FOREIGN INVESTMENT

KEY POINTS

- Huge surpluses generated from oil revenue and restrictive foreign direct investment, FDI, regimes mean FDI has been a less significant capital source for the Gulf economies than for East Asia.

- Progress in liberalising FDI restrictions is slow, but Qatar, Oman and recently, Saudi Arabia, lead reform. Important constraints on FDI across the Gulf region include restrictions on full foreign ownership outside the free trade zones, prohibitions on investing in many sectors (particularly oil), restrictions on both domestic and foreign competition in key infrastructure, energy and manufacturing sectors, and imprecise and inconsistently applied regulatory frameworks.

- However, opportunities for large scale foreign involvement are greater in the region's huge emerging gas industry than in oil, although some Gulf economies with smaller, less profitable oil resources are keen to attract more foreign investment.

- Infrastructure needs in the Gulf economies are massive. The greatest foreign participation opportunities are in pipeline construction, electricity and water. Dominant state owned monopolies constrain opportunities in the telecommunications sector, although World Trade Organization, WTO, driven liberalisation is yielding significant market opening in Oman.

- Key triggers to improve the foreign investment environment include further reforming regulations governing FDI in Saudi Arabia (the Arabian Peninsula's dominant economy), increasing regional economic integration and lifting US sanctions on Iran.

Since the first oil shock, foreign direct investment, FDI, has been a relatively minor capital source for Gulf economies. Most foreign participation has involved building productive facilities and providing services under contract, rather than through FDI. However, rapid population growth, burgeoning infrastructure requirements, diversification of economic activity away from oil, growing fiscal pressures and the desire to access new technologies are driving many regional governments to more actively seek FDI.

This chapter examines regional FDI policies, developments in FDI liberalisation, trends in key sectors receiving FDI, emerging FDI opportunities and major influences on the FDI outlook.

REGIONAL FDI POLICIES

Compared to East Asia, Gulf economies are relatively closed to FDI. Key features of Gulf FDI regimes include:

- the difficulty of having effective full foreign ownership outside free trade zones
- the requirement for majority local equity in many types of business, including distribution
- prohibition on FDI in the upstream oil sector (in Saudi Arabia and Kuwait), inability of new oil companies to enter the oil industry (in the UAE) or severe restrictions on foreign company involvement in the oil sector (Iran)
- imprecise and inconsistently applied regulatory frameworks.

Oman, Qatar and Saudi Arabia are progressing most towards liberalisation (Table 4.1). Furthermore, the need for rapid economic growth, the desire to diversify economic activity, growing fiscal pressures and burgeoning infrastructure requirements are likely to drive further opening of FDI regimes in the short to medium term. (See Chapter 1 - *Economic Prospects*.) Moreover, in April 2000, the Saudi Government announced measures to make full foreign ownership easier. Effectively implementing these reforms, including clearly indicating where FDI remains prohibited, should encourage more rapid reform in smaller Arabian Peninsula economies, particularly the UAE.

Table 4.1

Full Foreign Ownership Remains Elusive

Regional FDI Regimes

Economy	Key FDI Regulations
UAE	Representative offices, branch offices for export marketing and establishments in free trade zones can be 100 per cent foreign owned. Other firms must have a majority local partner, although the local partner need not be active, and profits need not be divided on the basis of formal ownership percentages. Foreign investment is prohibited in real estate, trading companies, agency companies, many service sectors and quasi state monopolies such as the telecommunications company, Etisalat. The UAE has the region's strongest intellectual property protection, and offered foreign investors minority shares in two build, operate, transfer projects in the electricity industry.
Saudi Arabia	Commercial agencies must be Saudi owned and the upstream oil sector is off limits to foreign companies. In January 1999, Saudi Arabia created the Supreme Petroleum and Mineral Affairs Council, separate from the Saudi Arabian Oil Company, ARAMCO, to direct post-production energy policy. In 2000, the Government established a new investment regulatory body, the General Investment Authority. Subject to all appropriate documents being lodged, it will process applications within 30 days. Until April 2000, foreign equity in the industrial sector was limited to 49 per cent. While in principle full foreign ownership was allowed in other sectors (except oil), wholly foreign owned firms could not bid for government contracts or access cheap credit or tax concessions. Proposals approved by the Council of Ministers in April 2000 allow foreign investors to wholly own projects and industrial property. These proposals also allow wholly owned foreign companies to access tax holidays and concessional finance in other sectors, making full foreign ownership more feasible.[1] However, to access government contracts, firms still need to be at least 50 per cent locally owned. Moreover, FDI remains constrained by a lack of detail on exactly which sectors are barred from foreign investment and by a lack of detailed implementing regulations. With revised corporate tax rates, the top marginal tax rate for foreign firms of 45 per cent of net profit has fallen to 30 per cent.

[1] The previous regulations required at least 25 per cent Saudi ownership to qualify for favourable loans from the Saudi Industrial Development Fund and five year tax holidays (ten years in agricultural or manufacturing sectors).

Table 4.1 continued

Full Foreign Ownership Remains Elusive

Regional FDI Regimes

Economy	Key FDI Regulations
Iran	In principle, FDI is allowed, subject to 51 per cent local ownership. However, in practice, approved FDI is negligible. Opportunities largely are limited to service contracts and buy-back arrangements.
Kuwait	Foreign firms are limited to 49 per cent ownership, unless they are legally registered as a local limited liability company. As in Saudi Arabia, foreign companies cannot invest in the upstream oil sector.
Bahrain	Full foreign ownership is permitted particularly among firms operating exclusively offshore, such as offshore banks, and for insurance, engineering, construction, trading and financial companies, and among industrial or service companies using Bahrain as a regional distribution centre. In all other cases, firms must be 51 per cent locally owned.
Qatar	In early 2000, Qatar increased allowable foreign ownership from 49 to 100 per cent in agriculture, industry, energy, tourism, natural resources and mining, provided projects are consistent with national development priorities.
Oman	Oman allows 70 per cent foreign ownership of most economic activities, subject to government approval. It also treats domestic and foreign firms equally for tax purposes.
Yemen	Full foreign ownership is permitted, except in the petroleum industry, where production sharing agreements and state participation limit foreign equity to 49 per cent.

