

The US-led invasion inflicted little damage on Iraq's oil infrastructure, but poor security has since resulted in looting and pipeline sabotage. In the north, this is choking off exports; in the south – which is generally operating in a more positive security environment – production is improving. The immediate challenge is to return production and exports to pre-war levels. At issue for the medium- and long-term, however, is what impact Iraq's gradual re-emergence as a major producer will have on global oil markets. Provided Iraq attracts significant foreign investment into the oil sector, production could reach a massive 6 million barrels per day (b/d) by the end of this decade. Such a scenario would pose challenges not least for OPEC, which invited Ibrahim Bahr al-Uloum, the oil minister appointed by Iraq's Governing Council, to the cartel's 24 September meeting in Vienna.

Having benefited from higher prices caused in part by the loss of Iraqi supply for much of 2003, the return of Iraqi oil will in the first instance exacerbate the current pressures on OPEC caused by slowing global oil demand and strong supply growth from non-OPEC producers. OPEC's decision in Vienna to cut its output by 900,000 b/d underlines its concerns about softening oil prices. Yet, within the next two years, OPEC may well conclude that propping up prices through further production cutbacks is untenable, and accept a period of low prices. The tasks of managing Iraq's reintegration into OPEC, and maintaining wider cartel discipline, will continue to be an issue of major importance.

Iraq's oil infrastructure

Iraq's oil industry consists, in the main, of two production and export systems – a southern region centred on the Rumaila fields near Basra, and a northern region centred on the Kirkuk field. Before the invasion, these accounted for two-thirds of production, with total sustainable capacity estimated at 2.7m b/d. Undeveloped southern reserves vastly outstrip those in the north, and geologists believe that there is a much greater likelihood of discovering new reserves in the south. According to current assessments, then, the oil industry's future lies in the predominantly Shi'i south, while the mainly Kurdish north has a sizeable but diminishing resource. Central Iraq possesses one major discovered resource in the giant but low-quality East Baghdad field, while the western desert is thought to have significant potential for new discoveries.

