# Iran's Regional Oil Policy: The OPEC Factor

## The Islamic Republic's Relations with the Desert Kingdom are Critical to Iran's Gulf Strategy

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For most of this century oil has played an important role in determining Iranian foreign policy. Revenue from oil constitutes over 95 percent of Iran's foreign exchange earnings and pays for most of its industrial inputs, food imports, and military purchases. In short, oil is Iran's economic and security life line. Yet, Iran has only limited control over the production, export, and prices of its oil since these factors are largely determined by changes in the world oil market and within OPEC. From the perspective of Iran's Persian Gulf policy, then, the OPEC factor, more specifically Iranian-Saudi relations within the organization, is critical.

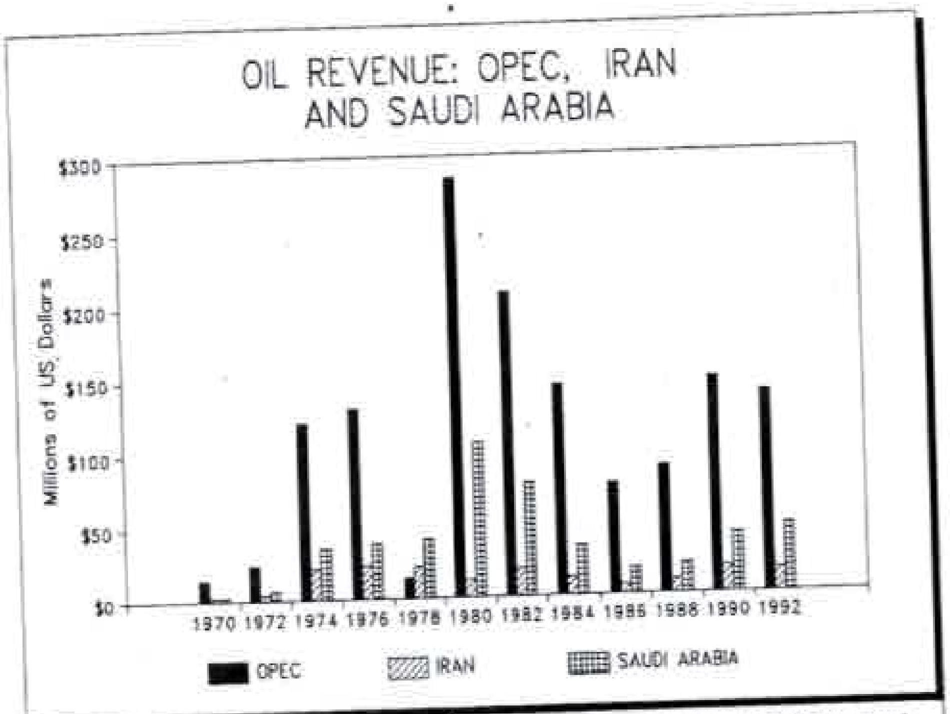
Following the 1973 oil price hike, an intra-OPEC power struggle grew over leadership of the organization. As a consequence, OPEC became increasingly politicized. From the very beginning the two main contestants were Iran and Saudi Arabia. Recognizing the significance of oil for the economy and national security, the Shah adopted a policy which linked oil, regional politics, and economic growth. Oil was used to finance both economic growth and a broad military buildup, which were then used to sustain sizable oil exports and near-dominant leadership within OPEC and in regional security affairs. Iran's friendship with the United States and accommodation of oil companies also contributed to the success of this policy approach.

## Oil and Ideology

With the Shah gone in 1979, the new Islamic regime changed this policy by de-linking Iran's oil, economic growth, and security interests. The policy was replaced by a combative approach based on the primacy of ideology and revolutionary zeal. Oil revenue and economic growth were de-emphasized as security tools and military strength was considered less significant than the power of Islamic ideology. Attention was focused on exporting the revolution to the neighboring states, challenging the superpowers with a "Neither East Nor West" foreign policy, contesting OPEC's production and pricing policies, exercising more control on downstream operations, and expanding spot oil markets. The government also terminated production and marketing agreements with most Western oil companies.

The de-linking approach (along with the American hostage episode and the war with Iraq) brought the Islamic Republic in direct conflict with all the major players in the oil and regional security arenas, including Saudi Arabia. With Iran's position lowered inside OPEC, Saudi Arabia became the absolute "swing producer" of OPEC. The Saudis used this new power to make economic and political gains with friends, and to punish perceived enemies. The Saudi friendship with the United States was cemented while US feuding with Iran steadily grew. According to OPEC expert Pierre Terzian, these events triggered the emergence of a new "strategic triangle" – with "OPEC at the mercy of Saudi Arabia, Saudi Arabia aligned with the United States, and the United States committed to the protection of Riyadh." Each feature of this triangle directly challenged Iran's interests in the Gulf.

