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| **RECONSTRUCTING THE GOVERNANCE OF IRAQI OIL (2003-2013) – Distribution of Oil Revenues Among Kurdistan and Iraq’s Provinces** |
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| A thesis submitted to the University of Sheffield for the degree of Doctor of Philosophy in the Faculty of Social Sciences  LORIAN ADMON YACOUB  PhD Thesis  Management School  December 2015 |
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**Abstract**

This thesis aims to characterise Iraqi oil governance, particularly the regional distribution of oil revenues between 2003 (the toppling of Saddam Hussein) and 2013. It explains the mechanisms which have been established to distribute oil revenues across the regions of Iraq. These revenues have been especially crucial to Iraq as it has sought to rebuild following the 2003 invasion, but throughout this period, they have also been a source of dispute between the center government, Kurdistan and other Iraqi provinces. The importance of these issues to Iraq’s economic development, and the fact that they have not yet been investigated in any other academic study (indeed, there is little literature about regional oil/gas revenue distribution generally) are what have motivated this research.

In order to understand how oil revenues are distributed it is first necessary to investigate how they are collected. Accordingly, the thesis starts by characterising Iraq’s petroleum fiscal regime. This is done by calculating the discounted cash flows for the West Qurna oilfield, which is operated under a Technical Service Contract (TSC) with the central government, and then comparing these with the performance of fields operating under Production Sharing Contracts (PSCs) signed by Kurdistan’s Regional Government (KRG). The thesis then goes on to characterise the regional distribution system. To do this, it draws on budget law, the draft oil and gas law, the national constitution, contracts signed with international oil companies and socio-economic data relating to Iraq’s provinces. The study also makes use of secondary sources in both Arabic and English. Finally, in order to gain a deeper understanding of the reconstruction of oil governance and the current regional distribution system, a series of semi-structured interviews were conducted with key players in the reconstruction process.

The results show that the governance of Iraqi oil has changed in many ways since 2003, and with it the system for distributing oil revenues among regions. Both the collection and distribution systems are politically driven, with preferential treatment being given to Kurdistan to prevent it from seeking independence. Even so, Kurdistan continues to act as a devolved and independent region and to demand full control over the collection of its oil revenues (petroleum fiscal regime). It is also demanding that its share of the total budget not be reduced like that of other provinces. The result is a distribution system which, because it ignores provincial socio-economic indicators and creates inequality between Kurdistan and other Iraqi provinces, is fostering resentment in oil producing and non-oil producing provinces alike. The danger is that this inequality among provinces may widen in the future if the government does not install some sort of equalisation system. Other oil-rich provinces may even follow Kurdistan’s example and demand greater autonomy or even independence. Such a fragmented Iraq would struggle without the revenues from the oil-rich provinces.

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## Chapter One: Introduction

## 1.1 Introduction

Oil represents the major source of government revenue in countries such as Iraq, Saudi Arabia, Kuwait, Qatar, Libya, Venezuela, Iran and Russia. Effective governance is vital for collecting and distributing these revenues. Unlike standard federal revenues derived from taxation, oil revenues come from the sale of a naturally occurring resource which belongs equally to all the country’s citizens (UN Resolution 1803, 1962). As far as oil revenues are concerned, the government’s task is one of wealth distribution rather than redistribution(Segal, 2012), but this distribution can be difficult in countries where oil is geographically unevenly spread. Furthermore, getting it wrong can have serious consequences; perceived inequality in regional distribution can lead to regional conflicts and even foster separatism. Such regional disputes have occurred in countries as far apart as the UK, Indonesia, Colombia, Canada and Iraq.

How revenues are distributed among regions depends on who has legal sovereignty over the resources. Where ownership is public rather than private, the oil may be owned by the country as a whole or by the specific region where it is found. If it is the latter, the producing region has the right to keep the resulting revenues in its territories. However, this can create inequality among regions, especially when revenues are concentrated in one area. If, on the other hand, the oil is nationally owned, then in theory, revenues can go directly to the central government and be distributed equally to all regions (or the central government may have other arrangements for distribution to prevent disputes or other fiscal gaps).

Distribution among regions becomes even more challenging when the revenues are large and represent a big percentage of total government revenues. To understand how governments approach this challenge, it is necessary to investigate the fiscal regimes they apply to collect revenues and the criteria they adopt for distribution of these revenues.

A country may choose to develop its oil industry through its own national oil company. In this case, the state takes the whole mineral rent, provides all investment and assumes all the risk. This is the model adopted by countries throughout the Middle East. Alternatively, it may choose to establish agreements with foreign oil and gas companies to develop the industry. These agreements regulate the relationship between the foreign companies and the host government. They take two main forms: concessions and contracts (Johnston, 1994); in either case, they establish the share of exploitable natural resources to be given to each party. Since these agreements determine the government’s share of the oil revenues, they also determine its ability to achieve socio-economic objectives such as job creation, the transfer of technology and the development of local infrastructure.

Iraq’s oil governance has been completely reconstructed since the toppling of Saddam Hussein’s regime in 2003. The new constitution, which was set out in 2005, regulates the distribution of oil revenues among regions and the signing of contracts with foreign oil companies. However, the articles pertaining to these two issues are highly controversial as they are interpreted differently by the central government and the Kurdistan Regional Government (KRG). The constitution was followed in 2007 by a draft hydrocarbon law, but at the time of writing, this is still under discussion in Parliament, mainly because of ongoing disputes with the KRG over the interpretation of the constitution.

Since 2003, two different types of fiscal regime have emerged in Iraq; that adopted by the central government and that adopted by the Kurdistan regime (which is considered illegal by the central government). Kurdistan also differs from the rest of the provinces in how it receives its share of the oil revenues; it receives a direct share of oil revenues from the centre, while the remaining provinces have most of their revenues centrally distributed by the national government.

## 1.2 The purpose of this study

This study aims to characterise Iraqi oil governance since the 2003 invasion and the toppling of Saddam Hussein, focusing mainly on the distribution of oil revenues among regions. The main reason for this focus is the mounting disputes between central government, Kurdistan and other Iraqi provinces about oil revenue distribution, but the aim is also to add to the literature; there is as yet relatively little literature about revenue distribution among regions or about disputes between central governments and oil-rich provinces. The study investigates the key dimensions of Iraqi oil governance, including the exercise of Iraqi property rights over oil and gas resources, Iraqi political governance, and the petroleum fiscal regime through which oil and gas revenues are collected, in order to understand how oil revenues are being distributed among Iraq’s regions. It also examines how other countries with substantial oil and gas resources have resolved conflict over the regional distribution of oil and gas revenues and consider whether these practices might be transferred to the current Iraqi context.

The development of Iraqi oil governance was researched using the relevant legal documentation such as drafts of oil and gas laws, the national constitution and contracts signed with international oil companies; the available data about the petroleum fiscal regime; and secondary sources in Arabic and English. In order to gain a deeper understanding of the reconstruction of Iraqi oil governance, a series of semi-structured interviews were conducted with key players in the reconstruction process. These included politicians, state oil company executives and advisers.

The value of the thesis will be in clarifying the links between governance and the level and distribution of Iraqi oil revenues among regions – thereby enabling policymakers to understand both the nature of the governance regime which has been established and how it might be changed to enhance the benefits of oil for Iraqi citizens without igniting regional conflicts. Other countries facing similar decisions, such as what fiscal regime to adopt, what sort of contracts to sign with foreign oil companies, and how to distribute oil revenues without igniting disputes, may also benefit from the findings.

## 1.3 Research questions

**The aim of the thesis is to characterise and analyse the distribution of oil revenues among Kurdistan and other Iraqi provinces. The distribution among regions is of central importance in a country as politically divided as Iraq since 2003. In order to understand the distribution of oil revenues among regions, the thesis needs to investigate, Iraq’s petroleum fiscal regime to determine the extent to which Iraq as a country exercise control over its oil; and benefits from its oil revenues. Also, because we are investigating distribution of oil revenues among regions, the thesis is interested to find out whether the disputes of oil revenue collections affect the distribution of oil revenues among regions.**

The principal question is:

* What were the principal characteristics of Iraqi oil governance between 2003 and 2013, mainly the distribution of oil revenues among Iraq’s regions?

This question is at the heart of Iraqi oil governance. After 2003, the revenue distribution system changed from centralised to decentralised, but the new system has brought the central government into conflict first with Kurdistan and then with other provinces. The main aim of this question is to investigate the origins of these disputes and how they might be mitigated. It also seeks to identify successful aspects of the Iraqi model which might be helpful to other oil producing economies facing regional conflict over oil revenues.

To understand and answer revenue distribution among regions, we need to have a specific question about collection of oil revenues: -

How successful were the central and KRG governments in capturing rent from oil and gas operations?

The fiscal regime plays a crucial role in determining the effectiveness of oil governance, particularly in Iraq, where it has long been a source of dispute. Prior to the nationalisation of the industry in 1971, Iraq’s petroleum fiscal regime suffered enormously due to the involvement of International Oil Companies (IOCs). The IOCs have returned since the 2003 war, so this question aims to investigate whether they have had any effect on the performance of the fiscal regime this time around by establishing how much money the government is able to collect. The question also determines the size of revenues to be distributed and whether the performance of the fiscal regime affects how revenues are distributed among regions, especially Kurdistan, which uses a different type of contract from the central government.

## 1.4 The structure of this thesis

In order to achieve the purpose of the study set out in section 1.2 and to answer the research questions outlined in section 1.3, this thesis is organised into nine chapters as follows:

**Chapter Two** discusses the philosophical assumption underpinning the research and the choice of methodological approach. It also describes the research design and explains how the research was conducted and the data collected and analysed.

**Chapter Three** discusses the history of Iraqi oil governance between 1916 and 2003. The aim of this chapter is to explore the first structures that were put in place for the governance of Iraqi oil and to trace how these changed over time. This will make it easier to understand the changes which have happened to the oil governance since 2003. The chapter is divided chronologically, starting with 1916 – the year in which the state of Iraq was formed. At the time, it was believed that there was oil to be found in the north of Iraq. The ensuing struggle between the French and British for control over the region was the first dispute over Iraq’s natural resources. This period also saw the beginning of Kurdish agitation for independence.

**Chapter Four** explores and characterises the governance of Iraqi oil from the toppling of Saddam Hussein in 2003 up to 2013. The chapter is structured chronologically according to the major events which affected oil governance in this period, with the main focus being on events that affected oil revenue distribution among regions. The chapter addresses the military occupation of 2003-2004, when oil governance underwent major changes, before examining the experience of the Iraqi oil industry under the Interim Government, the Transitional Government and the First Permanent Government (June 2004-2013). During these nine years, a permanent constitution was written which directly influenced how oil revenues are distributed among regions, controversial new oil and gas law was drafted, and IOCs signed contracts with the central government and the KRG.

**Chapter Five** reviews the literature relating to the concepts and principles of oil governance which influence the collection of oil rent. These are revealed in the relationships between the following key concepts and issues: sovereignty over mineral resources, private versus public ownership, terms of access to natural resources and revenues, the concept of mineral rent and its different forms, the evolution of petroleum fiscal regimes and the role of state oil companies. The chapter aims to explore these ideas and establish a theoretical framework for understanding different forms of oil revenue collection governance. These ideas assist the study in evaluating Iraq’s previous and current oil governance, especially its collection of oil revenues through the petroleum fiscal regime.

**Chapter Six di**scusses the petroleum fiscal regime in Iraq since 2003. The fiscal regime is important in shaping the success of the oil governance and in particular in determining the size of oil revenues to be distributed. The chapter discusses the two types of oil contracts employed in Iraq (those signed by the central government and those favoured by Kurdistan). It examines one field in detail – West Qurna1 field, Basra, southern Iraq, which is operated by ExxonMobil under a Technical Service Contract (TSC) with the central government in Baghdad. Discounted cash flows and net present values (NPVs) are used to determine the government take, while the company's combined internal rate of return (IRR) is used to determine company profitability. The chapter draws on other studies to examine the KRG’s use of Production Sharing Contracts (PSCs); similarly detailed cash flow analysis is impossible for the Kurdish fields because the data available in the public domain are insufficient and inconsistent.

**Chapter Seven** explores the concept of resource revenue distribution among regions. This chapter discusses the relevant literature and considers issues such as which government body gets to decide on the expenditure, which is primarily a political question. The chapter also discusses examples of other oil producing countries facing similar disputes over revenue distribution (i.e. the UK, Indonesia, Colombia and Canada) with a view to identifying useful lessons for Iraq.

**Chapter Eight** analyses the present system of regional revenue distribution in Iraq (2003–2013) and investigates how its vast oil revenues have been distributed across the country since 2003. It identifies the basis on which revenues are shared between Kurdistan and other Iraqi provinces and considers whether socio-economic conditions are taken into consideration. It also analyses how the conflict between the central government and Kurdistan regarding the petroleum fiscal regime is affecting revenue distribution to other Iraqi regions, and examines the growing dissatisfaction of other Iraqi provinces.

**Chapter Nine** summarises the findings and discusses the study’s contribution to the literature and policy analysis. Finally, it considers the limitations of the study and offers recommendations for future research.

## Chapter 2: Research Methodology

## 2.1 Introduction

This thesis seeks to trace the development of Iraqi oil governance, particularly since its reconstruction following the 2003 invasion and the toppling of Saddam Hussein. It focuses especially on those dimensions of oil governance that affect the regional distribution of oil revenues: the exercise of property rights over oil and gas resources, and the petroleum fiscal regime that controls oil and gas revenue collection. To this end, a review was conducted of literature relating to mineral property rights, petroleum fiscal regimes and revenue distribution to regions. Examples were sought of how other countries with substantial oil and gas resources have resolved conflicts over the regional distribution of revenues. The review also drew on Iraq’s growing body of oil and gas-related legislation, the limited data that are available about the petroleum fiscal regime and other secondary sources in Arabic and English. Further insight into the origins of the current system of governance was achieved via a series of semi-structured interviews with key players in the reconstruction process.

## 2.2 Research strategies

Saunders et al. (2006) identify several different research strategies, some of which are deductive while others are inductive. The chosen strategy must be able to answer the given research questions and meet the study objectives. Yin ([2003:5-7](#_ENREF_14)), who identifies five different research strategies (experiment, survey, archival analysis, history and case study), argues that the choice of strategy should be made according to three criteria, as presented in Table 2.1.

**Table 2.1: Criteria for choosing research strategies**

|  |  |  |  |
| --- | --- | --- | --- |
| **Strategy** | **Type of research question** | **Requires control of behavioural events?** | **Focuses on contemporary events?** |
| Experiment | How, why? | Yes | Yes |
| Survey | Who, what, where, how many, how much? | No | Yes |
| Archival analysis | Who, what, where, how many, how much? | No | Yes/no |
| History | How, why? | No | No |
| Case study | How, why? | No | Yes |

Source: Yin (2003)

Yin argues that the choice of research strategy depends on: the type of research question being posed, how much control the investigator has over actual behavioural events, and the extent to which the focus will be on contemporary as opposed to historical events. For reasons explained below, this study employs the history and archival analysis strategies.

**Table 2.2: How the chosen research strategies address the research questions**

|  |  |  |  |
| --- | --- | --- | --- |
| **Research questions** | **Research strategy** | **Data sources** | **Methods of collection and analysis** |
| How did the governance of Iraqi oil develop from the inception of the oil industry until 2003?  What problems have faced Iraqi oil governance in the past, especially in terms of conflict with Kurdistan?  (Mainly discussed in Chapter Three) | History | Mainly secondary sources (classic books on the history of Middle East oil from UK libraries and unpublished manuscripts) | Focus was primarily on aspects of oil governance (sovereignty, ownership, petroleum fiscal regimes and revenue distribution) |
| What have been the principal characteristics of the governance of Iraqi oil since 2003?  (Mainly discussed in Chapter four) | Archival analysis | 1- Timeline investigation since 2003 American invasion – using  secondary sources in Arabic and English (press and mass media)  2-Legal documents in Arabic and English (Iraqi constitution, draft hydrocarbon laws, revenue distribution law)  3-Semi-structured interviews with current Iraqi oil policy makers | Benchmarking against oil governance literature  (sovereignty over resources, petroleum fiscal regime, role of national oil company, revenue distribution) |
| How successful are the federal government and KRG in capturing the rent from oil and gas operations?  (Mainly discussed in Chapter Six) | Archival analysis | 1- Petroleum contracts with international oil companies, Iraqi Oil Ministry website, petroleum statistical websites  2-Semi-structured interviews with current Iraqi oil policy makers | Excel spread sheet economic models were used to calculate the present value and internal rate of return (cash flow profitability) of oil and gas fields under contract to estimate the size of the mineral rent in the Iraqi oil and gas industry |
| What proposals have been made or implemented regarding the distribution of oil revenues to Kurdistan and other Iraqi provinces?  ( Mainly Discussed in Chapter eight) | Archival analysis | 1-Government budgets and statistical data obtained from Ministry of Finance and Ministry of Planning  2-Press and mass media  3- Semi-structured interviews with current Iraqi oil policy makers | Analysed in relation to the literature on petroleum fiscal regimes and regional distribution of oil revenues  Comparison of statistical data for different regions |

## 2.2.1 History

According to Yin (2003:7), the history strategy is the favoured option when the researcher has virtually no access to or control over the research site. Without access to directly involved participants, the researcher must rely on primary documents, secondary documents and cultural and physical objects as the main sources of evidence. This strategy was the main method employed to explore how the governance of Iraqi oil developed from its inception up until 2003 and to identify the specific problems which have faced Iraqi oil governance in the past, especially in terms of fiscal regimes and oil revenue distribution. In particular, it was used to explore the origins of the “Kurdish oil question” and the development of the Kurdish independence movement. This historical analysis is crucial to understanding the current relationship between the central government and Kurdistan, and how this relationship is influencing the distribution of oil revenues to Kurdistan and the other Iraqi provinces. In broader terms, the historical analysis of the early development of Iraq’s oil governance allowed the researcher to assess the level of continuity apparent in the government’s current approach.

***Data sources***

The historical analysis drew on classic and modern works detailing the history of Iraq’s oil industry. Some of these authors (both Iraqi and foreign) were directly involved in the industry and are thus able to provide detailed and reliable information. Similarly, the Kurdish authors are able to offer a first-hand account of the Kurds’ involvement in the Iraq oil industry.Authors consultedinclude Longarigg (1961), Shwadran (1966), Mikdashi (1966), Harris (1977), Ghareeb (1981), Yergin (1991), Cleveland (2004) and Rutledge (2005).

## 2.2.2 Archival analysis

Archival analysis was the main strategy for exploring the development of oil governance from the 2003 American invasion up until 2013 (as Bryman (1989) points out, although the term archival has historical connotations, it refers to recent as well as historical documents.) This strategy entailed researching the issues surrounding ownership, the characteristics of the petroleum fiscal regime and the mechanisms which have been established to distribute oil and gas revenues to the different regions of the country.

Using the available information about a) the federal government’s contracts with IOCs and (b) the KRG’s contracts with IOCs, a detailed analysis was conducted of Iraq’s petroleum fiscal regime. Economic modelling was used to calculate the net present value (NPV) and internal rate of return of oil and gas fields under contract. Cash flow/NPV is generally considered the most straightforward way of determining whether an oil project will yield a return ([Drury, 2001:247](#_ENREF_4)). In this case, the values of many input parameters (e.g. original oil in place, decline rate, yearly oil price throughout the production life of the project in question, yearly costs, discount rate[[1]](#footnote-1) and applicable tax rates) were already known.

In order to determine whether the petroleum fiscal regime is yielding satisfactory results for the state, the output of the modelling was assessed in terms of three criteria: the size of the mineral rent, the size of the state take and the company rate of profit. These three criteria were operationalized as follows:

1. **Size of mineral rent**

The gross net present value (NPV) of the estimated future cash flow from an oil or gas field with proved reserves of a certain size, using an industry-conventional discount rate of 10% (for example, see Macmillan, 2000).

1. **The state take**

The percentage of the mineral rent (gross NPV) received by the state in the form of royalties, taxes, production shares, etc.

1. **Company rate of profit**

The internal rate of return (IRR) earned by the company contractor from its operations in developing and producing oil from the proved reserves of the oil field. The IRR represents the true interest rate earned on an investment over the course of its economic life ([Drury, 2005](#_ENREF_5)).

The optimum arrangement is when the absolute size of the mineral rent is acceptable to the state; the state receives an equitable proportion of the mineral rent; and the company’s rate of profit is not excessive.

Having established what proportion of the oil revenues is being taken by the government, the analysis then focused on how these revenues are distributed. This part of the analysis drew on the findings of the historical research, especially those relating to the petroleum fiscal regime, the KRG’s contracts with IOCs and the regional distribution of revenues. Comparisons were drawn between Iraq’s case and examples of oil revenue distribution in other oil producing countries. The analysis also drew on statistical data to compare oil revenues in Iraq’s different regions, while socio-economic data were employed to compare regions in terms of living standards and poverty levels. Finally, semi-structured interviews were conducted to further explore the reasons behind the current system of revenue distribution.

***Data sources***

As indicated above, a number of data sources were employed for the archival analysis. These included:

1. Petroleum contracts between (1) the federal government and international oil companies and (2) the KRG and international oil companies. These sources supplied the financial parameters for the cash flow analyses and allowed evaluation of the contracts’ terms.
2. Other studies on the recent Iraq fiscal regime and contracts signed with IOCs, such as those by Wells (2009) and Jiyad (2010a and b). These studies contain physical and financial parameters, not available elsewhere, that were used to calculate cash flows. The difference between this and Wells’ study, which also analyses the Iraqi government’s take in West Qurna, is that this study shows the detailed parameters, calculations of cash flows throughout the years of the project to gain results on discounted cash flows and IRR, while the Wells study gives only the results, without showing any detailed calculations. The Jiyad study gives no quantitative calculations of cash flows; instead, the discussion focuses on the terms of the contracts.
3. Legal documents such as the 2005 Iraqi constitution, the draft oil law and the Petroleum Law of the Kurdistan Region (2007).
4. The official websites of the Iraqi Oil Ministry and the Ministry of Finance. These official sources provide up-to-date information about Iraq’s oil governance, including statistical data about the distribution of revenues among regions; Iraq’s census; government budgets, expenditures and revenues; and data relating to oil and gas production and export. Most of these data are in Arabic.
5. The press and mass media. These sources are in Arabic and English. They offer up-to-date information about the issues currently affecting Iraqi oil governance, much of which cannot be found anywhere else. Journals in Arabic include: *Al Ghad, Nahrain, Elpha, Al Summarija News, Al Rafedien Center* and *Al Mustakbal*. Journals in English include: *Weekly Middle East Oil and Gas News (MEES),* the *Oil and Gas Journal, Middle East Intelligence, Iraq Updates, Iraq Oil Report Independent, Reuters* and the *Financial Times*.
6. Semi-structured Interviews – discussed below.

## 2.3 Interviews and primary data

It is extremely difficult to conduct primary research in Iraq because of the current security problems. However, the author was invited by the Iraqi Embassy in London to attend the Iraq Petroleum Conference, held every year by the CWC group in London. This conference is considered the major strategic meeting place for senior figures in the Iraqi oil and gas industry and is attended every year by key Iraqi government officials involved in the formulation of oil and gas policy. It was at this conference that the interviews were conducted for this research.

The semi-structured interviews were used to discover more about the reconstruction of oil governance since the 2003 American invasion and to understand in more depth how Iraqi policy makers perceive this reconstruction process. The intention was to gather their views regarding resource ownership, the petroleum fiscal regime and the regional distribution of oil revenues, as this information is difficult to find in secondary sources. Those interviewed were key players in the reconstruction process. They included the Chairman of the Advisory Commission Office/Prime Minister’s Office (this interviewee was also a former Iraqi Oil Minister and co-author of the hydrocarbon law); an Iraqi government spokesman; an oil policy advisor, who was also a founding member of Iraq’s National Oil Company, co-author of the hydrocarbon law and owner of the Petrolog Oil Consultancy Company in London; and a Member of the Iraqi Parliament (see appendix for interview lists and the attached CD for interview questions and transcriptions).

It had also been intended to interview Kurdistan’s Energy Minister at the conference, but this proved impossible. The Minister did, however, give a presentation at the conference, which was followed by a panel discussion with key officials from Baghdad. The presentation and subsequent discussion (both of which were recorded) gave further insight into the conflict between Baghdad and Kurdistan. Notes taken from the presentations of other oil policy makers at the conference (and the follow up comments from audience members) also gave an insight into contemporary issues surrounding the governance of Iraqi oil. Another source of data was the informal conversations the researcher had with key Iraqi officials and Parliament members during breaks and over lunch. During these chats, they expressed their opinions freely and supplied up-to-date information on issues such as revenue distribution decisions (see appendix 1).

In terms of interview preparation, permission for the interviews was sought in advance via email. Each interview lasted between 15 and 30 minutes and was recorded (with the interviewee’s permission). A general guide was prepared based on pre-prepared questions. The questions covered three broad themes: 1- the reconstruction of Iraq’s oil governance since 2003, including the question of ownership, the role of INOCs, and the IOCs’ relationships with the central government and the KRG; 2- the fiscal regime and the government take; and 3- the distribution of oil revenues to the regions (see attached CD). However, this guide was flexible; it was modified depending on the interviewee’s role. The questions were based on the results of a documentary search conducted beforehand. Documents consulted included the draft oil law, official records held on the Oil Ministry’s website, parliamentary debates, media and press releases, and previous interviews with these officials.

Although the number of interviews was small, they were conducted with people who were personally involved in the formulation of government policy and in writing the draft oil and gas law. Justification for conducting a small number of interviews is found in Hussey and Hussey([1997:55](#_ENREF_8)), who claim that: “The aim of a phenomenological paradigm is to get depth, and it is possible to conduct such research with a sample of one”. The comment suggests that for the qualitative researcher, rich information can be obtained even from a small number of interviews. The aim of the interviews was to gain the opinions of oil policy makers who were directly involved in the field, and this was achieved. As discussed earlier, the findings from the interviews were supplemented with data from a wide range of other sources.

## 2.4 Problems with primary and secondary data

## 2.4.1 Secondary data

It is not easy to obtain data about Iraq’s oil governance. As no data at all were published during the Saddam regime, it has not been possible to compare the central revenue distribution which was in place under Saddam with the current system. Even after 2003, it remains difficult as the government does not publish all data. The West Qurna1 field was chosen to illustrate Iraq’s petroleum fiscal regime because it is the field about which there is most information, but even then, only some of the data necessary for the analysis were available on government websites; some of the financial parameters needed to build the model were taken from studies by Wells (2009) and Jiyad (2010), while the field’s operation and capital costs were supplied to the researcher by an Oil Ministry contact from the Iraq Petroleum Conference. As there are not enough available data to establish the government take and IOC take in Kurdistan, it was only possible to compare the West Qurna result with the findings from other studies about Kurdistan contracts. Similarly, it was impossible to find any data on how much IOCs are receiving in Iraq and how much the government take is, as the government does not publish this information. The only available source is the Iraqi Extractive Industries Transparency Initiative (IEITI), which began in 2010. The only report published by the IEITI so far is for 2011 and, as Chapter Six shows, this report is flawed.

Another problem is that financial data vary, depending on the source. For example, GDP and GDP per capita in Iraq are reported differently by the World Bank, the IMF and Iraq’s own Central Bank. The figures are presented for all three sources, though the calculations use the Central Bank’s figures, as this is Iraq’s official source (see Chapter Eight). Similarly, crude oil export values are reported differently by the Development Fund for Iraq, OPEC and IEITI. Chapter Six reports these different values and offers possible reasons for the difference.

Statistical data about provincial living standards are also hard to come by. The most recent data on nominal per capita income in Iraq’s provinces are from 2007. Nor are there any numerical data for socio-economic indicators in the provinces and Kurdistan; the only available data source was a survey of living conditions published by the Central Statistical Organisation.

## 2.4.2 Primary data

As the interviewees were all politically affiliated to the central government in Baghdad, it is reasonable to assume that they would be biased. Similarly, the Kurdish Energy Minister was likely to be biased towards Kurdistan. In an attempt to mitigate the effects of the interviewee bias as far as possible, questions were pre-prepared. The same key questions were put to all the interviewees, so that the researcher could compare their answers on central issues such as ownership and sovereignty. Also, I chose the interviewee to be from Kurdistan and from the central government. The interviewees’ answers were also compared with a range of non-political secondary sources, including papers by academics, oil analysts and international lawyers’ works at Hogan & Hartson LLP. Crawford (2008), Professor James Crawford an academic and practitioner in the field of public international law, Ashley Burton and Mathiew Deeks ( 2007) – professors at the University of Virginia school of law. Professor Jawad Saad (2013), senior visitor fellow at Middle East Centre – London School of Economics. Different Middle East Oil and Gas News/ Analysis articles (MEES) where opinions of different academics are represented.

## 2.5 Conclusions

This chapter reviews the main research questions and explains how these determined the choice of research paradigm. An interpretivist/qualitative approach was selected as the research primarily seeks to understand and explain the government’s policy on the regional distribution of oil revenues.

The thesis follows an inductive approach but also includes some deductive elements. The literature was used as a guide to explore governance issues within the Iraqi oil industry, such as the question of ownership, previous and current fiscal regimes and the distribution of oil revenues to regions. These theories and concepts informed the characterisation of the petroleum fiscal regime and the revenue distribution system. A historical research strategy was employed in the belief that an understanding of the early history of Iraqi oil governance might provide insights into the obstacles currently facing the industry. The second research strategy, archival analysis, was selected to investigate the structure of oil governance between 2003 and 2013. This strategy allowed the detailed characterisation of Iraq’s current fiscal regime and regional revenue distribution system. These two research methods drew on a wide range of data sources. Qualitative sources included semi-structured interviews and informal conversations with key policy makers; the Iraqi constitution and legislation; and media reports. Quantitative data included the census and statistics relating to the financial terms in Iraqi contracts, government revenues and their distribution to citizens and regions.

## Chapter Three: The History of the Governance of Iraqi Oil (1916-2003)

## 3.1 Introduction

Iraq’s oil history is the key to identifying and understanding the changes that have occurred in the governance of Iraqi oil since its inception and in particular the current structure of governance of Iraqi oil which has started to develop since the 2003 invasion by the U.S. It will also help to explain the problems that presently face the governance of oil in Iraq.

The aim of this chapter is to explore the first structures that were put in place for the governance of Iraqi oil and trace the subsequent changes through history. This includes investigating the emergent ideas on oil governance discussed in chapters two and three, comprising sovereignty over oil resources, fiscal regime, role of the National Oil Company, distribution of revenues and political governance, which will include the Kurdistan issue, and oil revenues.

The chapter sections are divided periodically according to the major events which shaped Iraqi oil governance and brought about changes in the system. These sections are:-

Firstly, the section on the formation of Iraq (1916-1926) traces the formation of Iraq after the fall of the Ottoman Empire and identifies Iraq’s borders, which were drawn in this period. It discusses the disputes between the British and French over control of the anticipated oil riches of the city of Mosul and deals with the emergence and origins of Kurdish agitation for an independent region.

The second section discusses the Turkish Petroleum Company (1914-1929): how and when oil exploration started in Iraq and how the Iraq Petroleum Company, the major player in granting Iraqi oil concessions, was formed. Thirdly, the terms of oil concession contracts (1925-1952) signed with the IPC and its subsidiaries are explored, also how oil revenues were shared between the government and foreign companies, leading to the emergence of the first oil governance system in Iraq, the fiscal regime and the sovereignty of oil resources.

The fourth section deals with the Qassim government and the formation of the Republic of Iraq (1958-1963). The role of the Republic of Iraq in oil policy and its influence on oil industry nationalisation and regional disputes during this period are examined. The consequent changes in Iraq’s oil governance, the negotiation of better financial terms for Iraq, sovereignty of resources and nationalisation, the ending of the IOCs’ presence in Iraq and the effects on oil revenues, and also the effects of regional conflict during this period, are all discussed.

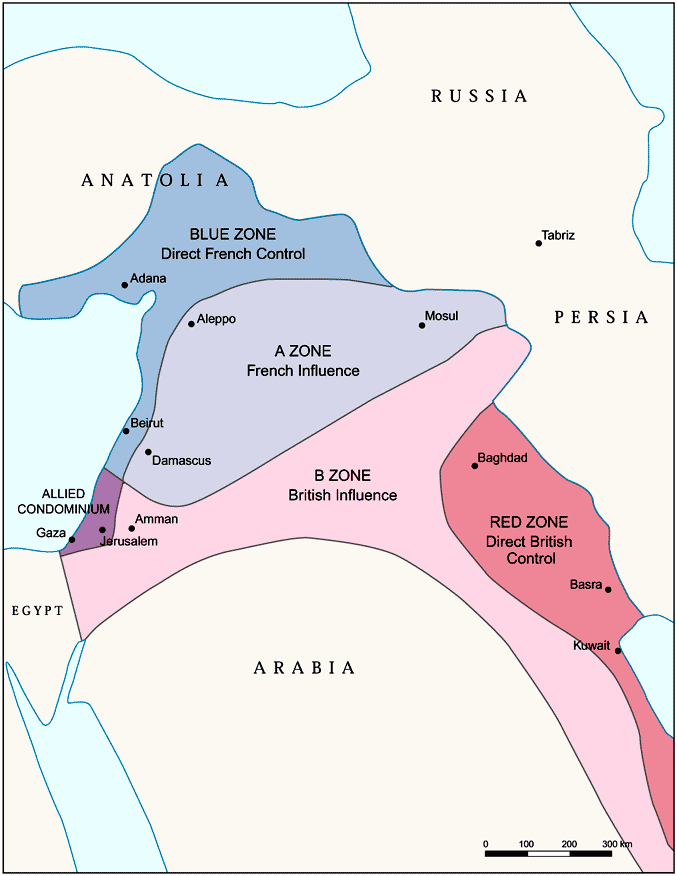
The fifth section discusses regional unrest, namely the Kurdish question, in greater depth (1964-1975). The sixth section discusses the role of the Iraq National Oil Company (1964-1974) in managing the oil industry before and after nationalisation and it discusses the factors which led to Iraq oil nationalisation in 1971. The seventh section then deals with the management of the Iraq oil industry after nationalisation (1974-1980).

The eighthly section details the reasons for the Iran-Iraq war (1980-1988) and discusses its effects on Iraq’s oil industry. The ninth section deals with the Gulf conflict and its impact on Iraq’s oil industry (1990-2003), detailing the reasons for Iraq’s invasion of Kuwait, the Gulf War and the impact of the subsequent economic sanctions on Iraq’s economy and the oil industry up to 2003. The final section discusses the Kurdish revolution after the Gulf War and the Kurds’ success in securing an autonomous region in Kurdistan and the management issues relating to this autonomous region (1991-2003).

## 3.2 The Formation of Iraq (1916-1926)

In 16 May 1916, the Sykes-Picot agreement was signed between the French, British and Russians to divide the Ottoman Empire[[2]](#footnote-2). Syria, Lebanon and Northern Iraq, including Mosul, whose inhabitants were mostly Kurds, became part of the French zone of control while present day Jordan, Southern and central Iraq and a small area around Haifa were placed under British control (Stivers, 1982:23).

Figure 3.1: Sykes - Picot Agreement Map



There were disputes between France and Britain about who should control Mosul Vilayet Province (the northern area of present day Iraq), for the reason that Mosul Province was projected to have petroleum on its soil. Thus after the Ottoman Empire collapsed in Oct 1918, the British army occupied Mosul and never left. The British thought at that time that their forces had made a greater contribution compared to their French allies to the victory in the war against the Turks (Stivers, 1982:26). In 1921 the British drew a line across southern Iraq to separate Kuwait in order to deny Iraq access to the Persian Gulf(Steven, 2006:1).

In 1919, the nations that had emerged victorious from WW1 met at the Paris peace conference to decide the peace terms with Germany and other defeated countries and to deal with the aftermath of the fall of the Ottoman empire in 1918. At this conference a Turkish Kurdistan was proposed by Sherif Pasha, who represented a Kurdish nationalist group called “the society for the ascension of Kurdistan”. Sherif Pasha defined the Turkish Kurdistan region as including Mosul province, Kurdish areas of Iran and parts of Syria in its territory(Ozuglu, 2004: 38). However, the treaty of Sèvres, imposed on the defeated Turks in 1920, did not endorse these proposals and decided on a smaller Kurdistan, located in Turkish Territory and leaving out the Kurds of Iran, with Iraq to be controlled by Britain and Syria by the French. The Sèvres treaty was not implemented either and was replaced by the Lausanne treaty in 1926, whenIraq and Turkey’s borders were defined.

Turkey maintained that Mosul was a Turkish territory and should be returned to Turkey. In January 1923 the issue of Mosul Vilayet was raised at the Lausanne conference to decide to whom Mosul territory should be allocated. The bases of the decision were to be ethnographical, political, historical, geographical, economic and military. Turkey and Britain presented contradictory data and the negotiations continued until December 1925. Mosul province was finally awarded to the British and under a treaty between Iraq and Turkey the latter was for twenty five years to receive 10% of Iraq oil revenues – taken from the Turkish Petroleum Company (see the next section) (Longrigg, 1961:70, Shwadran, 1973:219,).

After WW1, the European powers, and especially Britain, were in favour of creating a Kurdish state, the reason being that they wished to intimidate the new nationalist states of Turkey and Iran (Olson, 1992: 480). However, Britain decided not to create a Kurdish state in its mandatory territory of Northern Iraq, mainly for the reason that the Kurds of Iraq were important to strengthening British power in the region. At the time that Sunni Amir Faysal was appointed king of Iraq in August 1921, the Sharifian family was vital to promoting British policy in Iraq and in the Middle East. The British wanted the Sunni Kurds, especially the leaders of both secular and religious groups, to balance the Shia Arabs (Olson, 1992: 481). The Iraqi Sunnis represented only 30% of the population in 1920, including the Kurds, thus the Sunni Kurds were necessary to sustaining Sunni domination in the Iraqi government. However, British policy during its control of Iraq, which lasted until 1958, was to encourage Kurdish nationalism but not independence. By so doing the U.K was able to threaten Turkey and Iran and to force them to accept the policies they imposed on the Arab countries and to refrain from interfering in the affairs of the latter, especially the affairs of Iraq (Olson, 1992:480).

## 3.3 Turkish Petroleum Company (1914-1929)

It has been known since ancient times that Iraq has oil in its land but not until the end of the 19th century did it become known that the Vilayets of Baghdad and Mosul potentially contained oil rich fields (Shwadren, 1963: 195). Germany was the first nation to become interested in gaining concessions in Iraq. In 1890, the Deutsche Bank obtained a concession for the Baghdad railway, which included mining rights. In 1901, Britain, which already had major oil concessions in Persia, started to negotiate with the Turkish authorities for a concession in Iraq. On March, 1914 an agreement was made between British, German, and Dutch interests to form the Turkish Petroleum Co. Ltd. (TPC). The shares were allocated as follows: 50% to the British-D’Arcy group, later part of the Anglo Persian Oil Company (APOC) and later still British Petroleum (BP), 25% each was allocated to the Dutch Bank and Royal Dutch-Shell, and 5% to Gulbenkian[[3]](#footnote-3), who was vital in bringing the agreement forward; these percentages were taken equally from D’Arcy and Royal Dutch-Shell (Mikdashi, 1966:66).

In April 1920 the San Remo agreement was signed. This agreement substantially ended the Sykes-Picot agreement mentioned earlier in this section. Mosul Vilayet would now go to Britain rather than France. The agreement stated that Britain was to grant the French government 25% of the crude oil production which Britain or any private company might acquire from the Iraqi oil fields. Thus the assets of the TPC were redistributed as follows: 47.5% to APOC, 22.5% to the Royal Dutch-Shell company, 25% to France and 5% to Gulbenkian. Britain eliminated the German oil interests from the region but as we will see later an interested newcomer would emerge (Kanafani, 1982:18).

Baba-Gurgur oil field, north of Kirkuk in the northern province of Iraq, the first producing oil well to be discovered in Iraq, was found in June 1927 (Longarigg, 1961:70). After this the Americans gained shares in TPC. TPC’s shares were distributed in the following way, a form of distribution which lasted untill the end of the Iraq oil concession: 23.75% each to APOC, Royal-Dutch Shell, Compagnie Française des Pétroles and the American Group, and S.C Gulbenkian, 5%. In 1929 the name of the TPC was changed to the Iraq Petroleum Company (Shwadran, 1973:238).

## 3.4 Terms of the Oil Concessions and Government Share (1925-1952)

The first oil concession in Iraq was signed in 1925. By this agreement IPC was to choose 24 blocks, each covering eight square miles (the agreement covered the whole of Iraq apart from the transferred territories and the Basrah Vilayet), and the Iraqi government was to offer the rest for competitive bidding. The duration of the concession was 75 years (Shwadran, 1973:238, Longarigg, 1961: 75).

A new revised agreement was signed with IPC in 1931, which extended the concession and gave IPC the sole right to exploit all lands situated to the east of the Tigris River, covering an area of 35, 000 sq. miles (compared with 190 sq. miles in the 1925 agreement) (Kanafani, 1982:23). The company was to construct a pipeline to the Mediterranean by the end of 1935, royalties were to be paid to Iraq of four shillings (gold) per metric ton, with a minimum required payment of £400 000 (gold) for the first twenty years, beginning with the first exports. Until exporting started, the company had to give the government an agreed minimum-£400 000 (gold) annually. Half of this amount would be recoverable by the company from future royalties when they exceeded £400 000; while £200 000 was to be dead rent. The company was to pay no taxation but a yearly payment of £9,000(gold) to the government up to the beginning of commercial exporting, after which time £60 000 (gold) would be paid on the first 4,000,000 tons( 30 Million barrels per year) produced and pro rata, and £20 000(gold) on each additional million metric tons produced and pro rata. The company started drilling in April 1927, and oil was found near Kirkuk, in October 1927(Issawi and Yeganeh, 1962: 30-32; Shwadran, 1973:238,).

In 1932, the Iraqi government accepted four tenders for concessions for oil fields in the rest of the country; at the end of 1931 the British Oil Development Company (BODC) won the concessions. The company obtained a 75 year concession covering all lands in the Vilayets of Mosul and Baghdad west of the Tigris River and north of the 33rd parallel (about 46,000 square miles). Until commercial quantities were found, the BODC was to pay dead rent: £100 000(gold) in 1933; this would increase by £25,000(gold) annually up to £200 000. The company had to construct a pipeline with a minimum capacity of 1,000,000 tons or to make its own arrangements to export that minimum amount. The Iraqi government could take 20% of the oil for local consumption and for resale to the company. The royalties were 4 shillings (gold) per metric ton; the company was to be tax exempt but pay £1,000 annually until commercial production began, and then would pay the same royalties as were paid by the IPC (Mikdashi, 1966:73, Shwadran, 1973:239).

It seems that the Iraqi government wanted to create competition between the foreign companies, so it could improve production, exports, technical expertise, construction, and ultimately, revenues. The BODC concessions offered better terms for the government than the IPC contract – given the prospects for the area granted, and the free 20% in oil in addition to royalties and the annual payment to the Government. However, according to Mikdashi (1966: 72), the IPC had been annoyed by the concession being given to an outsider. The IPC chief executive considered that “competition for oil in Iraq was not economically sound”. Thus in mid-1937, BODC concessions were transferred to IPC, with the Iraqi government’s approval, and in 1941 to the Mosul Petroleum Company, a subsidiary of the IPC. Oil was discovered in Ain Zalah in 1939, but because of the war and higher royalty provisions, the field was not developed until 1952.

In 1938, the Basra Petroleum Company (BPC) – also a subsidiary of the IPC – obtained a 75 year concession covering all the other lands not included in the previous concession (about 93,000 square miles). Except that Basra was to pay dead rent of £200 000(gold) annually until the exploitation of commercial quantities, all the other terms were the same as in the Mosul Petroleum Company agreement. There were very little activity in this area until the end of the war, but in 1949 the Zubair oilfield was discovered and production and export of oil in Basra began in 1951(Shwadran, 1973:240).

**Table 3.1: Terms of the Oil Concessions and Government Share (1925- 1952)**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Agree-**  **ment year** | **Companies involved** | **Concession area** | **Concession Duration** | **Dead Rent** | **Royalty** | **Taxation** |
| 1925 | TPC | ( All Iraq except the transferred territories[[4]](#endnote-1) and Basra)  190 sq. miles | 75 yrs | - | 4 shillings (gold) per metric ton - | - |
| 1931 | IPC | Revised ( all lands east of Tigris river)  35,000 sq. miles |  | £200 000 (gold) | same | Exempt- £ 9,000(gold) until exports began then increased as agreed |
| 1932 | BODC ( British Oil Development Company) then taken over by IPC in 1938 | ( all lands west of Tigris river and north of 33rd parallel( around 46,000 square miles) | 75 yrs | £100 000 and rise to £200 000 and 20% of oil for gov. | same | Exempt-£ 1000 until production began then same as IPC |
| 1938 | BPC-subsidiary of IPC | All the rest lands (93, 000 Square Miles). |  | £200 000(gold) annually till export | same |  |
| 1950 | IPC | All |  |  | 6 shillings(gol-d) |  |
| 1952 | IPC | All |  |  | 50% of profits, 12.5% royalties included in the 50% profit |  |

Source: Longrigo, 1961, Issawi and Yeganeh, 1961, Mikadashi, 1966, Shwadran, 1973.

The Iraqis were unhappy with several points in the IPC concession agreement terms. First, they were unhappy with the size of the royalties they were receiving. Second, the number of Iraqi local staff in higher positions in oil production operations was unsatisfactorily low. Third, there was a lack of training facilities to enable Iraqis to operate the industry. Fourth, few refining facilities were installed in the country. Fifth, the company argued that the gold shillings paid as a fixed royalty must be based on the official London rate of exchange of gold, while the Iraqis wanted the calculation to be based on the free market value, which was higher. Sixth, IPC maintained a low production rate; the company argued that the low output rate was due to the difficulty in transportation; the company was investing in pipelines but because of the war they were short of steel (Shwadran, 1973: 245).

Therefore, in mid-1948 discussions between the government and IPC started, with the result that in November 1950 royalties were increased from four to six shillings (gold). Negotiations started again in early 1951, after Saudi Arabia had signed an agreement with Aramco replacing its existing royalty payment with a 50-50 profit sharing arrangement, and Nationalisation of the Iranian oil industry occurred in the same year. As a result, in February 1952 another new agreement was reached which provided equal sharing of profits, a guarantee of greatly increased oil production, supply of crude oil at cost to the refinery in Iraq to be built to meet local consumption, (Issawi and Yeganeh, 1962: 31; Shwadran, 1973:246-247).

The increased oil revenues for the Iraqi Government after the 1952 profit-sharing agreement led Iraq’s finance ministry along with the World Bank to issue a law for the utilisation of oil revenues. They established a development board; they awarded 70% of Iraq’s oil revenues to development projects, and only 30% to the ordinary budget. Decisions on oil revenue allocation to development projects were exclusively made by the board itself and the finance minister had no control over this fund. The amount of oil revenue received by the development board was reduced to 50% in 1958 (Stevens, 1983: 171; Chalabi, 2005:10).

Nevertheless, the IPC group was still able to make huge profits from Iraq’s oil reserves. In 1937, about two and a half years after Iraqi oil exports began, Jersey – one of the five American groups which together had a 23.7 per cent interest in IPC – estimated the market worth of its properties (mostly in IPC) at between $119 and $143 million. By comparison, Jersey’s total net investment was about $13.9 million at the end of 1939. This means that within 10 years of the granting of the first oil concession, Jersey obtained about $10 of capital value for every dollar invested. With respect to earnings, Jersey’s total net profit on sales of Iraqi crude oil since the beginning of export in 1934 amounted to $10.4 million by the end of 1937(Mikdashi, 1966: 102).

However, if we compare the government’s revenues with those of Jersey, one member of the five Americans company group (Jersey) which had only 4.74% of the IPC interest (see section 3.2), we find that by 1937 Jersey’s profits had reached £2.1 million assuming an exchange rate of £1=5 dollars[[5]](#footnote-4) (whilst the total accumulated IPC net profit mid1934-end1937= 2.08/0.0474=43.9, i.e. total IPC net profits over 2.5 years=£43.9m. Assuming the amount received by IPC in 1937 was for two and a half years (and the profit earned was the same in each of the years) then IPC’s net profit in 1937=34.9/2.5= £17.56m. This means that two and a half years after Iraqi exports commenced, the government was only receiving around 6.7%[[6]](#footnote-5) of the total net profit from Iraqi oil. This is clearly a fraction of the amount IPC members received. The government’s share of profits increased from £3.1 million in 1949 to £6.7 million in 1950; this was due to the royalty increase in 1950 from 4s. (gold) to 6s.( gold) per metric ton oil. Also, the government’s share increased from £15 million in 1951 to £40 million in 1952 after the introduction of the 50/50 profit sharing agreement; whilst IPC’s net profits for the same year were £44 million (see Table 3.2).

**Table3.2: IPC’s oil production and IPC group payments\* to the Iraqi government and IPC net profits (1925-1964).**

|  |  |  |  |
| --- | --- | --- | --- |
| **Year** | **Long Tons\*** | **IPC payment to Government \*\***  **£000** | **Company net profits**  **£000** |
| 1925 | - | 0.35 | n.a |
| 1926 | - | 1 | n.a |
| 1927 | - | 1 | n.a |
| 1928 | - | 1 | n.a |
| 1929 | - | 1 | n.a |
| 1930 | - | 1 | n.a |
| 1931 | - | 401 | n.a |
| 1932 | - | 579 | n.a |
| 1933 | - | 742 | n.a |
| 1934 | 962,609 | 1,484 | n.a |
| 1935 | 3,581,953 | 1,009 | n.a |
| 1936 | 3,914,213 | 1,049 | n.a |
| 1937 | 4,137,824 | 1,251 | 17,560 \*\*\* |
| 1938 | 4,162,939 | 1,896 | n.a |
| 1949 | 3,781,958 | 3,126 | n.a |
| 1950 | 6,160,765 | 6,781 | n.a |
| 1951 | 8,117,744 | 15,161 | n.a |
| 1952 | 18,060,803 | 40,740 | 44,448 |
| 1953 | 27,220,199 | 51,449 | 57,224 |
| 1954 | 29,615,569 | 68,517 | 74,496 |
| 1955 | 32,716,227 | 73,824 | 79,239 |
| 1956 | 30,606,282 | 69,165 | 74,239 |
| 1957 | 21,361,979 | 51,523 | 54,182 |
| 1958 | 34,931,461 | 84,604 | 61,809 |
| 1959 | 40,897,676 | 86,819 | 64,446 |
| 1960 | 46,534,398 | 95,358 | 71,640 |
| 1961 | 48,054,764 | 95,094 | 72,164 |
| 1963 | 55,576,822 | 110,045 | 82,862 |
| 1964 | 60,350,313 | 126,073 | n.a |

Source: Mikdashi, 1966: 106; 195-196

\* 1 long ton= 1.0161 metric tonne

\*\* Payments by the IPC group include tax commutation payments, inspection fees and scholarships to Iraqi students.

\*\*\* IPC net profit for 1937 is author’s estimate (see text)

The first fiscal regime in Iraq was non-proprietorial – it was a liberal fiscal regime whereby at the beginning of the concessions a royalty of only 4 shillings (gold) per metric ton was payable, but this only came into force when profits were made; £350 was paid to the government in 1925. The concession system (see chapter five for explanation) was the only available system at that time and indeed the first literature was written at the time of the first concession systems involving Iraq. The terms of concessions could be changed, as has been demonstrated in relation to Iraq’s concessions. The government, unhappy with the first set of terms, changed the terms in 1931, 1950 and 1952, to include rent, increase royalties and finally to introduce 50/50 profit sharing with increased production; thereby the government take increased to £401,000, £6 million pounds and £15 million pounds for the years 1931,1950 and 1952 consecutively.

Nevertheless, as our estimate for 1937 shows, until 1951, the government‘s income was very low, both in absolute terms and as a share of the total net profit. Government income was dependent on oil production; however, IPC deliberately maintained low production, as the contract did not impose any obligation for IOCs to increase production. Also, under the terms of concession systems, the government has no role in field development (see chapter five section, 5.5.2). Thus government revenues were very low: even after royalties were increased from 4 to 6 shillings (gold) in 1950, government revenues were a fraction of the foreign companies’ profits. Moreover, after the introduction of the profit sharing agreement in 1952, although Iraq’s revenues more than doubled, IPC’s share of total net profits remained higher than that of the Iraqi government, until the revolution of 1958.

