HOW MUCH FOREIGN INVESTMENT SHOULD IRAQ ALLOW IN ITS OIL SECTOR?

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ABSTRACT: The drafting of a National Oil Law has been proclaimed by many as a key step towards achieving unity, stability and economic growth in Iraq. However, since discussions began, the law has been marred with controversy. Rather than uniting the country, disagreements over how the industry should be structured have led to heated regional disputes, particularly regarding the role of the Iraq National Oil Company (INOC) and the use of Production Sharing Contracts (PSCs). If successful, the Oil Law could have the power to help lift Iraq from the social and economic turmoil in which it currently resides. However, if it fails, Iraq risks falling victim to the resource curse that has befallen so many before it. This paper will examine the main fiscal options for Iraq’s National Oil Law (NOL) and will assess which system offers the best prospects for the country’s future. It will focus on the disputes arising from the prospective roles of PSCs and the INOC in the drafting of the NOL and will examine how each system might function in the context of Iraqi oil sector.

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<th>Abbreviation</th>
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<tr>
<td>bpd</td>
<td>Barrels per day</td>
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<td>FOC</td>
<td>Foreign Oil Company</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>ICG</td>
<td>Iraqi Central Government</td>
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<td>INOC</td>
<td>The Iraq National Oil Company</td>
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<td>IPC</td>
<td>Iraq Petroleum Company</td>
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<td>ISG</td>
<td>Iraq Study Group</td>
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<td>ITIC</td>
<td>International Tax and Investment Centre</td>
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<td>KRG</td>
<td>Kurdish Regional Government</td>
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<td>MOO</td>
<td>Ministry of Oil</td>
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<td>Production Sharing Contract</td>
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1. INTRODUCTION

With the world’s third largest proven oil reserves\(^1\) and some of the lowest exploration costs in the region\(^2\), Iraq’s oil industry has been heralded by many as the key to securing a unified, stable and economically prosperous future for this long troubled nation. Despite its inviting geological prospects, Iraq’s political climate has prevented crude production from ever exceeding 3.6 million barrels per day (bpd)\(^3\). In 2004, following the American-led invasion of the country and the end of President Saddam Hussein’s 24-year rule, a study published by the International Tax and Investment Centre (ITIC) claimed that “under appropriate policies Iraq could be one of the four largest oil producers by the early years of the next decade”\(^4\). However, over three years later, crude production has in fact fallen and little real progress has been made in the drafting of a National Oil Law (NOL).

Since the approval of the Federal Constitution of Iraq in October 2005, the Iraqi Central Government (ICG) has been under intense pressure to draft an oil law that will provide a clear fiscal and legal framework for the industry as quickly as possible. A report by the US-based Iraq Study Group (ISG), published in December 2006, lists the preparation of the oil law as one of four key recommendations for the ICG, asserting that ‘immediate and long-term growth depends predominantly on the oil sector’\(^5\). However, the federal structure of governance supported by the constitution has led to continued

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4 *Petroleum and Iraq’s Future: Fiscal Options and Challenges*, ITIC (Fall 2004); p3
5 The Iraq Study Group Report (2006), Section 5: The Oil Sector.
internal disputes between the ICG and the regional governments, significantly delaying the process.

The external pressure from the US has roused suspicions among many Iraqis, who fear that by allowing Foreign Oil Companies (FOCs) to invest in Iraq, they are leaving their resources open to exploitation by the West\(^6\). These fears, although perhaps unfounded, carry a great deal of political weight and are central to one of the major disputes regarding the National Oil Law: How much foreign investment should the new Oil Law allow in Iraq’s oil industry? Whilst some in the ICG, including the Ministry of Oil (MOO) favour investing greater power in the Iraq National Oil Company (INOC), others, in particular the semi-autonomous Kurdish Regional Government (KRG), believe strongly in higher levels of foreign investment through Production Sharing Contracts (PSCs)\(^7\).

This paper aims to assess the extent to which foreign investment is needed in Iraq’s oil sector, and how the fiscal system should be structured in order to ensure that Iraq extracts maximum returns from its resources. It will look at Iraq’s past experience in the oil sector and will outline the major disputes that have arisen regarding the issue of foreign investment in the drafting of the NOL. The paper will then discuss the potential roles of PSCs and INOC in the industry. This discussion will consider the main arguments for and against each fiscal structure and will assess how they might function in the context of the Iraqi oil sector.

\(^6\) Iraqi Union Leader Urges Opposition to Oil Law, Reuters (18\(^{th}\) June 2007).