Source: Business Monitor International, 2000a and 2000b; Fawzi Al-Khatib and Malki, 2000; Economist Intelligence Unit, 1999a; and British Bank of the Middle East, 1997a and 1997b.

REGIONAL FDI LEVELS

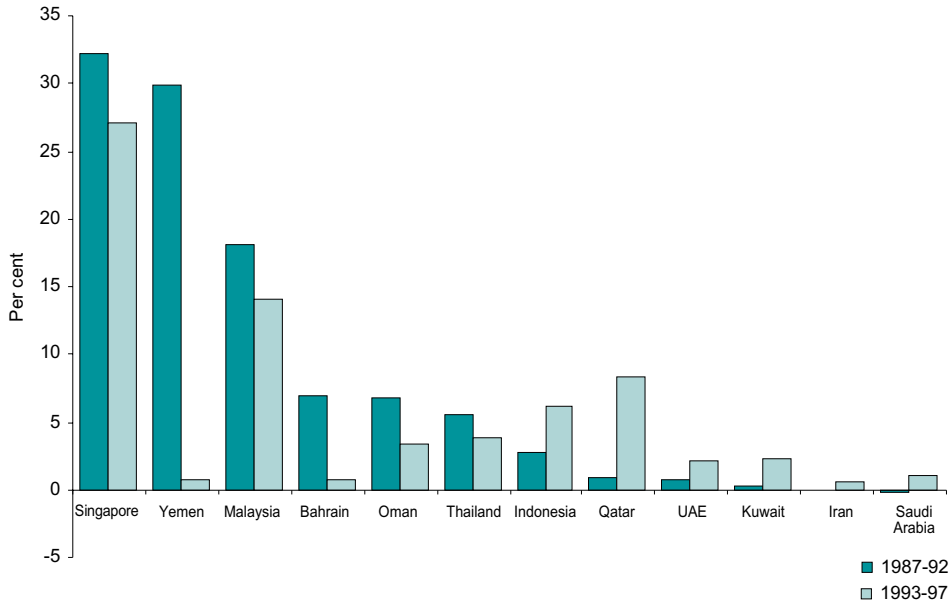
FDI is not a major capital source for most Gulf economies, although at various times, some smaller economies found it important (Figure 4.1). Relatively low FDI inflows primarily reflect policies prohibiting foreign investment in the oil sector and curtailing full foreign ownership of the most productive projects and land, as well as uncertainty about domestic legal and regulatory frameworks.

Saudi Arabia has the highest actual annual FDI inflows, averaging around US$600 million per year between 1993 and 1998, followed by the UAE and Iran (Figure 4.2). It is in these economies FDI inflows have increased most compared to between 1987 and 1992 (Figure 4.2).

Figure 4.1

FDI Lower in Gulf Region than East Asia

FDI as a Percentage of Gross Fixed Capital Formation, 1987-92 and 1993-97, Annual Averages



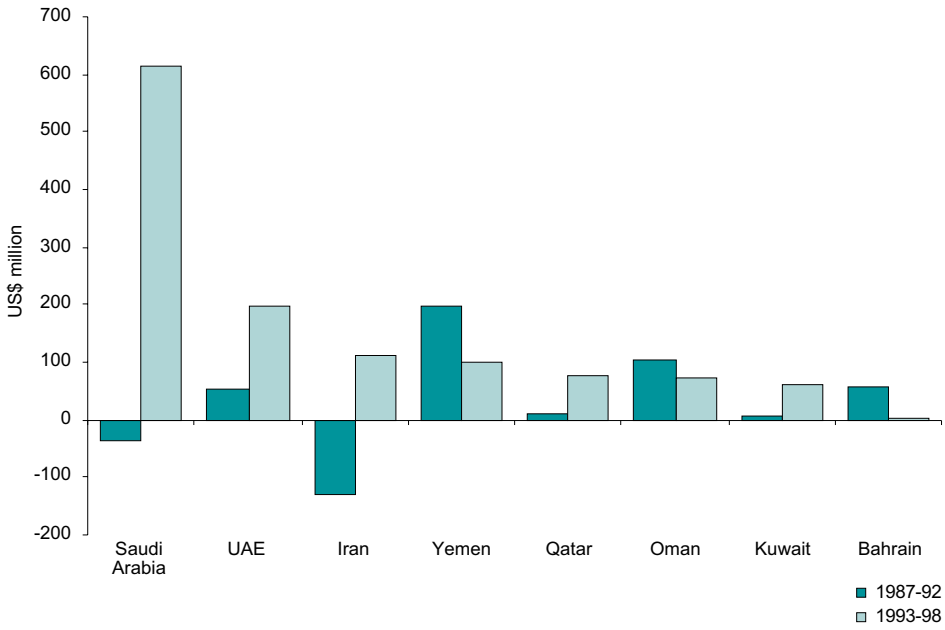
Note: Data for Iran also includes buy-backs expenditure, which is not FDI as it does not involve taking an equity share.

Source: United Nations Committee for Trade and Development, 1999.

Figure 4.2

FDI Levels Are Low

FDI in Gulf Economies, 1987-92 and 1993-98, Annual Average



Note: Data for Iran include buy-backs expenditure, which is not FDI as it does not involve taking an equity share.

Source: United Nations Committee for Trade and Development, 1999.

FDI DRIVERS IN INDIVIDUAL GULF ECONOMIES

Overall, continued FDI restrictions mean joint ventures and free trade zone investments dominate FDI in Gulf economies. However, the need to upgrade and install infrastructure across the oil, gas, pipelines, electricity, water and telecommunications sectors is driving FDI reform and expanding opportunities for foreign capital.

