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IRAQ: BUILDING A FRAMEWORK FOR OIL SECTOR DEVELOPMENT

1. Creating a legal and institutional framework for the long-term development of its oil reserves is an issue of critical importance for the new Iraqi Government. First and foremost, high-level political agreement is needed between the leaders of Iraq's main national groupings on the two separate questions of how Iraq will structure decision-making in its oil industry (resource management) and how it will manage and distribute oil export receipts (revenue management). This political agreement will need to satisfy both the proponents of loose federalism and those who champion strong central control as a guarantor of national unity.
2. Our starting point is that decisions on oil sector management have the potential to support or fatally undermine efforts to preserve the territorial integrity and democratic development of Iraq. Our key concern is therefore to preserve the integrity and competence of the Iraqi state as a basis for national unity, as well as to create a long-term basis for transparency and adequate investment in the sector.
3. So long as the wider security situation permits, our approach will be guided by the following high-level principles.
 - i. The industry should be structured to allow for managerial and financial autonomy of business units of the industry, within an environment principally regulated at the federal (national) level. Any extensive and rapid decentralisation of decision-making authority, currently held by the Ministry of Oil, risks both undermining a management structure that will produce good performance from the industry, and reinforcing existing sub-national divisions in Iraq. However, some degree of regional responsibility will be politically essential, and regions and governorates must be fully involved and consulted as decisions are taken.
 - ii. The emphasis should be on creating an effective public-sector national oil company (or holding company for several operating companies or business units). Within this overall framework, and subject to decisions of the Council of Ministers, private resources, accessed through foreign direct investment, bonds and commercial and concessional lending, are likely to be needed. In addition to resources, attracting foreign companies with modern skills in oil and gas technology will be essential.
 - iii. Revenue management is an equally important, and separate, issue. Agreement on resource management must be accompanied by a guaranteed revenue sharing formula acceptable to the KRG region and Iraq's governorates.
 - iv. Transparency, both in the role of the relevant Government institutions and in the collection and disbursement of revenues, is critical. As part of a broader revenue transparency approach for Iraq, we endorse the principles of the Extractive Industries Transparency Initiative (EITI).

In the event of a complete breakdown in security and imminent fragmentation of the country we would need to revisit these principles and consider an industry framework based on sub-national divisions; but this should not be publicly raised now lest it encourage those with an interest in fragmentation.

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Resource management

4. In the immediate term, it is important that the organisation brokering lasting agreements on resource management and revenue management is not seen as dominated by the federal Government. For this purpose, a relatively wide group (including KRG and producing governorate, as well as technical, representatives), reporting to the PM or DPM, might be more appropriate. In the longer-term, we support the creation of an Energy Council, reporting to the Deputy Prime Minister for economic affairs, to help develop a coherent energy strategy, addressing oil and gas production, distribution and export, as well as Iraq's own fuel and energy needs. As it develops, the Energy Council will need to have unambiguous ownership of the strategy for rebuilding the sector. However, it will be important that the creation of new bodies be balanced with an effort not to create too many potentially rival institutions that complicate decision-making and increase bureaucratic confusion.

5. We would endorse the creation of a public-sector national holding company that would manage the oil and gas sector – a reconstituted Iraqi National Oil Company (INOC). The INOC should be independent of the Oil Ministry, whose role would be focused on regulatory oversight and policy development. The INOC would have its own Director General, reporting to the Energy Council, and would implement strategy for the sector and negotiate agreements with investors and contractors. Progress in negotiating contracts will be slow if several Government institutions have overlapping approval rights on the detailed terms negotiated with investors or contractors. INOC should therefore be empowered by the Energy Council to negotiate within certain pre-agreed boundaries and a high (value) threshold, with the Energy Council approving major contracts over the threshold. This relatively high degree of competence at the national level would ensure that development of the sector is managed for the benefit of Iraq as a whole.

6. INOC would ideally be structured internally as functional operating companies (i.e. upstream and downstream). In order to meet regional demands, the upstream company could be divided into three regional divisions, tasked with managing upstream operations in their local sectors. Each regional division would effectively be a regional operating company. These divisions would have a direct link to the INOC board, and would be able to make recommendations about investment needs and local production and development policy. The key point is that the three regional divisions should report to INOC's head of upstream development, who would arbitrate in regional disputes as necessary. The Oil Minister and INOC Director must be free to focus on national executive implementation.

