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UNITED STATES AND THE MIDDLE EAST:  
POLICIES AND DILEMMAS

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THE JAMES A. BAKER III INSTITUTE FOR PUBLIC POLICY  
RICE UNIVERSITY - SEPTEMBER 2003

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A LONGER VERSION OF THIS ESSAY WAS PREPARED AS A BACKGROUND REPORT FOR THE STUDY "ENDING THE ENERGY STALEMATE: A BIPARTISAN STRATEGY TO MEET AMERICA'S ENERGY CHALLENGES" PUBLISHED IN DECEMBER 2004 BY THE NATIONAL COMMISSION ON ENERGY POLICY, A BIPARTISAN GROUP OF ENERGY EXPERTS FROM INDUSTRY, GOVERNMENT, LABOR, ACADEMIA, ENVIRONMENTAL AND CONSUMER GROUPS.

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## **Introduction**

The purpose of this paper is to explore the topic of the externality costs associated with rising U.S. oil consumption that are not easily quantifiable by strictly economic or monetary calculations. These hard to measure externalities include the strategic and diplomatic costs that, particularly since the attacks on the U.S. on September 11, 2001, have heightened relevance in American foreign policy debate. They also include the rising cost of U.S. military intervention of the protection of the flow of oil to the international community, both in terms of dollar expense and human lives.

While it is hard to put an absolute number on what Americans pay for our overwhelming dependence on oil as a transportation fuel, clearly the gasoline price at U.S. gasoline stations does not reflect the real cost to the American taxpayer. This paper is aimed to heighten awareness that oil is not as “cheap” as it seems to the average American motorist. Rather the seemingly higher costs of alternative fuels may not be so out of line with the cost of gasoline when juxtaposed against the real cost for depending on foreign oil that includes the taxpayers’ bills for U.S. expanded military operations abroad as well as the diplomatic and security challenges associated with this dependence.

For the past two decades or so, United States international oil policy has relied on maintenance of free access to Middle East Gulf oil and free access for Gulf exports to world markets. American policy in the Persian Gulf is not designed, as conspiracy theorists might argue, simply to keep the price of U.S. gasoline cheap or to make sure that American companies get handsome oil exploration contracts. Neither of these goals would likely merit the intense level of U.S. intervention in the region.

Rather, America ensures that oil flows from the Persian Gulf are available to fuel international trade and economy as part of its global superpower responsibilities. More simply put, the physical oil needs of the U.S. economy can certainly be met fully by protecting oil flows closer to home, from Canada, Mexico, South America, the North Sea and Africa. But the United States must consider the health of the overall global economic system since a massive shortfall of oil

elsewhere would not only affect the price of oil everywhere but almost certainly collapse the global economic system.

The Persian Gulf today represents 25-30% of world oil supply. Saudi Arabia is the world's largest oil producer and controls the majority of the world's excess production capacity, which it uses to stabilize and control the price of oil by increasing or decreasing production as needed during times of market crisis or instability. The sudden loss of the Saudi oil network would paralyze the global economy. Thus, the United States has a concrete interest in preventing any hostile state or internal groups from gaining control over the Persian Gulf region and using this control to amass power or blackmail the world community.

But this strategic and economic reality is costing the United States dearly in terms of military operations, diplomatic freedom and national security. At \$20 billion a year in military expenditures to protect the flow of oil, the U.S. taxpayer is spending roughly an extra hidden \$4 to \$5 a barrel for the crude oil beyond its market price or the equivalent of 10 cents a gallon tax on gasoline.

Continued dependence on Middle East oil can potentially place costly constraints on the U.S. freedom of maneuver in international relations. Such constraints are evident already in such areas as terrorist financing, human rights, political reform in the Middle East and the status of women. In important areas of national security, such as the U.S. campaign in Afghanistan, Middle East sensitivities were relegated to a lesser plain, but it is not out of the question that the United States could face, one day, a tough choice between the global economic hardship of a destabilized oil market and a foreign policy or national security imperative. Similarly, in a tight oil market, an important oil producer could try to use access to its exports as a lever to attain access to sophisticated military hardware or technology from a major oil-consuming nation.

While it might seem hard to imagine, beyond terrorism or banking, what other policies and undue pressures could realistically be pressed onto oil consuming countries by an important oil producer or group of oil producers, it needs to be remembered that Saudi Arabia's choice in the mid-1980s to lower the price of oil to defend its declining oil market share had the side effect of

weakening the Soviet Union as well as Iran and Iraq. This political fall out of the low price policy in 1985 suited U.S. as well as Saudi interests. In fact, to the extent that low oil prices helped foster the collapse of the Soviet Union, U.S. interests were promoted. But what of a case where an aggressive Saudi oil pricing policy threatens an important U.S. allied government? Such was the case in 1998 when extremely low oil prices put the last nail in the coffin of a friendly Venezuelan government and ushered into power the unfriendly regime of Hugo Chavez.

A key oil producer or group of producers could easily utilize a price war down the road to weaken the base of support for a favorable Russian leader or to dislodge a new Iraqi or Mexican government not to their liking. One imaginable motivation could be if a U.S.-allied country stepped up to the plate with huge investments (or an opening to massive foreign direct investments) designed to overtake Saudi Arabia as the pivotal oil superpower.

Finally, high dependence on Middle East oil has been cited as a troublesome factor in shutting down dangerous state-sponsored terrorism, terrorist financing and proliferation of weapons of mass destruction. Many important U.S. analysts argue that oil sales proceeds can be directed by authoritarian governments to fund terrorist organizations or to aid regional governments that harbor them. Some foreign policy analysts are now arguing that low oil prices—in addition to providing substantial economic benefits for the U.S. and global economies—will reduce the revenue available to oil states, which sponsor terrorism or pursue the acquisition of weapons of mass destruction. This argument has powerful logic, but raises the question as to whether the link between oil rents and terrorism is really bonafide. While the link between terrorism and oil is neither necessary nor sufficient, as this paper will discuss, several oil states remain on the U.S. Department of State terrorism list, and there are also private donors to terrorist groups who benefit from the trickle down of oil budgets into several key Middle East, Asian and North African societies.