\(^7\) J Gavin, There May Be Trouble Ahead, 74 (11) Petroleum Economist November 2007
2. A BRIEF HISTORY OF MODERN IRAQ AND ITS OIL SECTOR.

In order to fully understand the current disputes in the drafting of the NOL, it is useful to have some knowledge of the historical context in which the law is being decided and of the fiscal structures that have been implemented in the past.

Over the last century, oil has been at the forefront of Iraq’s domestic politics and international relations. Foreign interest in Iraq’s oil, together with its huge importance to the country’s domestic economy, have contributed to severe political instability, ethnic and regional tensions, and foreign interventions. Inevitably, the past experience of Iraq’s aggrieved oil industry provides a foundation for many of the arguments regarding the drafting of the current oil law.

2.1 The Creation of Modern Iraq

The boundaries of Modern Iraq were forged from the carve-up of the Ottoman Empire following Britain’s Mesopotamia Campaign in 1914-15. The British occupation began with the invasion of Basra in 1914 in order to protect British interests in Persian oil. The territorial limits of Iraq are said to have been decided out of “imperial convenience.” The new State of Iraq forced together diverse ethnic and religious groups with no regard for the historical tensions between them. The strong sectarian divide in the country remains today and is one of the major hurdles to be overcome in the drafting of the NOL.

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8 Mahdi, K., Iraq’s Oil Law: Parsing the Fine Print, World Policy Journal 24 (2), pp. 11-23
9 Ibid
10 Macintyre, B., Invasion, Bombs, Gas - We’ve Been Here Before, The Times, 15 February 2003
11 Ibid
12 Ibid
13 Ibid
2.2 The Iraq Petroleum Company (IPC)

Oil in Iraq was first discovered in commercial quantities in 1923. With the discovery of the Kirkuk field in 1927, Iraq’s oil industry became dominated by The Western-owned Iraq Petroleum Company (IPC). By 1938, the IPC had gained exclusive rights to almost all of Iraq’s petroleum resources under 75-year concessions.

The IPC’s monopoly severely constrained growth in Iraq’s petroleum sector compared to the rest of the region. The company’s interests in neighbouring countries such as Kuwait and Iran, where they held more competitive concessions, led to Iraq’s oil being left as “the reserve of last resort.” This meant that development in the industry was limited and Iraq was thus unable to fully benefit from its vast oil wealth. The IPC became the target of anti-Western sentiment in Iraq and was heavily criticised for exploiting Iraq’s petroleum resources for its own gains and not acting in the interests of the Iraqi people.

In 1958, a military coup, fronted by General Qassim, ended the rule of the British-installed monarchy and led to the passing of the country’s first NOL in December 1961. Public Law 80 called for the nationalisation of all of the IPC’s unexploited oil field concessions, totalling 99 percent of the company’s assets. The law also established INOC, which followed the path to full nationalisation in the 1970s.
2.2 The Saddam Era

In 1972, as Assistant General Secretary of the Baath party, Saddam Hussein fronted the movement that led to the expropriation of the remainder of the IPC’s assets and concluded the nationalisation of Iraq’s oil industry. The effects of the nationalisation were evident almost immediately. There was a significant increase in production levels and export capacity; and for the first time, commercial refining capacity was developed within Iraq and a local downstream industry was established. The nationalisation subsequently saw a marked increase in oil revenues, and in 1979, the year in which Saddam Hussein came to power; production reached 3.6 million bpd, which is its highest level to date.

Saddam’s rule was characterised by war and conflict from the outset. Production levels started to decline following the 1980 Iran-Iraq war. The then-president attempted to revive the industry in the late 1980s by encouraging FOCs back into the oil industry through long-term PSCs. However, this proposal was rejected by Iraqi oil professionals, who wanted to protect the industry’s nationalised status. In 1991, the sector suffered a further blow as the First Gulf War saw output fall to below half a million bpd. During the United Nations (UN) sanctions of 1990s, Iraq agreed to the introduction of some foreign investment into its oil sector through “development and production contracts”. These enabled production to increase to 2.5 million bpd prior to the American-led invasion in 2003.
3. **THE OIL SECTOR IN POST-WAR IRAQ**

The war had the inevitable consequence of lowering production levels\(^{30}\). Despite the passing of a new constitution and the election of a democratic government, the continued civil unrest and sectarian violence, together with a lack of political cohesion between the central and regional governments, has prevented the industry from restoring its output to pre-war levels\(^{31}\). In order to drive Iraq’s oil industry towards recuperation and future growth, the principal challenge now facing the federal Iraqi government is the agreement and ratification of a NOL so that the country can finally fully benefit from its natural resources.

