

~~CONFIDENTIAL~~
DECLASSIFIED

From: Dominick Chilcott
Date: 28 February 2003

cc: PS/Ministers Offices
PS/PUS
Peter Ricketts
Iraq Policy

To: Private Secretary

SUBJECT: IRAQ DAY AFTER - OIL POLICY

1. I assembled a group, last week, in the Iraq Planning Unit to look at oil-related policy issues in the aftermath of military action. Ministers might be interested in the attached paper setting out our preliminary, official-level thinking. The paper is intended to be a "living" document and will be refined further. It has been circulated fairly widely across Whitehall and incorporates comments from various OGDs. We plan to share our thinking with the Americans in due course, though the paper will need careful editing beforehand.

Dominick Chilcott
Dominick Chilcott
IPU
Tel:

NO. OF ATTACHMENTS: 1

~~CONFIDENTIAL~~
DECLASSIFIED

DECLASSIFIED
CONFIDENTIAL

Iraq Day After – Oil

Introduction

1. How oil is handled will be immensely important in determining the medium and long-term political and economic stability of Iraq post Saddam. This paper provides working conclusions on some of the main oil-related issues. For the purposes of the paper, we are assuming that after any conflict there would be:
 - a short period of occupation immediately after military action during which period the US-led coalition would run Iraq ("the military administration"); followed by
 - a longer period of civilian administration, whether UN-led or otherwise ("the interim administration"); followed by
 - a new representative Iraqi Government which would govern the country when it was ready. This would probably be after 1-2 years.
2. The legal context in which the military and interim administrations (referred to together as "the international administration") operate will be critical in determining the sorts of policies they can carry out. The UN will have a key role in determining this:
 - Unless it had a clear UN mandate, any occupying force's ability to administer a country would be strictly limited in line with international humanitarian law, in particular the Geneva Conventions and Hague Regulations. The military administration might be able to operate without a UN mandate in the immediate aftermath of conflict on the basis that it would not need more extensive powers to take necessary action. But the interim administration would almost certainly need a UN mandate to operate effectively, even if it were not UN-led.
 - Any changes to the Oil for Food (OFF) mechanism, including eg allowing access to the escrow account, would need Security Council action. It would probably be hard to get UN support for this, unless the UN were playing a significant role in the international administration.

DECLASSIFIED
CONFIDENTIAL

CONFIDENTIAL
DECLASSIFIED

Oil Prices

3. Oil prices have recently been close to two year highs. Despite extra production by OPEC, including more than 2 mbd this month from Iraq, the market remains extremely tight. Venezuelan production and exports are still at less than half their normal levels. Spare capacity is at a relatively low level - around 2 mbd, compared to 4-6 mbd over the last couple of years. This, combined with cold weather in North America and historically low stocks of both crude and products, has kept prices up.
4. It is widely believed that \$5-6 of the current price is a "war risk" or uncertainty premium. Should hostilities break out, Iraqi production (and perhaps some of Kuwait's 2 mbd) would be lost. OPEC, particularly Saudi Arabia, are publicly committed to meeting the shortfall. But at present spare capacity might not be sufficient to cover the loss. As a result, coordinated action by the IEA, including stockdraw, might be necessary. Even allowing for this, prices would probably "spike" upwards for a short time.
5. Should hostilities be prolonged or attacks/sabotage in the Gulf affect additional supplies, prices might rise even higher, though stockdraw would also be expanded accordingly. If the conflict appeared likely to be short-lived and contained, we would expect prices to fall to the mid-to-low 20s, especially if demand weakened as usual in the second quarter. But some commentators now see the supply/demand balance as likely to be tight for the medium term. The speed of resumption of Iraqi production could well affect market sentiment.

Our Objectives

6. Immediately after hostilities and the consequent expected removal of Saddam's regime, the UK's economic objectives should be rapid relief of humanitarian needs and restoration of public services. Beyond that we would need to win the peace economically. Reconstruction and economic reform must make possible early improvements in living standards and create the conditions for sustained growth in the long term.
7. Oil revenues generated by Iraq's enormous reserves would have a key part to play. Provided they were not interrupted, Iraq could be in a position to finance a substantial part both of the early spending on humanitarian assistance and emergency reconstruction and the longer term rebuilding of the country. External finance would almost certainly also be needed even if oil production were resumed quickly. There are too many uncertainties to make confident predictions at this stage about amounts or duration. Separate work is being done on how to handle debt payments and

CONFIDENTIAL
DECLASSIFIED

DECLASSIFIED
CONFIDENTIAL

reparations, which are one of the factors involved.