### **U.S. Dependence on the Middle East: Status Quo policies**

For the past two decades or so, United States international oil policy has relied on maintenance of free access to Middle East Gulf oil and free access for Gulf exports to world markets. This

policy was accelerated in the 1980s as the U.S. strengthened its special relationships with key Middle East exporters, notably Saudi Arabia and Kuwait. These exporters expressed and exhibited a common interest in stable oil prices and adjusted their oil output to keep prices at levels that would neither discourage global economic growth nor fuel inflation. Then Saudi Oil Minister Hisham Nazer announced in the late 1980s that Saudi Arabia intended to make available an “ocean of oil” in exchange for “security of demand,”<sup>i</sup> and Saudi Arabia made the bold step of purchasing a 50% stake in U.S. refiner Texaco to ensure a permanent, guaranteed outlet for its oil in the United States.<sup>ii</sup>

Taking this dependence a step further, the U.S. also counted on these countries to make the sizable investments needed to maintain enough surplus capacity to form a cushion against disruptions elsewhere in the world. This spare capacity has served as a vital protection to U.S. energy security. In August 1990, when Iraq attacked Kuwait, so much spare capacity existed in the international oil market that the 5 million barrels a day (b/d) of lost production from Iraq and Kuwait was easily replaced by production increases from Saudi Arabia, Venezuela, Abu Dhabi and other OPEC (Organization of Petroleum Exporting Countries) members.<sup>iii</sup>

The quid pro quo of this special relationship with the Arab Gulf was that the United States would guarantee the security of Saudi Arabia and its small Gulf neighbors in return for the Gulf Arabs’ cooperation in keeping a reliable flow of moderately priced oil to international petroleum markets.<sup>iv</sup> The United States communicated its willingness to intervene militarily should Saudi Arabia or another Gulf Arab ally be threatened by implementing a strategy through the 1970s and 1980s referred to in U.S. military circles as “offshore balancing,” that is, keeping American troops, pre-positioned equipment and navy positioned in and around the Persian Gulf and Indian Ocean.<sup>v</sup> Washington demonstrated its willingness to intervene more concretely in the mid-1980s when its navy escorted Gulf Arab oil shipping through the Persian Gulf to protect it from Iranian warplanes and mines during the Iran-Iraq war, and, most notably, in 1990-1 when it rushed troops to Saudi Arabia after Iraq invaded Kuwait.<sup>vi</sup>

### **Protecting the Oil: U.S. Military Costs in the Persian Gulf**

The policy, while producing relatively moderate oil prices over the 1980s and into the 1990s, was still an expensive one. The U.S. General Accounting Office (GAO) estimates that from 1980-1990 about \$33 billion a year of the U.S. military budget was spent on defending oil supplies from the Middle East. Other studies that tried to refine the GAO's approach to eliminate more general Mideast initiatives not directly related to the protection of oil flows attribute lower numbers of \$6.4 billion to \$14.3 billion.<sup>vii</sup> A more recent 1996 study projected that annual costs of U.S. military operations in the Persian Gulf would range between \$20 to \$40 billion in peacetime.<sup>viii</sup> Exports from the six Gulf Cooperation Council countries—Saudi Arabia, Kuwait, UAE, Qatar, Yemen, Oman—total about 12 to 13 million barrels a day or 4.4 to 4.7 billion barrels of oil a year. At \$20 billion a year in military expenditure to protect the flow of oil, the U.S. taxpayer is spending roughly an extra hidden \$4 to \$5 a barrel for the crude oil beyond its market price.

Prior to 1980, the United States maintained only three naval ships in the region and limited pre-positioned equipment in Oman and Bahrain.<sup>ix</sup> After 1990, the U.S. forged new agreements with most of the states of the Gulf Cooperation Council (GCC), fostering multilateral exercises, command and control coordination (now in Qatar), a defense initiative against chemical and biological weapons, and a multilateral missile launch early warning system.<sup>x</sup> The GCC is a regional security grouping founded in May 1981 in Abu Dhabi in reaction to the Islamic revolution in Iran, the Iran-Iraq war and the Soviet invasion of Afghanistan. The GCC membership includes Saudi Arabia, Kuwait, Bahrain, Qatar, Oman and the United Arab Emirates. U.S. readiness in 2000 entailed rapid access to two combat divisions, three carrier battle groups, and 14 tactical fighter squadrons, with 25,000 soldiers and one to two aircraft carriers permanently assigned to the Persian Gulf.<sup>xi</sup>

Beyond these routine costs, there has been the cost of occasional military actions to defend the region and its oil supply. During the latter years of the Iraq-Iran war, which began in 1980 and lasted eight years, the U.S. Navy engaged in an active escort campaign for Kuwaiti oil tankers in the Persian Gulf. This activity is estimated to have cost \$200,000, according to the GAO.



Operations Desert Shield and Desert Storm (the 1991 Gulf War), which removed the Iraqi army from Kuwait, is estimated to have cost \$61 billion, according to press reports and the GAO.<sup>xii</sup> The majority of this expense was paid for by Saudi Arabia and Kuwait, with the total cost to the U.S. taxpayer pegged at around \$7 billion.

Iraq's invasion of Kuwait was considered a major infraction to the international system, and the Bush Administration began its efforts to utilize coercive diplomacy to pressure Iraq to withdraw.<sup>xiii</sup> As diplomacy and economic blockage failed to motivate Iraqi strongman Saddam Hussein, the U.S. led a coalition to eject Iraq from Kuwait by military means. Although the Gulf War was not just fought about oil, senior Administration officials acknowledged that the need to go to war also had a large energy security component.

President Bush Sr. explained the need to go to war in an address before a joint session of the Congress on the Persian Gulf crisis and the Federal Budget Deficit on September 11, 1990, "Vital issues of principle are at stake. Saddam Hussein is literally trying to wipe a country off the face of the Earth. We do not exaggerate. Nor do we exaggerate when we say Saddam Hussein will fail. Vital economic interests are at risk as well. Iraq itself controls some 10% of the world's proven oil reserves. Iraq plus Kuwait controls twice that. An Iraq permitted to swallow Kuwait would have the economic and military power, as well as the arrogance, to intimidate and coerce its neighbors –neighbors who control the lion's share of the world's remaining oil reserves. We cannot permit a resource so vital to be dominated by one so ruthless. And we won't..."

Surprisingly, the debate surrounding the Gulf War and its aftermath did not lead to a strident political debate in the U.S. about the risks of heavy reliance on Middle East oil. The subject entered the American political debate from time to time, especially around 1999 to 2000 when oil prices rose significantly following a concrete agreement within the Organization of Petroleum Exporting Countries to reduce production to defend a \$25 oil price. But, it was not until the terrorist attacks on the United States on September 11, 2001 that the question of import dependence on Middle East supply became a more central concern among U.S. foreign policy elites.