Iraq's role in oil markets

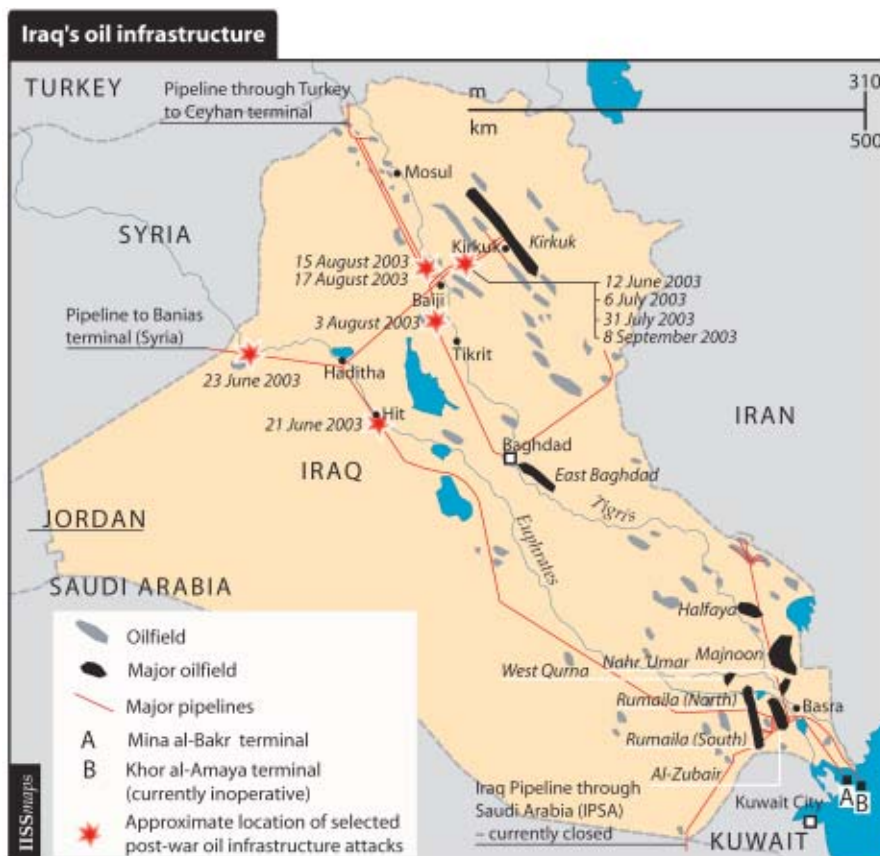
A complicating factor

The southern system is already the larger, with pre-invasion sustainable capacity of roughly 1.8m b/d (more than double northern capacity). Southern crude production is absorbed in three main ways: southern refineries can process some crude into products; it can be exported via Iraq's Gulf terminal at Mina al-Bakr (or, if it is repaired, the terminal of Khor al-Amaya); and it can be shipped north via the Strategic Pipeline for export through Turkey or Syria (or be consumed in northern refineries). The Strategic Pipeline exists specifically to allow for export flexibility between the north and south, but has been largely inoperable since the invasion. A fourth option used to exist in the form of the 1.6m b/d Iraq Pipeline through Saudi Arabia (IPSA), which was shut down following the Iraqi invasion of Kuwait. This pipeline terminates near the Saudi Red Sea port of Yanbu; re-starting it would require at least a year.

In the north, dominated by the Kirkuk field, pre-invasion production reached approximately 700,000 b/d (although this was thought to exceed sustainable levels and to be causing permanent damage to oil reservoirs). Crude oil production in the north is absorbed in four main ways: northern refineries can process some crude into products; it can be exported via the Kirkuk-Ceyhan pipeline for export from the Turkish Mediterranean coast; smaller volumes can be exported via a pipeline running to Banias in Syria; or crude can be shipped south on the Strategic Pipeline for export via the Gulf.

A haphazard role in oil markets

In the 1970s, Iraq's nationalised oil industry embarked on a major expansion in supply, capitalising on high oil prices to pay for infrastructure and military projects



designed to compete with Iran. Output reached nearly 3.5m b/d in 1979, compared with 1.7m b/d in 1971. Even as Iraqi production rose, OPEC sought to support high prices. Yet this strategy itself was questionable: few of OPEC's members – Iraq included – seemed to appreciate that sustained high prices would eventually dampen world economic growth, and so produce a fall in oil demand that would drag prices down sharply. In the 1980s, Iraq's invasion of Iran led to a protracted war that damaged Iraq's oil industry and saw output plummet by over two-thirds. Just as production began to recover towards the middle of the 1980s, oil prices finally did fall sharply in response to a drop in global demand, hitting Iraqi revenues hard. Throughout these various episodes, therefore, Iraq was seen by OPEC not as an integral member, but as a quasi-external complication whose fluctuating production patterns – driven by military adventures and other policy preoccupations – the cartel had to cope with.

As the Iran–Iraq war drew to a close, Iraq seemed to be moving towards a more conventional role within OPEC. Oil prices were improving, and, as Iraqi output recovered, the country's production quota within OPEC moved to parity with Iran's. But these positive developments were not sufficient to lift Iraq out of the difficulties in which it found itself by 1990. The need to service huge war debts was hampering Saddam Hussein's ability to rebuild Iraq – a fact that made him vulnerable domestically. He was irritated by the refusal of Gulf states to forgive debts accrued, he argued, partly in their defence. He additionally accused Kuwait of overproducing from a field shared with Iraq, thereby helping to depress prices at a time when revenue needed to be maximised. These perceptions formed part of the background to his August 1990 invasion of Kuwait.

In response to the invasion, Iraqi oil exports were immediately halted by UN Resolution 661, only resuming in the mid-1990s under the UN's oil-for-food programme. Production was only allowed to meet domestic consumption needs, with the first oil-for-food exports not flowing until December 1996. Investment in oil infrastructure was woefully inadequate in this period, leading to annual declines of 5–15% in production capacity.

