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ANNEX C

OIL/ENERGY POLICY FOR IRAQ

INTRODUCTION

1. The Inter-Ministerial Group on Iraq considered sanctions and Oil for Food (OFF) at its ministerial meeting on 17 April. This paper provides a stock-take of the current state of play on broader oil related issues, identifies immediate priorities and highlights longer term issues where further work is needed. It builds on the previous IPU papers on the oil sector and oil smuggling produced in March.

CURRENT SITUATION

2. Oil prices have fallen by about \$8/bl since early March and stabilised in the mid-twenties. The resumption of Iraqi oil exports is unlikely to lead to a collapse in oil prices.
3. Official Iraqi exports stopped with the last cargo lifted from the Turkish port of Ceyhan on 22 March. (Some 8m barrels of oil remain in storage there.)
4. Iraq's oil fields were undamaged by the fighting, though a few southern wells and one northern well were sabotaged. These fires are now all extinguished. Administration sections are largely intact and most staff would be ready to return to work.
5. Pipelines and oil refineries (Baiji, Doura and Basrah) were not bombed or sabotaged, but there has been some looting and damage to the sites. Refineries and the distribution network have not operated since 20 March, although we are getting reports that those in the north and centre are starting up again. Some repair work will be needed to the distribution system which is only likely to be able to operate at 50% capacity for at least another 90 days. ORHA estimate it will take 6 months before it is fully operational again.
6. There is a growing shortage of gas (for power stations), fuel (petrol) and cooking gas (LPG), particularly in the south, and there have been incidents of syphoning off from product pipelines. The US are planning to lobby for contributions, particularly of refined products, to make up the shortfall in supplies in the short term. Kuwait is already making donations.

LEGAL POSITION

7. Under the UN sanctions regime, OFF is the only legal way of exporting Iraqi oil. This allows the Iraqi Government to sell oil subject to UN monitoring. 72% of the proceeds, held by the UN in an escrow account, are then used to buy "humanitarian goods" (defined very broadly) according to a distribution plan agreed between the Iraqi Government and the UN. (Most of the remainder is used for compensation

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payments for Iraq's invasion of Kuwait.)

8. Following the onset of hostilities, the UN Security Council passed resolution 1472 to prevent a long hiatus in the distribution of humanitarian supplies to the Iraqi people. This allowed the Secretary General to reprioritise existing OFF supply contracts, purchase additional medical supplies and locally produced humanitarian goods and services and distribute OFF goods in Iraq. It did not give him the power to sell Iraqi oil or to buy the full range of humanitarian goods.
9. Under the Hague Regulations and the Geneva Conventions occupying forces are entitled to tackle fires (done through US Army Corps of Engineers) and repair other damage (main contract let to Kellogg, Brown and Root). Production could also be resumed for domestic refining and distribution, but not for export unless and until the sanctions are lifted or OFF amended to enable this. Restarting production fully is still thought likely to take at least three or four weeks; and there would be health and safety problems, and additional technical difficulties unless export production was resumed as well.

SITUATION AT THE UN

10. Within the Security Council, Iraqi oil issues remain highly contentious. Council members have different motivations. We and the US will be keen to get Iraqi oil flowing again as soon as possible to meet humanitarian/reconstruction needs. France and Russia are both concerned to protect the interests of their commercial companies which have outstanding contracts under OFF. They probably also see the oil issue as a point for leverage over the coalition: they will not agree to allow oil exports unless the arrangements for export and disposal of the revenue is in line with their objectives.
11. The key decisions required will be: what to do with UNSCR 1472 when its provisions expire on 10 May; what to do with OFF when its current phase expires on 3 June; when to lift sanctions on Iraqi oil; and who should control the oil when sanctions are lifted.
12. Linked to this there is a requirement to tackle debt and compensation claims which could be made against oil and oil revenue by Iraq's numerous creditors. Under sanctions oil and oil revenues are protected from claims, apart from UN-authorized claims under the UNCC for which separate provision will have to be made. With sanctions lifted they would not be. Given that it is unlikely that by the time of sanctions lift there will be a global solution to debt/compensation, the Council would probably have to tackle claims against oil and oil revenues in any sanctions-lifting resolution, perhaps by establishing some short-medium term protection against claims.
13. The UK is putting forward a three-phase approach to dealing with Iraqi oil and the Oil For Food programme. In the first stage we would extend the provisions on

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UNSCR 1472 to 3 June to tie in with the current OFF phase. Closer to 3 June we would consider extending OFF as a whole for a further period. We would, if OFF continued for any length of time, need to extend the powers available to the Secretary General so that he could sell Iraqi oil and buy the full range of humanitarian supplies.