Revenue management

7. The Constitution provides for revenues from *current* oil and gas fields to be distributed 'in a fair manner in proportion to the population distribution in all parts of the country, specifying an allotment for a specified period for the damaged regions, which were unjustly deprived of them by the former regime'. It makes no explicit provision for revenues from *future* fields. This is problematic as future fields are anticipated to be a) the main focus of IOCs; b) the main source of future Iraqi oil revenue. Therefore their exclusion from constitutionally mandated revenue sharing structures is a major potential weakness, and could create political problems.

8. Collecting all oil export receipts centrally would make it easier for Iraq's revenue collection arrangements to be adequately monitored and audited. In the interests of maintaining transparency and clear lines of accountability, we would therefore support the continuation of a mechanism broadly based on the current Development Fund for Iraq

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(DFI), with a suitable system of Iraqi oversight and independent audit. If revenues were collected regionally and partially remitted to the federal Government, it is less clear how the essential line of accountability to the Council of Representatives, as the only body representing all the people of Iraq, would be maintained.

9. Central collection and distribution of revenues must be accompanied by a guaranteed revenue sharing formula, ideally set out in a law. This must provide assurances to Iraq's region and governorates that the federal Government will honour its commitments to distribute oil revenues in an agreed, equitable and transparent manner. Experience from other oil producing countries of the world shows how vital it is to ensure producing regions receive their fair share of oil revenues in order to avoid long-term regional instability as witnessed for example in the Niger Delta.

10. **Annex A** provides an outline practical lobbying strategy for taking this approach forward.

British Embassy Baghdad
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Annex A

IRAQ: OIL SECTOR DEVELOPMENT - UK POLICY AND LOBBYING

1. This Annex proposes an outline lobbying strategy based on a preliminary assessment of the current state of play, of the risks and opportunities presented by ongoing political processes, and of the key groups we will need to target.

Current state of play

2. The current situation is characterised by severe constitutional uncertainty, a low level of trust between the key players and a lack of sense of urgency on the part of the Ministry of Oil.

3. On most interpretations, the current text of the Constitution leaves the federal Government emasculated on oil sector management. Promoting the vision outlined in the main body of this paper will therefore be difficult:

- The KRG currently refuses to countenance the possibility that the substantive concessions they won when the constitution was drafted – which give regional authorities control over development of new oilfields, and on some interpretations the rights to revenue from those fields – will be revisited. In the meantime, they are putting 'facts on the ground' by signing production sharing agreements (PSAs) with (mainly small, high-risk) international oil companies (IOCs) such as PetOil (January 2004) and DNO (December 2005), and moving ahead quickly with their own KRG petroleum law. The KRG are willing to share revenue with the rest of Iraq, subject to a satisfactory settlement, and some sort of preliminary agreement on revenue sharing may have been agreed between the KRG Oil Minister (Ashti Hawramy) and the central Government at the end of August 2006, but the details and depth of this agreement are not clear. Senior Kurdish leaders will continue to regard some control over their own oil as a precondition for remaining within a federal Iraq. They may be prepared to drive a hard bargain because they believe that the alternative of fragmentation would benefit Kurdistan both politically and economically;
- Shia proponents of a strong southern region see the same constitutional provisions negotiated by the Kurds as serving their own purposes, and will see no financial advantage in sharing revenues with the rest of the country.

4. The willingness of the US to try to broker a compromise will be critical. Until now, they have not expended significant senior political capital on this issue, but there are signs that this may soon change. The US shares our thinking on the need for strong federal institutions and transparency, and we should aim to work jointly with them on the ground where possible. We will need to point out the potential drawbacks of decentralised oil sector management compared to a national structure with a guaranteed revenue-sharing formula. Adequate provisions on revenue sharing, with agreement from the main political stakeholders, may make the issue of resource management somewhat less contentious, and increase the likelihood of building a consensus – though in view of Kurdish and Shia attitudes this is by no means a foregone conclusion.

