Iraq Petroleum Law Re-visited

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By
Tariq Shafiq
Director, Petrolog & Associates

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1. 0 Background & Geopolitics

1.1 In May 2006, following the initiation of Dr Maliki's cabinet of national unity and the appointment of Dr Hussain Sherristani to the portfolio of the Ministry of Oil (MoO), Petrolog & Associates consultants were approached with the task of drafting the Iraq petroleum law.

Three Iraqi technocrats, who have a combined international oil industry experience of more than 120 years, prepared the draft law within a few months and submitted it to the MoO in August 2006.

The draft was adopted by the MoO and submitted to the Prime Minister, who in turn appointed a ministerial committee which represented a spectrum of interests and views, including in the main representatives from the Regional Government of Kurdistan (KRG). It took some eight months of stop-and-go negotiations, chiefly to resolve the emerging disputes between the mainstream in the federal government and the KRG. The discussions did not start in earnest until agreement on the revenue distribution was secured.

1.2 The final negotiated draft was announced on 15 March 2007, by unanimous agreement within the ministerial committee, which was chaired by Kurdish Deputy Prime Minister, Dr Barham Saleh.

However, like the January 2007 draft before it, the March 2007 draft was soon thereafter denounced by the KRG, on the basis that their government had not been party to examining the four attachments, three of which allocate the discovered fields between INOC, the MoO and the regions, while the fourth defines 65 exploration blocks. Until today, 12th of June 2007, there is no sign of a successful outcome.

The KRG had already published their own draft petroleum law, based on a radically different interpretation of the constitutional articles governing the oil and gas resources from that adopted in the draft of the federal MoO. The divergence in positions was somewhat narrowed down by December 2006, when the KRG declared that it was prepared to "voluntarily" come to an interpretation which was more or less close to the federal perspective, but not without two major concessions secured in the January draft and again in the latest March draft in favour of the KRG and the regions and at the expense of the country's interests. It must be recalled here that the initial MoO draft, was strictly envisaged as a professional document without margins for negotiation.

The first of the two principal concessions concerned the decision-making process, whereby the role of the regions and the producing governorates became wider and more decisive despite the flaws and pitfalls this would entail. The second concerned the addition of a divisive and untimely article to enforce the urgent and immediate grant of exploration and development rights to IOCs for

vast 65 exploration blocks. The article would have provided the regions with further authority with potentially damaging consequences to the nation's interests.

1.3 The KRG has been pursuing an independent oil policy involving half a dozen PSA contracts in their region. They have also declared their intention to carry on future exploration and development by IOCs on the traditional PSA model. The latest negotiated draft of the law though has not however named as yet the PSA as a model. It is important to note that the first draft law and subsequent negotiated drafts have emphasised the principle of national control in model contracts. PSAs, however, require conceding control to the contractor to an extent which could be considered to infringe on the sovereignty of the state. For this reason and others, it may have to be excluded from the Iraqi petroleum law. It should be mentioned at this juncture that the PSA inclusion as a model contract was intended to refer to a modified form developed by the MoO, which adopts buy-back principles and not the standard PSA.

1.4 The last four years have witnessed repeated attempts at dismantling the basis for any well planned resources management for the whole nation only to replace it with market oriented destabilisation and fragmentation policies that are at variance, and in competition with each other and the national interest. Such policies have been advocated in turn by the Coalition Provisional Administration (CPA), the Transition Government of Dr Al'lawi.

The CPA Minister of Oil, Dr Bahr al-Uloum, announced the aspiration of the time as the privatisation of the oil industry. He declared however that the decision would be left for a democratically elected future government.

Prime Minister, Dr Al'lawi, of the Interim Government of June 2004, outlined his petroleum plans and policy to a newly formed Supreme Oil Council. He intended to remove the exploration and development operation from the Ministry and allocate it to a newly established INOC, whose operations, however, he limited to existing oil producing fields, with the prospect of its partial privatization.

He emphasized expediting the entry of IOCs to start developing Iraq's undeveloped oil and gas fields and explore other areas on a PSA model that bars any government entity becoming party in the PSA.

