Pioneering Mideast Economic Transformation

Three Views

The Changing Role of Oil - Developing a Modest Mideast Oil Producer: Oman - The Role of the World Trade Organization

Vahan Zanyan         Hunaina Al-Mughairy          Cecelia Klein

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Introduction

The U.S.-GCC Corporate Cooperation Committee and its Secretariat, the National Council on U.S.-Arab Relations, is pleased to present *Pioneering Mideast Economic Transformation: Three Views.*

One is seldom able to join together in the same format the expertise of a renowned petroleum analyst, a pivotal U.S. policymaker engaged in World Trade Organization issues, and a prominent official engaged in the formulation and implementation of an important Arab country’s economic and commercial policies. However, this is what occurred at the most recent U.S. Mideast Policymakers Conference, and both the sponsors and the host are pleased to publish their analyses and assessment of a range of trade and investment issues of interest to a great many people.

The timeliness and relevance of the subject matter is self-evident. Indeed, few topics are as laced as oil and the World Trade Organization are with the strongly divergent views, analyses, and prognostications of specialists about their potential implications for U.S. and other countries’ foreign policy needs, concerns, and interests. Regarding oil, one need only recall that, less than two years ago, the international price of oil dropped to below ten dollars, only to rebound to a level three times that much less than a year later.

Near the end of the same period, an event hardly less expected erupted in reaction to trends in the realm of international trade and investment. The latter event occurred in connection with the much-heralded meeting of the World Trade Organization in Seattle, Washington. The forum, which gathered a majority of the world’s major leaders responsible for their countries’ commercial and economic policies, convened amidst some of the most dramatic street protest demonstrations in recent memory.

Affected by both developments, and contributing to the substantive debate pertaining to each, was the Sultanate of Oman. The first Arab country to send an Ambassador to the United States, the first Arab country to sign a Defense Cooperation Agreement with the United States, the first country in the Arabian Peninsula to demarcate successfully the borders with all of its neighbors, and the country through whose waters most of the world’s internationally traded oil is transported, Oman is little known and even less appreciated and understood for its increasingly important position and role in world affairs. This publication helps to remedy that situation.

In presenting a unique range of viewpoints by practitioners with long experience in their respective fields of economic and commercial development, the Committee and the National Council do so in the spirit of contributing to the national dialogue on U.S. policies toward the Arab countries, the Mideast, and the Islamic world.

**Mr. Burton Bacheller**
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**Dr. John Duke Anthony**
President and CEO, National Council on U.S.-Arab Relations
Pioneering Mideast Economic Transformation: Three Views
The Changing Role of Oil, Mr. Vahan Zanoyan, President and CEO,
Petroleum Finance Company

There are essentially two basic messages to convey when discussing changes in oil prices: price changes and changes in structure. In spite of the price recovery from $10 to $12 per barrel to over $23 per barrel, global crude oil markets are structurally and fundamentally weak. One should not be fooled by this. This does not mean that one cannot have higher prices.

If producers decide to raise the price of oil to $30 per barrel, they need only to cut a few million barrels per day of production and they will get it. This means that the meaningful and defensible price level is much lower today than a few years ago and is actually on the decline. The price cannot be meaningfully defended without substantial volume sacrifices to achieve higher prices. Then, to maintain higher prices, even further volume sacrifices would have to be made. Therefore, there is no reason to celebrate the current higher price levels and revenues, since they do not indicate a healthy market.

Higher oil prices, higher oil revenues, and better financial liquidity do not necessarily mean more economic maturity. In the Mideast, more money does not always mean that one can solve one’s economic problems. Another indication that the markets are structurally weak is a simple rule of thumb. When production is rising and excess capacity is falling, prices usually rise.

Unexpected Developments …

On the eve of the new millennium, the exact opposite has happened. Higher prices have been achieved by increased excess capacity. When idle capacity is on the rise, which leads to higher prices, that is a fundamentally bearish sign even though the prices are rising. When idle capacity is declining and prices are rising as a result, that’s a much more sustainable and bullish sign – but that’s not what’s at play here.

The industry restructuring taking place in the form of consolidations, mergers, and acquisitions is changing the nature of commercial competition. It has changed the nature of many of the competitors themselves, and it has also changed the nature of the risks and opportunities that both the industry and the producing countries are facing.