3.1 **The Role of Oil In The Reconstruction Of Iraq**

Iraq holds 115’000 million barrels of proven oil reserves\(^{32}\). Even at its current low levels of production, oil revenues constitute around 70% of Gross Domestic Product (GDP) and 95% of government revenue\(^{33}\). An increase in oil output has the potential to significantly enhance economic growth through export sales and government revenues\(^{34}\). Oil sector surpluses are essential to fund rehabilitation projects in other areas of Iraq’s economy which in turn will raise output in non-oil sectors, creating new employment opportunities and improving the welfare of Iraqi citizens\(^{35}\).

Iraq’s national debt is estimated at between $79 billion and $128 billion, with a potential annual debt servicing obligation of $1 billion p.a.\(^{36}\). This debt, together with the

\(^{30}\) Behn, *supra* note 3  
\(^{32}\) BP Energy Statistics, *supra* note 1  
\(^{33}\) *Supra* note 31  
\(^{34}\) *Supra* note 4 at 15  
\(^{35}\) *Ibid*  
\(^{36}\) *Ibid* at 4
urgent need for investment in development projects for basic infrastructure in areas such as health, power and education, implies a high discount rate for oil revenues. The government must therefore seek a fiscal structure that will ensure high returns in the short-run, whilst still preserving long-term revenues, so that the economic recovery gains can be spread as quickly as possible. The question as to what fiscal regime will best facilitate this objective has been central to the debate over the drafting of the NOL.

3.2 The Draft National Oil Law

The issues relating to the drafting of the NOL are extremely complex and are interwoven with a lineage of ethnic and political sectarian divide. However, for the purposes of this paper, the discussion of the Draft Oil Law will be limited to the disputes over the issue of foreign investment in the industry.

In the early months of 2007, the prospect of implementing the NOL looked promising. A draft law based on the new federal constitution had been agreed by the ICG and the regional governments. The draft law facilitated a shift away from national control of Iraq’s oil resources. In particular, article 8d allowed for “collaboration with reputable oil companies” in undeveloped fields. This Article invited criticism from those opposed to foreign investment in Iraq’s who allege that the omission of specific guidelines on the contractual arrangement that should be used in these collaborations is a “wilful neglect” that “paves the road for production sharing contracts.”

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37 Ibid at 15
38 Mahdi, Supra note 8
39 Ibid
The draft oil law was approved by the Council of Ministers in February 2007 and was due to be voted on by the Council of Representatives in May 2007. However, in April, four unagreed annexes were submitted to the proposed draft law and were presented at a conference in Dubai. These were fiercely opposed by the KRG and nine months later no resolution has been reached.

The annexes carry significant implications for the fiscal structure of Iraq’s oil industry; particularly regarding the role of INOC. The annexes allocate present producing fields and discovered (undeveloped) fields to INOC. According to the KRG, this implies that INOC will have rights over almost 93% of Iraq’s petroleum reserves, with the majority of the fields in the remaining 7% being “marginal or not commercial”.

The proceedings of the oil law highlight a conflict between a desire to retain sovereignty over the country’s oil resources and the need for foreign investment in the sector. The remainder of this paper will discuss the likely implications of structuring the market to meet each of these objectives.

4. FISCAL OPTIONS IN THE IRAQI OIL SECTOR

The fact that Iraq’s oil industry was inefficient under previous regimes is not disputed. However, the new federal government now faces a number of fiscal options for the restructuring of the industry. Principally, it must decide between either maintaining the industry’s nationalised status and funding its own development projects through

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41 KRG Ministry of Natural Resources responds to statements from Baghdad deterring oil investment in Iraq, KRG Press Release 27 April 2007
42 Iraq Oil and Gas Law of 15 February 2007 (Draft); Barrows, Basic Oil Laws and Concession Contracts (Middle East), Supplement 174
43 Statement from Minister of Natural Resources KRG - Iraq, 27 April 2007
INOC or allowing foreign investment into the sector either through PSCs or through full or partial privatisation.

4.1 Public Sector Control

From a political standpoint, retaining the industry’s nationalised status is a favourable option. According to a joint statement by the Iraqi Unions in December 2005, “Iraqi public opinion strictly opposes the handing of authority and control over the oil to foreign companies.” The unions argue that allowing any form of foreign investment into the industry will result in a lower national income together with high domestic fuel prices which will negatively impact on the health and development of Iraqi people at a social and economic level. They also claim that the presence of FOCs will encourage the occupying troops to stay longer in Iraq and “will undermine the sovereignty of the state and the dignity of the Iraqi people.” The Unions thus call for “the Iraqi National Oil company (to) shoulder the responsibility of Iraqi oil policy.”