His plans, which by-passed his own oil ministry, were met with disapproval from senior Iraqi oil technocrats in informal meetings designed to explore the degree of their acceptability. As a long term policy, it ran counter to the Transition Administration Law (TAL) which permitted only short term plans.

1.5 The policy of the neo-conservative politicians prior to- and post- the invasion of Iraq has been the privatisation of Iraq's oil industry leaving future exploration and development in the hands of IOCs on the basis of the PSA model. They

called for Iraq's withdrawal from OPEC and an open oil production policy to rival Saudi Arabia and break the OPEC cartel.

Privatization, however, runs against the grain of the great majority of the oil technocrats and the nation. A strong state-owned national oil industry and unified central plan, policy and resource management, with a liberal attitude towards cooperation with the regions and governorates, have become the unchallenged principles of the overwhelming majority of Iraqi oil technocrats.

1.6 The constitution was drafted by a parliamentary committee but modified by the influential party heads, so called the "matbach" (kitchen), by a process of mutual concessions, "muhasasa", designed to serve the interests of the parties concerned, with complete disregard to transparency, effectively paralysing the parliamentary process. It was then put for parliamentary approval and passed by majority. Within a day this significant and complex document was put to a plebiscite and gained approval, without a fair period of debate given to NGOs, specialised groups or the public at large.

The articles governing oil and gas similarly received their share of modification by the "matbakh" to meet the parties' specific interests.

Article 111 of the constitution made the oil and gas assets the property of the whole nation and for emphasis added: *in all the regions and governorates*. The KRG took the view that the latter addition conveys ownership to each region and governorate.

Article 112 deals with the production management of the producing fields and the making of plans and policy thereto by the Federal government, in co-operation or consultation with the regions and governorates. The KRG took the view that the producing fields are limited to the presently producing fields and do not include all the discovered fields which are not developed partially or fully.

The article goes on to task, by exclusion, the management of future exploration to the regions and governorates. Since the location of oil traps takes no consideration of surface boundaries, this can cause serious regional boundary disputes, and envy among the haves and have-nots, leading to further fragmentation instead of unity, and becoming an obstacle against optimal management of the oil and gas resource.

KRG interpretation gained no acceptance from the main stream of the central government and was met with strong opposition from the Iraqi intellectuals, legal and oil industry technocrats alike. It created an environment for fragmentation, compounded the fear of a federal system and its promoters within and without the country, and enforced the need for a review of the constitution.

To quote from the Baker Hamilton report, "The politics of oil has the potential to further damage the country's already fragile efforts to create a unified central

government. The Iraqi Constitution leaves the door open for regions to take the lead in developing new oil resources. Article108 (changed to 111) states that 'oil and gas are the ownership of all the peoples of Iraq in all the regions and governorates', while Article 109 (changed to 112) tasks the federal government with 'the management of oil and gas extracted from current fields'. This language has led to contention over what constitutes a 'new' or an 'existing' resource, a question that has profound ramifications for the ultimate control of future oil revenue."

1.7 Ambassador Bremer, Head of the CPA, formed the Iraqi Advisory Governing Council and a ministerial cabinet on sectarian and ethnic lines, for the first time in the history of the country. From then on the concept of federated states took route in the system of governance through the Transition Administration Law (TAL) first, and then in the constitution. Central government has become equated to totalitarian rule. Seeking federated regions and governorates has become the logical pursuit of some of the religious parties of the south, where oil reserves are in abundance, to catch up with gains of the Kurdistan "confederate" region, through the use of sectarian religious means. This is not a surprising outcome, since the new constitution even grants supremacy to the provincial laws over the federal laws in wide areas of joint responsibility.

1.8 There was hope and aspiration when Maliki's government of national unity programme included amongst other vital matters, reform of the de-bathification laws and practices; reconciliation amongst the feuding religious parties themselves, and between other armed groups and government forces; dismantling the militias; reducing assassination, blackmail and other criminal acts and acts of terrorism; improvement of the social and economic situation and above all, life security; reducing record unemployment and quelling record corruption.

