstruction of the country and the betterment of the citizens of Iraq." He added that revenues should be "managed by a neutral agency, like the World Bank," where they could be properly audited and remain "transparent." In fact, it is expected that the Iraqi oil ministry, along with other ministries, will be presided over by an Iraqi assisted by an American "senior advisor," answerable only to Garner. Reportedly, this yet-to-be-announced senior advisor will be retired American oil executive Philip Carroll. In Baghdad, senior Iraqi oil executives are back at work in the unlooted oil ministry building, guarded by U.S. troops.

Straying into an outline of oil policy, the Times quoted Garner as stating that there was little question that oil would be the basis of new wealth in Iraq: "In the next few years they will be able to double, triple their production of oil. They may become the richest country in the Middle East." Such remarks -- which ironically mirror past comments of the former Iraqi regime -- also represent conventional wisdom; Iraq's proven reserves of 112.5 billion barrels, more than 10 percent of the world's total, can justify a much higher production rate than the 2 million barrels per day (bpd) averaged during 2002. Iraq's recent history -- war with Iran during the 1980s, the 1990 invasion of Kuwait and subsequent military defeat, refusal until 1996 to agree to export-revenue control via the United Nations (UN) oil-for-food program -- has meant that the country's true export potential has never been reached. Perhaps the only bonus stemming from reduced exports has been that Iraq has avoided OPEC's quota system -- the mechanism, often

observed only in the breach, by which OPEC members attempt to control prices.

The OPEC cartel's future is unclear. Currently, its collective oil production (not just exports) provides a little less than one-third of a world oil supply of around 77 million bpd. Nevertheless, OPEC effectively influences -- if not controls -- world oil prices because its crudes make up more than half of the oil traded internationally. If Iraq were to produce large volumes and operate outside OPEC, the cartel's ability to affect prices would be seriously diminished.

Rather than be accused of price gouging, OPEC members prefer to depict themselves as ensuring a plentiful supply of oil to the world economy at a price that is fair to both producers and consumers -- although what exactly constitutes a fair price is highly debatable. The collapse of oil prices in the late 1990s to less than \$10 per barrel coincided with record stock market highs, while the subsequent recovery of those prices has been counterpoised by a recession in many countries. When the price of oil was low, OPEC considered as fair a range of \$15 to \$18 per barrel. When the price rose above this range, OPEC adopted a new "fair" price of \$22 to \$28 per barrel. Thursday's meeting has been called because the price of OPEC's notional basket of crudes, although above \$26 per barrel, is considered potentially weak. (The marginal cost of a barrel of crude oil for many Saudi and Iraqi fields is less than \$2, representing extraordinary profitability. In other parts of the world the marginal cost is much greater, perhaps \$12 to \$15 per barrel.)

#### Technical and Legal Problems

The failure of Saddam's forces to set alight more than a handful of Iraq's oil wells means that the Iraqi oil industry has survived well the war. During the first few hours of combat, British special forces secured intact the main offshore loading facilities in the northern Persian Gulf. The country's internal pipeline structure is also intact, as well as its export pipelines. The greatest physical problem is that Saddam's regime may have damaged oil fields in recent years by using poor techniques to maintain production levels. Technically, it should be possible to revive oil production and resume export levels of around 1.6 million bpd within a matter of weeks. Given investment of several billion dollars, exports of around 4.5 million bpd should be possible within two or three years. The money is available: for the last six years, the UN-run oil-for-food program has set aside funds for Iraq's oil industry, earmarking a total of nearly \$5 billion. Only \$1.6 billion of oil industry equipment has been delivered; the remaining \$3.4 billion in Iraqi funds held in escrow by the UN is enough to pay for oil field recovery if the UN agrees to make these funds available.

To finance oil industry investment, Iraq could also use its oil revenues or borrow against them. More controversially, it could seek investment from foreign oil companies. Saddam's regime claimed to have signed several contracts with such companies (mostly Russian and Chinese). The legal status of these contracts is unclear, however, and may be the subject of dispute with the new U.S.-led interim administration as well as any successor regime. Were they to drag on, the disputes could challenge Iraqi hopes to expand oil production quickly.

Garner's more immediate problem is that the continuation of UN sanctions and the oil-for-food program may make it difficult to sell Iraqi oil except under UN auspices. Moreover, there is no consensus in the UN Security Council about how Iraqi oil sales should be conducted in the aftermath of the coalition victory.

A further distraction for Garner is the report that Israel wants the old Kirkuk-to-Haifa pipeline to be reestablished, although the pipeline has been unused since 1948 and the section crossing Jordan was sold for scrap years ago. Remarks by Israeli minister for national infrastructure Josef Paritzky that such a line would drastically cut Israel's energy bill have been widely reported across the Arab world. Even if the pipeline were used to supply Jordan's oil needs, the commercial logic of such a line is questionable. Politically, Israel becoming dependent on a pipeline from a single source passing through a third, potentially unstable country also seems dubious. A better way to ensure low oil prices for Israel would seem to be having multiple competing suppliers, each delivering oil along safe sea lanes.

## U.S. Policy

Despite predictions of oil market chaos, the price of oil has not soared during the war, partly because Saudi Arabia -- the largest oil exporter and the only one with spare capacity -- pumped extra volumes. In fact, the price of oil was lower during the war than during the preceding months of tension leading up to the war.

Any move now by Washington to weaken OPEC will be seen in Riyadh as ingratitude and will be contested. Two days ago, Saudi foreign minister Prince Saud al-Faisal stated, "If what the occupying forces intend is the exploitation of Iraqi oil, it will not have any legitimate basis." As with the war itself, the motives of Washington will be questioned, but a revival of the world economy boosted by a low price oil could be its own reward.

Simon Henderson, a London-based associate of The Washington Institute, is author of *Instant Empire: Saddam Hussein's Ambition for Iraq* (Mercury House, 1991), a biography of the former Iraqi dictator.

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