Saudi Arabia

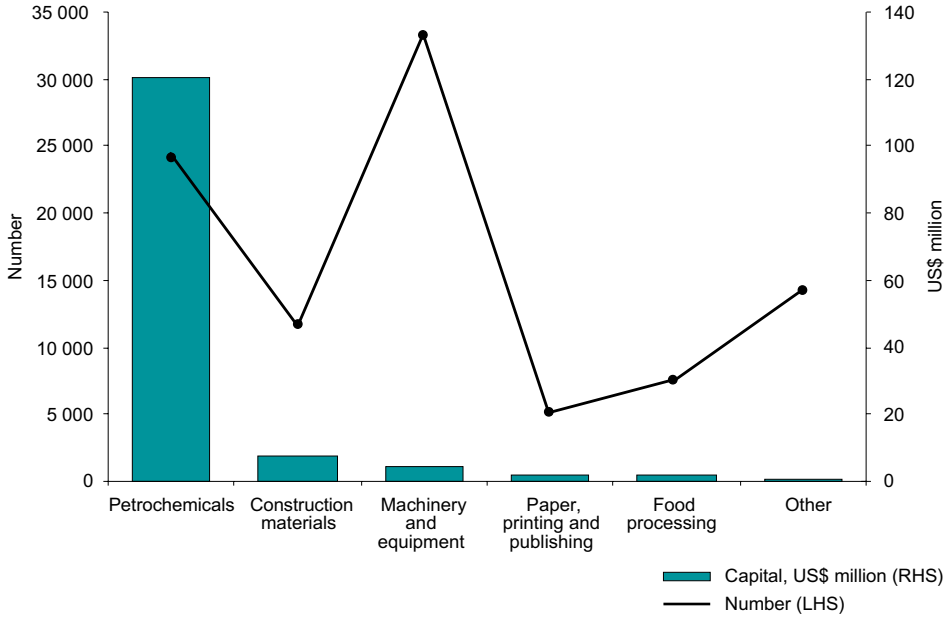
Virtually all FDI flows into Saudi Arabia are joint ventures; by value, most are petrochemical projects (Figure 4.3).[2] Outside the petrochemical sector, smaller projects supply either the local market or niche export markets. Offset arrangements, whereby defence suppliers must invest a share of project funds in non-defence sectors are important, but this importance should decline as the Government seeks to ensure offset projects are profitable.

2 These petrochemical joint ventures are mostly with the Saudi Arabian Basic Industries Corporation.

Figure 4.3

Chemicals and Plastics Dominate Saudi Joint Venture Investment

Sectoral Distribution of Saudi Joint Ventures, Cumulative,1997



Source: Saudi Consulting House, 1999.

The UAE

The UAE's successful free trade zones and vigorous efforts at economic diversification have created FDI inflows which are a higher share of total investment than those of Saudi Arabia and Iran (Figure 4.1). Firms located in free trade zones can be fully foreign owned, and include many distribution and processing facilities. Foreign investment in the oil sector is longstanding, and recently, some foreign firms began to privately provide electricity generation infrastructure. Offset arrangements also are important; since 1992, sectors including aircraft maintenance, education, health, agriculture, financial services and aquaculture, have received offset investments of US$550 million (Jeffreys, 2000, pp. 87-92).

Iran

Despite Iran's 49 per cent ceiling on foreign equity and its negligible actual FDI approvals, between 1993 and 1998, around US$100 million per year of foreign funds flowed into its oil sector. Iran's fiscal problems stimulated these inflows, as the Government was forced to permit the National Iranian Oil Company to seek international finance to develop offshore hydrocarbon resources.[3] To avoid giving

[3] Fiscal problems arose primarily as low oil prices coincided with massive reconstruction costs following the Iran-Iraq war.

foreign firms equity, petroleum projects are tendered on a buy-back basis, with foreign partners arranging finance and construction, and being repaid in dollar denominated crude oil deliveries once the project commences operation (Economist Intelligence Unit, 1999d). Total, Shell and Petronas (Malaysia) already participate in these buy-back agreements. In November 1999, Royal Dutch Shell Group signed buy-back contracts for the Soroush and Nowruz oil fields, which will cost around US$800 million to develop (Royal Dutch/Shell Group of Companies, 2000; and *Tehran Times,* 15 November 1999).

Other Gulf Economies

In most other Gulf economies, individual projects dominate FDI trends. Major FDI events include Kuwait's post war reconstruction (now largely completed), Qatar's development of the large North gas field, Oman's liquefied natural gas, LNG, development and production and development of power, telecommunications and pipelines infrastructure, and Yemen's World Bank assisted structural adjustment privatisation program.

SECTORAL FDI OPPORTUNITIES

The oil and gas sectors dominate most regional economies, and attract most FDI interest, both from major international oil companies and smaller energy companies and contractors. In several Gulf economies, new opportunities also are opening up in the mining, infrastructure, financial, manufacturing, distribution and service sectors. (See also Chapter 2 - *Australian Opportunities*.)

OIL SECTOR INVESTMENT

Despite 1970s oil facility nationalisations in Iran, Saudi Arabia, Bahrain, the UAE, Kuwait and Qatar,[4] Gulf economy markets remain extremely attractive for international oil companies due to their low production costs, massive reserves, and the opportunity to increase exploration and often, production efficiency.

Upstream Opportunities

Opportunities to participate in upstream oil sector drilling and production remain extremely limited in the key oil producers, Saudi Arabia, Kuwait, Iran and Abu Dhabi, UAE. In particular:

- Saudi Arabia does not allow foreign participation; the state owned oil company, ARAMCO, retains exclusive rights over oil exploration, drilling and production
- Kuwait bans foreign companies from owning natural resources, although the Government currently seeks to implement a policy permitting international oil companies to develop the Northern oil fields on a 20 year contract

[4] Until the 1970s, the major international oil companies dominated oil production in most regional economies. In Iran, Saudi Arabia and Kuwait, total nationalisation occurred. In Bahrain, the UAE and Qatar partial nationalisation occurred.

- Iran only allows participation in oil field development on a buy-back basis
- In Abu Dhabi, major international oil companies including British Petroleum, Shell, Mobil, Total and Exxon have minority shares in three state controlled oil and gas companies, with other international companies locked out of production.[5]

The region's smaller oil producers offer more diverse foreign investment opportunities in the upstream oil sector. For example, Petroleum Development Oman, the largest producer in Oman, which has small, geologically complex fields, is 40 per cent foreign owned, with the remaining share state owned.[6] Furthermore, in 1997, Occidental Petroleum of the United States, Novus Petroleum of Australia and Japex of Japan produced 21 million barrels of crude, or 6.3 per cent of total production (Economist Intelligence Unit, 1999a).

