Contracts and constitutions: The Kurdish factor in the development of oil in Iraq

ABSTRACT
The article addresses the interplay between oil policy and constitutional law in Iraq. Its central focus is the relations that the constitution allocates to Kurdistan authorities and the federal government. Through this prism it provides an account of the prospects for the Iraqi oil industry. This includes a discrete exposition of the production sharing and service contracts that have been concluded between the international oil companies and the Kurdistan authorities and the federal government. Both federal and Kurdistan authorities use interpretations of legal texts, both contracts and constitutions, to pursue their own political and economic projects. Law in this case is politics by another means.

INTRODUCTION
In the past decade, Iraq has experienced a remarkable combination of events in its history: invasion by foreign powers, followed by occupation and civil war; adoption of a new constitution giving significant regional autonomy to certain parts of the country, particularly Kurdistan in the north, and revival of its petroleum industry in what is generally agreed to be one of the richest petroleum-bearing areas in the world.

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The long-term viability of a federal constitution in such a volatile setting may be doubted. However, it is the impact of a revival of the country’s petroleum industry that is likely to prove the most decisive of all factors in determining the future direction of governance in Iraq. This is not only because of the overwhelming centrality of petroleum in the Iraqi economy. There is another, darker, factor at work. The oil revival is happening at a time when a growing number of international institutions, think-tanks and university bodies are directing research efforts into studying the highly negative effects of petroleum on economic and social development. This is likely to be particularly evident in post-conflict societies with fragile state structures, such as Iraq. The possibility that such negative effects may emerge in Iraq along with its petroleum revival is complicated by the operation of the recently established federal regime. Whether by intention or interpretation, the constitution of 2005 has permitted the establishment of two distinct, and potentially incompatible, legal regimes for the award and implementation of rights to the country’s petroleum resources. They have already given rise to serious tensions between the federal and the Kurdistan Regional Government (KRG). It is just this tension that provides the starting point for this study.

In this article I shall (1) examine the evolution of the two different models of investment contract between the state on the one hand and foreign oil companies on the other in the context of the recently established federal structure; (2) assess how the 2009 successes of the federal government in attracting foreign investors with their competing service contract model have impacted upon the tensions between the federal government and the KRG; and (3) consider the potential for coexistence of the contract models and a reduction of tensions in this respect. Two caveats need to be entered at the outset. The Iraqi general elections held in Iraq in early March 2010 triggered many months of bargaining among the various parties before a new government could be formed and start to function at the end of 2010. At the time of writing, a new coalition appears to have been agreed but any statements about future trends in such a fluid context have to be treated with caution. The second caveat concerns the scope of this article. Its focus is on the tensions between the federal government and the KRG through the public disagreements over investment contracts in the petroleum sector. The article raises doubts about the extent of the substantive differences between the models in contrast to their representation by the respective political parties. However, there are wider issues about the place of oil in a society’s development and about federalism that are not examined here.

POSITIVE STEPS AND CHALLENGES

In 2007 the World Bank produced a report entitled ‘Federal Aspects of Petroleum Regulation and Management in Iraq’. It considered a number of federal systems that have faced the challenge of developing large-scale petroleum resources. It warned against the dangers of over-centralization of resource management in Baghdad. Although it did not expressly address the possibility of a different petroleum regime emerging in Kurdistan, this possibility was implicit in that report.

Since then, much has changed in Iraq, with the most recent round of contract awards in December 2009 giving rise to considerable optimism about the prospects for a significant increase in production from Iraq’s petroleum sector, and resultant impacts upon the world’s oil economy. Two quite distinct
approaches to petroleum management have emerged; in chronological order, the first to emerge has been in Kurdistan, based on production sharing with foreign investors, and the second, developed by the federal government in Baghdad, has been based on a service contract model. The approach of the KRG was to move swiftly to develop an investor-friendly legal regime for petroleum exploration and development, based on a model production-sharing contract (PSC) and a framework petroleum law. It can hardly be doubted that this formed part of a wider agenda by the authorities to lay down a long-term economic basis for an independent Kurdish state. To date, this effort has attracted more than two dozen International Oil Companies (IOCs). By contrast, the federal government has worked hard to adapt a service contract model for several large fields with known reserves and to invite IOCs in on the basis of legal powers the government derived from the constitution and from previous legislation. In each case, the respective authorities have achieved considerable success. However, the compatibility of the two systems is doubtful and has in any case been overshadowed by a succession of disagreements between the federal authorities in Baghdad and the KRG in Erbil, the capital of Kurdistan. The most recent development in this long series of often bitter disagreements has been a dispute over the export of oil from Kurdistan through the federally controlled pipeline network. In effect, federal control over the pipeline network has been used to deny not so much the export of oil but rather full payment to the KRG from its sale by the federal marketing institution, the Iraqi State Oil Marketing Organization (SOMO), to the particular detriment of the foreign investors capable (and those soon to be capable) of producing oil. In response, following a short period of exports for several months in mid-2009, the KRG ordered the producers to cease further oil exports until the payment issue is resolved with the federal authorities. Since then, there has been a stalemate. In this setting, the vulnerability of foreign investors has been particularly apparent.

One observer has shrewdly remarked that in Iraq, ‘oil contracting and revenue sharing are not simply technical or commercial matters but rather proxies for differing conceptions among Iraq’s communities of the country and their place within it’ (Kane 2010). It is certainly true that the role of oil is a crucial one in a country that is seeking to engage in post-conflict reconstruction. It is the motor for almost 95 per cent of the country’s economy and pays for the country’s large security sector. It is also true that Iraq has the good fortune to own very large reserves of both oil and gas. For as long as modern and modernizing economies are dependent upon imported sources of oil, Iraq has abundant supplies of resources that can generate very large sources of revenue for a potentially very long period.