Judging from the sentiments of the Iraqi Unions, giving control of the industry to INOC might be a popular political decision. However, it is important to note that the arguments put forward by the unions are largely based on Iraq’s experience in the colonial era under the long-term concessions. The value of foreign investment is not considered in real economic terms, it is simply rejected as an evil of the West. In the light of Iraq’s current political climate, a decision that has the backing of Iraqi citizens is of course favorable. However, the government must also consider that public opinion

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44 Iraqi Trade Union Statement On The Oil Law, 14 December 2007
46 Id
47 Id
48 The opening paragraph of the statement refers to foreign interest in the industry as an attempt of the British and the Americans to dominate the industry as they did 80 years ago.
appears to be more influenced by a general negative perception of FOCs and the West than by the true economic implications of such a policy. Therefore, if the government is to consider giving control of the industry to INOC, it must carefully reflect on the economic consequences of doing so rather than adhering to the demands of public opinion to win popular support.

4.1.1 The Role of the Iraq National Oil Company (INOC)

The fundamental argument in support of self-financed development through INOC is the assumption that oil revenues will be lower if FOCs are allowed to share in the profits. However, economic analysis in the 2004 ITIC report suggests that this might not be the case. The report estimates that by attracting foreign investment into an expansionary plan to increase oil output to five million bpd, Iraq could expect to see an extra $4.2 billion in government revenue and an extra $8.5 billion in GDP gain after the fifth year compared to a scheme where the project is self financed. It also estimates that the higher economic growth resulting from foreign investment could lead to the creation of an extra 150-200,000 jobs in Iraq. The reasoning behind this is that by self-financing development in the oil sector, the government is accepting the opportunity cost of lower investment in other sectors of the economy. With so many areas of Iraq’s economy requiring substantial financial investment, this is a sacrifice that should not be undertaken lightly.

Thus, the arguments in favour of transferring control to INOC are largely political. INOC might be capable of self-financing development, but this would be at the

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49 Supra note 4 at 15
50 Ibid at 5
expense of investment in other sectors of the economy and would, at least in the short-
run, result in substantially lower revenues. Furthermore, there is a need for fast
development in the industry. Although Iraq’s oil has been advertised as cheap to extract,
the oil sector has remained relatively undeveloped for over 25 years and substantial
investment in rehabilitation and development schemes is required if production is to ever
exceed 3.6 million bpd\textsuperscript{51}. Development in the industry is likely to be much slower under
INOC due to the limitations of its financial and technical resources\textsuperscript{52}.

Further scepticism over giving power to INOC arises from questions over its
ability to act efficiently outside of competitive market forces. Under the annexes, the
power given to INOC implies “no accountability or contractual requirement to
produce.”\textsuperscript{53} With no obligation to meet production targets and no competition from
FOCs, investing this level of power in INOC risks surrendering the future of the industry
to the inefficiencies that have plagued its past.

4.2 Foreign Investment in Iraq’s Oil Sector

As previously discussed, encouraging foreign investment into Iraq’s oil industry
is an economically beneficial but politically controversial decision. Nonetheless,
proceedings thus far seem to indicate a favourable outlook for FOCs. The constitution
provides a clear framework for foreign investment\textsuperscript{54} and the draft NOL, even with the
addition of the annexes, suggests that FOCs will play a part in Iraq’s oil sector. The
question then is in what form should this foreign investment be received? The two main

\textsuperscript{51} Ibid at 3
\textsuperscript{52} Ibid
\textsuperscript{53} Ibid
\textsuperscript{54} Supra, note 43
\textsuperscript{54} See Article 112 (2) of the Constitution.
options for consideration are either full or partial privatisation of the industry or maintaining state control of resources but offering investment incentives in the form of Production Sharing Contracts.

4.2.1 Full or Partial Privatisation

Privatisation has the advantage of relieving the government of financial obligation in the oil sector and ensures a competitive market, which could lead to enhanced industry performance. Privatisation would encourage investment through the sale of assets and joint ventures. This would leave the industry open to a tax and royalty system which, if effectively implemented, could feasibly generate “substantial immediate revenues”.

However, aside from the previously discussed political arguments against this structuring of the industry, in Iraq’s current unstable political environment the contract risk may be too high to attract a significant number of investors. In this sense privatisation does not presently appear to be a viable option.