The surplus of excess profit for IPC, which is usually called the “economic rent” (see chapter five section 5.4) and which exceeds the “normal profit” – the difference between gross income and total operational costs and the return to capital, was not captured by the government. At least, there was no excess profit taxation which would normally be levied by the typical non-proprietorial fiscal regime, such as the Petroleum Revenue tax in Great Britain (see chapter five).

**Table 3.3: Estimates of Accounting Profitability of the IPC Group, 1952-1958**

|  |  |
| --- | --- |
| **Year** | **Accounting Rate of Return** |
| 1952 | 38 |
| 1953 | 46 |
| 1954 | 62 |
| 1955 | 69 |
| 1956 | 66 |
| 1957 | 46 |
| 1958 | 50 |

Source: Mikdashi, 1966

The high profitability for foreign companies of Iraq’s oil reserves and those of the Middle East in general is partly because of the higher productivity of these oil fields, very low production costs, and also the fact that Middle Eastern prices have remained in line with the high price of crude oil in the Gulf of Mexico (Issawi and Yeganeh, 1962: 105) and the fact that the terms were very generous to the companies. Thus the Iraqi Government, during the period of concessions, could not capture this economic rent, even after increasing the royalties at different times.The other problem with the IPC concession is that no taxes on profits were paid by IPC. Instead a small amount of money was paid annually by the IPC group.

However, there are explanations for this. The terms of concessions were very weak at the beginning of the 20th century for various reasons. First, the Iraqi government wanted the foreign companies to explore and extract the mineral from the ground. Second, Iraq was under the direct control of the British, who, as we have seen, went to a lot of trouble to control Iraq’s oilfields: so the rewarding of the British companies involved in the concessions was not unexpected that is, Iraq was not allowed sovereignty over its own oil: Britain ensured, through the power of its empire, that British companies enjoyed excess profits. Third, after Persia, Iraq was the first country in the Middle East to discover oil; thus there were no other examples or case studies for Iraq to learn from.

## 3.5 Qassim and the Republic of Iraq (1958-1963)

The Iraq revolution of 14 July 1958 came as a surprise to the entire world. It overthrew the Iraqi Hashemite monarchy under Faisal II. The Republic of Iraq was established, under the leadership of General Abdu Al Karim Qassim.

The oil policy in Iraq during this period excluded the idea of nationalisation, for the reasons that the revolutionary regime would need the oil revenues and any cut in production at that time would be disadvantageous (Khadduri, 1969:160). The Iraqi government realised that the Iraqis lacked several essential requirements: first the technical know-how to operate the industry (for which they blamed the international companies for not having provided them with training). Second, they lacked the financial resources to expand the industry; third, they lacked an international market for exportation (Shwadran, 1972:268). Therefore, immediately after the revolution the government announced the continuation of cooperation with IPC.

Later, Qassim realised that he needed more funds for his various major reconstruction schemes. In order to fulfil his purpose, he started to negotiate with foreign companies about several issues relating to the profit sharing agreement of 1952, which seemed simple at first but proved not easy to resolve (Khadduri, 1969:162).

The issues under discussion included, first, a request to hand over the land that was not being explored by the companies, second, over estimation of cost, as profits were calculated on the basis of fixed costs and the government was paid in advance. However, the agreement stated that if actual cost exceeded the fixed cost by 10% or more, the actual figure was to be used. IPC often claimed on the basis of actual cost, which caused annoyance to the government (Kanafani, 1982:30). Finally, with regard to the associated gas which was mostly wasted or flared, the IPC gave Iraq a limited quantity and suggested establishment of a joint venture to utilise the rest of the natural gas. The parties were unable to reach agreement on this point (Kanafani, 1982:31).

As we have mentioned earlier, even after the 1952 agreement, Iraq still could not capture the excess profit of its oil reserves. Another important reason for this, as the above text has shown, is the financial terms used to access the reserves. IPC used the lean design of the terms in the contract to its advantage and losses accumulated for the Iraqi government, e.g. over estimation of oil investment cost.

IPC had failed to present terms that would satisfy the government, thus no agreement was reached. The negotiations were suspended and the government prohibited all exploration activities (Khadduri, 1969:162-163; Kanafani, 1982: 31).

On December 12, 1961 decree no. 80 was announced. This law deprived the IPC of all lands that were not under actual exploration, some 99.5% of the concessionary area. The three sub-companies were left with only 740 sq. miles (Khadduri, 1969:162-163; Kanafani, 1982: 31-33). The Iraqis chose not to nationalise the industry at that time and let the companies continue to derive revenues from them; however, the possibility of nationalisation appeared stronger than ever.

In 1961, Abdu Al Karim Qassim’s position began to weaken; he could not control the Kurdish rebels. After the 1958 revolution, he promised the Kurds a radical transformation in their conditions and he acknowledged the Kurds as a legitimate ethnic group with national rights. Several Kurds were appointed to high positions in the government; also the exiled Kurdish leader in the Soviet Union, Mullah Mustafa Barazni, was allowed to return to Iraq. However, the latter’s power increased as he strengthened his control over the Kurdish movement and his relations with Qassim started to deteriorate, as the government, often deliberately, tried to restrain the growth of Kurdish nationalism, while it allowed the spread of pan-Arab movements (Kadduri, 1969: 174; Entessar, 1984:917).

Also, Qassim did not attempt to implement any of the Kurdish constitutional provisions. The Kurds had assumed that the provisions would mean administrative autonomy within Kurdistan, a better share of economic and social services, and the endorsement of the Kurdish language and culture.

In August 1961, Barazani, leader of the KDP[[7]](#footnote-6) (Kurdistan Democratic Party), requested that the Kurds be given virtual autonomy, a request which Qassim firmly refused. Barazani appointed himself the overall leader of the Kurdish people and whilst his short term objective was to achieve autonomy, his long term objective was not clear, but he predicted:

"*A Kurdistan which would take one-third of Iraq’s oil revenues – a share proportionate to Kurdistan’s population and a similar share of the seats in a new assembly in Baghdad, Local government, the region’s own finances and development and education would be in the hands of the government of the autonomous state, as would be the police and her own defence forces*” (Adamson, 1964: 50 quoted in Khadduri, 1969: 179-180).

This means that Barazani wanted to have an autonomous administration in Kurdistan, with oil revenues being distributed from the centre – and the Kurds share would be 33% of the oil revenues according to their population as they argued. These provisions would have been very difficult to be accepted by the central government at that time, mainly because of the high revenues to be dedicated to the Kurdish area while at the same time Qassim had major reconstruction plans for Iraq which needed a lot of funds. In addition, these broad objectives could be very close to independence which the central government was unlikely to approve it.

Fighting erupted between the Iraqi forces and Barazani Peshmergas in the autumn of 1961; it continued until 1963, when a ceasefire agreement was signed (Jawad, 1981: 63-105). This crisis along with Qassim’s campaign to annex Kuwait, which he claimed to be an integral part of Iraq, fuelled opposition to his policies and led to his assassination in 1963. Qassim was succeeded by his opponent Abd Al Salam Arif (Shwadran, 1973: 275, Entessar, 1984: 917).

## 3.6 The continuation of the Kurdistan question and the beginning of the Ba’ath regime (1964-1975)

On March 7 1963, the government reached a preliminary agreement with Barazani; the agreement points were: a general amnesty for all Kurdish revolutionaries, removal from the north of Iraqi officers guilty of misconduct, immediate lifting of the economic blockade of the Kurdish areas under Barazani’s control and withdrawal of Iraqi military units from Kurdistan (Ghareeb, 1981: 59). Ghareeb (1981) pointed out that the most important section of the agreement was the first article, which referred to

“*Recognition of the national rights of the Kurdish people on the basis of self-administration (this item to be incorporated into the provisional and forthcoming permanent constitution), and establishing a joint committee which would begin immediately to clarify the way to execute the above mentioned points*” (Ghareeb, 1981: 59).

On March 10, 1963 an announcement was made by the government of the recognition of the national rights of the Kurdish people on the basis of decentralisation. On 16 March of the same year Ali Salih al-Sadi(the Ba’athist leader) emphasised that “granting the Kurds a decentralised system of government does not mean delegation of power on foreign, economic, or internal political matters, for these are all within the competence of the central government” (Ghareeb, 1981: 60). This meant that although the Kurds’ rights to self-determination were recognised, the Kurdish area would not become an independent state or self-ruling region.

The Kurds’ demands on decentralisation included the election of a Kurdish Vice President of Iraq who would be elected by Kurds only and the establishment of a Kurdistan region which would have its own constitution, government and national council. The Kurds would generate revenues from the taxes inside Kurdistan and from their share in oil revenues and customs duties. This share would account for half of the income from the oil revenues in Kurdistan and a percentage, in proportion to the population of the Kurdish area, of Iraq’s customs duties and other taxes. Another alternative put forward was that Kurdistan should receive half of Iraq’s oil revenues, or a share of all taxes and income in proportion to the population figures. The proposal was refused by the government and a revised proposal for revenue sharing was submitted which, though it still required a proportionate share of all revenues to go to the Kurdish area, this share would be computed after the government had deducted its expenses for matters remaining under its control (Ghareeb, 1981: 62-64).

The other problem with the Kurds’ proposals related to the borders of the Kurdish area. The Kurds proposed that the Kurdish area should include the provinces of Sulaymaniyya, Kirkuk[[8]](#footnote-7), Irbil and the districts inhabited by Kurdish majorities in Mosul and Diala. The government opposed the proposal and soon a conflict started between the central government and the Kurds. The latter insisted that Kirkuk should become part of the Kurdish area, while the government claimed that Kirkuk, with the exception of the Chimchimal district, which would be ceded to the Kurdistan area, was mainly inhabited by Turkmens and Arabs. Fighting broke out between the two parties, ending with a ceasefire in February 1964 (Harris, 1977: 119).

The Ba’ath party[[9]](#footnote-8) came to power following a military coup on 17th July 1968 led by Ahmad Hassan Al Baker, who became the Iraqi president. In March1970, the new government for the first time recognised the autonomy of the Kurdistan area. An agreement was signed between Saddam Hussein (then the vice president) and Mulla Barazani to give the Kurdistan area its autonomy. The agreement included the following terms (Jawad, 1979: 179-180, Ghareeb, 1981:87-89):

* Full recognition of the Kurdish nationality within four years
* Recognition of the Kurdish language as an official language to be taught with Arabic all over Iraq. Kurdish also was to be a primary language in Kurdistan
* A Kurdish Vice President for Iraq, and five Kurdish ministers
* Enhancement of Kurdish education and culture
* The right to establish Kurdish students’, youth, women’s and teachers’ organisations
* Development of the economy in Kurdish areas
* Return of Kurds to their villages or the award of financial compensation
* Amendment to the constitution to read “the Iraqi people consist of two main nationalities: the Arab and Kurdish nationalities”

Barazani accepted the agreement because it recognised the right of self-rule. In terms of the Kirkuk problem the two sides agreed that it should not be included in the Kurdistan area and postponed the matter to a later decision (Jawad, 1979: 180). Though the terms of the agreement seem not to differ from the proposals for self-administration of 1963 which Barazani refused, the reason behind his acceptance was that Barazani had witnessed the Iraqi army’s success in controlling the Kurdish area, thus legal recognition of self-rule was a better option: to have a new beginning, make peace with the central government and start developing the Kurdish areas.

In an interview, Babakr Mahumd al-Pishdari – a leading Kurdish figure and supporter of Barazani until 1970 – declared that one of the reasons for Barazani’s acceptance of the agreement was the political pressure applied by the government through its adoption of measures guaranteeing the Kurds political and cultural rights (Ghareeb, 1981:89). Ghareeb(1981) added that Barazani doubted the sincerity of Iranian support of the Kurds after the 1964 war as he thought that it was based mainly on traditional hostility to Iraq – to aggravate internal problems in Iraq so the government would not free its army to fight with Iran – rather than real support for the Kurdish case. Also the agreement contained a broad autonomy; it offered Barazani a way to settle the conflict and time to assert his authority over the Kurdish region.

The first reason for the Ba’ath regime’s offer for the agreement was the realisation that a stable and popular government could not be achieved unless a wise and peaceful solution was found; the second reason was to maintain the image of the Ba’aths as an Arab nationalist party (Ghareeb, 1981: 92), promoting it as a model for all the other parties in the Arab world.

However, the agreement between the two parties did not last long and by September 1972 it had started to collapse. The main disputes were as follows (Ghassemlou et al., 1980: 176-179; Jawad, 1982: 54):-

* Kirkuk: the Kurds accused the government of Arabization[[10]](#footnote-9) of Kirkuk, which had started in the 1960s and was still in force, and not only of Kirkuk but also Khanaqin and the Kurdish districts of Mosul (Zammar, Sheikhan and Sindjar), in order to reduce to the population of the Kurds in these areas. The Ba’aths were determined that only Suleymanieh, Arbil and Dehok provinces were to be included in the Kurdistan area.
* Revenues: the Kurds insisted that the Kurdistan area should receive a share of the general state budget and the national development plan budget, and hence of oil revenues proportionate to the percentage of the total Iraqi population represented by the region’s inhabitants; also they added that revenues should be calculated after defence and important public sector project deductions. The government made no response to the Kurds’ demands and wanted complete control over the allocation of money to the region’s budget.
* Iran: the Iraq government accused the Kurds of strengthening relations with Iran and of receiving large amounts of arms, claiming that an increasing number of Kurds were receiving military training in Iran
* Internal policy in Kurdistan: the central government accused the Kurds of working to establish their own authority in Iraqi Kurdistan through bypassingand sometimes defying the authority of the central government
* The government accused the Kurds of plotting against the Iraqi regime directly or indirectly, including encouraging members of the Iraqi armed forces to leave or commit acts against military discipline.

On 11 March 1974 the government announced the Autonomy law for Iraqi Kurdistan. This was rejected by the KDP as they described it as incomplete and lacking their prior approval. The following day Mulla Mustafa ordered his Peshmarga to occupy border posts and strategic points and war broke out again. It was one of the most severe wars between the two parties. The Iraqi army’s position was strong, even in difficult areas such as the mountains. However, the Iranians’ support for the Kurds enabled them to hold out. This action threatened to bring about war between Iraq and Iran. The problem was solved in Algiers in March 1975, during an OPEC summit, after a number of secret meetings between the Iraqi Vice president (Saddam Hussein) and the Shah of Iran. Both sides agreed that they would stop interfering in each other’s internal affairs. Shortly afterwards the Kurdish revolt ended, the Iraqi army resumed control over all Iraqi Kurdistan and by May 1975 armed activity in Iraqi Kurdistan had ended completely (Jawad, 1982: 53-58).

## 3.7 Iraq National Oil Company (1964-1974)

The concessionary areas taken from the foreign companies needed to be developed by a state company that would secure national interests and guarantee that the excess profits were captured by the government and not the foreign companies.

Therefore, in February 1964, the Iraqi government implemented law No.11, which established the Iraq National Oil Company (INOC). The latter would operate all the oil industry’s activities apart from refining and distribution within Iraq, as these were already managed by local governmental agencies. This was followed by another piece of legislation, law No. 97, September 1967, to expand INOC territories to all the areas taken from IPC, including North Rumaila[[11]](#footnote-10) field, and to expand the government’s control over INOC. The engagement included all aspects of the petroleum industry inside and outside Iraq, from exploration through to the distribution and sale of the products (Shwardran, 1973:279; Bentham and Smith, 1987:48;).

The company’s capital would be paid by the government: a sum of 25,000,000 Iraqi Dinar (ID) that could be increased to ID 150, 000,000**.** Any capital not paid by the government was guaranteed by the Iraqi Treasury until payment was made. INOC had to pay 50% of its annual profits to the government. The company was administered by a board of directors, independent in finance and administration. However, all its members were appointed by presidential decree; also, its decisions required ministerial approval**.**

The law empowered INOC to create and own subsidiaries, the funds for these would be guaranteed by the government. Also it could form partnerships to pursue its objectives of oil industry development but not to grant oil concessions. The law also gave INOC the liability to exploit the super-giant oilfield North Rumaila, without foreign companies’ participation.

Consequently, INOC had been given the task of direct exploitation of oil in North Rumaila oilfield; however, INOC lacked the technical expertise and the finance to exploit the fields by itself. It also lacked expertise in development, transportation and above all marketing of the products as foreign companies were directly responsible for and controlled all these activities, with limited participation from local representatives. Thus the government and INOC needed an assistant from a country that was not involved in IPC because of all the complexities and problems of the former’s dealings with the latter.

The government made several agreements with the Soviet Union, as it was one of the countries that Iraq called “friendly countries”, to supply INOC with equipment, materials and technical expertise. This was followed by the Iraqi-Soviet Agreement on Economic & Technical Cooperation, which was signed in Moscow in July 1969, and later by a contract involving “techno export”, to provide technical expertise for the North Rumaila oilfield exploitation and installation of pumping and degassing stations, gathering pipeline networks, and the construction of the main oil pipeline from the oilfields to the terminal (INOC, 1973:2). In 1968, a three year plan was made for the field to produce five million tons annually(101372 b/d).

INOC also signed several agreements with other foreign companies. In February 1968, it signed a service contract with the French state oil company, Enterprise de Recherches et d’Activités Pétrolières (ERAP). The company was to prospect for oil in four different areas where oil reserves had not been proved (a total of 8,520 square kilometres onshore and 2,280 square kilometres offshore). These areas were to be decreased by 50% at the end of the third year, and by a further 25% at the end of the fifth year, and after the sixth year the area for exploration would be reduced to the proven area. ERAP was to finance the exploration and bear all risks in the case of oil not being found. If oil were discovered, the exploration costs were to be repaid as a free-interest loan by INOC at one-fifth of total yearly production or 10% a barrel. ERAP was to finance development of oil through loans with interest of no more than 6%, repaid by the government within five years from the first shipment of oil. ERAP was to pay a bonus of $2 million on commercial discoveries of oil and a further $2 million every two years and after 10 years it would pay $5 million in bonuses. There was also a royalty of 13.5% of [[12]](#footnote-11)posted prices and expenses and income tax. The agreement was for twenty years. INOC was to take over management of operations, with the cooperation of ERAP. All the oil produced was to be owned by INOC; 50% of discovered oil would be considered a national reserve and excluded from development when daily production reached 75,000, the other 50% was to be developed cooperatively. ERAP could purchase 30% of production on specific favourable conditions; INOC was to control the other 70% of the production to sell at the best prices it could get from the market and ERAP was to help in marketing and be granted a per-barrel fee of half a cent on the first 100,000 b/d and one and a half cents on each barrel above that amount. This agreement was criticised by some members of INOC and some western economists for the reason that it would give greater profits for ERAP and less revenue for Iraq than under the earlier concession system (Shwadran, 1973:280; Stork, 1975: 189-194).

The INOC agreement with ERAP can be categorised as a risk service agreement. The literature on these types of contracts focused first on Iraq and Iran as they were the first users of this sort of contract. The Iraqi government could have better control over its resources in this genre of contracts than with the concession system or 50/50 profit sharing contracts, whilst Iraq could save 50% of its reserves and also retain control of 70% of the produced oil that it could sell at the market prices. However, these terms were based on the condition that production reached 75,000 barrels before INOC could start saving 50% of its oil reserves; likewise the marketing side was very difficult for the government as it had lost its western customers because of its problems with IPC. Therefore, even if production reached more than 75,000 barrels a day and Iraq was able to save 50% of its oil reserves, INOC could not market production by itself and it would definitely need ERAP help. These terms or conditions in the contract put ERAP all the time on the safe side of profits and would render the service contracts no more advantageous to Iraq than the profit sharing or even the concessionary ones.

IPC’s disputes with the Iraqi government after the passing of the 1961 law 80 continued even after Iraq’s success, with the help of the Russians, in developing the North Rumaila field. IPC claims on North Rumaila oil made the marketing of that oil to the west very difficult. Also, IPC’s failure to expand Kirkuk or Basra’s activities constantly impeded Iraq’s efforts to increase its oil revenues (Stork, 1975:102-108).

In February 1971, the President started negotiations again with IPC regarding Kirkuk and Basra. In March and April 1971, Kirkuk’s Mediterranean exports decreased by half. IPC claimed that the extra premium on Mediterranean liftings made them more expensive than Gulf exports to the European market**.** The Iraqis accused IPC of decreasing production in Iraq in order to promote oil from other sources. The Iraqis pointed out that the 44% decline in Kirkuk’s production happened at the same time as the increase in Nigerian production, which was largely controlled by IPC’s partner, Shell; also they added that there was no reduction in Aramco’s Mediterranean output via tapline (Stork, 1975:102-108).

In mid-May the government insisted that IPC return the production level in Kirkuk to normality and refused a 35 cent discount per barrel on the posted prices**.** TheIraqi government gave IPC three options (1) give production to INOC at cost (2) submit non-producing activities to INOC or (3) hand over control of the Kirkuk fields to INOC. By the end of May 1971 IPC had failed to give a satisfactory answer (Stork, 1975:102-108).

Consequently, after all the previous efforts had failed, assets were nationalised on June1, 1972, a decision that the government had longed to take for many years.

Nationalising IPC’s concessions left Iraq with full control of 75% of its crude oil. Settlement with IPC was made early in 1973. Compensation to IPC for the takeover was $300 million, payable in crude. However, it was reduced by an IPC payment of $345 million in back claims. Thus by 1974 all of Iraq’s oil was nationalised and placed under government control and a law had been issued to give exclusive rights to INOC to explore, develop and produce oil throughout Iraq. The foreign companies bound by service agreements stayed in Iraq. Iraq dramatically increased its exploratory efforts, which resulted in the discovery of the giant fields of Majnoon and West Qurna (Stork, 1975:102-108).

## 3.8 Iraq after Nationalisation (1974-1980)

From 1968 (the start of Ba’ath party rule) a Revolutionary Command Council held overall responsibility for general decision-making on oil in Iraq and a follow-up committee for Oil Affairs and the Implementation of Agreements was responsible for the details of the oil sector. The Ministry of Oil worked under the general guidance of the follow-up committee. In January, 1973 this committee took over direct responsibility for INOC and marketing crude oil and reviewing all agreements on oil before contracts were finalised. The committee worked closely with an advisory council for oil affairs; the council was very influential during that period because of the oil industry expertise that its members had. As a result, the power of the oil ministry lessened in 1973-4. This can be related either to the reorganisation of IPC in 1972 or internal political troubles. Consequently, Iraq’s oil administration was changed by law 101(1976), with the responsibilities of the follow-up committee reverting to the oil ministry and in the same year the ministry gained direct control of INOC (Stevens, 1982:174).

After nationalisation of the oil industry, the share of this sector in the economy increased from 35% in 1970 to 60% in 1974. Government revenues from this sector increased from 52% per cent in 1971 to 87% in 1976, and crude oil accounted for 98% of total exports in 1975 (see table 3.4) ( Stork, 1982: 37).

**Table 3.4: Iraq oil revenues- selected years**

|  |  |
| --- | --- |
| **Year** | **Revenue($ million)** |
| 1950 | 19 |
| 1953 | 144 |
| 1958 | 224 |
| 1964 | 353 |
| 1968 | 488 |
| 1972 | 575 |
| 1974 | 5,700 |
| 1977 | 9,600 |
| 1979 | 12,180 |
| 1980 | 26,000 |

Sources: from Stork (1983: 32), who obtained figures up to 1977 from Richard Nyrop, Iraq: a country study, Area Handbook Series (American University, Washington, DC, 1979), and 1979 figure from the Economist Intelligence Unit special (Iraq a new market in a region of Turmoil (EIU, London, 1980). 1980 figure from Cleveland, 2004: 412).

The huge increase in oil revenuesduring that period was due mainly to the sharp increase of prices which accompanied the Arab-Israeli war. The government at that time brought in social and industrial reforms. The greatest investment was in the public sector, especially in heavy industries such as iron, steel and petrochemicals (Cleveland, 2004: 412), whilst the agricultural sector grew by 15.8% yearly. The government implemented a new agrarian reform law in 1970 to place limitations on the size of land holdings and authorise the government to take additional acreage from large landowners and re-rent the lands or distribute them to small owners or peasants without land. In spite of the investment in the agriculture sector, imports of grain doubled between 1978 and 1982 and the agriculture sector lagged behind. Imports of food increased between 1969 and1980 (Cleveland, 2004: 413; Cedeno, 2008: 19-20).

The other reforms that the government implemented at that time were reductions of taxes, subsidising of basic foodstuffs, establishment of free health care, abolition of university tuition fees, improvement of the legal status of women, sponsorship of an extensive campaign against illiteracy in 1978: aimed not only at the school aged population but at mature citizens as well. These measures, combined with availability of employment, led to an improvement in living conditions and income levels during this period for the whole population.

## 3.9 Iran-Iraq war (1980-1988)

In 1979 Ayatollah Khomeini came to power. Iran then became the Islamic Republic of Iran; the Ayatollah called for Islamic revolution right across the Middle East. Tension between the two countries grew after Iran started to contravene the 1975 Algiers Agreement; the Kurds attempted to resume their revolution against the Saddam regime and were encouraged by the new Iranian revolution. The latter violated the Algiers agreement by opening its borders to Kurds seeking refuge from the Iraqi army (Cleveland, 2004: 416; Mearsheimer and Walt, 2003: 53).

Khomeini saw a threat to the existence of the Saddam regime; he identified Saddam Hussein and the Ba’ath party as enemies of Islam. In 1980, following Saddam’s execution of a leading Shia clergyman, Khomeini called for the Shia of Iraq to overthrow the regime. Another dispute was over the Shatt al-Arab river[[13]](#footnote-12); Iraq wanted the whole river, whilst Iran demanded half of it. Saddam’s demands contravened terms of the treaty of Algiers in 1975 which recognised certain straight lines close to the thalweg (deepest channel) of the waterway as the official border. Each country had legal, geographic and historical arguments to support its objectives (Pipes, 1983: 12-23, Cleveland, 2004: 415-417).

As a result, Saddam officially abolished the Algiers agreement and on 22 September, 1980 Iraq invaded Iran and launched a war that lasted for eight years and caused Iraq great losses in human and economic terms.

Iran destroyed the port installations at Basrah and hampered the activities of the southern oil fields; also it damaged the important fields in the north. This severely harmed the oil industry and thus affected the government’s income. Iran also attacked the oil ships trading with Kuwait and Saudi Arabia (Iraq’s allies). This action affected Iraq’s exports and caused problems in financing its military operations.

Iraq received foreign aid from Arab countries such as Kuwait, Saudi Arabia and Egypt and Western countries such as France and the United States of America, also from the Soviet Union, Kuwait and Saudi Arabia, who were Saddam’s main financial backers; they gave Iraq between $50 and $60 billion worth of aid during the war. Meanwhile, the American oil company Mobil began negotiations with Baghdad for northern oil field operations. In 1982, two agreements were signed to import oil to America. Mobil signed a 60 000b/d contract and the other American oil company (Ashland oil) had a 30 000b/d production deal (Cedeno, 2008: 50)

The U.S.’s enemy during that period was Khomeini not Saddam. It had the same desire as all the other supporters of Iraq to prevent the hegemony of Iran in the Middle East and the spread of Islamic radicalism through the influence of the anti-US Khomeini. But, more importantly, as Cleveland (2004: 418) has pointed out, the Gulf States controlled most of the world’s proven oil. If Iraq were to be defeated there would be a probability that the Gulf States would fall into Iran’s hands. This was a serious threat to the oil reserves on which the U.S. was becoming increasingly dependent; thus it was a better option to support Iraq.

On August 20, 1980, a UN sponsored ceasefire started and the war was ended. The border problem remained unsolved until 1990, when the Algiers agreement was restored (Cleveland, 2004: 419).

The economic impact was very severe. The Basra port facilities had been destroyed; the outstanding development projects had been cancelled; and a huge foreign debt, estimated at $80 billion, had been incurred (Cleveland, 2004). The oil sector in particular was affected negatively. The extent of the damage was reflected in oil production, which declined from 3,4MMBD in 1979 to 897MBD in 1981. This was the lowest output since 1959. The loss of exporting capacity was huge; Iraq’s oil revenues had peaked in 1980 at $26.3 Million (66% of the national income) but decreased to $10.4 in 1981 (see table 3.4).

After this period Iraq’s oil output began a steady recovery. At the end of 1985, Iraq demanded a rise of 600, 000b/d in its OPEC quotas of (1.466 MMBD). OPEC agreed in that year for recovery of the market share which had been lost to non OPEC producers. Iraq’s oil reserves increased in 1986, and in 1987 reached 72, 100 billion; along with its 40 billion probable reserves, this ranked the country second in terms of possession of the world’s largest oil reserves. Iraq demanded that its quota should be raised to equal any increase by Iran but this was regarded as a threat to political stability. In 1987, Iraq increased its production to exceed the official OPEC production quota, in the same year matching the 2.3MMBD of Iran’s quota. Iraq was unable to sell enough oil to maintain its production levels, and amidst reports that it had moved its crude to longer term contracts it demanded an increase in its quotas to 2 MMBD. OPEC was concerned about Iraq’s behaviour but in order to maintain solidarity among its members, Iraq was excluded from production quotas. Iraq began to produce as much oil as it could. Iraq became the second largest producer in OPEC in 1987-1988. The former Iraqi oil minister Issam Al-Chalabi argued that although Iraq was excluded from OPEC quotas, it adjusted its oil production according to the market trend at that time. This would not cause a collapse in oil prices because Kuwait and Saudi Arabia would stop the oil exporting that they had engaged in to support Iraq in war time (Cedeno, 2008:55-63).

**Table 3.5 Iraq’s proven oil reserves, production, exports and revenues from 1979-1988**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | **Oil proven Reserves (Million Barrels)** | **Oil Production**  **(Million Barrels)** | **Oil Exports**  **( Million Barrels)** | **Oil revenues**  **(Million $ US)** |
| 1979 | 31,000 | 3.4 | 3.2 | 21.3 |
| 1980 | 30,000 | 2.6 | 2.4 | 26.3 |
| 1981 | 32,000 | 0.89 | 0.87 | 10.4 |
| 1982 | 59,000 | 1.0 | 0.84 | 10.1 |
| 1983 | 65,000 | 1.0 | 0.70 | 7.8 |
| 1984 | 65,000 | 1.2 | 0.86 | 9.3 |
| 1985 | 65,000 | 1.4 | 1.0 | 10.6 |
| 1986 | 72,000 | 1.8 | 1.3 | 6.9 |
| 1987 | 100,000 | 2.3 | 1.7 | 11.4 |
| 1988 | 100,000 | 2.7 | 2.0 | 10.9 |

Source: OPEC Annual Statistical Bulletin 1990 and 1993

## 3.10A Gulf Conflict (1990-1991)

Iraq specifically pressurised Kuwait to reduce its oil production. Iraq was claiming that Kuwait had periodically been part of the Basrah Vilayet during the Ottoman Empire. For this reason the borders between Iraq and Kuwait had never been separated by any agreement. Also, Kuwait consistently refused to give up or rent the two northern Islands Warbah and Bubiyan, which could have given Iraq greater access to the Gulf. This dispute had become increasingly intense, particularly during the Iraq-Iran war, when Iraq was unable to use its other outlet through the Shatt al-Arab waterway and the country was mainly relying on exports through Turkey and Saudi Arabia’s pipelines. These means of exporting were uncertain because the pipelines could be closed at any time by the countries through which they passed and the solution as the government saw it was the acquisition of one of Kuwait’s offshore islands to build deep water port facilities (Dannreuther, 1991: 16; Cleveland, 2004: 479-480).

In July 1990 Kuwait announced that it had been producing more than its allowed quotas and agreed to reduce its production accordingly. However, in August 1990, Iraq invaded Kuwait and declared the annexation of Kuwait, according to Baghdad, because of Kuwait’s oil overproduction, its use of Rumaila oilfield and refusal to cancel debts which had inflicted a heavy burden on Iraq (Cleveland, 2004: 479).

The U.S. responded to the above invasion aggressively. Saddam Hussein did not expect the Americans to react in the way they did, especially in the light of his prior consultations with the U.S. Ambassador to Iraq (April Glaspie) on 25th July regarding the Kuwait problems. The ambassador stated “we have no opinion on Arab-Arab conflicts, like your border disagreement with Kuwait. This issue is not associated with America”(Gittings, 1991: 115). Cleveland (2004: 479) stated that the U.S.’s quick reaction was for the reason that the Americans feared Saddam would take control over the oil in the Gulf oil producing countries after its occupation of Kuwait (See also Rutledge, 2005:51-52).

However, Al Nasrawi (2002) a foreign policy expert, had an alternative view; the U.S. wished to take control of the oilfields in the region, in order to pressure its economic rivals Japan and West Germany. As we can see from the above, America’s responses before and after the war were contradictory. And, as Nasrawi suggested, America was seeking to increase its power and control in this region and, indeed, after the Gulf war, by gaining a permanent military base in Saudi Arabia, the U.S. did achieve more control over the Gulf Oil Producing Countries.

Thirty-four countries participated in the war. The major military participants, in order, were the United States, Saudi Arabia, The United Kingdom and Egypt. Around US$40 billion out of $60 billion was outlaid by Saudi Arabia(Peters and Deshong, 1995). The war lasted for forty-two consecutive days and nights of intensive air strikes. On February 27, 1991, Bush announced the liberation of Kuwait and ordered the suspension of the war operations (Cleveland, 2004).

## 3.10B Impact of the Gulf War (1990-2003)

Iraq’s infrastructure was badly damaged by the war. Communication, power generation and supply systems were almost entirely destroyed. Most of Iraq’s transport system, industry, water and sewage network were also destroyed. Although bridges and government buildings in Baghdad were rapidly rebuilt in an intensive reconstruction campaign to enable the city to continue to function, the sanctions brought further negative effects (Cleveland, 2004: 488-489).

On August 1991, The Security Council approved (resolution 706) the oil for food program, which allowed Iraq to export $1.6 billion in oil every six months to obtain humanitarian supplies (the amount was raised to $2 billion in 1996, $5.8 billion in 1998 and to $8.3 billion in 1999) (Sanford, 2003: 16). The money from these exports was to be used mainly for food subsidies, which were to be distributed monthly to all the Iraqi population.

The money was placed in a UN controlled bank account; before the distribution commenced there was a deduction of 30% of the funds to pay Iraq’s war compensation; another amount was deducted for humanitarian supplies for the Kurds and to fund the UN’s other operations in Iraq, such as the Iraq-Kuwait boundary demarcation, UN special commission monitoring contracts for oil sales and inspections. After all these deductions, the amount left to Iraq was insufficient to reduce the suffering of the Iraqi people (Nasrawi, 2000:13; Cleveland, 2004: 489).

By 1991, Iraq oil production had declined to 278.8 thousand b/d (see Table 3.6). Iraq immediately announced that it could sell to any country or company for $21 per barrel(GSN 11/12/1990)**.** The oil price at that time was $40 a barrel. In 1991 Iraq resumed its oil exports to Jordan as an exchange for its debts to that country (Cedeno, 2008:94). In August, 1991, Iraq’s oil minister called on OPEC to increase Iraq’s quotas, since it had been a founding member of OPEC, saying:

“ *Iraq would like to secure greater revenues through a greater quota...it is time to show solidarity with Iraq, irrespective of...the gulf crisis*” (OPEC bulletin,1991:61).

The Iraqi oil minister was asking the other members to reduce their production in order for Iraq to increase its production. Iraq was ready to export 2MMBD once the UN sanctions were lifted (OPEC bulletin, 1992:31). Iraq was determined to boost its production to its pre-war period (Iraq oil production was 2.7 MMBD in 1989). In 1993, Iraq was seeking a full lifting of the oil embargo and it did not want any limitations on sales (Cedeno, 2008:95).

**Table 3.6: Iraq’s Oil Production, Exports and Value of Oil Exports from 1990-2003**

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Oil Production**  **1,000 b/d** | **Oil Exports**  **1,000 b/d** | **Value of Oil Exports**  **(m $)** |
| 1990 | 2,113 | 1,596 | 9,594 |
| 1991 | 283 | 39 | 351 |
| 1992 | 526 | 60 | 482 |
| 1993 | 659 | 59 | 425 |
| 1994 | 749 | 60 | 421 |
| 1995 | 740 | 63 | 461 |
| 1996 | 740 | 88 | 680 |
| 1997 | 1,383 | 721 | 4,280 |
| 1998 | 2,181 | 1,554 | 5,111 |
| 1999 | 2,720 | 2,024 | 12,104 |
| 2000 | 2,8110 | 2,040 | 19,771 |
| 2001 | 2,594 | 1,710 | 15,685 |
| 2002 | 2,126 | 1,494 | 12,593 |
| 2003 | 1,378 | 389 | 7,519 |

Source: OPEC Annual Statistical Bulletin 1999

OPEC was certain that Iraq would return to the export market but they were sceptical about its claims of reaching 3MMB production, as they predicted Iraq’s potential to be 1.5-2 MMBD (OGJ: 1995, 42). The oil minister claimed that Iraq could reach 8MMBD by end of 1993 but this clearly was unrealistic, especially as the Gulf War had reduced the available operational capacity by some 75.000 b/d (OPEC Bulletin, 1998:9-15).

## 3.11 Kurdistan’s autonomy (1991-2003)

In March 1991, Shia[[14]](#footnote-13) areas in the south of Iraq started a revolution against Saddam. Retreating soldiers felt that the government had abandoned them once the Gulf War had started. These soldiers were joined by civilians in a revolt against Saddam and the hardship which his disastrous policies had inflicted on the southern people (Cleveland, 2004). The Shia revolution took control of most of the cities, including Basra, Karbala, and Najaf, in the first two weeks. The demonstrators attacked the public buildings in the controlled cities. However, the revolution was chaotic and unorganised so it was easily put down by the Iraqi army at the end of March(Ibid, 2004: 485).

Similarly, the uprising spread to the Kurds in the north, after the Iraqi army was defeated in Kuwait and later during the initial Shia uprising. The Kurds thought that it was the right moment to call for autonomy. During a two week period in March, Kurdish forces took over the major cities and towns in the north and set up municipal administrations in the controlled cities. Nevertheless, the Iraqi army, having quelled the rebellion in the south, moved to the north. The Kurdish army broke up and this created panic among the civilians and caused more than one million Kurds to flee to Turkey and Iran in the spring of 1991. This turned out to be advantageous in the long run for the Kurds. The U.S. and the UK felt that they had to declare a “no-fly” zone north of the 36th line of latitude in order to create a “safe-haven” for the Kurds to return under protection. Later a no-fly zone was imposed in the south as well – south of the 23rd line of latitude(Cleveland, 2004: 485-486; Bengio, 2005: 175; O’Leary and Salih; 2005:24-25).

The creation of the safe haven and no fly zone in the north led the Iraqi army to withdraw from the north and to the creation of Kurdistan. In contrast, although there was also a no-fly zone in the Shia south, self-rule was not achieved here. This might be traced to the fact that this group was not as organised as the Kurds, who had started their campaign for self-autonomy immediately after the First World War.

O’Leary and Salih (2005: 24) argue that Saddam at that time thought that by maintaining an economic blockade against Kurdistan, he would get the Kurdish leaders back into the national government. Shortly afterwards, the Kurdish leaders (Barazani and Talabani[[15]](#footnote-14)), uncertain of continued British and American support, approached the Iraqi government to negotiate a new relationship between Kurdistan and Baghdad. On 24 April 1991, Talabani announced that Saddam Hussein had agreed in principle to grant a measure of autonomy to the Kurds on the basis of the 1970 agreement. However, shortly after, there were some problems regarding its implementation. Barazani and Talabani asked for Kirkuk, Khanquin, and Mandali (as was negotiated with Mustafa Barazani in 1970) to be included in the new Kurdistan region. However, no agreement was made and fighting between the Kurds and the Iraqi army resumed in October 1991 until a de facto line was drawn to separate Kurdistan from the rest of Iraq. The Kurdistan border ran from near Zakho on the Turkish border to the Iranian border and their territory included the three big Kurdish cities of Dohuk, Erbil, and Sulaymanyah (see figure 3.2).In May1992, the Kurds of Iraq established a Kurdistan National Assembly (O’Leary and Salih, 2005: 24).

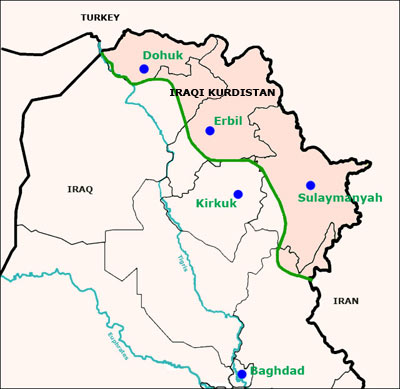
It is clear that from the beginning of the Kurdish Revolution, Kirkuk has been the main source of dispute between the two parties (Kurds and central government). Neither party wants to let go of the oil rich city of Kirkuk. The Kurds claim that it is one of their historic cities and that in the late 19th centuryKurdsmade up three quarters of its population (Behner, 2007). The Kurds argue that Arabization policies changed the ethnic composition in the city; in other words without the Arabization, which started in the late 1950s, it would still be a predominantly Kurdish city. However, this view is controversial and an academic study by Edmonds (1957) found that in 1949 (before Arabization) Kurds accounted for only 25% of the population.

“ *The population at the time of which I am writing numbered perhaps about 25,000 of whom the great majority were Turkomans and about one-quarter Kurds, with smaller colonies of Arabs, Christians and Jews”* ( Edmonds, 1957: 265).

The presence in the city of the Turkmens can be traced back to the 1957 census and it is claimed that historically they comprised the majority of the population, while in the surrounding province Kurds were in the majority (Beehner, 2007). Meanwhile, in 1997, Arabs made up 58% of the city’s population (some claim that the data are misleading because Kurds were obliged to identify themselves as Arabs in order to hold on to their lands)(Beehner, 2007).

After the Gulf War, although Barazani and Talabani were seeking legal status and approached the government for negotiations, they could not leave Kirkuk without an attempt at discussions, as in the 1970 agreement with Barazani, it was agreed not to include Kirkuk city in Kurdistan area but to postpone a decision on its future until later. Thus it can be seen that the Kurdish leaders thought that discussing the Kirkuk issue at that time was appropriate, especially as Saddam was in a weak position after the Gulf War.

**Figure 3.2: De facto Kurdistan 1991-2003, adapted from KRG map**

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Kurdistan was subject to a double embargo after the Gulf War, by the U.N. and by Baghdad. However, Kurdistan was trading with neighbouring countries, in particular Turkey and Iran. The Kurdish trade activities were ignored by the West as after all the Kurds were against Saddam. After the Oil for food program ended in 1996, Kurdistan enjoyed a proportional allocation of oil revenue. Although, at 13%, the allocation was less than fully proportional, the Oil for food program estimated that Iraq’s revenue from oil sales was U.S.$ 64.2 billion, from which approximately U.S.$ 8.4 billion was allocated to Kurdistan. Humanitarian issues were a problem in Kurdistan but compared to the rest of Iraq, socioeconomic conditions were improving. Teachers in schools had higher salaries and there was investment in building (Stanfield, 2005: 209-211).

## 3.12 Conclusions

Iraq’s system of oil governance has changed frequently throughout history; these changes occurred due to dissatisfaction with foreign oil companies, political changes, and civil and external wars. The changes in Iraqi oil governance are briefly explained as follows:-

**Fiscal Regime**

In the beginning, the Iraqi fiscal regime took the form of non-proprietorial governance, as identified by Mommer (see chapter five), whereby very generous terms were granted to the international companies. The underlying reasons are that the state of Iraq at that time had only recently been formed after years of Ottoman occupation, thus the Iraqi government was weak and dominated by foreign powers. Also, as the government did not have the technical knowledge needed to explore for oil themselves; they accepted very modest returns for the Iraqi people.

Access to the sub-surface was granted through concession contracts signed in 1925. The financial terms of these contracts favoured the IOCs; the government received very little of the oil revenue. Oil revenues received by the Iraqi government amounted to only 6.7% of the total net profit from Iraqi oil. As a result of constant disputes, changes were made in the terms of the contracts, in order to increase the Iraqi revenues. The changes introduced included dead rent in 1931 and 50-50 profit sharing in 1952. In turn, these changes dramatically increased the Iraqi government’s revenues from oil. However, even after these changes the oil companies’ take was still greater than that of the Iraqi government; thus the Iraqi government started to negotiate better terms with the foreign oil companies in order to capture the excess profits. Nevertheless, no agreement was reached and so in 1961 the government took away the IOCs’ 99.5% concessionary area. In this way oil governance moved towards a proprietorial regime whereby the interests of the owner were prioritised and the state had more control over development and revenues. Finally, in 1971, the industry was nationalised and a non-liberal fiscal regime was imposed which was completely proprietorial, with only local companies permitted to extract and develop the oilfields.

Currently, oil companies are securing contracts with Iraq, namely service contracts and production sharing contracts, and are returning to Iraq after an absence of more than thirty years. Will the past repeat itself, or will the Iraqi government take into consideration the mistakes of history and try to avoid repeating them?

**Sovereignty over oil resources**

The international oil companies took title to their share of the gross production minus the government’s royalty (see chapter five for concessions terms) and assumed responsibility for production, marketing, and prices. This situation gave rise to a number of disputes with the Iraqi government as there were no production obligations and the government had no role in exploration or field development; also, very few locals were employed by the foreign oil companies. The government accused the IOCs of deliberately decreasing production in order to serve their sales interests in other markets and to keep export prices low. Later, after the foundation of INOC and the removal of concessions from the IPC, Iraq engaged in some risk service contracts with IOCs in 1968, whereby all the oil produced was owned by INOC. However, many critics have pointed out that the terms of these service contracts were no better than those of the concessionary ones because Iraq could not market its oil by itself. In 1971, ownership was restricted entirely to the government, and only local companies were permitted to prospect or to develop the oil and gas industry.

**Distribution of Oil Revenues**

In 1952, after the introduction of the 50/50 profit sharing agreement, government revenues increased, and the government initiated a policy to give 70% of these revenues to development projects and only 30% to the ordinary budget. This step was intended to develop the non-oil sectors and thereby diversify the economy and also to deal with the natural depletion of these revenues. This step was beneficial to the Iraqi people, because expenditure on development projects would nourish the private sector and increase employment.

After nationalisation of the oil industry, the Iraq government’s revenues from the oil industry increased from 52% in 1971 to 87% in 1976; and benefits were passed on to the Iraqi people in all regions (owners of the resources) in the form of reduced taxation, subsidies on basic food stuffs, establishment of free health care, and job creation through investment in the massive public sector. This led to an improvement in living conditions and income levels for the whole population during the 1970s.

However, the situation did not last long because of the wars with Iran in the 1980s, which led to the reduction of oil revenues, whilst the Gulf War and the economic sanctions that followed almost destroyed Iraq’s economy. After the Gulf War, the Iraqi government introduced the distribution of food rations to all Iraqis in order to reduce poverty, with funding for the food rations coming from the oil for food program signed up to with the U.N. Currently, Iraq oil revenues are increasing by the year and represent more than 90% of government revenues; consequently, the way in which the government is distributing the oil revenues to its citizens is worthy of investigation.

**Kurdistan and distribution of oil revenues**

The denial by the Lausanne treaty of the Kurds’ demands for an autonomous region in northern Iraq was the start of Iraq’s regional problems, The decision of the British in 1919 not to create a Kurdish state in the north of Iraq was mainly for political reasons. It was expected that oil would be found in the Mosul Vilayet, where the majority of the population were Kurds. Kurdish rebels continued to demand an autonomous Kurdish region, and fighting continued to erupt between them and the central government. Although attempts were made to give the Kurds autonomy, these efforts all ended in failure, mainly for the following reasons: 1- the proportionate distribution of oil revenue between the central and the regional government. Distribution at that time was centrally controlled and the Kurds wanted more revenue and more control. 2- The Kurds wanted the oil rich city of Kirkuk to be included in an independent Kurdistan. After the Gulf War, the Kurds succeeded in gaining an autonomous area in the north. From 1991-2003, Kurdistan included Sulaymanyah, Erbil and Dohuk, whilst central distribution of oil revenues from the central government continued. However, for political reasons, the UN granted the Kurds complete control over spending.

## Chapter Four: The Governance of Iraqi Oil (2003 – Present)

## 4.1 Introduction

The previous chapter traces the evolution of Iraqi oil governance from its inception up until 2003, the year of the American invasion, highlighting the main problems faced by the industry during this period, particularly the conflict between the Kurds and the Iraqi government**.** This chapter examines how oil governance in Iraq has changed since 2003 and the extent to which the old problems still persist. The chapter is structured chronologically around the major changes and events which have affected oil governance since 2003.

The chapter helps clarify the current structure of Iraqi oil governance and how this has been shaped by events since 2003; to understand how and why oil revenues are distributed among Kurdistan and other Iraqi provinces, it is necessary to understand the circumstances in which the policies and laws that govern the industry were first formed.

The chapter begins by examining the period of direct military occupation (2003-2004), during which the Iraqi oil industry was under the control of the Coalition Provisional Authority. This period saw major changes to the industry, including changes in oil ownership and sovereignty, the opening up of the industry to international oil companies, and the creation of the Development Fund of Iraq (following the removal of economic sanctions and the oil for food programme). Also in this period, questions began to be asked about Iraq’s membership of OPEC. The rest of the chapter examines the Iraqi oil industry under the Interim Government, the Transitional Government and the First Permanent Government (June 2004 – present). The years since 2004 have seen the writing of the permanent constitution of Iraq and the drafting of oil and gas law (although this has not yet been ratified by Parliament). These are discussed in detail, with particular emphasis being placed on the articles relating to oil and gas ownership, petroleum fiscal regimes and the regional distribution of oil revenues.

## 4.2 The Iraqi oil industry under the Coalition Provisional Authority (CPA) (March 2003 – June 2004)

On March 20, 2003 Iraq was invaded by British and American troops because, it was claimed, Iraq possessed weapons of mass destruction. However, in a comprehensive search of the country following the invasion, no such weapons were found. This increased criticism of the war and suspicions over the intelligence reports. Kurds played a major role in the war, fighting with the Americans to occupy the two major cities of Mosul and Kirkuk (O'Leary, McGarry et al., 2005)**.** The Kurds knew that the 2003 war would have a major impact on their future. It would get rid of Saddam Hussein, who had been antagonistic to them throughout his rule (see Chapter Three), and their alliance with the US would enable them to remain autonomous. Thirdly, they would be able to renegotiate old demands which had not been met under the Kasim and Bathist regimes. These demands included the absorption of Kirkuk into Kurdistan and control over the oil revenues from Kurdish oil fields**.**

Prior to the invasion, representatives from the US met Iraqi exiles to discuss the management of the oil industry after the war. These Iraqis included Fadhil Al Chalabi (executive director of the London-based Centre for Global Energy Studies and former under-secretary at the Iraqi Oil Ministry), Ahmed AL Chalabi (leader of the Iraq National Congress, an opposition group[[16]](#footnote-15)), Ibrahim Baher al-Ulom (a US educated petroleum engineer whose father was a leading Shia cleric) and Muhamad Ali Zaini (analyst at the Centre of Global Energy Studies, previously an official in the Iraqi Oil Ministry). On the American side, attendees included State Department officials, Vice President Cheney’s staff and representatives from US oil companies including ExxonMobil, Chevron Texaco, Conoco Philips and Halliburton (Rutledge, 2005:180). Three major issues confronted the participants in the meeting (Ibid, 2005:180):

1. How should the US protect the Iraqi oil industry from sabotage by Iraqi forces?
2. How should ownership of the industry be structured so as to provide the necessary conditions for US oil companies to move in?
3. How would the Iraq oil industry relate to OPEC after the invasion?

Plans were drawn up to protect the oilfields and Oil Ministry to ensure the quick recovery of the industry, and Halliburton was appointed to do the necessary reconstruction work after the invasion. In December 2001, anticipating the coming invasion, the US Defence Department had signed a contract with a Halliburton subsidiary, Kellogg Brown and Root, to extinguish oil well fires, clean up oil spills, repair and reconstruct damaged infrastructure, operate facilities and distribute products. Halliburton was awarded the contract without any competition from other bidders. This contract was later described by the Committee on Government Reform in a letter to the US army corps of engineers as a “contract that has no set time limit and no dollar limit and is apparently structured in such a way as to encourage the contractor to increase its costs and consequently the cost to the taxpayers” (CNN, 2003).

Muttitt (2011), in his book *Fuel on the Fire*, claims that the primary motivation for the Iraq war was to stabilise global energy supplies by ensuring the free flow of Iraqi oil to the world market, while the secondary goal was to benefit US and UK companies. The pre-invasion meeting described above and the awarding of the non-bidding contract to Haliburton certainly suggest that the two main aims of the US were to ensure that Iraqi oil production would continue and increase, preferably unhindered by OPEC, and to guarantee that US oil companies would play a central role in this production. Having said this, it would have been almost impossible for the US government to open up such contracts for competition, given the secrecy and uncertainty surrounding its post-invasion plans for managing Iraq.