THE EVOLUTION OF TWO MODELS

From an early stage, there were clear indications that Kurdistan would seek to move quickly to attract inward investment by IOCs. This investment policy was to be based on a modern form of petroleum regime and a modest role for the state in monitoring petroleum operations. The IOCs would be able to explore for new oil and gas fields, where prospects were thought to be quite high, even if the giant fields in other parts of Iraq were not thought likely to exist. Presumably, this combination of factors made the anticipated risk profile of petroleum exploration attractive to foreign investors at that time. By contrast, in the rest of Iraq the knowledge base of geology was much higher and the geological
risks were correspondingly lower: several oil fields were known to contain very large reserves of petroleum even if the current levels of production were low due to neglect; this low geological risk supported those in government or their advisers who argued that a 'service' form of contract relationship with foreign investors would be appropriate. However, that analysis offered the prospect of much lower returns on an investment by an incoming foreign company. Most importantly of all, it ignored the very considerable investment risk in Iraq that remained even in the presence of highly favourable geology.

At the outset, the KRG made it clear that it favoured the conclusion of PSCs with foreign investors. Indeed, it offered such contracts to foreign investors even before there was an agreement on the text of a new constitution. This kind of contract has considerable attractions to investors over the alternative available in this region, known as the service contract. Since the two types of contract play an important part in what follows, I offer some brief observations on their key features relevant to the making of an investment in the exploration for and development of petroleum.

**Production sharing**

As its name implies, this type of petroleum agreement requires a sharing of the fruits of the venture in predetermined proportions between the company and the host State, usually through its National Oil Company (NOC). Title to the oil and gas remains vested in the host state or the NOC. The foreign oil company contracts with the host state or the NOC to provide the capital and the expertise required to explore for petroleum resources within a specified contract area, paying all the costs. It becomes a 'contractor' that fulfils work obligations at its sole risk and expense. In return, it obtains a right to recovery of its costs from the petroleum produced or from a proportionate part thereof, and for a share of the production or profit oil if commercial production is established. The sharing is usually done according to a sliding scale or formula set out in the PSC, granting a major share to the state from the balance of petroleum remaining after the recovery of costs, and with variations permitted according to whether the discovery is a marginal one or located in deep water. Usually income tax is also levied on the contractor's operations, and sometimes a royalty too. The PSC offers a number of advantages to the foreign investor. The investor is able to 'book' in its accounts the petroleum reserves it finds, enhancing the value of its shares. The PSC can also create its own legal regime, which has attractions in countries where the principal legal regime for foreign investment is of recent origin or is still unsettled, as was the case in Kurdistan, at least in the early days.

**Service contract**

The general idea behind a service agreement is that the host state hires the services of the IOC as a 'contractor' (Smith et al. 2000: 480–93). The financial, exploration and development risks are carried by the contractor. In the event that commercial production becomes possible from the contract area, the contractor is reimbursed for its costs and investments and paid a fee for its services from the sale of the oil produced. The foreign investor is granted no mining or mineral rights and the production belongs in its entirety to the host state or the NOC. The investor resembles a 'hired hand' working for 'wages'. A key feature is the method of payment in oil. If this is specified in volumes, it
will be vulnerable to volatile prices, leading to potential windfall gains to the investor at the state's expense. If it is specified in terms of a fixed fee denominated in dollars and valued at market prices at the time of the transaction, this problem is avoided. The relationship between the investor and the state under these arrangements has been described as 'like a creditor of a debt obligation', in which the investor receives 'income calculated to cover its expenses plus a fixed return on its debt investment' (Occidental Exploration and Production Company v. The Republic of Ecuador 2004). From the earliest days, this contract form (in one variant or another) has been favoured by the central government in Baghdad as a means of avoiding a 'give-away' of proven reserves to foreign oil companies.

**The impact of the constitution 2005–06**

The Constitution of Iraq was approved by referendum in October 2005 and entered into force in 2006. However, its interpretation with respect to oil and gas management has been controversial. The interpretation that has prevailed in Kurdistan is one that recognizes that ownership lies with the Iraqi people according to Article 111, but that the KRG may exercise managerial control over the oil and gas in its region for all of the people of Iraq. Its own Oil and Gas Law envisages a sharing of net revenues with all of the Iraqi people. This interpretation has been opposed consistently by the federal government in Baghdad and by key advisers involved in the drafting of the federal Oil and Gas Law. In general terms, they have seen it as contradicting any kind of national oversight of petroleum operations in the country.

The KRG assessment of its legal competence under the Constitution to negotiate and conclude contracts to IOC's was supported by a legal opinion from an internationally recognized authority on international law, Professor James Crawford of Cambridge University. In his opinion (January 2008), commissioned by the KRG, he reviewed the Constitution but also the draft federal Oil and Gas Law and the Oil and Gas Law that had been adopted by the KRG in August 2007. The KRG had, in his view, the authority to manage the oil and gas resources in Kurdistan as set out in the Oil and Gas Law of the Kurdistan Region – Iraq (Law No. 22 of 2007), in full conformity with the constitution of Iraq. This is a view that is contestable. A distinguished authority on constitutional law, Professor Cheryl Saunders of Melbourne University took a contrasting view of the division of authority between the federal government and the regions and governorates. It was much less favourable to the exercise of power over the petroleum sector by the KRG, emphasizing instead the key role of the Council of Representatives (Bell and Saunders 2011).