The return of Iraqi oil exports presented OPEC with a challenge. For much of the 1990s, Saudi Arabia had filled the gap in production left by Iraq. In

keeping with King Fahd's pro-American policies, the Kingdom had used this position to ensure the relatively low oil prices preferred by the US. This diplomatically desirable policy proved economically harmful: insufficient revenues were generated to cover the Kingdom's expenditure, leading to a large build-up in domestic debt. As Iraqi supplies returned, Saudi Arabia now had to cede back Iraq's market share to avert a drop in prices. However, the unforeseen 1997–98 Asian financial crisis and associated slowdown in global oil demand growth ultimately made a sharp fall in prices inevitable.

In the cyclical nature of oil markets, low prices eventually encouraged demand and inhibited non-OPEC supply growth, so that by 2000 OPEC was once again enjoying high prices. In Saudi Arabia, Crown Prince Abdullah, willing to bear the diplomatic cost, looked to further increase oil prices to improve the Kingdom's parlous finances. He turned to Iran and Venezuela for help. Under President Hugo Chavez, Venezuela moved away from its traditional position of OPEC 'quota cheater' to tighter compliance. In Iran, moderate President Mohammad Khatami introduced a period of détente and cooperation between Riyadh and Tehran that extended to oil issues. It was hoped that the conditions were being put in place for maintaining higher oil prices, despite even the return of Iraqi supplies.

The next two years...

Iraqi production in September was estimated to have recovered to 1.3m b/d from a low of 160,000 b/d in April, and compared with 2.6m b/d in February. Recovery has been most successful in the south, where exports resumed in July after UN Resolution 1483 established a legal framework for post-war oil sales that placed the occupation authorities in control of revenues. While the northern oil fields are mostly in relatively calm Kurdish territory, many pipelines run through the so-called 'Sunni triangle', where insurgents are active and can easily commit sabotage. Nevertheless, led by recovery in the southern fields, nationwide production could conceivably return to the 2.0–2.5m b/d range by mid-2004.

As Iraqi production recovers, the country will take market share back from the remainder of OPEC. This will happen at a time when market pressures similar to those witnessed in 1998 are asserting themselves: high prices are providing an

incentive to non-OPEC producers to boost supplies, but also putting a drag on oil demand growth. Within the next two years, OPEC may again be faced with a choice between reducing output to untenably low levels or – more likely – accepting low prices. At present, it appears that prices will average in the low-\$20s per barrel throughout 2004 (compared with the current mid-to-high-20s level), but there is a strong likelihood that new Iraqi supplies will by 2005 help push prices down to the mid- or even low-teens.

...and beyond

Iraq's oil ministry has already begun to signal that it will seek foreign investment to quickly increase production. Under the right political and security conditions, and given confidence in the legal framework protecting foreign investors, production could be brought up to 6m b/d by the end of the decade. Foreign investment is likely to be limited to new projects, while existing Iraqi production would remain in the hands of state oil companies. New projects would first focus on developing such discovered giant fields as Majnoon and West Qurna in the south. Further exploration, such as in the western desert, would be the lowest priority.

Although the strategic dynamics unleashed by an Iraq producing 6m b/d are hard to predict, any substantial increase in Iraqi production is likely to have an impact on OPEC. The first question to be faced, then, is how Iraq can be re-integrated into the OPEC quota system – a process that may be contentious and may temporarily weaken the organisation's cohesion. That debate will open when Iraqi production begins to surpass pre-war levels and approach parity with Iran. Beyond that, some analysts have speculated about the possibility that a pro-American Iraq might exit and undermine OPEC. However, this is an unrealistic scenario: Iraq, like the rest of OPEC, has an interest in maximising its revenues, rather than providing low prices to consuming countries. It would also make little sense for Iraq to embark on a long-term policy that would be sure to antagonise many of its neighbours, particularly Iran and Saudi Arabia. The key deciding factor is, however, the currently poor security situation in Iraq. If Iraq remains unstable, and thus unable to rehabilitate infrastructure and attract foreign capital, OPEC may not have to deal with the question of reintegrating a fully-fledged Iraqi oil industry for some time. 