However, a year has passed with little or no progress made in almost every single area of governance as it turned into a government of national disunity. On the contrary, terrorism and criminal acts have greatly increased. The number of Iraqi refugees forced to leave their homes is approaching four million. There is an average of over 100 violent deaths a day. Many Iraqis live under stark warfare conditions, afraid for their lives to go out for even basic necessities, or to send their children to schools where they remain open. Some areas still make do with limited supplies of electricity, water, telecommunications, for a month at a time, while its corruption record places Iraq near the bottom of 163 countries surveyed, and unemployment is estimated at a record of 30%-60%.

With regard to oil, the smuggling of crude oil is in the range of 100,000 to 300,000 bpd. Products smuggling is as bad. The oil products black market and smuggling coupled with the ineffectiveness of the management of oil refineries are such that the country has to import products to the tune of $6 billion a year. But the beneficiaries are many and too powerful to be stopped.

The Baker Hamilton report describes the risk of the present situation, “Recent polling indicates that only 36 percent of Iraqis feel their country is heading in the right direction, and 79 percent of Iraqis have a “mostly negative” view of the influence that the United States has in their country. Sixty-one percent of Iraqis approve of attacks on US-led forces. If Iraqis continue to perceive Americans as representing an occupying force, the United States could become its own worst enemy in a land it liberated from tyranny.”

1.9 The most important law in the life of the country after the constitution, the petroleum law, is being negotiated in the midst of this chaotic environment. Oil is a global strategic commodity. In Iraq it feeds 95% of the state revenue and, of late, finances many internal power pockets. And, no power can be sustained without money. No wonder the struggle for control and power is being reflected today in the wranglings over the draft petroleum law from within and without the country, from political, regional and international powers.

It is no surprise, therefore, that over 50 Iraqi oil technocrats met in Amman last February and 61 signatory overwhelmingly came out to declare that the time is inopportune to legislate a petroleum law under the current conditions in Iraq. They suggested deferment pending the scheduled review of the constitution, and expressed suspicion if the draft law were to be rushed through under today’s circumstances. In a constructive move, however, a fair majority suggested modifications along the line of a central unified policy; i.e. central planning and management in cooperation with the regions and provinces, a strong state-owned national oil company and a liberal attitude towards IOCs service contract but against PSAs.

2.0 The Draft Petroleum Laws

The first petroleum law was drafted with an appreciation of the above geopolitical background. The overall objective was to ascertain unified oil and gas resource management plan, optimise Iraq’s oil and gas exploitation, maximise return, and unite the country and nation.

2.1 The constitutional articles governing the management of the oil and gas resources lack clarity and consistency. This required that a neutral and objective interpretation be sought to provide the basis for the petroleum law. A competent legal authority was sought who provided such interpretation.

Article 111 dictates that the oil and gas assets are the property of the nation. And, article 112 made the oil and gas strategic policy contingent on achieving the highest benefit to the nation. This made it mandatory that the most efficient exploration and development management policy and plans be sought, and that any policy that does not lead to achieving highest benefit, revenue and fringe benefits, to the nation is not acceptable.

But article 112 requires that the strategic policy and management of the discovered fields be carried out by the federal government in cooperation or consultation with the regions and governorates.

The oil and gas geological reality is such that the proven oil reserves of 115 Billion barrels (B bbls) are housed in some 80 oil fields spread unevenly and across provincial boundaries throughout the country. Basra, for example, holds over 50% of the country's oil reserves and there are scores of fields crossing provincial boundaries. There are potential reserves of 215 B barrels among already identifies 415 structural surface and subsurface anomalies, distributed unevenly throughout the country. It becomes ever clearer, in the interest of unity of the country and nation, that unified decision making, plans and policy run from the centre are vital to optimise the resource management and avoid potential conflicts across borders and between those who have and have not.

Articles 112 continue with a complimentary statement which implies that the exploration and development for potential oil and gas (which is estimated at 215 B bbls) and its development are carried out by the regions and governorates.