In spite of the severe problems with internal security in the country at the time, the Constitution of Iraq appears to have been drafted and negotiated in a spirit of some optimism about the long-term prospects for a federal state in Iraq and especially about the prospects for the development of a working relationship between Kurdistan and the rest of the country. There were doubts however. In his book *The End of Iraq* published in 2006, Peter W. Galbraith refers several times to Iraq as a 'failed state', and argues that an impending civil war is a strong reason for US withdrawal. He is also categorical about the prospects for the incorporation of Kurdistan within the framework of Iraq as a single, federal state. His sympathies lie clearly with the KRG on constitutional matters. From a quite different perspective, Tariq Shafiq, one of the leading drafters of the Iraqi Oil and Gas Law 2007, uses the same designation for the country, but his sympathies lie with a unified Iraqi state. He states (2009) that
today, there are further serious obstacles that limit the Iraqi government's ability to govern effectively and to promote cooperative and coordinated policies by the different components within any ministry or between ministries. These involve failed state impediments, ethnic-sectarian divisions, widespread corruption, and the near absence of functioning institutions and proficient human resources.8

He continues:

This is demonstrated, for example, in the Kurdistan Regional Government's unilateral decision to manage oil and gas resources within the region and so called 'contested territories' without reference to the Iraqi national government, parliament, or the central Ministry of Oil, forcing the ministry to pursue its own development policy.

The model of a workable, federal state that the drafters of the Constitution assumed that could develop has remained elusive. However, the constitution remains a frame of reference for divergent interpretations of the powers of the central and regional authorities.

**Enactment of an oil and gas law by the KRG in 2007 and the subsequent renegotiation**

Following the adoption of the constitution, the KRG prepared a draft Oil and Gas Law for Kurdistan. This went through several drafts and included some provisions directed at existing petroleum agreements. Essentially, some forms of these agreements were subject to a review that might result in changes, while others could be subject to nullification and validity. Under Article 54, '[a]ll agreements related to Production Sharing Contracts’ which entered into force before the Law was passed were to be reviewed by a Regional Council within the KRG to ensure they were consistent with the standards established in the Law. Further, it provided that the decisions of the reviewing body were to be regarded as ‘final’. A second provision provided that '[a]ll pre-existing authorisations and memoranda of understanding related to oil and gas’ were to be considered null and void unless their validity and effectiveness had been affirmed by the same KRG entity that was charged with the review under the first part of the Article.

This provision not only allowed the KRG to change the rules of pre-existing agreements following a review, but it also represented a change of direction by the KRG from its earlier proposals in this respect. In the earlier October 2006 draft, Article 79 declared that ‘Any agreement related to Petroleum Operations entered into by the Regional Government prior to entry into force of this Act, and approved by the Minister, shall remain in force.’ The definition of ‘agreement’ was wide, and included licences, permits, memoranda of understanding and other legal acts. The rejection of this approach was deliberate.

The key point is that a legislative measure was adopted, which allowed the state authorities to target specific aspects of the existing PSCs for amendment and require the parties to accept both these and new, more onerous terms or face the risk of failing to receive the new form of PSC. The threat facing existing right holders was one of cancellation of their rights. This procedure adopted by the KRG has implications for any estimation of the future security of contract rights of foreign investors. That the KRG was willing to introduce substantial
changes that struck at the economic core of the original bargain made by the parties at such an early stage in its programme of attracting foreign investment does not augur well for the long-term stability of foreign investments.

It is notable that the substantive changes and the manner of their introduction into the revised contracts were made without any apparent pressure from the central authorities in Baghdad, at a time when tensions between the KRG and the federal government were considerably less marked than they are now, and when the KRG production-sharing approach was subject to far fewer challenges to its legitimacy. It cannot therefore be inferred that these steps were taken by the KRG as a result of pressure from the authorities in Baghdad or a perceived need by the KRG to take measures to appease the authorities there. An alternative and more plausible explanation of this approach by the KRG is that at a time of rising oil prices it did what many other host governments were doing around the globe and adopted coercive measures to persuade ‘captive’ investors to agree to changes in their contracts on a voluntary basis. In Latin America such tactics had been singularly successful in achieving a shift in terms to favour host states without leading to an expected surge of international arbitral proceedings. It is irrelevant whether the pressure to renegotiate the initial deals struck with foreign investors came from the parliament or other parts of the state or civil society in Kurdistan and that the government was simply reacting; the behaviour fits into a pattern that is evident elsewhere.

Failure to adopt a federal oil and gas law

A key requirement for long-term stability of contract rights is the adoption of a petroleum law for Iraq and a unified petroleum resource management policy based on the Constitution. Efforts to develop an Oil and Gas Law at the federal level have continued over several years but appear to have been suspended in 2009, at least de facto. This lacuna has the potential to generate challenges to the legitimacy of contracts awarded in the meantime by the KRG under its own Oil and Gas Law. Similarly, if the central government were to award rights under long-term contracts (as it did in 2009–10 under auctions), there is a risk that those contracts might also be deemed illegitimate by a subsequent government. In this sense, a holder of petroleum rights in either the KRG or the rest of Iraq is vulnerable to a declaration by a subsequent government that such rights are illegal and need to be either revoked or renegotiated. Currently, the minister of oil in the federal government has declared that all petroleum contracts awarded by the KRG, including those awarded before the Constitution was adopted, are indeed illegal.

In this context of uncertainty about the legitimate legal framework for the petroleum sector, it may be noted that some have placed the blame for the absence of an agreement on the text of a federal Oil and Gas Law firmly upon the KRG itself. For example, the KRG and Kurdish members of the Iraqi Parliament were, in Dr Shafiq’s view, responsible for the fact that the negotiations on the Oil and Gas Law were stretched out ‘for over a year and resulted in three revisions by the ministerial committee, with each in turn rejected by the KRG’s political leaders for one reason or another’ (Shafiq 2009: 24). In an article published in the influential Middle East Economic Survey (MEES) on 25 May 2009, Dr Shafiq went further and blamed the KRG for stalling the progress of the draft federal Oil and Gas Law. However, a different interpretation of these events was presented in a profile of the KRG Minister of Natural Resources, Dr Ashti Hawrami, in the specialist newspaper, Upstream (Shirkhani 2009). It

9 Specifically the introduction of bonuses; increased royalty payments; reduction in the cost of oil entitlement; more onerous sliding scale calculation for profit oil; shorter exploration periods; increased expenditure on exploration; lower working interest; and more extensive reporting obligations.