### **Tightening Oil Markets and the Role of Saudi Arabia**

The renewed focus on energy security post-September 11 comes in the context of increasing U.S. vulnerability to a disruption of oil supply from the Middle East. This exposure is more pronounced because there has been an extraordinarily rapid erosion of spare capacities at critical segments of the energy supply chain over the past decade. Sustained growth in oil use worldwide, combined with under investment in OPEC oil fields, has eaten away at the amount of spare capacity carried by key OPEC countries. The constraints to OPEC investment in expanding oil productive capacity has been driven by social/economic pressures in many oil producing countries whose government spending has had to be shifted away from capital investment to social programs in an effort to relieve the pressures of rapidly growing populations and an accompanying growth in unemployment. OPEC capacity has also been constrained by international and American economic sanctions policy, which has discouraged investment in key producing countries such as Iraq, Iran and Libya.<sup>xiv</sup> In the late 1980s, OPEC had planned capacity expansions to a total of 32.95 million barrels a day targeted for 1995, but by early 1997, OPEC capacity had reached only 29 million barrels a day. Iran, Libya and Iraq all failed to achieve production targets due to international sanctions policy.<sup>xv</sup> The decline in spare capacity means that the rapid and sizable replacement of disrupted supplies implemented by OPEC in 1990 would be difficult to repeat.

During the 1985 oil price collapse, OPEC was estimated to be carrying some 15 million b/d of shut in production capacity, equal to 25% of world oil demand. Saudi Arabia's shut-in capacity represented 60% of total spare capacity. When oil prices came under pressure in the early 1980s, Saudi Arabia agreed to play the role of swing producer, pulling back its oil production single-handedly to help OPEC stabilize fixed oil prices set by the producer group. By 1984, a glut of oil supplies from non-OPEC countries and flagging demand meant that Saudi Arabia had been forced to cut its production to 2.3 million b/d, down substantially from its production capacity of 10 million b/d.

By 1990, when Iraq invaded Kuwait, OPEC had about 5.5 million b/d of spare capacity, enough to replace the oil from those two countries and representing about 8% of global demand. Again,

Saudi spare capacity represented about 60%. But by 2000, OPEC's spare capacity was a negligible 2% of world oil demand and resided almost exclusively in Saudi Arabia, roughly about 90% of current world spare capacity. That situation carries forward to today, leaving the oil markets extremely vulnerable to short term disruptions. These persistently tight crude oil markets highlight the concentration of spare capacity in Saudi Arabia and the vulnerability of the global economy to domestic conditions there.

In late 2002, Venezuela's deepening social and financial problems and increased political polarization eventually prompted extra-constitutional attempts to remove Chavez from power. Violence became more prevalent until December 2002, when Venezuelan opposition groups organized a nation-wide strike that crippled the oil sector, bringing oil production to a virtual halt. The strike was designed to force an early referendum on the President's rule. President Chavez declared the strikers' demands as unconstitutional and called in loyal factions of the military to put down the protests.

The strike quickly curtailed close to 3 million barrels a day of Venezuelan oil production, prompting oil prices to rise but not dramatically so because the strike was not expected to last for a long time and other OPEC members had producing more than their production quotas mandated by the group. When OPEC met on December 12 and agreed to restrain output, prices began to rise more precipitously, reaching \$31 by year end.<sup>xvi</sup> As prices climbed to a two-year high, OPEC producers met on January 12 and agreed to increase output to cool markets but failed to replace fully the lost Venezuelan volumes. This, combined with fears of an impending U.S. attack on Iraq, kept oil prices high throughout most of the spring of 2003.

Saudi Arabia's place in the oil world is unrivaled despite the existence of other countries, notably Russia and the United States, whose total hydrocarbons liquids production is of similar magnitude. The kingdom is the only oil producer in the world that can replace single-handedly, within months, the total loss of *exports* of any other oil producer on the globe. The kingdom currently carries about 1 to 2 million barrels a day of sustainable spare production capacity, that is, production that can be maintained for more than 30 to 60 days. But Riyadh has the ability to surge its production temporarily by 3 to 4 million b/d in an emergency for 30 days or so. With

massive investment, the kingdom could also increase its capacity by significant volumes more quickly than other oil producers because of its prolific geology and giant oil export facilities. No other nation currently has enough spare capacity and investment revenue to claim this role.

Saudi Arabia's cushion of spare capacity has provided security and stability to world oil markets for two decades. The kingdom has intervened to calm markets on numerous occasions in recent years by quickly raising its production and exports, most notably during the 1990 Gulf crisis; immediately following the September 11, 2001 attacks; and most recently during the U.S. campaign in Iraq, preventing oil prices from soaring above \$40 for any length of time during major supply interruptions from the Gulf. Saudi Arabia raised production to 9.5 million barrels a day in March and April 2003 (up from its OPEC quota allocation of 8.256 million b/d) to limit the rise in oil prices caused by the U.S. campaign in Iraq.<sup>xvii</sup> Despite coaxing the International Energy Agency (IEA) to forego a major consumer strategic stock release, the kingdom did not use surge capacity to replace fully all Iraqi exports lost to the market, but chose rather to push out just enough oil to keep prices close to the OPEC price target range of \$22 to \$28 a barrel.<sup>xviii</sup>

The kingdom derives its international clout from this custodial role and is unlikely under the current regime to relinquish it. The oil market regulator role played by Saudi Arabia is also an important element to its strategic relationship and alliance with the United States.

Yet, despite the kingdom's general reliability in oil emergencies as the supplier of last resort, key voices in the United States policy community have increasingly voiced their discomfort with continuation of a high level of dependence on Saudi largesse. Senior U.S. officials have publicly expressed the need to reduce dependence on Middle East crude. These concerns stem not only from worries that a deterioration of the U.S.-Saudi relationship might adversely affect the kingdom's willingness to continue to act as the world's oil superpower but also about the anxiety about the future stability of the desert country.