Terms for foreign companies in the Yemeni oil sector, with its relatively small reserves by Gulf standards, improved dramatically in the late 1990s. For new fields, companies now can claim 50 to 70 per cent of oil earnings to recover development costs, compared to 25 to 45 per cent previously (Economist Intelligence Unit, 1999b).[7]

Downstream Opportunities

In the downstream oil sector, opportunities largely are confined to contractual work and financing assistance for state owned oil companies. For example, Kuwait is calling for bids from eight international oil companies to construct an oil pier at the country's largest refinery. Oman is receiving bids to construct a refinery at Sohar, and Iran has expanded its buy-back program to refinery development.[8] Financing major oil sector developments also provides many opportunities; for example, Citibank is financial adviser for the US$800 million expansion and refurbishment of the state owned Bahrain Petroleum Company's Sitra refinery and is arranging a syndicated loan to cover 75 per cent of project costs (Economist Intelligence Unit, 2000a).

However, over time, joint venture opportunities are likely to increase as expansion of the refining sector accelerates, and as emphasis on producing higher value products increases. One promising development was the September 1998 Saudi invitation to 18 major foreign oil and energy companies to submit investment proposals in Saudi Arabia's downstream oil sector and upstream and downstream gas sectors; the gas sector is emerging as a main area of focus.

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5 These companies are the Abu Dhabi Company for Onshore Oil Operations, ADCO; the Abu Dhabi Marine Operating Company, ADMA-OPCO; and the Zakum Development Company. The Abu Dhabi National Oil Company, ADNOC is wholly state owned.

6 Foreign companies holding the 40 per cent share are Royal Dutch Shell, Total and Partex (Economist Intelligence Unit, 1999a).

7 In 1999, Yemen's proven recoverable oil reserves were around 1.7 billion barrels compared to 261.5 billion in Saudi Arabia and 96.5 billion in Kuwait.

8 However, the project to reconstruct Iran's largest refinery at Abadan (bombed in the Iran-Iraq war) has attracted little investor interest to date.

AUSTRALIAN RESOURCE COMPANIES ACTIVE IN THE GULF REGION

BHP Petroleum

BHP Petroleum, BHPP, has been involved in the Iranian oil and gas sector since 1994, and has undertaken several feasibility studies regarding establishing long term strategic partnerships with the National Iranian Oil Company and the National Iranian Gas Company. BHP opened a representative office in Tehran in 1999. Projects BHPP is considering include a gas pipeline between Iran and Pakistan, construction of LNG export facilities, and buy-back oil production projects. BHPP also is participating in an Iranian gas resource assessment study, and is committed to assisting Iran develop its world class petroleum resources.

Novus Petroleum

Novus Petroleum, an Australian based and owned oil and gas exploration and development company, uses its regional office in Dubai to target smaller oil and gas resources in the Middle East and South Asia which do not attract major oil company attention, but which are viable given current technology. It operates a small gas field off Oman, producing 3 000 barrels of gas and condensate per day to supply the northern UAE. It also is negotiating to develop a potentially larger field straddling the border between Oman and Iran, and is exploring an area off Qatar where it has a 25 per cent interest.

Source: BHP Petroleum, 2000; and Novus Petroleum, 2000.

GAS

Gulf governments are according increasing priority to developing the region's significant gas resources. (See Chapter 1 - *Economic Prospects*.) Here, prospects for large scale foreign involvement are brighter than in the oil sector for three key reasons:

- large scale, commercial gas production has only accelerated over the last decade, so in-country vested interests and state owned oil company expertise is weaker
- gas marketing, transport and processing challenges are all greater than for oil
- LNG processing facilities and gas pipelines are very expensive, providing an incentive for governments to seek foreign investors.

Already, foreign capital is helping to expand gas production in Qatar, Saudi Arabia and Oman.

Qatar

Two joint ventures underpin the rapid expansion of Qatar's large North gas field; one is between the Qatar General Petroleum Corporation and Total, Mobil, Mitsui and Marubeni, and the other is between Qatar General Petroleum Corporation and Mobil, the Korean Gas Corporation, Itochu and Nissho Iwai (Economist Intelligence Unit, 1999c). In addition, in early 2000, Elf and Enron became major partners on the Dolphin project, a proposed US$8 billion to $10 billion pipeline and industrial

DOLPHIN: A GIANT PROJECT

The Dolphin project proposal involves building a pipeline from Qatar's giant North field to Abu Dhabi, Dubai and Oman. The project aims to supply gas to meet projected shortages in these economies to generate electricity and fuel industries such as aluminium, steel and petrochemicals in new industrial zones. The project's projected cost to 2007 is between US$8 billion and $10 billion.

By mid 2000, this ambitious project was progressing well. The project's coordinators, UAE Offsets Group, have in principle support from the governments of Qatar, Abu Dhabi, Dubai, Oman and Pakistan.[9] UAE Offset Group also has secured contracts from several potential end users, and announced Elf and Enron as the project's major upstream and downstream developers. These developers are expected to create partnerships to invest in production, storage, distribution and generation facilities.

The major risk facing the project is possible failure to gain effective cross-border transport arrangements; in the past, this has proved difficult in the Gulf.

Source: Fawzy, 2000.

development project to transport and use Oman's North field gas. If it proceeds, the project will generate immense subcontracting opportunities, although its size and profile mean success will depend on high level lobbying and the ability to break into the consortiums bidding for large project blocks.

Saudi Arabia

Saudi ARAMCO's exclusive right to explore, drill for and produce gas was lifted in February 1999 and, following a September 1998 request from the Crown Prince, many foreign companies have submitted proposals for upstream and downstream gas development investments. Among the most attractive proposals are integrated 'wells to wires' projects which use gas from non-oil bearing fields to produce electricity (Miles, 2000).[10]

Oman

The Omani Government actively encourages private gas exploration outside the three existing non-associated gas fields Petroleum Development Oman and its foreign partners are developing. The most notable development is the early 1999 signing of a gas exploration deal between the Omani Government and Occidental Petroleum (United States), BP Amoco (United States and UK) and Fortum Oyj (Finland) to explore and develop several prospective areas for gas reserves. The accord provides for expenditure of US$25 million and production of seismic data for an area of at least 1 700 square

9 In July 1999, UAE Offsets Group, the Pakistani Minister of Petroleum and the Privatisation Commission of Pakistan signed long term supply contracts, contingent on the pipeline being extended to Pakistan, a medium term project goal.