Throughout the 1980s, Iran and Saudi Arabia clashed repeatedly over oil pricing policies. The sudden rise in oil prices that followed the Iranian Revolution – a boon to Iran – was met by Saudi efforts to force OPEC to lower its prices. Encouraged by its Western allies, Saudi Arabia boosted its production levels and unilaterally cut its own prices, ultimately forcing its will on the rest of OPEC. These policies had a




Sources: World Oil Trends, 1993; CIA's World Fact Book, 1992; OPEC Annual Statistical Bulletin, 1987,

particularly debilitating impact on Iran. The Islamic Republic was involved in a war for which it had no international support, and had inherited an economy that was in deep crisis and highly dependent on oil revenue.

Meanwhile, Saudi Arabia and its GCC allies were financing Iraq's war effort through transfers of cash and goods, credit arrangements, and loans. This grouping effectively counteracted Iran's partly successful efforts to create a united front with the other radical states in OPEC (such as Algeria and Libya), in the hope of, in the words of Iran's then-Minister of Petroleum Mohammed Gharazi, "isolating Saudi Arabia [and] compelling her to behave as one member amongst others."

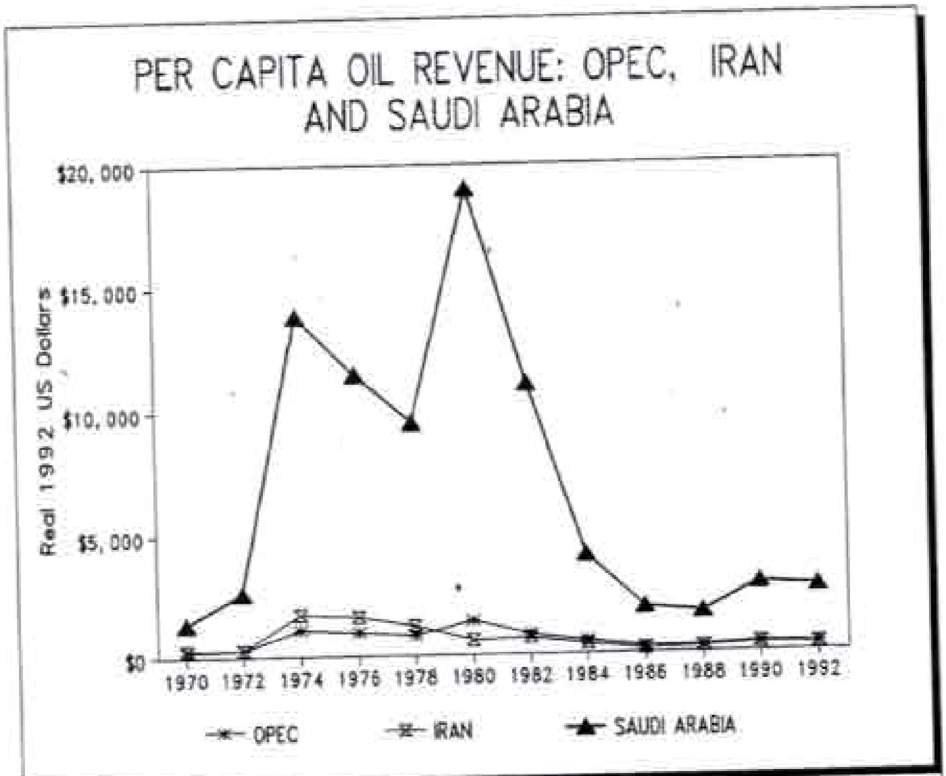
Over the course of several years, OPEC's Saudi-led price controls not only weakened Iran, but eventually led to the crash of 1986, which sent oil prices into a free fall. Worried about the impact of the crash on the American oil industry, the United States convinced the Saudis to end their overproduction. Under pressure from the Reagan administration, the Saudis signed an agreement with Iran on lower production and stabilized oil prices at $18 per barrel in August 1986.

But almost immediately after the Iran-Iraq war came to an end in August 1988, the Saudis, together with Kuwait, the United Arab Emirates, Qatar, and Iraq, stepped up their oil production. Meanwhile, the Saudis and other Arab members of OPEC persuaded Iran to accept production parity with Iraq as a condition for a new OPEC accord on price and production, despite Iran's much larger economy and population. The Saudis then placed additional conditions on the agreement's implementation, demanding the settling of certain political disputes with the Islamic Republic, and threatening to lower oil prices if Iran did not agree.