On the Supply Side …

On the supply side, what has been transformed in this business in the last several years is extremely important. The biggest story here is technology. There is no doubt that it is cheaper, faster, and easier today to discover, produce, and market oil than ever before. This is one of the reasons why defensible price levels keep coming down.
The biggest story here is technology. There is no doubt that it is cheaper, faster, and easier today to discover, produce, and market oil than ever before.

Also important is the fact that many countries have opened up the upstream sectors of their energy industries. Ten years ago, a vast majority of the earth’s surface was closed to direct foreign participation by international oil and gas corporations that had the technology to exploit these resources. Today, more of the planet has become more open to foreign investment than ever before. Two additional factors are the existence of new players and changes in the relationships between oil-producing countries.

...and the Demand Side

On the demand side, the big story in the past year has been Asia. Despite this, the depth, diversity, and duration of Asia’s economic rebound remain uncertain. The minute Asian economies recover, it is quite possible that Asian energy demand will return with force, leading some to forget the downturn of several years ago or to regard it as little more than a blip on the radar screen and, overall, a minor interruption in an otherwise formidable growth in Asian demand.

Environmental issues are far more permanent. They will influence consumption patterns and demand patterns in this business for a long time to come. More than economic factors, environmental issues may become the primary consideration pushing the technology drive on the supply side.

There are a few other important issues to consider in the supply and demand story. There is the question of what makes two major oil-producing countries decide to change their strategy and agree on production, as exemplified by the case of Saudi Arabia and Iran. Producer relations, producer politics, and policy drivers are absolutely critical to this, as is industry restructuring.

Again, how do the dynamics of the market and the industry change when, all of a sudden, $200 billion in share equity disappears from the market or changes hands?

The competition, the competitive environment, and the arena in which these companies compete is substantially different than it has been for a long time. Geopolitics and capital issues also affect the new oil industry.

Continuity and Change

In the 1980s, the oil business was cash-rich and opportunity-constrained. Although there was a lot of money in the industry, there were relatively few natural resource energy opportunities in which an outsider could invest. In the 1990s, the industry has shifted. The situation is now opportunity-rich, since an increasing number of countries have opened up. At the same time, the investment opportunities are cash-constrained due to the price environment.

The oil and gas business is still fundamentally a government business. Over 91 percent of known reserves are still largely owned by governments. However, over 30 percent of production of oil and gas is owned by the private sector.
One of the ways in which technology has influenced the price of oil downward is in the cost of production. The overall average cost of production has decreased from $5.70 a barrel to $4.00 a barrel. In spite of the price surge, the cost of production continues to decline, thanks to advances in technology.

The latest technology allows for the recovery of almost double the amount of oil that was previously produced. Also, whereas it used to take an average of seven years to fully develop an oil field from date of discovery to actual production, the same process now only takes 1.5 to two years.

Higher oil prices achieved by OPEC should not necessarily be a cause of celebration for the medium or longer term. However, it is a cause for celebration in the short term because it helps producing governments obtain badly-needed revenue.

The Implications of Opening Up to Direct Foreign Participation

As evidence of the extent to which international energy has opened up, look at the top 30 or 40 countries that have oil or gas reserves in the world. Among these, only two remain totally closed to direct foreign participation — Saudi Arabia, with the highest amount of reserves (262 billion barrels), and Mexico. All of the others either allow full direct foreign participation and competition or a higher level of access, albeit still limited, than before.

What is interesting is that, in the last ten years or so, the countries that have opened up or allowed some level of access to foreign companies to come and exploit their upstream sectors represent more than 460 billion barrels of proven oil reserves. In a matter of a few years, almost half a trillion barrels of proven oil reserves have become either fully or partially available to foreign companies.

This opening up process has substantially transformed the arena within which these companies compete. This is even more the case on the gas side. There has also been a substantial amount of privatization within the countries in the oil and gas sector. This process is being pushed partly by the necessity of governments to raise capital from new sources and partly by the need of some of the newly independent states for massive amounts of infrastructure investment in order to develop. Common to almost every case, however, is that a pressing financial requirement has led the country to open up its upstream energy sectors to direct foreign participation.