10 Production of gas from non-oil bearing fields or 'non-associated gas' is attractive for electrical production as OPEC oil quotas do not affect it.

kilometres; any gas produced would supply the Sohar and UAE markets (Economist Intelligence Unit, 1999a). Downstream projects include a liquefaction facility being developed by Oman LNG and a range of foreign partners, with output sourced to Japan, the Republic of Korea and India.[11]

MINING

Of all the Gulf economies, Saudi Arabia and Iran have the largest mineral deposits. If foreign investor access improves, weaker nationalist sentiment than in the oil sector may open up opportunities for foreign companies.[12] Foreign involvement in the Saudi mining sector is negligible, although the mining code is under review (Miles, 2000). In Iran, some foreign companies are obtaining buy-back mining projects or contract work. For example, the Iran National Copper Industries Company, NICSICO, which operates Sar Cheshmeh, one of the world's largest copper deposits, engaged BHP Engineering in 1997 and 1998 to construct a smelter.[13] A Canadian firm has started gold mine operations in Iran's West Azerbaijan province, with other Canadian firms negotiating to develop zinc and gold deposits (Economist Intelligence Unit, 1999e).

INFRASTRUCTURE

Gulf governments recognise improved infrastructure is critical for the region's long term economic prospects and increasingly, they are considering private participation. (See Chapter 1 - *Economic Prospects*.) Key areas of need include electricity and water production and distribution, telecommunications and transport infrastructure. The need for fiscal stringency (regional governments have run budget deficits throughout the 1990s) and the inability of regional governments to fund infrastructure provision from oil revenue drive opportunities for private sector involvement. Unless oil prices remain above US$25 per barrel, only Kuwait can fund new electricity infrastructure from budgetary revenue alone (Atkinson, 2000).

Electricity

Analysts put the cost of new electricity infrastructure between 2000 and 2006 in Saudi Arabia, Iran, the UAE, Kuwait, Qatar and Oman at US$40 billion, with Saudi Arabia accounting for around US$20 billion and Iran requiring around US$8 billion (Figure 4.4). Beyond 2006, needs will increase further. For example, by 2020, Saudi Arabia's generating capacity may need to triple from 2000 levels to 70 000 MW (Business Monitor International, 2000c).

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11 The Government of Oman holds a 51 per cent share in Oman LNG. Royal Dutch Shell is the largest foreign partner with a 30 per cent share. Other partners include Korea LNG, Partex of Portugal and Mitsubishi, Mitsui and Itochu of Japan (Business Monitor International, May 2000).

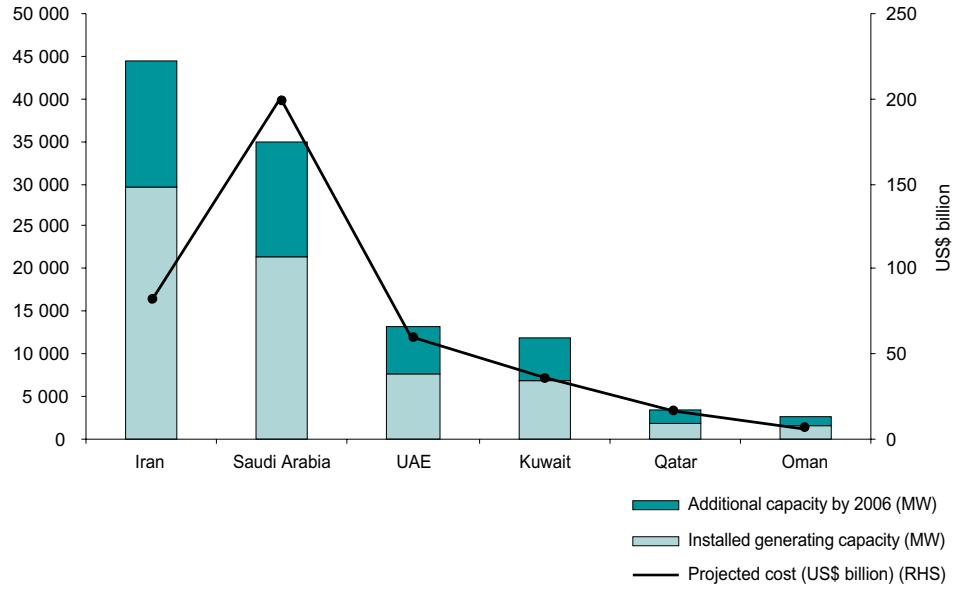
12 Saudi Arabia has substantial deposits of gold, iron ore, copper, phosphates, silver, uranium, bauxite, coal, tungsten, lead and zinc (Economist Intelligence Unit, 1999d). Major Iranian mineral deposits include copper, aluminium, lead, manganese and zinc, with copper production largest (101 000 tonnes in 1998) followed by zinc (76 500 tonnes) and aluminium (62 500 tonnes) (Economist Intelligence Unit, 1999e).

13 BHP Engineering was sold in December 1999 to the Hatch Group of Canada.

Figure 4.4

Electricity Infrastructure Requirements to Surge

Installed and Required Generating Capacity (MW) and Projected Cost



Source: Business Monitor International, 2000d.

Oman and the UAE lead private electricity generation. In 1994, Oman's 90 MW Al Manah power plant was the Middle East's first build, operate, transfer, BOT, power project. Oman also has called for tenders for the 240 MW Sharqiya build, own, operate, BOO, project and the 400 MW Barqa BOO project.[14] In the UAE, the Taweelah A2 project is underway in Abu Dhabi, with the Taweelah A1 project to follow. The US company, CMS Energy Corporation, is building the Taweelah A2 project, with 49 per cent equity in the company, and along with a French-Belgian TotalFina-Tractabel consortium, is shortlisted for the Taweelah A1 project (Business Monitor International, 2000c).

