

U.S.-Saudi Energy Policy Stands at the Brink

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Brief Analysis

Just short of four years since Crown Prince Abdullah, while on a trip to Washington, met leaders of U.S. energy companies to discuss cooperation efforts, negotiations to secure \$25 billion of investment for Saudi gas projects have broken down. A policy that should have cemented the energy-supply facet of Washington's sixty-year friendship with Riyadh is in tatters, alongside the diplomatic and military relationships, themselves frayed by a purported lack of Saudi cooperation since the September 11 attacks.

The Natural Gas Deals

The negotiations on natural gas investment have been deteriorating for quite some time. Last month, the chief executives of the leading companies involved -- ExxonMobil and Royal Dutch/Shell -- flew to Saudi Arabia for talks with the de facto ruler, Crown Prince Abdullah. Last week, the executives had separate meetings with the Saudi ministerial committee charged with handling the negotiations, but they failed to reach an agreement. The most crucial sticking point appears to have been the Saudis' unwillingness to offer commercial rates of return for the projects.

The oil companies' role was to make use of unexploited natural gas alongside the kingdom's giant oil reserves -- the largest in the world. Petrochemical projects were to accompany power and desalination projects. Many international companies were attracted by the potential business, but the Saudis were only interested in U.S. and European bids. Apparently, the Saudis felt that American and European companies could offer more technical sophistication and capital, in addition to their potential for securing the diplomatic support of Washington, London, and Paris. Therefore, when the Saudis selected companies in 2001 to handle the three core projects they had devised, they chose ExxonMobil to head two of them and the Anglo-Dutch conglomerate Royal Dutch/Shell to head the third. Lesser roles were given to other U.S. companies (Philips, Occidental, Marathon, and Conoco), and BP of Britain and TotalFinaElf of France also received shares of the action.

It was inevitable that the commercial side of the deal would be difficult. Over the last few years, oil companies have faced tough competition and have reacted by taking over or merging with rival players. Although the prospect of reentering Saudi Arabia -- closed to business since nationalization in the 1970s -- might once have produced a sensation of euphoria among oil executives, today both their companies and their shareholders are demanding

appropriate rates of return on Saudi projects, competitive with those on projects in other parts of the world.

What Happens Now?

Officially, the Saudi ministerial committee will review its options at the end of July before making recommendations to Crown Prince Abdullah. The consortia have been invited to make their "final offers." Industry speculation is that the projects will be repackaged and opened up to new bids from companies not currently involved; some of these companies might be less fastidious in demanding high rates of return, in the hope that commercial conditions will improve in the long term. One Saudi newspaper reported excitedly this week that a Taiwanese company had expressed interest in the projects.

At the very least, the failure to make progress on the projects means that plans for using natural gas for Saudi electricity generation and water desalination will be further delayed. Despite Saudi Arabia's reputation for wealth and extravagance, the tremendous demand for electricity in the kingdom in recent years has led to brownouts during times of peak demand. Sections of the population still have no regular and reliable access to a major water supply. Sewerage services remain primitive even in some parts of the capital. Some have claimed that approximately \$100 billion will be needed to maintain and improve these services by 2020. Foreign investment in natural gas is crucial to the Saudis' electricity and water plans in two ways: first, the natural gas would provide a low-cost fuel for electricity generation and desalination, and second, the gas projects might have encouraged the additional foreign investment needed to fulfill the Saudis' electricity and water needs. The likelihood of meeting the growing demand for these resources was always considered low, but now it has become even lower, with unpredictable social and political consequences.

Political Implications

Politically, the projects have become a contentious issue in Saudi Arabia, arousing nationalist ire at the prospect of Saudi oil and gas once again falling under the control of foreigners. Moreover, the electricity and water projects will be viable only if utility rates are raised significantly or if the government guarantees existing subsidies and allows for increases. Neither route is politically acceptable in the kingdom, where the per capita income has been reduced to a quarter of its level twenty years ago due to huge population increases and several years of comparatively low oil prices.

The decision to invite foreign energy companies to invest was Crown Prince Abdullah's, and he chose his trusted adviser, Foreign Minister Prince Saud al-Faisal, to lead his negotiating team. (Prince Saud, who is in poor health, also plays a leading role in putting forward the kingdom's views on Middle East peace, as he did to President George W. Bush in the White House last week.) But many of the Saudi elite opposed the policy from the start, and it became identified with the Crown Prince. One open opponent has been Oil Minister Ali Naimi, who doubles as chairman of the state oil company, Saudi Aramco, and who has argued that the Saudis can handle the gas projects on their own. As a commoner, Naimi could only have maintained his opposition with some heavy royal backing, which suggests that the royal family may be split on the matter. The decisionmaking process in the kingdom is usually opaque. In recent years, the assumption has been that Crown Prince Abdullah's opinion is paramount. But this analysis received a knock last week when Egyptian president Hosni Mubarak visited the ailing King Fahd (who is undergoing medical treatment in Geneva), apparently for talks on the Middle East crisis. Egypt may be angry that its preeminence in Arab politics has been put in danger by Crown Prince Abdullah's decision to proffer a Middle East peace plan earlier this year; speculation to this effect was heightened when Mubarak failed to attend the April Arab summit in Beirut, where a version of the peace plan was officially adopted.

Finally, the apparent collapse of plans for Saudi-U.S. energy cooperation will add weight to those in Washington arguing that an Iraq liberated from Saddam Husayn's yoke will be a more congenial energy partner. Moreover,

Russia has been moving to maximize production and become a major supplier to the United States, ignoring the pleas of the Organization of Petroleum Exporting Countries. Since September 11, despite claims to the contrary, Saudi Arabia has already dropped from its pole position as the top oil supplier to the United States. The Bush administration's patience has already been stretched in April by a Saudi threat to cut off oil supplies for two months unless President Bush reduced his support for Israel. Riyadh might need to be reminded once more of certain economic and political realities, but there is little more that Washington can do to improve the prospects for energy cooperation.

Simon Henderson is an adjunct scholar of The Washington Institute.

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