The US representatives and Iraqi oil experts who were present at the meeting knew very well that IOCs would face strong opposition from the Iraqi people because of the historically bad reputation of IOCs in Iraq. However, later problems might have been avoided if these companies had found ways to work with the Iraqis already running the country’s oil industry (Iraq was producing more than 2 million b/d before 2003 – see Table 3.6) and waited for the permanent Iraqi government to discuss IOC involvement in the industry. Muttitt (2011) is struck by the fact that Iraqi companies were not discussed as potential contractors to rehabilitate Iraq. Indeed, he observes that hiring American companies that did not know the Iraqi oil industry or how to work in the local conditions was a risky strategy.

The war ended on April 9, 2003 and Iraq was placed under the full occupation of the Americans and the British. On May 12, 2003 Paul Bremer was appointed as the head of the Coalition Provisional Authority (CPA). The war caused very significant damage to Iraq’s main infrastructure, but much more damage was caused by burning, looting and bombs after the war because the occupiers failed to provide adequate security or effective administration. The entire institutional network of Iraq collapsed. The Bathist civil service, police force, ministries and state-run businesses were dismantled, and lawlessness and chaos prevailed. The only institution in Baghdad which was well guarded by the American tanks was the Oil Ministry building. The ministry contained valuable geological databases which would be very important to US oil companies once they embarked upon the task of raising Iraq’s oil production (Rutledge, 2005:181).

It was starkly apparent that it was not enough to plan for and protect only one industry in the country. It became clear that no attempt had been made to understand and learn from the flaws of the Saddam regime, nor to protect Iraq’s public institutions. The abrupt dismantling of the civil service and police was particularly damaging in Iraq’s tightly controlled system; had the CPA brought in change gradually and drawn on the experience of existing employees, it may have been better able to control security. Instead, it responded to the chaos with a new system of governance which, unlike its arrangements for the oil industry, was completely unplanned. Critics of its approach included *The Washington Post,* which in 2005 published an article arguing that the Bush administration had failed to plan adequately for the aftermath of the war. It claimed that the Pentagon had ignored departmental studies on how best to achieve stability after the invasion and administer a post-war government to rebuild the country (Pincus, 2005). Ironically, the resulting disruption and corruption eventually affected the oil industry the US had taken such trouble to protect.

The CPA’s main mission was to restore oil production to its pre-war level (this was 2.8 mbd in 2000 and 2.1 mbd in 2002). By the end of 2003, oil production was 1.3 mbd, reaching 2.1 mbd in 2004 (see Table 4.1). Within a year of the war, oil production was back on track, although it fell again to 1.8 mbd in 2005.

**Table 4.1: Iraq’s oil production, exports and value of oil exports, 2003-2005**

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Oil production 1,000 b/d** | **Oil exports 1,000 b/d** | **Value of oil exports ($millions)** |
| 2003 | 1,377 | 388 | 7,990 |
| 2004 | 2,107 | 1,450 | 18,490 |
| 2005 | 1,853 | 1,472 | 22,039 |

Source: OPEC Annual Statistical Bulletin, 2006

On May 22, 2003, after thirteen years, the Americans managed to lift trade sanctions against Iraq through UN Security Council Resolution 1483. This was followed by the cancellation of the oil for food programme. The decision was made to transfer 95% of oil revenues into the Iraq Development Fund (DFI), with the remaining 5% going to the UN’s Gulf War Compensation Fund (Security Council, 2003). The DFI was supplemented by the funds left in the UN oil for food programme’s account. Also transferred into the fund were financial assets that had been removed from Iraq by Saddam and his officials during his regime. In total, more than $20 billion was deposited in the fund between May 22, 2003 and June 28, 2004 (KPMG, 2003; IAMB, 2004) (see Table 4.2).

**Table 4.2: Development Fund for Iraq (DFI) – statement of cash receipts, May 22, 2003 - June 28, 2004 ($000)**

|  |  |
| --- | --- |
| **Receipts** | **Amount** |
| Net proceeds from export sales of petroleum and petroleum products | 11,362,361 |
| UN oil for food programme transfers | 8,100,000 |
| Deposits from assets frozen outside of Iraq | 1,056,096 |
| Net deposits by Iraqi ministries for payments on their behalf | 217,170 |
| Food and Agricultural Organisation | 148,879 |
| Interest on US treasury bills | 33,495 |
| Interest on overnight deposits | 7,700 |
| Other | 583 |
| **Total receipts** | **20,923,584** |

Source: International Advisory and Monitoring Board for Iraq, 2004

At the time of the occupation and the chaos, creating a fund outside of Iraq seemed sensible to prevent corruption on the part of the CPA and other officials. However, the fund had to immediately be monitored by an international organisation to protect it. Also, upon its initiation, timing and conditions of DFI transfers to Iraq had to be carefully regulated. The CPA was expected to manage Iraqi funds in a transparent manner according to Security Council Resolution 1483, but within six months, it was felt to be necessary to establish the International Advisory and Monitory Board for Iraq (IAMB)[[17]](#footnote-16) to oversee matters. A few months after that, the Bahrain office of KPMG was appointed to act as auditor. The latter advised that total payments from the DFI had reached more than $14 billion when CPA rule ended on June 28, 2004. According to articles by Harriman (2005) and *The Guardian* (2005), the CPA spent up to $20 billion of Iraqi money compared with just $300 million of US funds, although Congress had actually voted to spend $18.4 billion on the redevelopment of Iraq. The authors suggested that the fact that it was Iraqi rather than American money which was being spent during the CPA period might explain IAMB’s finding that vast sums of money were unaccounted for. According to IAMB auditors, $8.8 billion of the money that had passed through the new Iraqi government ministries in Baghdad while Bremer was in charge had disappeared. There was little prospect of finding where it had gone (Harriman, 2005).

The fact that the DFI was not being monitored by an international organisation made it susceptible to corruption. The IAMB found weaknesses in the CPA’s management of the DFI and its handling of Iraq’s oil export sales. For example, oil production was not metered, leaving Iraq's oil supplies vulnerable to smuggling and robbery. Contracts funded from the DFI were awarded on the basis of non-competitive bidding, while barter transactions with neighbouring countries of crude oil for electricity, which were not accounted for at all in the fund, made it difficult to determine whether fair value was being received for Iraq’s oil exports (IAMB, 2004).

The cost-plus contract (with guaranteed 7% profit margin) awarded to Halliburton, which was estimated on signing in 2003 to be worth around $1 billion (Morgan, 2003), snowballed; Halliburton ultimately received $2.5 billion in December 2004 under its no bid Restore Iraqi Oil (RIO) contract, plus an additional $8.3 billion for work done under its Logistics Civil Augmentation Program (LOGCAP) troop support contract – in total, the company received $10.8 billion (Waxman, 2004). However, a year after the Kellogg (part of Halliburton) contract ended, it emerged that the new water injection system it had installed was unreliable (Moore, 2005). In other words, not only did the company take more money than was authorised, but it did not do the job properly. Similarly, in April 2003, the American engineering company Bechtel was awarded an initial contract of $680 million over 18 months by USAID (United States Agency for International Development) to do reconstruction work on Iraq’s infrastructure, including the electricity supply. In the end, Bechtel received $2.31 billion for three years’ work (Bechtel, 2006).At the time of writing, Iraqis still regularly experience power cuts in excess of eight to ten hours per day during summer time. Despite their previous failings, Kellogg Brown was awarded another contract in January 2004 (RIO 2) for the southern oil fields. This one was valued at $1.2 billion. Again, the company performed badly (House of Representatives, 2006). Parsons/Warley was awarded a contract for the northern oilfields worth $800 million.

**Table 4.3: Companies involved in rehabilitating Iraq’s oil fields, 2003 - 2005**

|  |  |  |  |
| --- | --- | --- | --- |
| **Field** | **Company involved** | **Period** | **Work value** |
| All Iraqi oil fields | Kellogg Brown, part of Halliburton RIO 1 | March 2003 -December 2005 | $2.5 billion |
| Southern Iraqi fields | Kellogg Brown, part of Halliburton RIO 2 | January 2004 - present | $1.2 billion |
| Northern Iraqi fields | Parsons/Warley | Jan 2004 - present | $800 million |

Source: House of Representatives, 2006

As discussed above, these contracts were awarded to US companies to rehabilitate the oil industry as quickly as possible after the invasion. However, cost-plus contracts leave it to the investor to determine the cost of materials, meaning that cost is not controlled and can easily be inflated. Ideally, the CPA should have waited and put the contracts out to bid with specific terms. Alternatively, they should have insisted that the contracts include guarantees that costs, quality and timescale would fall within set limits, and that costs would be monitored by Iraqi officials. The way these companies handled Iraq’s oil fields is evidence of the mismanagement and even corruption that existed within the Iraq oil industry under the CPA (though it should be noted that the contracts, as costly and inefficient as they were, continued to be renewed by subsequent governments).

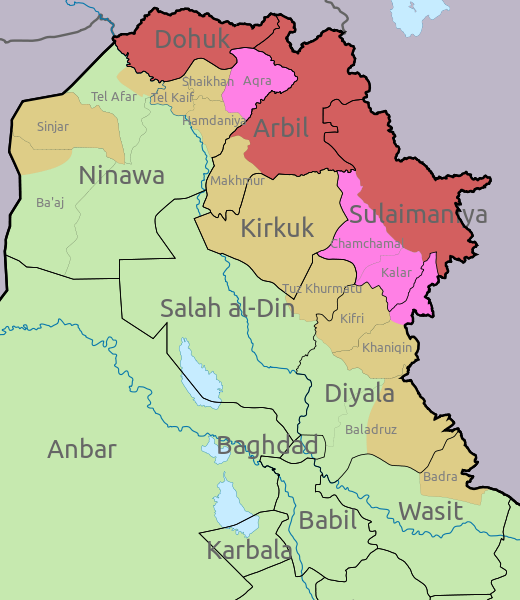
## 4.2.1 Law of Administration for the State of Iraq (TAL)

The Law of Administration for the State of Iraq (TAL) was signed by the Iraqi Governing Council[[18]](#footnote-17) (GC) in March 2004. The principles established by the law included (The Coalition Provisional Authority - CPA, 2004):

* Recognition that ownership of the oil industry should be vested in the people of all regions and governorates of Iraq (Article 25).
* Recognition of Kurdistan as a legitimate government within the new Federal Government of Iraq; also recognition of the Kurdish language as an official language in Iraq.
* Recognition of the need for equitable oil revenue distribution in Iraq: “Oil revenue management requires consultation with other governorates, and distributing the revenues resulting from their sale through the national budget in an equitable manner proportional to the population throughout the country, and with regards to the areas that were unjustly deprived by the previous regime” (Article 25 section E).
* Recognition of the Kurdistan Regional Government as the official government of the territories that were administered by the Kurdistan government on March 19, 2003 in the governorates of Dohok, Irbil, Sulymania, Kirkuk, Diyala and Nineveh. The term “Kurdistan Regional Government” to refer to the Kurdistan National Assembly, the Kurdistan Council of Ministers and the regional judicial authority in the Kurdistan region (Article 53).
* Recognition of the injustice of the Arabisation of Kirkuk by the previous regime and of the need for mechanisms to resolve the Kirkuk issue (Article 58).

TAL created the basis for the permanent constitution. It addressed the issue of the federal administration of Iraq, which affects ownership and the distribution of oil revenues. However, although it stipulated that the oil industry belongs to all Iraqis; it did not make clear whether this means the state as a whole or all those in the producing region. Similarly, although asserting that special regard should be given to areas affected by the previous regime, it did not identify these regions or say how the harm was to be measured, how they were to be compensated or for how long. TAL identified the areas which had been under the administration of Kurdistan since March 2003, including Kirkuk and Mosul (see Figure 4.1). These were areas where the Kurdish army had assisted the American army to take control. Kurdish leaders took over the administration of these two cities soon after. Finally, TAL formally recognised the Arabisation (in the Kurdish view) of Kirkuk under Saddam’s regime; it was the first official attempt to resolve the Kirkuk issue by proposing it be absorbed into Kurdistan (Rafaat, 2008).

Figure 4.1: Map of Iraq showing areas disputed with Kurdistan



Key:

Disputed area

Kurdistan

Disputed and part of Kurdistan since 1991

Critics of TAL have argued that it was produced hastily and in secret and was heavily influenced by US political interests. Jawad suggests that the CPA wanted TAL to be seen as an interim constitution that had been written and approved by Iraqis (Jawad, 2013:10), but that in reality, it was “imposed” on the GC (Jawad, 2013:11), which was weak during this period. Since the most active and well-prepared members of the GC were the Kurds, it is perhaps not surprising that TAL met many of the demands they had been making over the previous decades (see Chapter Three). As Jawad (2013) discusses, it was in the US’s interest to turn Iraq into a federal democratic country. It may have seen this as a way to ensure that the political system would reflect all Iraqi groups and to avoid Iraq being ruled by one sect or dictator. Its decision may have been prompted by sects like the Shiites and the Kurds, who felt that their voices had not been heard during the previous regime. However, it might also be argued that the US chose this political system in the belief that it would make it easier to influence Iraq’s new government. It is easier to justify intervention in the domestic affairs of another country if it is ruled jointly by several groups and these groups are in conflict.

## 4.2.2 Ownership, contracts and revenues from the oil industry

In the chaotic aftermath of the war, there was much discussion about who owned the Iraqi oil industry. In the pre-war meeting between the US and Iraqi exiles, many of those present had come out in favour of some form of privatisation of the industry. Production-sharing agreements (PSAs) were suggested as one form of privatisation (Rutledge, 2005:184). A number of authors, including Rutledge (2005) and Muttit (2006; 2010), have argued that the true motivation for the war in Iraq was in fact the West’s desire to ensure it had easy access to Iraqi oil, and that it would like nothing better than to see the industry privatised. However, as Chapter Five explains, PSAs do not represent total privatisation; a national oil company partner is essential to set one up, and ownership is retained by the state. In many cases, the state oil company is not an active explorer or oil producer but more of a revenue-collector – much depends on the specific terms of the contract. In January 2004, McKee[[19]](#footnote-18) advised the formation of a state-run oil company – the Iraq National Oil Company – to attract foreign investment into the industry (Teather, 2004). The role of this company would be to act as a partner for future PSAs.

During the CPA period, the Iraqi oil industry was under the direct control of the CPA, and the US managed the oil revenues. It was not clear what type of contracts or management would ultimately reign in the industry, but it was speculated that it would no longer be nationally owned.

Major decisions taken during this period had far-reaching consequences that continue to affect Iraq. TAL formed the basis of the permanent legislation passed in 2005 (see section 4.2.1), its ambiguity on the question of ownership (regional or state) creating long-term problems. Against this background, the Iraqi Governing Council was attempting to establish a complicated political system that involved Sunnis, Shiites and Kurds to create a democratic system for a country which had lived for more than 30 years under dictatorship.

## 4.3 The Iraqi oil industry under the Interim Government, Transitional Government and the First Permanent Government (June 2004 – present)

Following the principles set out by TAL, the Coalition forces, led by Paul Bremer and the UN’s special envoys, appointed the Iraqi Interim Government (IIG) on June 28, 2004. The IIG members were selected to represent the different ethnic and religious groups in Iraq. The President was a Sunni Arab – the Sunnis were dominant during Saddam’s regime, as they had been ever since the British occupation in 1918 (seeChapter One). The most important post (Prime Minister) went to a representative of the Shiites, who constitute the majority of Iraqis. The Kurds, who represent 20% of the population, also had key posts, including one of the deputy presidencies (Otterman, 2004). For the first time in Iraq’s history, government was shared among the different ethnic and religious groups, but rather than creating national unity, the new political system only served to divide the country and exacerbate sectarian divisions (Bennis, 2009:23; Anderson and Stansfield, 2004; Al-Jobouri, 2009). The Sunnis and Kurds in Iraq’s northern provinces and the Shiites in the south were all more concerned with maximising regional power than with making decisions that would benefit all Iraqis.

In May 2005, the IIG was replaced by the Iraqi Transitional Government (ITG). Its main function was to draft a permanent constitution for Iraq. The Sunnis boycotted the elections for the ITG because they wanted them to be postponed for security reasons and they wanted the Americans to leave before elections were held. As a result, 48.19% of the votes went to the Shiite United Iraqi Alliance, 25.73% were taken by the Democratic Patriotic Alliance of Kurdistan, 13.82% by Ayad Allawi or the secular group Iraqi List and only 1.78% were won by the Sunni group**.** This had consequences for the drafting of the permanent constitution (see section 4.3.1). In May 2005, Iraq became a federal state, with the presidency being divided between a Shiite prime minister, Kurdish president and Sunni vice-president. Other ministers were appointed on the same basis. In this respect, it followed the same path as the previous temporary governments (IIG, ITG).

However, the divisions between groups widened even further under this new political system. It is estimated that the Sunnis and Kurds combined represent 40%[[20]](#footnote-19) of Iraq's population, with Shiites accounting for almost 60%. Although less numerous, the Sunnis had been the dominant group under the Saddam regime, but it now felt that its interests were threatened. There were a couple of reasons for this. Firstly, during the CPA period, much had been made of the ill-treatment meted out to Kurds and Shiites under Saddam, and there had been calls for these two groups to be compensated by future governments (Al Jobouri, 2009). Secondly, oil reserves are mostly located in areas that are controlled by the Shiites and the Kurds. Thus, the Sunnis may have feared that they would get the smallest share of the oil revenues.

In January 2005, before the introduction of any oil law or even the writing of the permanent constitution, contracts were awarded to international oil companies to develop some of Iraq’s oil fields. Unlike those awarded before the war, these were not given to the US, though as they were still non-bidding contracts, there was no guarantee that they were the best contracts from Iraq’s perspective. The Interim Government awarded upstream oil deals, granting Turkey's Avrasya Technology Engineering a contract worth $150 million to develop the Khurmala Dome field in the north of the country, and the Canadian OGI group a contract of $180 million for eighteen months to work on the smaller Hamrin field, again in the north. In September 2005, the Suba-Luhais field in the south was awarded to Ireland’s Petrel in a contract worth $200 million. The goal was to increase production by 100,000 b/d by the end of 2006 (EIA, 2006). These contracts were non-risk service contracts, whereby the investment cost was paid by the government (see Chapter Five for a discussion of the various contract types).

Like the central government, the KRG began signing oil contracts with IOCs, but unlike the central government, it waited for the permanent constitution to be written first (though not the oil law). On December 1, 2005, shortly after the writing of the permanent constitution, the Kurdistan Regional Government awarded a PSC contract to Norway’s DNO to drill for oil at the Tawke well in the Kurdish region, near the Turkish border. The KRG effectively ignored the service contracts already awarded by the central government (EIA, 2006), arguing that its own contract was legal according to its interpretation of Article 112 of the permanent constitution. The central government, however, disagreed and began blacklisting those companies that entered into unauthorised contracts with the KRG (Elaf, 2012). Nevertheless, Kurdistan has continued to grant PSCs to IOCs. In 2010, there were more than 37 current oil and gas contracts in Kurdistan, with more than 40 international oil companies (Ashti Hawrami, 2010).

It seems likely that the KRG, anticipating that it would take time to produce the oil law, took advantage of its absence to interpret the constitution in a way that served its own interests. It was not inclined to wait for a law which it knew would be likely to favour central government interests and which would probably leave Kurdistan bound by unfavourable conditions. It was also keen to start exercising control over its oil and gas fields and receiving revenues as quickly as possible. The KRG’s assessment of the situation has been borne out by subsequent developments; in 2008, when the central government finally started putting contracts out for bidding (see Chapter Six), there was still no oil law. Even now, at the time of writing, the oil law remains stuck at the draft stage in the Iraqi Parliament – the result of the ongoing dispute between the central government and Kurdistan over power and contracts.

## 4.3.1 Iraq’s political parties and their objectives when drafting the permanent constitution

The Iraqi Transitional Government (ITG), which was given the mission of drafting the permanent constitution, was made up of several political parties, each of which had its own objectives.

***The Shiite parties***

The Shiites, which represent the majority of Iraq’s population, were marginalised and persecuted under the Saddam regime (Cleveland, 2004) (see Chapter Three). Shiite political parties within the ITG were loosely affiliated to form the Shiite United Iraqi Alliance (SUIA). This was dominated by two groups – the Islamic Dawa Party and the Supreme Islamic Iraqi Council (ISC). However, there was disagreement within SUIA as to the objectives of the constitution and how Iraq should be ruled. Al Dawa was against federalism and wanted Shiites to be the dominant force in government, reflecting their position as the major ethnic group. It also wanted central government control over oil and gas management and revenues (Kane, 2010). In contrast, other Shiite groups (the minority) were pro-federalism on the grounds that this would ensure no single dominant power could ever arise to persecute the Shiites (Kane, 2010). Indeed, the ISC wanted to establish a new region (like Kurdistan) in the oil-rich southern provinces (Almokhtasar, 2006; Wong, 2005), where most of the Arab Shiite population live, to give them greater autonomy and control over these oil and gas fields and their income.

The two ideologies were obviously incompatible. However, the majority of the Shiites did not want to weaken or disintegrate Iraq but they wanted a greater share of power within it (Kane, 2010). It means even if there will be a federalism in the Constitution same as TAL; the Shiites being the dominant member of the Iraqi government are still pro greater central control of oil and gas.

The other issue that concerned the Iraqi Shiite parties was the perceived threat to Iraq’s control over its resources. It was widely believed after the 2003 invasion that IOCs would return to Iraq and get involved in the oil industry, leading to speculation about its possible privatisation. These fears were exacerbated when the ITG began signing contracts with IOCs. Shiites like Muqtada Al Sadir, an influential cleric whose father was killed by Saddam in 1999, insisted that Iraqi oil must be protected from US control (Al- Marashi, 2015). When Al Sadir asserted that “the oil is being controlled by political forces that are in agreement with the US” (Ibid, 2015), he may have been referring to the continuing influence the CPA had on the GC and later the ITG.

***The Sunni parties***

The main Sunni parties were the Iraqi Islamic Party (IIP) and the Association of Muslim Scholars (AMS). The primary goal of this group was to prevent the constitution from becoming an instrument for the disintegration of Iraq (Al- Marashi, 2005). It feared that creating federal entities in the north and south would divide the country and leave Sunnis with no access to oil and gas revenues (Al- Marashi, 2005). Some Sunni parties were willing to give some autonomy to Kurdistan as they believed that this would make little difference to a region that had been independent since 1991, but they were not prepared to do the same for any other region (KRG, 2005). They particularly feared the prospect of the oil-rich south forming a region, as this would include the oil-rich province of Basra.

Like Muqtada el Sadir, some of the Sunni groups were anti-American and opposed the US occupation. They organised multiple centres of resistance, especially in Falluja in Anbar Province, west of Baghdad, and Sunni clerics called for a boycott of the US-organised January 2005 elections for the transitional government (Cogan, 2005). They wanted a united Iraq and the national ownership of resources and were against IOC intervention in the oil industry. The AMS criticised the draft oil law, arguing that it would reverse the popular Law 80 of 1961 and the nationalisation of 1970 (Muttitt, 2011:238).

***The Kurdish party***

The Kurds were in favour of federalism. The main reason, explains Al- Marashi(2015), was that the Kurds did not want Iraq to be centrally controlled as it was during Saddam’s regime; a federalist structure would give Kurds the autonomy to negotiate independent oil deals and secure their long-held demands. As discussed in Chapter Three, the Kurds have fought several civil wars with the central government regarding the distribution of oil revenues and control over the oil-rich city of Kirkuk. They saw the new constitution as their chance finally to formally decentralise power to the semi-autonomous region they controlled, especially control over its oil revenues. They may even have seen it as a step towards eventual independence.

After the 2003 invasion, Iraqi Kurdistan welcomed and supported the US military occupation. The Kurds were also open to IOC intervention; oil and gas in the region had not been explored as they had been in the rest of Iraq, so the IOCs’ technical expertise was welcomed by the KRG. It was reluctant to accept this expertise from the central government as it would have meant giving direct control to the latter.

## 4.3.2 Iraq’s permanent constitution

Iraq’s permanent constitution, which was approved by referendum on October 15, 2005 (Council of Representatives, 2005; Guirguis, 2005), replaced the TAL. As previously discussed, the Sunni boycott of the January elections left the National Assembly dominated by Shiites and Kurds, who wanted a constitution based on a federal structure that would grant considerable autonomy to the regions. The outnumbered Sunnis were thus unable to exercise much influence over the writing of the constitution or to achieve their main objective of retaining centralised control over Iraq and its oil and gas.

When interviewed for this research, the energy consultant to the Iraqi Prime Minister (see appendix 1) claimed that the wording of the constitution had already been prepared, mainly by the Kurds, before the constitutional committee ever came together to write the final document, and that it was based on consensus between the Shiite Islamic Alliance and the Kurds (the secular (and therefore neutral) Iraqiya group was not active at the time). As a result, he claimed, the constitution articles are too vague.

*“The wording of the constitution was done in the kitchen. This means it was done by the politicians, outside the constitutional committee, outside the Parliament, which is really something that we weren’t satisfied with. I was a member of the constitutional committee and National Assembly; we had completely different phrasing. The current constitution phrasing is an outcome of consensus among too many groups: the KRG and the Islamic Alliance. At that time the Iraqiya group was not present or active……that’s why it is vague.”* (INTER1, see appendix1)

According to this interviewee, the permanent constitution, like the TAL, was effectively handed over to the constitutional committee ready-made (see section 4.2.1). Indeed, Jawad (2013:10) claims that a copy of TAL, translated from English, was simply handed to the GC and a committee was selected to rewrite and approve it as the permanent constitution. However, this interviewee explained that members of the committee and National Assembly had very different reactions to the document. Some of the Sunni groups who opposed the constitution (e.g. the National Dialogue Council and the Muslim Clerics Association) criticised the Sunni Iraqi Islamic Party (IIP) for accepting it (under considerable but well-disguised US pressure), arguing that it would lead to national division and sectarianism, loss of identity and the waste of Iraqi riches (MEES, 2005).

Jawad (2013) puts these disagreements down to the fact that each group was concentrating on its own limited objectives. The Shiites were mostly focused on establishing Islam as the state religion in recognition of their majority, the Sunnis were concerned with establishing national unity and the Kurds, supported by US and European experts, wanted to pursue their own objectives of federalism, authority over Kirkuk and a share of the wealth. Jawad (2013) also suggests that neither the Shiites nor the Sunnis fully understood the articles they were accepting, and that those who did were too afraid to speak out. He claims that some of the legal experts and academics who did dare to warn of the dangers posed by some of the constitution’s articles were either threatened by unknown militia or detained simply because of their opposition; he cites one example of a law maker who was obliged to leave the country (Jawad, 2013:11).

As the following sections indicate, a number of the constitution’s articles are contradictory and ambiguous. The discussion below focuses mainly on those articles that are relevant to this research; that is, those relating to regional power, especially in Kurdistan, and to oil and gas ownership and the distribution of oil revenues.

***Articles related to regional power and Kurdish autonomy***

The articles relating to regional power and Kurdish autonomy are contradictory and open to different interpretations. Article 110 gives the federal government exclusive authority over the negotiation, signing and ratifying of international treaties and agreements; the formulation of fiscal and customs policy; the regulation of commercial policy across regional and governorate boundaries; the drawing up of the national budget; the formulation of monetary policy; and the establishment and administration of a central bank. This suggests that contracts with IOCs should be the responsibility of the federal government. On the other hand, Article 112 states that “the federal government *with* the producing governorates and regional governorates shall undertake the management of oil and gas extracted from *present fields*” (my italics). This suggests that the responsibility for managing oil and gas does not lie solely with the federal government. (The central government interprets the article to mean that existing fields are to be operated by the state-owned NOC.) [Bell and Saunders](#_ENREF_6) (2006) argue that the precise nature of the relationship between the federal government, regions and producing governorates may have been deliberately left ambiguous. Whether this is the case or not, the focus of the article is the federal government, and the requirement for regulation by law refers, as it does elsewhere in the constitution, to federal legislation. In other words, whatever the nature of the collaboration between the governmental units, final action is to be determined by the federal Council of Representatives.

Bell and Saunders go on to say that Article 112 does not define what is meant by management, nor is it subject to any words of limitation. They say it should be taken in the ordinary sense of conducting or supervising the activities associated with oil and gas extraction from existing fields: production, transport, refining and disposition. According to one of the authors of Iraq’s hydrocarbon law, who also helped establish INOC in 1964 (INTER2, see appendix 1), Bell and Saunders’ interpretation informed the writing of the first draft of Iraq’s oil and gas law. However, according to Ashti Hawrami (the KRG Natural Resources Minister), the term “management” (*Edara* in Arabic) means administration only; thus, the KRG’s view is that the federal authorities should play a purely administrative role, rather than being directly involved in the handling of the extracted oil and gas (Oil Diplomacy, 2007). Another interpretation is that the management of oil and gas should be shared with central government only after the oil has been produced (Oil Diplomacy, 2007); in other words, the shared management should be restricted to marketing. Crawford (2008), an academic and practitioner in the field of public management, came to the same conclusion. In a report for the KRG, he argued that the requirement for joint management seems to be limited to the post-extraction stage, and that the extraction/production process falls outside the scope of the article. Joint federal power in this case is limited to the processing, transportation and export of oil and gas. Crawford also added that Kurdistan has the right to complete control over its fields, on the grounds that the shared management principle is restricted to *present* fields – that is, those fields that were in existence on the date the constitution came into force. Since there were no producing fields in what is now KRG territory at that time, the shared management provision of Article 112 does not apply.

The above discussion is evidence of the confusion surrounding the constitution. In the absence of a common understanding or consensus among those who passed it, there is no official interpretation of its articles to which the writers of the oil and gas law can turn for guidance; instead, they have had to depend on the interpretation of outsiders. It is clear that the three writers of the law have followed Bell and Saunders’ interpretation, which supports the interests of the central government. If one of the writers had been a Kurd, they may have chosen to follow a different interpretation.

The energy consultant to the Iraqi Prime Minister (seeappendix 1) acknowledged in his interview that most of the constitution’s articles are ambiguous, especially Article 112, with the result that the federal government and Kurdistan are able to interpret them differently. The KRG interprets the federal government’s role as beginning only after the oil has been produced, and then only in existing fields. The federal government, on the other hand, interprets its management role as encompassing everything from exploration to marketing. It is not surprising then that the drafting of the oil law has been so fraught with difficulties:

*“The wording of the constitution is imbalanced and fake, especially Article 112. It discusses the oil produced and the marketing of oil produced from current fields. Thus, when we started formulating a draft law, we had so many difficulties; we and the KRG had different interests”.* (INTER1)

The interviewee echoed Jawad’s (2013) observation that the KRG had a very different agenda from the other groups who were involved in developing the constitution. Unlike the Sunnis, who wanted to maintain state unity, the KRG wanted an emphasis on regional power (though some of the Shiite group also preferred decentralised control, especially over oil and gas). It was difficult to reconcile these different interests – instead, it was easier to leave the constitution open to interpretation. However, the legacy of this decision has been ongoing disputes between the federal government, Kurdistan and other provinces.

Although the federal government generally assumes that its interests take priority over those of regional governments, several articles within the constitution explicitly support the authority of regional governments. Article 141[[21]](#footnote-20), for example, stipulates that all KRG contracts formed prior to the constitution are still valid, while Article 115 states that all powers, unless identified in Article 110 as being exclusive to federal government, belong to the regions and governorates; where there is a clash, then the regional or governorate law prevails**.** This is particularly relevant in terms of the oil and gas sector, since Article 112 can be interpreted as meaning that federal and regional governments share responsibility for this sector. Article 115 makes clear that if a problem arises with this shared responsibility, regional law takes priority. Similarly, Article 121[[22]](#footnote-21) gives priority to the regional law in matters outside the exclusive authority of the federal government – the KRG see the signing of contracts as one such matter. This article gives regions the right to exercise power in their own right or to share power with the federal government.

The status of Kurdistan as a region, which was recognised under TAL, is reaffirmed under the first clause of Article 117[[23]](#footnote-22) of the constitution. Article 119, meanwhile, stipulates that any two or more governorates can form a region as long as the majority of voters approve this in a referendum[[24]](#footnote-23). This means it would be as easy for the Shiites in the south to form their own region as it was for Kurdistan in the north. Further, Article 120[[25]](#footnote-24) gives regions the right to form their own constitution (this allowed Kurdistan to introduce its own oil and gas law). The legal recognition of Kurdistan as a region (under the Saddam regime Kurdistan was not legally recognised in Iraq) is a positive development in that it has opened up the prospect of dialogue between the KRG and the central government, but despite this, Sunnis have objected to these articles because they fear that if other provinces choose to follow the same path, this will threaten national unity and Iraq’s future growth. They argue that while this model may be appropriate for Kurdistan, which was a region long before the 2003 invasion, it may not be suitable for other provinces that lack experience of handling their own affairs. They are especially concerned that if the south forms a region, the government will lose a major share of the oil revenues on which it depends.

Article 140[[26]](#footnote-25) reaffirms TAL Article 58 regarding the Kirkuk issue and proposes conducting a census to decide whether Kirkuk should become part of the Kurdistan region or stay under federal government control. This issue was meant to have been resolved by December 31, 2007, but the census did not take place for security reasons. Once again, there is division among the ethnic groups concerned. The Turkmen in Kirkuk are opposed to Kirkuk being ruled by the Kurds. They, along with other minorities, complain of being discriminated against by the Kurds, who have taken control of key positions in Kirkuk, including the civil service, intelligence service and police (Forum for Cities in Transition, 2009). Article 140 is also opposed by Arab Shiites and Sunnis – indeed, some Shiites wanted to postpone discussion of the Kirkuk issue until after the constitution had been completed (KRG, 2005). Ammar al-Hakim, a prominent Shiite cleric, has called Kirkuk an Iraqi city and objected to any Iraqi being made to leave any Iraqi city (Yunnis, 2005). Similarly, Sunnis, who also regard Kirkuk as an Iraqi city, do not want to see Arabs being made to leave, despite the acknowledgements in TAL 58 and the constitution of the injustice of the forced Arabisation of Kirkuk under Saddam (Kuduaimati, 2007). The majority of both Shiites and Sunnis want a unified Iraq with central control, especially over oil and gas. Both groups want to make sure that oil-rich Kirkuk is controlled by Baghdad rather than the KRG.

***Articles related to oil and gas ownership***

Article 111: Oil and gas are under the ownership of all the people of Iraq in all the regions and governorates.

This article, which derives from TAL Article 25, perpetuates the ambiguity regarding the regions’ ownership rights**.** Brown (2005:13)and Deeks and Burton (2007:68)claimthat the article is deliberately unclear on whether the benefits of oil and gas are to be distributed equally throughout the country or shared only with the producing sub-national units. Conversely, Deeks and Burton (2007:68) argue that although this provision is not clear, it could support an interpretation that the revenues from the sale of these resources, as well as the resources themselves, belong to all the Iraqi people in all the regions and governorates. However, McGarry and O’Leary (2007:680) argue that this article should be read in conjunction with Article 115, which gives power to the regions in non-federal matters and prioritises regional law where there is a clash between federal and regional interests. They say it should also be read with Article 121, which gives the regions general power to amend legislation in areas not subject to exclusive federal control, and with Article 112, which stipulates that the “federal government, with the producing governorates and regional governments shall undertake the management of oil and gas extracted from *present* fields” and that “the federal government, with the producing region and governorate, shall *together* formulate the necessary strategic policies to develop the oil and gas wealth in a way that achieves the highest benefit to the Iraqi people” (my italics).

Writing in the Kurdish pressAl Ittihad, Barazenchi, a member of Iraq’s Parliament, argued that ownership implies direct control over the management and use of resources, and that this ownership rests with the whole of the Iraqi people rather than the government or a single group as it did during Saddam’s regime (Barazenchi, Anon). This interpretation is endorsed by Article 112, which confirms that oil and gas revenues are to be distributed equally to all Iraqi people. However, Barazenchi goes on to argue that as it is practically impossible for Iraqis in every region to control and manage the resources in every other region, this responsibility will in practice fall on those living closest to the oil and gas. It is perhaps not surprising that a writer writing in a patriotic Kurdish newspaper should interpret the constitution in a similar way to the KRG, but there is a certain tension between his support for the equal distribution of revenues to all Iraqis and his view that the control and management of oil fields are regional responsibilities. Nor does he explain whether the principle of equal distribution applies only to revenues from present fields.

Once again, Article 111 is highly controversial, and again, there has been no official interpretation. The pro-central government interpretation is that ownership of oil and gas rests with all Iraqis, and that revenues should go to the central government as the representative of all Iraqis. But it can also be interpreted to mean that the oil – and the revenues it generates – belongs to those regions where it is found. Unfortunately, the other constitutional articles do little to remove this ambiguity.

McGarry and O’Leary (2007:680) argue that these clauses together limit the federal government’s power regarding oil and gas in several ways: its managerial power is shared with the regions and governorates; it is subordinate to the regions and governorates at times of conflict; and its influence is restricted to current fields. Ashti Hawrami’s (KRG Natural Resources Minister)claimthat the federal government is unable to interfere with the KRG’s contracts with foreign companies because its power is limited to administration only seems to confirm McGarry and O’Leary’s view. Deeks and Burton (2007:57) argue that these clauses were inserted into the constitution for the benefit of the Kurds, who sought to limit the ownership of the Iraqi people to existing oil and gas resources so that Kurdistan could own and control all future resources discovered on its land.

At the Iraq Petroleum Conference, held in London in 2010, the author asked several members of the Iraqi government for their opinions on the wording of Article 111. They all interpreted it to mean that the ownership of Iraq’s oil rests with all Iraqis, though the energy consultant to the Iraqi Prime Minister (INTER1, seeappendix 1)admitted that it is ambiguous, and two others (an Iraqi government spokesman (INTER3) and a member of the Iraqi Parliament (INTER4)) pointed out that although the management of current fields is wholly federal, under Article 112, that of future fields must be shared. The Iraqi government spokesman felt that the wording of Article 111 represents a compromise; ownership rests with all Iraqis, but the regions can have a say on the new fields. INTER2 (one of the authors of the 2007 hydrocarbon law and a co-founder of INOC – see appendix 1) saw no ambiguity as regards ownership; he asserted that the oil belongs to all Iraqis, not just according to the constitution but also under Islamic law, which decrees that natural resources belong to everyone. In this respect, Islamic law is similar to the French Mineral Law of 1791, which states that minerals are a gift of nature and as such belong to the community as a whole.

Though the interviewee interprets ownership to be for all Iraqi people; there is confusion about the distribution of oil revenues. The government spokesman and INTER 3 mention that the region can have a say on the future fields. This is not how the KRG interprets the constitutions as we will see below. As according to article 112 it is shared management of present fields and there is no mention of new fields in the whole constitution. As members of the Iraqi Parliament, the interviewees, predictably, supported central government control. This suggests that they either did not appreciate the ambiguity of many of the constitution’s articles (and the fact that this ambiguity often favours the regions), or they were simply toeing the central government line.

***Articles related to oil and gas******revenue sharing***

Article 112[[27]](#footnote-26) confirms the declaration made in TAL Article 25 that revenue from *present* oil fields should be distributed among the regions according to population. However, the article makes no mention of revenue distribution for *future* fields. Exploiting this fact, the KRG insists that while revenues from current fields in Kurdish territory should be distributed by the central government in Baghdad, those from new fields should be exclusive to the region (MEES, 2006a). Not surprisingly, the interviewees took a different view. The Iraqi government spokesman (INTER3, see appendix 1), for example, explained that the federal government in Baghdad will share the management of new fields with the regional governorate, and that the revenues generated by these new fields will be treated in the same way as those from present fields. This seems clearly to contravene Article 112’s stipulation that current redistribution rules only apply to existing fields as there is no reference to future fields at all.

The central government’s interpretation would see the oil revenues from future fields, like those from current fields, being distributed equally across all of Iraq’s provinces and Kurdistan. Under the KRG’s interpretation, however, only the revenues from Kurdistan’s current fields would be distributed to other provinces, while those from future fields would stay in Kurdistan. At the same time, it would continue to receive oil and gas revenues from other provinces such as Basrah (as long as the latter does not follow Kurdistan’s example and form a region in the south in order to hold on to its revenues).

Given what is at stake, it is not surprising that the language of Article 112 has led many to question what constitutes a “new” or “existing” field, as this crucial issue will determine who ultimately controls future oil revenues (MEES, 2006b). Once again, the constitution gives no official guidance – in fact, it makes no specific mention of future fields at all. INTER4 defined existing fields as fields which are already developed or which are due to be developed; that is, those included in annexes one and two to the draft oil law of February 2007. This law identified four tables of fields. Table one covers primary producing fields (brownfields) which were offered in the first and second bidding rounds (see Chapter Six); table two covers semi- or non-producing fields, some of which were offered in the second bidding round; table 3 covers non-producing fields; and table four includes exploration blocks. The fields in tables one and two are current fields which, according to the government’s interpretation, should be completely managed by the federal government (Kurdistan argues that present fields should only come under shared management after extraction, for example at the marketing stage). The management of fields in tables three and four (the future fields) can be shared with governorates. The question is further complicated if one accepts the view of one of the authors of Iraq’s hydrocarbon law (INTER2, see appendix 1) that the distinction between present and future is illogical. A field is not called a field unless it is producing: before it is a field, it is called an anomaly. Whether producing, approaching development or undeveloped, these are all current fields; in other words, all the Iraqi fields in tables one, two, three and four should be considered current fields.

The Kurdish Oil and Gas Law of 2007, identifies current fields as those that were in commercial production prior to 15 August of that year (see section 4.3.3). In terms of Iraq’s 2007 draft oil and gas annexes, this means that most current fields fall into table one, future fields fall into tables three and four, and table two is a mixture of current and future fields. However, it should be remembered that the Iraqi oil and gas law is still only at the draft stage; indeed, these annexes have been the main cause of dispute with the KRG (see section 4.3.3). The KRG has already started managing its own contracts, but it is not made clear in the constitution how the revenues from these contracted fields are to be managed (see Chapter Eight).

The other key article concerning revenue distribution is Article 121[[28]](#footnote-27), which stipulates that revenues should be shared equitably between regions and governorates, according not only to population, as stipulated by Article 112, but also according to the regions’ resources and needs. Again, however, no specific reference is made to revenue collected from future fields.

Zedalis (2009:38-39) highlights several points arising from Articles 112 and 121. First, these two articles have different goals. Both articles state that revenue should be distributed according to population, but while Article 112 stipulates that special consideration should be given to areas badly affected during the former regime (as a form of compensation), Article 121 aims to ensure that the distribution system will meet the individual administrative, managerial and social needs of every region. In other words, 112 gives special treatment to some regions, while 121 says every region should get special treatment. Zedalis also points out that Article 121’s stipulation that revenue allocation should take into account each region’s resources contradicts Article 111, which seeks to ensure that Iraqi oil and gas resources benefit all Iraqis, wherever they may live.

Zedalis argues that the standards of revenue distribution under Article 112 are not clear; although it is clear that distribution is according to population, it is unclear how population is related to the other measures or standards stipulated in the article. Nor does the article explain how it is to be determined whether regions suffered sufficiently during the former regime to be classified as “unjustly deprived” of revenues. In fact, the whole idea that special treatment should be given to damaged areas is highly contentious, as there are no criteria to measure this damage – the entire country suffered during and after Saddam’s regime. Nor does the article explain how long this compensation should last.

Finally, Zedalis questions the language used in the two articles. Article 121 sets standards for regions and governorates to receive their share of the total “national revenues”, while 112 establishes standards in terms of revenues derived from oil and gas. The author questions whether there are different standards for oil and gas revenues and non-oil and gas revenues. He suggests that while Article 121 has been interpreted as referring to revenues from regional oil and gas activities, it actually refers to national revenues taken by the federal government from both oil and gas activities and other sources. It is not clear from the articles what the term “national revenues” actually means, or what percentage of these revenues should be distributed regionally. This question is explored in Chapter Eight.

**Table 4.4: Articles in the constitution related to oil issues: law regarding the ownership of oil and gas, contracts with IOCs and oil and gas revenue distribution**

|  |  |  |
| --- | --- | --- |
| **Oil issue** | **Article number** | **Comments** |
| Ownership | Article 111  Article 115  Article 121  Article 112 | Not clear if ownership is shared or not, or if this only applies to present fields - Oil and gas ownership for all Iraqi people in all regions. However, some power is delegated to regions. In the event of clashes, regional law prevails. Shared management with federal government only applies to present fields,nothing mentioned about future fields. |
| Contracts with IOCs | Article 110  Article 112  Article 115  Article 141 | Not clear if it is legal for KRG to sign contracts with IOCs or not – only the federal government has the power to sign contracts, according to Article 110. However, Article 141 validates contracts signed in KRG since 1991. Article 112 is differently interpreted by KRG and the federal government regarding power and authority. Where power is shared and there is a clash, Article 115 gives control to regional governments. |
| Revenue distribution | Article 112  Article 121 | Criteria and standards for revenue distribution are not clear, nor is it clear whether the injunction to share the benefits of oil revenues among all Iraqi people applies only to present fields. |

## 4.3.3 The hydrocarbon law

In summer 2006, three Iraqi oil experts, Tariq Shafiq, Thamir Ghadban and Farouq al Kassem (an Iraqi geologist who played a vital role in the development of the Norwegian oil industry), prepared the first draft of a hydrocarbon law to regulate Iraq’s oil and gas sector. According to Tariq Shafiq, the aims of the draft were to create the optimum environment for investment in the oil and gas industry, to ensure the highest possible levels of return and to unify the Iraqi people (Shafiq, 2007). However, this draft (which is not available to the public) was criticised on a number of points, including: 1- its advocacy of foreign participation and production-sharing contracts, 2- its proposal to put the bulk of oil reserves under federal control, 3- its proposal to set up a Federal Oil and Gas Council and 4- its proposal for managing revenues. A modified version of the document was published on January 15, 2007, to be followed by a revised draft on February 15, 2007. This was approved by the Council of Ministers on February 26 of the same year. In an interview with this author, Mr. Shafiq expressed dissatisfaction with the changes that have been made to the original 2006 draft. He stated that the original draft was written by professionals, but that it has been reshaped by politics and the current draft no longer meets the needs of the Iraqi people, or the original intent of the drafters (Hussari, 2011). At the time of writing, the oil and gas law has still not been approved by the Council of Representatives. It remains at the draft stage, mainly because of the ongoing dispute between the KRG and central government.

It is not clear why the draft was written by only three Iraqi oil experts or why the other Iraqi groups that were involved in writing the constitution were excluded. While employing experts in the field was undeniably sensible, in retrospect, all those involved in the writing of the constitution should also have had the chance to have input into the drafting process. Leaving the job in the hands of just three people increased the likelihood that the resulting document would follow one ideology rather than accommodating a range of views. The decision to place the bulk of Iraq’s oil reserves under federal government control, for example, suggests that the writers were biased towards the government’s interpretation of the constitution rather than the KRG’s or other provinces’. The fact that there was no compromise in the writing of the draft oil and gas law is one of the main reasons why it continues to be highly contentious and remains, even now, at the draft stage. The main areas of dispute in the draft law are discussed below.

***Foreign participation***

Gregg Muttit (an investigative journalist)hasclaimed thatthe primary purpose of the oil law was to create a framework which would allow multinationals to play a key role in Iraq's oil industry (Issa, 2012). The draft hydrocarbon law of 2006 was the first attempt since 1970 to partially de-nationalise Iraq’s oil industry and open it up to foreign companies. The issue divided Iraqis: while some were reluctant to encourage any foreign participation in the sector, others realised the need for foreign involvement – although they wanted it to be limited to the buying in of foreign expertise. A third group wanted greater involvement through production-sharing contracts, but when this appeared in the original draft of the oil and gas law, it caused major disagreements among Iraq’s oil and gas policy makers. The February 2007 version therefore deleted the term completely, replacing it with “production and exploration contracts” (Zedalis, 2009).

It is not clear why it was deemed necessary to include production-sharing contracts in the oil and gas law draft as Iraq was already producing and exporting oil during the Saddam regime. In fact, there was no clear explanation of why foreign participation was deemed necessary at all. But the perceived reasons for involving IOCs (such as the need for foreign money to build infrastructure and increase production) should have been discussed with members of Parliament before the draft was written. As discussed in Chapter Five, it is not the type of fiscal regime which brings more profits or benefits to the host country, but the terms of the contracts. These terms should have been discussed before a decision was made as to the type of contract to be stipulated in the oil and gas law. In fact, the replacement of PSCs with production and exploration contracts in the February 2007 version of the draft law was more of a political manoeuvre than a reflection of a better deal; despite the new name, these contracts offered the same terms as PSCs.

Notwithstanding the fact that Iraq has no formally approved oil and gas law, the federal government has now signed between twelve and fourteen contracts with IOCs. Forty-five blocks have been contracted in the north, plus a number of exploration blocks (Husari, 2011:1). These contracts were signed in accordance with the government’s interpretation of the constitution, but this document does not detail in clear terms how Iraq’s oil and gas should be managed. The oil and gas law is therefore doubly important as it offers an opportunity for policy makers to clarify who is responsible for managing contracts with investors (central or regional government?), what types of official contracts are available and what terms they should contain. In other words, the oil and gas law is vital to help protect both the Iraqi people and investors’ rights.

***The question of control: regional or federal?***

The constitution’s ambiguity about the roles and powers of central, regional and governorate authorities has impacted the drafting of oil and gas law. Kurdistan maintains that the draft oil law is illegal on the grounds that it does not comply with the constitution articles. The Kurds want greater regional autonomy to develop existing and new fields on their territory, as well as those near the northern city of Kirkuk. They want to be able to bypass Baghdad and sign contracts with foreign companies (Beehner and Bruno, 2008). However, the draft law puts the management of Iraq’s oil industry into the hands of the government; in effect, 93% of the country’s oil reserves have been put under the management of the Iraq National Oil Company. The first draft of the oil and gas law created the INOC to run operating companies, which could be up to 50% owned by the province or region. The region or province could appoint its own INOC directors, thereby ensuring, according to Tariq Shafiq, that oil sector professionals had an input into decision making, rather than it being left to politicians and party members, who might be intent on following their own agenda (Hussari, 2011).

One of the authors of Iraq’s hydrocarbon law (INTER2, see appendix 1) explained that the 2006 draft was primarily shaped by Articles 111 and 112 of the Iraqi constitution, in conjunction with Articles 2, 49, 109 and 110 (these broadly define the distribution of authority and responsibilities between the federal government and provincial authorities). In an effort to clarify the ambiguity in the constitution articles, independent and objective legal advice was sought from the Revenue Watch Institute, Joseph Bell of Hogan and Hartson LLP (2006) and Malik Dohan Al Hassan (a well-known Iraqi legal expert). They all interpreted the articles in the same way, and their conclusions were sent to the Ministry of Oil for adoption. Current fields were defined as actual producing fields, while discoveries were only to be defined as fields if they were judged by geologists to be capable of producing oil.

The revised draft of the oil and gas law, issued in February 2007, included four annexes which were not included in the 2006 draft. Annexes one and two identify oil and gas fields that are either known and producing, or discovered and ready for development. These are under the authority of the Iraq National Oil Company (INOC). Annexes three and four cover discovered fields that will be more challenging to develop and all undiscovered fields. These lie outside the authority of INOC. These annexes became another source of conflict with the KRG, as evidenced by Hawrami’s demand that some of the fields listed under annexes one or two be moved to annex three or four (Al Ghad, 2007).

As explained above, many of Iraq’s oil sector professionals have expressed dissatisfaction with the 2007 draft; 108 of them have urged Parliament to reject the draft law and its annexes until constitutional amendments have been agreed resolving the uncertainty over whether control rests with central or regional government and whether the provisions also cover future fields (MEES, 2007a).

***The Federal Oil and Gas Council (FOGC)***

The first draft of the oil and gas law established a new Iraqi Federal Oil and Gas Council (FOGC) with ultimate decision-making authority over the types of contracts that were to be employed. This council was to include, among others, “executive managers from important related petroleum companies”. This made it theoretically possible for foreign oil company executives to sit on the country’s key oil and gas decision-making body – an unprecedented move (Jarrar and Juhasz, 2007). Commenting on the possibility of foreign consultants sitting on the council, INTER2 (see appendix1) said that there is no reason why this should not happen – he added that one of the government’s consultants is English. Others, however, have questioned the wisdom of allowing foreign companies to have a presence on the board of an Iraqi agency, arguing that they may be biased in favour of their own companies and/or seek to influence the contracting process. Nationalists also point to past mistakes made by the IOCs in the days before the oil industry was taken into public ownership. They do not want foreign companies to play any part in developing Iraq’s oil and gas fields, let alone giving them a key role in the contracting process and oil and gas management.