10 The two sides, the federal government and the KRG, lost interest with time in legislating the oil and gas law despite the public statements to the contrary: ‘Ghadban assesses progress’ 1 March 2010.

11 But note that there has already been a challenge to the legality of the awards made by the federal government in the December 2009 round: a member of Parliament, Mrs Shaida Musawi, filed a lawsuit in the Supreme Federal Court, which would challenge the constitutionality of one of the oil deals signed after the first auction in June 2009: Iraq Oil Report, ‘Not Done Yet’, 8 December 2009. The claim is made that for a contract to be valid it requires the approval of the legislature and that process must include local government leaders. The claim is also made that the signature bonus is essentially a loan from a foreign entity and must therefore also be
noted that the federal government was seeking to add annexes to the draft Oil and Gas Law, which would remove loopholes in the text of the constitution that allowed the KRG to award contracts for exploration. The Kurdish deputies have resisted the addition of such annexes. Minister Hawrami is quoted as saying:

"The annexes as they are written now will not be accepted by the KRG. If I don’t get the lion's share of fields (in the region) then it’s a bad law. If the law dilutes regional control then it is unconstitutional. It is the dream of some in Iraq to go back to centrally controlling the oil as before, and that will never happen."

The disagreements over the causes of the stalemate over the text of the Oil and Gas Law are rooted in wider sources of instability however. In fact, there are many other reasons why the oil industry in the non-Kurdish parts of Iraq has stagnated. A focus on the undeniable difficulties facing the 2007 draft Oil and Gas Law and the relations between the central government and the KRG should not obscure this. Among the difficulties are:

1. **Linkage of oil sector legislation:** the decision was taken to include the draft Oil and Gas Law in a package of laws which comprises a revenue-sharing law, a law to revive the NOC, Iraq National Oil Company (NOC) and a law on the reorganization of the oil ministry. Because the law refers to several laws to be legislated at a later date, there is a certain integration of the four elements, suggesting that the Oil and Gas Law should be adopted at the same time as the rest to ensure coherence.

2. **Allegations of corruption on a large scale:** the United States Government Accountability Office has stated that between 100,000 and 300,000 barrels of oil a day are stolen, and oil production continues to decline (Abd Allah 2009). The market value of such smuggling is estimated to range from between US$5 million and US$15 million a day.

3. **Technical problems:** irrespective of whether an Oil and Gas Law is passed, there are serious problems with existing equipment such as a lack of measuring gauges that identify the volume and quantity of crude oil and gas at production points and also at loading facilities and shipping ports. Existing equipment has to be repaired or replaced, or adequate measuring equipment installed. Moreover, neglect and incompetence are alleged to characterize important parts of the oil industry such as in the south, (Laibi tells tale of Iraqi’ 25 May 2009). Pipeline infrastructure needs to be expanded and upgraded.

4. **The uncertain future after the withdrawal of US troops:** a reason for the limited commitment by IOCs to investment in Iraq’s oil sector has been not only the absence of a stable legislative framework on which to base their business projections. There are more serious uncertainties that follow from the withdrawal of US troops from the country in the foreseeable future.

5. **Opposition to the Oil and Gas Law itself:** the model contract that will be approved by the law contains within it many blanks in crucial clauses such as production bonuses, the amount of oil produced to be allocated to the foreign company for cost recovery, the period over which such costs will be recovered and the portion of total production to be obtained by the foreign company as profit—these matters (and many others) are left to the discretion of Iraqi negotiators, as is the selection of IOCs that are to be included in
the shortlist and exclusively allowed to bid for exploration and production rights. Drafters of the law proposed the establishment of an independent expert advisory board, charged with monitoring the negotiation and contracting of rights to explore and exploit oil and gas; the aim was to limit the scope for corruption in the allocation of rights. This has been retained but in a severely reduced form so that it has no real powers. Given these weaknesses and their potential for abuse, some have concluded that the proposed law is a vehicle for channelling funds to a privileged minority, and have opposed it.

**The emergence of an alternative approach to petroleum management**

By March 2010 the package of laws that had been under discussion for more than two years had failed to make any progress. There is still no federal Oil and Gas Law; no revenue sharing law; no law establishing a NOC and no law that delimits the competence of the Iraqi Ministry of Oil as the regulator of oil and gas activities. In the absence of an Oil and Gas Law, there is no consensus about the process and authority for the negotiation and signature of new contracts. This is reflected in the most recent events.

The central government has reacted to this situation by signing contracts with several leading IOCs following a round of competitive bidding for contracts designed on service (not production-sharing) lines. The contracts were signed without the express approval of the parliament and therefore have attracted censure. In October 2009 the minister (Dr Hussein al-Shahristani) was summoned to appear before the parliament’s Oil and Gas Committee to answer questions that included ones about the legality of the contracts he has signed or is negotiating, as well as ones about political bias in employment of staff in the Iraqi petroleum industry (‘Iraq issues formal’ 15 October 2009). The session was postponed, but among the parliamentary groups that lobbied for the minister’s summons were the Kurdistan Alliance block as well as the Basra-based Fadhila Party.

To some extent, the minister’s hand was forced by the need to respond to criticisms of his management. The contract awards by the ministry were partly an attempt by the minister to defend his record. In spite of the legal lacuna, the federal government had acted in a manner similar to the KRG and initiated contract negotiations with IOCs. However, there were important differences in their approach, which was also designed to permit continued criticism of the KRG contracts already awarded to IOCs.

The contracts awarded by the federal authorities in 2009 have been the result of lengthy negotiations following announcement of a competitive tender. Their overall aim is to boost current production from around 2.5 million barrels per day (mbd) to 7 mbd within seven years. Two key differences from the KRG approach are evident in the contract awards made to date: firstly, there is a difference in the manner of award, in which a competitive tender has been favoured, and secondly, there is a difference in the type of contract used: the service contract variety instead of a PSC.