Key messages

5. We need to ensure consistency in our top-level messages for key players. We are likely to have a hard sell with Kurdish and Shia (particularly SCIRI) proponents of

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federalism, who will see both economic advantage in control of 'their' oil and the possibility of a more benign security environment if the centre is excluded. We should draw on the following points with **all key players**, focusing our efforts on these Kurdish and Shia proponents:

- The Iraqi constitution states explicitly that oil resources belong to all Iraqis. Only the federal Government is positioned to discharge the responsibility of ensuring that these resources are developed to the maximum benefit of all Iraqis. For this reason we support a substantive role for the federal Government in developing oil resources.
- The regions should be involved in the management of oil resources, particularly in respect of future fields. However there are real disadvantages to a wholesale, rapid and uncontrolled regionalisation of responsibility for oil sector management e.g. through the establishment of three integrated regional oil companies.
- This model would hinder the dissemination across the country of people, technology, R&D and equipment for the upstream. It would waste resources, take no advantage of economies of scale, drive down overall margins and create no incentive for the sharing of transport infrastructure. It would dissipate Iraq's scarce international petroleum negotiation experience, reducing the likelihood that agreements with foreign companies would maximise value for Iraq, and it would leave the less prospective regions of Iraq (the KRG area and central Iraq) in a weak position, reinforcing sub-national divisions.
- Large reputable IOCs would rather sign contracts with sovereign, national Governments, seeking the protection of the highest courts and constitutional bodies in the country, rather than any one region.

6. With representatives of the **KRG** we should make the additional points.

- The KRG would face difficulties in guaranteeing smooth exports from its land-locked territory lacking transport infrastructure.
- The Kurdish region may be less prospective than other regions in Iraq and has the highest production costs of any region in Iraq.
- The KRG therefore stands to gain in the long-term by a federal system that gives it ready access to transport infrastructure across Iraq through an INOC, a say in sovereign negotiations with Iraq's neighbours on the transport of crude oil for export, and a revenue-sharing formula that guarantees it a long-term share of revenues from Iraq's southern oil resources.

7. The KRG has already signed PSAs with small companies and we understand they are in negotiations with larger companies (ENI, Statoil). We should draw on the following messages in contacts with **international oil companies**.

- Level of political and constitutional risk remains high.
- We believe unilateral KRG action on oil (i.e. signing further deals) could undermine the prospects for a lasting political deal between the centre and the regions in Iraq.
- Encourage IOC efforts to build relationships with all key players in Iraq, including the federal Government, KRG and producing governorates. But we would not be able to

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support UK oil companies pursuing deals with the KRG at this stage – it would be a premature and dangerous step in the current febrile political climate.

Political processes – risks and opportunities

8. We should consider the potential of the following processes to help move the parties towards an agreement on oil sector management.

- i. **Constitutional review.** The constitutional review may provide an opportunity to review provisions on oil and gas, but it will have many issues to address and may not bring sufficient political focus to bear. The constitutional review committee has been formed, but the full scope of the review is not yet clear. However, assuming the process does go ahead and that oil sector management is not addressed through a separate process, the constitutional review process may provide a process through which to engage all parties and generate a solution that is more acceptable to the Sunni parties.
- ii. **International Compact for Iraq.** Following endorsement at UNGA in mid-September, Iraq will be aiming to present an agreed plan for a series of medium-term economic reforms to the international community at the end of November 2006. The energy sector is recognised by all parties as a key plank of the Compact's economic reform programme. First and foremost we should ensure that the potential of the Compact to help the Iraqis grip the problem of oil sector management is realised, initially by sufficiently strong language in the November document. We should use this process to advocate the advantages of responsible federal management.
- iii. **IMF Stand By Arrangement (SBA).** The current SBA will expire at the end of March 2007. We should not expect the IMF to involve itself bringing about political agreements on resource and revenue management. However, we should encourage the IMF, possibly through the framework of the stand-by arrangement, as well as the World Bank, to offer impartial expertise and advice on the implementation of revenue sharing arrangements. We should ensure that the requirements of the SBA do not create a false timetable for conclusion of political discussions (for example, the Iraqi commitment in the current SBA to produce a draft Hydrocarbons Law by end 2006 looks increasingly unrealistic. It may be one reason for the repeated public statements of Iraqi Ministers to the effect that the law will be ready by the end of the year.
- iv. **Debate on federalism and the formation of regions.** The federalism debate has exploded since the introduction of SCIRI's draft law on the formation of regions on 7 September. Though divisive, the debate has demonstrated divisions within the Shia United Iraqi Alliance (UIA) umbrella. SCIRI have led the push for a 9-province southern region, with some support from the Kurds. However, Da'wa are more ambivalent and Fadhila and the Sadrists are both opposed the principle of large regions and a low bar for forming them. This debate may therefore produce useful alliances across the Shia/Sunni divide.

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