The FOGC was established to facilitate agreement between the federal ministry and Iraq’s various provinces. It was to be a professional, non-political entity that could act as an arbitrator when necessary and advise the Ministry of Oil when its plans or policies needed to be modified. The professional team would be aided by an independent think tank or advisors. Representatives from the provinces and region, who would make up one third of the team, would be professionals with hands-on experience in the oil and gas industry. This would ensure uniformity of practice throughout the country and encourage participation among the region and provinces (Husari, 2011).

The February 2007 draft law enlarged the FOGC, overlapping it with the Oil Ministry. Zealdis (2009:63)argues that by drawing in so many new players, the February 2007 version increased the likelihood of intergovernmental battles: either born out of honest confusion regarding who has authority in what area, or arising from the natural tendency of intelligent and ambitious professionals to claim authority which is not rightfully theirs. Tariq Shafiq also had concerns about the 2007 draft’s proposal that the composition of the expanded FOGC should “take into consideration a fair representation of the basic components of Iraqi society." Fearing that selection would be based on sectarian and political affiliations, he asked: *"Should you qualify a member because he's a Shiite or a Sunni? Is that how we want to govern oil?"* He held to the view that candidates should be selected only on the basis of ability (Husari, 2011) – a view with which this author entirely agrees.

Mr Shafiq also observed that the 2007 draft shifted more power to "embryonic regions" despite the fact that these regions lack the expertise to develop their sectors without central government support or help from international oil companies (Lando, 2007). He criticised the draft for wanting to give regions the power to approve development plans for oil fields, arguing that this would make it impossible to achieve uniformity or establish national contractual standards (Husari, 2011). Mr Shafiq’s fears on this score are not unreasonable; as has already been discussed, the central government and the KRG already use different types of contract. If the south decides to award its own contracts, this may introduce a third type into the mix. However, it is less easy to agree with his view that regions should be denied power because they lack expertise. After all, if they do lack expertise, it is because they were not given the opportunity to be involved in strategic decision making under the previous regime. Allowing them to join the FOGC, where they can be trained and monitored by central government, is one way of helping them develop this expertise.

***Revenue management***

Iraq’s Sunnis, who reside mainly in regions lacking in major oil reserves, favour a hydrocarbon law that would give the central government greater managerial control over contracts and infrastructure development. They fear that otherwise, control of the revenues will fall entirely into the hands of the oil-rich regions (Beehner and Bruno, 2008). Article 11 of the 2007 draft oil and gas law does not specify how oil and gas revenues should be distributed. Instead, the article assigns the job of drafting a federal revenue law to the Council of Ministers. Knowing that the constitution articles are ambiguous on the question of revenue distribution, the drafters of the oil law may simply have wanted to avoid tackling such a contentious issue.

## 4.3.4 Kurdistan Oil and Gas Law No. 22 (2007)

According to its interpretation of the Iraqi constitution, the KRG believes it has the right to manage its own oil and gas and then share its revenues with all Iraq. Since the draft federal law does not provide for this, the KRG decided to create its own law (MEES, 2007b). Zealdis (2009) suggests that the KRG was mainly motivated by a desire to assert its autonomy and by continuing frustration at the inability of the central government to establish policies favourable to Kurdistan. Taking as its authority Article 115 of the constitution, which gives priority to regional law in the event of conflict between regional and federal governorates, the KRG rejected Baghdad’s draft oil law and promulgated the KRG Oil and Gas Law No. 22 (2007). However, in drafting its own oil and gas law, Kurdistan behaved like a devolved region; this law, and the contracts it signs with IOCs, are considered illegal by the central government.

Not surprisingly, government spokesman INTER3 argued that federal oil and gas law takes precedence over any regional law; however, he went on to say that as long as the Kurdistan regional law does not claim regional ownership of the resources (which would contravene the constitution), it will be tolerated. In other words, it appears that the Iraqi government can accept a regional hydrocarbon law as long as it holds to the principle of universal national ownership. The KRG gets around this by leaving the question of ownership ambiguous; Article 2 of the KRG Oil and Gas Law No. 22 (2007) states that ownership of oil and gas in the KRG follows the principle established by Article 111 of the permanent constitution (which, as discussed earlier, is open to interpretation).

Tariq Shafiq is less accepting of the law, however, calling it(2006:1):

“Politically incendiary, reflecting efforts by the Kurds to impose their own maximalist federal (or in this case confederal) interpretation of the new constitution on the country’s hydrocarbon sector; In that sense, the draft law is Kurdish nationalism dressed up as national petroleum legislation, designed to alter the balance of authority in favour of the regions, and leaving the KRG as a quasi-independent state”.

The KRG drafted its oil and gas law according to its interpretation of the constitution, particularly Articles 112 and 115. According to the KRG, these articles give the regional government the right to initiate contracts and negotiate with IOCs. Kurdistan’s contracts and licensing agreements, according to the fourth clause of Article 3 of the oil law, require the approval of the KRG Parliament only. The law asserts that full sovereign titles and management authority over petroleum resources within KRG boundaries rest locally (Shafiq, 2006), leaving open the possibility that the boundaries may in future be extended to include the disputed areas of Kirkuk, part of Mosul, Salah-al-Din and Diyala. It limits the central government to an administrative role – the exporting and marketing of oil and gas extracted from existing fields – in accordance with the KRG’s interpretation of Article 112 of the constitution. However, even this role was reduced in 2007 when the KRG started to export its own petroleum via its own pipelines (Khudhairi, 2007). Although the KRG accepts that the management of producing fields is shared with the central government, this exists only on the basis of a prior agreement between the two, with the former granting a licence to the latter to participate in upstream operations.

Current fields are defined as oilfields that have been producing more than 20,000 b/d since the enactment of the constitution on 22 August, 2005. As a result, minor and aging fields, plus discovered but undeveloped fields, which together account for around 60 out of the 80 fields in Iraq, will revert to the KRG and other regions and governorates (Shafiq, 2006:2).

Walid al Khudhairi, economic editor of *Al-Hayat* and Editor-in-Chief ofMEES, has also stated that the Kurdish law is based primarily on the KRG’s interpretation of Articles 112 and 115. According to the KRG, these articles give the regional government the right to initiate contracts and negotiate with IOCs, limiting the federal government’s role to exporting and marketing. However, in 2007, the KRG not only signed its own PSCs but started to export its own petroleum in its own pipelines. In other words, Kurdistan not only manages its own oil contracts but also controls its own exporting and marketing (Khudhairi, 2007).

## 4.4 Conclusions

The governance of Iraqi oil has changed in many ways since 2003. From being completely nationally owned, Iraq’s oil industry has now arrived at a point where IOCs play a major role.

American occupational rule may only have lasted for one year, but this was when the new oil industry took shape. Decisions made in this period had a profound influence on both Iraq and its oil industry, and Iraq is still living with their consequences. For the first time in its history, Iraq’s government was assembled from a range of ethnic and religious groups, but this only served to create civil war. The inability of Shiites, Sunnis and Kurds to reconcile their conflicting interests had a major impact on the writing of the permanent constitution and consequently, Iraq’s oil governance. The Kurds, who were the most organised, managed to achieve most of their objectives during the writing of the permanent constitution, but in the absence of a willingness to compromise, it was easier for the drafters to leave key articles open to interpretation. As a result, the central government and the KRG have interpreted these articles very differently.

During the CPA, it was decided that IOCs would become involved in Iraq’s oil governance, and PSCs were put forward as the preferred type of contract. This period also saw the writing of the TAL (Law of Administration for the State of Iraq), which was later to form the basis of the controversial permanent constitution. The writers of the TAL, under pressure from the different Iraqi parties and the US, were deliberately ambiguous on the question of who owns Iraq’s oil reserves, with the result that academics, industry experts and the Iraqi authorities have all interpreted it differently; while some see ownership as resting with all Iraqis, others see it as regional. Unfortunately, when this article was written into the permanent constitution, nothing was done to remove this ambiguity.

The criteria for distributing revenue among governorates and regions were first defined in the TAL and then extended to the permanent constitution. The first criterion was regional population, while the second was the degree of hardship suffered under the previous regime. The second criterion has been much debated, as no timescale was set for the compensation of these negatively affected areas (which, in any case, were not identified). To further complicate matters, many areas were damaged – some even more so than they were under Saddam – during the 2003 war.

The TAL was also the first Iraqi law to recognise the Arabisation of Kirkuk, which happened during the previous regime, and to suggest mechanisms to resolve the issue. It gave the Kurds administration rights not only over the provinces that currently make up Kurdistan (Irbil, Dohok and Sulymania) but also over the disputed areas of Kirkuk, Diyala and Nineveh. Oil governance was shaped in this way during this period primarily to guarantee the involvement of IOCs in Iraq, but the intention may also have been to reward the Kurds for helping the Americans during the 2003 war. As Chapter Three shows,almost all of the demands that Kurds have made since the birth of Iraq’s oil industry have been met since 2003.

Since the 2007 oil and gas law is still to be ratified by Parliament, the central government and the Kurds continue to refer to the permanent constitution of 2005 in their dispute over the governance of Iraqi oil. The constitution’s articles are ambiguous, especially in the parts that deal with the division of power and control between the federal and regional governments. While the central government interprets the constitution as stating that management of the oil industry should be entirely in its hands, the KRG interprets it as stating that the central government only has a role to play post-production, at the marketing stage, and even then, this role is shared with the regional government. The oil and gas law was intended to clarify these issues; ironically, it is being held up in Parliament by the very ambiguity it was meant to resolve.

There have been several major disputes over the draft oil and gas law. The central debate is whether the oil fields should be controlled by the central government through INOC or by regional governments – the first draft of the oil and gas law put most of Iraqi’s fields under the management of INOC, arousing the anger of the Kurds. The second point of contention was the proposal, made in the 2006 draft, that INOC should use production-sharing contracts in its dealings with IOCs. From a political point of view, Iraqis do not like this type of contract as they consider it too lucrative for the IOCs; they prefer service contracts. In the event, the central government has signed a number of contracts with IOCs following bidding rounds (discussed in Chapter Seven). These are production and exploration contracts, though the government calls them service contracts. Kurdistan, on the other hand, has signed a number of production-sharing contracts with IOCs.

When the first draft of the oil and gas law proposed the formation of an oil and gas council, controversy arose over the fact that this important council could have IOCs or foreign consultants on its board. Subsequent drafts extended the membership of the council to represent the different ethnic and regional groups in Iraq, imitating the way that government members are selected.

Finally, there has been continuing division on the question of how revenues from the oil industry should be distributed. The Sunnis, who do have not much oil, prefer centralised control over the oil industry as they fear that otherwise, oil revenues will stay in the producing regions. On the other side, the resource-rich regions (mainly Shia and Kurdistan) want to hold on to their lion’s share of oil revenues. There is also the question of what should happen to revenues generated by future fields. One author has already advised the KRG that the regulations governing the redistribution of oil and gas revenues only apply to present fields; it is for producing regional governments to decide how to distribute revenues from any new fields in their region.

The Kurds currently enjoy devolved oil governance: they have their own oil and gas, which they consider to be legally theirs according to their interpretation of the constitution. They have signed PSC contracts with IOCs, which differ from the central government’s production and exploration contracts or, as the government terms them, service contracts. The KRG manages all the technical issues regarding oil and gas development in Kurdistan. It also exports oil and gas, although this activity is considered illegal by the federal government and has given rise to disputes over revenues.

## Chapter Five: The Concepts and Principles of Oil Governance

## 5.1 Introduction

This chapter analyses the issues which inform the structures of Oil Governance. These are revealed in the relationships between the following key concepts and issues: sovereignty over mineral resources, private versus public ownership, terms of access to natural resources and revenues, the concept of mineral rent and its different forms, the evolution of petroleum fiscal regimes and the role of state oil companies. The chapter aims to explore these ideas and establish a theoretical framework for understanding different forms of oil governance. These ideas will assist this study in evaluating Iraq’s old and new oil governance and reconstructing it in the most suitable way.

The chapter is divided into seven sections. Each part explores an issue of oil governance. Section 5.2 discusses sovereignty over mineral resources in general and explores the key issue of ownership rights: who is the owner of the subsurface minerals and what rights are conferred by this ownership? These questions are answered by means of a typology based on some of the modern literature on mineral sovereignty and some historical examples.

The two ‘modern’ types of private and public mineral ownership are discussed in more detail in section 5.3 by examining theterms of access to the mineral resource in each system. In doing so the concept of ‘public ownership’ of mineral resources is expanded by introducing the concepts of proprietorial and non-proprietorial governance used by the Venezuelan economist, Bernard Mommer (Mommer, 2002). The economic concept of ‘mineral rent’ is introduced in section 5.4 and two basic forms of mineral rent are differentiated. In section 5.5, we examine specific forms of mineral rent as they occur in the oil industry and the contractual relationships embodied in petroleum fiscal regimes. We also present a classification of different types of petroleum fiscal regime.

In section 5.6 the emergence of state oil companies is described and their increasingly dominant position in the world oil industry. The manner in which they interact with private sector oil companies, especially those from foreign countries, is also examined.

## 5.2 Sovereignty Over and Ownership of Mineral Resources

Oil is a non-renewable resource. It is unlike other natural resources such as plants that we can grow. It is exhaustible – continued extraction of oil will lead eventually to its depletion. This means that states are likely to take a sovereign interest in it because depletion raises issues of control – is it wise to allow private companies to decide the rate at which the mineral is depleted or should the state, representing the wider society, make this decision? Secondly, because oil is found in the subsurface, the issue of ownership is also posed: does the owner of the surface (the landowner) own the resources below the surface? Or should these automatically belong to the state on behalf of its constituent population? How have perceptions of these issues developed? The following simple typology can assist us in clarifying these issues (table 5.1).

**Table5.1: Patterns of Sub-surface Mineral Ownership**

|  |  |  |
| --- | --- | --- |
| **TYPE OF GOVERNANCE** | **“PRE-MODERN”** | **“MODERN”** |
| Sub-surface minerals owned by surface landowner | Example: Cornish Tin & Copper mining, 16th-19th centuries | Example: USA Oil Industry (except Federal & State Lands), 19th-21st centuries |
| Sub-surface minerals owned by the State | Example: Spanish & Portuguese Colonial Gold & Silver Mining, 16th-19th centuries | French Republic, late 18th & 19th centuries, and  Former Colonial & Semi-Colonial States (e.g. Middle East) 20th & 21st centuries. |

## 5.2.1. Pre-modern mineral ownership under private governance

For many centuries the County of Cornwall in the UK had a flourishing copper and tin mining industry based on the deep-mining of the mineralised lodes (See Earl, 1968). There was also a similar industry in the adjacent county of Devon. There were three groups of individuals involved in the industry – the landowners, the *adventurers* (an early form of capitalist enterprise) and the mine workers. (Here we are only concerned with the first two groups.)

The grant for working a mine was called a *set*. As described by Taylor (1837) the owner of the land, in this case an aristocrat (a Lord)*,* was alsothe owner of the sub-surface minerals and granted a lease for twenty-one years to the individuals who operated the mines (the *adventurers*), having power of termination if the mine should not be adequately worked. As the owner of the subsurface minerals, the Lord received a certain proportion of the ore or its value in money (Taylor, 1837: 17). The proportion of ore paid to the landowner, was called the *lord’s dues*, and varied considerably depending on the circumstances of different mines, and the nature of the prospects under which they might be undertaken.

In the very deep, high cost mines – less profit and greater risk – the lord’s dues did not often exceed a fifteenth or eighteenth part of the ore (or its value), and sometimes not more than a twenty-fourth or even a thirty-second proportion. In some of the newer mines where the geology was easier and the cost was lower the dues were often as much as a tenth or twelfth part of the produce, and there were some mines which paid an eighth (Taylor, 1837:17).The dues were delivered to the lord, or to his agent, free of all expenses. Thus, the landowner risked nothing – only a little damage to the surface of his fields, which would be considered insignificant if the mine were unsuccessful (Ibid, 1837:18).

Lemon (1838) also provided some data on the size of the *Lords Dues*. He analysed the accounts of two Cornish mines – Consolidated Mines and Fowey Consols for the year 1836. He calculated that the *Lords Dues*, as a percentage of the total value of the ore extracted and sold were 4.3 percent and 5.6 percent respectively (Lemon, 1838: 68). Although these Lords Dues, and some of those referred to by Taylor, appear to be quite small, it is interesting to note that Taylor thought that the manner in which they were calculated – as a percentage of the value of the output, (which Taylor calls the ‘Gross Produce’) rather than the net profit – was a disincentive to the *adventurers*.

“The mode of levying the dues on the gross produce of a mine tends to discourage enterprise, where considerable expense is incurred by the adventurers without an immediate return. It seems reasonable that the landowners should contribute something in favour of that exertion which so often leads to their great advantage. If an equitable mode of assessing the dues in some proportion to the net profit could be devised and was liberally and fairly acted upon, it would probably tend more than anything else to the encouragement of mining.” (Taylor, 1837:18)

This is an argument which has been used on many occasions by oil companies against the use of a similar system by the Modern State as a means of charging for the extraction of a depletable natural resource. Today this system of charging a percentage of the value of the oil produced is called *Royalties.* However, as we shall see, there are also some good arguments in favour of Royalties from the point of view of the State.

## 5.2.2. Modern mineral ownership under private governance

One example of this form of governance is in the U.S. The surface landowners also own the natural resources below the surface (Dam, 1970:3). The property owner has the freedom to sell, lease, and gift these rights to others (Scott, 2008). In the USA about 75 percent of oil and gas extracted onshore in the Lower 48 states (the onshore oil producing states excluding Alaska) is from reserves which are privately owned. There are about 4.5 million private landowners possessing subsurface oil reserves who receive payment in the form of a royalty. Data on the total value of these royalties is scarce but in 1997 total private royalty payments amounted to around $US 6.15 billion (about $US 8billion in today’s money) (Rutledge, 2003:5).

The first successful oil lease in 1859 set up a fixed royalty of $4.20 per barrel (Mommer, 2002:49). In the first year, Oil prices varied substantially between twenty dollars and ten cents a barrel. Thus, percentage *Royalty* rates varied accordingly. During the following ten years 50 per cent was the usual royalty rate, and even at that rate the production of oil was profitable (Mommer, 1997: 44). However, the introduction of long-distance pipelines in 1879 brought transport costs down compared to their previous level. Hence competition between landlords increased, and the usual royalty rate decreased to one eighth (12.5 percent of revenue) (Ibid, 2002). This rate became generally accepted and today is the most common percentage royalty rate although in some regions (e.g. parts of Texas) the royalty rate can be as high as 20 percent.

However, today, in the United States most new petroleum resources are found on public lands and waters – on the vast tracts of land owned by the federal government or by states such as Alaska (Dam, 1970:3) and in particular in the deep waters of the Gulf of Mexico Thereby, the government manages the development and exploitation of natural resources by leasing to oil companies and receives royalties in return. Thus, although the state owns the sub-surface minerals, in this case, the traditional form of charging for the depletable resource (Royalties*)* is the same as on the privately owned lands.

## 5.2.3. Pre-modern mineral governance under State ownership

Before the advent of republican and/or democratic governments in European countries and their colonies the sub-surface minerals were owned by the State: but in this case the State was the Monarch. For example, in Spain and Portugal during the 16th to early 20th centuries all sub-surface minerals belonged to the King and this was the system also imposed in the colonies which these countries acquired in Latin America. Thus the rich silver mines of Potosi (in modern day Bolivia) and at Real del Monte (in modern day Mexico) were granted to rich Spaniards by the royal government in Spain but in return, they had to pay a Royalty to the King of Spain which was usually one fifth of the value of the silver extracted from the mines. The same royal ownership of the sub-surface mineral existed in the Portuguese colony of Brazil and when Brazil became a major gold producer during the 18th century the miners had to pay the same Royalty rate of one fifth (Eakin, 1985:12)

## 5.2.4. Modern mineral governance under State ownership

The advent of Republican government in late 18th century France meant the transfer of sub-surface mineral ownership from the Monarch to ‘the People’. According to the French Mineral Law of 1791 devised by Mirabeau, minerals are a gift of nature, and because of their natural origins they belong to the community as a whole – there was no reason to allow a particular individual (i.e. the King) or a group of individuals to benefit from them exclusively (Montel, 1970: 104). These natural, free gifted and valuable resources were now in “public ownership”. However, this did not mean the same as “state ownership” but only the opposite of private property (Mommer, 1994: 3). The French law of 1791, which is to this day the basis of French law of mineral property, specified that ownership of minerals should not be given to the state; the state only acts as administrator of the resources and these cannot be exploited without its consent and then only under its supervision; and since the government does not own the minerals it does not charge a royalty when it leases a mineral property to a private company.

Why was no royalty charged? Mommer suggests the following answer (n.b. in this quotation instead of ‘royalty’ he refers to ‘ground rent’ and ‘special taxes’ but it means the same thing).

“Mirabeau never discussed explicitly the question of ground rent. But he had in mind the development of France: French companies, and French consumers. Under these circumstances – a ‘closed economy’ so to speak – special taxes on mining do not add to national income, though they affect, of course, the national distribution of income.” (Mommer, 2002: 88)

So, because the mining sector of the economy was thought of as a purely domestic industry whose only beneficiaries were French citizens, there would be no need for a royalty payment. In other words, the fundamental role of the republican state in the mineral sector was simply to encourage the production of minerals. “There is no other purpose or motive for eminent domain rights to prevail but the working of the minerals” (Mirabeau 1792: 441).

However, the situation changes dramatically when the mineral industry is no longer a purely domestic one – that is, where the mining or Oil Company is a foreign concern. This was the situation faced by the emerging new nations in the period when European colonialism and imperialism were in decline. The newly independent countries, e.g. Iraq, Algeria, Kuwait, and Nigeria, and those which had previously been under a kind of semi-colonial rule, e.g. Persia (Iran) and Venezuela, were confronted by oil companies which they did not own but were owned and controlled by citizens of the former colonial and imperialist powers.

Initially these new states granted *Concessions* to the foreign oil companies for very long periods and with fairly low royalty rates and taxes (Mikdashi, 1966). However, by the 1960s the belief in full state ownership of sub-surface minerals became dominant as is reflected in the United Nations (UN) Resolution on “permanent sovereignty” over mineral resources - Resolution 1803 (XVII) of 14 December 1962.

“The right of peoples and nations to permanent sovereignty over their natural wealth and resources must be exercised in the interest of their national development and of the well-being of the people of the State concerned”. “The exploration, development and disposition of such resources, as well as the import of the foreign capital required for these purposes, should be in conformity with the rules and conditions which the peoples and nations freely consider to be necessary or desirable with regard to the authorization, restriction or prohibition of such activities.”

This was the ideological and legal basis of the wave of nationalisations of foreign oil companies which took place during the 1970s (See Sampson, 1975: 283-318; Yergin, 199: 633-698; Rutledge, 2005: 42-46). All countries in the world today, except very few such as the United States where private ownership still has a substantial presence, exercise sovereign rights over the subsurface to manage and distribute the revenues of these. In practice this means that state ownership of the sub-surface minerals – the most important of which is oil – is exercised either by means of a national oil company (NOC), or allowing private sector operators access to national resources, but at the same time charging them for the extraction and depletion of the resource in the form or royalties, taxes or some other form of petroleum fiscal regime.(See Figure 5.1 ).

**Figure 5.1: The Basic Structure of Governance in a modern oil or mineral producing country.**

Own

Terms of Access

(Fiscal Regimes)

Control Resources

**1.3 Private and Public Governance in the Oil Industry**

We now consider in more detail the terms of access in the oil industry, under modern private governance (i.e. the USA) and modern public/state governance What, if any, are the significant differences between these two forms of governance? Or is the private-public distinction less important than the differences within the different types of public governance?

## 5.3.1 Private Ownership of oil reserves (the USA)

In the USA, the oil industry gains access to the natural resource by lease contracts. In this case the relationship between the surface landowner and the oil company is comparable to that between a landowner and a tenant in the agricultural sector and it will be useful to continue to use this metaphor. This also means that it will be convenient to refer to things like royalties and taxes as ‘Rent’’, although we shall examine this concept in more detail later.

In the USA the landowner receives a *bonus* on signing the contract and shares in the benefits (through royalties) in the case of success. The amount of the bonus depends on expectations and probabilities; the leases are signed only if both negotiating parties are satisfied with the expected utilities – bonuses and royalties (on the part of the landowner) and profits (on the part of the tenant). In particular, landlords and tenants will not sign a lease unless the expected utilities are greater than or equal to, certain positive minima, known as “reservation utilities” in the literature on the theory of principal and agent (Mommer, 1997:3; Adelman, 1972: 72). The tenant’s reservation utility (minimum profit) is defined by the profits that they would make elsewhere with the same effort and risk (referred to in economics as the ‘opportunity cost’).However, profit is never mentioned in the oil lease contract; it is a residual after all costs are deducted and after the payment of the ground rent (i.e. royalty) (Mommer, 1997:4).

The lease period is divided into a primary period to explore for the oil or gas, followed by a secondary period of development and production if exploration is successful (Mommer, 2002:12). If exploratory drilling does not commence within one year of signing the lease agreement, the company must pay a ‘delay rental’ to the landowner, a process which is repeated for each year of delay until the end of the primary term. If no oil is found by that time, the lease ends with the termination of the primary term.

The state government may also charge a “severance tax” (typically about 3%) which is also levied on the gross revenue per barrel extracted. This is equivalent to an additional royalty. Finally, the company must pay the general federal corporation tax on company profits just like any other company.

Tenant companies are usually interested in acquiring new leases, even if their proven reserves are more than sufficient. Companies want to maximize profits, so naturally they will always be looking for more opportunities to make profit. The reason is that depletion may entail rising cost but not necessarily prices, because the development of productivity, new technologies, and the accumulation of geological knowledge act as compensatory forces; and new geological data derive from exploring new lands, not only from existing lands. “Exploration is needed to prevent an otherwise inevitable rise in developing-operating costs” (Adelman 1972: 74). Although this reason is a true fact, but companies would try to explore even if it weren’t true, in order to maximize profits.

## 5.3.2 Public Ownership of Oil Reserves

Under the modern form of state mineral ownership the state creates an oil ministry, or some other form of licensing agency which exercises the powers delegated to it. In this context should the ministry allow access to foreign oil companies but also act as a private landlord charging royalties and taxes?Or should it take ownership of the whole industry and control all the revenue flows via a National Oil Company? Or should it consider the natural resources as a free gift of nature to producers and consumers and act merely as administrator, as under the French Republican Law of 1791. In fact these three possibilities are not strict alternatives but in reality are usually found in some form of combination. What is therefore important is the relative weight of each element in the combination. To answer these questions Mommer introduces two further definitions of oil governance.

**5.3.3 Non-proprietorial and proprietorial Governance**

Obviously, once public mineral ownership is established in the country, then private vs. public mineral governance is no longer an issue: instead, according to Mommer, the issue becomes Non-proprietorial vs. Proprietorial governance, although here again, these are not strict alternatives but points on a continuum (Figure 5.2).

**Figure 5.2: Non-proprietorial and Proprietorial State Governance in Oil Industries**

Completely Completely

Non-Proprietorial Proprietorial

French Mineral ‘Liberal’ Fiscal Regime ‘Non-Liberal’ National

Law 1791 Fiscal Oil Companies

Regime Only

EXAMPLES

France (1791) United Kingdom Libya, Saudi Arabia

## 5.3.3.1. Non-Proprietorial Governance

As we have already seen, this system involves the concept of minerals being a free gift of nature with no concern for who in particular benefits from them. At the point on the extreme left of the continuum in Figure 5.2, there is no royalty or rent in this regime. The state landlord’s aim of allowing free access to the mineral is simply to attract tenants to invest, to benefit the private investor and the consumer of natural resource and at the same time to develop marginal resources that could exist on state lands or waters (Moose, 1982: 57).

The central criterion of this system is to guarantee the profitability of investment (Mommer, 2002:90). Where at least some royalties and taxes are charged (i.e. in the ‘Liberal’ Fiscal Regime in Figure 5.2) the fiscal regime emphasises taxes which only target profits, which means that government revenues may only come after years of extraction or in the event of weak prices, never ( Mommer, 2002). The Fiscal regime is typically based on some form of excess profit taxation, such as the Petroleum Revenue Tax (PRT) in Great Britain or the Resource Rent Tax (RRT) in Australia. Excess profit taxation requires a benchmark for “normal” profits. This, for example, can be an average profit rate over a given number of years. However, as Mommer points out,

‘It is not unreasonable to expect high excess profit tax rates to suffer the same fate as high income tax rates and to settle, in the long run, at relatively modest effective levels” (Mommer, 2002: 94).

In addition, a Non-proprietorial regime tends to accelerate production and therefore it has a smaller reserve to production ratio. Hence, this system is better than the Proprietorial type for consumers in the short-term, as it maintains higher supply and therefore results in lower prices.

Access to the sub-surface mineral in this system is through a licensing agency, which regulates the process of granting licences to tenants according to certain conditions set by the agency itself (Mommer, 2002:49). This can be through investment-related bidding parameters such as the length of seismic lines to be shot, the number and the depth of wells to be drilled, or simply the total amount to be invested in the primary period (exploration). But this may affect the investment programs. One alternative is *bonus bidding* where the companies offer competing bids for a lease in a closed-bid auction, the highest bidder winning access to the oil reserves. This system has been used, in combination with royalties, in the USA offshore oil industry.

## 5.3.3.2 Proprietorial Governance:

At the points to the right of the centre of the continuum in Figure 5.2 the proprietorial regime prioritises the interests of the owner of the resources (the state). The owners of the resources decide on development and aim to extract maximum rent and do not allow access to their land without an appropriate payment. Typically, this system encourages a larger reserve to production ratio. Mommer (2002:96) accepts that a fixed royalty increases operating cost and that this might pressurise oil companies to restrict their production. As a result there would be a higher price for the international consumer. In other words this system takes a long-term perspective, preferring higher prices and a lower level of production.

However, state ownership of sub-surface minerals does not necessarily imply a proprietorial form of governance. The social return to ownership of the resource depends not on the fact of ownership itself, but on the arguments used to extract a return and the way these arguments are put into practice. In other words, the return to ownership of natural resources depends on the *financial terms of access* to reserves, which are more important than the question of private/public ownership.

Even if the landlord is a state which claims sovereignty over a country’s sub-surface resources, this does not guarantee that this state’s return will automatically be maximised. A state which is the direct proprietor of its natural resources may, at one extreme, hand out extremely cheap concessions to foreign companies or, at the other extreme, construct a fiscal regime which maximises its return from ownership. For example, the former case often has been the pattern in the UK oil industry (See Rutledge & Wright, 1998, Boué and Wright, 2011).

## 5.4 The concept of Mineral Rent

## 5.4.1 Ricardian or Differential Rent

The concept of mineral rent was based on agricultural rent theories. David Ricardo (1772-1823), a British economist writing in the early 19th century, defined rent as “the difference between the produce obtained by the employment of two equal quantities of capital and labour”. He also added “if all land had the same properties, if it were unlimited in quantity, no charge could be made for its use, unless where it possessed peculiar advantages of situation” (Ricardo, 1821: 5). Ricardo is arguing that land differs in quality; in order for investors (Ricardo here was thinking of tenant farmers cultivating the land for profit) to get access to the most fertile and potentially most productive, they should expect to pay a higher rent than for poorer land. This is called differential or Ricardian rent. Ricardo’s theory implies that on the poorest land no rent is charged. There is ‘no-rent land’ and all rent is ‘differential rent’.

There is another important aspect of Ricardo’s theory of rent. Ricardo believed that, from the perspective of the agricultural economy as a whole, the amount of rent received by the landlords depended entirely on the price of the agricultural produce which was determined in a competitive market of supply and demand. In other words, using economics terminology, ‘Rent is price-determined – not price-determining’; i.e. the landlords couldn’t increase the price of agricultural produce by increasing their rents. For Ricardo, rent is not part of the cost of production but is the surplus of income which is left-over once production has reached a level where cost (including ‘normal’ profit) per unit = market price.

**Figure 5.3: Differential or Ricardian Rent in Agriculture**

Current Price of Agricultural produce

Cost and Price of agricultural produce per tonne

Payments to Capital and Labour

Potential Differential Rent

Diminishing quality of land and higher production cost per tonne

**Figure 5.4: Differential or Ricardian Rent in an Oil Economy**

Current oil price

Cost and price per Barrel

$US

Oil Fields

No.1 No.2 No.3 No.4 No.5 No.6 No.7 No.8 No.9 No.10

500MB 5000MB

Diminishing quality of oil and gas reserves and

higher total production cost per barrel

Key:





Operating cost per Barrel

Capital Cost per Barrel

Differential Rent (Surplus over Costs) per Barrel

The diagram above shows ten oilfields. Each field is producing 500 million barrels per year. In order to simplify the idea all the ten fields have the same operating costs but have increasingly high capital costs, reflecting the point that as we move from left to right the reserves are of diminishing ‘quality’ (e.g., at greater depths, more complex geology, if offshore - deeper water). Because they are of diminishing quality, greater capital investment is required to extract each barrel. In this model the capital cost (rate of interest) is included. This is because if the investment in the oilfield is not expected to make this rate of profit the investment will not happen.

At the current oil price all the oil fields except for No. 10 make an extra profit over the sum of capital and operating costs (differential rent). Oil field No. 10 just breaks even (which means it just makes the average rate of profit, and no more). In economic terminology this is the marginal oilfield, while all the others are intra marginal.

In this model there is no ground rent (royalty) – only the differential rent is available as income so the landlord state must try to implement a system of taxation which enables it, rather than the company, to acquire this income. In theory the state should be able to acquire all the differential rent, as long as it does not force the company’s income per barrel below the break-even point where the price just covers all the costs (including the average rate of profit). In practice, however, this is rarely the case. Indeed, the state will be lucky to get as much as half the differential rent per barrel since the type of tax applied will have to be super-profits tax of some kind

If there is no ground rent (royalty), then from the diagram it would appear that the oil region with the least favourable reserve – and therefore the highest production cost per barrel – is allowing the oil company to operate without receiving any tax payment at all.

Karl Marx (1818-1883) accepted Ricardo’s concept of differential rent but argued that it was an insufficient explanation because it seems to imply that there is some agricultural land just at the margin of profitability (for the farmer) which does not yield any rent to the landlord. In Das Capital Vol. III, Marx states,

“Thus, assuming the demand requires that new land be taken under cultivation whose soil, let us say, is less fertile than that hitherto cultivated – will the landlord lease it for nothing just because the market price of the product of the land has risen sufficiently to return to the farmer the price of production [Marx means the cost of production plus minimum required profit] and thereby the usual profit on his investment in this land? By no means” (Marx, 1966, p.757, my additions in parentheses)

And he continues, from the landlord’s point of view,

“The investment of capital must yield him a rent. He does not lease his land until he can be paid lease money [rent] for it. Therefore the market-price must rise to a point above the price of production … so that rent can be paid to the landlord” (Marx, 1966, p.757).

Marx called this type of rent ‘Absolute Rent’, i.e. the rent which the landlord charges the tenant on even the worst quality land which he owns. Thus we can see that Marx agreed with Ricardo about the existence of ‘differential rent’ but differed from Ricardo on two points: (1) There is no such thing as ‘no rent’ land – access to all privately owned land is charged a rent regardless of its fertility (Absolute Rent); (2) Unlike differential rent, ‘Absolute’ rent is price-determining, i.e. it adds to the cost of production and hence the market price which is paid by the consumer. These modifications of Ricardo’s theory by Marx are relevant to the question of ‘Mineral’ Rent to which we now turn.

From the late 19th to the early 20th century an important debate took place about the role of ‘royalties’ in the British coal industry. As in the tin and copper mines of Cornwall and Devon, in the coal-producing regions, the sub-surface mineral was owned by the landowner, who charged the capitalist mining company (the tenant) a sum of money called a ‘royalty’. In practice the forms taken by royalty were many and varied but in its simplest form it was a fixed sum of money charged for every tonne of coal extracted by the company.

The coal companies and some economists complained that one of the problems of the royalty system was that the royalty was an increase in cost of production for the mine owners which was passed on to the consumers, and this could make British coal less economical in the world market – Britain might lose its market share.

Other economists believed that the royalty was just another kind of rent (i.e. differential/Ricardian rent) – and therefore couldn’t affect the market price.

In reply, the English economist Alfred Marshall (1842-1924) identified an important difference between rent in agriculture and mineral rent in extractive industries – in the mineral industries the raw material is depleted as production takes place whereas in agriculture the land (provided it is properly cultivated) exists for eternity.

Marshall wrote,

“A royalty is not a rent, though often so-called. For except when mines, quarries etc., are practically inexhaustible, the excess of their income over their direct outgoings [costs] has to be regarded, in part at least, as the price got by the sale of stored-up goods – stored up by nature indeed, but now treated as private property; and therefore, the marginal supply price of minerals [the cost of the mineral in the most high cost mine in operation] includes a royalty in addition to the marginal expenses of working the mine. …the royalty itself on a ton of coal, when accurately adjusted, represents the diminution in the value of the mine, regarded as a source of wealth in the future, which is caused by taking the ton out of nature’s store house” (Marshall, 1959, p.364).

So although Marshall was dealing with an extractive industry while Marx was still thinking of an agricultural industry, both of them thought there were two categories of ‘rent’ (broadly defined). For Marshall the two categories were ‘royalty’ and what he simply called ‘rent’ (meaning differential rent); for Marx the two categories were ‘Absolute Rent’ and ‘Differential Rent’.

Marx tried to explain the economic origins of ‘Absolute Rent’ by an extension of his Labour Theory of Value, but it is generally agreed that he was unsuccessful. Marshall, as the above quotation illustrates, believed that the owner of the sub-surface minerals required compensation for the reduction of his depleting resource and the mineral rent – however it was charged – would therefore contain two elements: part of it would be the ‘compensation for depletion’, a kind of depreciation charge which would vary directly with extraction (e.g. a charge per barrel of oil), and the other part would be the differential rent which would arise where the mineral deposit could be worked at lower cost than in the most marginal mine. In the economic literature, this first element of the mineral rent continued to be called the Royalty (however it was calculated) while the second element was just called the Rent. In short,

MINERAL RENT = ROYALTY + (differential) RENT.

With the dramatic changes which took place in the World oil industry during the 1970s and the nationalisation of foreign oil companies and the creation of OPEC, most western oil economists and other experts have chosen to define mineral rent in the oil industry simply as ‘super-profit’. For example, according to Johnston, oil rent is,” The difference between the value of production and the costs to extract it. These costs consist of normal development and operating costs as well as an appropriate share of profit for the petroleum industry. Rent is the surplus. Economic rent is synonymous with excess profit” (Johnston, 1994, p.6)

Furthermore, this ‘excess profit’ is usually attributed to the monopoly power of the OPEC ‘Cartel’ which has increased the market price to levels substantially higher than the total cost of production. This is the view, for example, of the U.S. oil economist, Morris Adelman, (See for example, Adelman, 1995, 1991, 1990).

However, most oil producing countries favour the ‘depletion’ argument, arguing that a price higher than production cost (including normal profit) is necessary to compensate the country for the gradual disappearance of its natural resource and that the high price of oil reflects, at least in part, the fact that the price incorporates a ‘scarcity rent’ (this phrase is now more currently used than ‘royalty’).

Mommer (2002) follows Marx and Marshall in arguing that Mineral Rent consists of two elements: Royalty + Differential Rent.

**Figure 5.5: The Impact of Imposing a Royalty**

Cost and

Oil price after production fall

Price per

Barrel $US

Current Oil price

Loss

**B-Royalty**

Capital and

Fall in Output

2

Operating cost

1

Per barrel

Oil No.1 No.2 No.3 No.4 No.5 No.6 No.7 No.8 No.9 No.10

Regions

Diminishing quality of oil and gas reserves

and higher production cost per barrel

The area (A) in the diagram shows the capital and operating cost per barrel in different oilfields in one country or different regions. The line number 1 represents the minimum payment to the landlord (signature bonuses and surface rental); the area (b) between lines 1 and 2 represents the customary ground rent (royalty) or ground rent after the imposition of the royalty, the break-even level of production falls, as shown by the arrow. However, reduced output can cause an increase in price and the price increase can make it profitable to restore the production level.

After the royalty is added, the oil fields with higher costs per barrel, the two oil fields furthest to the right in the diagram, become un-profitable for the company since cost per barrel would exceed the price per barrel in these two oil fields. As a result total production declines as these oilfields are neglected by companies and the state loses because there is a loss in differential rent. However, the fall in production would be expected to result in the price increasing according to the usual laws of supply and demand, leading to the equilibrium decline in supply being smaller than illustrated.

## 5.4.2 Customary Ground Rent:

Mommer (2002) avoids explicitly identifying the first element of Mineral Rent “Royalty” with Marshall’s idea of a depletion charge. He sees this first element of the mineral rent as being determined by social factors rather than by any economic rationale. He therefore refers to this first element (absolute rent, royalty) as the “customary ground rent”. In some places in his 2002 book he suggests that it is the equivalent of Marx’s “Absolute Rent”.

He identifies it as the minimum charge per barrel levied by a landlord (state or private) below which the landlord will not lease his land to an oil company. Although he avoids identifying it with Marshall’s idea of a depletion or depreciation charge, this definition of rent has a particularly intuitive appeal in mineral industries because the source for which the rent to be charged is certainly a depleting resource and clearly it is not sensible to allow its removal without requiring some minimum charge. This is regardless of how plentiful the resource is currently. The amount of ground rent is explicitly identified in the contract.

In addition to a royalty-type payment, the customary ground rent – particularly in its US form – consists of a signature bonus and a normal surface rental payment. In U.S private leases it is taken in two terms; the primary term (exploration period), it consists of signature bonuses and surface rental. The second term (production period) still comprises surface rental and also a royalty. Fixed and percentage royalty correlate directly with volume. Thus the bigger the discovery, the more the landlords get in royalties over the years. The landlord and the tenants share the risk regarding the volume. The landlords have the rights to monitor their mineral deposit and demand proper treatment to prevent the deposit from over-exploitation (Mommer, 2002: p13-14).

With percentage royalties, landlords also participate in the price risk, thus, they need to monitor prices, and they usually can take their royalties in kind. The advantage of percentage royalties is evident in the long-term contracts as they are inflation-proof. The disadvantage is the cost of monitoring prices; however, this can be reduced through market advancement and transparency.

Having established that, in theory, the Mineral Rent is composed of two parts, from the perspective of governance there are two implications for a country which is richly endowed with a valuable natural resource:

Where the State is the ‘landlord’, i.e. in the modern world, (except the USA) the State should seek to maximise its share of the Mineral Rent in the interests of the whole population. Where foreign oil companies are contracted to extract the oil, the State will do this through a ‘proprietorial’ petroleum fiscal regime

## 5.5 Different methods of charging for mineral rent – Petroleum Fiscal Regimes

After discussing the theory of mineral rent, the questions now are: what are the instruments for capturing them? What are the advantages and disadvantages of these instruments? Which one generates more revenues for the government and targets the excess profits of these resources? How does the government maintain a tough fiscal system and not discourage investment? What is the effect of the instrument on oil and gas production? Does the chosen system discourage exploration, development and production, especially of the marginal fields?

A high level of total oil revenues can be the mutual objective of the host government and the investor (Tordo, 2007: 13). At the same time the government would want the maximum share of the revenue. Tordo, (2007:13) argues that “the host governments want to gain the maximum value (not oil volume) for their countries over time in terms of net receipts for wealth. Their goal is to increase their income from natural resources, and at the same time attract foreign investment”. He adds that “host governments also have socioeconomic objectives, such as: job creation, transfer of technology, and development of local infrastructure”. On the other hand, the investor aims to maximise returns by exploring and producing oil and gas fields at the lowest cost and highest possible profit margin, which is consistent with the risk of the project.

Johnston (1994:21) identifies two basic petroleum fiscal arrangements: Concessionary and Contractual. The latter is divided into a number of different types of which the most common are: (1) Production Sharing Contracts (PSCs); and (2) Service Contracts. The fundamental difference between the concessionary and contractual arrangement is the attitude towards ownership. The concessionary system, as the term implies, allows private ownership of mineral resources, while under the contractual system the government holds the ownership of minerals. Johnston (2007:56) argues that while concessionary and contractual systems can be differentiated from a mechanical and financial view, there may be particular differences between them. When we examine specific fiscal systems, there are more systems in the world than there are countries. In some countries more than one fiscal system is used during the transition period when they are applying new terms. Other countries offer two types of fiscal options concessionary system and also service or production contracts. Peru used to have that system (Johnston, 1994: 5). Others have a hybrid form which is a combination of the other basic systems, e.g. USA, Shallow water Outer Continental Shelf – Bonus Bidding combined with Royalty.

We shall now examine some of these different petroleum fiscal regimes in more detail.

**5.5.1 Royalty:** royalty has been historically the most popular method of extracting rent used by governments (Tordo, 2007). It is usually a per-barrel charge levied as a proportion of the per-barrel gross revenue. It can be paid in cash or in kind. Royalty is the first percentage taken from the gross revenue; it is usually tax-deductible as it represents “the cost of doing business”. Royalties are the same under most of the fiscal systems. Some systems have a netback[[29]](#footnote-28) of transportation costs which is related to transporting the hydrocarbon from the point of assessing royalty measurement to the point of sale (Johnston, 1994:53). Although modern royalty systems are usually “proportional”, i.e. a percentage of the price, historically they have often been fixed, e.g. 4 shillings (gold) per barrel.

Royalties are attractive for governments because they ensure upfront government revenues as soon as production starts. They are attached to production or sales so they can be easily estimated, calculated collected and monitored (Tordo, 2007). The royalty scale generally ranges from 1% to 20% but some countries, e.g. Venezuela, use higher rates.

Sometimes a sliding scale is used for royalties. This system involves imposing a greater scale of royalties on a bigger field than on a smaller one, as larger fields maybe more profitable than the smaller ones, or it may depend on output per well (Dam 1976:134, Mommer 2002:16)**.** However**,** Dam (1976) pointed out that large fields can also be marginal, specifically when they are in deep water or far from shore or where their geological structure requires great technical complexity. Second, development of large fields requires the utilisation of large pipelines which have to be built early in the project life; while smaller fields can be managed with tanker loading. In this case smaller fields are more profitable than larger ones as the cost is reduced in general (Dam, 1976: 134-135).

However, sliding scale royalties can be complex to administer in practice, whilst their progressivity may discourage economically optimal rates of production (Dam, 1976).

The tenant may reduce output in order to decrease his royalty obligation. The landlord, in this case the government, may need to introduce production monitoring to regulate current production. This could lead to disputes between International Oil Companies (IOCs) and the government which would result in high administration costs for both parties (Mead, 1993:241, quoted in Mommer 2002: 16).

Actually, any royalty will be expected to discourage optimal rates of production, as the figure above showed. If the royalty is x% of the value of a barrel, then fields where the cost of extraction is between (100-x)% and 100% of the price will not be operated because they will not be profitable for the company, even though it would be economically optimal to operate them. Indeed, if a sliding-scale royalty means that the royalty declines for higher-cost fields, then such a scale would encourage economic optimality.

**5.5.2 Concessionary System (Including royalty):**

Concessionary arrangement was the only petroleum fiscal system available before the end of the 1960s (Johnston, 2007: 58). It can be traced to the discovery of oil in the Middle East in the 1920s (see Mikdashi, 1966). This system had several features:

* Oil and gas companies were given the rights to explore for hydrocarbons
* If a discovery was made, then the international oil and gas company had the right to develop and produce hydrocarbons
* The principal type of mineral rent charge was a signature bonus and fixed royalty payments
* Upon the production of hydrocarbons, the international oil company took title to its share at the wellhead ( gross production minus royalty)
* IOC owned exploration and production equipment
* IOC’s paid taxes on profits from oil sales

This system is also called a tax/royalty system; the government transfers the title of mineral ownership to the company. The latter then pays royalties and taxes.

The rates of the royalty and taxes are normally mentioned in the state’s legislation. The terms of concessionary systems can be changed because governments can be changed and thereby petroleum law and taxation levels are changed as well (Kaiser and Pulsipher, 2004:5).

IOCs pay all the costs of developing oil fields and endure all the risks if oil and gas are not discovered. There is no standard duration for the concessionary system, but in general it is very long period. This system is recognised nowadays as being too favourable to the foreign oil companies. There are no drilling obligations under the concession system and the government has no role in exploration and field development. Moreover, IOCs are sometimes exempted from taxation other than that agreed upon in the concessions (Wright et al., 2008: 18).

**5.5.3 Joint Ventures**

Joint ventures started in the Middle East from 1957 to the mid-1960s. The first joint venture agreement was between the National Iranian Oil Company (NIOC) and Azienda Generale Italiana dei Petroli (AGIP), an Italian Oil Company (Dam, 1970). Governments now desired to formulate policies based on nationalisation and rights of resource ownerships, which resulted in the creation of national oil companies. In joint ventures, governments participate in decision-making and management of hydrocarbon projects via a government owned Oil and Gas Company. The difference between concessions and joint ventures is that the government acquires in addition to royalty and tax, a share of the petroleum and/or profits (United Nations, 1995). It can greatly increase the information available to the government regarding costs, which is very important for monitoring fiscal terms. E.g. it should be harder to the IOC to artificially increase costs in order to reduce tax payments if the NOC has access to the same information on extraction.

In most joint ventures contracts the contractor pays all the costs of exploration and bears all the risks. The government backs in after discovery. For the government to receive more than royalty and tax, it has to contribute its share of development and operating costs. The contractor might be allowed to recover all or part of the exploration costs. The government can even pay these direct to the contractor which can then start sharing production profits with the government (United Nations, 1995:3; Johnston, 1994:105; Gallun et al., 2001).

**5.5.4 Production Sharing Contracts (PSCs)**

Production sharing contracts started to surface in the 1960s when governments demanded more involvement in mineral exploration and development and more rights in resources ownership. The first model PSC was signed in 1966 between the independent Indonesia American Petroleum Company (IIAPCO) and PERTAMINA, Indonesia’s National Oil Company (Johnston, 2007: 60). The features of this system are as follows: (Johnston, Johnston and Roger, 2008; Johnston, 2007; Johnston, 1994; United Nations, 1995)

* The government sometimes actively partakes in exploration and development operation and this system may even provide a joint committee from both parties to monitor the operations
* The state maintains ownership of the resources. The contractor receives a share of production for the performed services
* As in the relevant concessionary system, the IOC assumes all exploration risks and if there is no discovery then the government will not reimburse the cost
* In the event of discovery, production is split between the parties according to negotiated percentages and the company can recover its costs
* Contractor share of profit is subject to taxation

The company is reimbursed for its expenditures through allocation to it of a certain quantity of oil which, at prevailing market prices, would be equal to the value of the investment and operating expenditures incurred by the company. This quantity of oil is called the cost oil and the company usually sells this oil back to the state at the current market price. The oil remaining after costs deduction is called the Profit oil. This is divided between the oil company and the state according to agreed proportions.

Many of the characteristics in the concessionary system are found in PSCs with the exception of the cost recovery limit and production sharing. Under a PSC the cost which should be recovered is specified; the contractor may be limited as to the amount that can be recovered, however, unrecovered cost can be carried forward to subsequent years. Cost recovery limits (cost recovery ceilings) range from 30%-60%. There are some exceptions to cost recovery; some contracts do not limit cost recovery (the second generation Indonesian PSC); others have no cost recovery (1971 and 1978 Peruvian model contracts); in others the government takes on the extra cost recovery (Egyptian and Syrian PSCs) For example, the government and the contractor agree the cost recovery ceilings, let’s say 40%, but the contractor is entitled to recover only 21%, with the remaining 19% going directly to the government, if not subject to profit oil split (Johnston, 1994: 49-59)

Mommer (2002:16) argues that profit sharing requires a deep understanding and careful monitoring. This system may allow the contractor to gain premium profits. The contractor may import costs from downstream or from any other unrelated business to minimise the calculation of the shared profits.

The costs which are allowable for Cost Recovery via the cost oil usually include the following:

* Exploration costs ( where appropriate )
* Operating cost
* Annual Capital Expenditure or current depreciation charge
* Interest charges on financing ( where allowed)
* Provision for abandonment costs
* Unrecovered costs carried over from the previous year

Johnston (1994:64) discusses the importance of the discovery’s commerciality in a PSC; there are cases where exploration costs have huge economic impact on development decisions. These costs will be classified as cost recovery or used as deductions. If these are too great, the government will end up with a fraction of the gross production. Therefore the contractor, before the start of development, is required to prove that the discovery development will generate profits for both parties.