The first awards made in 2009 were the result of a bidding round launched in June 2009, the first since the 2003 war. Six oil fields were put on offer for bids as well as two gas fields. The only award made was to a consortium of British Petroleum (BP) and the China National Petroleum Corporation (CNPC) for the very large Rumaila field; the round was therefore perceived as a failure.
The first public example of this — to my knowledge — became evident in November 2009 with the publication of a fiscal comparison of the terms obtained by the KRG and those obtained by the authorities in Baghdad. Mr Peter Wells (2009), a consultant, published the results of a study in the Middle East Economic Survey, under the title, ‘Iraq’s technical service contracts — a good deal for Iraq?’

and the ministry was blamed for demanding terms that were too onerous. However, very shortly afterwards, this consortium was persuaded by the ministry to accept only half of the remuneration that it had proposed in its initial bid. Negotiations with other foreign investors continued and a second service contract was awarded to a consortium led by the Italian State energy company, ENI (comprising Occidental Petroleum, Korea Gas Corporation, Missan Oil Company of Iraq) to develop a giant oil field, Zubair, in south-east Iraq. This followed the failure of ENI to obtain the contract at an auction launched in June 2009.

It is interesting to note that an important reason for the initial failure of the ENI-led bid was the Iraqi government’s insistence that the ENI consortium drop the participation of Sinopec, another Chinese state-owned oil company. The reason for this stance was Sinopec’s entry into Kurdistan through its acquisition of Addax Petroleum, which has a stake in the Kurdish Taq Taq field (‘Eni wins Iraq’ 13 October 2009). The federal government has promised to punish companies for dealing with the KRG and as an example it has excluded Sinopec from taking part in the second licensing round. This gives an idea of the strength of feeling against the KRG’s approach and its willingness to act against those foreign oil companies that agree to deals with the KRG for oil and gas development. Comments by Iraqi officials to the media underlined this impression. The deputy director of the Contracts and Licensing Directorate, a government body, was quoted as saying: ‘Sinopec is blacklisted unless it changes its position and withdraws from these [Kurdish] contracts (‘Iraq deals China’ 9 October 2009). This decision also removed Sinopec from the list of qualified companies that could submit bids for the ten major oilfields offered in the second auction in mid-December 2009. This may cause Sinopec to reconsider its strategy in Kurdistan, a strategy that it did not make but rather inherited from the preceding owner of Addax. More importantly, other IOCs are clearly ‘voting with their feet’ and avoiding the kind of commitments in Kurdistan that they have been willing to make in the rest of Iraq.

Overall, these deals (in the first and second rounds in 2009) are likely to weaken KRG leverage to win Baghdad approval for existing Kurdish contracts. Once these very large fields increase their production, the revenue from Kurdish oil fields will matter much less. This is particularly so in the light of the success of the federal government in the second round, considered below.

The terms offered to foreign oil companies appear to be very tough: in return for raising oil production from current levels of around 195,000 barrels a day (b/d) to a level of 1.125 mbd in the next seven years, the contractor would receive a payment amounting to US$1.90 a barrel for oil produced plus recovery of costs after a minimum production level is achieved; the duration was 20 years, extendable to 25; the state-owned South Oil Company of Iraq would have a 25 per cent carried share in the project. They invite comparisons between the terms that the federal government has managed to negotiate and those that have been obtained by the KRG from foreign investors. 

Obstacles to export: Relations between Baghdad and the KRG in 2009

In one respect the condition of relations between the central government and the KRG is of paramount immediate importance. Kurdistan lacks access to an independent, secure pipeline system for export of its oil. Currently, producers from Kurdistan rely upon the state-owned sales network for international
marketing and sales. This is operated by the SOMO, which is the only entity that has authority to market and sell crude oil that is produced from fields in the country; effectively, it is the federal government that disposes of the oil to Ceyhan in Turkey and receives the revenue. On 1 June 2009 the KRG permitted exports of produced oil from the Tawke oil field, which were sold by SOMO. However, in the absence of an agreed payment mechanism between the KRG and the central authorities it soon became clear that the federal government had no intention of delivering additional sales revenues from such transactions to the KRG, refusing to increase the 17 per cent budget share allocated to the KRG under the demographic rules formulated according to the Constitution. Instead, it retained the revenues from the oil sales at federal government level. As a result, the KRG ordered the cessation of oil exports on 22 September 2009. The producers did not receive any income from the KRG for exports of oil from the Tawke field that took place between June and September 2009, in spite of having a PSC with the KRG (they did not have a contract with SOMO to deliver and sell the oil). Other companies in northern Iraq face a similar situation in trying to monetize their petroleum production. There is no indication of a date when production might resume.

There is another emerging problem. The central government’s rush to conclude service contracts with foreign oil companies that aim at an expansion of Iraqi oil exports have not been accompanied by a similar haste to upgrade and expand the pipeline network and export capacity. Even if there are no major setbacks or damage to current rehabilitation projects, the maximum existing oil export capacity has been estimated by one expert, Dr Issam Al-Chalabi, as no more than three million barrels a day from both the south and the north (‘Iraq’s oil export’ 30 November 2009). Expansion plans will be reliant upon good relations with neighbours such as Saudi Arabia, Kuwait and Syria. In this context of competition for export pipeline access, export requirements from Kurdistan are likely to have to compete for priority in access.