## **Saudi Arabia's Internal Stability under Pressure**

Western Middle East studies analysts are increasingly writing specialized articles and books showing that the kingdom of Saudi Arabia is becoming a less stable place.<sup>xxix</sup> Population growth rates in Saudi Arabia are among the highest in the world at over 3% per annum. The kingdom's population is expected to double over the next twenty years or so. Moreover, in the year 2000, 42% of the total Saudi population was 15 years or younger.<sup>xxx</sup> This demographic boom is placing the Saudi regime under increasing pressure, with the state being called upon to create more jobs and provide more services with lower per capita resources than in the past. The kingdom has, in recent years, been lowering subsidies for basic services, and has called upon the private sector to enhance its ability to provide jobs. However, many Saudis lack basic job training, and the Saudi education system faces fundamental challenges. Many Saudis are graduating from the Islamic university system with degrees in Islamic law, sciences or religious studies.<sup>xxxi</sup> The Saudi economy to date remains highly dependent on foreign labor, which represents about 75% of those employed in the kingdom.<sup>xxxii</sup>

Saudi Arabia has a long history of forging closer ties with outside powers to promote its national security. As far back as 1957, it supported the "Eisenhower doctrine" that aimed to check communism in the Middle East. The move towards the United States was driven in part by a then revolutionary movement in Iraq whose foreign policy included support for national liberation movements that sought to overthrow conservative monarchies such as the regime in Saudi Arabia.<sup>xxxiii</sup> By 1979, Saudi anxiety about its northern neighbors worsened with the establishment of the Islamic Republic of Iran. Prior to the revolution, the Shah of Iran was seen as a key guardian of the status quo in the Gulf.<sup>xxxiv</sup> But, Saudi-Iranian relations became greatly strained following the Islamic revolution, especially in light of the 1979 Mecca Grand Mosque takeover and the 1981 disturbance in Medina where a number of Iranian pilgrims were arrested and deported for distributing leaflets calling for the overthrow of the Saudi government.<sup>xxxv</sup>

With the toppling of the regime of Saddam Hussein of Iraq and an improvement in Saudi-Iranian relations following the election of President Mohammed Khatami, the threat to Saudi stability is shifting and may become more internal than external. This has prompted the United States to

announce the withdrawal of its decades long military presence inside the kingdom. Both U.S. Secretary Donald Rumsfeld and Saudi Defense Minister Prince Sultan Bin Abdul Aziz attributed the imminent end to the American air force presence in the country to the success in the war on Iraq, stressing that there is no longer a need for American flights to use the Prince Sultan airbase outside Riyadh to patrol the southern no fly zone over Iraq. The withdrawal of U.S. troops was meant to mollify the kingdom's fundamentalists and even moderates who opposed ongoing American military presence in the Gulf country for both political and religious reasons.<sup>xxvi</sup>

The announcement by the Bush Administration on April 29, 2003 that it was effectively ending its military presence in Saudi Arabia, with most of the 5,000 American troops (save a 500-member training crew) leaving the Kingdom by the end of the summer 2003, surprised most observers, who were prepared for an eventual announcement but were caught off guard by the timing and immediacy of the move. The U.S. has already moved the U.S. Combined Air Operations Center from the Prince Sultan air base to Qatar's Al Udeid air base, which the tiny emirate built in 1996 at a cost of \$1 billion to encourage the U.S. military to base its regional aircraft there.

Ironically, the announcement of the U.S. withdrawal was followed almost immediately by an attack on Westerners in the Kingdom. The simultaneous suicide bombing attacks carried out by 15 Saudis on three compounds housing foreigners in Riyadh on May 12 that wounded 200 people and killed at least 34, including eight Americans and seven Saudis, highlights the threat that internal groups now pose inside the kingdom.<sup>xxvii</sup> The attack, since linked to the Al-Qaeda terrorist network, was one in a series of incidents.<sup>xxviii</sup>

Worries about Saudi Arabia's stability started creeping into U.S. foreign policy literature prior to September 11. And, it was observed that a less stable Saudi Arabia mightn't have as much flexibility to carry and use spare oil capacity to help the industrialized West. "Things have changed," observed a 52-person task force sponsored by the James A. Baker III Institute for Public Policy and the Council on Foreign Relations on Strategic Energy Policy Challenges for the 21<sup>st</sup> Century in April 2001. "These Gulf allies are finding their domestic and foreign policy

interests increasingly at odds with U.S. strategic considerations, especially as the Arab-Israeli tensions flare.”

### **Neo-Conservative Critique of the Special Relationship between the U.S. and Saudi Arabia**

But post-September 11, the neo-conservative critique of the special relationship between the U.S. and Saudi Arabia became sharper in the aftermath of the attacks on New York and Washington DC. It entered the mainstream U.S. foreign policy debate as never before.

In a typical example of American conservative policy essays focused on the risks of growing dependence on Middle East oil, former CIA director R. James Woolsey wrote in “Defeating the Oil Weapon” in *Commentary* in September 2002, “We had a working partnership with the Saudis for much of the cold war, offering them protection against the Soviets (and Soviet clients states) in exchange for a reliable supply of cheap oil. But in light of the direction taken by the Saudis for nearly a quarter-century now (accommodating extremist Wahhabi views) it is also imperative that we take steps to reduce their hold over U.S.”

Ariel Cohen, energy specialist at the conservative Heritage Foundation, warns of additional specific risks. “(Osama) Bin Laden understands both economics and the politics of terrorism. He has proclaimed that if he takes over his native land, he will drive oil to \$125 a barrel...and Bin Laden’s engineering and managerial skills can conceivably suffice to stage a super attack on the kingdom’s oil infrastructure, one that could neutralize Saudi Arabia’s 2 million barrels a day surplus oil producing capacity, vital for price stability.”<sup>xxix</sup>

Neo-conservative ideology on the risks of heavy reliance on Middle East oil transcends more than the direct economic impact of high oil prices and volatility on the U.S. economy. It centers on a belief that oil revenues permit Middle East countries to sustain authoritarian regimes and promote anti-American policies such as support for international terrorism or pursuit of weapons of mass destruction. Under this analysis, state-owned oil companies in major Middle East producers serve as a government agent for the collection of economic rents that would, under a privatized system, flow to the people of the countries themselves. Collusion on production levels

through OPEC, in turn, sustains those rents at a high level. Saudi Arabia, though an ally of the United States, plays a particularly pernicious role in neo-conservative analysis, using its immense oil revenues and leadership in OPEC to promote the Kingdom's own brand of fundamentalist Islam–Wahabism–in the Middle East and Central Asia.