8. It would be important to Iraq's long term future that everything possible were done to protect the oil infrastructure and preserve the flow of oil production and exports. The military planning needs to take this into account. A separate IPU paper is being produced on this.
9. In the immediate aftermath of any conflict – and within the legal, political, economic and security constraints – the military administration's immediate priorities should be to:
 - cap any well fires and prevent further damage to the Iraqi oil infrastructure; and
 - restore production by repairing existing oil production facilities.
10. Iraq's oil infrastructure is ageing and has suffered from decades of under-investment. Getting it back into shape would be a major task, requiring enormous investment over a number of years. This should be a major focus for the international administration. Depending on how long it was there and the legal basis for any occupation, the military administration might bring in assessment teams to establish initial requirements for rehabilitating the oil fields and start making arrangements for rehabilitation contracts. But much of this work would probably fall to the interim administration.
11. The interim administration could also start work on the longer term development of Iraq's oil industry, including tendering contracts for the exploration and exploitation of new areas. (If all such work were deferred until a new Iraqi Government were in place, this would seriously delay the maximisation of Iraq's oil revenue and increase the cost to the international community of its reconstruction.) It would be important to ensure that:
 - Any such moves were clearly in the interests of the Iraqi economy and people;
 - the interim administration had an appropriate UN mandate;
 - everything was done in as transparent a manner as possible; and
 - production was not pushed beyond OPEC-type depletion rates, even though this could be in the interests of the Iraqi people.

Iraq's oil industry

DECLASSIFIED
Page 1

CONFIDENTIAL

CONFIDENTIAL
DECLASSIFIED

12. There is no reason for the international administration to carry out a radical overhaul of Iraq's oil industry. It is relatively well run given the circumstances. Many of its personnel are experienced. While their expertise may be out of date, they have unmatched knowledge of the infrastructure and how it has been maintained under sanctions. The international administration should therefore aim to work with the existing staff in place. Of course, it would want to remove those with strong links with the regime and would be legally entitled to do so.
13. The military administration would therefore need to be ready to take over the existing oil production operations. We understand the Americans have already done some work on this including identifying key figures within the Iraqi oil industry and some of those from the Iraqi diaspora who could take pivotal positions.
14. We should do the same ourselves, with a strong focus on our geographic area of interest, drawing on what the Americans have already done. The military planning process should if possible factor in the need to locate and make safe key personnel and any major administrative buildings for their records, IT systems etc.
15. Winning hearts and minds amongst the Iraqi oil workers would be vital, particularly for the UK given the economic importance of the oil industry in our likely area of focus. We need to make sure we are ready to tell the oil workers what to expect and what we expect of them. We also need to have the necessary resources to pay them.
16. It is likely that many of the senior staff in southern Iraq would have started their careers with the Basra Petroleum Company, which was managed by BP until it was nationalised in 1975. We should consider preparing information leaflets carefully drafted to take into account of historic sensitivities.
17. In addition to a public information campaign targeting the Iraqi oil industry, we should bear in mind the wider internal and international perceptions of what the UK forces do on the ground. There would inevitably be significant interest in how we handled the oil issue. If we got it right, it should help local acceptance of UK forces and increase international support for military action.
18. This means we would want to be seen to be helping to get Iraqi oil pumping again. Visible demonstrations of assistance would be important (eg UK forces and UK funded specialists working on oil infrastructure). But at the same time, we should balance this with robust messages that we have no selfish interest in Iraqi oil.