2.2 While oil and gas are the property of the whole nation, there is no logical reason why future oil and gas exploration and development are left to the management of the regions and governorates and not to the Federal government which is the only executive of the whole nation. In addition to the above cited drawbacks, management of the future resource potential, amounting to double the present proven reserves, through IOCs on PSAs would lead to uncontrolled competition against the state's own oil from INOC and among the provinces themselves. Worse yet, as the proven reserves are exhausted, reliance on the IOCs grows, leading to greater dependence of the state on the foreign companies, with undesirable consequences, including limiting the state's economic sovereignty.

2.3 In the absence of radical corrective measures to the above constitutional article, the first petroleum draft sought cooperation with the regions and governorates, and beyond that, also their participation in important instances, in lieu of their falling in line with a unified policy and resource management of exploration and development from the centre.

Optimum management of the petroleum resource to produce the highest benefit can only be achieved through unified plans, policy, regulatory and supervisory roles, operations and decision-making process. Efficient management of the resource and highest benefit to the nation can be realized only when the plans and policy are designed to encompass the country as a whole and not any localized region or province in isolation from the rest.

2.4 A radical solution to truly satisfy the objective of the overriding article 111, is for exploration and development of potential oil reserves to be managed in the

same way as the discovered and proven oil and gas. Amendment of the constitution is, therefore, needed in such a way as to modify article 112 to include the management of the exploration and development of new reserves, in the same way, under the umbrella of the Federal Government.

But this radical solution was not in hand, hence a compromise approach had to be adopted in order to balance the ambition of the regions and governorates on the one hand, and the stated and implied overall responsibility of the Federal Government, as the executive custodian of the whole nation, on the other, in such a way so as to manage the petroleum resource with the efficient management required to realize the highest benefits to the nation.

2.5 Therefore, a new management scheme had to be devised. A decision-making Central Commission was created to act on behalf of the Council of Ministers, the ultimate executive authority, under the chairmanship of the Prime Minister and with the Ministry of Oil as the Secretariat plus ministerial level members, necessarily of managerial quality. They were tasked with making decisions over the MoO plans, policy, regulatory and supervisory rules and regulations, among others.

To carry out their task two administrative units were created: a think tank Advisory Consulting Council (ACC) of nine experienced members in the upstream oil industry, of which three are from the regions and provinces, and a specialized Negotiating Unit, to be tasked with the vital process of the grant of exploration and development rights. Representatives from the concerned region and provinces would participate therein.

The MoO remained tasked with all its traditional duties of policy proposals, federal planning, supervisory and regulatory roles, in consultation and cooperation, however, with the regions and provinces. The supervision of the provincial fields was tasked to the regional or provincial authority concerned in coordination with the MoO.

2.6 The latest negotiated draft of the law has in the main radically modified the decision-making process concerning the grant of exploration and development rights, the tasks of the Federal MoO, the make-up and tasks of the Oil and Gas Commission and of the Advisory Consulting Council. The responsibilities and tasks of the Federal MoO were reduced, and passed mainly to a Federal Oil and Gas Council (FOGC), and some to newly established Regional Units, while the ACC was re-named the Independent Consulting Bureau (ICB) and down-graded.

Considering what has been conceded to the KRG today, it is likely to snow ball vertically and horizontally with damaging consequences to the management of the resource and the unity of the country.

The FOGC was enlarged up to a potential of 15-20 members when other regions

are formed and provinces qualify for membership upon achieving a production 100,000 bpd, in addition to other members who may not qualify as decision-makers but are chosen to represent the country's sectarian and ethnic divide, which the law requires. Amazingly enough the executives of some oil companies (who and how many?) have also been added to the list of members.

Decisions of the FOGC are subject to 2/3 majority instead of the simple 50% majority and can be blocked by a powerful region. There is duplication and occasionally overlapping roles for the MoO (in charge of provinces other than the Kurdistan region) the KRG and other provincial units. The latter are delegated the vital task of pre-qualifying potential bidders, negotiating and signing contracts, approving development plans and appointing the operator, while some of these tasks are too technical for the embryonic authorities.