An important aspect of the 2009 export incident is that the federal government takes the view that such additional production from northern Iraq is less pressing and that revenues could be generated more quickly from a revival of the existing, very large fields in other parts of Iraq. Currently, it is in the process of awarding service contracts to foreign investors to do just this. The federal government is therefore gaining leverage against the KRG in this dispute. When foreign contractors take management responsibility for the very large existing fields, it can be expected that the revenues accruing to the federal government will grow, but its need for a share of the revenue from production from the fields in northern Iraq will be minimal or non-existent. Production under the service contracts is explicitly linked to certain targets or plateaux which the contractors will be obliged to meet (the aim is to raise existing production), which will itself raise an issue of how much oil Iraq as a state may produce without breaching any quota set by Organization of Oil Exporting Countries (OPEC). This linkage between the restoration of Iraqi production and OPEC quotas has surfaced repeatedly in discussions among regional experts about the future of Iraqi oil. It is quite possible that in this context, when production is restored and is climbing to reach externally imposed limits, oil production from the new Kurdish fields will be seen as marginal. It may therefore be subject to disruptions, but it may also never be permitted to transit through SOMO pipelines because such production is deemed unnecessary.

The export incident unfolded against a background of deteriorating relations between the central government and the KRG throughout 2009. This
represents the continuation of a trend that has been evident for at least three years. One commentator notes:

If Baghdad prevails in the battle of wills, the real losers will be the international oil companies that have taken advantage of the hostilities to plough money into the region with no guarantees of any return.

(Shirkhani 2009).

**Prospects for cooperation between Baghdad and the KRG**

The impact of changing and increasingly adverse international conditions for access to oil by the IOCs was vividly illustrated by the change of mood in the run-up to Iraq’s second round of contract awards in 2009. On 11–12 December 2009 the federal government held a second round of contract awards, with 44 IOCs eligible to submit bids for contracts of the service variety. The federal government has since agreed on the terms of contracts with several of these IOCs, with signatures following in January and February (‘Baghdad ratifies round’ 11 January 2010; ‘IRAQ: Second oil’ 15 December 2009). The ten fields on offer were reputed to contain 36 per cent of Iraq’s 115 billion barrels of proven reserves. Given our theme of federalism and petroleum management, an interesting feature of the second round was its ‘public relations’ use by the federal government to demonstrate that the service contract model can be as attractive to foreign investors as the production-sharing model used by the KRG, and at the same time it can provide the framework for much tougher terms that will generate greater benefits to the people of Iraq than the Kurdish PSCs. Similarly, the round was used to demonstrate that negotiations with foreign investors, left in the capable hands of the federal government, are likely to deliver greater benefits to all of the people of Iraq than negotiations left to the government of a single region.

On the face of it, such comparisons do not bear close scrutiny. The service contracts were awarded to consortia to revive oil fields known to be very large and in need of investment to boost recovery. They also contained hybrid elements to make them more attractive than service contracts usually are to IOCs: early cost recovery and a booking of reserves are two of these (although the precise terms of the contracts remain confidential). By contrast, the Kurdish PSCs were concluded for acreage that was largely unexplored, resulting in new discoveries, albeit ones that are significantly smaller in size and potential than those in southern Iraq. Given this significant difference in geological risk, a simple comparison of the contract terms (such as has been implied by the federal government) does not appear to be appropriate.

However, the comparisons need to be understood in terms of the ongoing bargaining between the federal government and the KRG about the degree of autonomy that Kurdistan should enjoy in Iraqi law with respect to the development of oil and gas resources. The long-standing criticism of the KRG oil policy from the central government, as well as much of the parliament and many Iraqi experts, is that the KRG has effectively given away rights to oil and gas resources to foreign oil companies. In the light of Iraq’s history with foreign investors, this is a charge that has a great deal of public resonance. It is in this context that the second round is a development that has important implications for the KRG bargaining position, particularly for the export of oil through the centrally controlled pipeline system. The IOCs involved in the second round have made commitments not only to invest large amounts
but to achieve demanding production targets so that over the course of the
next seven years Iraq has an opportunity to become a major international oil
producer once again. Such an increase in production from the large fields in
southern Iraq would generate significant revenues for the federal government
and would limit its need for revenue from the Kurdish development of relatively
small fields in northern Iraq.

A principal policy objective of the second round was to secure commitments
from IOCs to raise oil production from ten of the existing Iraqi oil fields within
a period of only seven years. The overall target is to increase oil output from the
current level of 2.4 mbd to more than 6 mbd. A further objective was to raise
cash from bids by the IOCs. Both of these objectives were generally seen by
commentators to have been achieved in the December round.17 For the West
Qurna-2 field alone, the winning bidder paid a signature bonus of US$150 mil-
lion and agreed to invest a minimum of US$250 million. The Russian company,
Lukoil, in partnership with Norwegian Statoil, agreed to this and to a reported
take after expenses of only US$1.15 per barrel, before tax (irrespective of the oil
price) (‘We are really happy’ 12 December 2009). In general, the terms offered
were that IOCs would recover their costs and as profit would receive a fee for
each barrel of oil that added to current production. The tax is 35 per cent, and
a share of 25 per cent is due to the Iraqi state oil company partner, giving a net
gain to the IOC per barrel of oil that is even lower than US$1.15. Nonetheless,
the terms remain confidential so that caution should be exercised in attributing
weight to the published reports in the media.

The low remuneration fees were also used to secure legitimacy for the
contracts awarded. The auction itself was televised on state television. In his
opening remarks at the event, Minister of Oil Dr Shahristani declared that the
auction was held on behalf of all the Iraqi people, a remark that was inter-
preted as a swipe at the Kurds for wanting to monopolize the oil in their region
for their own benefits (‘In the Theatre of Oil’ 17 December 2009).

The contract model adopted by the federal government for the second
round awards was the service contract model with joint venture elements added
to it to ensure Iraqi participation in the operations. PSCs were not available, and
no element of production sharing was available to foreign investors in the new
contracts. Some of the largest IOCs in the world showed that they were pre-
pared to accept the service contract model on terms that were strict. The IOCs
included Shell, Lukoil, Statoil and Gazprom. In this respect, the round was a
vote of confidence in the service contract model (for fields such as these), in the
long-term role of Iraq as an oil-producing country and was an endorsement of
the federal government’s approach to contract design with respect to attracting
foreign investment into Iraq.