CONFIDENTIAL
DECLASSIFIED

CONFIDENTIAL
DECLASSIFIED

The Oil For Food Arrangements

19. Under OFF, the Iraqi National Oil Company (INOC) produces oil under the supervision of the Oil Ministry. The oil is then marketed and sold by the State Oil Marketing Organisation (SOMO). All lawful Iraqi oil contracts are sent to the UN in New York, which controls the prices and holds all monies generated in an escrow account.
20. Recently lawful Iraqi oil exports have generated about US\$5 billion of revenue every 180 days. (Iraq has also exported about 0.4 mbd illegally. Our aim should be to bring these exports into OFF – see below.) 72 percent of this revenue is used to buy “humanitarian goods”, defined very broadly to include eg oil field equipment, according to a distribution plan agreed between the Iraqi Government and the UN. Most of the remainder (25 percent) is applied to settle outstanding compensation for Iraq’s invasion of Kuwait through the UN Compensation Fund.
21. The OFF escrow account is currently extremely short of funds – its 59% account (which holds monies for central and southern Iraq) has a deficit of US\$4.4 billion and its 13% account (holding monies for the north) has a surplus of US\$1.7-2 billion. Using funds in the 13% account to fund projects in south or central Iraq could provoke enormous protests from the Kurds in the north.
22. There are strong reasons for continuing to use the OFF mechanisms in the immediate aftermath of any conflict:
 - Sanctions could still be in place for some time. Under the current sanctions regime, OFF is the only legal way of exporting oil from Iraq.
 - Unless and until it had a proper UN mandate, the international administration would not have the legal authority to redesign Iraq’s oil production and distribution structures, even if it wanted to.
 - The OFF model should be flexible enough to enable expenditure on the sorts of tasks the international administration would probably want to carry out. This would include maintaining the oilfields. The Iraqi Government is currently allowed to spend US\$600 million on this every 6 months, but in practice chooses not to do so. At a recent briefing, BP suggested that this level of investment would be insufficient to restore the Iraqi oil industry to health in any reasonable time frame. So there might be a need to increase this figure.

DECLASSIFIED
CONFIDENTIAL

CONFIDENTIAL
DECLASSIFIED

- Funds in the UN escrow account are protected from external claims and readily available for supporting humanitarian needs.
- Continuing UN involvement through the OFF programme and escrow account which is transparent would help rebut assertions that the Coalition had simply invaded Iraq to seize its oil.

Short term adjustments to the OFF

23. The way the OFF model operates would need to be adjusted in the run up to and after any conflict. This could only be done by the Security Council. Adjustments would need to be made:

- To allow the distribution of OFF goods during any military action. An adjusted procedure would be needed to ensure that humanitarian supplies continued during any military action and in the immediate aftermath. As things stand, the withdrawal of UN OFF staff from Iraq in preparation for conflict would bring OFF to a halt. Without the UN staff in place, it would be possible neither to export oil nor to import OFF-funded goods. So unless a new procedure were established there would probably be no further OFF activity until UN staff could return, probably after coalition forces occupied (more or less) the whole country. Given the Iraqi people's dependence on OFF (ie 60 percent of the population relies on the food ration) it would be important to minimise any disruption. One option would be to give the UN Secretary General authority to decide how to distribute goods and to nominate people to do it.
- To order goods against the money held in the escrow account post conflict. Under the terms of the OFF, only the Iraqi Government is entitled to decide what goods should be ordered for distribution to the Iraqi people, subject to limitations determined by the Security Council. In the event the current regime fell from power and there was no immediate Iraqi successor regime, OFF would need to be changed to give someone else this authority. It would almost certainly be appropriate for the Security Council to confer power on the UN Secretary General to do this. It is hard to see who else the international community would trust.
- To restart oil exports post conflict. Again, at present only the Iraqi Government can approve oil exports. This authority would need to be given to someone else. Otherwise there would be a risk that the OFF system would be paralysed with buyers refusing to commit to new oil purchase contracts and doubts being raised about existing ones. Even with a Security Council resolution and robust media message (both before and after any conflict) we would expect uncertainty to disrupt ongoing OFF activity to some extent.

CONFIDENTIAL
DECLASSIFIED

CONFIDENTIAL
DECLASSIFIED

Again, it is hard to imagine the Security Council members agreeing that oil purchase contracts should be allowed out of the overall control of the Secretary General.