Despite its massive needs, Saudi Arabia is moving slowly to make private sector power provision more attractive. In August 1997, it gave power projects access to tax holidays and concessional funding, and in February 2000, it increased electricity tariffs and formed the Saudi Electricity Company by amalgamating regional power companies. Although the Government has not limited the Saudi Electricity Company's power sourcing, no major projects using foreign capital are underway yet. Saudi 'well to wire' gas projects remain the most prospective private power generation projects.

In Iran, despite large additional power requirements, most industry observers believe changes needed to allow private sector participation will take time (Atkinson, 2000).

14 The Barqa power plant also will produce 756 million litres of water per day.

Water

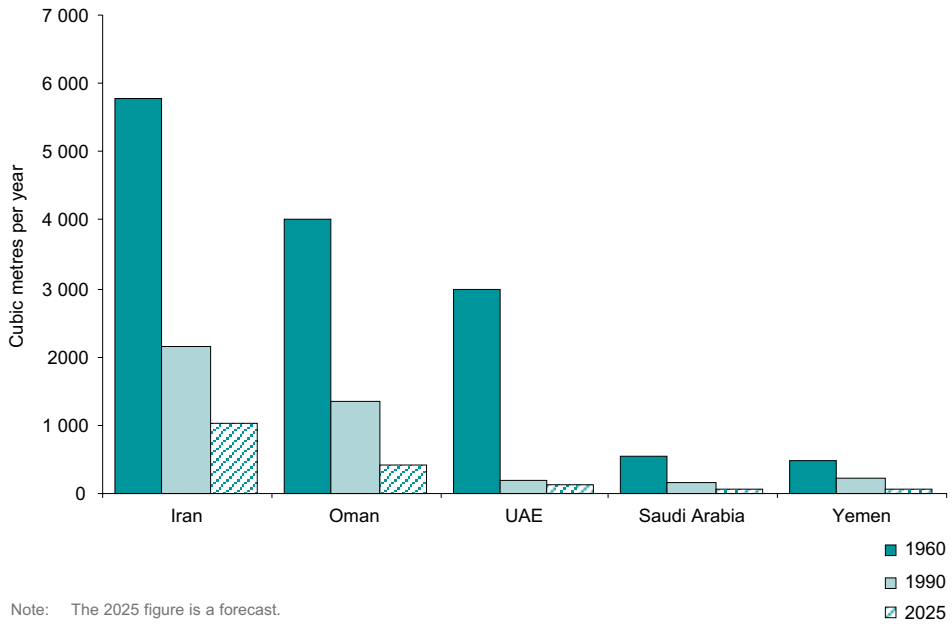
Foreign participation opportunities also are likely in water supply, as Gulf economies' per capita renewable water supplies are falling rapidly (Figure 4.5). Water mostly is produced through desalination, using heat from electricity generation. As desalination costs are falling steadily, private sector participation is increasingly viable.[15] Governments also seek private participation in waste water treatment.

Major water projects are underway in Kuwait and the UAE. In February 2000, five shortlisted Kuwaiti and international teams submitted bids for the 375 000 cubic metres per day, 20 year concession for the Sulaibiya waste water treatment plant in Kuwait; when completed, this plant will be one of the largest waste water BOTs in the world. In the UAE, the Taweelah A2 electricity generation project also will produce 189 million litres of desalinated water per day. The Taweelah A1 project requires developers to acquire an existing power station and desalination facility, and finance extensions to both.

Figure 4.5

Water Shortages Drive Opportunities

Renewable Water Resources per Capita, 1960, 1990 and 2025



Note: The 2025 figure is a forecast.

Source: *Middle East Economic Digest*, 28 January 2000, p. 8.

[15] For example, in 1979, the delivery price of 1 cubic metre of desalinated water was US$5.50. By 1999, the cost including interest, capital recovery, operation and maintenance had plunged to US$0.55 (*Middle East Economic Digest*, 28 January 2000, p. 10).

While Iran's mountainous areas hold relatively large water reserves, Saudi Arabia is facing a sharp decline in its renewable water resources; Jeddah and other large cities already experience shortages. The Government has not announced any large water projects with major foreign involvement, although projects emerging from the ongoing negotiations with major oil companies could well involve water production alongside gas extraction and electricity generation.

JEDDAH: MAJOR SHORTAGES AHEAD

According to Dr Adel Bushnak, member of the Supreme Economic Council and the Jeddah Chamber of Commerce and Industry, Jeddah needs one million cubic metres of fresh water per day to solve its water shortages; existing resources cover only 40 per cent of requirements. He estimates by 2020, population and economic growth will push daily fresh water requirements to 3.5 million cubic metres. He anticipates over the next decade, Jeddah's water supply alone will need an investment of US$533 million per year.

Source: Atkinson, 2000.

Telecommunications

As in the rest of the world, telecommunications demand in the Gulf is exploding. In 1994, the Saudi Telecommunications Company installed 80 000 fixed lines per year; now it installs 80 000 fixed lines per month (Atkinson, 2000). To date, state owned monopolies dominate regional telecommunication markets; foreign investors may be limited to taking equity in existing state telecommunications companies as privatisation proceeds.[16] For example, Oman and Saudi Arabia aim to privatise state telecommunications companies, and foreign investors may be able to buy equity shares. The latest Saudi offer in WTO negotiations with the United States includes sale of a 20 to 40 per cent share in Saudi Telecommunications Company to a single foreign partner (Economist Intelligence Unit, 2000b).[17]

However, further liberalisation is in prospect. Most notably, under its WTO accession, Oman is progressively liberalising access to its telecommunications sector. (See Chapter 5 - *Trade*.) If other Gulf economies are to capitalise on electronic commerce and maximise telecommunication's potential to contribute to economic growth, many could recognise their need to further liberalise their markets along these lines, at least for mobile, international and Internet services.

16 The UAE is slightly different as the telecommunications company, Etisalat, is publicly listed, although foreigners cannot yet own equity. However, Etisalat's monopoly currently is under serious review.

17 The Saudi Telecommunications Company was corporatised as a first step to privatisation (HE Khalid ibn Mohammed Al-Gosaibi, 2000). The Omani Government is inviting strategic investment in the national telecommunications company as a precursor to its privatisation (HE Ahmed Bin Abdulnabi Makki, 2000).