## A Return to Pragmatism

But with the further decline of the Iranian economy, the destruction caused by the war with Iraq, and the realignment of regional and international forces (including the formation and influence of the GCC and the decline of Soviet power), the Islamic Republic lost the ability to sustain its confrontational approach in its dealings with OPEC. Instead, Tehran began to move gradually away from its ideologically-based oil and security policy and toward a more pragmatic and depoliticized one. This trend became noticeable in the period immediately following the cease-fire with Iraq in August of 1988 and was accelerated after Ayatollah Khomeini's death in June of 1989 when post-war reconstruction became a priority.

A total transformation in this policy, however, occurred only after the Gulf War was concluded in February of 1991. The military defeat of Iraq at the hands of the US-led coalition radically changed the Islamic Republic's perception of its security and sparked it to pursue the development of a deterrent military force that would safeguard Iran's interests and territorial integrity. Thus, as under the Shah, oil

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revenue would again be used to spur economic growth and military strength. In turn, this would ensure a leading role for the Islamic Republic within OPEC and in regional security matters.

To apply the linkage policy, the government adopted a more accommodating attitude toward the major players in OPEC and in questions of regional security, and the Majlis approved an economic reconstruction plan that was heavily dependent on oil revenue. Iran's dealings with OPEC were to be depoliticized, and the Tehran government decided to begin playing a more responsible role as the second oil power in the organization.

The new policy also meant that Iran could rewrite its own economic program. The First Five Year Development Plan

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(1989-1993), which hoped to achieve 8 percent annual growth, was based on a foreign exchange budget of some $147 billion for the entire plan period, or around $28.1 billion per year. Some $27 billion would be borrowed from long-term capital markets, another $17 billion would be earned from non-oil exports, and the remaining $103 billion would come from oil.

The Second Five-Year Development Plan (1994-1998), however, was even bolder, especially with regard to the contribution of oil revenues which, together with gas and petrochemicals, have become the axis of the country's future development. Given this level of foreign exchange needs, oil revenue predictability and price stability have become important for Iran and have necessitated "producer-consumer cooperation." In addition, it is clear to the Tehran government that the proposed program of economic reconstruction and military build-up will require Western technology. So a redefinition of foreign policy objectives and approaches has become necessary. This policy can only be successful if Iran works for regional political stability and good relations with its neighbors.

Beginning in 1988, annual international conferences held in Teheran have underlined Iran's quest for friendship with its Arab neighbors and have invariably focused on the themes of stability, unity, and solidarity. The conferences have also emphasized common interests and cultural affinity between Iranians and Arabs. However, it was the May 1991 conference on "Oil and Gas in the 1990s: Prospects for Cooperation" in Isfahan that promulgated the new oil policy and its accompanying pragmatist foreign policy. The conference was significant because it brought together oil ministers from the Gulf and executives from the major Western oil companies.

The Islamic Republic's new oil policy is based on a number of considerations. In his message to the Isfahan conference, President Rafsanjani emphasized that the "bipolar world system" is all but gone; and Foreign Minster Ali Akbar Velayati spoke of an emerging " new order" in which "economic considerations overshadow political priorities." Other officials indicated that Iran wants to build a free market economy and plans to borrow and attract foreign investment. In a press interview, Minister of Petroleum Aghazadeh Gholamreza said that the conference reflected the changes brought about by a Persian Gulf Crisis, by an evolution in the world oil markets, and by restructuring of the world's economy. He noted that the demand for oil will increase in the 1990s, while non-OPEC oil production will decline, increasing, the demand for Persian Gulf oil.

"Iran, as a founding member of OPEC," he said, "has initiated an unprecedented attempt to further mutual understanding, among the main players in the oil industry, including producers, consumers, and oil companies." In a post-conference interview, the Minister also indicated that Iran was changing, its production, pricing, and marketing policies. In keeping with this approach, another senior Iranian official confirmed that "price stability and revenue predictability constitute the government's major areas of concern." In other words, the Tehran government has said that it will focus on the actual market situation and seek a stable price rather than a higher unstable price. The OPEC marker price of $21 per barrel is considered by Iran to be reasonable, and its maintenance will require cooperation between Iran, Saudi Arabia, and the oil companies.

Another important policy concept advocated by Iran is "reciprocal supply-demand security." The policy means that OPEC will guarantee an adequate flow of oil at fair prices to its consumers, particularly in times of crisis. , Demand security, on the other hand, should lend to easy access by oil producers to stable markets at fair prices. Consumer governments will make no attempt to limit this demand unless it is well-planned in accordance with the revenue needs and production levels of oil producers.

The next major component of Iran's new oil policy is increased production. A $2 billion expansion project started in 1991 has increased production capacity to 5 million barrels per day (b/d), from the 1992 average level of about 3.5 million b/d. While most of the drilling was done by the National Iranian Drilling Company (NIDC), Iran has contracted out numerous reconstruction, repair, gasification, exploration, and expansion projects to Japanese and Western (including American) oil companies. To complete these projects, some $5 billion in investment was needed, a level of expenditures that Iran could not easily afford, particularly since an additional $3.5 billion was needed for development of Iran's huge gas resources. Attempts to borrow the money or to induce foreign investment, however, met with only partial success, largely due to Iran's political isolation and the fact that Iran had run up a debt of some $30 billion by the end of 1992.