### **Growing Bi-Partisan Consensus**

However, concerns about Saudi Arabia, its stability and its foreign policy are not limited to the neo-conservative vein. Mainstream policy leaders are voicing similar concerns in mainstream journals. “The flow of funds to certain oil producing states has financed widespread corruption, perpetuated repressive regimes, funded radical anti-American fundamentalism, and fed hatreds that derive from rigid rule and stark contrasts between rich and poor. Terrorism and aggression are byproducts of these realities. Iraq tried to use its oil wealth to buy weapons of mass destruction. In the future, some oil-producing states may seek to swap assured access to oil for the weapons themselves. It is also increasingly clear that the riches from oil trickle down to those who would do harm to America and its friends. If this situation remains unchanged, the United States will find itself sending soldiers into battle again and again, adding the lives of American men and women in uniform to the already high cost of oil” wrote Timothy E. Wirth, C. Boyden Gray, and John D. Podesta, in “The Future of Energy Policy” *Foreign Affairs*, July/August 2003.

Harvard University's John F. Kennedy School of Government hosted an executive seminar on “Oil and Security” in May 2003, noting that “developments in the Middle East have highlighted the need to reassess the economic and political implications of the United States' growing dependence on imported petroleum, and to evaluate the changing relations between the United States and the Middle East oil producing countries.” The seminar, which brought together many of America's top experts on oil and security, concluded, “Terrorism has emerged as a key concern in two regards. One is the risk to the oil industry's infrastructure and its “soft targets” in both consuming and producing countries. The other is the use of the proceeds from oil sales to fund terrorist organizations and the governments who harbor them.”



The discussion at the Harvard seminar regarding Saudi Arabia focused on the Saudis critical role in oil markets and elaborated the obstacles to reducing or diluting their importance. The Rapporteur's report, published by the Environment and Natural Resources Program at the Belfer Center for Science and International Affairs, concluded that the global oil market benefits from having a "swing producer" who can raise production to regulate oil prices and noted that there are few, if any, other countries besides Saudi Arabia who might play this role in the coming decades. "The criteria for candidates are essentially economic," noted the seminar report. "The swing producer would need to be the low cost producer, and someone with sufficiently centralized and enforceable policies. It is unlikely to be Russia given the multitude of private producers with different interests, and the limited discretionary power of the central government. While Iraq may have the prerequisite volume of reserves, its economic needs will make it virtually impossible for it to forego 20-25 percent of its production capacity. In the short- to medium-term, this leaves only Saudi Arabia."

The Harvard report posited the possibility that Saudi Arabia could experience a change in government, and that this could negatively impact its international oil market regulator role but suggested, "Economic necessity would constrain the government to adopting export-friendly policies in the medium- and long-term." Still, the report qualified this optimism by noting that "a change of regime in itself might be problematic." It added that the exodus of skilled personnel and foreign expertise might result in a loss of adequate personnel required to operate the system, resulting in a drop in production, or at the very least a curtailment of the investment needed to maintain and expand production. "History has not been kind on the impacts of regime change on oil production," explained the report. "It took approximately 10 years for Russia to start reviving its former production levels, and Iran has yet to return to the levels it was producing in 1980. It is thus conceivable that world oil supplies could be disrupted considerably longer than the "few months" that analysts have hinted at so far."

### **The Links between Terrorism and Oil: Real or Imagined?**

As discussed above, some analysts are arguing that low oil prices—in addition to providing substantial economic benefits for the U.S. and global economies—will reduce the revenue

available to those oil states which sponsor terrorism or pursue the acquisition of weapons of mass destruction. This argument has powerful logic, but raises the question as to whether the link between oil rents and terrorism is really bona fide.

The proposition that oil producing countries have the resources to sponsor international terrorism seems, at first glance, to have merit upon glancing at the State Department list for such “states of concern.” In the 1990s, several among the top violators, Iran, Iraq, Syria, Sudan, and Libya, all have state budgets supplemented by oil export revenues. Sudan is no longer on the list, and U.S. military sits in Iraq. On the U.S. government’s current watch, Iran registered annual oil revenues of \$18 billion in 2002, with \$22 to \$24 billion in foreign assets; Syria, oil revenues of \$5.4 billion; and Libya, oil revenues of \$11 billion, with \$25 billion in foreign assets.<sup>xxx</sup> However, it should be noted that oil revenue is not a necessary and sufficient requirement to host terrorist networks or to develop nuclear weapons since many states lacking oil resources (or in fact, wealth of any kind), similarly have pursued such policies including Afghanistan (prior to 9/11), Pakistan, and North Korea.

Iran’s economy is highly dependent on oil export revenues, which constitute roughly 80% of total export earnings and 40-50% of the government budget and 10-20% of GDP. The U.S. Department of State concluded in its 2002 Patterns of Global Terrorism Report that Iran remained “the most active state sponsor of terrorism in 2002.” Oil revenue represents a significant portion of Iran’s disposable income. The State Department report concluded that Iran provided Lebanese Hizbollah and Palestinian rejectionist groups such as HAMAS, the Palestine Islamic Jihad, and the Popular Front for the Liberation of Palestine-General Command, with funding, safehaven, training and weapons. Iranian funding for Hizbollah was reportedly about \$60 million to \$80 million a year in the 1980s. The State Department report also asserted that Iran provided support to extremist groups in Central Asia, Afghanistan, and Iraq with ties to Al-Qaeda.

The U.S. first placed Iran on the State Department terrorism list in 1984, in response to allegations of Iranian involvement in the 1983 suicide attack by Hizbollah on U.S. marine barracks in Lebanon.<sup>xxxi</sup> Iran was also linked to the bombing of Khobar Towers in Saudi Arabia,

where 19 American servicemen were killed. On June 21, the Justice Department announced that it had indicted thirteen Saudis and one Lebanese who were members of Saudi Hizbollah. The indictment said that these individuals belonged to groups that were “inspired, supported and supervised” by elements of the Iranian government.<sup>xxxii</sup> In April 2001, Iran sponsored an international conference supporting Palestinian groups, including groups promoting violence in Israel. In January 2002, a shipment of fifty tons of arms from Iran to the Palestinian Authority was uncovered.<sup>xxxiii</sup> The U.S. maintains economic sanctions against Iran because of its terrorist links, and American firms are not allowed to purchase oil from Iran, nor invest in its oil fields.<sup>xxxiv</sup>