In assessing the new awards, Mr Joost Hilterman of the International Cri-
sis Group, a leading figure in the expert body, concluded that if the IOCs that
had entered Iraq on the basis of these contracts were successful in achieving
their targets and Iraq’s oil production reached 6 mbd, the very modest pro-
duction from Kurdish oil fields would cease to have any importance for Iraq:
‘This is a very bad scenario for the Kurds’ (‘Baghdad’s oil deals’ 2 December
2009). Increased production of oil from the southern fields could deliver the
revenue to the central government which it needs to continue to limit the Kur-
dish development of the northern fields. At the same time, this ought to be
understood in terms of leverage. The longer-term prospect of increased pro-
duction and the present success of the second round allow the central govern-
ment to ignore KRG demands (such as for the right to receive a fair share of revenues

17 Second oil round, 15 December 2009; the significant confidence and
commitment shown by IOCs suggests that hydrocarbons development is
gaining strong momentum that will not be derailed by political arguments
over oil policy under the next
government; ‘Shell wins Iraq’, 11
December 2009; ‘The international oil
companies have
raced each other to
the bottom to get to
Iraq’s reserves. The
Iraqis have got to be
growing after this
round’ is a quote
included in this
report from an
analyst at PFC
Energy.
from exports of oil) until these demands are moderated. The oil minister said in January 2010:

About the Kurdistan fields, there are not any talks now about them. We look forward to meet a delegation from the region to review all the KRG contracts to see if they have any defects.

(‘As election nears’ 15 January 2010)

Despite the foregoing, the legal basis for any participation by foreign investors in Iraq remains controversial. The draft Oil and Gas Law has made no further progress and is not expected to evolve further during the period of months following the March elections when discussions on the formation of a new government will take place. In this context of very shaky legitimacy, the service contract model is the most favourable that foreign investors are likely to get in Iraq at the present time. There remain many however who oppose both the form of the contract and the manner in which the contracts have been allocated. A key question about these new contracts is their capacity to survive beyond the term of this or perhaps the next government. Nevertheless, the terms on which the second round contracts have been reached with IOCs make them less vulnerable to the criticism that has been levelled at those contracts that have been concluded with the KRG: that the terms are extremely lucrative, and represent a poor deal for Iraq. As one commentator has said:

[T]he relatively straightforward nature of the technical service contracts under offer as well as the emerging broader picture of a reasonably balanced mix of foreign and Iraqi participation in developing the country's oil sector mean that these deals are on the whole less vulnerable to criticism than those previously entered into by foreign companies on extremely lucrative terms with the Kurdistan Regional Government – and therefore also stand a chance of surviving in their existing form in the long term.

(‘Political implications’ 14 December 2009)

The above quotation is interesting not only in the way it underlines the continued challenges to the KRG-granted contracts but in its failure to appreciate how these contracts have, as a matter of fact, been modified by the KRG on several occasions to whittle away the initial benefit of the bargain to the foreign investors. Inevitably, it is open to debate whether the terms on which IOCs are involved in Kurdistan are ‘optimal’, but it is stretching credibility to represent the current terms as constituting some kind of ‘give-away’.

A pre-bargaining phase to find a solution to the export problem appears to have begun in early 2010. On 17 January 2010 the KRG issued a press statement on its website on Kurdistan oil contracts and revenues (the ‘Statement’). Issued under the name of Dr Ashti Hawrami as minister for natural resources in the KRG, it was presented as a response to Iraqi prime minister al-Maliki’s statement on 3 January 2010 that it was time to ‘look at this file and settle it with flexibility and realism, in order to preserve the rights and interests in these contracts’. The Statement asserts the KRG’s willingness to start a ‘serious dialogue’ on this matter and invites the federal government to engage in such a dialogue with the KRG to reach a comprehensive agreement on this matter in the interests of Iraq as a whole. It indicated the KRG’s willingness to immediately resume oil exports at a rate of no less than 100,000 b/d and to work to
increase production to more than 200,000 b/d in 2010. This ambitious target has to be understood in the context of a Statement that has very limited objectives. It is a declaration that on the KRG side there is a willingness to discuss past and present differences on these matters with the federal government, to start as soon as possible and to conduct negotiations in good faith. It is not therefore the start of negotiations or talks of any kind. Indeed, the federal oil minister has been quoted as saying in mid-January that ‘There are not any talks now about them [the KRG contracts]’ (‘KRG sets guidelines’ 19 January 2010).

With respect to the current foreign investments in Kurdistan, it is notable that the Statement distinguishes (in paragraph 3) between cost recovery and profit share. This suggests that the first stage of discussions will not necessarily encompass full compensation and that the profit that investors will be allowed to take from their investment is one of the items for later discussion between the KRG and the federal authorities. Such an interpretation is strengthened by the sentence: ‘[the amount of profit] should be viewed in comparison with what is an acceptable standard in the international oil industry regarding oil exploration and production’. It is not clear how that would be calculated, since what is ‘acceptable’ will no doubt vary according to the stage of development of the project, circumstances in which the investment was made, country risk and many other factors. The wording in the Statement suggests that, with respect to profit share but not cost, a renegotiation of some kind may be envisaged by the KRG.