## A Preference for Stability

The new oil policy is also based on a new marketing strategy. The Islamic Republic is now eager to enter into stable markets, rather than selling oil in spot markets or markets with a less predictable demand. Iran also prefers to sell its oil for hard currency whenever possible so as to facilitate the purchase of modern technology and technical expertise. As a consequence, Western markets are given priority and large quantities of oil are being made available (in storage) near Rotterdam and a port in France. In fact, according to Aghazadeh, the Islamic Republic now has two channels for exporting its oil – Kharg Island and Rotterdam.

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Iran has also attempted to open up to the American market. In 1992, about one third of Iranian oil was purchased by American oil companies and the Exxon Corporation became, according to the Washington Post, "the largest US buyer of Iranian crude, purchasing about 250,000 barrels a day, which would be worth $1.8 billion on an annual basis." The deals are not subject to the American trade embargo against Iran because the oil is not directly imported to the United States.

Gulf oil will remain strategically important in the future and the industrialized countries are expected to take whatever measures they feel are necessary to control its flow and prices. Therefore, the politics of oil policy will continue to be a central concern to the future of the Persian Gulf. As major producers, Iran and Saudi Arabia are bound to remain vulnerable to global oil politics, and their rivalry will play itself out within OPEC. What are the prospects that the nascent Saudi-Iranian confrontation over oil policies will continue – or be exacerbated?

At present, the prospect of an Iranian-Saudi conflict in the near future is very real. Even though Iran's new oil policy accommodates a key Saudi demand by emphasizing price stability, it has become a source of concern to the GCC states because it links Iran's oil revenues with its military build-up. Saudi Arabia, moreover, has been consistently reluctant to lower its production to pre-Gulf War levels, despite Iran's preference that they do so.

As long as Iraq and Kuwait continue to export low levels of oil and the price remains stable at around $20 per barrel, Iran can afford to tolerate Saudi resistance. But tensions could rise when Iraq and Kuwait reenter the oil market in full, and the price of oil begins to fall. The Saudis have said that they will no longer assume the role of OPEC's swing producer – a position that Iran has also eschewed. Moreover, the outline of a future dispute over oil policy has begun to emerge: in September 1992, OPEC refused to increase Iran's quota of 3.2 million b/d, saying its production level did not warrant an increase in the quota. In response, Iran unilaterally increased production to 4 million b/d in October and November in an attempt to demonstrate the country's ability to overproduce and establish itself as the second largest OPEC producer. In a November meeting of OPEC in Vienna,

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however, Iran agreed to reduce its production to 3.5 million b/d in a coordinated attempt to bolster declining revenues.

Similar tensions between Iran and Saudi Arabia were also apparent at the February 1993 OPEC meeting in Vienna and the June 1993 OPEC meeting in Geneva. It is almost certain that a triangle of contention over oil policy will develop in the future between Iran, Iraq (after Saddam Hussein), and Saudi Arabia. The possibility of increasing tensions between the Gulf nations over oil policy is very real, but other recent developments in the Persian Gulf region have created a completely new and potentially fruitful window of opportunity for improved relations between Iran and its neighbors. In particular, several related events in the last few years have shifted the interests of the GCC states closer to those of Iran.

By 1985, most Arab oil producers of the Gulf had amassed large foreign exchange reserves. In the face of the lower oil prices of the mid-to-late 1980s and the fear of possible social unrest, many of the GCC states decided to maintain their high levels of social welfare expenditures. The combination of these outlays and the unforeseeable expenditures resulting from financing an astronomically expensive war against Iraq – to the tune of some $600 billion according to some reports – contributed to the depletion of GCC foreign exchange reserves to alarmingly low levels. In addition, non-OPEC lesser developed countries have managed to raise their oil production by 70 percent to a level of over 40 percent of OPEC production, thus reducing global demand for OPEC oil. At the same time, studies point to a declining role for oil in the global energy economy in the next century.

As a result of these significant factors it is easy to see that now, more than at any other time in recent history, the political and economic interests of the GCC countries are in line with those of Iran. They both need the security of stable foreign exchange earnings derived primarily from oil exports. Taking advantage of the present trend in the politics of oil in the region, the Islamic Republic is making overtures to Saudi Arabia, Kuwait, the UAE, and others for expanded regional cooperation. However, one cannot be conclusive about the outcomes; there still exist issues — including a dangerous regional arms race — that tend to exacerbate tensions between Iran and its neighbors.