14. In the second stage, once a credible interim administration was established, control of Iraqi oil and oil revenues should be passed to it, subject to certain checks. The checks would be those necessary to assure us (the UK) that oil and oil revenues were protected against major mismanagement, corruption and national bias, lack of transparency or other unfairness in the awarding of contracts. And they would have to be acceptable to the Security Council.
15. They might involve, for example, oversight of sales and purchase contracts by a representative of the Secretary General or a committee of IFI representatives. We would not favour oversight by a group of UN member states (eg a Security Council committee). We do not think oversight by the coalition or ORHA would be politically acceptable or achievable in the Security Council. We would want as light a check as possible - a backstop against corruption, not a body directing spending. The ideal would be a mechanism which never needed to take any action.
16. During the second phase considerable external support would be needed for any provisional government/interim authority in control of oil, both in terms of advice on spending priorities (leading from needs assessment from the IFIs, which would play a defining role in setting the provisional government's reconstruction priorities) and handling negotiation of major contracts.
17. The third phase would be handing control of oil and oil revenue to a democratically elected Iraqi government.

US PLANS

18. The Organisation for Reconstruction and Humanitarian Assistance (ORHA) which will administer Iraq until there is a sovereign representative Iraqi government, plans to attach advisers to each of the existing Iraqi Ministries to help them back into operation. ORHA has identified a number of foreign and Iraqi experts (both exiled and internal) to advise the Ministry of Oil and help run the industry. Assessment teams, advisers, modern technology and equipment will be needed.
19. We have stressed to the US our legal concerns on the limits to the authority of occupying powers to export oil outside the OFF whilst sanctions are still in place and to alter policy or carry out structural reorganisation. We have also highlighted the presentational and other problems of doing anything which looks like seizing control of Iraqi oil. The US Administration are well aware of these concerns.
20. But there will certainly be pressure to move as quickly as possible to restore production, distribution, exports and revenue. Some within the US Administration

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are arguing for an Executive or Advisory Board composed of senior foreign and Iraqi oil industry figures to oversee operations. The thinking is that this would provide a degree of international legitimacy and could enable ORHA to restart oil exports, working around the UN sanctions and OFF programme.

21. We and the Americans agree that all strategic decisions about the development of Iraq's oil industry should be deferred until a representative Iraqi Government is in place and that in the intervening period all oil business should be handled in as transparent a manner as possible. The focus for the coalition and any interim administration should be on restarting production and rehabilitating existing infrastructure, which will take a number of years. But there will be scope for shaping Iraqi thinking as it evolves, both to help ensure appropriate decisions are taken and to protect UK commercial interests.
22. Countries like Russia, France, India and China whose companies initialled oil exploration and production agreements with the previous regime are likely to press for these to be revived in the interests of speedy development. Others - including ourselves - advocate a slower approach. Most western advisers are likely to propose some form of Production Sharing Agreement (PSA) formula to attract foreign investment. A number have recommended breaking up the existing INOC corporation into its component parts (North Oil Company, South Refining Company etc) with a view to subsequent privatisation.
23. We share with the US a general concern to avoid the centralisation of oil revenues in the hands of a minority, to encourage an equitable distribution through the regions and to help limit their corrosive effect on political life. Of course, much will depend on the nature of any political settlement. But there will probably need to be (1) a robust system of revenue sharing between the regions and the centre; and (2) effective arrangements for the management of oil revenues at a national level to ensure they are used in an effective and sustainable way in the interests of the Iraqi people and future generations. Transparency will be important.
24. Some pundits have argued that rapid resumption of Iraqi production will lead to a sharp fall in world prices and strains within OPEC over quotas. Reflection shows that it could take some time even to return to early 2003 levels, that production could dip for two years while fields recover from two decades of underinvestment, and that a return to 1979 production - (3.5 mbd) and Iraq's historic OPEC quota - could be three or four years away. Raising production to 4.5 or even 6.0 mbd might be achieved by 2010 - and require investment of \$35bn.

ISSUES

25. Our short term priorities should be to:-

- Maintain the security of oil infrastructure.

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- Continue to pursue our line on OFF/sanctions (see above) and getting Iraqi exports flowing again.
 - Make sure the UK has a strong presence in ORHA on the oil side, with the necessary back-up at the UK end (perhaps including a virtual team of energy experts from UK industry). As a first step we should identify and fund a UK oil sector advisor from within Whitehall. This needs to be done quickly.
 - Help ORHA identify the most appropriate internal and exiled Iraqi oil sector experts to help manage the industry.
 - Promote UK firms as subcontractors or specialist suppliers to KBR.
 - Pending resumption of adequate domestic production, work with the US/ORHA to arrange the urgent import of oil products from regional sources.
 - Identify current (or ex-) UK industry specialists whose services can be offered to the Iraqi Interim Authority, when it is established – preferably at no cost. In doing so, we should draw on our contacts with the Iraqi Reconstruction Group and other professional networks.
26. In slower time, we should develop our thinking on sensible longer term structures for an Iraqi oil industry open to foreign investment, with appropriate arrangements for the exploitation of new fields (eg well-designed PSAs). In doing so, we should ensure that UK companies are well placed to take advantage of future commercial opportunities. Whatever is established will need to balance the sustainable and transparent management of Iraq's oil reserves and the overall objective of creating and preserving future wealth for the Iraqi people with the country's immediate reconstruction needs.

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