Profit oil splits in most countries range from under 15% to over 55% for the contractor. Geology, costs, infrastructure, political stability, and other factors that influence the work are set against contractor take (Johnston 1994: 63).  **5.5.5 Service Agreements**

In this system, the contractor is paid a fee for producing hydrocarbons. All the production is owned by the state. These contracts started to be used in the late 1960s in Iraq and Iran followed by Venezuela (Dam, 1970). There are two types of service agreements: risk service agreements and non-risk service agreements.

In non-risk service agreements the government pays the contractor a fee for petroleum services and this fee covers all costs. This arrangement prevails where the state has the capital but seeks technical expertise (Johnston, 1994:24).

In risk service agreements the contractor provides all the costs for production and development of hydrocarbon resources as in concessionary and PSC systems. In return if the exploration is successful, the government allows cost recovery after payment of oil and gas and gives the contractor a percentage of fees on the remaining revenues. The fee is normally taxable. IOCs are sometimes allowed to purchase petroleum at reduced prices (Johnston, 1994:87-89; Johnston, 2007:62-64; Wright et al., 2008:29).

The nature of payment is the main difference between PSCs and service contracts (Johnston, 1994:88). In service contracts the contractor receives his share in cash or crude oil, while with PSCs the contractor receives his share only in kind. This doesn’t seem to be a bigger difference than the absence of risk in a non-risk service agreement.

**5.5.6 Buy Back Agreement**

Buy back agreements, used in Iran, are considered a variation of service contracts. The first buy back agreement was signed in 1995 between the National Iranian Oil Company (NIOC) and TOTAL (France) and PETRONAS (Malaysia). The agreement includes field development, after the contractor starts production, and NIOC buy-back, and gives the contractor costs and an agreed rate of return during the buy-back period (five to eight years). The contractor does not have any equity rights. This type of agreement has received a lot of criticism from contractors because of the inflexibility of the term regarding scope of work and cost recovery, the short period of the lease compared to 10 or 20 years in the PSC and concessions, and the fact that the contractor has no access to the field once production starts, which can affect costs and returns (Groenendaal and Mazzarati, 2006, Wright et al., 2008).

**5.5.7 Evaluation of Petroleum Fiscal Regimes**

For a petroleum fiscal regime to be satisfactory to the state, ideally the following three criteria should be satisfied:

1. The absolute size of the mineral rent received should be acceptable to the state
2. The proportion of the mineral rent which is received by the state should be equitable
3. the tenant Oil company should not be permitted excess profitability

To satisfy the first criterion, the state may insist on receiving a certain payment per barrel, for example in the form of a high royalty. However, the oil lease in question may offer an exceptionally high differential rent, so the *proportion* of the total mineral rent may be below the proportion considered equitable by the state. Therefore, in the ideal system the state should insist on receiving high payment per barrel

Similarly, where oil leases in question offer an exceptionally high differential rent, although the absolute rent and the state’s desired proportion of the total rent may be acceptable, the oil company may still be left with huge excess profits. Clearly this indicates that the fiscal regime could be strengthened without deterring the oil company from investing – in theory, strengthened up to the point where the company rate of return just exceeds the average rate of profit being earned in oilfields with similar characteristics.

We conclude this section by answering the questions that we have posed in the introduction of the section. There are a number of different forms of petroleum fiscal regime to choose from, and although some differences exist between them, these differences are limited to mechanical, political and financial points. It is not really possible to characterise any of the fiscal and contracted systems described above as ‘strong’ or ‘weak’ per se, as it depends on the precise details of the regime. For example, a regime of royalties can be tough or weak depending upon the percentage royalty chosen (from 1% to 30%). There is no better fiscal regime per se which generates more revenues for the government, but the toughness of the system depends on the fiscal terms of the specific contract. In order for the country to determine whether it should establish a tough or weak fiscal regime and not discourage investment or development of marginal fields, it should consider the geological potential of the wells, the extent of existing knowledge about the country oil and gas reserves and whether they are explored, the degree the reserve in the ground is proved, competing oil companies seeking access to state oil reserve, extraction costs and political costs.

**5.6 National Oil Companies (NOCs)**

As an alternative to levying very high royalties and taxes on foreign oil companies, the state can obtain *the whole of the mineral rent* by establishing a monopoly national oil company. However, the ‘downside’ of this is that the state has to provide all the capital investment and take on all the risk. It may also lack the managerial and technical capacity that can be gained from employing IOCs.

However, today, NOCs are recognised as a basic element of petroleum policy in almost all petroleum exporting and importing nations (Khan, 1985). The rationale for direct state participation is to secure national interests more effectively than market forces and private initiative allow (Noreng, 1997).

The first NOC was created in Austria in 1908 due to the private producers of crude being faced with a surplus and being unable to agree how to manage it (Stevens, 2008). Early nationalisation of the oil industry in Russia in 1917 and in Mexico in 1938, with the formation of PEMEX (Petroleos Mexicanos), saw a major expansion of state oil companies (Bentham, 1988).

However, it was during the 1970s that the most rapid growth of national oil companies occurred, especially in the Middle East. The governments of these countries believed they had the right to exercise their sovereign rights over their depletable natural resources (Olorunfemi, 1991). They wanted to establish ownership and dictate the pace at which national reserves are exploited.

Before 1973, the vast majority of IOCs in the Middle East operated in isolation, without any concern for the domestic economy of the host country. Little use was made of local labour (especially in high management positions) and there was a lack of involvement of local firms. This made it impossible for the national governments to get access to the information they needed (van der Linde, 2000: 98). The state’s control over its natural resources lies in its ability to run the industry itself (Nore, 1980). Greater control over natural resources required a higher degree of information; this need was reflected through the creation of NOCs. For example, it was explicit in the creation of Statoil (Stevens, 2008).

During the 1990s some national oil companies which had been established in the rich, economically developed countries like Britain, France and Canada were privatised. But more recently “resource nationalism” (as it has been called) has returned to prominence. As well as the desire to obtain a higher share of the oil rent, a central objective of resource nationalism is to establish greater national control over national resource development (Stevens, 2008).

The actual role of the NOC differs among countries. While they play a major role in development and exploration and operate with private companies’ in some countries, e.g. Italy, Canada and Saudi Arabia, they do not manage all aspects of operation in others although they have the petroleum rights of states, e.g. the U.K (Khan, 1985).

The NOC can act as a channel for technology transfer (Nore, 1980). Economic power in oil stems from control of oil reserves/ or market openings (Philip, 1982). Hence, “the IOCs are willing to contract out other aspects such as the production of technically sophisticated capital goods to competing specialist firms and this technology is available for the NOCs to use” (Stevens, 2008:14). This allows the local staff of NOCs to gain technical training and thus the NOC and the state acquire greater control over the natural resources. Thereby, as the example of Saudi Arabia amply illustrates, an NOC can move from being a sleeping partner or absentee landlord to being a fully active oil company (Khan, 1987: 188).

The strength of the state’s position in relation to private sector companies is inversely proportional to the scale and the technological complexity of the industry concerned (Vernon, 1971). Likewise, the oil company’s strength of position depends ultimately on the capability of incapability of a producer state to run the industry itself (Nore, 1980).

The formation of a state company may assist in promoting national interests such as security of supply for the domestic market, the conservation of resources, regulation of safety, health, welfare and environmental matters, the obtaining of a proper return and the training and employment of its own nationals in the industry. “Oil rich” countries, as is the case with some OPEC countries, can exploit their own natural resources, use only their capital and buy in outside technical expertise as needed (Bentham and Smith, 1987).

However, exploitation through a national company can be extremely expensive. The risks are high, and it may be that other regulated contracts serve a state’s interest better (Bentham and Smith, 1987)*.In this case the state company will have less control.* The government will act as an administrator, inspect and monitor performance and take the state’s rent, royalty and income tax. This can be the cheapest route and bears the least financial risk. But there is less state involvement and knowledge (Bentham and Smith, 1987)

NOCs have some other drawbacks. Stevens (2008) discussed that although the NOC was created to defend the government’s interests, the NOC might use the government to fulfil its own interests, especially in a situation where there are few balancing powers. There is always the danger of the NOC becoming a ‘state within a state’ - the so called “PEMEX syndrome”. The political system in Latin America can be described as an ‘iron triangle’ Szabo, 2000 in Stevens, 2008: 18). This consists of the industrial oligarchies (small number of firms with high power) which seek preferential economic treatment, politicians who give the oligarchies advantageous treatment in return for some benefits (Stevens, 2008). The problem is that so much rent is tied up in oil; the NOC can become too powerful and, backed by the labour unions ( ibid, 2008), effectively the state will have only limited control over it.

Mommer (1994) adds to the discussion on national oil companies. Initially they were nothing more than tax-collecting operators. These companies in the third-world oil exporting countries are the most modern, sophisticated and efficient enterprises, with highly qualified human capital. Their personnel are enthusiastic and fond of their companies – but not necessarily of being state owned. Thus, they would never accept being just tax collecting operators.

Al-Mazeedi (1992) argues that NOCs, recruitment policies are influenced by tribal and religious considerations, instead of qualifications, performance or personal attributes. This is especially in the Middle Eastern NOCs. The practise has exerted an adverse effect on the Gulf NOCs’ managerial and technological expertise (ibid, 1992)[[30]](#footnote-29). Another managerial problem is that too many NOCs have developed a large gap between the top management and the next generation to protect the existing top management (Stevens, 2008). Governments are discouraged from replacing senior management on the grounds that their successors are not ready to take over (ibid, 2008). This seems like weakness on the part of the NOCs; however, the senior managers have wide experience which should not be neglected.

Mommer also argues that the role of NOC has changed over time; he questions their role as being mere operators, claiming that they are interested in minimising their tax. This means that such NOCs might become potential allies of the international oil companies (Mommer, 2000). He argues that some of the NOCs in oil-exporting countries have direct control in the design of upstream contracts, also the applicable fiscal regime and its administration, while the foreign investors remain in the background. He concludes that eventually these NOCs could take over the administration of the natural resource from the ministries. Consequently, according to these trends, privatisation will be the logical conclusion (ibid, 2000).

Whether or not state oil companies are used as vehicles for state ownership of reserves, it still remains the case that it is the *terms of access* rather than ownership per se which determine the return to governments. National Oil Companies may be used as levers to achieve desired terms of access, but they may equally impede the achievement of this goal if they start to develop autonomous interests which determine national policy.

**5.7 Conclusions**

This chapter reviews the literature relating to oil governance up to the point of revenue distribution. It also explores patterns of sub-surface mineral ownership and how these have changed. In the pre-modern period (the 16th to 19th centuries), sub-surface minerals were owned by the landowner (see for example the Cornish tin industry). In modern times (the 19th to 21st centuries), sub-surface minerals are generally owned by the state, apart from some countries such as the US, where they still belong to the landowner.

According to Mommer (2002), under the public ownership model, the key decision for governments is whether to adopt a proprietorial or a non-proprietorial regime. Mommer characterises regimes and suggests that a proprietorial regime may offer a better return to governments. However, in practice, the characterisation of regimes is not always clear-cut because many are hybrids of both regimes. Moreover, a proprietorial regime may not always offer the best return, while the returns to government under non-proprietorial regimes can be relatively high depending on its components.

The concept of mineral rent has been interpreted in various ways by academics. Modern authors such as Mommer (2002) define mineral rent as being made up of two constituent parts: ground rent (royalty) and differential rent (excess profit). Numerous instruments and fiscal systems have been developed to capture mineral rent and ensure that governments maximise their share. Which is the most appropriate system will vary from case to case, depending on the terms of the contracts involved. Alternatively, the state can create a national oil company and establish a monopoly over the resource. This ensures that the whole mineral rent goes to the state, but this step has its own advantages and disadvantages.

Having considered the issues surrounding ownership, mineral rent and fiscal regimes, the following chapter explores the next stage in oil governance; that is, how oil revenues are managed, and how they are distributed at regional and individual levels.

## Chapter Six: Iraq’s Petroleum Fiscal Regime/Analysing Oil Contracts

## 6.1 Introduction

The fiscal regime is the central pillar of oil governance. Given the importance of the fiscal regime in determining the success of oil governance, and its specific importance in Iraq as a source of dispute, this chapter investigates in detail the performance of the fiscal regime since 2003. It seeks to answer the first research question: whether the federal and Kurdistan governments are successfully capturing oil rents on behalf of the Iraqi people, who, under Article 111 of the constitution, are the owners of the country’s mineral resources.

Prior to nationalisation, the government clearly failed to capture rent from oil companies, both by concession-type contracts in the early days of the industry and in production-sharing contracts (PSC’s) from 1952 onwards. The two types of contract differ mainly in terms of ownership rights. In the concession type, the contractor retains ownership of the field and pays royalties and taxes on profits to the state, while in PSCs, international oil companies may only own cost oil plus profit oil.

Shortly before the 2003 war, opponents of Saddam’s regime met with representatives from foreign oil companies in London. Immediately after the invasion, as discussed in Chapter four, production-sharing contracts with IOCs were mooted as an option for developing the Iraqi oil industry. However, Iraqi oil policy makers disagreed on whether to involve foreign oil companies again or to have a completely nationalised industry, and there were strong objections to PSCs in the Iraqi Parliament, mainly on the grounds that most Iraqis were against the shared ownership and entitlement these contracts offered to IOCs. A compromise was eventually reached in 2009 with the signing of the first technical service contracts (TSCs). TSCs had the advantage of releasing Iraq from the financial burden of raising the capital for investment while preserving the principle of national control. Under a service contract, the state retains all ownership of the oil and its production. The IOC is merely a contractor and is paid a cash fee for producing mineral resources.

But while the central government has signed TSCs, the KRG prefers PSCs. The central government considers the latter to be illegal and too generous to the IOCs, but the KRG disputes this, arguing that not only are PSCs legal, but they offer better terms than the service contracts signed by the central government. Accordingly, this chapter analyses these two types of contract in more detail. The West Qurna1 field in Basra, south Iraq, is examined as an example of a TSC (between the central government in Baghdad and Exxon Mobil). Discounted cash flows and net present values (NPVs) are used to calculate the government take, the company’s combined internal rate of return (IRR) and company profitability**.** This field was chosen primarily because of the availability of a considerable amount of technical and economic information, which was absent in most other oil fields. This is certainly the case in the Kurdish fields – the data available in the public domain is inadequate and inconsistent, rendering detailed cash flow analysis impossible. Consequently, the chapter draws on existing studies to analyse the KRG’s use of PSC contracts in more general terms.

## 6.2 Background to the contract negotiations

The first oil field to be contracted with an IOC after 2003 was the Al Ahdab field, in an agreement with the China National Petroleum Corporation (CNPC). In November, 2008, CNPC signed a development service contract with the Ministry of Oil. This contract was a continuation of an agreement signed in June 1997 with the Saddam regime to develop the field. Jiyad ([2010a:13](#_ENREF_22)) describes this contract as disadvantageous to Iraq in comparison with the later first and secondgeneral bid rounds. Arguing that the contract should be reconsidered, Jiyad claims that the annual cap on cost repayments (100%) is around twice what it should have been, and that the $3m signature bonus was far too low. Compare it, for example, to Sinopec’s (another Chinese company) payment of $2.2 billion for two exploration blocks in Angola ([IHS, 2006](#_ENREF_13)).

Perhaps realising the deficiencies of the Al Ahdab contract, the Iraqi government decided to offer its remaining oil and gas fields for investment by means of a competitive bidding process (see Chapter Five).Applicants must meet technical, financial, legal, training and HSE (Health and Safety and Environment) criteria, most of which are standard in bidding contracts around the world (e.g. Brazil, Mexico, UK, Australia and Yemen) ([Tordo et al., 2010:22](#_ENREF_36)). Companies that have signed contracts with the KRG without the central government’s approvalare barred from applying([Business Monitor International, 2009](#_ENREF_2)).

Companies which are qualified to do so participate in sealed bid rounds. The bid parameters and evaluation criteria are the remuneration fee bid (RFB) and the plateau production target (PPT). Countries differ in their bidding parameters; the Gulf of Mexico uses cash bonuses as bidding parameters, Brazil uses cash bonuses, local content and minimum exploration work programmes[[31]](#footnote-30), and Austria uses work programmes together with indicative cost (for detailed discussion of the allocation of petroleum exploration and production rights, see [Tordo et al., 2010:22](#_ENREF_36)). Since increasing production is of paramount importance for Iraq, the central government favours the use of PPTs.

The Oil Ministry accepts the highest scoring bidder for each contract area, providing that the RFB does not exceed the ministry’s pre-defined maximum remuneration fee (MRF). If there is a single high scorer whose RFB is less than or equal to MRF, that bidder is the winner. If there is a single score whose RFB exceeds the MRF, the chairman will make the MRF public and invite the highest scoring bidder to accept it. If it is approved then the highest scoring bidder wins the contract; if it is rejected then the same option will be offered to the second highest scoring bidder. If accepted then the second place scorer is the winner. If declined, the bidding process for the contracted area is terminated ([Ministry of Oil Petroleum Contracts and Licensing Directorate (PCLD), 2009](#_ENREF_31)).

The objective of the first bid round in June 2009 was to develop/redevelop eight contract areas, which included the already producing fields (brown fields), Rumaila, Kirkuk, West Qurna1, Zubair, Bai Hassan and Missan, and two gas fields, Akkas and Mansuriya. This was to be achieved by means of TSCs guaranteeing a fixed fee of $2 per barrel produced. The first bid round resulted in just one field (Rumaila) being awarded to British Petroleum (BP) and the China National Petroleum Corporation (CNPC). However, in October 2009, several other companies returned to accept the offered remuneration fee. Exxon Mobil and Shell were contracted for West Qurna1 and ENI, and Oxy and Kogas were contracted for Zubair field ([Eni, 2009](#_ENREF_7); [Hafidh, 2009](#_ENREF_9)) (see Table 6.1 for these fields’ parameters). Apparently, the IOCs had reassessed their valuation of the $2 remuneration fee and, taking into account the low risks and the low cost of the already producing fields, decided they would still be profitable.

Husari ([2009](#_ENREF_11)) suggests that the IOCs’ return may have been inspired by the apparent confidence of BP/CNP, who had entered into their contract in October 2009 without even waiting for the approval of the Iraqi Council of Ministers. This may have led them to suppose that the contract was likely to be profitable as it was unlikely that these big companies would have miscalculated and gone for the fields unless there were good opportunities for profits. They may also have been concerned that of the fields offered in the second bid round, only West Qurna2 and Majnoon were super giants like West Qurna1, Zubair and Kirkuk. The only two oil fields which were not taken by any company in the first bid round were Kirkuk and Bai Hassan. The reason for these two fields not gaining a foreign contractor could be that they were being disputed with the regional government of Kurdistan. Chalabi ([2010:1](#_ENREF_3)) says that “the reasons Kirkuk and Bai Hassan were not awarded to IOC are more related to Kurdish objections than anything else”.

The second bid round, in December 2009, offered ten fields for bidding (West Qurna2, Majnoon, East Baghdad, Halfaya, Garraf, Najma, Qaiyarah, Middle Furat, Badra and Eastern fields ([Iraq Oil Forum, 2009](#_ENREF_17))). These fields are green fields; that is, undeveloped. Hence, the type of contract which was signed for these fields was a Production and Development Service Contract. Baseline production did not apply in this bid round simply because, apart from Majnoon, Halfaya and East Baghdad fields, these fields have no current production or only nominal production. All fields were awarded in this bid round apart from the smaller fields (Middle Furat, East Baghdad and Eastern fields) (see Table 6.1).

In the third bid round, in October 2010, Iraq contracted three gas fields, two of which had been involved in the first bid round but had found no qualified bidder (Mansurya and Akkas) and another field that had been added to the list (Siba). Since these are green fields (non-producing fields), Production and Development Service Contracts were employed. There were no signature bonuses in this bid round ([Iraq Oil Forum, 2011](#_ENREF_18)). Prior to this, in September 2008, the Ministry of Oil had signed a Head of Agreement joint venture deal with Royal Dutch Shell and Mitsubishi to build new processing facilities to separate the gas produced by the southern fields into dry gas for industry and export and LPG for local users (Yacoub and Rutledge, [2011:253-256](#_ENREF_40)). The contract was criticised by a number of Iraqi oil and gas experts and by members of the Iraqi Parliament on the grounds that it had not passed through the Parliament. Critics pointed out that the contract, for which there was no competitive bidding, gives these companies a twenty five year monopoly over the associated and non-associated gas fields in southern Iraq. They argued that although the priority is to provide gas for domestic usage, a large part of production is destined for export and that it will actually result in an increase in the price of gas for local industries and consumers ([Yacoub and Rutledge, 2011](#_ENREF_40)).Despite these objections, however, the contract was formally approved by Iraq’s national gas company in 2011 ([Hassan, 2012](#_ENREF_10)).

**Table 6.1A: Basic parameters of the awarded oilfields**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Oil Field** | **Governorate** | **N/IOCs**  **Consortium (75%)** | **State**  **Partner**  **(25%)** | **CP- mbd**  **(BLP)** | **PPTs- mbd/Y** |
| Al Ahdab | Wasit | CNP (100) | SOMO | 0.000 | 0.115a/\*Y |
| Rumaila (N&S) | Basrah, Missan | BP (50.666),  CNPC (49.333) | SOMO | 1.050e | 2.850/  7Y |
| West Qurna1 | Basrah, Missan | Exxon Mobil (80),  Shell (20) | OEC | 0.300  0.244f | 2.350/  7Y |
| Zubair | Basrah | Eni (43.747), Oxy (31.253),  Kogas (25) | MOC | 0.200  0.183f | 1.200/  7Y |
| Missan (Buzurgan  Fauqa  Abu Ghirab) | Missan | CNOOC (85),  TAPO (15) | IDC | 0.100 | 0.450 |
| West Qurna2 | Basrah, Missan | Lukoil (75),  Statoil (25) | NOC | 0.000 | 1.800/  13Y |
| Majnoon | Basrah, Missan | Shell (60),  Petronas (40) | MOC | 0.045d | 1.800/  10Y |
| Halfaya | Missan | CNPC (50), Total (25),  Petronas (25) | SOC | 0.003 | 0.535/  13Y |
| Garraf | Thai Qar | Petronas (60),  Japex (40) | SOC | 0.000 | 0.230/  13Y |
| Badra | Wasit | Gazprom (40), Kogas (30),  Petronas (20), TPAO (10) | OEC | 0.000 | 0.170/  7Y |
| Qaiyara | Nineveh | Sonangol (100) | SOC | 0.000 | 0.120/9Y |
| Najma | Nineveh | Sonangol (100) | IDC | 0.000 | 0.110/9Y |
| Total |  |  |  | 1.698 | 11.730 |

Source: [Jiyad (2010b](#_ENREF_23)), Petroleum Law Annexes (2007)

Notes:\*: Not available

N/IOC: National and international oil companies

CP: Current production; BLP: Baseline production

PPT: Proposed production target

RF: Remuneration fee

SB: Signature bonus

MEO: Minimum expenditure obligation

IPT-FCP: Improved production target-first commercial production as payment commencement condition

Y: Duration in years (how many years it will take to reach the production plateau)

IR-bln: Investment requirements in $ billions comprising Capex and Opex

a: MoO announced that new information made available would increase the production plateau to 200,000 per day (as reported on government-run TV Channel AlIraqia on 29 January, 2010)

b: Loan with LIBOR+1

c: More than

d: <http://www>.upstreamonline.com/live/article209880.ece [Accessed March 29, 2010]

e: MEES reported 1,066 mbd (MEES, 53, January 11, 2010)

f: revised after contractual setting of baseline production http://www.upstreamonline.com/live/article207648.ece [Accessed March 1, 2010]

**Table 6.1B: Basic parameters of the awarded oilfields continued**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **R F**  **$/b** | **SB**  **$m** | **IPTFCP**  **000bd** | **Reserve billion barrels** | **MEO**  **$m** | **IR**  **$bln** |
| 6 | 3 | \* | 1.00c | 350 | 1.6 |
| 2 | 500b | 10%  BLP | 17.8 | 300 | 15-20 |
| 1.9 | 100 | 10%  BLP | 8.6 | 200 | 40-50 |
| 2 | 100 | 10%  BLP | 4.1 | 200 | 35 |
| 1.15 | 150 | 120 | 12.876 | 200 | \* |
| 2.30 | 300b | 10%  BLP | 2.5 | 200 | \* |
| 1.39 | 150 | 175 | 12.580 | 300 | \* |
| 1.40 | 150 | 70 | 4.098 | 200 | \* |
| 1.49 | 100 | 35 | 0.863 | 150 | 7-8 |
| 5.50 | 100 | 15 | 0.109 | 100 | 3.52 |
| 5.00 | 100 | 30 | 0.807 | 150 | 2.0 |
| 6.00 | 100 | 20 | 0.858 | 100 | \* |
| Total | 1853 |  | 67.285 | 2500 | \* |

Source: see Table 6.1A

**Table 6.2A: Basic parameters of the awarded gas fields**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Gas Field** | **Governorate** | **N/IOCs Consortium (75%)** | **State Partner**  **(25%)** | **CP-Mcf/d**  **(BLP)** | **PPTs-Mcf/**  **d/Y** | **Rf $**  **/boe** |
| Akkas | Al Anbar | Kogas/KMG  (50/50), Kogas operator | ? | 000 | 400/13 | 5.50 |
| Mansuriya | Diyala | TAPO/KE/KOg (50/30/20) | OEC | 000 | 320/13 | 7.0 |
| Siba | Al-Basra | KE/TPAO  (60/40), KE operator | MsOC | 000 | 1000/9 | 7.5 |

Source: [Jiyad (2010b](#_ENREF_23))

CP-Mcf(BLP): current production - thousand cubic feet (baseline production)

PPT: Proposed production target

Y: Duration

RF: Remuneration fee

SB: Signature bonus

IPT-FCP: Improved production target-first commercial production as payment commencement condition

MEO: Minimum expenditure obligation

IR-bln: Investment requirements in $ billions comprising Capex and Opex.

Res/bcf: Reserve/billion cubic meter

**Table 6.2B: Basic parameters of the awarded gas fields continued**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **SB $m** | **IPT-FCP**  **000bd** | **Reserves/ bcm** | **MEO**  **$m** | **IR $bln** |
| Nil | 25% PPT | 60.9 | 25 | 4 |
| Nil | 25% PPT | 86.4 | 25 | 2 |
| Nil | 25% PPT | 50 | 25 | 1 |

Source: Reserve data: Petroleum Law Annexes (2007). The rest of the table, see Table 6.2A.

## 6.3 Fiscal regime terms in the three bidding contracts

As discussed above, the type of contract offered in the three bidding rounds was the Technical Service Contract. The two parameters which companies competed on were (1) amount of remuneration fee paid to the contractor and (2) the production target for the field.

## 6.3.1 Signature bonuses

These are upfront payments made by the contractor and are generally non-recoverable. Signature bonuses were not included as parameters in Iraq’s bidding process, although they are applied elsewhere (e.g. Angola, Brazil, US Gulf of Mexico) ([Tordo et al., 2010](#_ENREF_36)). Jiyad (2010a) expressed surprise that signature bonuses were not included in the bidding parameters in Iraq, arguing that where oilfields are highly prized and allocated by competitive bidding, signature bonuses may become a key factor. This was the case in Angola when the Chinese company Sinopec paid $2.2 billion in 2006 to outbid its competitors to gain the rights for oil and gas exploration in two blocks.

The model contracts in the three bidding rounds had different provisions for signature bonuses. The signature bonus for the first contract awarded to an IOC in Iraq (Al Ahdab field) was only $3 million. This was much lower than those in the first bid round, which generated a total of $1500 million (Rumaila: $500m, West Qurna1: $400m and $300m each for Missan and Zubair) ([Jiyad, 2010a:3](#_ENREF_22)). However, the first bid round bonuses were actually interest bearing loans at (LIBOR+1), payable with interest over five years, starting two years after the contract’s effective date ([Iraq Ministry of Oil, 2009a:31](#_ENREF_19)). This is a most unusual form of signature bonus and was heavily criticised.In fact, it doesn’t make much sense to call it a bonus at all – it’s just a loan.

Responding to the criticism, in April 2010 the Ministry of Oil removed the repayable element from the signature bonuses on two fields (West Qurna1 and Zubair) but reduced the bonuses to $100 million each ([*Energy-Pedia News*, 2010](#_ENREF_5)). Jiyad (2010a:4) points out that the decision to reduce the two fields’ signature bonuses by the same amount was not a proportional measure as West Qurna1 and Zubair initially had different amounts of bonus. Rather, he argues (Jiyad, [2010b](#_ENREF_23)), the move was intended to weaken the case that was being brought against the Ministry in the Federal Supreme Court (by former Parliament member Shetha Musawi) challenging the legality of the loan provision. The bonuses in other fields (Rumaila and Missan) were not reduced, nor were the loan element removed. Jiyad ([2010b](#_ENREF_23)) claims that the Ministry of Oil justified this on the grounds that the bonuses had already been paid on these fields, but that it then changed its position and requested a $100 million bonus for Rumaila field, with no interest loan. He explains that if the Ministry had stuck with soft loans, it would have required parliamentary approval, but in December 2010, when the new request was made, there was no functioning parliament ([Iraq Directory, 2010](#_ENREF_15)).

In April 2011, Adnan Al Janabi, the new chairman of the Parliament’s Oil and Energy Committee, explained that:

“Standing law requires oil and gas contracts to be approved by Parliament, including deals already awarded in the licensing rounds and a draft joint venture with Royal Dutch Shell to capture natural gas…Under Iraq’s current legal regime, each upstream contract must adhere to a stringent 1967 law that requires Parliament to sanction each deal” ([Maliki, 2011:1](#_ENREF_29)).

This indicates that the scope exists to alter contract terms, including the loan-bearing signature bonuses of Rumaila and Missan. The Iraqi Parliament acts as a representative of the Iraqi people, owners of the natural resources; it should be able to approve contract terms or change them if they are not acceptable. As explained above, there had already been attempts to change the Rumaila signature bonus to a non-bearable loan bonus.

The second bid round generated $850 million in unrecoverable signature bonuses ($150m each for Halfaya, Majnoon and West Qurna2, and $100m each for Badra, Garraf, Najma and Qaiyarah) (Jiyad, 2010b:3). Contract terms improved as the government responded to the criticisms of the first bid round, but critics argued that the bonuses were still too small given the characteristics of the fields (production plateau, duration and total proven reserve) and qualitative aspects such as the quality of the crude, type of reservoir and location (Jiyad, 2010b). To compare once more with Sinopec’s deal in Angola: two exploration blocks with a high level of associated risk generated $2.2 billion in revenues, while in Iraq, eleven oil fields which are already producing around 1.6 million b/d, and which upon full development could produce 11.2mbd, generated $2.05 billion ($805m in bonuses and a further $1.2b in loans) (Jiyad, 2010a:3).

In the third bid round there were no signature bonuses. It appears that the government was desperate to encourage companies to invest in these non-producing gas fields in order to increase its production for both domestic and export use.

## 6.3.2 Remuneration fee (RF)

These are the fees international oil companies receive for each barrel of oil produced**.** The RF was one of the two main bidding parameters in the bidding process; IOCs were competing against each other and against a pre-specified maximum RF the Oil Ministry was willing to pay. The RF varies according to oilfield parameters. The actual payment of RF is reduced by the R-factor[[32]](#footnote-31), which is the ratio of cumulative cash receipts to cumulative expenditures. The R-factor is standard and fixed for all oil fields in the relevant model contract. In effect, the R-factor reduces the RF or the potential profitability of the project increases ([Jiyad, 2010a](#_ENREF_22); [Iraq Ministry of Oil, 2009a](#_ENREF_19))**.** This in turn reduces the company’s profitability in the next accounting period (see Table 6.3A).

**Table 6.3A: R-factor for first bid round (PFTSC)**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Field** | **0<R<1**  **100%RF** | **1<R<1.25**  **80%** | **1.25<R<1.5**  **60%RF** | **1.5<R<2**  **50%** | **2<R**  **30%** |
| Rumaila | 2.00 | 1.60 | 1.20 | 1.00 | 0.60 |
| West Qurna1 | 1.9 | 1.52 | 1.14 | 0.95 | 0.57 |
| Zubair | 2.00 | 1.60 | 1.20 | 1.00 | 0.60 |
| Missan | 2.3 | 1.84 | 1.38 | 1.15 | 0.69 |

Source: [Iraq Ministry of Oil (2009a](#_ENREF_19)), [Jiyad (2010a](#_ENREF_22))

**Table 6.3B: R-factor for second bid round (DPSC)**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Field** | **0<R<1**  **100%RF** | **1<R<1.25**  **80%RF** | **1.25<R<1.5**  **60%RF** | **1.5<R<2**  **40%RF** | **2<R**  **20%RF** |
| West Qurna2 | 1.15 | 0.92 | 0.96 | 0.46 | 0.23 |
| Majnoon | 1.39 | 1.112 | 0.834 | 0.556 | 0.278 |
| Halfaya | 1.40 | 1.12 | 1.84 | 0.56 | 0.28 |
| Garraf | 1.49 | 1.192 | 0.894 | 0.596 | 0.298 |
| Badra | 5.50 | 4.4 | 3.3 | 2.2 | 1.1 |
| Qaiyarah | 5.0 | 4.0 | 3.0 | 2.0 | 1.0 |
| Najma | 6.0 | 4.8 | 3.6 | 2.4 | 1.2 |

Source: [Iraq Ministry of Oil (2009a](#_ENREF_19); 2009b), [Jiyad (2010a](#_ENREF_22))

As can be seen from the above tables, the R-factor’s effect on remuneration fees changed from 50% and 30% in the first bid round to 40% and 20% in the second bid round. These changes were to the advantage of the government as they meant Iraq had to pay less to IOCs in remuneration fees. The other factor which reduces the remuneration fee received by the IOC is Corporate Income Tax (CIT). On January 25, 2010, Parliament approved a law requiring IOCs to pay 35% of their realised income in CIT ([Zawya, 2011](#_ENREF_41)), bringing them into line with all other Iraqi companies. The federal government also has a 25% “carried interest” in each field. The combined effect of the CIT and the state’s interest results in the remuneration fee being divided between Iraq and N/IOCs in a ratio of 51.25% and 48.75% respectively (Jiyad, 2010a:5):

State share of RF= 0.25RF (state participation) + tax on IOC share (0.75 RF x 0.35) = 51.25 RF

IOC share of RF= 0.75RF (IOC share) x 0.65 =48.75% RF

The introduction of the R-factor has helped Iraq to capture more of its windfall. It is progressive, which means that as profitability increases, so does the government’s take (Johnston, 2007:81).

Remuneration fees can be reduced further if the net addition in production is lower than the agreed PPT (the second bidding parameter) (see Tables 6.1A and 6.2A). Jiyad (2010a:11) argues that companies adhering to the PPT could face a dilemma, as it may be incompatible withBest International Petroleum Industry Practices (BIPIP). Many experts question the production plateau target on the grounds that it is unrealistic, and even if it is achievable, it is not sustainable, or if it is obtained and sustained this might be at the expense of optimal depletion and inflict damage on the oilfield (Wells, 2009). Conversely, if an IOC commits to BIPIP, this could lead to production below PPT. In this scenario the contractor would be penalised according to their R-factor performance, or ROC could even terminate the contract.

## 6.3.3 Commencement and caps on cost repayments

The IOC’s income (service fees) comes from (a) the RF agreed in the contract and (b) the repayment of its capital and operating costs (petroleum cost). Under the Al-Ahdab contract, petroleum costs and remuneration fees can be recovered from 100% deemed revenues of the production in that quarter**.** Unpaid fees are subject to a LIBOR+3 points interest rate, and payment begins when commercial production reaches 25,000b/d ([Jiyad, 2010a:9](#_ENREF_22)). In contrast, first and second bid round contracts stipulate that service fees (petroleum cost and remuneration fees) will be paid without interest and are limited to 50% of the deemed revenues of the incremental production(the planned bid productionminus the baseline production of the pre-existing production where the field is a brown field). This limit on the repayment of petroleum cost is similar to the cost cap applied in production-sharing contracts (see Chapter Five). Supplementary costs[[33]](#footnote-32)are paid up to 10% of the deemed revenues of baseline production[[34]](#footnote-33). Unpaid supplementary costsbear interest at LIBOR+1 per annum.

Remuneration fees and petroleum cost are paid after the net production rate has risen by above 10% of the initial production rate (IPR). Petroleum cost is paid before remuneration fees in case the total amount exceeds the agreed cap ([Jiyad, 2010a](#_ENREF_22); [Iraq Ministry of Oil, 2009a](#_ENREF_19); [2009b](#_ENREF_20)). The average cost recovery limit globally is 65%, and this is based on gross revenues (Tordo et al., 2010:57).WhileAl-Ahdab’s cost recovery limit is much higher than the world average, the first and second bid round contracts set a much more modest 50% recovery limit. Although recovery limits are mostly found in PSCs (Tordo et al., 2010:57), Iraq’s service contract terms are similar to PSCs in the respect that under the normal conditions of service contracts, the government pays all costs (see Chapter Five). However, under these service contracts, the contractor pays all the costs.

## 6.4 Government oil revenues and payments to IOC’s in 2011

It is very difficult to find data about what is happening on the ground in Iraq because the government does not publish any financial details about the contracts it has signed with IOCs. The only website containing information about government oil revenues and payments to IOCs is that published by the Iraqi Extractive Industries Transparency Initiative (IEITI), which began in 2010.

IEITI (2013) was the first organization to report the remuneration fees and cost recovery for international oil companies working in Iraq. In 2011, according to Iraq Oil Marketing Company SOMO, the overall government take of oil revenues was $83 billion (see Table 6.4), while a total of $4.5 billion was paid to IOCs in remuneration fees and cost recovery ($278 million remuneration fees and $4.2 billion cost recovery). The IEITI report also mentions a payment of $1.3 billion for internal services, though it is unclear what this refers to. All for the above payments for IOCs represent 7.1% of government take for this year. This shows that government take is actually more than 90%.

The IEITI is the only source to show the IOCs’ take. Its report for 2011 (its last report at the time of writing) was published in December 2013. However, there are several issues with this report. Although it covers remuneration fees and cost recoveries for IOCs for that year, there is a difference of $679.5 million between the figure claimed by the IOCs and that claimed by the Oil Ministry. The report explains that this is because the Oil Ministry’s figure includes cost recoveries for 2010 and 2011 (arriving at a total of $4.5 billion), while the IOCs’ figure includes cost recovery for 2011 only ($3.8 billion).

In West Qurna1, there is a disputed amount of $6.2 million cost recovery between the Oil Ministry’s and IOCs’ figures (IEITI, 2013:61). The report observes that settlement was made in 2012, but does not explain how this was done. This dispute about cost recovery emphasises our analysis that the cost recovery system in Iraq can be a gold plating system for IOCs as by increasing their costs, they can also increase their remuneration fees (see Table 6.4 for state take and IOC’s take under different scenarios amount of RF and cost recovery). The IOCs in West Qurna1 also reported $33.6 million more in remuneration fees than the Oil Ministry. The report attributes this to differences in how production is measured and claims that a settlement was made in 2012, but again gives no details.

**Table 6.4: State take and IOC take under different scenarios (the amount of RF and cost recovery is disputed)**

|  |  |  |
| --- | --- | --- |
|  | Government take  $000 | IOC take  (RF+ cost recovery)  $000 |
| Actual | 82,986,002 | 4,539,654 |
| Extra cost as claimed by Exxon Mobil for West Qurna | 82,979,764 | 4,545,892\* |
| Extra cost and remuneration fees as claimed by IOCs | 82,946,155 | 4,579,501 |

Source: IEITI (2013)

Note: IOC take will be more as cost recovery increases. RF also increases, but data is unavailable to calculate this.

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | **Oil production 1,000 b/d** | **Oil exports 1,000 b/d** | **Value of oil exports ($millions) (OPEC reporting)** | **OPEC Reference Basket (ORB) and corresponding spot components prices *($/b) Basra light*** | **My calculation (export and price)**  **$million** | **Crude oil exports – DFI (before 5% Kuwait deduction)\***  **$million** | **Crude oil exports-**  **DFI (5% Kuwait deductions included)**  **$million** | **IEITI (SOMO reporting)**  **$million** | **Crude oil exports after deducting Kuwait 5% (my calculation) $million** |
| 2003 | 1,377 | 388 | 7,990 | 26.60 | 3,777 | - | 3,726 | - | 3,588 |
| 2004 | 2,107 | 1,450 | 18,490 | 34.60 | 18,362 | - | 16,491 | - | 17,444 |
| 2005 | 1,853 | 1,472 | 19,773 | 48.33 | 26,038 | - | 21,914 | - | 24,736 |
| 2006 | 1,957 | 1,450 | 29,500 | 57.97 | 30,765 | - | 28,312 | - | 29,226 |
| 2007 | 2,035 | 1,460 | 37,300 | 66.40 | 35,481 | - | 35,883 | - | 33,707 |
| 2008 | 2,280 | 1,855 | 63,726 | 92.08 | 62,519 | - | 58,790 | - | 59,390 |
| 2009 | 2,336 | 1,906 | 39,430 | 60.50 | 42,204 | 41,329 | 37,016 | 41,329 | 40,094 |
| 2010 | 2,358 | 1,890 | 51,764 | 76.79 | 53,119 | 52,202 | 48,825 | 52,202 | 50,463 |
| 2011 | 2,652 | 2,166 | 83,253 | 106.17 | 84,167 | 80,796 | 75,416   |  | | --- | |  | | 82,986 | 79,958 |
| 2012 | 2,942 | 2,423 | 94,311 | 107.96 | 95,741 | - | 89,154 | - | 90,954 |

**Table 6.5: Iraqi oil export revenues according to OPEC, Iraqi Extractive Industries Transparency initiative (IEITI) and Development Fund for Iraq (DFI) (2003-2012)**

\*: 5% compensation for Kuwait invasion in 1990 (for more details, see Chapter Three)

Sources: OPEC (2008; 2013), IEITI (2009; 2010; 2011)

Table 6.5 indicates that the value of oil exports differs according to whether it is being reported by the IEITI, OPEC or the DFI. The fact that IEITI reports fail to clearly identify these differences is a serious problem as it undermines transparency. According to Ahmad Mousa Jiya[[35]](#footnote-34) (an Iraqi oil consultant), there is always a difference between total values of exported oil as reported by international oil buyers and the DFI. This is usually due to the time-lag between “lifting” the oil shipment and crediting the value of the shipment in the DFI. There should be at least a month between the lifting (shipment) date and the payment date. Thus, shipments lifted in December of year X are registered in the export figures for that year, but payment occurs in year X+1. This occurs twice a year. 2011 does not cover December export of 2009 but it covers its payment, which occurs in January 2010; similarly, it covers December export of 2010 but does not cover its payment. Usually, the reconciler who prepares the IEITI report provides an accounting explanation so that the “real” difference comes to zero.

Jiyad (2014) adds that comparison of export revenues as reported by the IEITI/DFI and OPEC is not useful because of the different methodologies used. The IEITI report is an accounting reconciliation of actual sales operations. It reflects true market conditions, taking into account the quality of the Iraqi crude and the premier or surcharges incurred in East Asia, Europe and the Americas, and regional discounts offered to Jordan, Syria and Sudan. This is very different from the OPEC calculation, which is based on average price, average daily export and actual number of days in a year.

Through the above data collated, we can derive state take and IOC’s for the year 2011. However, this data is only applicable for one year (the only published year at the time of writing). Detailed information is not provided for OPEX, CAPEX, and the profitability of service contract parameters for the whole period of the fields that include details on the calculations of state take and IOC take. Thus, the next section illustrates a model to calculate company and state cash flow analysis for the entire project. This model will incorporate actual contract features (discussed in sections 6.2 and 6.3) and reasonable assumptions about its physical and financial aspects of which there is no published information.

## 6.5 West Qurna1 field cash flow

Having explored the background of the different Iraqi fields and described the contract parameters that were employed in the bidding rounds, this section takes West Qurna1 field as an example to compute the state and company discounted cash flow, the state take for the whole project and company profitability as measured by internal rate of return (IRR).

West Qurna1 was chosen because more information was available on this field than any other, particularly in regard to capital investment and the planned production profile**.** Wells (2009) has already explored the parameters and fiscal terms of West Qurna1 and compared these to KRG contracts, but his study does not give detailed computations for the different financial parameters of the field; it only shows the state take and contractor’s real rate of return. This study, on the other hand, calculates results for the different financial parameters for the whole project to show the discounted net present value, internal rate of return for the company and state take.

West Qurna is one of Iraq’s giant fields, located north of Rumaila field, west of Basra**.** It was discovered in 1972. It was originally developed by Iraq’s national oil company and Oil Ministry as it was established after the industry’s nationalisation. In 1997, Lukoil signed a service contract with Saddam’s regime, but it did not progress very far because of the sanctions imposed on Iraq at that time ([O'Sullivan, 2003](#_ENREF_32)).

In November, 2009, a service contract was drawn up with Exxon Mobil (80%) and Shell (20%) to develop West Qurna phase one (8.6 billion reserve). Production was to be increased from a BLP of 0.244 mbd (revised from 0.300 mbd after contractual setting of the baselineto 2.350 mbd) within seven years (see Table 6.1A). Payments to the IOC were to start after the achievement of a 10% increase on baseline production. Investment needed in terms of Capex and Opex to develop this field was between $40 and 50 billion (see Table 6.1A).

## 6.5.1 Definitions and parameters of West Qurna1

West Qurna1: Exxon-Shell Model (based mainly on Jiyad, 2010; Wells, 2009; *Technical Services Contract for Brown Fields*):

Type of Contract: Bid Round 1 (BR1) Producing Field Technical Services Contract (PFTSC). Contract length 20 yrs + 5.

Note: There are a number of inconsistencies between the descriptions of the West Qurna1 version of the contract in Jiyad, Wells and other sources. The parameters given below are therefore something of a compromise between the different versions.

**Table 6.6: Physical parameters**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Parameter** | **Value** | **Acronyms** | **Document Source** | **Notes** |
| Reserves in place | 25 billion barrels |  | Wells (November 2009:2) |  |
| Recoverable reserves | 12.163 billion barrels (48.6%) |  | Estimate based on Jiyad production schedule (December 2010:6) and decline rate in Wells (2009:3) | Jiyad (December 2010:19) states 8.6 billion but this is not consistent with his own production schedule |
| Initial production rate in 2010/ baseline production | 0.544 mbd | BLP | Contract p.6  Jiyad (December 2010:6,19) | 0.544 mbd = 198,696 000’s barrels per year (1 yr = 365.25 days) |
| Baseline production rate | BLP declining at 5% per annum | BLP rate | Contract p.3  Jiyad (September 2010:8) |  |
| Incremental production | Actual production in excess of BLP |  | Contract p.6 |  |
| Plateau production | 2.325 mbd | PPP | Contract p.8  Wells (2009:3)  Mousa (2010:10) | 2.350 mbd according to Jiyad (December 2010:6,19) |
| Plateau start year | 2017 |  | Wells (2009:3) | 2016 according to Jiyad (December 2010:6) |
| Estimated decline rate after PPP | 13% per annum |  | Wells (2009:3) | Inconsistent with Jiyad (December 2010:6) (approx. 5%) |

Source:West Qurna1: Exxon-Shell Model (based mainly on Jiyad, September and December 2010; Wells, 2009; and *Technical Services Contract for Brown Fields*)

**Table 6.7A: Financial parameters**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Parameter** | **Value** | **Acronym** | **Document Source** | **Notes** |
| Oil price | $60 per barrel  SEE NOTE BELOW |  | Wells (2009:7) | For simplicity, all prices and costs in model are assumed to be “real” (i.e. after allowing for inflation) |
| Capital expenditure | $25 billion | CAPEX | Wells (November 2009:7) | Distributed similar to Wells p.7 |
| Operating expenditure | $24.13 billion  ($2/barrel) | OPEX | Wells (November 2009:7) | Actual figure is $25 billion in Wells (2009:7)  No breakdown between fixed and variable OPEX available so all OPEX is variable |
| Signature bonus | $100 million | SB | Jiyad (September 2010:3)  Jiyad (December 2010:19) | Original $400 million SB (loan) recoverable as supplementary cost now abandoned |
| Minimum expenditure obligation | $200 million | MEO | Jiyad (December 2010:16) |  |
| Early recovery payment cap | 50% of “deemed revenues” of incremental production | ERPC | Jiyad (December 2010:15,16) |  |
| Basic remuneration fee | $1.9 per barrel | RF | Jiyad (December 2010:19) |  |
| R-factor | Ratio of cumulative cash receipts to cumulative expenditures |  | Contract p.33  Jiyad (December 2010:12) | For Bid Round 1 (BR1)  0<R<1 = 100%  1<R<1.25 = 80%  1.25<R<1.5 = 60%  1.5<R<2 = 50%  2<R = 30% |
| Service fees | Remuneration fees + petroleum (production) costs |  | Contract p.9 |  |

**Table 6.7B: Financial parameters**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Parameter** | **Value** | **Acronym** | **Document Source** | **Notes** |
| Cash receipts | Service fees +  any other income |  | Contract p.34 |  |
| Petroleum cost | All recoverable costs excluding corporate income tax |  | Contract p.8 |  |
| Supplementary costs | Originally mainly composed of repayments of signature bonus (loan) – now abolished.  Environmental costs etc. |  |  | No estimates available |
| Corporate income tax | 35% of remuneration fees |  | Contract p.38 |  |
| Assumed discount rate | 10% |  |  | Conventionally used in petroleum economics literature |

Source: West Qurna 1: Exxon-Shell Model (based mainly on Jiyad, September and December 2010; Wells, 2009; and *Technical Services Contract for Brown Fields*)

Note on Oil Price Assumption:

At the time of writing, the world oil price (Brent) is around $100 per barrel. However, many experts expect this price to fall in the coming years as a result of stagnating demand (because of the world economic crisis) and some increase in supply. This was the opinion expressed by the Norwegian State Secretary for Petroleum and Energy, Mr Rune Henrikson, at the 22nd International Petroleum Tax Conference, Oslo, 2-3 November 2011. His view was that the likely real price over the next two or three years will be around $60/b; accordingly, this is the figure used in the cash flow model. However, sensitivity analysis has also been conducted to calculate the results of a higher and lower price (see below). Companies never use the current oil price for project appraisal – it is always lower and ratcheted up or down with a lag.

Other Assumptions in Model:

No other income (since no estimates available)

No 1% administration costs since available information is unclear as to how these are calculated.

