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UK OBJECTIVES FOR IRAQ'S OIL AND GAS SECTOR

1. This paper seeks Ministers' views on our long-term goals for Iraq's oil and gas sector. Our approach to the development of the sector will be guided by three key objectives.

   i. **Iraq's successful economic development**, for which oil revenues will provide the basis in the medium term.

   ii. To promote the development of Iraq's contribution to **global energy security** in the long term and its role as a constructive influence within OPEC.

   iii. **To support UK companies** seeking to do business in Iraq.

2. These objectives are to a great extent mutually reinforcing. This paper will provide an agreed basis for UK action to ensure Iraq is offered advice on oil and gas sector development from a broad range of sources, and that the UK's commercial and energy interests are protected.

Context

3. Iraq holds the fourth largest proven oil reserves in the world (115bn barrels; 11 per cent of global reserves) and its actual potential is held to be considerably higher. Its natural gas (2 per cent of global reserves) remains largely untapped. The International Energy Agency (IEA) projects that Iraq's oil production will reach 3.2mbpd (million barrels per day) in 2010 and 7.9mbpd in 2030 (compare Saudi Arabia's current production of 10.6mbpd), on the assumption that security is restored and reserves are developed progressively. OPEC's worldwide oil market share is projected to rise from 39% in 2004 to 50% in 2030, with Middle Eastern producers (Saudi Arabia, Iraq, Iran) accounting for most of the increase. Iraq's gas production is projected to rise from 2bcm (billion cubic metres) in 2003 to 4bcm in 2010, then surge to 32bcm in 2030.

4. Oil has dominated Iraq's economy since the 1970s, and currently accounts for 95% of GDP. Increased oil production could deliver 7% annual GDP growth for the next twenty years. However, the challenge for Iraq is to expand oil production while stimulating private sector growth in the non-oil sector. Economic diversification would help generate employment as well as increasing Iraq's chances of escaping the political and governance problems that have afflicted other natural resource-rich countries.

5. The immediate priorities for the US in Iraq are improving infrastructure security and creation of a robust regulatory and legal framework for development of the sector.

Iraq's oil sector needs

6. Iraq's oil output has been declining since 2003 (key information on its recent production and export levels is at **Annex A**). These figures make it clear that Iraq is currently producing at well under its historical peak of 3mbpd in 1989, and indeed its current installed capacity of 2.3mbpd. This is due to failure to secure the infrastructure against insurgent attacks, short-term maintenance and storage problems and lack of technical and managerial capacity. We are cautiously optimistic that these constraints will start to be addressed in 2006. However,

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although development costs are low, raising production in line with IEA projections will require **significant new investment** - $59bn to 2030. This represents 11.4% of total projected oil industry investment in the Middle East over this period.

7. It is unlikely that Iraq will be able to finance this scale of investment through its own resources. Nor does it have recent experience of the regulatory, fiscal and administrative framework needed to make optimal use of private investment, or the technical and managerial expertise which rapid expansion of the industry will require. A key challenge facing the Government is therefore to **access external financing and expertise**. This means Iraq needs to engage, firstly, with experienced development partners who can provide the skills and advice the Government needs. The **World Bank** is a leader in providing independent advice on the development of fiscal, regulatory and foreign investment frameworks for natural resource management. To attract both capital and technical expertise it also needs, secondly, to engage with **International Oil Companies (IOCs)** and Oil Service Companies (OSCs). They hold the most up-to-date industry skills and technology, and IOCs increasingly have the funds and appetite to invest. They could play a key role in increasing production (upstream) as well as refining capacity (downstream) to reduce Iraq's fuel import bill ($5bn in 2005).

8. Whatever the form of engagement with IOCs and OSCs, this will be politically sensitive and decisions on the nature and extent of foreign private involvement in the sector have not yet been taken. The most straightforward way, and the way most likely to deliver rapid growth in output, would be to promote **foreign direct investment (FDI)** into the sector, whereby the IOCs would bring both capital and expertise. But the appropriateness of FDI and the contractual form it might take, along with the internal distribution of oil revenues, is likely to be a hotly contested issue in the constitutional review process. Regional comparisons illustrate the problem: of Iraq's two key oil-producing neighbours, Saudi Arabia allows no foreign investment in upstream oil and Iran allows only a heavily constrained form. Neither permits production sharing agreements (PSAs), the form of FDI most favoured by IOCs. Other options such as debt/bond finance and joint ventures should also be considered, and these reforms should be part of an integrated energy strategy that joins up oil, gas and electricity. The strategy should also consider the reconstitution of the Iraqi national oil company (NOC), independent of the Ministry of Oil.

9. The position that foreign companies might own rights to Iraqi oil (as opposed to the right to sell Iraqi oil they have produced) would be met with broad-based opposition in Iraq. However, the oil industry has very specific infrastructure and skill shortages that, if addressed, could rapidly increase production. Key areas of weakness are the deteriorating drilling and work-over rigs and above ground infrastructure, and lack of modern field management techniques and project management skills. These issues could be addressed through technical service agreements with IOCs or OSCs and/or long-term PSAs involving significant IOC investment, provided appropriate legislation is passed and constitutional decisions on resource management are finalised.

10. IOCs, including BP, Shell and other UK companies, are not currently working in Iraq due to the security situation and the lack of a foreign investment law. However, both BP and Shell are engaging on technical studies of oil fields (Maysan, Kirkuk, Rumaila) using existing Ministry of Oil data, and providing training to Iraqi officials, including through the UKTI-supported Joint Board on Learning in the Oil and Gas sector. Although international

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competition will be strong, UK IOCs and OSCs should be well-placed to play a significant role in addressing key skills and infrastructure weaknesses in the Iraqi industry, as and when security permits.