PETROCHEMICALS

The desire for economic diversification, high oil and gas prices flowing through into petrochemical end markets and resurging Asian demand drive the region's rapidly expanding petrochemical industry.

While Saudi Arabia's new investment guidelines should allow 100 per cent foreign ownership of petrochemical projects, most existing foreign participation is through joint ventures. The Saudi Arabian Basic Industries Corporation, SABIC, remains a likely partner in all major projects; between 1998 and 2002, it plans to spend US$9 billion in joint ventures with foreign and domestic partners (*Middle East Economic Digest*, 24 March 2000, p. 16).

Abu Dhabi, UAE also is expanding its petrochemicals industry, while Oman's plans are less advanced.[18] These plans may open up new joint venture opportunities for foreign companies. The largest project is the US$1 billion Borogue polyethelene joint venture between Abu Dhabi National Oil Company and Borealis of Denmark (Economist Intelligence Unit, 1999f).

Another important development is the November 1999 signing of a letter of intent between National Petrochemicals Company (Iran) and Elenac (Germany) to construct a low density polyethylene plant; start up is scheduled for 2003.[19] The first Iranian foreign joint venture since the 1979 revolution, the project will have Elenac owning 55 per cent (Atkinson, 2000).

MANUFACTURING

Thus far, most foreign investment in Gulf economies' manufacturing sectors is in light manufacturing. However, increased investment is likely in the region's expanding heavy industry sector.

Heavy Manufacturing

In addition to the region's expanding petrochemicals industry, other types of heavy manufacturing are developing, using the region's cheap energy, abundant land, favourable tax regime and cheap expatriate labour. For example, the region contains two of the world's largest aluminium refineries, Dubai Aluminium, Dubal, and the Aluminium Company of Bahrain, ALBA.

Thus far, major heavy industry companies, such as Dubal, ALBA and SABIC, are majority state owned. However, opportunities may arise to increase foreign capital's role in aluminium, petrochemical and steel production, including electric arc furnaces and downstream rolling mills. Three main factors are likely to drive increased foreign involvement in heavy industry:

- firstly, if major gas pipelines, such as Dolphin proceed, the scale of investment required to establish downstream gas using heavy industry in aluminium, steel and petrochemicals may stimulate further interest in attracting foreign investment

[18] Oman's petrochemical industry expansion is delayed by the need to complete the Sohar gas pipeline to augment gas supplies and develop a range of industries to efficiently use the gas feedstock. (Economist Intelligence Unit, 1999a).

[19] Elenac is a joint venture between Royal Dutch Shell Group and BASF.

- secondly, major expansion in mining activity, particularly in Saudi Arabia or Iran which have the largest reserves, could create investment opportunities in minerals processing, given the availability of cheap energy and need for foreign expertise
- thirdly, as in the infrastructure sector, increased investment requirements may stimulate better regulatory and foreign access regimes.

Light Manufacturing

Foreign light manufacturing investment is concentrated in UAE free trade zones and Saudi joint ventures in food processing, paper, printing and publishing, and construction materials (Saudi Consulting House, 1999).

Tariff free imports, cheap labour and energy, and regional market access attract foreign light manufacturing investment to free trade zones, including Sony (electronics), Acer (electronics), Mannesmann Demag (small motor and gearbox assembler) and Clipsal (Australian electrical components maker). For example, Sony assembles many products in Jebel Ali before shipping them throughout the Middle East, to states of the former Soviet Union and to Africa, while Clipsal produces electrical and wiring accessories at Sharjah International Airport Free Zone to distribute throughout the Middle East (*Gulf Business*, 1999 and Clipsal, 2000).[20]

The proposed introduction of a common Gulf Cooperation Council, GCC, tariff and free trade between members in 2005 should increase access to the whole GCC market, thus increasing the region's attractiveness for light manufacturing investment.

DISTRIBUTION

International distribution sector investment is concentrated in UAE free trade zones. However, investment in ports is growing strongly across the region.

Free Zone Investment

Major region wide distribution operations run out of UAE free zones include BASF, Colgate-Palmolive, Johnson and Johnson, Samsung, LG and IBM. In addition, freight companies, Lufthansa, DHL, Federal Express and TNT Worldwide Express have major hubs in the UAE. Lufthansa's largest air cargo hub outside Germany is at Sharjah International Airport Free Zone.

Investment in New Ports

Large scale investment in new ports is region wide, often occurring as part of free trade zones. Major port upgrades are underway at Aden in Yemen, Salalah in Oman and Jeddah in Saudi Arabia. Of these upgrades, Salalah largely is funded through a joint venture between Maersk Sealand and the Omani Government, while the Aden upgrade is a joint venture between the Port of Singapore Authority and the Government of Yemen.

[20] In addition to these multinationals, many companies are from the UAE, India and Iran.

In addition, the UAE's ports and Bandar Abbas in Iran also have been upgraded. While Bandar Abbas has no foreign partner and Iran's trade regime is relatively closed, the port has good physical infrastructure and a direct customs bonded rail link with Turkmenistan, allowing access to states of the former Soviet Union.

FREE TRADE ZONES

UAE free trade zones are the most established in the region. Other notable free zones are in Oman, Yemen and Iran. Oman and Yemen are prospective as distribution hubs, but are yet to attract diverse investment, while the dubious legal status of foreign investment, which the constitution technically prohibits, constrains Iranian zones.

UAE

The UAE has major free zones in Dubai, Sharjah and Abu Dhabi, and smaller zones in the Northern Emirates. The highly successful Jebel Ali free zone focuses on light manufacturing and distribution, while Sharjah focuses on heavy industry. Current plans for the Saadiyat Island free zone proposed for Abu Dhabi focus on bulk commodities, with offshore banking services to support commodity trading, storage and transformation activities. The UAE also features airport free zones in Dubai and Sharjah; the Sharjah zone is a large air cargo hub between Asia and Europe.

All these zones offer a range of benefits including:

- 100 per cent foreign ownership[21]
- exemption from all import duties
- exemption from corporate tax
- no national agent requirement for branches of foreign companies (Jeffreys, 2000, pp. 118-20).