**Table 6.8A: West Qurna1 cash flow**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Year | Date | Baseline production rate (1000 b/yr) (DF = 5%) | Exxon-Shell planned bid: oil production (1,000 b/yr) (DF=13%) | Incremental production (1000 b/yr) | Oil price ($/b) | Total revenue from oil sales ($1,000) | Incremental revenues (deemed revenues) | 50% deemed revenues | Signature bonus ($1,000) | Estimated CAPEX ($1,000) | \*OPEX $1.95/b | \*\*OPEX ($1,000) | Total petroleum cost ($1,000) | Cumulative petroleum cost incurred ($1,000) |
| 1 | 2010 | 198,696 | 198,696 | 0 | 60 | 11,921,760 | 0 | 0 | 100,000 | 200,000 | 2.00 | 397,392 | 597,392 | 597,392 |
| 2 | 2011 | 188,761 | 270,000 | 81,239 | 60 | 16,200,000 | 4,874,328 | 2,437,164 |  | 2,000,000 | 2.00 | 540,000 | 2,540,000 | 3,137,392 |
| 3 | 2012 | 179,323 | 360,000 | 180,677 | 60 | 21,600,000 | 10,840,612 | 5,420,306 |  | 2,000,000 | 2.00 | 720,000 | 2,720,000 | 5,857,392 |
| 4 | 2013 | 170,357 | 450,000 | 279,643 | 60 | 27,000,000 | 16,778,581 | 8,389,291 |  | 7,000,000 | 2.00 | 900,000 | 7,900,000 | 13,757,392 |
| 5 | 2014 | 161,839 | 630,000 | 468,161 | 60 | 37,800,000 | 28,089,652 | 14,044,826 |  | 6,000,000 | 2.00 | 1,260,000 | 7,260,000 | 21,017,392 |
| 6 | 2015 | 153,747 | 720,000 | 566,253 | 60 | 43,200,000 | 33,975,169 | 16,987,585 |  | 6,000,000 | 2.00 | 1,440,000 | 7,440,000 | 28,457,392 |
| 7 | 2016 | 146,060 | 800,000 | 703,146 | 60 | 50,952,360 | 42,188,771 | 21,094,385 |  | 1,800,000 | 2.00 | 1,698,412 | 3,498,412 | 31,955,804 |
| 8 | 2017 | 138,757 | 849,206 | 710,449 | 60 | 50,952,360 | 42,626,950 | 21,313,475 |  |  | 2.00 | 1,698,412 | 1,698,412 | 33,654,216 |
| 9 | 2018 | 131,819 | 849,206 | 717,387 | 60 | 50,952,360 | 43,043,221 | 21,521,610 |  |  | 2.00 | 1,698,412 | 1,698,412 | 35,352,628 |
| 10 | 2019 | 125,228 | 849,206 | 723,978 | 60 | 50,952,360 | 43,438,678 | 21,719,339 |  |  | 2.00 | 1,698,412 | 1,698,412 | 37,051,040 |
| 11 | 2020 | 118,967 | 849,206 | 730,239 | 60 | 50,952,360 | 43,814,362 | 21,907,181 |  |  | 2.00 | 1,698,412 | 1,698,412 | 38,749,452 |
| 12 | 2021 | 113,018 | 849,206 | 736,188 | 60 | 50,952,360 | 44,171,262 | 22,085,631 |  |  | 2.00 | 1,698,412 | 1,698,412 | 40,447,864 |
| 13 | 2022 | 107,367 | 849,206 | 741,839 | 60 | 50,952,360 | 44,510,317 | 22,255,158 |  |  | 2.00 | 1,698,412 | 1,698,412 | 42,146,276 |
| 14 | 2023 | 101,999 | 849,206 | 602,842 | 60 | 42,290,459 | 36,170,518 | 18,085,259 |  |  | 2.00 | 1,409,682 | 1,409,682 | 43,555,958 |
| 15 | 2024 | 96,899 | 704,841 | 607,942 | 60 | 42,290,459 | 36,476,515 | 18,238,257 |  |  | 2.00 | 1,409,682 | 1,409,682 | 44,965,640 |
| 16 | 2025 | 92,054 | 585,018 | 492,964 | 60 | 35,101,081 | 29,577,834 | 14,788,917 |  |  | 2.00 | 1,170,036 | 1,170,036 | 46,135,676 |
| 17 | 2026 | 87,451 | 485,565 | 398,114 | 60 | 29,133,897 | 23,886,813 | 11,943,406 |  |  | 2.00 | 971,130 | 971,130 | 47,106,806 |
| 18 | 2027 | 83,079 | 403,019 | 319,940 | 60 | 24,181,135 | 19,196,404 | 9,598,202 |  |  | 2.00 | 806,038 | 806,038 | 47,912,844 |
| 19 | 2028 | 78,925 | 334,506 | 255,581 | 60 | 20,070,342 | 15,334,848 | 7,667,424 |  |  | 2.00 | 669,011 | 669,011 | 48,581,855 |
| 20 | 2029 | 74,979 | 277,640 | 202,661 | 60 | 16,658,384 | 12,159,665 | 6,079,832 |  |  | 2.00 | 555,279 | 555,279 | 49,137,135 |
| TOTALS |  |  | 12,163,726 |  |  |  |  |  |  | 25,000,000 |  | 24,137,135 | 49,137,135 |  |

**Notes:** \* OPEX: is the remuneration fee that the government has to pay

\*\* OPEX: the calculation of the contractor’s fee according to the production.

**Table 6.8B: West Qurna1 cash flow continued**

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Costs recovery required | Costs carried over ($1,000) | Company receipts: (1) petroleum cost recovery (provided column N < column I) ($1,000) | RF $/b | Company receipts: (2) RF ($1,000) | Total company cash receipts ($1,000) | Cumulative company cash receipts ($1,000) | R-factor | Company profit after tax & after state share @ 48.75% of RF  ($1000) | Company cash flow ($1,000) | State cash flow ($1,000) |
| 597,392 | 597,392 | 0 | 1.9 | 0 | 0 | 0 | 0.00 | 0 | -697,392 | 12,021,760 |
| 3,137,392 | 700,228 | 2,437,164 | 1.9 | 154,354 | 2,591,518 | 2,591,518 | 0.83 | 75,247 | -27,589 | 13,841,942 |
| 3,420,228 |  | 3,420,228 | 1.9 | 343,286 | 3,763,514 | 6,355,032 | 1.08 | 167,352 | 867,580 | 18,355,706 |
| 7,900,000 |  | 7,900,000 | 1.52 | 425,057 | 8,325,057 | 14,680,089 | 1.07 | 207,215 | 207,215 | 19,317,842 |
| 7,260,000 |  | 7,260,000 | 1.52 | 711,605 | 7,971,605 | 22,651,694 | 1.08 | 346,907 | 346,907 | 30,904,697 |
| 7,440,000 |  | 7,440,000 | 1.52 | 860,704 | 8,300,704 | 30,952,398 | 1.09 | 419,593 | 419,593 | 36,201,111 |
| 3,498,412 |  | 3,498,412 | 1.52 | 1,068,782 | 4,567,194 | 35,519,592 | 1.11 | 521,031 | 521,031 | 48,001,699 |
| 1,698,412 |  | 1,698,412 | 1.52 | 1,079,883 | 2,778,295 | 38,297,887 | 1.14 | 526,443 | 526,443 | 49,807,388 |
| 1,698,412 |  | 1,698,412 | 1.52 | 1,090,428 | 2,788,840 | 41,086,727 | 1.16 | 531,584 | 531,584 | 49,812,792 |
| 1,698,412 |  | 1,698,412 | 1.52 | 1,100,447 | 2,798,859 | 43,885,586 | 1.18 | 536,468 | 536,468 | 49,817,927 |
| 1,698,412 |  | 1,698,412 | 1.52 | 1,109,964 | 2,808,376 | 46,693,961 | 1.21 | 541,107 | 541,107 | 49,822,804 |
| 1,698,412 |  | 1,698,412 | 1.52 | 1,119,005 | 2,817,417 | 49,511,379 | 1.22 | 545,515 | 545,515 | 49,827,438 |
| 1,698,412 |  | 1,698,412 | 1.52 | 1,127,595 | 2,826,007 | 52,337,385 | 1.24 | 549,702 | 549,702 | 49,831,840 |
| 1,409,682 |  | 1,409,682 | 1.52 | 916,320 | 2,326,002 | 54,663,387 | 1.26 | 446,706 | 446,706 | 41,350,391 |
| 1,409,682 |  | 1,409,682 | 1.14 | 693,054 | 2,102,736 | 56,766,123 | 1.26 | 337,864 | 337,864 | 41,235,967 |
| 1,170,036 |  | 1,170,036 | 1.14 | 561,979 | 1,732,015 | 58,498,138 | 1.27 | 273,965 | 273,965 | 34,219,059 |
| 971,130 |  | 971,130 | 1.14 | 453,849 | 1,424,979 | 59,923,117 | 1.27 | 221,252 | 221,252 | 28,395,365 |
| 806,038 |  | 806,038 | 1.14 | 364,732 | 1,170,770 | 61,093,887 | 1.28 | 177,807 | 177,807 | 23,562,022 |
| 669,011 |  | 669,011 | 1.14 | 291,362 | 960,374 | 62,054,260 | 1.28 | 142,039 | 142,039 | 19,550,653 |
| 555,279 |  | 555,279 | 1.14 | 231,034 | 786,313 | 62,840,573 | 1.28 | 112,629 | 112,629 | 16,221,509 |
|  |  |  |  |  |  |  |  |  |  |  |
|  |  | 49,137,135 |  | 13,703,439 | 62,840,573 |  | **NPV 10%** |  | **$3,371,062** | **$283,463,436** |
|  |  |  |  |  |  |  |  |  | **-$697,392** | **$12,021,760** |
|  |  |  |  |  |  |  |  |  | **$2,673,670** | **$295,485,196** |
|  |  |  |  |  |  |  | **IRR** |  | **49.47%** |  |
|  |  |  |  |  |  |  |  |  | **TOTAL** | **$298,158,865** |
|  |  |  |  |  |  |  |  |  | **state take =** | **99.10** |

Sources: Iraq Oil Ministry Technical Service first bid round, Jiyad (December 2010) and Wells (November 2009)

## 6.6 Results of the model and discussion

**Table 6.9: Cash flow results at price $60**

|  |  |
| --- | --- |
| Total NPV (10% discount rate) | $298,158,865,000 |
| Discounted state take | $295,485,196,000 |
| State take | 99.10% |
| Discounted contractor take | $2,673,670,000 |
| IRR | 49.47% |

Iraq’s firstbid round contracts are service contracts (see Chapter Five). These bear some similarities to the buyback contracts used in Iran (see Chapter Five); the contractor pays all the costs for producing petroleum until production reaches a specified level over the base production (this is 10% for West Qurna1), payment will start. As in the buyback contracts, IOCs pay all fees at the beginning in the development phase then the Iranian National Oil Company becomes involved and pays the IOCs.

The fees which the contractor receives in Iraq’s service contracts are cost recovery from a cap of 50% in deemed revenue + remuneration fee ($ 1.99 per barrel for WQ1). The remuneration fee is reduced by R factor and taxes and the state’s participation. Payment may be extracted from petroleum exports (i.e. taken in kind) or made in cash (Iraq Ministry of Oil, 2009a).

The company is committed to reaching the plateau target (2.350 mbd) by 2017; if it cannot reach this planned plateau target, then the contract could be terminated according to Article 8 (Iraq Ministry of Oil, 2010). Experts in the field ([Jiyad, 2010a](#_ENREF_22); [Wells, 2009](#_ENREF_39); [Uqaili, 2010](#_ENREF_37)) have argued that this plateau target is unrealistic and probably unsustainable. The calculation here, which is based on Jiyad (2011a; 2011b) and Wells (2009), assumes the plateau target will be reached in 2017 and that production will peak at 849,206 b/year until 2024, when it will decline by 13%. However, this result in a total estimated production of more than 12 billion barrels, which is more than the proved reserve of the field (8.6 bn barrels). This suggests that the experts’ views about the unsustainability of the field and the unattainable production level could be correct. With West Qurna1 reserves at 8.6 bn barrels, a higher rate of decline is needed if the field is to reach the plateau target, and even then, this rate cannot be sustained for seven years. Wells (2009:2) confirms this conclusion as he says: “with the published reserve of 8.6 bn barrels, a 2.325 mbd plateau could not be sustained for seven years, indeed, with these reserves it could only be sustained for one year followed by immediate and steep decline at over 15% per year”.

The following parameters were employed to illustrate this model as accurately as possible: reasonable physical and financial parameters based on actual service contract terms, an official government source and oil expert’s publications. However, it should be noted that parameters may not reflect reality. Both the state take (over 99% of the project NPV) and the company IRR in the West Qurna1 model are very high. This is unusual since they would normally be expected to work in opposite directions – a high state take leading to a low IRR and vice-versa. Moreover, the state take itself is exceptionally high; this would normally be expected to be somewhere around 75-85% in the Middle East environment. However, it should be noted that the outcome of this model has been replicated independently by another analyst (Wells, 2009:7). The reason both the state take and the company IRR are so high is probably because the capital and operating cost are very low in relation to the peak production plateau. The cost cap is also very generous, so the company recovers all its costs very quickly. Indeed, it is well known that oil production costs in Iraq are probably the lowest in the world (see EIA, 1996). In 2011, Exon Mobil and Shell spent $910 million on West Qurna1 and were repaid $470 million in cash (Mackey, 2012). Owing to the cap of 50% of deemed revenues that can be recovered; these companies were successful in recovering almost half of their investment in the second year. Our model reflects these quick cost recovery results (see tables 6.8A, 6.8B and Appendix 2). Based on this data, it is clear to see that companies have an opportunity to recover all of their investments in the third year; a factor that explains the resultant high IRR. However, this is a model based on approximate figures; the reality possibly differs. Furthermore, other fields may not reap similar results as West Qurna1 is already a producing field hence no exploration risks are involved. The government offered better terms for companies in the first bid round of which West Qurna1 was one. Following critique of the first bid round, the government offered fewer remuneration fees for IOC’s in subsequent bidding rounds. In these latter rounds, fields were green (not explored before) which means that they probably needed higher cost per barrel and more investment.

## 6.6.1 Sensitivity to oil prices

When the WQ1 model was subjected to a price sensitivity test to examine the impact of different prices on (a) the total field NPV, (b) the state take and (c) the company IRR, it was revealed that when prices increase, the IRR of the company also increases (see Table 6.10). At a price of $100, the negative cash flow becomes positive from the second year, meaning that the company recovers its costs and starts to make a profit in the second year of the project. In contrast, when the price is $40, company cash flow is still negative in the fifth year of the project**.**

**Table: 6.10: Test of price sensitivity of West Qurna1 field under prices of 40$ and 100$ a barrel**

|  |  |  |
| --- | --- | --- |
|  | **40$** | **100$** |
| Total NPV 10% | $195,148,838,000 | $511,873,451,000 |
| Discounted state take | $192,720,666,000 | $509,183,254,000 |
| State take | 98.76% | 99.47% |
| Discounted contractor take | $2,428,172,000 | $2,690,197,000 |
| IRR | 30.23% | 59.28% |

The state take also increases from 98.76% at $40 to 99.10% at $60 and 99.47% at $100. This shows that the system is progressive ([Johnston, 2007](#_ENREF_24)) as the state take goes up when prices go up. The rise from 99.10% at $60 to 99.47% at £100 effectively cuts the IOC share by 41% (from 0.90% to 0.53%). Obviously, there is no room for a large absolute increase in the government take because it is already close to 100%.

## 6.7 Criticisms of the Federal TSC

As soon as the main outline of the TSC was disclosed, the contract came under a good deal of criticism. The following sections identify some of these criticisms, though it should be noted that some have since been addressed by subsequent modifications to the contractual terms.

## 6.7.1 The contract encourages higher costs

Park ([2010](#_ENREF_21)) and others have argued that the fee structure creates a tendency to “gold plating”. There is no incentive to keep costs to the minimum since these are all recovered in full, regardless of the amount. He argues that most host governments incentivize investors to keep costs low by allowing them to draw some of the profits from the activity. A super-progressive regime in which none of the excess profits go to the investor naturally creates a structure whereby you have the golden R-factor + full cost recovery. The higher the costs of the field development project, the lower will be the total value (NPV) to the state, even though the state take might remain the same and the company IRR might not be affected very much.

## 6.7.2 Changes in the contract after signing

Meurs (2009) has argued that the contract encourages corruption by allowing the parties to make changes or additions after it has been approved by the Council of Ministers. For example, according to Article 2.3, if an adjacent reservoir is discovered after the contract has been signed, the contractor can make a proposal for its development and the parties can negotiate a revision of the service fees. However, since this happens after the contract has been signed, the revised agreement is not subject to competition or to the Council of Ministers’ approval. Similarly, the bidder could win a contract by agreeing low service fees with a specific government or state company official, only to increase the service fees later ([Meurs, 2009:3-6](#_ENREF_30)).

## 6.7.3 Weak inclusion of local content

Article 26 in the Iraq oil Service contract, briefly and non- specifically provides provisions on employment, training and technology transfer. The contractor is obliged to employ the maximum possible number of qualified Iraqis, but Meurs (2009) argues that this and the other requirements are lower than the minimum requirements for PSCs and risk service contracts anywhere in the world. The requirement for $5 million to be provided annually for education, training and technology is not adjusted for inflation, meaning that the amount of training will decline during the contract. Nor does the contractor have any incentive to spend more on training than the annual amount, as this is a non-recoverable cost. Article 30, meanwhile, stipulates briefly that the contractor should give preference to local goods and services, but gives no details about suitable procedures; for example, the contractor is not obliged to invite local companies to bid for goods and services.

INTER2, when interviewed at the 2010 Iraq Petroleum conference in London, criticised the local content provisions, arguing that the service contract should have stipulated a similar level of local content to that expected in Norwegian contracts (50-70%). At the same conference, Park acknowledged that local employment and training for employees is addressed in Iraq’s service contract – but in a manner which indicates that it is not viable. The contract indicates that Iraqi services will only be selected if they meet international standards, which is no incentive for IOCs to hire local people or make use of local goods and services. He observed that some would say that this is what killed the old concession system in Iraq, though as Chapter Five indicates, local content was in fact only one of many contributory factors. The old concessions gave the government a tiny share of revenue, no powers to monitor the IOCs’ activities to make sure that everything was proceeding as it should, and no control in terms of developing activities. In addition, the environmental outlook was poor.

Meurs (2009), Park (2010) and INTER2 have all criticised the ambiguity and lack of clarity in local content provisions. INTER2 wanted the contract to set out obligations for local involvement and use of local services and goods, not just in general terms but with clear fiscal specifications. His arguments were based on his personal experiences working for the Iraq Petroleum Company in Baghdad in the ’50s and later as the co-founder of Iraq’s National Oil Company in 1964. He argued at the conference that history may repeat itself and that the Iraqi people could be deprived of the opportunity for participation in these contracts. The high oil revenues received by the government may be of less importance than the failure to involve local enterprise and labour in developing the oil industry.

## 6.7.4 Incompatibility between production plateau target (PPT) and Best International Petroleum Industry Practices (BIPIP)

As already mentioned, the contract could potentially place companies in the position of having to choose between meeting the PPT (one of the bidding parameters) and conforming to BIPIP. The production plateau target has been challenged as unachievable, while others argue that even if it is achieved, it cannot be sustained, and that optimal depletion rate can only be met by violating BIPIP and inflicting major damage on the field ([Wells, 2009](#_ENREF_39); [Jiyad, 2010a; 2010b](#_ENREF_23); [Husseini, 2010](#_ENREF_12)). Choosing to commit to BIPIP means the IOC is even less likely to meet PPT and increases the risk of penalties or even termination of the contract.

## 6.7.5 Complex approval process and procedures

Park (2010) has argued that the approval system in the contract creates the world’s most complicated approval process for petroleum contracts. Nowhere else are five levels of approval required for development and three levels for programmes. This is going to be very difficult to administer. Control is theoretically in the hands of the Iraq Oil Ministry, which will need to be very heavily staffed to cope with the administrative demands. However, since the US invasion, occupation and civil war, Iraq has lost hundreds of thousands of skilled professional people and it now lacks the administrative capabilities to deal with such a complicated contract by itself. It may need to bring in IOC staff to help. This could lead to serious conflicts of interest and even manipulation by the IOCs.

## 6.8 Disagreements between the KRG and the Federal Government over contracting practices

When Kurdistan awarded its first oil contract to the Norwegian company DNO to drill for oil at the Tawke field ([EIA, 2006](#_ENREF_4)), this incurred the anger of the central government. The situation worsened when, unable to agree with the central government about the draft hydrocarbon law, the KRG wrote its own hydrocarbon law authorising the signing of production-sharing contracts (PSCs) with IOCs. As the central government regards itself as having sole authority to sign contracts, it dismissed the KRG’s contracts as illegal and halted Kurdistan’s oil exports.

A further cause of contention was the KRG’s proposal that the Federal Government should pay the costs Kurdistan would incur by entering into contracts with international oil companies. The Federal Government wanted the KRG to pay these fees itself from the 17% of oil revenues it is allocated under the National Oil Law (this 17% is contingent upon the KRG exporting 150 000 BPD, which is itself another source of dispute) ([Iraq Business News, 2011](#_ENREF_14)). However, in January 2011, the government relented and agreed to pay the KRG’s contractors, even though exports from KRG were only 100 000 BPD ([Iraq Business News, 2011](#_ENREF_14)). In other words, although the government still considered these contracts to be illegal, it agreed to pay the related costs. The first payment was made in May 2011. The Iraqi Prime Minister (Nouri al- Malki) confirmed via *Energy-pedia News* ([2011](#_ENREF_6)) that the payment to the KRG contractors amounted to around 50% ($243 million) of the net revenues derived from the export of over 5 million barrels of oil from the Kurdistan Region between the start of February 2011 and March 27.

When the energy consultant to the Iraqi Prime Minister (INTER1, see appendix 1) was interviewed by this researcher, he was asked why the government had agreed to pay for the KRG contracts, when at the previous year’s Iraq Petroleum Conference he had expressed opposition to this. He replied that the contractors had not been paid, so it was decided that the practical solution would be for the KRG to use 50% of its export revenues to pay the contractors and for the other 50% to go to the federal budget. In an interview with the *Financial Times* in 2011, one oil and gas banker from the Middle East suggested that in fact, financial necessity could have been behind Baghdad’s decision; the central government wanted Kurdistan to resume exporting so it could take a share of the revenue to pay its own service contract companies, who had met their 10% increase target and were wanting to be paid ([Vinales, 2011](#_ENREF_38)). Thus, the central government’s change of heart may have been prompted both by a desire to resolve its stand-off with Kurdistan and to increase the oil revenue in the central annual budget.

At the 2010 Iraq Petroleum Conference, Kurdish Energy Minister Ashti Hawrami argued that contractors should be paid from central government expenditure and not from the 17% Kurdistani share of Iraq’s total oil revenue. This was before the government started to pay contractors in March 2011. At the time, INTER1 responded:

“*the development cost you are proposing to be deducted from the top, I have no problem with that, but this means it is a sovereign cost and sovereign cost means that we are dealing with sovereign activities and this, according to observers of the constitution, those people who deal with sensitive legal issues and power between federal government and the region, gives the impression that we are dealing with activities that concern the nation and that is why we are paying and considering this cost as a sovereign cost*”.

The energy consultant was saying that if the government pays for the KRG’s contracts out of government expenditure, before this money is distributed to governorates, it has a claim on all of Kurdistan’s oil revenues; that is, whoever pays the sovereign cost owns the oil. If the Kurds want the central government to pay these costs, then they are implicitly ceding ownership and control of oil that is found on Kurdish territory to the central government.

## 6.9 KRG production-sharing contracts and the basic parameters of awarded fields in Kurdistan

Exploration began in Kurdistan’s oil and gas fields after the 2003 war. In 2011 the Kurdish Energy Minister, Ashti Hawrami, speculated that Kurdistan has potential reserves of 45 billion barrels of oil and 3-6 trillion cubic meters of gas ([KRG.org, 2011:7-8](#_ENREF_25)). However, this has not been confirmed by reputable international sources such as the EIA (see EIA, 2010) as they are still working with old estimates dating from 2001.

At the time of writing there are 37 oil and gas contracts in Kurdistan, involving 40 multinational oil companies. All these contracts are PSCs. The reason the KRG chose the PSC was probably to encourage companies to sign contracts as they wanted to act quickly to secure the oil revenues. In an interview given by Ashti Hawrami to the Invest Media Group, Kurdistan Region of Iraq ([2011:5,6](#_ENREF_26)) he argued that service contracts such as those used by the Federal Government would not work for Kurdistan because in a service contract the contracting company has to be paid its costs whether the operation is profitable or not. The problem for the KRG was that the oil and gas fields in Kurdistan are largely undeveloped and the resources much more speculative. The KRG did not have the financial resources to take the risk that the new field developments might be unsuccessful. On the other hand, in a PSC agreement the company is paid its costs out of the profit oil, so if there is no profits oil it doesn’t get paid. All the risk therefore falls on the company.

Table 6.11 lists the current producing oil and gas fields in Kurdistan at the time of writing. The rest of the contracted fields are under exploration and development.

**Table: 6.11: Oil-producing fields in Kurdistan 2011**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Oil field** | **Governorate** | **N/IOCs consortium (80%)** | **Estimated current production** | **Estimated reserves,**  **million**  **barrels** |
| Taq taq | Erbil | Turkey’s Genel Energy (44%) and China’s Sinopec (36%) | 60,000 b/d  75 000 (c) | 366(a) |
| Tawke | Erbil | Genel (25%)  DNO (55%) | 72,000 b/d (d)  75 000 (c) | 636 in 2011 up from 306 in 2010 (b) |
| Shaikan |  | Gulf Keystone Petroleum (50%) | 5,000 b/d (d) | 170 (e)  10800 (f) |

Sources: (a) Petroleum Law Annexes (2007), (b) *Petroleum Economist* ([2011](#_ENREF_33)), (c) Genel Energy ([2011](#_ENREF_8)), (d) Lando ([2011](#_ENREF_28)), (e) Shamran Petroleum ([2009](#_ENREF_34)), (f) Bradbury ([2011](#_ENREF_1))

As can be seen in the table above, estimates of both production and reserves vary significantly. This may be because there is still no official data from the KRG, and Kurdish fields are still under development, so production changes from month to month. As the fields are still under exploration, reserves may increase further; for example, reserves from Tawke increased to 636 mb in 2011 from 306 mb in 2010.

## 6.9.1 Parameters of PSCs awarded by the KRG

***Signature bonuses*:** There are no pre-production bonuses; however, the contractor pays $2.5 million when the regular sale of crude oil abroad through a pipeline commences, and $5 million when total production reaches 10 million barrels. This increases to $10 million when cumulative production reaches 25 million barrels and to $20 million when it reaches 50 million barrels ([Kurdistan Region PSC, 2007: Article 31](#_ENREF_27)). This compares very favourably with the TSC for Al Ahdab field, which guarantees a much lower $3 million bonus. The other TSCs have much higher bonuses, although it must be remembered that Rumaila and Missan still have interest-bearing loans which are considered unacceptable by many Iraqi oil policy makers.

***Profit Oil:*** There is no remuneration fee in this contract, but profit petroleum is shared – this is the profit from all crude oil and natural gas sales after cost recovery. Crude oil cost is recovered from 40-45% of gross annual revenue from incremental production after deducting a 10% royalty (Kurdistan Region PSC, 2007: Article, 25, 26). This cost cap is tougher than that in the service contract (which is 50% of gross revenue). The TSC allows contractors to recover their cost more quickly than the KRG’s PSC; especially since the 10% royalty is deducted from gross revenue in the latter.

Maximum cost petroleum as a proportion of total profit is 36%-40.5%, varying between low risk and high risk areas (see*Kurdistan Risk/Reward Commercial Guidelines for Exploration, 2007*). The amount of profit petroleum to be shared after the recovery of costs is 54%-59.5% of total profit. This percentage is divided according to the R-factor, which is cumulative contractor income/cumulative contractor cost.

**Table 6.12: R-factor and contractor’s % share of profit crude oil under PSCs awarded by the KRG**

|  |  |
| --- | --- |
| **R Factor** | **Contractor’s**  **% share of**  **profit crude oil** |
| R <or =1 | 30% |
| 1<R<or = 2.5 | Contractor’s share is calculated using a formula:  30% - (30-15.6)\*(R-1)/(2.5-1)   |  | | --- | |  | |
| R>2.5 | 15.6% |

Source: KRG PSC (2007), Genel Energy (2011:30) (based on Taqtaq field)

Shamran Petroleum Company (a member of the Lundin Group), which has a PSC for Pulkhana field in Kurdistan, has made its calculations on the basis of a reserve of either 100m or 250m barrels, assuming a market price of between $65/b and $100/b (Brent). The results for the 250m reserve scenario are presented in Table 6.13.

**Table 6.13: Main commercial terms of the Shamran PSC for Pulkhama oil field**

|  |  |  |  |
| --- | --- | --- | --- |
| Duration: exploration period | Initial term 5 years, extendable by 2 years | | |
| Development period | Initial term 20 years, extendable by up to two 5 year periods | | |
| Signature and capacity building bonuses | $45 million | | |
| Royalty rate | 10% | | |
| Cost recovery ceiling | 40% | | |
| Profit oil parameters | R-factor: (0 to 1) 26%; (1 to 2) sliding scale between 26 and 13% (>2)13% | | |
| Exploration costs | $72 million | | |
| Capital costs | $508 million | | |
| Fixed operating costs | 20 m/year | | |
| Variable operating costs | $2/b | | |
| Reserves | 250 million barrels | | |
|  | $65/b Brent | $80/b Brent | $100/b Brent |
| Net present value at 10% discount rate (NPV10) | $460m | $624m | $802m |
| Rate of return (ROR) | 34% | 44% | 56% |

Source: Shamran Petroleum Corporation (August 2009), Wells (2009)

Comparison with the West Qurna TSC is difficult because the fields are of different sizes, though it is evident that the ROR is extremely high (ranging from 34-56%), even though the field is much smaller than West Qurna. Wells (2009:2) argues that this ROR is much higher than the rate in other OPEC countries, where ROR on pure exploration contracts rarely exceeds 20%. He adds that the KRG cedes an excessive amount of rent to the contractor, as well as a significant oil price windfall.

## 6.9.2 Inclusion of local content and training

The contractor provides $300 000 each year for training, with a similar amount for environmental assistance to the contract area. These are considered petroleum costs and are to be recovered. Similarly, technological transfer, which is provided at a value of $250 000, is considered assistance from the contractor ( [Genel Energy International Limited et al](#_ENREF_31).,[2008: Article 23](#_ENREF_35))**.** Thus, the criticism levelled at the Federal TSC applies even more to the PSC, as it provides significantly less money for training and technology transfer than the TSC. What is more, this money is cost recoverable. Meurs (2009) criticised the unrecoverable cost element of the TSC as it limits the contractor’s incentive to spend money on training. However, the KRG contract is worse on this point because the recoverable cost is not only defined and limited, but approval from the management committee is required each year. Thus, it can be difficult to spend more than what has been agreed upon in the contract.

With regard to the provision of local goods and services, Article 18 of the PSC merely states that the contractor should prioritise purchasing equipment from Kurdistan and the rest of Iraq, provided it is available in the required quality and quantity. As in the case of the TSC, there are no details about procedures and thus the contractor is not specifically obliged to invite local companies to bid for goods and services.

## 6.10 Which is superior: the PSC or the TSC?

Wells (2009:7) argues that the Federal TSC either equals or is considerably superior to the KRG’s PSC. If the KRG’s PSC model were to be applied to West Qurna1, the state take would be similar to that achieved under the TSC (99% for the TSC and 97% for the PSC), but he calculates that Iraq’s oil revenue would be $8 billion less over the life of the project. The author adds that this situation would be made worse if oil prices were high as the PSC has a limited cap on windfall profits from high oil prices. He argues that the contract terms of the TSC incorporate a very effective mechanism for preventing the accumulation of windfall profits as a result of high oil prices.

Meurs (2008:25-28) confirms Wells’ point about the variation in government take between low and high oil prices and between small and large fields, but argues that the KRG’s PSC is superior to the TSC as in the latter, the costs of contractors are not aligned with government interests; hence, there is no strong incentive to keep down the cost of a project.

Cash flow analysis for West Qurna1 shows that when oil prices are high, both the state take and the contractor’s IRR increase. This is because the costs are recovered more quickly. However, the effect of the R-factor means that the contractor’s RF decreases.

When asked what he saw as the differences between the Federal TSC and the PSC used in Kurdistan, INTER2 (see appendix 1) replied:

“*There is no difference between the service contract and the PSA; when you participate in the decision making process, it means you participate in sovereignty. Theoretically, it is a sovereign state but in practice this is impossible, because the investors are providing the mone*y. *The Baghdad Service Contract is a mirror image of the PSA. I don’t think condemning one or praising the other on the basis of cash flow analysis is always correct. We should take into consideration the fiscal terms involved. I am afraid that Baghdad imitated the PSA in adopting decision making, which is the overall important factor. Also it imitated the KRG agreement in maximising the front loading of the expenses and as a result the cash flow is poor at the beginning in Baghdad. They both use the R-factor, which promotes the early payment of expenses and lets the company get its return quickly. The decision making process in both is identical; as long as you ask the investor to put up his money, he is entitled to be involved in decision making and that is the case in the Baghdad service contract. The decision making is shared, the final authority should be in the hands of the state but that is not the case in the service contract”.*

Asked the same question, INTER1 replied:

*“The PSC contracts will end up with an inferior government take as compared with the service contracts signed by MOO. I have seen an independent study about this and KRG officials have probably seen it too”.*

So while some authors and oil policy makers view the PSC used in Kurdistan as being more successful, others view Baghdad’s TSC as having better terms, and yet others are of the view that the two are almost identical. It is this researcher’s view that the Federal TSC and the KRG’s PSC share similar basic characteristics. These are:

1) The TSC is, throughout the four bid rounds, a risk service contract; as in the PSC, the contractor pays the cost, recovering his investment when he makes a discovery or achieves a target production level.

2) The state take in both contracts is high by international standards: in each case over 90% of the project’s NPV.

3) Neither contract gives much incentive to keep costs to a minimum.

(4) Local content is weak in both contracts.

The researcher agrees with INTER2’s (see appendix 1) comment:

“*I hope we will have a solution to what are called the two types of management of the oil industry. This is not compatible with the essence of the Iraq constitution, which states that oil and gas belongs to all Iraqi people. That type of management does not optimise, it does not help to achieve extraction of oil in the interests of the nation. Neither of these contracts, the service nor the PSA, has served the needs of the nation well; neither has gained Federal Parliament approval, so both parties are guilty of mismanagement by assuming authority that does not belong to them*”.

## 6.11 Conclusions

The central government in Baghdad has recently opted for oil service contracts. This type of contract replaced the production-sharing contract which was first identified in the first published draft of the oil and gas law in 2006. The transition came about because of the many objections from Iraqi oil consultants and politicians that PSCs are too generous to IOCs. As a compromise, service contracts have been signed with IOCs which differ from the normal fee payment service contracts discussed in Chapter Five. The Iraqi service contracts have similarities with the buyback contracts used in Iran as the contractor pays all costs, which are later paid back at an agreed rate of return. As in Iran, the contractor is paid recovery costs and remuneration fees. The Iraqi service contracts also have some similarities with production-sharing contracts; for instance, the costs are initially paid by the contractor and recovered later, there is a 50% limit cost payment of deemed revenues, and the remuneration fee is split by the R-factor. Finally, service fees can be paid in kind, which also happens with the PSC.

The central government offered contracts for its fields via several rounds of competitive sealed bidding. In the face of criticism of its specified fiscal parameters, it improved its fiscal terms as the rounds progressed. The fields which were offered in the first bid round were brown fields that were already producing; the second bidding round was for green fields that were non-producing, whilst the other rounds were for under-developed or exploration fields. In contrast, Kurdistan offered its fields without ever publishing the awarding criteria. It signed PSCs with IOCs: an action that is considered illegal by the central government, which argues that it should be solely responsible for signing contracts, and that these contracts should all be awarded through the same bidding round process.

Chapter Two sets out three main criteria for judging how successful the KRG’s PSCs have been in capturing the rent from oil and gas operations: (1) the absolute size of the rent (i.e. the NPV of the future cash flow), (2) the state take (the percentage of the NPV which flows to the government) and (3) company profitability as measured by the company’s IRR. This should not be too large as this indicates a loss of rent from the point of view of the state.

Considering criterion number 2 first, in both the Federal TSC and the KRG’s PSC, the share of the cash flow going to the state is in excess of 90%. According to West Qurna model, the state take is increased by the R-factor (which reduces the IOC’s remuneration fees) and by corporate tax (35%) and state participation (25%). However, it is difficult to show this empirically because the government does not publish the relevant financial data. The only report it publishes is the IEITI report, and the 2011 report only includes data about remuneration fees and cost recovery for IOCs. Although the data shows a government takes of more than 90% for that year, it reveals inconsistencies in the figures reported by IOCs and central government, and it is vague on the subject of settlement. It also highlights a dispute over cost recovery figures, but again, it does not clearly explain how this was settled. The report makes no mention of the 35% corporate tax and the state participation percentage, so it is not clear if the final state revenues include these or not.

In the case of criterion number 3, according to West Qurna1 model the company’s IRR is higher than one would have expected. This is because cost recovery for oil companies is quick and cost per barrel is very cheap in Iraq. The cost recovery gap is very generous, allowing IOCs to recover their money quickly. Furthermore, it cannot be assumed that all Iraq’s fields under service contracts generate such significant IRR levels because West Qurna1 field is already a producing field so no risk in exploration, possibly cost per barrel in green fields ( non-producing fields) would be higher. Also, the government offered more favorable terms in the first bid – round for IOC’s compared to other rounds. However, it is difficult to see it is worthy to modify the contracts to reduce this profit rate, given the already high state take.

On balance, using Mommer’s terminology as described in Chapter Five, both forms of Iraqi oil contract appear to be proprietorial, apart from in one particular aspect – the desire to (perhaps excessively) accelerate production, which has been noted by many authors, including Wells (2009) and Jiyad (2010). As large quantities of Iraqi oil flow out into the world, there could be an oversupply, which could create a problem in terms of OPEC quotas and Iraq’s membership of OPEC. If Iraq does not restrain this oversupply, world oil prices could collapse back to very low levels, which would clearly be disadvantageous to both Iraq and the other oil-producing countries. Wells (2009:3-5) shows that high production plateaus for Iraq will be needed only after 2017, when oil demand will increase. Until then it may be necessary for Iraq to restrain its planned production increases in order to maintain prices and hence total revenues.

Turning to criterion number 1, it has not been possible to obtain estimates of the NPV for all the various oil and gas projects which are now underway or planned. Indeed, it is difficult to know how such a figure could be reasonably calculated. However, according to the Iraq Ministry of Finance, Iraq received a total of $47 billion in oil revenues in 2010 and $64 billion in 2011(see Table 8.5). These are already very large sums and if the various oil projects progress as the companies and the state authorities have forecast, they will become progressively larger. It is therefore important to address the question of how these very large sums can be divided equitably between the various regions of Iraq so that the country can recover from its recent terrible history. This is the subject of the second part of the thesis.

## Chapter Seven: Oil Revenue Distribution in Theory

## 7.1 Introduction

The preceding chapters have discussed Iraq’s petroleum fiscal regime and established that the country receives vast oil revenues. This chapter explores the various ways in which governments around the world distribute their oil revenues regionally, looking at how resource revenues are distributed between central and sub-national governments, and which government body gets to decide on expenditure. These are political questions, thus the literature will be of a political nature. As Chapter Four shows, the distribution of resource revenues is the subject of dispute between central government and Kurdistan. Accordingly, this chapter discusses examples from other oil-producing countries where there are similar disputes over resource revenues, in the hope of drawing lessons for Iraq.

A country not only needs to be successful in maximising its share of the rent, it has also to decide how the revenues should be distributed to benefit its citizens. The resource revenues captured by government are different from all other tax revenues because the resources that yield them are nationally owned (see section 2.2.4). As Segal (2012) explains, resource revenues are not taken from anyone; they are collected directly from unearned value and distributed, unlike central government taxes, which are taken from citizens and businesses and redistributed. These revenues have become an increasingly important part of the national budget in many countries, especially where they represent a high percentage of the GDP. Often, they are channelled straight into the general budget with no special management arrangements. However, governments face a number of questions when it comes to the distribution of these revenues, such as how to distribute them equitably to the different regions of the country; whether producing regions should have a larger share, and if so, according to what criteria, and what the implications of this would be. In the longer term, they must also decide how best to ensure that the revenues benefit not just current but future generations. Another question asked by observers is whether revenue distribution is affected by political conflict between central and regional governments and if so, how?

In order to answer these questions, this chapter is divided into three sections. Section 7.2 discusses distribution between the present and future generations, analysing how governments choose whether to save oil revenues for future generations or to spend them now, and considering the effect these policies have on regional distribution.

Section 7.3 discusses various regional distribution regimes, highlighting other countries which, like Iraq, face disputes over revenue distribution. The first regime described is the centralised distribution model, in which central government controls all revenue collection and spending. This is illustrated by reference to Kuwait and the UK (where there is a dispute with Scotland about oil revenues). The second regime is the decentralised distribution model, including revenue sharing among regions. This is somewhere between centralised control and true decentralisation as the central government receives revenues in the first instance but then gives local governments some control over expenditure. This regime is illustrated by reference to Indonesia and Colombia, where revenue sharing has been implemented for political reasons. Since this is the closest to Iraq’s current oil/gas revenue distribution model, it is hoped these countries may provide some useful lessons for Iraq. The other decentralised distribution system is revenue based collection by sub-national governments, in which the latter control the collection and spending of oil/gas revenues. This system is illustrated by reference to Canada, where, as in Iraq, non-oil producing regions are complaining that oil revenues are being distributed unfairly. There are fewer studies on the decentralised distribution of revenues, making this discussion particularly useful.

Finally, section 7.4 explores another revenue distribution system, which is the direct distribution of cash to individuals as direct transfers. This area has been more widely studied than indirect distribution. The section discusses Alaska as an example of an oil rich country that is using its oil revenues to combat poverty – a problem also faced by Iraq.

**7.2 Distribution between the present and future generations**

Oil producing and exporting countries make a choice between consuming and/or investing in fixed assets today, or investing in financial assets for future generations to consume. The intertemporal distribution of resource revenues requires special attention for two reasons: first, revenues are highly volatile, as a result of price fluctuations, and second, they are finite. Volatility calls for short-run expenditure smoothing, while exhaustibility may call for long-run saving for the future (longer term smoothing). Both short-term and long-term saving require that part of the oil/gas revenues be held back, reducing the money available for expenditure and distribution to sub-nationals. Governments may be tempted to spend all the revenue available at the time. However, “the standard intertemporal economic model of consumption, based on the proposition of diminishing marginal return to income, encourages the consumption of the same amount each period, demanding saving in periods of high revenues and dissaving in the opposite situation” (Segal, 2012:342).

**7.2.1 Volatility of resource revenues**

Some authors (Engel and Meller, 1993; Engel and Valdés, 2000; Davis, 2001) have suggested that oil funds or saving funds should be used to address the problems created by oil price instability. These funds, known as stabilisation funds, are especially important for countries which are dependent on oil/gas revenues. When oil revenues are high, part of these revenues can be diverted from the budget to the stabilisation fund, but when oil prices drop, the stabilisation fund finances the shortfall; the country will not be forced to cut spending on development or interrupt unfinished projects, but instead can finance these projects through dissaving from the fund. A number of oil producing countries have attempted to address price instability and make provision for future generations by setting up saving schemes and/or oil stabilisation funds, despite the difficulty of predicting oil prices.

In a recent study, Landon and Smith (2010) found that although the Alberta Heritage Saving Trust Fund (AHSTF) is unable to completely eliminate the volatility of revenues, it could help protect Alberta from resource shocks. The authors recommend that the most effective way of addressing revenue volatility is to establish a resource revenue stabilisation fund with fixed contribution and withdrawal rates. The government is then committed to allocating a share of the oil revenues to the fund and to including it in the budget. It might also help steady the government’s spending and reduce waste and corruption when revenues are high. However, the major difficulty is likely to be finding the money for the contribution in low revenue years. Also, At times of very low revenues, the country might even need to withdraw more money from the fund. When AHSTF was set up in 1976, it received only 30% of non-renewable resource revenues. The contribution was then reduced to 15% until 1987. Between 1987 and 2006 no payments were put into the fund. Payments into the fund recommenced in 2006 (Landon and Smith, 2010).

Collier et al. (2009) agree that there is a need to control revenue volatility by creating short term stabilisation funds; however, they believe the emphasis of these funds should be on helping to smooth expenditure at times of boom. They encourage developing countries to invest revenues in domestic projects rather than in long-term funds (see 7.2.2), but to be cautious in spending and to progress slowly. Since revenues are volatile, one effective strategy is to smooth expenditures through a short-term fund known as a Sovereign Liquidity Fund (SLF). The problem here is that if the government is under no binding legal obligation to add money to the fund, at times of high revenues it may be tempted to spend the money rather than save, especially if the country needs investment. As the name SLF suggests, it works as a stabilisation fund rather than a saving fund and for a much shorter term. Collier et al. suggest that investment should be structured carefully to cope with fluctuations. Investment is the most volatile component of income in all countries, which suggests that the cost of fluctuation is quite modest. Collier et al. (2009:32) argue that using revenues for investment rather than foreign assets means that investment as a share of GDP will be high. The role of the SLF is to smooth investment to the level needed to reduce the cost of fluctuations. It is not necessary to keep the rate of investment constant, but sudden large increases in investment should be avoided as this requires the build up of precautionary liquid balances (ibid). Collier et al. suggest that the investment process should focus on high long-term rates of investment and allow major variation around this high level. This implies that investment policy should be able to deal with major contractions and fluctuations. However, this is not easily achieved because most investment projects involve private investors who want to see a return on their investment within a specified timeframe. Reducing investment in these kinds of projects is very difficult once the project has started. Contrary to what Collier et al. (2009) suggest, cutting investment can cost governments dearly. It may lead to job losses and, in developing countries where the basic infrastructure is weak, cutting projects can adversely affect other economic activities. Iraq, for example, continues to experience major power supply problems, especially during summer time when the electricity can be cut off for fifteen or sixteen hours a day (Yacoub and Rutledge, 2011). Since electricity is not only necessary for people’s wellbeing but also for factories and businesses, investment in the industry should not be reduced.

Segal (2012) argues that expenditure volatility does not take into consideration the macroeconomic cycle, despite the fact that standard macroeconomic analysis requires that fiscal policy should still be countercyclical[[36]](#footnote-35) where possible. Segal (2012:342) adds that: “the point is not exactly to smooth expenditures, but to vary total expenditures according to macroeconomic needs, and not to the level of current resource revenues”. Kuwait’s spending, for example, is driven not by revenue availability but by fiscal policy. Kuwait has adopted a countercyclical strategy and has two funds, one of which is a stabilisation fund. The General Reserve Fund (GRF), which was established in 1960, is financed by surplus oil revenues. In 1976, another savings fund was established, the Reserve Fund for Future Generations (RFFG). This fund is financed by taking 50% of GRF revenues and 10% of total government revenues. The RFFG has strict rules for accumulation and withdrawal. It works as a long-term savings plan to protect future generations, while the GRF is more flexible to meet short-term financing needs. Oil revenue in general has been budgeted on oil price assumptions, while government spending has been kept within the budgeted amount and has not been driven by revenue availability. This is good practice, but it is arguably easier for Kuwait to adopt it as it has a high GDP per capita (USD 52,197 in 2013) (World Bank, 2013). Kuwait can afford to have two funds, but it is difficult for poorer oil producing countries like Iraq, which has a lower GDP per capita (USD 6,596 in 2013) (see Table 8.3) and more demands on government spending.

There are other important practical reasons to avoid expenditure volatility. A sudden rise in expenditure and demand can create economic friction if labour and capital are unable to respond quickly enough, leading to inflation and shortages, while a decline in expenditure can lead to unemployment and idle capacity (Segal, 2012). When revenues fall, bureaucratic and political pressure may make it difficult to cut expenditure. This is likely to lead to fiscal and/or current account deficit and, in time, to unsustainable debts (Segal, 2012). For example, in Zambia in 1980 there was a crisis when government expenditure failed to respond to the decline in copper prices (Adam and Simpasa, 2009). Smoothing is difficult because it requires the prediction of long-run commodity prices (as well as extraction costs), but market uncertainty makes such prediction virtually impossible (Segal, 2012). At times of high oil prices, Iraq has dramatically increased expenditure, but this has left the country with deficits and debts in times of low oil prices and cuts in investment. A stabilisation fund is therefore crucial to avoid these problems. In 2007-2008, government expenditure increased by almost 57%, while revenues went up by 61% (reflected in DFI and government expenditure). However, in other years, revenues have been low, forcing the government to reduce its expenditure. It was obliged to reduce expenditure by 38% in 2009 (**Table 8.2**), but even so, it was still left with deficits of 24.9% of GDP. These deficits were financed a) from surpluses between assumption of oil revenues and actual oil revenues based on actual market price when estimated oil revenues are higher than the actual price, and b) by borrowing from inside and outside Iraq. The problem is that once expenditure, a large proportion of which goes on public wages and operational expenditures, has been cut, fluctuations in oil prices are most likely to be reflected in cuts to the investment budget – in 2009, for example, this was cut by 50% (Iraq Ministry of Finance, 2009).

Resource volatility can be a source of dispute between central and sub-national governments, especially if these regions collect oil revenues independently (as in the case of Alberta in Canada) or are given shares which fluctuate with the oil/gas revenues. Where the government has committed to pay a set premium to oil producing regions (such as Iraq’s petrodollar, which equates to $1-$5 per barrel of oil produced), reduced revenues may leave it unable to fund these commitments. For these reasons, short-term funds are vital to stabilise revenues.

**7.2.2 Exhaustibility of resources**

Because resources are exhaustible, long-term saving is crucial. The permanent income hypothesis (PIH), developed by Friedman (1957), posits that since revenues may rise or fall, only the permanent or annuity value should be spent each year and some or all of the remainder saved. In this way, a fairly constant standard of living is maintained, even though income may vary considerably from year to year. Increases and decreases in revenues will have little effect on consumption spending; rather, this will be determined by the amount of revenue that is expected to be earned over the long term.

The IMF encourages funds which are based on this hypothesis. These so-called Sovereign Wealth Funds (SWFs) are usually invested abroad (Davis, 2001; Barnett and Ossowski, 2003; Leigh and Olters, 2006; Segura, 2006; Olters, 2007; Basdevant, 2008). The advantage of investing abroad is that the return on the funds is largely unaffected by internal shocks such as a rise or fall in oil or gas prices. However, spending only the annuity value of the revenues can be difficult. An even moreconservative approach is the bird in hand hypothesis(BIH) (Bjerkholt and Niculescu, 2002; Barnett and Ossowski, 2003), which proposes that all revenues go to the fund, with consumption being based only on the interest earned. Expenditure starts at a lower level under the BIH approach than under the PIH approach, rises gradually and then levels out when resources are exhausted. However, BIH can be even more difficult to apply than PIH, particularly in countries where oil revenues represent a very large percentage of government expenditure and the country is in need of basic investment.

The BIH approach is sometimes called the Norwegian model. In 2001, Norway established its Government Pension Fund-Global with the intention of using oil revenuesto finance the pensions of its citizens. Since 2005, oil and gas revenues have accounted for 19-25% of Norway’s GDP as value added. The fiscal rule states that all the oil and gas revenues go to the fund, with only the expected return of the fund being used to finance the government deficit; the expected return is estimated to be 4% annually (Norwegian Ministry of Finance, 2012). This approach is not a good example for resource-rich developing countries, however; those that are highly dependent on oil revenues cannot afford not to spend the lion’s share of these revenues each year in the short term. Iraq’s oil revenues represent 60% of GDP, 99% of exports and over 90% of government revenue. It is in a very different situation from Norway, which is a developed country that can afford to deposit 100% of its oil and gas income in the Government Pension Fund and spend only the expected return of the fund because it has other sources of revenue to fund government expenditure.

Although both Collier et al. (2009) and Ploeg (2010) advise the use of short-term stabilisation funds to mitigate revenue volatility, they do not recommend the same treatment for longer-term funds which are to be preserved for future generations. They argue against PIH as the foundation of SWFs, particularly in developing countries, where, they claim, governments should decide what assets to acquire before deciding how much to save. Developing countries lack capital so this asset needs to be accumulated, but this should be done by investing more rather than by depending on foreign financial assets, which bring lower return. Accordingly, these authors encourage direct domestic investment on infrastructure, education and other public services. This seems especially appropriate in Iraq’s case, given the pressing need to rebuild the country’s basic infrastructure.

They argue that in resource-rich developing countries, a high level of direct investment is likely to generate fast growth. Where the starting point is poverty, the resulting consumption is of high social value (this value declines as society becomes wealthier). These countries are using their resource revenues to raise consumption *towards* the level of the distant future rather than to raise the level of consumption *in* the distant future, as is the case with long-term saving funds (Collier et al., 2009). Everyone benefits: the current generation benefits from investment in the basic infrastructure, which encourages the expansion of private business, boosts growth and creates jobs; and future generations benefit by inheriting this economic growth. The danger is that countries may waste revenues by investing in the wrong projects and producing poor quality or unsustainable infrastructure (e.g. the inefficient investment by Bechtel and Haliburton in Iraq – see Chapter Four), or by pursuing inappropriate economic development strategies that lead to increased deficits and debts. Collier et al. (2009) also caution that the return on this investment may be dependent on the domestic investment process. Managerial or other problems might develop that reduce the marginal returns in capital-scarce countries. They suggest that in order to overcome this problem, countries should invest first in their capacity to make effective investments and manage projects. This echoes Segal’s (2012) warning that increasing expenditure may lead to labour shortages (see 7.2.1), though one might argue that this is unlikely in developing countries, especially where there is high unemployment, unless it is a specific skill shortage**.**

Segal (2012) argues that a country’s decisions on how much to save have to be made in accordance with the future level of income expectations and the stock of capital more generally. Specifically, the higher the expected rate of per capita economic growth, the less it makes sense to postpone consumption to the future. The fact that people will be richer in the future indicates that people should consume more of the non-renewable resources now rather than in the future. This will not do any harm for the future generations because the current generation who consume the finite resources will leave their fiscal assets in the form of capital stock. However, Segal’s argument does not take into account the fact that external circumstances such as war or other political or economic crises may undermine government predictions about future income levels.