Oil-rich Iraq was also reported to fund terrorist training and operations prior to the U.S. invasion. Iraq defector interviews published on the internet include stories of terrorist training camps and U.S. troops encountered such camps during the 2002 campaign against the regime of Saddam Hussein as reported on CNN. Press reports also covered Iraq’s generous support of Palestinian suicide bombers. Saddam Hussein reportedly pledged \$25,000 each for the families of suicide bombers. The Arab Liberation Front, a Palestinian group, said that it had distributed between \$30 million to \$35 million in Iraqi money.<sup>xxxv</sup>

But by far the most controversial in the debate of terrorist financing is the indirect role of Saudi oil revenues to assist terrorist groups. Oil and oil derived products account for roughly 90-95% of total Saudi export earnings, 75% of budget revenues, and approximately 30-35% of GDP. A 34 page private study compiled at the end of 2002 at the request of the President of the United Nation’s Security Council concluded that Saudi-funded charities and businesses are still supporting Al-Qaeda terrorist networks. “Al-Qaeda was able to receive between \$300 million and \$500 million over the last 10 years from wealthy businessmen and bankers, whose fortunes represent about 20% of Saudi GNP, through a web of charities and companies acting as fronts” Jean-Charles Brisard, the report’s author and former analyst for French intelligence told the London Times.<sup>xxxvi</sup>

The government of Saudi Arabia has declared its support for the U.S. War on Terror but has been fairly open in support of Palestinian terrorist groups. Saudi Crown Prince Abdullah, the de

facto ruler of Saudi Arabia, met with a delegation from Lebanon's Hizbollah, praising resistance to Israel's attacks against southern Lebanon.<sup>xxxvii</sup> Newsweek Magazine also reported in July 2003 that while the Saudi government has cracked down on Islamic extremists since September 11, it has increased its support of HAMAS.<sup>xxxviii</sup> A Saudi Government spokesman acknowledged at a Washington press conference in June 2003 that the Saudi government provides some funding for the "political wing" of HAMAS.

A Council on Foreign Relations Task Force on Terrorist Financing concluded similar findings, saying "For years, individuals and charities based in Saudi Arabia have been the most important sources of funds for Al-Qaeda; and for years, Saudi officials have turned a blind eye to this problem."<sup>xxxix</sup>

But prominent Middle East analysts note that Saudi Arabia has increased its support for the War on Terror since the bombing attacks on three compounds housing foreigners in Riyadh. Reports of Saudi police raids on Al-Qaeda hideouts have become more common place, and U.S. officials have been quoted in the press as saying the Kingdom is providing more cooperation in shutting down Al-Qaeda.

The Bush administration has tried to press Saudi Arabia to crack down on Saudi charities, businesses and individuals who have links to terrorist groups. But the U.S. is limited in how much of a conflict it can generate with Riyadh over the issue—despite its importance—given the importance of Saudi cooperation in keeping oil markets stable. The U.S. must also concern itself not to press the kingdom for cooperation too stridently, thereby prompting a negative reaction from Saudi Arabia that would affect its cooperative oil policies. Additionally, the U.S. has to worry that too much U.S. diplomatic pressure for sweeping changes might precipitate Saudi policies that could lead to the fall of the current Saudi government in favor of a more radical one. Finally, the U.S. is closed off—by the inexorable dependence on Saudi swing capacity in times of unexpected crisis—from using the kind of tools that might be utilized to pressure regimes with similar "issues" such as denying the country access to international lending, instituting oil sanctions or other economic sanctions or banning its businesses from the U.S. market.

The constraints that dependence on Saudi oil creates on U.S. foreign policy are not, however, necessarily limited to issues related to terrorism or policies related directly to Saudi Arabia itself. The Saudi “relationship” could also be called into force to influence other U.S. foreign policy choices -should a potential American policy choice be considered of vital national interest to Saudi Arabia.

Such was the case in 1998 when extremely low oil prices put the last nail in the coffin of a Venezuelan government friendly to U.S. interests and ushered into power the unfriendly regime of Hugo Chavez. Prior to the change of leadership in Caracas, Venezuela had been actively expanding its oil production capacity through an opening up to foreign direct investment by American oil companies initiated in 1992. The program was expected to take Venezuela’s oil production as high as 7 million barrels a day by 2010, a level that would have greatly enhanced U.S. energy security and provided ample commercial opportunities for American oil firms. But the Venezuelan capacity expansion program would have brought the South American nation to oil production levels almost rivaling Saudi Arabia, reducing the importance of Saudi Arabia in world oil markets and to large oil consuming countries like the U.S.

For a period of many months, Saudi Arabia warned Venezuela to stop overproducing and to abandon its plans to expand its oil market share. It threatened to initiate an oil price war to knock out the incentives for continued investment in Venezuela and to “punish” the Venezuelan government. Venezuela failed to heed Saudi warnings, and Saudi Arabia sat back as oil prices moved into a free fall. As oil prices were reaching a low of \$8 a barrel, Venezuela’s long-standing conservative government was voted out of office and in 1999, the new, more radical Venezuela government immediately trimmed back plans to expand oil production capacity and embarked on a campaign to promote more aggressive oil pricing policies within OPEC. Subsequent political unrest in Venezuela led to an oil workers strike that has set Venezuela’s state oil industry back tremendously. Venezuela’s production capacity has fallen from 3.7 million barrels a day prior to the election of Hugo Chavez to roughly 2 million b/d today, contributing dramatically to the tightening of oil markets in recent years and related high prices.<sup>x1</sup> Concluded the Harvard seminar report about this Saudi strategy, it “has been costly for countries

attempting to challenge the position of Saudi Arabia. The Saudis have responded aggressively and ruthlessly to protect their leading role in the world market.”

## Conclusion

October 17, 2003 marks the 30<sup>th</sup> anniversary of the 1973 Arab oil embargo. Thirty years later, oil remains, incomprehensibly, a continuing worry for the international community. Ironically, despite three decades of liberalization and the development of global markets and free trade, the world has not been able to shake off the “threat” of political interdiction of oil supplies. To such long standing worries, new concerns are being added that oil revenues are being diverted to support international terrorism and development of weapons of mass destruction.