- To relax UN controls on goods bought using OFF monies. The international administration would presumably wish to maintain some form of arms embargo on Iraq. But depending on the situation, it might want to relax UN controls on dual use goods purchased under OFF, facilitating their delivery to Iraq. Similarly it might want greater flexibility in what it could purchase using OFF funds (eg "pure" service contracts).
- To renew OFF. OFF would run out on 2 June 2003, unless sanctions had been lifted by then. Each phase of OFF runs for only 180 days and has to be renewed by UN resolution. The programme does not roll over automatically. So if it were not renewed the exemption to sanctions provided by the OFF programme would stop and all Iraqi oil exports would be forbidden.

24. These various requirements would need to be met by a series of resolutions. Some of the elements could be combined. How difficult it would be to get these resolutions through the Council would depend on the wider political climate (in particular whether there had been a second resolution authorising military action) and on their precise terms. In general any resolution keeping control of OFF within the UN would be much easier than one delegating authority to a Coalition general.

25. Some Americans have talked about using the OFF account to help cover the cost of the military occupation. Under international law, an occupying force is entitled to use resources in the ground such as oil for the purposes of the occupation. This could include using locally produced petrol for vehicles etc. But it would not extend to drawing on the escrow account to finance running costs. This would require a further Security Council resolution.

26. Seeking such a resolution would not be advisable since it would inevitably raise accusations that the military action was motivated by oil. It is also uncertain that OFF funds would in any case be sufficient to meet Iraq's needs, let alone the cost of occupation. But it might be possible in due course to get a resolution allowing OFF funds to be used to cover the running costs of the civilian administration, particularly if it were UN-led.

Evolution of OFF

27. Continuing the system of subsidised/rationed food would be massively distorting to the future development of Iraq's economy. So the aim should be to transform OFF into a conventional social security system as quickly as

DECLASSIFIED
CONFIDENTIAL

CONFIDENTIAL
DECLASSIFIED

possible. This could only be done with the authority of the Security Council. Detailed consideration should be given to how this should be done.

28. The international administration would need to think carefully before transferring the funds in the escrow account elsewhere, since this might want to make them vulnerable to legal action. Possible options include: linking any such transfer to broader agreement on debt and reparation payments; or establishing a new UN mandated trust fund. It is also possible that the transfer of money out of the escrow account could be tied into an IFI programme.

Oil smuggling

29. Iraq has been exporting oil illegally outside the OFF programme to a number of its neighbours, particularly Jordan, Syria and Turkey. Under the Jordanian arrangements, which are tolerated but not expressly authorised by the UN, the oil is exchanged for humanitarian goods. The trade with Syria and Turkey involves goods exchange and cash payments to the Iraqi regime. All derive significant economic benefits from this trade: under these illicit arrangements Iraq provides oil at subsidised rates, from US\$3-7 lower than market prices.
30. The international administration would need to reach a decision on how to handle this trade. To maximise Iraqi oil revenues it should press for immediate termination of all such smuggling. It would not want to provoke economic crises elsewhere, particularly not in Jordan. The IMF, perhaps with US bilateral contributions in support, would be best placed to help Jordan make the adjustment to market priced oil.

Iraq and OPEC

31. Iraq's oil production is currently about 2.5 mbd. Its historic OPEC quota is 3.4 mbd, but this is no longer valid. Iraq would probably need to establish a new OPEC quota if it exceeded current production levels. It is unlikely there would be any significant increase in production during the first 1-2 years after any conflict, so we would not expect difficult negotiations in OPEC at the outset.
32. The international administration would need to identify someone appropriate to attend OPEC meetings. (The next meeting is on 11 March and then one in June.) This person should probably be an Iraqi with the appropriate expertise and limited connections with the current regime. He should certainly not be a Coalition General.