Another way in which governments can mediate between current and future generations is to invest in oil in the ground rather than in financial assets or the local economy and its infrastructure**.** The rate of consumption of existing reserves is measured by the production rate (annual production as a percentage of proven reserves). The production rate forms the basis of depletion policy (Tordo et al., 2011:18), but Tordo et al. (ibid) argue that this policy – and the decision whether to hold petroleum in the ground as wealth or to invest in assets above the ground – must also take into consideration a number of other factors ( listed below).

* The need for good oilfield practice: deviation from good oilfield practice may permanently damage the reserves. Thus, production should adhere to standard oilfield practice.
* Politics: nation states may have made international commitments on productive capacity and output (e.g. OPEC quotas) that limit discretionary decision making. State budget: poor public finances may increase the pressure for early and/or high levels of production. However, a clear understanding of the size of the reserves is necessary if the government is to design sustainable macroeconomic policies and adopt consumption rates that will allow intergenerational equity.
* Public pressure on spending: an increase in public income may result in pressure to spend the money irrespective of the availability of suitable reinvestment opportunities. This policy can create problems such as labour shortages, lack of capital and inflation (see discussion above).
* Domestic economy: where reinvestment opportunities are available, this may encourage accelerated production. On the other hand, a lack of suitable reinvestment opportunities, fears of hyper-inflation, or a lack of potential production linkages to the rest of the domestic economy may discourage an aggressive depletion policy.
* Institutional framework/national governance: in the absence of appropriate checks and balances, governments might be tempted to direct funds from petroleum production to inappropriate or even illegal purposes.
* Resource curse: related to both the domestic economy and the institutional framework is the failure of governments to translate wealth from natural resources into sustainable economic development.
* Price expectations: changes in the prices of oil and gas affect the value of underground assets.
* Cost expectations: the cost of extracting oil in the ground might be lowered by progress in technology.

There is a good case for Iraq to invest in the ground, according to Tordo (2009), but the signs are that this is not going to happen. Rather, the government plans to increase oil production to the plateau production target agreed with the international oil companies. However, sustaining production at this level will only accelerate the depletion rate and damage the fields. The need to rebuild the country after the war has driven the government to speed up production schedules, but the petroleum reserves for which it has initiated production are not large enough to sustain the proposed production plateau. This is illustrated in Chapter Six in the analysis of the WestQurna1 field. West Qurna1’s published reserves are 8.6 billion barrels, but the suggested plateau is 2.35 m b/d. Since this rate of production can only be sustained for one year before there is a sharp decline, a lower production plateau is advisable.

Furthermore, increasing oil exports to more than its quota may threaten Iraq’s membership of OPEC. Finally, increasing oil production will generate much money, which the government will be under pressure to spend. However, it is ill-equipped for this pressure. Iraq could not spend all its allocated investment budget for 2003-2013; although allocated a total of $203.6 billion for investment purposes, only $123.7 billion was spent, giving an overall average “fiscal performance” of 61% (Jiyad, 2015:18). The problem is compounded by the high level of corruption in Iraq. Funds from petroleum production are directed to inappropriate or even illegal purposes, including to terrorists (Worth and Galnz, 2006), and smuggling is rife. The fact that the Iraqi government has already agreed with several IOCs to increase oil production suggests that it is not going to invest in oil in the ground.

**7.3 Regimes for distribution among regions**

**7.3.1 Central distribution of oil revenues**

A fully centralised model is one in which all oil revenues go into the central government budget. This includes taxes on extraction and production, royalties, bonuses and any oil and gas revenues. This arrangement is mainly found in unitary states[[37]](#footnote-36), especially in Middle East countries such as Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, Yemen and Iraq (until 2003). The government decides the spending and distribution pattern, including whether some income is saved in resource funds (discussed above), or whether everything is spent on goods and services, infrastructure and regional development or diversification projects.

Kuwait, which is an example of a fully centralised model, has always had its oil revenues accrued directly to the state. It is a good example of a country where central distribution has greatly benefited all citizens. The main channels through which the Kuwait government distributes revenues are: 1- domestic public investment, 2- land purchases (central government buys unused land from Kuwaiti nationals at high prices, uses some and sells the rest to the public at low prices), 3- public transfer payments and pensions (which constituted 42% and 59% of total government expenditure in 2007/8 and 2008/9 respectively), 4- subsidies (electricity, water, food and housing), 5- public employment (a job in the public sector is guaranteed to Kuwaiti nationals, along with attractive salaries and benefits), 6- transfer to the business sector, 7- foreign investment (highly regulated and protected jobs for Kuwaiti nationals and maintenance of Kuwaiti control over its natural resources and rents) and 8- Kuwaiti investment abroad (creation of the General Reserves Fund (GRF) (El-Katiri et al., 2011).

One of the major reasons why this distribution system works for Kuwait is that the country has a relatively small population: 2.2 million in 2005. Foreign nationals account for around 60% of this number (El-Katiri et al., 2011:5), but they do not have the same legal right as Kuwaiti nationals to a share of oil revenues. The small population means that Kuwait can afford this distribution model; on the other hand, although there are no regional conflicts, the exemption from the distribution system of expatriates living in Kuwait can create friction between Kuwaitis and non-Kuwaitis.

El-Katiri et al. (2011) argue that although the Kuwaiti system indirectly distributes rent to benefit its citizens, it has some major inefficiencies. Kuwait is financed by oil rather than by taxing businesses or individuals; the system does not adjust the existing distribution of income but simply aims to ensure all Kuwaitis have a share from oil rents. The authors add that a significant proportion of Kuwait’s public sector employment is non-productive. What is worse, over-employment in the public sector stops employees from developing the skills needed for productivity and growth in both public and private sectors. The authors conclude that the public employment system is likely to be wasteful and that it is primarily a way to distribute oil rents to the population. Unfortunately, Iraq seems to be following in Kuwait’s footsteps. According to one senior member of the Iraqi parliament (INTER5, see appendix1) attending the Iraq Petroleum Conference in London in June 2012, “In order to take Iraqi people out of poverty, we employ them in the public sector”. In an interview with Rafydayn in 2010, Ali Baban, the then Iraqi Minister of Planning, stated that 70% of public sector employees in Iraq are unproductive. He added that the reason behind this and the increase in public employment is the ambiguity of the government’s employment law, and warned that this increase is not financially sustainable.

Consequently, the system has no clear direction; in particular, there are no efforts to direct social benefits specifically to the poor. The subsidies it offers are highly inefficient and lead to overuse of the subsidised goods or services. For example, electricity consumption and production were subsidised by the government to the amount of Kuwaiti Dinar (KD) 425 million in 2003 (around 6% of total government revenues for the year). Electricity prices in Kuwait are the cheapest in the Middle East at around US 0.7 cents per kWh. This explains why Kuwait has the highest electricity consumption per capita in the region (El-Katiri et al., 2011).

In the ideal unitary state, social citizenship rights – the public’s expectation to receive basic public services – would be maintained in all regions (Boadway and Shah, 2009). However, in practice, this is very difficult to achieve (as it was in Iraq’s unitary system before 2003) because the cost of delivering these services differs widely across regions (Boadway and Shah, 2009:222). This is reflected in most countries in the differences between urban and rural areas, with better public services being available in the former than in the latter. It is generally cheaper to provide services in cities, which are usually commercial hubs; cities have better transportation systems, for example, as demand is more concentrated, which makes it cheaper to maintain the system.

Recent studies (e.g. Ahmad and Mottu, 2002; Mclure, 2003; Brosio, 2006) have argued that management of oil revenues should be centralised because central governments, most of which also have non-oil based tax bases, are better able to absorb oil revenue fluctuations and are in a better position to establish an equalisation mechanism to mitigate inter-regional differences **[[38]](#footnote-37).** Although this is true, not all governments can afford such an equalisation system, as will be discussed later. These authors argue that sub-national regions are less likely than central governments to invest windfall money efficiently, as the latter are more likely to spend the windfall money on national priorities. However, these national priorities may be biased towards serving government interests, leading it to invest more in some cities and neglect others. Under the Saddam regime, for example, the government invested most in Baghdad’s infrastructure as it was the capital city and the commercial hub. Consequently, while other cities had only intermittent electricity, Baghdad had a 24 hour service.

The central government is also more capable of expanding the economy during a recession or contraction when inflation is very high. Finally, they argue that fiscal discipline is more difficult to control at sub-national level. A lack of control might lead to budget deficiencies and reduce social welfare. Ross (2007) argues that oil-rich sub-national governments are entitled to revenues to compensate for the environmental, social and infrastructure costs of oil and gas extraction, but that any action beyond this is undesirable as it is likely to be taken purely for political reasons. Arguably, this is what has happened in Kurdistan and Basra, prompted by the KRG (see Chapter Eight). Ross acknowledges, however, that local people sometimes claim ownership of the resources and may threaten separation if they get less than they want.

Clearly, central revenue distribution is not without problems as it can give rise to conflict between the central government and oil-rich regions, especially those with a distinct ethnic identity and different language. Ross (2007) argues that if the regional government has no authority to levy taxes, its booming mineral sector will have no impact on living standards (this is the situation in **Basra – see Chapter Nine)**. However, this argument ignores the effect on living standards of the central government spending money on the region (though this may not raise living standards more than in non-resource regions). Conversely, Ross (2007) claims, if the local government can tax mineral revenues directly or indirectly, regional employment and wages will rise sharply (though this argument ignores the possibility that this will encourage migration from other areas, increasing the area’s population and creating inflation). While a rise in actual incomes can be good, an unequal rise in expected incomes may pose problems (ibid). People have different expectations in terms of real income and it is possible that even though their income is large compared to that of other people, their expectations may be even greater. This can lead to political and social unrest. This is especially dangerous in regions that are geographically marginal, have little influence on central government and have a different ethnic and linguistic background (ibid). To some extent, this is the case in Kurdistan, which though it has a higher per capita income than the other provinces, still wants more. However, the KRG does have an influence on central government (see Chapter Eight).

Another good example of the central distribution model is the UK. Approximately 90% of the UK’s oil and gas is extracted from the Scottish area (GERS, 2012), but the oil revenues are collected and distributed centrally by the Westminster government. Scotland has had devolved rule[[39]](#footnote-38) since 1997, under which it has the power to manage local issues such as education, but it does not have control over oil and gas revenues as the British government considers them to belong to the UK as a whole. The UK example is comparable to the situation in Iraq in that Scotland, like Kurdistan, has been accorded special treatment in an attempt to defuse calls for regional independence. Clearly, giving Scotland devolved rule and control over some of its main public services was a political policy designed to head off this threat, but it has done little to mollify the Scottish National Party (SNP), which continues to demand independence from the rest of the UK. The SNP’s economic confidence is based largely on the revenues from oil and gas (Lynch, 2003), but GERS (2012) figures for the financial year 2010/11 show that while the Treasury spent about £61.6 billion on Scotland, it received just £45 billion in revenues from that country, plus £8 billion in revenues from the North Sea (see Table 7.1). In other words, the central British government transferred £8 billion more to the Scottish government than it received in total revenues. The Treasury figures (GERS, 2012) also show that in 2009-10, central government expenditure on public services was around £11.370 per capita in Scotland. This was £1,050 or 10.2% higher than the UK average. The same figures indicate that Scotland accounts for 9.3% of the UK’s expenditure, but only 8.3% of the UK population; this is clearly a higher level of spending per capita. But although Scotland has the advantage of higher per capita spending and control over some of its important institutions, the SNP still sees independence as a better option for the region.

The SNP’s actions perhaps stem from national pride and its sense that Scots have a distinct identity. In an ICM poll conducted in March 2015, 62% of Scots said they would describe themselves as Scottish rather than British, with 31% stating the opposite (*Independent*, 2015). This poll happened six months after the Scottish Independence Referendum, held on the 18th September 2014, in which the motion to make Scotland an independent country was rejected by 55.3% to 44.7%. Shortly after the referendum, the Scottish Parliament was promised greater devolved power in matters such as taxation and welfare (HM Government, 2014). This may well lead Wales and Northern Ireland to want the same, especially as they also have distinct cultural identities and languages. The UK may consider adopting a revenue sharing system (discussed in 7.3.2) where distribution is still central, but regions are allowed to control their own spending pattern. This might be more satisfactory to Scotland and other parts of the UK, including England.

**Table 7.1: Scotland fiscal balance 2007-2011, actual, £billion, nominal prices**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | **2007-2008** | **2008-2009** | **2009-2010** | **2010-2011** |
| Scottish government revenues excluding North Sea revenues | 45.0 | 43.5 | 41.9 | 45.1 |
| Scottish government expenditure | 55.7 | 59.0 | 59.4 | 61.6 |
| Balance excluding North Sea revenues | -10.7 | -15.5 | -20.1 | -18.6 |
| North sea revenues | 7.5 | 11.8 | 7.5 | 8 |
| Balance including North Sea revenues | -3.3 | -3.8 | -14.1 | -10.6 |
| Balance including N.S. as a percent of GDP | -2.3% | -2.6% | -10.7 | -7.4 |
| Balance excluding N.S. as a % of GDP | -9.3% | -13.5% | -17.9% | -15.6% |

Source: GERS (2012)

Further evidence to suggest that Scotland is financially better off staying in the UK was the government’s autumn 2009 bailout of the Bank of Scotland (HBOS) and Royal Bank of Scotland (RBS). The two banks received £61.6 billion in emergency funding (BBC News, 2009) to keep going following the economic crisis of 2008-2010. If Scotland had been independent at the time of the crisis, it would have had difficulty financing the bailout. Its own revenues, a high proportion of which come from oil, would not have been enough. McLaren et al.’s (2011:6) report shows that the Scottish fiscal deficit position is worse than that of the UK by over 7% of GDP post 2008-2009 if North Sea oil revenues are excluded, but that if oil revenues are included, then the Scottish fiscal deficit position is equal to or better than that of the UK by 3% of GDP. However, it warns that the advantage of oil revenues will have disappeared by 2015-16 as North Sea production levels decline. As these non-renewable resources become depleted, an independent Scotland might not be able to manage in future economic crises without UK assistance.

**7.3.2 Decentralised distribution of oil revenues**

One way of solving central/regional government disagreements about revenue distribution is to decentralise the distribution of oil revenues. This involves giving the sub-national government authority over its own revenues from natural resources such as oil and gas. Decentralised distribution is mainly granted for political reasons (Ahmad and Mottu, 2002; Ross, 2007); for example, it may be the strategy adopted by central government to deal with separatist tendencies in the resource producing region (Ahmad and Mottu, 2002). Alternatively, it may be the result of constitutional change that gives the region or producing area ownership of the natural resources or the authority to levy taxes on certain bases or sources of income. This happened in Colombia in 1991, in Indonesia in 1999 and in Iraq in 2005.

The main motivation for decentralising revenue distribution is that local administrators are closer to their people and better able to choose policies that will meet their needs; this is especially relevant when natural resources are geographically concentrated in one place. In essence, decentralisation enables the local government to benefit more from the resources under its land. Ross (2007) states that the case for giving sub-national governments the right to levy taxes or a direct share of revenues is strengthened if such policies will help to appease independence movements in these regions. On the other hand, giving regional authorities taxation rights or a direct share of revenues may give them the resources they need to strengthen their secessionist movement.

A number of studies have examined the link between oil production and civil war (see Collier and Hoeffler, 2002; Fearon and Laitin, 2003; Humphreys, 2005; Fearon, 2005). Table 7.2lists ten examples of violent independence movements in regions with significant oil, gas and other mineral wealth.

**Table 7.2: Oil/mineral resources and secessionist movements**

|  |  |  |  |
| --- | --- | --- | --- |
| **Country** | **Region** | **Duration** | **Mineral resources** |
| Angola | Cabinda | 1975-2002 | Oil |
| Congo, Dem. Rep | Katanga/Shaba | 1960-65 | Copper |
| Indonesia | West Papua | 1969- | Copper, gold |
| Morocco | West Sahara | 1975-88 | Phosphates, oil |
| Myanmar | Hill tribes | 1983-95 | Tin, gems |
| Nigeria | Biafra | 1967-70 | Oil |
| Papua New Guinea | Bougainville | 1988-97 | Copper, gold |
| Sudan | South | 1983- | Oil |
| Yemen | East and South | 1994 | Oil |
| Iraq\* | North( Kurdistan) | 1990-2003 | Oil, gas |

Source: Ross (2003:246) \* author added

Although mineral wealth was not the only reason for these independence movements, in each case the separatists believed that mineral money would make independence easier. The temptation to claim local ownership of discovered resources can encourage the population in marginal or peripheral regions to favour independence (Collier and Hoeffler, 2002). Where the discovery is very large, the region is even more likely to want to keep the revenue and not to share it with the rest of the country. Such divisions create severe economic and social unrest, so central governments generally respond quickly to any rise in inter-regional inequality (Ross, 2007). They may even approve the demands of the producing region even if they go against the national objectives. This is especially likely if the majority of government revenues are from oil and gas resources.

Decentralised revenue distribution tends to be done in one of two ways. Sub-national governments may receive direct transfers from central government of a share of the mineral revenues (revenue sharing). This may be based on a formula, which may be mentioned in the constitution. Countries operating this system include Colombia and Venzuela. Alternatively, sub-national governments may themselves levy taxes and take royalties directly from the mineral industry (shared revenue bases). This is what happens in Canada.

**7.3.3 Revenue sharing among sub-national governments**

This is somewhere between centralised control and true decentralisation. Under this mechanism, the central government collects revenues and distributes them to regions according to a specific formula. The structure of revenue sharing systems differs between countries, but almost all feature unconditional transfer (Boadway and Shah, 2009). The central government may, however, impose conditions if it wants to retain control over a region with which it is in dispute. It might be an economic condition designed to serve the national interest, such as the stipulation that investors in the region must buy only local raw materials, or it might be a political condition, such as the Iraqi government’s demand that Kurdistan exports a specific amount before it transfers oil revenues to the region (see Chapter Eight). The usual reason for revenue sharing is to fill the gap between revenue means and expenditure needs of states, and it is mostly seen as political (Searle, 2007). Although the central government retains overall control over collection and sometimes expenditures, some control is given to local governments. This may be enough to resolve regional conflicts about oil revenues and even alleviate secessionist tensions in a producing region, though it may not work if the oil producing region feels it would be economically better off if it were separate.

Revenues may be distributed through derivation whereby revenues are transferred to states in accordance with where the revenues were raised. In other words, it is the percentage of oil revenues that producing states retain from taxes on oil and other natural resources. In this case, there is no redistributive element. The key problem with this model, as with revenue-based collection by regions (discussed below), is that it creates a high level of inequality that governments cannot afford, especially if the oil is concentrated in one area. Alternatively, funds may be transferred using a simple per capita rule, which is implicitly redistributive. States which have higher than average per capita tax bases are implicitly transferring to poorer regions. The revenues might be distributed according to an equalisation system (Boadway and Shah, 2009), or according to population or basic needs. The limitation of revenue sharing according to population is that regions do not all have equal fiscal capacity, so some may need more transfer than others. The formula for revenue sharing may be determined in the constitution, or it may be suggested by the local government. However, according to Boadway and Shah (2009) the most common practice is for the central government to determine the formula based on its own political and economic objectives. Arriving at an intergovernmental formula is difficult because every region wants to take the lion’s share of the pie (Boadway and Shah, 2009). The difficulty is likely to be compounded if the central government gives undue weight to the interests of one region (for example because it wants to avert the threat of secession, or because the region has some power over the central government). As Chapter Eight shows, this is the problem the Iraq government faces with Kurdistan.

Revenue sharing through a well-designed formula can be the best way to provide unconditional transfer to regions. Regional governments have full control over how they spend these revenues. This is especially beneficial in federal states, where decentralisation is encouraged (Boadway and Shah, 2009). However, revenue sharing may not always succeed in averting political conflict or filling the gap between the region’s fiscal needs and expenditures; indeed, it may be the source of more conflict. Problems can arise, for example, if, as is usually the case, the percentage of revenue granted to a region is decided on a political basis rather than according to the economic environment. Furthermore, where there is more than one level of local government, these will be competing not only with the central government but with each other. The best option, which can be very difficult to achieve, is to measure the level of fiscal stress that each level of region finds itself in and to base its share on this (Searle, 2007). This is especially useful if there is high inequality among regions and some regions are much poorer than others.

Conflict can arise when revenue is shared according to a predetermined principle. If revenues were shared out equally, this would reduce the gap between fiscal need and expenditure at regional or provincial level and bring the various regions up to the same level of fiscal capacity. However, this is very difficult to achieve in practice because of the political consideration of the origin of the resource; the more an individual location sees itself as the origin of the revenues, the more difficult it is to distribute these revenues according to a general principle (Searle, 2007). It may be more politically expedient for the producing region to keep a share of the revenues and for the remainder to go to central government for redistribution to other regions (Ahmad and Singh, 2003). In practice, however, producing regions may demand anything up to 100% of the revenues. The problem is exacerbated if there are ethnic or religious differences involved, as is the case in Nigeria, Aceh in Indonesia (Fedelino and Ter-Minassian, 2010), Kurdistan and Basra in Iraq (see Chapter Eight). Whether the producing regions keep a share of their revenues or take all the mineral rent or tax, they will enjoy greater fiscal capacity than non-producing regions unless the government employs an equalisation mechanism.

Indonesia is a particularly salient example here because it has a number of similarities to Iraq. After the collapse of General Suharto’s New Order regime on 21 May 1998, Indonesia moved toward a more decentralised system and revenue sharing arrangement for its oil and gas resources, primarily to satisfy producing regions’ demands. Law 25/1999 stipulated that 15% of oil revenues and 30% of gas revenues should accrue to the producing regions (Alisjahbana, 2005:115), while a special autonomy law for Nanggroe Aceh Darussalam (Aceh) and Papua gave these regions 70% of the revenues earned, with the remaining 30% going to the central government. This arrangement lasted for eight years, after which their share fell to 50% (Miller, 2004:346). These two provinces were accorded preferential treatment to resolve separatist disputes and to accelerate the development of their education and health sectors and their infrastructure, which lagged behind that of the other regions (Alisjahbana, 2005). As in Iraq’s resource-rich region of Basra, poverty in these regions was high and living standards were low. A few years after decentralisation, and inspired by the special treatment given to Ache and Papua, the resource-rich provinces of Riau and East Kalimanatan also demanded a larger share. The government responded by raising their share of oil revenues slightly from 15 to 15.5% (Alisjahbana, 2005:121).

The Indonesian revenue sharing system created high fiscal inequality among producing and non-producing regions, forcing the government to develop equalisation mechanisms. These are based on population but also take into account the shared revenues of natural resources in the computation of fiscal abilities; thus, regions with greater fiscal capacity and smaller fiscal deficits receive a smaller general share (Alisjahbana, 2005). However, the government cannot afford to completely bridge the gaps in fiscal capacity (Searle, 2007), and regional and central governments are collectively running a budget deficit. Another problem is that the system requires accurate data on the contribution of industries and regions; this is very difficult to measure with any accuracy, and figures are routinely disputed (Searle, 2007). Implementing the system is also very complicated; Acehnese politicians were initially concerned that the Finance Ministry, which collects Aceh’s resource revenue before redistributing it back to the province, would withhold a portion of its funds (Miller, 2004).

Another disadvantage of revenue sharing is that sub-national governments’ revenues are subject to the volatility of oil prices, which leaves their public services exposed to fluctuation (Ahmad and Singh, 2003; Brosio and Jimenez, 2009; Boadway and Shah, 2009; Fedelino and Ter-Minassian, 2010). This can create further tension between oil producing regions and the central government, even to the point of driving regional governments to opt for independence. Producing regions push for as big a share as possible of their oil revenues, while the central government seeks to do the same by controlling the formula for distribution. However, the central government is in a better position to absorb price fluctuations; when revenues are low, it can draw instead on other income sources, funds or borrowing. It is also more able to withstand the effects of production instability and other disturbances, and of resource depletion.

The other disadvantage of revenue sharing is that it is within the central government’s power to change the distribution formula, which it may do as frequently as the annual central budget if it wants to increase its revenues for its own spending or for other general economic objectives. In this scenario, regions control their expenditures but not the revenues received (Boadway and Shah, 2009). This is a main source of contention between the central government and Kurdistan (see Chapter Eight). This situation may nominally be a revenue sharing system, but in effect, it is no different from the central distribution of revenues, in which money is distributed according to government discretion without a fixed formula. Indeed, the formula for allocating revenues may bear little relation to actual state expenditure. State revenues depend on the rate of growth of central tax rather than the growth of regional expenditures(Boadway and Shah, 2009).

A particular problem in developing countries, where general regional administration may be weak (Brosio and Jimenez, 2009), is that oil producing regions, when given a larger share of the oil revenues, may misspend them on non-economical projects. This was the case in Colombia which up until 2010, distributed more revenues to resource producing regions without regard to socio-economic factors like poverty (as still happens in Iraq). Revenues were misspent, and there was a high level of inequality between producing and non-producing regions. Colombia is a unitary republic with sub-national governments, which were granted responsibility for major expenditure and assigned some revenues under the 1991 constitution. The largest beneficiaries of the oil revenues were the oil producing regions (see Table 7.3), while the central government’s share rose and fell (from 43% in 1998 to 20% in 1999 and 45% in 2002) with fluctuations in energy prices and production. The oil revenue transfers had a negative impact on macroeconomic stability by encouraging regional governments to contract debts beyond their payment capacity. Several sub-national governments were on the verge of bankruptcy (Ahmad and Mottu, 2002; Echavarria et al., 2005) and public savings declined dramatically from 8% of GDP to a deficit equivalent to 0.2% of GDP (Ministerio de Minas y Energia Colombia, 2011).Oil revenue increases triggered economic booms and encouraged more spending, higher demand, inflation and a fall in savings. This triggered an economic recession between 1997-2001 that led to increased poverty, unemployment and loss of income (Ministerio de Minas y Energia Colombia, 2011).

**Table 7.3: Colombia – distribution of rents and royalties ($ millions)**

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | **1998** | | **1999** | | **2000** | | **2001** | | **2002** | |
| **MM US$** | **%** | **MM US$** | **%** | **MM US$** | **%** | **MM US$** | **%** | **MM US$** | **%** |
| Central Government | 220.5 | 43 | 180.5.0 | 20 | 406.5 | 30 | 646.2 | 47 | 540.9 | 45 |
| Producing Departments | 174.5 | 25 | 233.2 | 26 | 383.1 | 28 | 336.3 | 25 | 295.2 | 24 |
| Non-producing Departments |  |  | 33.0 | 4 | 26.2 | 2 |  |  | 5.9 | 1 |
| Producing Municipalities | 65.7 | 9 | 95.6 | 11 | 149.7 | 11 | 178.2 | 13 | 165.6 | 14 |
| Non- producing Municipalities | 43.3 | 6 | 62.2 | 7 | 34.3 | 3 | 0.7 |  | 1.6 |  |
| Corporations | 1.1 |  | 1.4 |  | 1.9 |  | 1.4 |  | 1.5 |  |
| Investment Funds | 9.2 | 1 | 11.8 | 1 |  |  |  |  |  |  |
| National Royalties Fund | 164.4 | 23 | 266.1 | 30 | 337.6 | 25 | 193.4 | 14 | 177.5 | 15 |
| Social Aid | 27.9 | 4 | 19.6 | 2 | 19.4 |  | 7.1 | 1 | 13.6 | 1 |
| Total | 705.5 | | 893.1 | | 1,358.5 | | 1,363.1 | | 1,202.2 | |

Source: Ministry of Economy in Joint UNDP/World Bank Energy Sector Management Assistance Programme (ESMAP, 2005:78)

The distribution of revenues was concentrated such that regions with only 17% of the population were receiving 80% of the royalties. From 1994 to 2009, the regions of Casanare, Meta, Arauca and Guajira collectively received 56% of royalties (see Table 7.4). High inequality prevailed as a result of this distribution mechanism, with Casanare, which had less than 1% of the population, receiving 24% of the royalties, and Goal, with 2% of the population, receiving 12%. In contrast, poor regions like Choco and Narino received very low shares (Ministerio de Minas y Energia Colombia, 2011).

**Table 7.4: Distribution of revenues among Colombian regions/ departments 1994-2009**

|  |  |
| --- | --- |
| **Departments** | **% of Royalty** |
| CASANARE | 23,5 |
| META | 12,1 |
| ARAUCA DEPTO | 10,4 |
| LA GUAJIRA | 9,7 |
| HUILA | 8,9 |
| SANTANDER | 5,6 |
| CESAR | 5,4 |
| CORDOBA DPTO | 4,9 |
| ANTIOQUIA | 3,4 |
| TOUMA | 3,3 |
| BOUVAR DPTO | 2,9 |
| BOYACA DPTO | 2,6 |
| SUCRE DPTO | 2,5 |
| PUTUMAYO | 1,7 |
| MAGDALENA | 0,8 |
| NORTE DE SANTANDER | 0,8 |
| CUNDINAMARCA | 0,6 |
| NARINO DPTO | 0,4 |
| CAUCA | 0,3 |
| CHOCO | 0,2 |
| CALDAS DPTO | 0,1 |
| VALLE DEL CAUCA | 0,0 |
| ATLANTICO | 0,0 |
| SAN ANDERS DEPTO | 0,0 |
| RISARALDA DEPTO | 0,0 |
| GAUINIA | 0,0 |
| QUINDIO | 0,0 |
| VAUPES | 0,0 |
| CAQUETA | 0,0 |
| AMAZONAS | 0,0 |
| VICHADA | 0,0 |
| GUAVIARE | 0,0 |

Source: Ministerio de Minas y Energia Colombia (2011)

Royalty distribution policy changed in August 2010 from favouring producing departments (states) to distribution designed to drive national development. The rationale was that the poorest departments in the country are not generally producers, and that the producing departments were receiving too much and allegedly corruptly wasting their allocations (Ministerio de Minas y Energia Colombia, 2011). The new policy was designed to enable Columbia to save for the future and to pay into stabilisation funds, and to focus more on the poor regions. The criteria for distribution were to be based on poverty indicators and population and regional equity (ibid).

The allegations of corruption in Columbia highlight another drawback of the revenue sharing model. Corruption may exist at the national level, but in a small region with a lot of money, there is arguably greater danger of corrupt behaviour (Brosio and Jimenez, 2009; Fedelino and Ter-Minassian, 2010). This was the case in Colombia, where small producing regions had high levels of corruption among their officials; investigations revealed that the governors of Casanare and Meta mishandled $31,500 million of royalties (Ministerio de Minas y Energia Colombia, 2011).

**7.3.4 Revenue-based collection by sub-national governments**

This is a system whereby sub-national governments have the right to collect revenues from natural resources directly. This right may arise from the region’s ownership of the resources and/or it may be written into the national legislation that revenues from oil and gas sources are to accrue to regional governments. This system operates in Canada and, to a limited extent, in Alaska (McLure, 2003). Although the national legislation may limit the type or level of taxation regional governments may impose (ibid), Ahmad and Mottu (2002) argue that this arrangement is still preferable to revenue sharing, as it represents a stable and fixed revenue stream for local governments. Accordingly, these authors advise assigning specific tax bases (e.g. production excise duty) to sub-national governments – possibly with some overlap between levels of government. They argue that revenue sharing arrangements are at the mercy of price and resource volatility, which makes it difficult to guarantee stable financing for local public services, although they do not explain how opting for regional taxation over revenue sharing will avoid this problem. Finally, they argue that revenue sharing does not always diffuse separatist movements, as it may be difficult to agree on the percentage of revenues to be shared.

One might argue, however, that a completely decentralised system, in which all resource revenues are collected by sub-nationals, would have more negative effects than the revenue sharing system as it would create even greater inequality among sub-nationals, especially if the natural resources are concentrated in a few regions. The central government would end up receiving little revenue from these resources. Furthermore, complete decentralisation of revenues would make it easier for sub-national governments to become independent, particularly if the region has a distinct identity and/or language, like Scotland and Kurdistan. As the region would already be economically independent, with control over its own revenue collection and expenditure, it would be easy to break away in the event of a dispute with the central government.

Canada offers an example of how revenues can be managed in a completely decentralised system where ownership rests with regions. This is particularly relevant to the situation in Iraq where, as Chapter Four explains, the constitution is ambiguous on the question of who owns the country’s oil and gas. It is also worth examining the effects of this revenue distribution system on the Quebec region, which, like Kurdistan, has a strong independence movement. In Canada, the right to tax and/or receive royalties on resources rests with the provinces where these resources occur. Oil and natural gas are concentrated mainly in Alberta, which generates one quarter of Canada’s total oil revenues (Ahmad and Mottu, 2002:21). As mentioned above, decentralisation of oil revenues creates disparities in fiscal capacity between regions. For the year 2008-2009, fiscal capacity per capita in Alberta was $12,500, of which natural resource revenues represented $8,500; in the same year, Quebec’s per capita fiscal capacity was $5,800, very little of which was due to natural resources (Lecours and Béland, 2010:16). The federal government established a fiscal equalisation system in 1982 to address these fiscal disparities and address the gap between revenue raised and expenditure. Saskatchewan, Alberta, Newfoundland and Labrador do not qualify for the equalisation fund, though other per capita transfers are provided for health and education (see Table 7.5). Equalisation accounts for the bulk of transfers from the federal government.

It is not difficult for Canada to follow a completely decentralised system of revenue distribution as most of its federal revenues come from taxation; in 2013-2014, for example, total budget revenues were $264 billion, 81% of which were tax revenues (see Table 7.6). In contrast, it is almost impossible for oil-rich countries such as Iraq, Kuwait and Oman to follow the same system, as tax revenues currently represent only a fraction of government revenues in these countries. Oil and gas revenues are considered the rightful compensation of the population, who, according to the constitution, are the owners of these resources.

**Table 7.5: Canada federal support/transfers to provinces 2008-2009 and 2009-2010**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Region** | **Year** | **Equalisation**  **(millions of $)** | **Total transfer from government**  **(millions of $)** | **Per capita allocation**  **($)** |
| Newfoundland and Labrador | 2008-2009 | - | 1,137 | 2,246 |
| 2009-2010 | - | 2,146 | 1,091 |
| Prince Edward Island | 2008-2009 | 322 | 469 | 3,363 |
| 2009-2010 | 340 | 493 | 3,493 |
| Nova Scotia | 2008-2009 | 1,465 | 2,483 | 2,653 |
| 2009-2010 | 1,391 | 2,669 | 2,840 |
| New Brunswick | 2008-2009 | 1,584 | 2,373 | 3,177 |
| 2009-2010 | 1,689 | 2,505 | 3,341 |
| Quebec | 2008-2009 | 7,160 | 16,209 | 2,093 |
| 2009-2010 | 8,028 | 16,847 | 2,155 |
| Ontario | 2008-2009 | - | 13,501 | 1,045 |
| 2009-2010 | 347 | 14,567 | 1,116 |
| Manitoba | 2008-2009 | 2,063 | 3,335 | 2,770 |
|  | 2009-2010 | 2,063 | 3,386 | 2,782 |
| Saskatchew | 2008-2009 | - | 1,131 | 1,117 |
| 2009-2010 | - | 1,208 | 1,176 |
| Alberta | 2008-2009 | - | 3,033 | 846 |
| 2009-2010 | - | 3,223 | 879 |
| British Colombia | 2008-2009 | - | 4,693 | 1,072 |
| 2009-2010 | - | 4,889 | 1,098 |

Source: Finance Canada

**Table 7.6: Canada revenues 2012-2014 – $ billions**

|  |  |  |
| --- | --- | --- |
|  | **2012-2013** | **2013-2014** |
| **Income taxes** | | |
| Personal income tax | 125.7 | 130.1 |
| Corporate income tax | 35 | 35 |
| Non-resident income tax | 5.1 | 5.5 |
| Total income tax | 165.8 | 170.6 |
| **Excise taxes/duties** | | |
| Goods and Services Tax | 28.8 | 29.9 |
| Customs import duties | 4.0 | 4.2 |
| Other excise taxes/duties | 10.8 | 10.6 |
| Total excise taxes/duties | 43.6 | 44.8 |
| **Total tax revenues** | 209.3 | 215.3 |
| Employment Insurance premium revenues | 20.4 | 21.5 |
| Other revenues | 26.9 | 27.1 |
| **Total budgetary revenues** | **256.6** | **264** |

Source: Finance Canada, 2013 <http://www.budget.gc.ca/2014/docs/plan/ch4-2-eng.html>

The increase in oil and gas revenues in western Canada, especially in Alberta, has led to a major shift of economic activities and workers to the west, further increasing the fiscal imbalance between Alberta and the rest of the provinces to a point beyond the capacity of the equalisation system. The system, which redresses only the below average fiscal capacity of the non-resource producing provinces, does not come close to eliminating the major inequality between provinces. It leaves the major oil and gas producing province, Alberta, with a revenue raising capacity twice as large as that of its nearest provincial rival (Ontario) after equalisation (Boadway and Shah, 2009).

However, while scholars like Boadway and Shah (2009) argue that resource-rich provinces like Alberta and Saskatchewan should transfer more revenue to their poorer counterparts; this is a politically sensitive suggestion. These provinces argue that the revenues from their natural resources should not be included in the calculation of fiscal capacity because these resources rightfully belong to them. Furthermore, as they are non-renewable, they should not be part of the endless revenue stream (Lecours and Béland, 2010). Alberta’s politicians point out that over the last four decades, $200 billion has left the province in official and unofficial federal transfer programmes and argue that as part of the nation, they should receive transfers from the federal government equal to those received by the rest of the provinces (Lecours and Béland, 2010).

Quebec is also a source of contention, with other provinces claiming that the equalisation system benefits Quebec first and foremost. The strong and continuing separatist threat in Quebec means that the government is ready to accept its demands to deter this movement. The other provinces believe that Quebec receives much more from the government than it contributes. The federal government has paid over $5.5 billion in equalisation payments since their introduction in 1957, with Quebec receiving 47% of this amount (Lecours and Béland, 2010). This perceived inequality has led Alberta to claim that: “The fate of Alberta appears to be the opposite of Quebec’s: the more it contributes financially, the less it receives politically” (Morton, 2005:3). As this and the other examples discussed above illustrate, whatever the distribution mechanism, when a region is given preferential treatment, it is usually with the aim of deterring a separatist movement (see Table 7.7).

**Table 7.7: Preferential treatment for regions to deter separatist movements**

|  |  |  |  |
| --- | --- | --- | --- |
| **Country** | **Region** | **Distribution mechanism** | **Preferential treatment** |
| United Kingdom | Scotland | Central | Devolution in 1997 |
| Indonesia | Nangaroo Aceh, Darussalam (Aceh) and Papua | Revenue sharing | 70% of the oil and gas revenues earned in the region for eight years, starting from 1999, then reduced to 50% |
| Colombia | Casanare, Meta, Arauca and Guajira | Revenue sharing | From 1994-2009, these departments received 56% of royalties |
| Canada | Quebec | Revenue-based collection by sub-nationals | It receives more from the federal government through the equalisation system than it contributes. Quebec has received 47% of the equalisation fund since its inception in 1957 |

**7.4 Direct distribution**

This is the distribution of resource revenues to the entire population in the form of an equal, universal and unconditional cash benefit. A number of authors have argued that developing countries should adopt direct distribution – notably citing the case of Iraq (see Palley, 2003; Birdsall and Subramanian, 2004; Sandbu, 2006; Segal, 2012). The easiest way to ensure that all citizens receive an equal share of the resource revenues is through the direct distribution of universal and unconditional cash transfers (Segal, 2012). Segal (2012) believes that this mechanism can significantly reduce poverty, arguing that if all developing countries adopted this model, global poverty at the $1-a-day line would be more than halved. He claims that a universal scheme such as this is more effective in reducing poverty than a targeted scheme, as targeted benefits often fail to reach the right recipients. He also highlights the transparency of the direct distribution mechanism. Once the total quantity of resource revenues and the size of population are known to the media and the population, then it is known how much each individual should receive; this transparency reduces the risk of theft or leakage before the money reaches the intended recipients. Removing revenues from government expenditure budgets eliminates some standard mechanisms of corruption, such as over-bidding for contracts (Segal, 2012). Ross (2007) stresses that it keeps at least part of the state’s oil revenues out of the hands of politicians, and gives citizens a more direct stake in the government’s management of oil revenues, reducing corruption and making the government more accountable.

Kuwait distributes some of its revenues in the form of salaries for public sector jobs, some of which are unproductive. In contrast, direct distribution is unconditional; thus, there is no incentive for citizens to take unproductive jobs (Segal, 2012). However, Ross (2007) argues that direct distribution of revenues can be a powerful tool if distribution is made conditional on certain practices – such as immunising children or enrolling them in school. In this way, cash distribution of resource revenues can be used to reduce poverty and enhance development.

Direct distribution does not end the need for smoothing; a stabilisation fund may still be used to reduce the volatility of the dividend, which will depend on the income earned by the fund, rather than current oil prices (Segal, 2012). However, direct distribution of cash to the population can increase demand and thereby trigger inflation, which will dissipate the effects of the money received. It might seem preferable to target distribution towards the poor, but this can be difficult in developing countries, where governments may not have accurate population data and earnings are often undeclared.

There are other problems with direct distribution in developing countries. Governments in developing states are less likely to follow the rule of law, have less institutional stability, and are more liable to corruption than governments in advanced industrialised states (Ross, 2007). In these circumstances, it is much more likely that the cash distribution will be mishandled.

A direct distribution plan would have to work in a way which is not characteristic of oil-rich developing countries: it would require strict adherence to the law, intertemporal stability, and protection from political pressure (ibid). Several studies (e.g. Collier and Hoeffler; 2002, Ross, 2004) have argued that when developing countries have large amounts of rent available, their political leadership is often adversely affected; politicians, on gaining office, seize these rents and use them for political gain. Ross (2007) argues that even if such a fund is established under a wise government, it creates an incentive for more opportunistic leadership later. It is difficult to promote transparency or to know how much the government is actually taking out of the natural resources money and how much it is distributing.

Although Segal argues that all that is needed to set up a direct distribution plan is the population census and revenue figures, these plans can be complex to administer. First, obtaining accurate population figures requires the state to maintain a large and reliable database of all its citizens. This is difficult in Iraq’s case as there has been no census since 1997 (the Kirkuk issue has prevented the taking of a more recent census – see Chapter Four). Furthermore, with a direct distribution plan, there is great incentive for fraud and manipulation of the distribution list (Ross, 2007). This is especially true in developing countries and in countries which have had regime changes, such as Iraq. It is also the case in countries with high levels of organised crime, such as Colombia, and countries with high poverty levels, such as Nigeria. Finally, direct resource revenue distribution can create conflict with producing regions since these regions are likely to demand a larger share of the funds.

On the other hand, a properly functioning direct distribution system is the best way to reduce poverty in developing countries and ensure that citizens get a fair share of the revenues from the resources they own. It is a good way of using the stabilisation funds so that the returns from the revenues rather than the revenues themselves are distributed. Governments that do decide to adopt direct distribution must weigh these advantages against the possible drawbacks and be ready to monitor for fraud and corruption. They should create a special institution to manage the direct fund and target distribution to encourage social goals such as school enrollment for children, removing beggars from the streets or preventing child labour.

The US state of Alaska is a good example of a state that has used direct distribution of its resource revenues to reduce poverty. It is an informative example for Iraq, which though an oil-rich county, has 22.9% of the population living under the poverty line. Though 77.9% are above the poverty line, many are only slightly above it (World Bank, 2011a:20-23). Alaska has a state-owned fund, called the Alaska Permanent Fund, which receives by law at least 25% of all oil royalties received by the state government.From an initial investment of $734,000 in 1977, the fund had grown to approximately $38 billion by October 2011. Each year, every Alaskan (who has resided in the state for at least one calendar year) receives an equal share of the dividend from the fund. This dividend is calculated as 52.2% of the fund’s nominal income averaged over five years, divided by the number of eligible recipients. In most years, the dividend is somewhere between $800 and $2000 (see Figure 7.1); in 2011, for example, the government distributed $1174 to 710,231 Alaskans (Alaska Permanent Fund Corporation, Segal, 2012:346-347). Between 1982 and 2009, a total of about $17.5 billion was paid to Alaskans through annual distribution of the shared fund revenue (Segal, 2012:346-347). The success of the strategy is illustrated by the fact that by 2007, Alaska had the joint second lowest poverty rate of all the states in the US, despite having only the nineteenth highest per capita personal income (Segal, 2012:346).

**Figure 7.1: Alaska Permanent Fund dividend, current $**

Source: Segal (2012:347)

The Alaskan Permanent Fund Corporation states that the programme has had significant effects on the state economy, with the dividends representing an important source of income for rural Alaskans (Segal, 2012).The fund is a good mechanism for using the returns on some of the resource revenues to reduce poverty and to make the people, who are the owners of the resources, feel that they are actually sharing the benefits of their treasure. Simultaneously, the revenues are being saved for future generations.

**7.5 Conclusions**

The chapter begins by discussing the question of how revenues might be distributed between present and future generations. In mediating between current and future generations, countries may choose to hypothecate their resource revenues and put them into long-term funds to protect against resource exhaustion, invest them into the local economy, or adopt a depletion policy and invest in the ground. Some authors favour long-term funds for the reason that these resources are non-renewable and should be saved for the future. Only the returns on investment in foreign assets should be spent. However, others believe that short-term funds should be used to smooth expenditure at times of boom. They would prefer the revenues to be spent on investment, especially in developing countries, arguing that future generations will inherit the fruits of these investments and continue the development. It is this researcher’s view that as developing countries generally lack the basic infrastructure they need to develop and grow, the best strategy is to spend resource revenues on basic infrastructure and invest in other industries which can start to generate revenues for the government. Future generations will inherit these non-exhaustible revenues and the economy will continue to grow.

Iraq’s resources are not inexhaustible, and care must be taken to protect therights of future generations. One could argue that Iraq should invest in the ground in order to mitigate the effects of corruption, adhere to OPEC quotas and avoid damaging reservoirs with increased production. However, as Iraq has already signed long-term contracts with IOCs to increase production, this is not an option. Sovereign wealth funds may not be appropriate for the reason that at present, Iraq is in dire need of reconstruction of its basic infrastructure. This leads the author to follow Collier et al. (2009), Ploeg (2010) and Ploeg and Venables (2011) in suggesting that the best way to protect the interests of future generations is to invest in domestic projects. These will not only benefit the current generation but also generate sustainable revenues for those to come. Iraq’s revenues are climbing, but so is its budget, and every year there is a deficit. At the time of writing, Iraq does not have the funds to protect itself from price/production volatility; instead, at times of low revenues it borrows from international markets and increases its debts. It needs to solve the volatility problem by creating a short-term fund to smooth out revenues, as suggested by Angel and Meller (1993), Engel and Valdes (2000) and Davis (2001). To forestall any dispute with the KRG (payments into such a fund may reduce the amount left for Kurdistan), contributions to the fund need to be fixed by law. In times of great macroeconomic need and low oil revenues, deficits can be financed from the fund. The government must also smooth its expenditure, which now follows the same pattern as oil revenues.

The chapter then considers how oil revenues are distributed among regions. It begins with centralised distribution, which is regarded by some as the best mechanism for distributing resource revenues, mainly because it emphasises the unity of the country and maintains equality among regions. Kuwait and Scotland show that central distribution does indeed help preserve unity, though the Scottish case indicates that central distribution does not necessarily promote equal distribution of revenues, as Scotland is given a higher per-capita share than other UK regions. Kuwait is an example of central distribution benefiting all citizens, but it is aided in this by the fact that it has a small population and there are no regional conflicts.

Complete centralisation is not possible for Iraq; it has a larger population than Kuwait, and the oil is concentrated in regions that have a distinct cultural identity/language (like the Kurds) or religious affiliation (like the Shiites). In addition, unlike the UK, oil and gas revenues represent a high percentage of the government’s income. During the Saddam regime, provinces in the south were unhappy with the centrally controlled system, and it was a major cause of dispute between the regime and Kurdistan. Post-2003, the Kurds (with no objections from the Shiites) were able to redress this by influencing the writing of the constitution to specify that Iraq should become a federal country with an emphasis on decentralisation. Another factor that would make it difficult to reintroduce a centralised system of revenue distribution is that throughout Saddam’s regime, Kurdistan was already receiving a direct population-based revenue share from the U.N.

Revenue sharing among sub-nationals is regarded by some as the second best distribution mechanism. This is the system currently being followed by Iraq. In this system, central government gives up some power to regions. This can help resolve regional conflicts and alleviate secessionist pressure, but as the cases of Indonesia and Colombia show, revenue sharing, while averting conflict with some resource-rich producing regions, can inspire other producing regions to agitate for a bigger share and create resentment among non-resource-rich regions. The next chapter discusses the extent to which these positive and negative effects are being felt in Iraq.

Revenue-based collection by sub-nationals allows regions to collect revenues directly. However, the Canadian example shows that this actually creates higher inequality than the revenue sharing system, and that this cannot be eliminated by equalisation mechanisms. This form of revenue distribution is difficult to implement in countries such as Iraq, where oil revenues represent a high percentage of total government revenues. The final mechanism considered in the chapter is direct distribution, in which cash is transferred equally to all members of the population. The Alaskan case shows that distributing some oil revenues directly can help eliminate poverty, making this mechanism potentially useful for countries like Iraq, which are resource-rich but have high poverty levels. Table 7.8 below summarises the advantages and disadvantages of the various mechanisms which governments use to distribute resource revenues to sub-nationals, as discussed in this chapter.

**Table 7.8: Distribution among sub-national governments**

|  |  |  |
| --- | --- | --- |
| **Revenue distribution** | **Advantages** | **Disadvantages** |
| **Central distribution of oil revenues** |  |  |
|  | * Absorbs oil revenue fluctuations * More efficient in adopting new investments * More capability to expand the national economy * More capability to maintain fiscal discipline and administer complex types of taxes | * It creates conflicts with oil-rich regions, especially if they have distinct ethnic identity and different language and it can lead to resource-rich regions seeking independence |
| **Decentralised distribution of oil revenues** |  |  |
| **Revenue sharing** | * Local governments are closer to their citizens * It resolves regional conflicts and appeases independence movements * Can overcome the gap between revenue means and expenditure needs of states * Common unconditional transfer to sub-nationals * Some decision making transferred to sub-national governments | * Local governments can become stronger and can be encouraged to seek independence * Percentage of revenue sharing is most likely decided on political basis rather than economic environment * Producing regions always want a bigger share. * Volatility of oil/production prices jeopardises the sub-national governments’ revenues * Difficult to conclude formula because every region wants most of the pie * Formula decided by the government can be changed frequently * The formula has little relation to actual sub-national expenditures * Misspending on non-economic projects may rise |
| **Revenue-based collection by sub-national governments** | * More attractive than revenue sharing as long as only part of resource taxation accrues to sub-nationals, e.g. specific production excise duties * More likely to diffuse separatist movements than revenue sharing | * If all the resources are collected by sub-nationals then much more revenue will be decentralised * Inequality will exceed the revenue sharing if all resources are decentralised * The fiscal gap is bigger under this system; equalisation cannot eliminate it if all resources are decentralised |
| **Direct revenue distribution** |  |  |
|  | * Easy and all citizens receive equal share * Reduces poverty * It takes some money away from government, eliminates corruption * Citizens have direct share in managing resources | * Difficult to implement in developing countries; these countries are less bound by rules and more susceptible to corruption * It can encourage political gain and opportunistic leadership * Complex to administer |

**Chapter Eight: Oil Revenue Budgeting and Distribution Among Iraq’s Provinces and Kurdistan**

**8.1 Introduction**

Having explored the concepts of oil revenue distribution among regions, this chapter uses these concepts to investigate closely how the vast amount of Iraqi oil revenues have been distributed across the country since 2003. This chapter analyses whether the conflict between the central government and Kurdistan regarding the petroleum fiscal regime is extended to the current revenue distribution system among Iraqi regions and how it is affecting it. It also examines the conflicts that the system creates with other Iraqi provinces.

Iraq is sub-divided into provinces. Three of these provinces, Sulymania, Irbil and Dohok, together form the region of Kurdistan, which is run by the Kurdistan Regional Government (KRG).