Diplomatic creativity by the United States and the other industrial democracies in the 1970s helped counter and limit the economic and political damage wreaked upon the West by OPEC’s oil weapon. Renewed focus on similar efforts is imperative for U.S. and its allies. Serious efforts need to be made to lower dependence on oil and to marginalize oil supplies from the Middle East and elsewhere that are not available to our citizens on terms suitable to our interests. This can be done by simultaneously nurturing sources of “new” oil such as Russia, the Caspian and Canadian tar sands while at the same time allocating more substantial resources towards developing alternative energy sources.

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<sup>i</sup> “Search for New World Order Confronts Oil World” Petroleum Intelligence Weekly, Monday, February 11, 1991 and February 4, 1991, page 1.

<sup>ii</sup> “Texaco, Saudis Finalize Joint Oil Venture” Associated Press, November 11, 1988, as printed in the Wall Street Journal p. 16

<sup>iii</sup> “The Political, Economic, Social, Cultural, and Religious Trends in the Middle East and the Gulf and Their Impact on Energy Supply, Security and Pricing, available at [www.bakerinstitute.org](http://www.bakerinstitute.org); also Petroleum Intelligence Weekly covered these production increases in great detail in various issues from August 1990 to January 1991

<sup>iv</sup> Strategic Energy Policy: Challenges for the 21<sup>st</sup> Century, Report of an Independent Task Force Co-sponsored by the James A. Baker III Institute for Public Policy of Rice University and the Council On Foreign Relations, 2001, available at [www.bakerinstitute.org](http://www.bakerinstitute.org). While no formal written treaty to this affect exists, the quid pro quo of oil pricing policy was a common feature of private discourse between US officials and Saudi officials during the mid to late 1980s. For discussion of the Gulf Arab pricing policies to keep pricing artificially low, see F. Gregory Gause, “Iraq’s Decision to Go to War” Middle East Journal, Winter 2002 (Volume 56, No. 1) and Lawrence Freedman and Efraim Karsh, The Gulf Conflict 1990-1991 Princeton University Press, Princeton, 1993) as well as The Washington Post, January 15 1991 which described Iraq’s dissatisfaction with the Gulf Arab policy of keeping oil prices low. Also, William Quandt, Saudi Arabia in the 1980s: Foreign Policy, Security and Oil, The Brookings Institution, Washington DC, 1981

<sup>v</sup> Kenneth M. Pollack, "Securing the Gulf" *Foreign Affairs*, July/August 2003, Vol. 82, No. 4. For other readings on this subject of the security of the Persian Gulf, see "Toward a New Regional Security Architecture," Joseph McMillan, Richard Sokolsky and Andrew Winner, *The Washington Quarterly*, Summer 2003, Vol. 26, No. 3 or "Towards a Regional Security Regime for the Middle East: Issues and Options at <http://projects.sipri.se/mideast/MEreport.pdf>.

<sup>vi</sup> For discussion and analysis of the formation of the GCC, Simon Henderson, "Policy Watch: The Gulf Cooperation Council Defense Pact: An Exercise in Ambiguity" at <http://washingtoninstitute.org/watch/policywatch/> and the U.S. Library of Congress, entry under Persian Gulf. Henderson's piece lays out the Clinton Administration's efforts to integrate GCC defenses within the GCC with the US in the areas of communications systems and early warning missile systems. The US has formal defense agreements with some of the GCC states and has pre-positioned military equipment in Kuwait, Qatar, the UAE and Oman. A formal defense alliance between the US and the entire GCC has proved elusive over the years for a variety of local political reasons. For more deeper analysis of the politics and security deliberations of the GCC, see *Iran, Iraq and the Arab Gulf States*, Edited by Joseph A. Kechichian, Palgrave, New York, 2001 and for discussion of the Gulf war and security in 1990-1991, see F. Gregory Gause, "Iraq's Decision to Go to War" *Middle East Journal*, Winter 2002 (Volume 56, No. 1); Also, Shibley Telhami, "Between Theory and Fact: Explaining American Behavior in the Gulf War" *Security Studies*, Vol. 2, No. 1, 1992. Also, James A. Baker III, *The Politics of Diplomacy*, New York: Putnam) 1995

<sup>vii</sup> Hu, Patricia "Estimates of 1996 Military Expenditures on Defending Oil Supplies from the Middle East: Literature Review, Oak Ridge National Laboratory

<sup>viii</sup> *Ibid*

<sup>ix</sup> Presentation by James Bodner, principal deputy undersecretary for defense for policy, in "Running on Empty: Prospects for Future World Oil Supplies" Baker Institute Study No. 14, available at [www.bakerinstitute.org](http://www.bakerinstitute.org)

<sup>x</sup> *Ibid*

<sup>xi</sup> *Ibid*

<sup>xii</sup> Hu, Patricia *Op cit*; Congressional Research Service, Document on Persian Gulf War: US Costs and Allied Financial Contributions, Washington DC CRS, IB 91019, September 21, 1992. Also, Patrick Tyler and Richard W. Stevenson, "Profound Effect on US Economy Seen in a War with Iraq" *The New York Times*, July 30, 2002.

<sup>xiii</sup> Jon B. Alterman, In Robert J. Art and Patrick M. Cronin, "Coercive Diplomacy Against Iraq, 1990-1998" *The United States and Coercive Diplomacy*, P 275-303, Washington, D.C., The United States Institute for Peace, 2003; Also, this strategy is confirmed in the autobiography of James A. Baker III in which Sec. Baker recounts that the US planned to "begin with diplomatic pressure, then add economic pressure...and finally move toward military pressure by gradually increasing American troop strength in the Gulf." *The Politics of Diplomacy*, p. 277

<sup>xiv</sup> For a detailed discussion on sanctions impact on investment, see Meghan L. O'Sullivan, "Shrewd Sanctions: Statecraft and State Sponsors of Terrorism" Brookings Institution Press, Washington DC, 2003

<sup>xv</sup> Iran had aimed to reach 4 million b/d, Libya 1.6 million b/d and Iraq 4.5 million barrels a day, but were constrained at 3.8 million b/d, 1.4 million b/d and 1.2 million b/d respectively. See *Political, Economic, Social, Cultural, and Religious Trends in the Middle East and the Gulf and Their Impact on Energy Supply, Security and Pricing*, *op cit*