CONFIDENTIAL
DECLASSIFIED

CONFIDENTIAL
DECLASSIFIED

Oil contracts

33. There are four broad types of oil contract which need to be considered:
34. Oil purchase contracts under the OFF programme: We would want to ensure these were affected as little as possible by the conflict and that the sale and purchase of Iraqi oil continued with minimal disruption (see paragraph 23 above).
35. Agreements for oil investment in new fields: The interim administration should focus largely on repairing existing infrastructure. But to avoid delaying the longer-term development of Iraq's oil industry, it is also likely to want to enter into contracts for new fields. It would be critical that any such contracts were as transparent as possible and followed internationally recognised tendering procedures. This would help avoid charges that the West was motivated by greed for oil.
36. There are a number of existing oil investment contracts entered into by the current regime. Some may be unlawful in that they break the sanctions regime. Others may be looser agreements which were never concluded. It would primarily be a matter for the new Iraqi Government to assess their lawfulness (or the interim administration if it had appropriate powers under its UN mandate), but legal challenges might be mounted.
37. Firefighting contracts: We understand the US are close to tendering contracts to tackle oil well fires in the aftermath of any military action. The oil well firefighting industry is a small and specialised one. In the event of large numbers of fires, there would probably be work for almost all the main companies. But we should make sure that British companies are aware of the likely opportunities and that the Americans keep us in the picture.

Rehabilitation work: Much of this work would need to be commissioned quite quickly after any conflict and some of the contracts may already have been let. We want to make sure that UK companies are able to compete effectively and fairly for any contracts. The key may partly lie in mobilising British assessment teams to be invited in to weigh up the damage. In addition, we should ensure that contracts are tendered and awarded in as transparent a way as possible. We have already raised this issue with the US Administration. There could be a role for the World Bank which has significant experience in tendering big construction contracts in post conflict situations. We should ensure that UK companies are aware of the opportunities and fully understand the tender processes.

DECLASSIFIED
CONFIDENTIAL

CONFIDENTIAL
DECLASSIFIED

Conclusions and Follow Up

38. In the aftermath of any conflict, the international administration should seek to ensure that:

- Iraqi oil revenues were available to be used for the benefit of Iraq and that there was minimal disruption to the flow of Iraqi oil; and
- All Iraqi oil industry business was handled in as transparent and even handed a manner as possible to rebut allegations about oil motivations.

39. The analysis highlights the role the UN would need to play in achieving these objectives and underpins our wider arguments that the UN should have a central part in any post Saddam administration.

40. We should explore US thinking on the modalities, including in particular: whether they envisage using oil revenues to fund the occupation costs; how they are intending to pay Iraqi oil workers immediately after the conflict; whether they would want to encourage further oil exploration post conflict (ie before an Iraqi administration was in place); how they plan to handle Iraq's illegal oil exports.

41. We should also explore with the Americans a World Bank role in contract award. This could be attractive to them since they hold considerable influence in the Bank and would not anticipate slow progress (which they might fear from a UN lead role).

42. By way of specific follow up we should:-

- Convene a meeting with BP, Shell and other appropriate UK companies (whether together or separately) to explore our ideas and tap into their expertise. We would need to handle this carefully and ensure it was confidential to avoid charges of oil motivations.
- Obtain US data on the Iraqi oil sector and oil personnel.
- Carry out detailed research of the key Iraqi oil industry structures in our area, identifying key personnel (and possibly where they live) and where the key installations and administrative buildings are.
- Start preliminary work to ensure UK companies are well-placed to pick up contracts in the aftermath. This is already in hand with TPUK. Our present policy prevents UK companies from communicating with Iraq about likely contracts to be fulfilled after sanctions are lifted. British nationals continue to

DECLASSIFIED
CONFIDENTIAL

CONFIDENTIAL
DECLASSIFIED

be advised against travel to Iraq for any reason. So the scope for preparatory work is heavily curtailed. A practical first step would be to discuss with UK firms whether they would be able to provide assessment teams to assess rehabilitation requirements as soon as any oil well fires were out. And as soon as we know whether the UK is to get a sector, we should open high level contacts with the major companies to discuss the implications.

- Develop a specific information campaign for the oil sector in Iraq.
- Calculate how much it would cost to pay Iraqi oil personnel to work in the immediate aftermath of conflict, should that be required.
- Ensure key oil messages are woven into our media lines (eg confirming that existing oil purchase contracts will be recognised).
- Factor rapid assistance for oil field installations into our military planning (possibly paying UK specialists to assist with this?).
- Start thinking about appropriate wording for UN resolutions. This is already in hand.
- Carry out further research into the existing oil investment agreements. We do not have a great deal of information on these at present. John Mitchell and Valerie Marcel at Chatham House have done a lot of research and we should get a fuller picture from them. We should find out what work the Americans have done on this.

27 February 2003

DECLASSIFIED
CONFIDENTIAL