The oil minister, Ashti Hawrami, was quoted as saying that this was the start of a ‘serious dialogue’ with the federal government on this issue. The market response was positive, but the press response was more cautious. The Financial Times noted that ‘the statement appeared to be a political overture, not a binding plan capable of breaking the deadlock’ (‘Kurdish minister pushes’ 18 January 2010). The specialist Iraq Oil Report was sceptical: ‘both sides have frequently made sincere statements with no subsequent conciliation’. It also noted that the issues of difficulty between the KRG and the federal government are mostly not ones that concern the compensation due to the oil companies mentioned in the Statement. The really difficult issues are the package of hydrocarbons and revenue-sharing laws and the status of the oil city of Kirkuk which are ‘rooted in fundamental differences about the extent of federalism in governance and the role of foreign oil companies in Iraq’s nationalized oil sector’ (‘KRG sets guidelines’ 19 January 2010). Its conclusion bears quotation:

A lame duck government in the run-up to crucial and highly contested national elections [on] March 7 has little chance to accomplish what a fully-fledged government failed to do for four years. Unless, of course, political factions are looking to exchange compromise before the vote for solidarity in forming a ruling coalition afterward.

The response of the Iraqi oil minister to these overtures may be gleaned from remarks made in February in an interview. It is worth quoting at some length. He says:

We have always said and told them that these contracts have to be reviewed by the ministry of oil. We have to make sure that they provide Iraq with the best or highest revenue possible and they have to be approved by the Iraqi government like any other oil contract. All of these
have to go to the cabinet for approval. And without that we cannot really accept them. That position remains the same.

However, recently they’ve indicated they’re willing to send these contracts for review and we will be happy to do that. Without reviewing them we cannot really say. But now, everybody realizes the kind of contracts that Iraq is able to get, the kind of service fees the companies are willing to pay and we have to be in conformity basically with the general form of contracts in the country.

('Ten deals make' 5 February 2010, emphasis added)

With respect to a timeline and a procedure for moving forward, the oil minister was clear in his position. He said:

There are discussions now and there are proposals. Not for approving the contracts because that will take much longer and a lot of discussion, as you said, there are serious differences between these contracts that cannot be resolved so quickly. But there are other suggestions without having to accept those contracts how we can start moving forward.

('Ten deals make' 5 February 2010, emphasis added)

Presumably, the last sentence of the quotation means that oil exports can resume while the lengthy process of deciding what to do with the existing contracts is thrashed out between the federal and regional governmental authorities.

The above statements made by the parties can be interpreted as setting out positions at the start of a bargaining process. When Minister of Oil Shahrzadi declares the contracts to be illegal, this is best understood as indicative of a bargaining position by a minister in an outgoing government, looking ahead to the negotiations that will accompany the formation of the next government during 2010. It means that some adjustment to the existing contracts is inevitable when a policy agreement is eventually reached on this issue if the contracts are going to be given a ‘blessing of federal legitimacy’. The tougher the stance of the federal government at this stage, the more likely it is that they will achieve significant concessions from the KRG as the bargaining moves ahead, or so they calculate. And such bargaining will embrace a wide range of subjects, from the financing of the Peshmergas (the Kurdish military) to the status of the disputed city of Kirkuk. In such negotiations, there is inevitably a risk that an adjustment to the existing contracts awarded by the KRG, to go some way to meeting the demands of the federal authorities, may be deemed a small but acceptable concession by the KRG in the interests of obtaining benefits in other areas and perhaps also an increased share of the revenues from oil exports. If so, it is hard to see how such an adjustment could be other than detrimental to the interests of the existing PSC holders in Kurdistan.22

CONCLUSION

The contract models that have played such an important role in the federal–KRG interplay in recent years are ones that have been politically charged in other countries too. In Russia and in parts of Latin America, the production sharing form has been rejected. In a growing number of producing countries, most recently Mexico, the service contract model is the model considered to
be compatible with the overall constitutional or political framework of a nation state, acting responsibly as custodian of its natural resources. However, behind the rhetoric and the legal forms of the contracts, both contract models permit substantive provisions that result in hybrid versions, as both federal and KRG authorities have been aware. Yet real differences do exist, and the potential for a rapprochement in Iraq remains just that and no more.

Taking a wider view, the provisions in the constitution that have allowed the KRG to pursue a quasi-autonomous petroleum policy since 2005–06 were guaranteed by the presence of foreign troops in Iraq. In the foreseeable future, this factor will largely disappear. On a negative scenario, it is possible to envisage many kinds of internal upheaval as a result of this change, including violence between the federal authorities and Kurdistan, and even the collapse of the constitution itself. However, another view might seek to develop a more positive scenario, in which the parties recognize a large measure of common interest in the resumption of large-scale petroleum development in Iraq. Such a view could draw strength from the changes in party politics in Iraq itself. Following elections in Kurdistan, the hitherto homogenous Kurdish bloc in the National Assembly now includes a new grouping (Gorran) critical of the dominant government positions and perhaps willing to consider new approaches to negotiation with the federal authorities that ensure the maintenance of their hard-won autonomy. There is also the undeniable factor of leverage by Kurdish interests in the formation of any new coalition, with its potential for influence over the priorities in Iraqi oil policy.

The past six years in Iraq's history may turn out to be a prelude, albeit a bloody one, to a new stage in which a resurgent petroleum industry offers the potential for transformation of the country within a relatively short period. In such a setting, the challenges to the fragile Iraqi constitution may come not from the deep and long-standing differences of view between the federal authorities and the KRG. Instead, they might well come from the familiar paradox facing many resource-rich economies: in spite of their resource wealth, the governance and institutional frameworks often fail to deliver the economic benefits to their peoples. The key tests are ones that have already figured in the tensions between federal and Kurdish authorities in Iraq: the award of contracts to investors; the regulation and monitoring of petroleum operations; the collection of taxes and royalties; and revenue distribution and economic management. We may add to this list the test of whether sustainable development policies are being implemented. It is too early to assess what progress or lack of it is evident in Iraq in relation to these tests. However, since 2009 it would seem that a new dawn is on the horizon. It remains to be seen whether the sunlight will reveal a government determined to tackle the challenges these tests present to a growing petroleum economy. Unfortunately, the experience of other resource-rich economies in these areas is not encouraging.

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