4.2.2 Service Contracts

Service contracts provide a means of benefiting from the technical expertise of FOCs without sacrificing power over resources or entering into long-term contracts with the investor. These contracts have the advantage of not implying any transfer of power to the FOC. The investor can simply be contracted to perform a service on a short-term contract and is paid by the government for doing so. However, although these contracts might be a viable option in fields that have undergone substantial development, they are

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55 Supra note 4 at 23
unlikely to attract investors in the case of undeveloped fields due to the large capital investment required and the short-term nature of the contracts\textsuperscript{56}.

4.2.3 Production Sharing Contracts (PSCs).

In recent years, PSCs have gained significant ground in the oil sectors of non-OECD countries. A PSC is a contractual agreement that allocates profit between a host government and an investor. Under PSCs, the government retains ownership of all oil reserves and oil produced and the investor is simply appointed as a contractor. The investor typically agrees to bare the risk of exploration and development costs, and in return they receive an agreed share of any resulting production. The contract can therefore be structured so that the prospect risk is born entirely by the investor and they will have no right to payment in the event that a commercial discovery is not made. Where a commercial discovery is made, the first allocation of oil will be given to the company to allow it to recoup its investment. This is known as cost oil. There will usually be a limit on how much of the investment can be recouped in cost oil in any given year. The remaining oil is known as “profit oil.” The revenue from this will be shared between the investor and the host government at an agreed rate\textsuperscript{57}. In addition, taxation on profits and royalty payments on production can be further source of revenue for the host state. PSCs typically allocate 75-90\% of revenue the host government\textsuperscript{58}.

The major advantage of PSCs is their ability to generate high levels of risk free investment in the industry, without sacrificing the state’s legal ownership of the resources. This makes PSCs a highly attractive option for the Iraqi oil sector given the

\textsuperscript{56} Ibid
\textsuperscript{57} Behn, Supra note 3
\textsuperscript{58} ibid
strong aversion to private sector control. The debts incurred over Saddam Hussein’s quarter-century reign, and the lack of advancement in technical expertise due to the stagnant growth of Iraq’s oil industry over this period, has left Iraq with insufficient financial resources and technical expertise to develop and extract their natural resources effectively. Although controversial in nature, PSCs have seen positive results in a number of other developing countries such as Nigeria and Kazakhstan. Furthermore, within Iraq itself, the relatively stable Kurdish region has already generated substantial investment via this system since the approval of its own regional oil law in August 2007.59

The main arguments against PSCs arise from the seemingly high share of profit offered to the FOCs and the long-term nature of the contracts. However, due to the huge capital investment requirement of these contracts, these characteristics are necessary if the PSCs are to attract investors. The profit share will be determined through an analysis of the risk being undertaken by the investor. In partially developed fields the profit share is likely to be much lower than in unexplored territory. Further consideration must be made for the additional risk incurred by the FOCs when they invest in politically unstable regions. The optimum contract from the point of view of the host state is one that meets the FOC’s minimum requirement for investment60. Provided there is an adequate legal framework in place, PSCs are an attractive solution to Iraq’s financing problems.

5. CONCLUSION

The fiscal structuring of Iraq’s oil industry carries significant implications for the future development of the industry and for the rebuilding of the country as a whole.

59 The KRG has signed over 20 contracts with FOCs in the past 5 months.
60 Supra note 4 at 25
Insufficient investment has left the oil sector significantly under-developed and there are strong fears that the involvement of FOCs will lead to the exploitation of Iraq’s resources. The principal requirement of the fiscal regime is therefore to create a mechanism that will provide sufficient funding for the fast rehabilitation and expansion of the oil sector but that will also satisfy public concerns over the security of the country’s natural resources. The public pressure to keep the industry nationalised is an important political consideration particularly given the current civil unrest. However, an outright rejection of any form of foreign investment closes the industry to potentially profitable financing options. Furthermore, whilst INOC has an important role to play in the industry, giving it sovereign control over Iraq’s resources would leave the market vulnerable to inefficiencies.

This paper considers that the most effective fiscal policy for Iraq’s oil sector will permit for foreign investment in the form of PSCs. In more developed fields, short term service contracts may be a feasible option. This paper does not consider that INOC should be given sovereign control of assets, or even the level of control implied by the “Dubai annexes” in the Draft Oil Law. INOC should instead be made to bid for contracts on a competitive basis alongside the FOCs until it has proven itself as an efficient organisation. Without foreign investment, there is little scope for growth in the Iraqi oil sector. However, with a transparent and a secure legal framework in place, foreign financing of the industry could allow Iraq to extract maximum benefits from its vast wealth of natural resources.
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