<sup>xvi</sup> For press accounts, see Carola Hoyos, Saudis quick to act on oil cut, December 14, 2002; Neela Banerjee, Pressure points for Oil Market, *The New York Times*, January 2, 2003, page 5. Matthew Jones, Crude Prices Rise on OPEC agreement, *The Financial Times of London*, December 14, 2002. p 16; David Ivanowich, OPEC agrees to boost output; Action seeks to allay shortage fears, *Houston Chronicle*, January 13, 2003, p. 1; Eric Pfanner, As Worries over Iraq War Rises, So does the price of Crude oil, *The New York Times*, January 17, 2003, p C8

<sup>xvii</sup> Private US government and Saudi sources and Energy Intelligence "Oil Market Intelligence" which tracks production by country. Also, Market Report of Deutsche Bank tracked these same increases

<sup>xviii</sup> For a detailed discussion of collaboration between the IEA and OPEC, see Bhushan Bahree, And the Lion Lay Down with the Lamb, *The Wall Street Journal*, July 29, 2003. Notes the article, "In return for a pledge that the IEA will use its emergency stocks only as a last resort, OPEC has promised to keep the world well-supplied with oil." The article even quotes US Secretary of Energy Spencer Abraham as saying that "quiet diplomacy has paid off."

<sup>xix</sup> Mahmoud Fandy, *Saudi Arabia and the Politics of Dissent*, Palgrave, New York, New York, 1999; Robert Baer, *Sleeping with the Devil*, Crown Publishers, New York, 2003; Anthony Cordesman, *Saudi Arabia: Opposition, Islamic Extremism, and Terrorism*, A report by CSIS, available at [www.csis.org](http://www.csis.org); Joseph Kostiner, *State, Islam, and Opposition in Saudi Arabia*, *The Middle East Review of International Affairs*, June 19, 1997; Ariel Cohen, *Energy Security at Risk*, *Washington Times Commentary*, May 23, 2003

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<sup>xx</sup> Gregory Gause III and Jill Crystal, "The Arab Gulf" Will Autocracy Define the Social Contract in 2015?" ed. Judith S. Yaphe, *The Middle East in 2015*, National Defense University Press, Washington DC 2002

<sup>xxi</sup> For a broader discussion of the plight and perceptions of Saudi youth, see Mai Yamani, *Changed Identities*, Royal Institute for International Affairs, 2000. "...the domination of higher education by the 'ulama has led to a general rise in complaints by Saudi students about the curriculum's lack of relevance to their every day practical needs..." Ms. Yamani's treatise argues.

<sup>xxii</sup> Gregory Gause, *op cit*

<sup>xxiii</sup> David Holden and Richard Johns, *The House of Saud: The Rise and Rule of the Most powerful Dynasty in the Arab World*, Holt, Rinehart, and Winston, 1981, New York, p. 198-225

<sup>xxiv</sup> R.K. Ramazani, "Iran's Islamic Revolution and the Persian Gulf" *Current History*, 84, No. 498, January 1985.

<sup>xxv</sup> Joseph A. Kechichian, "Trends in Saudi National Security" *Middle East Journal*, Vol. 53, No. 2 Spring 1999, p. 232-253. Also, for an overview of political instability in Saudi Arabia, see Milton Viorst, "The Storm and the Citadel," *Foreign Affairs*, Jan/Feb 1996

<sup>xxvi</sup> Eric Schmitt, *Aftershocks: The Pullout: US to Withdraw All Combat Units from Saudi Arabia*, *The New York Times*, April 30, 2003, p 1; Sean O'Neill, John Bradley, David Rennie, *Pullout may make life easier for Saudi regime*, *The Telegraph*, May 1, 2003

<sup>xxvii</sup> Glenn Kessler, *Saudis Tie al Qaeda to Attacks*, *The Washington Post*, May 14, 2003, p 1

<sup>xxviii</sup> Discussed on the online service *Gulf 2000* at Columbia University; Several publications, including the U.K.'s Sunday newspaper, *The Observer* and the on-line intelligence group, *Stratfor.com*, also reported that anti-government demonstrations occurred across the Kingdom in the spring and summer of 2002 and into 2003.

<sup>xxix</sup> Ariel Cohen, *Energy Security at Risk*, May 23, 2003, available in the press room at [www.heritage.org/press/commentary/ed052703a.cfm](http://www.heritage.org/press/commentary/ed052703a.cfm)

<sup>xxx</sup> Country analysis briefs available at [www.eia.gov](http://www.eia.gov). Also, *Energy Intelligence Group's Oil Market Intelligence*, July, 2003, Vol. VIII No. 7

<sup>xxxi</sup> Meghan L. O'Sullivan, "Shrewd Sanctions: Statecraft and State Sponsors of Terrorism" *Brookings Institute Press*, Washington DC, 2003, Chapter 3

<sup>xxxii</sup> <http://news.findlaw.com/cnn>

<sup>xxxiii</sup> Overview on Iranian terrorism links also outlined by George Tenet, *Testimony given on Current and Future Threats to National Security*, Senate Armed Services Committee, February 2, 1999

<sup>xxxiv</sup> For a detailed account of the US oil sanctions policy against Iran, see Meghan L. O'Sullivan, "Shrewd Sanctions: Statecraft and State Sponsors of Terrorism" *Brookings Institute Press*, Washington DC, 2003

<sup>xxxv</sup> "Saddam paying suicide bombers" *The Associated Press*, October 10, 2002

<sup>xxxvi</sup> Sebastian Rotella, "Saudis must stem cash for terror, report says" *London Times*, December 24, 2002

<sup>xxxvii</sup> *BBC World Service*, March 3, 2000

<sup>xxxviii</sup> *Newsweek Magazine Website*, July 30, 2003 "Financing Terror: Are the Saudis increasing support for Hamas?" By Michael Isikoff

<sup>xxxix</sup> *Terrorist Financing*, Report of an Independent Task Force sponsored by the Council On Foreign Relations, Maurice Greenberg, Chair; William F. Wechsler and Lee S. Wolosky, project co-directors, 2002, available at [www.cfr.org](http://www.cfr.org)

<sup>xl</sup> David Bird, *Saudis Not About to Concede Any Markets*, October 16, 1997, *Dow Jones & Co.* 10:25 GMT; *Saudis Subdue Doubters by Plowing Ahead with Crude Production*, *The Oil Daily*, January 8, 1998; Also, see discussion on this subject in *Rapporteur's Report*, Harvard University Oil and Security Executive Session, May 14, 2003, Environment and Natural Resources Program, Belfer Center for Science and International Affairs