In addition, Dubai is developing a free zone for technology, e-commerce and media, the so called Internet City. While construction only started in early 2000, the Government's commitment to the zone's success is reflected in its decision to allow 100 per cent foreign ownership, provide 50 year guarantees on the ability to transfer capital and repatriate profit, and offer 50 year leases on land or offices. In addition, the zone's governing authority is not bound to use Etisalat, the UAE's monopoly telecommunications provider (Jeffreys, 2000, pp. 118-20; and Business Monitor International, 2000b). Thus far, Oracle has confirmed a move in its Europe and Middle East headquarters from Vienna to Dubai, with IBM and Sun Microsystems also negotiating to establish in the zone (Jeffreys, 2000, pp. 124-26).

21 Investors must establish a branch office or single shareholder free zone establishment to be 100 per cent foreign owned (Jeffreys, 2000).

JEBEL ALI FREE TRADE ZONE

Jebel Ali in Dubai is the most successful free trade zone on the Arabian Peninsula, attracting over 600 international manufacturing, distribution, trading and processing companies. In addition to major multinationals, large GCC, Indian, Iranian and Russian companies and a range of Australian companies include:

- Alutech, which provides engineering and technology services for refurbishments and installations at Dubai's aluminium smelter
- Hunter Watertech, which produces measurement, process control and automation products for the agricultural, oil and gas sectors
- Worley Engineering, which undertakes engineering projects, primarily in the oil and gas sectors, and which recently shifted its international head office to Jebel Ali from Indonesia
- Orica Explosives, which has a local joint venture, Emirates Explosives.[22]

Factors distinguishing Jebel Ali from other free zones include its early establishment, well developed deepwater port, efficient management and proximity to Dubai's relatively large population (30 minutes by road).

Yemen

The Aden duty free zone is a joint venture between the Yemen Government and the Port of Singapore Authority, which has a 20 year management contract and 60 per cent project equity (*Gulf Business*, 2000). Aden only requires ships to deviate 2 nautical miles from established Europe-Asia sealanes, so it is ideal for distributing goods coming through the Suez Canal. However, after Yemen's mid 1990s civil war and recent kidnappings, it needs to establish credibility. Also Yemen's market size is small and infrastructure is weak compared to the UAE.[23] (See Chapter 5 - *Trade*.)

Oman

Echoing Omani traders' historic role, trade throughput through Salalah duty free zone is growing rapidly, due largely to a US$260 million joint venture between the Omani Government and Maersk Sealand. However, like Aden, Oman's internal market is small compared to the UAE. In addition, Salalah may experience competition from Aden, as Salalah requires a larger and more costly deviation from established Europe-Asia sealanes.

22 Austrade's Dubai office supplied information on all these companies.

23 The UAE's GDP of US$49 billion and per capita GDP of US$15 100 compare to US$14 billion and US$6 120 in Oman, and US$5.6 billion and US$340 in Yemen.

Iran

Iran has both free trade zones and special economic zones, which are industry focused and under the control of individual ministries. Kish Island free trade zone, in the middle of the Gulf, focuses on tourism, services, and light industry, but thus far has mainly attracted Iranian tourism investment. The Qeshm Island free zone, near the southern port of Bandar Abbas, lies adjacent to large gas fields, and is intended for heavy industrial, particularly petrochemicals and LNG investment. The Chahbahar free zone, which lies outside the Gulf, on the Indian Ocean, lies at the terminus of direct road and rail links between the Gulf and Central Asia.

Despite their undoubted promise, the Iranian free zones fail to attract significant foreign investment because of infrastructure deficiencies, the dubious legal status of foreign holdings and the United States Iran Libya Sanctions Act.[24]

Iran's special economic zones experience the same impediments as the free zones, but have superior infrastructure. The Al-Mahdhi zone, adjacent to Qeshm Island near the port city of Bandar Abbas, features excellent infrastructure for heavy industry development and seeks foreign investors for a large aluminium smelter and a steel manufacturing complex; both are operational but require further investment.

MAJOR INFLUENCES ON THE FDI OUTLOOK

While investment liberalisation is underway throughout the Gulf region, much remains to be done. Apart from oil price trends, key factors affecting the investment outlook include reform progress in Saudi Arabia, regional integration and the lifting of US sanctions on Iran.

Oil Price Trends

If oil prices remain above US$25 per barrel, government revenues will rise dramatically and reforms could slip, as foreign capital becomes less important. However, despite current high oil prices, major reform slippage is not apparent. For example, the Saudi Government recently finalised new tax rates for foreign companies and is proceeding to open gas and downstream oil sectors to foreign investment.

Reform Progress in Saudi Arabia

The Saudi economy's size and massive oil and gas reserves make its FDI reform progress critical to the Gulf's future investment environment. Continued progress in Saudi Arabia will trigger further reform elsewhere in the region; otherwise, smaller economies will struggle to compete for investment capital. Saudi accession to the WTO would raise the probability of further investment reform.

[24] Ongoing disputes within economic and political circles over the desirable level of foreign presence in the economy affect Iran's free zones. In addition, religious concerns centre on the more liberal social environment required to attract foreign investment to the zones.

Regional Integration

Increased regional integration would boost investment prospects by increasing the likelihood of competitive reform programs. Furthermore, successfully harmonising tariffs in the 5.5 to 7.5 per cent range would increase intra-regional trade flows and the attractiveness of establishing distribution centres and regional headquarters. Finally, reduced tensions between GCC economies and Iran would boost trade flows and increase the region's attractiveness to investors.

US Sanctions on Iran

US sanctions on Iran apply to both US and non-US firms investing more than US$20 million in Iran's oil and gas sectors in any year, although foreign companies can apply for exemptions. These sanctions expire in mid 2001 and their non-renewal would open the way for a wave of new investment in Iran.

CONCLUSIONS

Although much remains to be done, Gulf FDI regimes are improving gradually, led by Qatar, Oman and Saudi Arabia. Potential for large new foreign investment is greatest in gas, infrastructure, petrochemicals and heavy industry. In these rapidly growing areas, the single most important step that would increase foreign capital's contribution to economic activity is to move beyond selling shares in existing or privatising companies; instead, broad ranging reform implementation is required, allowing freer domestic and foreign competition, including 100 per cent foreign ownership in most sectors.

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