Another way of understanding essentially the same phenomenon is to look at the national oil companies and ask, what do they need from the rest of the world? Specifically, what do they need from the big international oil companies? In the low price environment, which means there is more supply than demand, these countries need access to markets. Marketing, then, has become a major issue, as has competition among governments seeking to capture new markets or gain a higher percentage of participation in existing markets.
To give an idea of what has happened on the corporate side, in the last few years alone the amount of capital that has changed hands in the oil business is in the neighborhood of $200 billion. This is a major development within the industry.

In the United States, one of the biggest stories has been the competition between Saudi Arabia and Venezuela to increase their share of the U.S. energy import market. Access to capital, access to technology and access to management skills are also needed by governments in the oil and gas sector. In a relatively high price environment, such as was present in the 1980s, oil and gas sector countries need access to technology and management skills. Yet these countries haven’t yet felt an urgent need for international marketing skills since, for some time now, it has been a seller’s market. Moreover, for some countries, capital has not been a factor because of their budget surpluses or other large financial cushions that could be drawn upon.

As oil production and trade move gradually out of government hands and into the hands of the private sector, even as ownership of a country’s actual reserves is likely to remain with the governments of the countries in which the reserves are located, the day-to-day market administration decisions continue to be transferred from government to private sector hands. This brings that much closer the idea that oil is nothing but another commodity that is traded on the open market. It is thus not as easily administered as it used to be by OPEC, which acted as an administrator of oil supplies and prices.

**Corporate Consequences**

To give an idea of what has happened on the corporate side, in the last few years alone the amount of capital that has changed hands in the oil business is in the neighborhood of $200 billion. This is a major development within the industry. First, it not only consolidates market power and market concentration, and ownership of assets and production—which is a traditional way to look at what the impact is on a market—but the process and outcome tend to eliminate an entire culture, a whole corporate existence and way of doing things.

In the old days, one dealt mainly with the large oil companies and a few small independents that had found a niche of some kind. That was the extent of the competition. In the 1990s, tens of companies got into the business even though they did not understand it, although they were quick to comprehend the importance of high-level government access. These companies are starting to die out now, leaving the super-majors, which is the regime we are in presently, as well as the big independents, like Burlington Resources and BHP.

Today, the super-majors face a totally different management challenge than the big independents. This is all by way of illustrating that things as they stand today ought not to be mistaken for “business as usual.” Indeed, the way the oil industry was organized and operated for the past 25 to 30 years no longer exists.

Something else that is new is that the perceived proportional advantage a Mideast country enjoyed as a reserve holder does not necessarily translate into a proportional advantage in terms of production. For example, a country can have a production share that is much smaller than its reserve share.

Source: Oil Patch Photos.
Persian Gulf producers, not including Iraq, are at the same level now as they were almost 20 years ago. This re-emphasizes the structural weakness of the oil markets.

Something else that has changed in the last ten years is the nature, concept, objective and purpose of resource nationalism. The new resource nationalism of the 1990s is one that recognizes and exploits the needs and the strategies of the international oil and gas companies in order to expand their production capacity without giving up control over national resources. Venezuela remains a prime example of today's resource nationalism being more political than commercial.

Source: Oil Patch Photos

The new resource nationalism of the 1990s is one that recognizes and exploits the needs and the strategies of the international oil and gas companies in order to expand their production capacity without giving up control over national resources.
Developing a Modest Mideast Oil Producer: Oman

Ms. Hunaina Al-Mughairy, Business Development Director, Mission of Oman to the United Nations

In the past three decades, the Sultanate of Oman has developed from a medieval country to a country of the 21st century. Oman has a population of 2.3 million, and is approximately 2,000 square miles in size, roughly the size of Kansas.

Oman has a per capita GDP of $7,000, which is roughly equivalent to that of Saudi Arabia. Oman is an investment-friendly country which has a rich history of maritime trading and is blessed with abundant sources of oil and gas. Oman is currently going through the final stages in the membership process for the WTO. In 1840, Oman sent the first Arab diplomatic mission to the United States. It was the first GCC country to successfully demarcate its borders with all its neighbors.

Like its fellow members of the GCC, Oman is committed to creating a stable macroeconomic framework through diversification. With the longest coastline of any GCC country, a regional geographic location that is second to none in terms of export-import trade and the transshipment of goods to East Africa, the Indian Subcontinent and all of Asia, as well as a business-friendly government, the Sultanate’s prospects for achieving sustainable economic development are bright.