The FOGC reviews and checks the initialed contracts' compatibility with the Council's instructions and model contracts, and at times reconsiders their choice of those pre-qualified (at this delayed time in the decision making process!) with or without reference to its ICB within a prescribed two months period, which may prove unrealistic.

The ICB members are demoted to one year service instead of four, are elected by unanimity of the FOGC instead of the normal 50% majority, and are limited to studying only matters referred to them and denied from publishing an annual report. The ICB, therefore, has lost its effectiveness and its checks and balances role. These changes are bound to promote malpractices and inefficiency instead of strengthening transparency, accountability and effectiveness which are so badly needed today.

Clearly this decision-making process needs to be reviewed to remove overlapping roles and ensure uniformity and transparency of contracts and related development execution.

2.7 The technical and commercial roles are charged to an independent National Oil Company (INOC) with all the discovered fields ear-marked thereto. INOC is designed as a holding company. It is granted the rights to explore and develop the discovered fields, holds the state participation shares and enters into competitive bidding for new exploration and development projects. It operates through affiliated companies where the regions and the governorates may hold up to 50% participation. Directors of these operating companies become directors of the INOC and thus form the linkage with the regions and governorates through shared decision-making at the holding company level. This is designed to permit the regions and governorates unreserved participation in the management of the discovered oil resource.

The negotiated draft law has infringed on INOC's independence by the inclusion into its board of directors members from the relevant federal government, the regions and producing governorates.

2.8 The first draft law prioritised the rehabilitation of the infrastructure and building production capacity to monetize the reserves and make the most of the country's bulk of idle proven reserves of 115 Bb. At today's production of 2 mbpd Iraq needs no more that 17Bb, calculated on the generally accepted Reserve to Production ratio of 20. In line with this rule, Russia, for example, produces some 9.5 mbpd from its reserve of 74 Bb. In effect, Iraq is wasting the finding cost and the earning capacity of 98 Bb undeveloped.

The latest draft calls for the immediate grant of rights to IOCs for exploration and development of 65 blocks with billions of potential oil reserves. The discovered reserves shall be developed and produced to unrestricted capacity without delay or a cap to earn investment capital and provide a healthy return. They will, therefore compete with the INOCs oil large production capacity over a limited share of markets open to Iraq, cause oversupply, destabilize the crude oil price structure and contravene Iraq's obligation towards OPEC, among other undesirable consequences.

IOCs, in my view, are advised to aim for urgently needed rehabilitation of the infrastructure, expansion of the production capacity of partially developed fields, improve damaged reservoir performance, and develop the many discovered but not yet delineated oil fields, rather than going for exploration for unnecessary new oil. A rush for exploration and development contracts would be viewed as mortgaging the reserves of future generations. It would provide fuel to the view that the war was for oil.

Old timers in the industry have learned their lesson from the concessionary era post the First World War, when concessions and the major oil companies become known 'dirty imperialists', as they became the biggest and strongest economic enclaves. I wish the new IOC generation recognises the pitfalls of history and does not repeat old mistakes in the new era of post- March 2003.

This policy of whole sale exploration contracts based on a long-term debatable PSA model is uncalled for and divisive. Announced and applied at this time, when the country is in desperate need for peace with its major OPEC neighbors, Iran, Kuwait and Saudi Arabia, is most unwise.

The first petroleum draft law would have achieved, with the least but simple and effective administrative changes to the existing oil and gas organisations, the objective of achieving optimum management of the resource, participation of and reward to the nation in all its regions and governorates, with clarity, efficiency, accountability and transparency, through unified plans and policies run from the centre.

Unless the pitfalls of the latest draft petroleum law are reviewed and amended in light of professional recommendations, its parliamentary approval through the process of “muhasasa” may produce damaging consequences for the reconciliation effort, the unity of the country and the nation, the social and political fabric of Iraqi society and, last but not least, to the successful execution of Iraq petroleum law and the stability of the global oil market.