Iraq and UK energy security in the long-term

11. Pursuing this approach in the medium term will assist Iraq in realising the potential of its oil reserves. Although Iraq is not currently a supplier of oil or gas to the UK and will not become one in the medium term, it has the potential to play a key role in HMG's long-term energy security strategy. Against a backdrop of volatile oil prices, little spare global production capacity and growing demand, sustainable increases in Iraqi oil production would make a significant contribution to global supplies. Gas imports to the EU could conceivably start within 5-10 years, if security allowed pipelines (e.g. through Turkey) to be built. In the longer term, LNG exports to the EU/UK may also be possible.

Long-term risks

12. HMG's over-arching approach to securing reliable and diverse energy supplies is to promote well-functioning international markets in energy and energy services, and to ensure the free movement of capital within open, transparent and stable investment frameworks. This framework should also guide our approach in Iraq, taking into account the specific risks associated with Iraq. These are some of the key risks.

    i. **Continued insurgency and political instability hampers Iraq's reconstruction in the medium term**. Progress in rehabilitating and developing the oil industry depends on a sustained reduction in acts of sabotage on the oil infrastructure. Even short-lived disruptions cause significant loss of oil revenue due to lack of storage capacity and contingency planning. Without improved security the IOCs will not engage to the necessary extent in the medium term.

    ii. **Failure to establish an open and transparent oil sector investment regime in Iraq deters foreign investment**. Transparency International ranks Iraq the 24th most corrupt country in the world. The establishment of robust and transparent mechanisms for oil revenue management and the embedding of best practice in good governance will be essential in attracting FDI.

    iii. **Iraq's export capacity remains low due to insecurity and lack of investment**. Iraq's nominal export capacity is 2.5mbpd (2mbpd via the Gulf and 0.3-0.5mbpd via Turkey). Other routes via Saudi Arabia and Syria are shut. The export pipeline has repeatedly been the object of sabotage and threats by insurgents. With the complete rehabilitation of the southern terminals and the Kirkuk-Turkey pipeline, Iraq's export capacity would reach 4.9mbpd – more than enough to provide the necessary medium-term expansion capacity. At present there is only one gas export route, by pipeline to Kuwait, and this is in need of rehabilitation.

    iv. **The US dominates the field in advising Iraq on energy sector development**. The US has spent $4.9bn on rehabilitating the energy sector in Iraq. They have excellent access to key ministers through IRMO (Iraq Reconstruction and Management Office) private-sector consultants and a $6m US capacity development

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programme for Ministry of Oil employees is being finalised. No US IOCs are operating in Iraq, although US Service Companies have been active in Iraq since the start of the CPA. We know that US IOC commercial lobbying effort is gathering steam and will continue to do so (e.g. through visits to Houston of Iraqi Ministers and officials).

v. **Assertive entry into the Iraqi market by Asian and Russian national oil companies (NOCs) in the short-medium term reduces longer-term opportunities for UK oil companies**. Asian oil companies may be prepared to take greater risks with their operations and personnel than UK IOCs, and may gain first-mover advantages. Asian NOCs in particular are actively buying oil and gas assets around the world, and undoubtedly have Iraq in their sights. In the short term their involvement in Iraq could help raise production levels. However, in the long term it may reduce opportunities for UK oil companies, and inhibit the transfer of cutting edge skills and technology to the Iraqi industry, thereby failing to maximise oil and gas recovery.

HMG action

Key actions for the UK in 2006.

i. Deliver **Ministerial-level messages** on the need for a long-term vision in the development of the oil sector. (Iraq Minister Kim Howells to Iraq in March 2006; Energy Minister Malcolm Wicks at the International Energy Forum in Doha in April). **Action: FCO, DTI, DFID.**

ii. Strengthen regular contacts between HMG and UK IOCs and OSCs interested in doing business in Iraq to discuss key points of policy concern and security. **Action: DTI, FCO, MOD.**

iii. Facilitate contact (outside Iraq) and knowledge sharing between **UK oil companies and the Iraqi Government**, including through the UK-Iraq Joint Board and the proposed Senior Management Development Programme for Iraq. Pursue early visit to the UK by new Minister of Oil with a team of officials. **Action: UKTI, DTI, FCO.**

iv. Pursue small, cross-sectoral **commercial mission to the KRG area** in spring 2006, subject to travel advice and progress on direct flights into Kurdistan. **Action: UKTI, FCO.**

v. Continue to support **World Bank engagement** in Baghdad. Retain DFID-funded World bank adviser in the Ministry of Electricity and recruit adviser for the Ministry of Oil to support development of an integrated energy sector strategy. **Action: DFID.**

vi. Promote the development of a transparent investment regime in the oil sector. BE and DFID Baghdad and push the **Extractive Industries Transparency Initiative (EITI)** in co-ordination with US anti-corruption efforts. **Action: DFID, FCO.**

Iraq Policy Unit, FCO
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Annex A

Iran oil production and exports:

	Average Production (mbpd)	Average Export volume (mbpd)	Export Revenue (bn $)	Implied export price $ per barrel
Jun-Dec 2003	2.6	0.9	5.08	15.5
2004	2.25	1.48	17.6	32.6
2005	2.08	1.37	23.4	46.8
2006 (plan)	2.3	1.65	28.07	46.6
2010 (target)	3.6	2.9	47.78	45.1

International Energy Agency projections:

	Production (mbpd)	Export (mbpd)
2010	3.2	2.5
2030	7.9	6.9

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