By the year 2020, Oman will no longer rely primarily upon oil. To further illustrate the direction in which the economy is headed, the Sultanate’s oil revenues are estimated to be 9 percent of GDP in 2020, and the gas sector is estimated to rise to 10 percent. The non-oil industry sector of the Omani economy is expected to increase from 7.5 percent to 29 percent of GDP by 2020.

Strategic Development Priorities

Oman’s economic development is proceeding apace in four strategic areas. The first is human resources development. This includes strengthening and expanding the country’s system of basic education and increasing the number of health and nursing institutes, banking institutes, and technical training. To provide a context for comparison, Oman is challenged to create 22,000 new jobs per annum for its rapidly growing and increasingly young population. By contrast, Egypt has to find 500,000 new jobs yearly for its population, and Saudi Arabia is challenged with placing 100,000 new entrants into its labor force annually. Increasing the levels and diversity of direct foreign investment is central to this key component of the Sultanate’s ongoing commitment to modernization and development.

A second strategic focus is upon the creation of supportive institutions. Oman, as the most recent of the eastern Arab world countries to embark upon a multifaceted process of development across a broad front, confronts an array of challenges and opportunities of institutional development that exceed those of any other GCC country.
Oman's third strategic priority is to increase the overall size, position, and role of its private sector. Four key sectors targeted for privatization are electric power generation, telecommunications, waste water treatment facilities, and airports, seaports and roads. Oman has already succeeded in privatizing a new power-generating facility.

The Sultanate's fourth strategic development emphasis is on transportation. Here the opportunities for Oman to play an increasingly pivotal role as a bridge linking the six GCC countries, South Asia, the length of the East African littoral all the way to Cape Town, and to serve as lead port for imports in conjunction with the pan-GCC customs union and common market scheduled to come into being by March 2005, are limited mainly by the imagination. Like other bold economic and business concepts introduced throughout history in this region and elsewhere, there are, of course, other challenges, amongst which not least are the maintenance of regional peace and stability, visionary leadership, and adequate amounts of investor capital.

Investor Incentives

Judged in terms of peace and stability, on one hand, and member-states' visionary leadership, on the other, Oman, for the past three decades, has been the envy of most of the world's 140 developing countries. With regard to providing incentives to increase the overall nature, extent, and pace of increased foreign investment, at the core of the incentives is a business- and investor-friendly government.

Prominent among the elements that contribute to this exceptionally favorable investment climate are the Omani Basic Law, financial institutions, price stability, stable currency, and skilled local and expatriate workers. Investor incentives include no personal income tax, no foreign exchange controls, no customs duties on machinery and raw materials, and no corporate tax for five years, renewable for another five years. In addition, Oman allows 100 percent foreign ownership. This is decided on a case-by-case basis by the foreign ministry.

As for investment-friendly financial institutions, Oman has well-established international and local banks, the Muscat Securities Market, and the Omani Center for Investment, Promotion, and Export Development (OCI PED), which was set up to attract inward investments and promote Oman's exports.

There are three kinds of investors in Oman. One consists of those who administer projects that are developed, operated, and financed by the investor. A second includes those who have the necessary financial wherewithal and interest to invest in Oman, but, being new-to-market firms, need the government to identify appropriate projects for their investment. A third has projects but, lacking funds, relies upon the government to help recruit investors. Among major projects underway are Oman's liquefied natural gas plant, a petrochemical plant, seaports, a urea fertilizer plant, tourism, industry, infrastructure, mining, the expansion of health care facilities, and education.

With its strategic location, pro-investment climate, and increasingly attractive opportunities for American business, Oman is understandably being considered as a potential linchpin for U.S. firms.

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The Role of the World Trade Organization

Ms. Cecelia Klein, Director, Office of Accessions, Office of the U.S. Special Trade Representative

The World Trade Organization (WTO) is a lineal descendent of the General Agreement on Tariffs and Trade (GATT). It has existed for almost five years. The agreement establishing the WTO effectively codified 50 years of experience in institution building and trade liberalization by the contracting parties to the GATT, which expired at the end of 1995. Although the WTO is an institution, it is also a framework for 21 agreements.

After World War II, negotiators liberalized and regularized trade among consenting countries. The WTO institutionalized and provided a structure for these agreements. The WTO does not advocate free trade; rather, it seeks to regulate protection. Countries are naturally protective of their right to decide who gets access to its markets, and governments should have the right to regulate and protect in order to look after their most important interests.

The Uruguay Round, which established the WTO, took place in 1986, was formalized in 1994, and implemented in 1995. Whereas the GATT covered only goods, the WTO also covers goods but adds intellectual property and services. The general level of external tariffs was brought down. The WTO has expanded the level of detail involved in GATT and is more precise. Joining the WTO requires that the acceding country introduce changes in its legislation regarding trade and investment.

GCC and Other Applicants Pending Admission

Currently, 32 countries are trying to enter the WTO. They range in size from Andorra to China. The process for each prospective member remains similar and consists of a series of negotiations. A country that completes the process will have a set of internal rules related to trade and investment that is being used by 85 percent of the world’s nations. Without exception, business practices of the member countries are characterized by a greater degree of transparency than existed prior to their membership.

This is not to say that trade regimes in the past did not work for countries; they did. But there was widespread consensus that the internationally recognized rules of the game were in many cases misunderstood, insufficiently enforced, and, hence, open to abuse. The consensus’ corollary was that the two-fold need for economic reforms conducive to enhancing free trade among the member countries, and for a general tightening and clarification of the rules by which international commerce was conducted, was self-evident.

Of the six members of the Gulf Cooperation Council (GCC), four are members of the WTO. They came into the WTO as GATT members. They joined the GATT, in the case of Kuwait some years ago, and in the case of Bahrain, the United Arab Emirates, and Qatar more recently during the Uruguay Round. Oman and Saudi Arabia did not have a previous association with the GATT. Saudi Arabia had considered the possibility of accession to the GATT, but delayed acting on that consideration until 1993. By that time, the GATT was winding down and the WTO was beginning. Oman had also been giving consideration to joining, and in 1996 the Sultanate submitted its application.
Since that time, Oman and Saudi Arabia have described at length their trade regimes to WTO representatives. We are presently at the stage where we are really negotiating. Both countries accept the fact that certain laws will have to be changed. New legislation is being drafted and discussed in their capitals. Both countries have tabled offers on tariffs and services, and those offers are under active negotiation.

Oman’s negotiations are in their final stage. The government of Oman hopes to conclude these negotiations by the end of 2000. With Saudi Arabia, a broad range of issues remains under active discussion, and both sides agree that it is not a matter of whether the Kingdom will be admitted to the WTO, but when.

The Criterion of Credibility

The accession process is interactive. In effect, the process acquaints the applicant countries’ governments with the way they will be required to do business in the WTO. From the date an applicant applies to the WTO, it is expected to use only WTO-consistent forms of protection. Of all the commitments a country will make in the accession process, the most important one is that, from that point forward, WTO principles and provisions will become the primary points of reference for the development of that country’s international trade regime.

Some countries complain that the accession process is too difficult and too time consuming and that the requirements should be waived or eased. But were one to allow a country entry into the WTO without its prior formal commitment to implement the organization’s rules, this would not come cost-free. It would be tantamount to undermining the credibility and value of the system, not only for the applicant but for all the other members as well. In short, the credibility of the system is of immense importance.

Of the 32 countries currently engaged in the accession process, relatively few are in the Mideast. Far more are from the former Soviet Union and the former Yugoslavia.

Predictable, Effective, and Reciprocally Beneficial

WTO membership ought not to be viewed as a panacea for a country’s needs, concerns, interests, and challenges in the areas of foreign trade and investment. Nor does membership necessarily imply that change on the commercial or inward investment front of a given country is immediate or imminent. Over time, being a member of the WTO is not unlike being a member of other international organizations in the sense that certain functions, in this case those related to the formulation and implementation of a broad range of a country’s international commercial and economic policies, become more predictable, effective, and, between trading partners, more reciprocally beneficial than before.

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In short, the choice before a country weighing the potential benefits of WTO membership is that, as a member, one becomes part of the consensus that adopts the rules that govern the present and future trading and investment relationships among a substantial majority of the world’s countries. Non-membership does not mean that a country will be prevented from enhancing its foreign trade and investment prospects; but insofar as the non-member country’s major trading partners are members, the non-member country will have elected to become just an observer of the world’s most dynamic international trade organization. As Oman and Saudi Arabia join the other GCC nations in the WTO, instead of simply being subject to the rules of the WTO, they will be in a position to help make those rules.

Source: Oil Patch Photos