Under the Saddam regime, Iraq was a unitary state and the distribution of revenues was highly centralised. Following the fall of the Saddam regime in 2003, Iraq became a federal state, and the system of central distribution changed to one of revenue sharing – revenues were shared indirectly via the national budget. The revenue sharing system led to Kurdistan becoming a semi-autonomous region rather than the [[40]](#footnote-39)de-facto region that had existed since 1990. However, the revenue sharing system has always been the cause of disputes between the central government and the KRG, prompting some to agitate for an independent Kurdistan. Disputes have also arisen between the central government and other Iraqi provinces – especially oil-rich provinces such as Basra and Kirkuk.

This chapter examines the current, asymmetric system of regional revenue distribution in Iraq. It considers the potential of the system to create conflict and the impact it has had on Iraq’s national development and unity. The chapter begins by examining how the Development Fund for Iraq (DFI) is managed. It then identifies the total financial revenues (oil and non-oil) that are available to the government and how much of the country’s GDP they represent, before exploring the current revenue distribution system in Iraq. It discusses in detail the budget share given to provinces and to Kurdistan. It concludes with a discussion of the disputes that the current revenue sharing system has created between the central government, Kurdistan and the rest of the provinces.

**8.2 Iraq’s oil revenue account: the Development Fund for Iraq (DFI)**

The DFI was created in May 2003, after the cancellation of the oil for food programme (see Chapter Four). The main aim of the fund is to monitor Iraq’s oil money. It is not a savings or investment fund per se; rather, it is more like placing one’s money in a bank under the surveillance of another party. The DFI receives 95% of Iraq’s oil export revenues, after 5% has been paid into a special fund for compensation for Gulf War damage and reparation to Kuwait, as established by United Nations Security Council Resolution (UNSCR) 687 (1991). (This 5% is not included in the DFI statement.) At the end of 2010, Iraq still owed $22 billion of the $53 billion which the UN ordered it to pay to Kuwait (Baban, 2010).

Making the DFI transparent and holding it in an independent bank was meant to minimise the possibility of corruption, but it seems that this has been insufficient. Part of the problem is that the fund was not monitored from the outset by an international agency; corruption was particularly apparent immediately after the 2003 invasion. This led Iraq Revenue Watch[[41]](#footnote-40) to call for greater transparency and for more Iraqis to be involved – in 2003; the only Iraqi on the DFI committee was the Minister of Finance, Kamal Al-Kilani (MEES, 2003). In 2005, the media reported that some $8 billion was unaccounted for (see Chapter Four), but by June 2011, this figure had risen to $17 billion (Ibrahim, 2011). The figures highlight the importance of more transparent accounting for the DFI, particularly given the ongoing civil wars and political unrest in Iraq.

Under UNSCR 1483, the Internal Advisory and Monitoring Board for Iraq (IAMB) should have started monitoring the fund in May 2003, but it did not in fact start until the end of 2003. From this point on, the board published regular updates on the fund’s cash flows. The IAMB was succeeded by the Iraqi Committee of Financial Experts (COFE), which was appointed by the Iraqi cabinet in October 2006, although it did not take over responsibility for monitoring the fund until June 2011. COFE, like IAMB, monitors oil revenue collection and administration. At the same time, the DFI was returned to the control of Iraq’s central bank, although it continues to be held in New York to avoid other foreign claims on the fund, according to Iraqi government spokesman Ali Al Dabag (Al Arabiya News, 2011). By the end of 2010, there was a surplus of $7.5 billion in the DFI (PWC, 2010). This money was transferred to Iraq’s Ministry of Finance for government spending. It is not clear what the ministry did with it after that as it only started to publish the government budget in 2008.

**8.2.1 Cash receipts in the DFI, 2003-2010**

Most of the cash receipts in the DFI are for crude oil exports; in 2009 and 2010, for example, these accounted for 98% of cash receipts (see Table 8.1). (Even so, IAMB suggested that the lack of metering made it difficult to be certain that all oil revenues were being placed in the DFI; indeed, the CPA has shown that unknown quantities of petroleum and petroleum products were smuggled out of Iraq during this period, particularly in the months following the end of major hostilities (MEES, 2004)). The DFI has also held the surplus from the oil for food programme since its cancellation; most of this money – more than $9 billion – was transferred to the DFI by the end of 2004 (see Table 8.1). Under UNSCR 1483, passed in 2003, the intention was to transfer the balance as quickly as possible, but at the end of 2010 it had still not all been transferred to the DFI. It remains unclear why the transfer has been delayed, and whether Iraq will be paid interest on the money owed.

**Table 8.1: Cash receipts in the DFI, December 2003-December 2010**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Year** | **Crude oil exports**  **$billion** | **UN oil for food programme**  **$000** | **Proceeds from frozen assets**  **$000** | **Interest received**  **$million** | **Other receipts**  **$million** | **Total cash receipts**  **$billion** |
| 2003 | 4 | 5,600,000 | 757,550 | 8 | 215 | 10 |
| 2004 | 16 | 3,628,000 | 366,869 | 107 | 251 | 21 |
| 2005 | 22 | 812,321 | 405,518 | 198 | 485 | 24 |
| 2006 | 28 | 185,000 | 16,748 | 457 | 589 | 30 |
| 2007 | 36 | 186,105 | 5,150 | 561 | 883 | 38 |
| 2008 | 59 | 5,860 | 833 | 577 | 1,966 | 61 |
| 2009 | 37 | 121 | 47,817 | 129 | 457 | 38 |
| 2010 | 49 | 656,000 | 523 | 26 | 288 | 50 |
| Total | 251 | 11,073,407 | 1,601,003 | 2,062 | 5,136 | 271 |

Source: International Advisory and Monitoring Board for Iraq (IAMB) – Audit Reports – DFI Audit Reports: <http://www.iamb.info/> DFI statements of cash receipts and payments from 2003-2010.

**Figure 8.1: Cumulative cash receipts in the DFI, May 2003-December 2010 ($millions)**

Source: International Advisory and Monitoring Board for Iraq (IAMB):

<http://www.iamb.info/> DFI statement of cumulative cash receipts and payments

May 2003-December 2010

Other money coming into the DFI includes the proceeds from frozen assets (funds, other financial assets and economic resources of Saddam’s government that are held in other countries) and interest from accounts held with the FRBNY – these are subject to investment in US treasury bills (see Table 8.1). Finally, there is a miscellaneous category of income (listed as “other receipts”) that includes letters of credit, cash margins, mobile network license fees and some of the money only named as “others”, In 2008, $118,000 named as others (IAMB, 2008: 9).

## 8.2.2 Cash payments from the DFI, 2003-2010

In 2003, the Iraqi ministries drew funds from a range of sources, including funds left by the previous regime, frozen money held in the US under UNSCR 687, and monies seized in Iraq under the laws of war (KPMG, 2003). This explains the large surpluses in the DFI in this year (Table 8.2). After 2003, the Minister of Finance, in conjunction with the Prime Minister, authorised the transfer of money from the DFI in the FRBNY to the Central Bank of Iraq[[42]](#footnote-41). The Ministry of Finance was then responsible for distributing the money to the other ministries, provinces and regions. By the end of 2010, 70% of the oil revenues had been transferred to the Ministry of Finance in this way (see Figure 8.2). Of the remainder, 25.2% was spent on payments for letters of credit[[43]](#footnote-42) issued on behalf of Iraqi entities (PWC, 2010).

**Table 8.2: Cash payments from the DFI, 2003-2010**

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| **Year** | **Transfers**  **to the Ministry of Finance**  **$billion** | **Letters of credit issued for the benefit of Iraqi entities**  **$billion** | **Contracts administer-**  **ed by US agencies**  **$000** | **Iraqi external debt repayme-nts**  **$million** | **Other payments**  **$million** | **Total cash payment**  **$ billion** | **Excess/deficit receipts over payment**  **$million** |
| 2003 | 1 | - | 245,182 | - | 125 | 2 | 8,485 |
| 2004 | 14 | 2 | 6,509,815 | 444 | 1,254 | 24 | -3,611 |
| 2005 | 15 | 7 | 419,049 | 160 | 198 | 22 | 1,360 |
| 2006 | 18 | 10 | 251,120 | 539 | 104 | 29 | 773 |
| 2007 | 27 | 8 | 115,522 | 142 | 151 | 35 | 2,850 |
| 2008 | 45 | 15 | 314,750 | 229 | 27 | 61 | 397 |
| 2009 | 23 | 13 | 852 | 100 | 1,429 | 38 | -318 |
| 2010 | 41 | 11 | 2,025 | \_ | 3,543 | 52 | -2,433 |
| Total | **184** | **66** | **7,858,315** | **1,615** | **3,094** | **263** | **7,504** |

Source: International Advisory and Monitoring Board for Iraq (IAMB) – Audit Reports – DFI Audit Reports: <http://www.iamb.info/>

**Figure 8.2: Cumulative cash payments from the DFI, 2003-2010 ($millions)**

Source: International Advisory and Monitoring Board for Iraq (IAMB): <http://www.iamb.info/>

Figure 8.2 indicates that 2.9% of the cumulative cash payments over this period were payments for contracts administered by US agencies. The American Coalition Provisional Authority (CPA) administered certain projects and payments on behalf of the Iraqi ministries during their period in charge (May 2003-June 2004).After this date, the government of Iraq gave the CPA limited authority to administer the outstanding contracts.By the end of 2010, almost $8 billion had been spent on these contracts (see Table 8.2), most of which led to substantial loss of revenues as the projects concerned were either obsolete or mired in corruption (see 3.2). The other significant expenditure in this period was external debt repayments, which accounted for 0.6% of the cumulative cash payments from the DFI by the end of 2010. The “other payment” category is noteworthy as its purpose was not clearly defined; in 2007, for example, it included a payment to the municipality of Baghdad. It is not clear why this came from the DFI when it should have come from the Ministry of Finance. In that year, $67,000 worth of payments was made under this category (IAMB, 2008:16) with no indication of their purpose.

The DFI showed its largest deficit (when payments exceeded receipts) in 2004; the deficit for that year was $3.5 billion. From January to June 2004, the CPA spent $12.5 billion, and from July to December 2004, the Iraqi Interim Government spent $12 billion. However, as oil prices rose, Iraq’s total cash receipts gradually increased. Oil prices went up from $36.31/b in 2003 to reach a peak of $100.83/b in 2008 (OPEC, 2010).In this year, the DFI’s cash receipts stood at $61.8 billion and it made $61 billion in payments.

Iraq’s government expenditure, which is collectively decided by the central government, provinces and regions, is closely tied to oil revenues; indeed, the budget is based on projected oil prices. As Chapter Seven explains, the government has no protection from oil price volatility; when oil prices plunged to $68.76/b in 2009, it was obliged to reduce payments from the DFI to almost half the amount in 2008 (see Tables 8.1 and 8.2). Even so, the account was still left with a deficit at the end of the year. This deficit increased in 2010 to reach $2.4 billion. By the end of 2010, $7.5 billion was left in the DFI account. Thus, Iraq is subject to accumulating debts that cannot be returned. Deficit in the DFI has a knock-on effect, since government budget deficits elsewhere are usually financed from the surplus in the DFI account. Lower revenues also create problems with Kurdistan and the other provinces by forcing the government to reduce their funding. One possible solution is the formation of short-term funds, as explained in Chapter Seven.

**Figure 8.3: Total cash receipts to and cash payments from the DFI, 2003-2010 ($million)**

Source: International Advisory and Monitoring Board for Iraq (IAMB): <http://www.iamb.info>

## 8.3 Government revenues (oil and non-oil revenues)

The ebbs and flows in government revenue are best understood in terms of their effect on Iraq’s GDP and GDP per capita.However, the various sources of information on Iraq’s GDP – the World Bank, the IMF and Iraq’s Central Bank – are inconsistent (see Table 8.3) because they are all based on estimates. Since Iraq’s Central Bank is the official financial institution for the Iraqi government, its GDP figures are used throughout the thesis.

**Table 8.3: Iraq’s GDP and GDP per capita, various data sources**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Year** | **World Bank GDP**  **(current prices**  **$billions)** | **World Bank GDP per capita** | **IMF GDP**  **(current prices $billions)** | **IMF GDP per capita** | **Iraq Central Bank GDP**  **(current prices $billions)** | **Iraq Central Bank GDP per capita** |
| 2007 | 88 | 3,091 | 88 | 3,002 | 79 | 2,847 |
| 2008 | 131 | 4,472 | 131 | 4,327 | 130 | 4,162 |
| 2009 | 111 | 3,702 | 111 | 3,574 | 117 | 3,764 |
| 2010 | 142 | 4,613 | 138 | 4,373 | 145 | 4,466 |
| 2011 | 191 | 6,019 | 185 | 5,686 | 180 | 5,419 |
| 2012 | 215 | 6,215 | 216 | 6,410 | 208 | 6,079 |
| 2013 | 222 | 6,676 | 229 | 6,594 | 229 | - |

Sources: The World Bank <http://data.worldbank.org/country/iraq>

IMF estimates – World Economic Outlook database April (2013)

Central Bank of Iraq – Statistics (Various Years) <http://www.cbi.iq/index.php?pid=Statistics>

Government budget revenues are normally estimated on the basis of expected average oil price and production for the next year; for example, 2009 budget revenues were estimated based on an assumed average export of 2 mb/d and a price of $50/b. According to government calculations, total oil export revenues for that year were $36 billion. If the 5% for Kuwait debt is subtracted, $34 billion is left. The actual revenues deposited in the DFI account for 2009 were $37 billion (see Table 8.1). Thus, in 2009, Iraq was still left with some surplus in oil exports (the calculated difference between the government assumptions of price and average export and the actual price and export). However, expenditure greatly exceeded revenue, leading to a budget deficit of 19 trillion Iraqi Dinars (ID). This is equivalent to $15 billion – or 13% of GDP (see Tables 8.3 and 8.4).

**Table 8.4: Total government revenue and expenditures, 2008-2013**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | **2008**  **ID trillion** | **2008**  **$billion** | **% of GDP** | **2009**  **ID trillion** | **2009**  **$billion** | **% of GDP** | **2010**  **ID trillion** | **2010**  **$**  **billion** | **% of GDP** | **2011**  **ID trillion** | **2011**  **$**  **billion** | **% of GDP** | **2012**  **ID trillion** | **2012**  **$**  **billion** | **% of GDP** | **2013**  **ID trillion** | **2013**  **$**  **billion** | **% of GDP** |
| Total Revenues | 80 | 69 | 53 | 50 | 43 | 37 | 62 | 52 | 36 | 81 | 69 | 38 | 102 | 87 | 42 | 119 | 100 | 44 |
| Total Expenditures | 92 | 79 | 61 | 69 | 58 | 50 | 85 | 72 | **50** | 97 | 82 | 46 | 117 | 99 | 48 | 138 | 117 | 52 |
| **Deficit** | **- 12** | **-10** | **8** | **-19** | **-15** | **13** | **-23** | **-20** | **14** | **-16** | **-13** | **8** | **-15** | **-12** | **6** | **-19** | **-17** | **-8** |

Source: Iraq Ministry of Finance – Budget Law for Federal Iraq 2008- 2013 <http://www.mof.gov.iq>,

Note: for GDP see Table 8.3 (all GDP are in $billions)

**Table 8.5: Government revenues, 2008-2013**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Revenues** | **2008**  **ID trillion** | **2008**  **$ billion** | **\*%**  **of GDP** | **2009**  **ID trillion** | **2009**  **$billion** | **% of GDP** | **2010**  **ID trillion** | **2010**  **$ billion** | **% of GDP** | **2011**  **ID trillion** | **2011**  **$ billion** | **% of GDP** | **2012**  **ID trillion** | **2012**  **$ billion** | **% of GDP** | **2013**  **ID trillion** | **2013**  **$billion** | **% of GDP** |
| Oil export revenues | 73 | 61 | 47 | 43 | 36 | 31 | 56 | 48 | 33 | 76 | 65 | 36 | 94 | 80 | 38 | 111 | 94 | 41 |
| Other revenues | 7.5 | 6 | 5 | 7 | 6 | 5 | 6 | 5 | 3 | 5 | 4 | 2 | 8 | 7 | 3 | 8 | 7 | 3 |
| **Total** | **80.5** | **67** | **54** | **50** | **42** | **36** | **61** | **52** | **36** | **81** | **69** | **38** | **102** | **87** | **41** | **119** | **101** | **45** |

Source: Iraq Ministry of Finance – Federal Budget – Budget Archives, http://www.mof.gov.iq/

\*Author calculation based on GDP (see Table 8.3)

**8.4 Revenue distribution in Iraq**

Iraq had a fully centralised revenue distribution model before 2003, with the government deciding on the distribution and spending pattern for all provinces and the Kurdistan region. Wars during this period (see Chapter Three) meant that there was little investment in infrastructure, especially in the provinces. For example, most provinces were without electricity for several hours each day, and only Baghdad had a continuous power supply. Under Saddam’s dictatorship, the provinces were unable to demand any control over revenues. This highly centralised control of revenues drove Kurdistan to seek independence in 1990. This independence was not recognised by the central government in Baghdad, the then autonomous KRG was granted 13% of Iraq’s oil revenues, which it received directly from the UN.

After 2003 and the fall of Saddam, revenue distribution became less centralised. As discussed in Chapter Four, revenue distribution was a contentious issue during the writing of the constitution; the Kurds wanted greater control over oil revenues and a better deal than the 13% they received before the war. The articles of the Iraqi constitution that deal with revenue distribution are confusing and contradictory but essentially, they serve the interests of the KRG. In general terms, they stipulate that national revenues, 90% of which derive from oil, are to be shared equally among all regions and provinces in Iraq. The criteria for distribution are that sufficient revenue must be allocated to local governments to enable them to discharge their responsibilities, taking into account the size of population, any damage sustained during or since Saddam’s regime, any resources produced and general need (although not defined exactly in the constitution, this presumably refers to poverty and income gaps). In reality, however, the above criteria are only applied to Kurdistan.

Although a semi-autonomous region, Kurdistan receives most of its revenues (96.6% in 2010, seeTable 8.14) from central government. After sovereign expenditures such as defense have been subtracted, Kurdistan receives 17% of the remaining budget. This share is calculated according to the above criteria. In the other provinces, revenues are distributed centrally for services such as education, health and domestic security. These provinces then receive additional revenues for their operational budget, a share of reconstruction costs according to population and, since 2010; resource-rich provinces have received a share of the revenue from their resources in the form of petrodollars. This began as one dollar for each barrel of oil produced or refined and/or 150 cubic meters of gas produced, rising to $5 in 2013.

The current revenue sharing arrangement with the KRG is meant to deter the development of an independence movement, but it contains a number of problems which may ultimately drive the KRG to seek independence. The other problem caused by the asymmetric revenue sharing system is that other provinces, especially the oil-rich provinces, want to copy the KRG region because they perceive the KRG as receiving more benefits than them.

**8.5 Kurdistan’s budget share**

Article 4 of the Law of Financial Resources stipulates that a region or province’s revenue share is to be calculated after the deduction by the federal government of the cost of sovereign and ruling expenditures and strategic projects for the benefit of all. These projects must be agreed with the regions and provinces. Sovereign expenditure includes major federal expenditure for the whole country such as the Presidency, the Council of Ministers, foreign affairs, defense, debt repayments and infrastructure projects such as the construction of dams and the rail network. As Table 8.6 shows, Kurdistan also receives a share of the reconstruction budget, which is distributed according to population for reconstruction and development projects, plus a share of the petrodollars distributed to resource producing provinces. Since 2011, it has also included payments towards Kurdistan’s production-sharing contracts (see Chapter Six). Ruling expenditure covers Kurdistan’s share of some social benefits, including food rations and subsidised medical treatment.In 2013, total government sovereign and ruling expenditures amounted to ID59 trillion ($50 billion), or 41% of the total budget (see Table 8.6). Kurdistan’s revenue share (17%) was thus calculated from the remaining budget. The main problem with this arrangement is that it is based on political considerations (to prevent Kurdistan seeking independence) rather than economic need (poverty or estimates of needs). This is one of the main dangers of revenue sharing (see Chapter Seven). It makes Kurdistan more powerful and may even encourage it to seek independence – and inspire other rich provinces to follow suit.

The total budget has risen steadily since 2007, with just one drop in 2009 (because of the decline in oil prices that year) (see Table 8.4). In 2013, the budget increased by 18% compared to 2012. Kurdistan’s share also increased in this year – but by just 14%, from ID12.6 trillion ($10.6 billion) to ID14.6 trillion ($12 billion). The fact that Kurdistan’s share is not rising at the same pace as sovereign expenditure means that in real terms, it is declining. The law stipulates that sovereign expenditure should be agreed with regions and provinces, but this was not the case with the 2013 budget, which was passed without KRG agreement (MEES, 2013A). The KRG boycotted the budget in protest at the fact that the federal government had paid only ID750 billion ($645 million) towards oil investors’ costs, less than a fifth of the ID4 trillion ($3.5 billion) the KRG had demanded (MEES, 2013A). The central government in turn defended its refusal to pay, arguing that by reducing its oil exports and keeping the oil for domestic consumption (see section 8.9.3), the KRG had breached its budget conditions.

**Table 8.6: Calculation of Kurdistan’s share of the budget**

|  |  |  |
| --- | --- | --- |
|  | **2012 ID billions** | **2013**  **ID billions** |
| **Total budget**  less **sovereign expenditures:**  Council of Representatives | **117,123**  283 | **138,424**  228 |
| Human Rights Committee | - | 20 |
| Commission of Integrity | 62 | 80 |
| Presidency | 113 | 95 |
| Council of Ministers | 81 | 95 |
| Prime Minister | 418 | 396 |
| Deputy Prime Minister’s Office for Energy Affairs | - | 4 |
| Deputy Prime Minister’s Office for Economic Affairs | - | 8 |
| Deputy Prime Minister’s Office for Social Affairs | - | 8 |
| National Security Council | 11 | 19 |
| Iraqi Council for Radioactive Sources | 3 | 4 |
| General President’s Office | 63 | 65 |
| Iraqi National Intelligence Service | 223 | 274 |
| General Inspector Intelligence Service | 4 | - |
| Foreign Ministry | 451 | 604 |
| Border and Nationality | 938 | 1,259 |
| Defence | 7,061 | 9,206 |
| Interest due to World Bank | 10 | 8 |
| Interest due to Arab banks | 12 | 8 |
| Interest due to other foreign agencies | 6 | 25 |
| Interest on bonds for private sector debts | 189 | 189 |
| Interest on Treasury Bond transfers | 374 | 271 |
| Debt payments | 3,421 | 2,923 |
| Financial Experts Council | 6 | 6 |
| Payment towards production cost of crude oil exports, including Kurdistan oil contracts | 2,950 | 2,400 |
| Foreign oil company projects for federal government | - | 13,600 |
| Foreign company projects for Kurdistan | - | 750 |
| Cost to transport oil via Turkey | 300 | 300 |
| Contributions to Arabic and world events | 145 | 108 |
| Kuwait debt | 4,719 | 5,553 |
| Foreign oil companies’ projects | 7,500 |  |
| Joint funding expenses | 100 | 100 |
| Debts of old Treasury Bonds | 578 | 400 |
| Debts owed to private sector in foreign countries | 58 | 42 |
| Debt payments to World Bank | - | 239 |
| Debts settlement for Iraqi airlines | - | 233 |
| Weather forecast projects | - | 1,400 |
| Cost of constructing Council of Representatives building and housing for its members | 21 |  |
| Dam projects | 360 | 250 |
| Marine projects | 285 | 163 |
| Rail infrastructure | 247 | 388 |
| Airline management | 2 | - |
| **Minus total of sovereign expenditures** | **(30, 997)** | **(40,382)** |
|  | 86,126 | 98,042 |
| **Minus total of ruling expenditures** | **(8,952)** | **(10,101)** |
|  | 77,174 | 87,941 |
| **Minus reconstruction projects for provinces and Kurdistan** | **(6,184)** | **(7,256)** |
|  | 70,990 | 80,685 |
| **Minus petrodollars to resource-producing provinces and regions** | **(1,676)** | **(1,317)** |
|  | 69,314 | 79,368 |
| Kurdistan’s share | (17% \*69,314)  11,783 | (17%\*79,368)  13,492 |
| Plus Kurdistan’s share of petrodollars and reconstruction fund | 821 | 914 |
| **Total share of Kurdistan** | **12,605** | **14,406** |

Source: Iraq Ministry of Finance – Financial Statements – Kurdistan share, [www.mof.gov.iq](http://www.mof.gov.iq)

**Figure 8.4 Federal budget transfers to KRG and other provinces in 2013**

Oil money

83%

Total budget

ID138 trillion

Other federal revenue

Sovereign expenditure, 30%

Ruling expenditure, 7.3%

Reconstruction, 5.2%

Petrodollar, 0.9%

KRG

17%

Provincial budget expenses

Provincial petro dollars+ reconstruction projects

KRG share of Petrodollar + Reconstruction

Remainder of ID79 trillion

Budget Based on estimated expenses

Ministry expenses, e.g. Education

Source: Author’s calculation of Kurdistan’s budget share from data published by the Iraq Ministry of Finance (Law of Financial Resources, Article 4).

**8.6 Budget share for local provinces**

Under Article 4 of the Law of Financial Resources, the rest of the central budget money is divided between the national ministries in Baghdad (e.g. interior, education, trade and higher education) and the fifteen remaining provinces. In other words, part of the revenue is spent centrally on services such as education, health, policing and municipal administration, and the rest is transferred direct to provinces to spend on their own development. In 2013, the federal government transferred ID8.9 trillion ($7.6 billion) – 6.4% of its total budget – directly to provinces(see Table 8.7).

In 2013, although direct transfer to provinces was the highest since the implementation of the revenue sharing law in 2007, it was ID513 million ($43 million) less than they had demanded; they had estimated their expenditures to be ID9.4 trillion[[44]](#footnote-43) ($8 billion), but the government reduced this to ID9 trillion ($7.6 billion). It was also very little compared to the amount given to Kurdistan, which had wanted ID22 trillion ($18 billion)[[45]](#footnote-44) but was given $12 billion. This created resentment, especially among oil-rich provinces, who were bitter at Kurdistan’s disproportionate share of decentralised revenues and angry that their own demands were not fully met. However, it can be argued that if the central government gives provinces their demanded expenditure, they will only demand more each year. Searle (2007) suggests that the best option is to measure the level of fiscal stress for each province and transfer the shares accordingly, but this is difficult; measuring fiscal stress requires accurate data and plans, and some provinces may add expenditures that are not strategically necessary. The other option is to distribute according to a formula. This is discussed below.

The direct share given to provinces is affected by any rise or falls in oil revenues; when oil prices go down, the government, unable to significantly reduce operating expenditures such as public sector salaries, must find savings by cutting back investment projects and provinces’ allocations. As the overall budget goes down, Kurdistan’s revenues also go down because its share is a percentage of the overall budget; however, the provinces total share is not determined by a percentage or a formula. Table 8.7 shows how fluctuations in oil prices have affected the government’s budget in recent years. In 2008, the rise in oil prices drove up both government revenues and expenditure; transfers to the provinces reached ID8.8 trillion ($7 billion), 9.6% of the total budget, while the sum transferred to Kurdistan was ID9.5 trillion ($7.6 billion). In 2009, however, oil prices dropped to $68.76/b (from more than $100/b in 2008), and transfers to the provinces declined to ID3.6 trillion ($3 billion), 5.1% of the total budget. The transfer to KRG decreased to ID8.2 trillion ($7 billion) or 11.4% of total budget. In 2010, the provinces’ transfer fell again, to ID4 trillion ($3.4 billion), though Kurdistan’s share increased to ID10.6 trillion ($8.5 billion). By 2012, the transfer to the provinces had climbed back up to ID8 trillion ($6.8 billion), almost the same amount as in 2008; as oil revenues and the budget went up, provincial transfers were raised accordingly.

**Table 8.7: Share of budget revenue given to Kurdistan and the provinces, 2007-2013 (ID billions)**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Year** | **Total budget** | **Kurdistan’s share** | **Percentage of total** | **Local councils and public institutions in provinces** | **Percentage of total** |
| 2007 | 39,031 | 5,994 | 15.4 | 2,389 | 6.1 |
| 2008 | 92,097 | 9,541 | 10.4 | 8,834 | 9.6 |
| 2009 | 69,165 | 8,284 | 11.9 | 3,561 | 5.1 |
| 2010 | 84,657 | 10,609 | 12.5 | 4,043 | 4.7 |
| 2011 | 96,663 | 11,179 | 11.5 | 5,377 | 5.5 |
| 2012 | 117,123 | 12,605 | 10.7 | 8,049 | 6.8 |
| 2013 | 138,424 | 14,406 | 10.4 | 8,915 | 6.4 |

Source: Iraq Ministry of Finance – Federal Budget – Budget Archives, <http://www.mof.gov.iq/>

As oil prices fluctuate, so do the revenues received by Kurdistan and the provinces. However, Kurdistan is cushioned to some degree because its share is determined by a legally binding formula. Since no such formula exists for the provinces, the government is able to adjust the amount distributed to them; thus, the amount transferred to the provinces was reduced from ID8.8 trillion ($7.2 billion or 9.6% of the total budget) in 2008 to ID3.5 trillion ($2.9 billion or 5.1% of the total budget) in 2009 (see Table 8.7). If the provinces’ share were based on a formula or a defined percentage of the total, **there would be less scope for fluctuation.**

The funds transferred to provinces are intended to cover their operating expenditure, reconstruction and development projects and their petrodollar entitlement. Operating expenditure covers employees’ salaries, some social benefits, and goods and services for public institutions. In 2012, the total transferred for operating expenditure in the provinces (minus Kurdistan) was ID479 billion ($409 million), or 6.8% of the total transfer (see Table 8.8). Reconstruction and development projects and petrodollar transfer together totalled ID7 trillion ($6 billion) or 93% of total transfer in 2012. The reconstruction element is determined according to population, so Baghdad, which has 25.3% of the population, received ID1.3 trillion ($1.1billion) out of the total ID6.1 trillion ($5.2 billion) reconstruction budget in 2012. The final element covered by the direct transfer is the petrodollar programme, which started in 2010. This gives one dollar for each barrel of oil/gas produced or refined in the province. In 2012, this amounted to ID1.6 trillion ($1.3billion).

**Table 8.8: Direct transfers to Iraqi provinces (revenue sharing), 2012**

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Province  /region | \*Population | %  of  total population | \*\*Operating expenditure  Billion ID | \*\*Reconstr- uction projects  Billion ID | \*\*Petro  dollar  Million ID | \*\*\*Prov-  inces’  total allocation  Billion ID | Percentage of provinces’  total allocation | Per capita budg-et alloc-ation  000 ID | Per capita budg-et alloc-ation  USD |
| Baghdad | 7,357,572 | 22.1 | 80 | 1,367 | 37,617 | 1,485 | 20 | 202 | 172.5 |
| Basra | 2,562,579 | 7.7 | 27 | 476 | 877,572 | 1,380 | 18.5 | 539 | 461 |
| Nineveh | 3,365,787 | 10.1 | 33 | 624 | 7,758 | 666 | 9 | 198 | 169 |
| Dhi-Qar | 1,906,861 | 5.7 | 23 | 352 | 13,784 | 389 | 5 | 204 | 174.5 |
| Anbar | 1,519,386 | 4.6 | 20 | 284 | 24 | 304 | 4 | 200 | 171.2 |
| Missan | 1,034,815 | 3.1 | 16 | 191 | 42,585 | 250 | 3.5 | 242 | 207 |
| Diyala | 1,435,707 | 4.3 | 19 | 266 | 1,377 | 287 | 4 | 200 | 171 |
| Kirkuk | 1,332,025 | 4.0 | 13 | 247 | 517,648 | 778 | 10 | 584 | 499 |
| Diwania | 1,157,880 | 3.5 | 19 | 216 | 2,328 | 238 | 3 | 205 | 175 |
| Wasit | 1,196,893 | 3.6 | 17 | 223 | 15 | 239 | 3 | 200 | 171 |
| Najaf | 1,287,216 | 3.9 | 102 | 241 | 8,410 | 352 | 5 | 273 | 234 |
| Muthana | 753,489 | 2.3 | 11 | 142 | 11,317 | 165 | 2 | 219 | 187 |
| Salah al-Din | 1,321,092 | 4.0 | 27 | 247 | 113,348 | 388 | 5 | 293 | 251 |
| Babil | 1,794,677 | 5.4 | 44 | 334 | - | 378 | 5 | 210 | 180 |
| Karbala | 1,044,060 | 3.1 | 27 | 192 | - | 218 | 3 | 209 | 179 |
| **Total** | **29,070,039** | **87.4** | **479** | **5,405** | **1,633,783** | **7,517** | **100** | **-** | **-** |
| Kurdistan | 4,189,702 | 12.6 | 11,783 | 779 | 42,400 | 12,604 | - | 3008 | 2, 516 |
| **Total** | **33,259,741** | **100** | **12,262** | **6,184** | **1,676,183** | **20,122** | **-** | **-** | **-** |

Sources:

\* Iraq Ministry of Finance - Federal Budget – appendix tables – Iraqi census

\*\* Iraq Ministry of Finance – Financial Statements- Provincial total expenditures 2012

\*\*\*Provinces’ total allocation is the sum of operating expenditure plus reconstruction and petrodollar payments.

Notes: \*in 2012, total transfer to provinces was ID8 trillion (see Table 8.7). This comprised: ID479 billion (operating expenditures for general local administration in provinces) + ID7.7 trillion (investment expenditures for general local administration in provinces) + ID233 billion (local councils) + ID32 billion (investment councils).

Provincial transfers have risen from ID3.5 trillion ($2.9 billion) in 2009, to ID4 trillion ($3.4 billion) in 2010, ID5 trillion ($4 billion) in 2011, ID8 trillion ($6.7 billion) in 2012 and ID8.9 trillion ($7.5 billion) in 2013 (see Table 8.7). In 2012, petrodollars represented only 1.4% of the total budget, which is a very small proportion. However, they accounted for 22% of the direct transfers to provinces, excluding the KRG (see Tables 8.8 and 8.9). The petrodollar system may not take much from the federal budget, but it does create inequality among producing and non-producing regions. The oil is concentrated mainly in Basra, which, according to 2010 estimates, has 69 billion barrels in oil reserves (61% of Iraq’s total oil reserves), and in Kirkuk, which has a minimum of 10 billion barrels (9% of total reserves) (EIA, 2010). In 2009 and 2010, the direct transfer money was shared more or less equally between the various provinces. However, since the introduction of the petrodollar, resource-rich provinces, especially Kirkuk and Basra, have received a significantly increased proportion of the funds(see Figure 8.5).

**Figure 8.5: Per capita budget allocated to provinces by central government via direct transfer (revenue sharing), 2009-2012**

Source: Iraq Ministry of Finance - Financial Statements - Total Budget Allocations to the Provinces - see appendix3

**Table 8.9: Petrodollar distribution to provinces and KRG (ID millions), 2012 -2013**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Province/region** | **Petrodollars**  **2012** | **Percentage of total** | **Petrodollars**  **2013** | **Percentage of total** |
| Baghdad | 37,617 | 2.2 | 36,822 | 3 |
| Basra | 877,572 | 52.3 | 853,956 | 65 |
| Nineveh | 7,758 | 0.5 | 2,750 | 0.3 |
| Dhi-Qar | 13,784 | 0.8 | 15,155 | 1 |
| Anbar | 24 | 0.001 | 0 | 0 |
| Missan | 42,585 | 2.5 | 0 | 0 |
| Diyala | 137,7 | 0.08 | 4,877 | 0.4 |
| Kirkuk | 517,648 | 31 | 239,896 | 18 |
| Diwania | 2,328 | 0.1 | 3,550 | 0.4 |
| Wasit | 15 | 0.0009 | 17,585 | 1 |
| Najaf | 8,410 | 0.5 | 11,304 | 0.9 |
| Muthana | 11,317 | 0.7 | 8,522 | 0.7 |
| Salah al-Din | 113,348 | 6.8 | 123,419 | 9 |
| Babil | - | 0 | 0 | 0 |
| Kerbela | - | 0 | 0 | 0 |
| Kurdistan | 42,400 | 2.5 | 42 | 0.004 |
| **Total** | **1,676,183** | **99.9** | **1,317,805** | **99.7** |

Source: Iraq Ministry of Finance – Financial Statements- Total Provincial Expenditure 2012, 2013

As Table 8.9 shows, Basra accounted for 52% and Kirkuk for 31% of total petrodollar transfers in 2012. This increased Kirkuk’s per capita income to $502 and Basra’s to $486, which are both much higher than Baghdad’s per capita income of $178 (see Figure 8.5). This was despite the fact that Baghdad has more people living in poverty than Kirkuk. Meanwhile, Kurdistan received only 2.5% of the petrodollar transfer, rather than the 6% plus it would have got, had it contributed the agreed 150,000b/d to Iraq’s 2.5 million b/d average (as per its 2011 agreement with the central government). In fact, it exported much less than this.

The inequality between producing and non-producing regions is creating conflict in Iraq. The petrodollar arrangement satisfies the oil-rich provinces, which are mainly dominated by Shiites, but the non-producing regions, which are mainly dominated by Sunnis, are left out of this transfer. An equalisation mechanism like those implemented in Indonesia and Canada is necessary to bridge the gap between provinces (see Chapter Seven) and ensure that needy regions with smaller fiscal capacity receive more funds. Though not ideal, this would be better than nothing.

Article 121 of Iraq’s constitution stipulates that resources are to be distributed equally and are to be sufficient for the discharge of the province’s/region’s responsibilities but having regard to regional and governorate resources, needs and size of population. However, Figure 8.5 clearlyshows unequal per capita distribution among the provinces since 2010. Paradoxically, this is because of the requirement to take into account regional resources (through the petrodollar payment). As these are concentrated in Kirkuk in the north and Basra in the south, there is now a big gap between these two provinces and the others. The condition relating to provinces’ responsibilities has been met by dedicating a percentage of the transferred funds to cover operational expenditure (see Table 8.8), but it seems that the condition relating to the need to reduce poverty is being largely ignored.

According to the World Bank’s (2011a) poverty head count survey, the three highest poverty head count[[46]](#footnote-45) rates are to be found in Muthana (48.7%), Babil (41.2%) and Salah-al-Din (39.9%) (see Table 8.10)**.** However, Iraq’s population is not evenly distributed; thus, although Baghdad has a poverty head count rate of 12.7%, which is significantly, lower than Muthana’s, more than twice as many people in Baghdad are living in poverty.

**Table 8.10: Iraqi governorates ranked by poverty share (most to least poor)**

|  |  |  |  |
| --- | --- | --- | --- |
| **Governorate** | **Number of poor** | **Poverty share**  **(%Total)** | **Poverty**  **head count rate\*** |
| Baghdad | 882,909 | 12 | 12.7 |
| Basra | 820,025 | 11 | 32.6 |
| Babil | 735,818 | 9.9 | 41.2 |
| Nineveh | 673,158 | 9.1 | 23 |
| Dhi-Qar | 591,127 | 8 | 31.9 |
| Salah-al-Din | 515,226 | 6.9 | 39.9 |
| Diyala | 473,784 | 6.4 | 33.9 |
| Wasit | 406,944 | 5.5 | 34.7 |
| Al-Qadisya | 405,258 | 5.4 | 35 |
| Kerbela | 375,862 | 5 | 36.9 |
| Muthana | 361,675 | 4.8 | 48.77 |
| Anbar | 303,877 | 4.1 | 20.9 |
| Najaf | 308,932 | 4 | 24.4 |
| Missan | 258,704 | 3.5 | 25.3 |
| Dohok | 151,886 | 2 | 9.3 |
| Kirkuk | 119,882 | 1.6 | 9.8 |
| Irbil | 44,523 | 0.6 | 3.4 |
| Sulymania | 30,539 | 0.4 | 3.3 |
| **Total** | **7,385,067** | **100** |  |

Sources: World Bank (2011a:25), Iraq Ministry of Finance

\*poverty head count rate represents the percentage of total population in each geographical area whose per capita expenditure (PEC) falls below the poverty line, which the World Bank identified in Iraq as ID76,896 ($65) per person per month.

There is no relation between the size of transfer and poverty share, either before or since 2010 (seeappendix 3). Baghdad received the lowest share in 2011, even though it has the highest poverty. Its per capita budget allocation in this year was only ID100, 211($86), while in 2012 it received the second lowest allocation, at ID208, 222 ($178). Nineveh received the least in 2012: ID203, 243 ($174) (see Figure 8.6). At the other extreme, Kirkuk has the lowest poverty share, but as a resource-rich province, since the introduction of the petrodollar it has received one of the largest per capita transfers of all the provinces.

**Figure 8.6: Per capita budget transfer in 2012 and poverty share among governorates**

Source: see Tables 8.8 and 8.10

Basra may possess significant natural resources, but it also has the second highest poverty share, so it makes sense to transfer more revenues to this governorate. However, the government’s decision to raise Basra’s per capita transfer level was as much a response to the political situation as to social economic indicators. Since 2003, the Basra governorate has been lobbying to become a region with Missan and Dhi-Qar. By 2008, it had secured a fifth of the votes needed in the Council of Ministers to enable it to hold a public referendum on the issue (Al Sumariya News*,* 2011). Like Kurdistan, it wants to become a region in order to protect its oil revenues, especially as 60% of all Iraq’s proven oil reserves are in this area (EIA, 2013). The government’s decision to introduce the petrodollar in 2010, and thereby raise Basra’s per capita transfer level, was in part an attempt to avert this threat.

The fact that oil and gas revenues are being distributed for political rather than economic reasons has caused resentment in several non-oil producing provinces. An Arabic local newspaper, AL Summariya News (2012) discussed that Baghdad complained about its share of the budget, the paper further argued that Baghdad council had been obliged to use money transferred from unspent funds allocated to the different ministries.Similarly,thecouncil chairman of theBabil governorate, Khadim Majeed Toman, complained that not enough money had been allocated for reconstruction in the central government’s 2012 budget, forcing the province to abandon a number of unfinished projects (Iraqi Agency Central News, 2012)**.** Nineveh has also protested that it has not received enough money to fund the clean-up of the city(Al Mustakban al Iraqi, 2011).

Law 21 of 2013[[47]](#footnote-46) gives provincial governments’ greater control over oil and gas activities and administration. It reinforces Article 121 of the constitution by stating that: “In an area of shared competency between the central government and the governorate, the policy of the governorate shall prevail” (Article 7.4). The law is intended to appease producing provinces such as Basra and Missan, but it is also designed to give greater powers to provincial governments to resolve local conflicts, and to prevent the annual demands from provinces for more power and from oil producing provinces for more money. Although Article 7.4 disproportionally benefits oil producing provinces, it remains unclear whether they are being given the same degree of control as Kurdistan (from the signing of contracts to the export of oil). Nor is it clear what will happen to the revenues from these provinces. If provinces follow the KRG and interpret the constitution as giving them exclusive rights to the revenues from future fields, regional inequality will massively increase, while the loss of these revenues will bankrupt the central government.

With the increase in the petrodollar from $1 to $5, the gap between oil producing and non-producing provinces will become even wider. Had the government increased the petrodollar transfer to $5 in 2013, the total petrodollar transfer to producing provinces would have been ID8 trillion[[48]](#footnote-47) ($7 billion) or 7% of the total budget, most of which would have gone to Basra and Kirkuk. Basra would have received ID4 trillion ($3.3 billion) or 50% of the petrodollar transfer and Kirkuk ID2.5 trillion ($2 billion) or 31% of the total, with the rest going to the other provinces and Kurdistan. Basra would have closed the gap between its per capita poverty share and total budget transfer (see appendix 4). Its per capita revenue transfer would have been ID1.9 million ($1,600), while Kirkuk, which has the lowest per capita poverty share, would have seen its per capita revenue transfer increase from ID584, 000 ($499) to ID2.1 million ($1,800). At the $1 rate, Baghdad (which has more poor than the other provinces) received $172 per capita in revenue transfer, or 34% of the figure received by Kirkuk; at the $5 rate, it would have received $187 per capita total transfer, but this would have been only 10% of the amount given to Kirkuk (see appendix 4).

Article 121 of Iraq’s constitution stipulates that transfers should take into account each region or province’s resources, which is what the government claims to be doing with the petrodollar. However, this contradicts Article 111, which emphasises that the country’s oil and gas resources belong equally to all Iraqis. This implies that revenues should be distributed in such a way as to benefit everyone equally. When asked by the author whether the introduction of the petrodollar contravenes the principle of universal ownership expressed in Article 111, INTER1 (energy consultant to Iraq’s Prime Minister,see appendix1) argued that the petrodollar should be seen as compensation for the environmental damage sustained by these resource-rich provinces. However, his answer also implied that the system is a political mechanism to appease resource-rich producing regions and deter them from following the KRG and forming a separate region (a move which would not be too difficult under the terms of the constitution).

*“No it does not contradict ownership, because there is an argument that those governorates that have oil or refine oil are suffering from environmental damage caused by the production of oil or refining plus the emission of CO2 and the spillage of oil on their land. Thus, they don’t feel that they own the oil, they produce it and they don’t get any benefit. Once they feel that they are getting benefit they will not say that this is ours and we should not give revenue to another region which does not have oil, thus they will be satisfied”.*

Similarly, INTER3, the government spokesman on oil, saw the petrodollar as helping provinces to address the environmental issues associated with oil production.

**“***Ownership is federal but the petrodollar supplies a bounce for these governorates that face pollution, also they may need to build extra infrastructure to meet the needs of the big oil companies, so we reward them for this*”.

However, it might be argued that the building of extra infrastructure should be incorporated into the provincial expenditure or the federal budget for sovereign projects. It does not need a yearly commitment of revenues to be transferred to these provinces.

**8.7 Total per capita share of revenue received by the provinces and the KRG**

The total per capita share of revenue from central government is the sum of the directly transferred revenues described above and the value of services provided by the central government (to all provinces except Kurdistan). In the absence of any official government statistics (the only information available relates to operating expenditures, share of the reconstruction fund and petrodollar transfers), each province’s share of services has been calculated for this study according to population size (Articles 121 and 112 of the constitution stipulate that funding for these services should be determined on this basis). Thus, for 2012[[49]](#footnote-48), the total per capita share of revenue may be calculated as follows:

1. The total budget is ID117 trillion ($99 billion). Deducting sovereign, ruling, reconstruction and petrodollar expenditures (ID48 trillion) ($40 billion) leaves ID69 trillion ($59 billion).
2. Deducting the 17% transferred to the KRG leaves ID56.7 trillion ($49 billion).
3. Deducting operating expenditure ID479 billion ($404 million) leaves ID56.2 trillion ($48 billion). Each province’s share of central government services can then be calculated according to population. Operating, reconstruction and petrodollar expenditures can then be added for each province (seeTable 8.11).

**Table 8.11: Total per capita share of revenue received by the provinces and the KRG in 2012**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Province** | **\*Population** | **% of total popul-ation** | **\*\*Provin -cial share of central distributi- on**  **Trillion**  **ID** | **\*\*\*Provinces’ operating expenditures +reconstruction+ petrodollar share**  **Billion ID** | **\*\*\*\*Provincial/**  **KRG total share**  **Trillion ID** | **Provi-ncial/**  **KRG per capita share**  **Million ID** |
| Baghdad | 7,357,572 | 25.3 | 14.2 | 1,485 | 15.7 | 2.1 |
| Basra | 2,562,579 | 9 | 5 | 1,380 | 6.4 | 2.5 |
| Nineveh | 3,365,787 | 11.6 | 6.5 | 666 | 7.1 | 2.1 |
| Dhi-Qar | 1,906,861 | 6.5 | 3.6 | 389 | 4 | 2.1 |
| Anbar | 1,519,386 | 5.2 | 2.9 | 304 | 3.2 | 2.1 |
| Missan | 1,034,815 | 3.5 | 1.9 | 250 | 2.2 | 2.1 |
| Diyala | 1,435,707 | 5 | 2.8 | 287 | 3 | 2.1 |
| Kirkuk | 1,332,025 | 4.6 | 2.5 | 778 | 3.3 | 2.5 |
| Diwania | 1,157,880 | 4 | 2.2 | 238 | 2.4 | 2.1 |
| Wasit | 1,196,893 | 4 | 2.2 | 239 | 2.4 | 2 |
| Najaf | 1,287,216 | 4.4 | 2.4 | 352 | 2.8 | 2.2 |
| Muthana | 753,489 | 2.6 | 1.4 | 165 | 1.6 | 2.1 |
| Salah al-Din | 1,321,092 | 4.5 | 2.5 | 388 | 2.9 | 2.2 |
| Babil | 1,794,677 | 6.2 | 3.4 | 378 | 3.8 | 2.1 |
| Kerbela | 1,044,060 | 3.6 | 2 | 218 | 2.5 | 2.2 |
| **Total** | **29,070,039** | **100** | **56.2** | **7,517** | **63.7** | **2.2** |
| Kurdistan | 4,189,702 | 100 | - | 411 | 12.6 | 3 |
| **Total** | **33,259,741** |  | **-** | **7,928** | **75** | **-** |

Source: Iraq Ministry of Finance

**\*** Iraq Ministry of Finance - Federal Budget – appendix tables –Iraq’s census

\*\*Provincial share of central distribution calculated by the author based on provincial/KRG population

\*\*\* Iraq Ministry of Finance – Financial Statements- Provincial total expenditures

\*\*\*\* The provinces’ total share is the sum of their share of central distribution + government transfer for operating expenditure, reconstruction and petrodollars

Table 8.11 indicates that the provinces receive roughly the same level of per capita transfer, apart from the resource-rich provinces of Basra and Kirkuk. However, comparisons between the provinces should be made with caution; the calculations above assume that everyone receives an equal share of the ID56.2 trillion ($48 billion) the government spends on services, though there is no empirical evidence to support this. What is evident is that although the ID7.5 billion ($6.3 billion) in direct cash transfers may seem unfairly distributed between Basra, Kirkuk and the rest, it accounts for a relatively small share of total government expenditure on the provinces, compared to what is spent on services. Lack of data may make it difficult to rank the provinces with confidence, but it is possible to compare Kurdistan (which receives no services from central government) and the rest of Iraq in terms of total per capita benefits received: Kurds get ID3 million ($2,500) per capita, 36% more than non-Kurds, who get ID2 million ($1,600) per capita.

**Figure 8.7: Total per capita share of revenue received by the provinces and the KRG in 2012 (ID000)**

Source: Author calculation (see Table 8.11)

The disparity is also reflected in per capita income. The only available data for per capita income is for 2007. In this year, per capita income was higher in Irbil, Dohok and Sulymania (the three provinces that make up Kurdistan) than in the other provinces(see Figure 8.8)

**Figure 8.8 Nominal per capita income in Iraq’s provinces, 2007 ID/000 per month**

Source: Central Organisation for Statistics (Iraq) - Annual Abstract for Statistics 2010-2011, <http://cosit.gov.iq/english>

Per capita expenditure across Iraq’s provinces and Kurdistan follows the same pattern as income expenditure. Kurdistan has a higher living standard than other provinces. As Table 8.12 indicates, per capita expenditure on education is around 80% higher in Kurdistan than it is in the federal ministry, and it spends around 15% more per capita on higher education. However, spending is higher in the other provinces in terms of health, municipality, interior (domestic security) and electricity. The difference in spending on security may be explained by the fact that since 2003, the security situation in Kurdistan has been relatively stable; Iraq Household Socio-Economic Survey (IHSES) data show, for example, that less than 1% of the population in the Kurdistan region have experienced security-related violence, compared to 6.6% nationally (The World Bank, 2011a:28). Similarly, the electricity supply is very poor in the other provinces, and a higher level of spending is required. KRG saves in this respect by using gas from its Khor mor and Kim chemical fields to supply electricity to its people (Dana Gas, 2012). While this is good from an environmental point of view, these resources belong to all Iraqis, not just Kurdistan. This is another source of dispute with the central government (see section 8.9.3).

**Table 8.12: Main ministry expenditure in central government (services extending to all provinces) and Kurdistan expenditure, 2010**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Ministry** | **\*Central government expenditure**  **Billion ID** | **\*\*Per capita expenditure**  **(provinces)**  **000 ID** | **\*\*\*Kurdistan expenditure**  **Billion ID** | **\*\*\*\*Per capita expenditure**  **(KRG)**  **000 ID** |
| Health | 5,709 | 172 | 473 | 113 |
| Education | 5,544 | 167 | 1,253 | 299 |
| Higher Education | 2,548 | 77 | 368 | 88 |
| Municipality | 2,341 | 70 | 31 | 7 |
| Interior | 7,188 | 216 | 794 | 189 |
| Electricity | 6,890 | 207 | 104 | 25 |

Sources:

\*Iraq Ministry of Finance - Federal Budget - Budget Archive - 2010 Budget

\*\* Per capita expenditures are calculated by dividing central government expenditure by the province’s population (see Tables 8.3 and 8.8 for census information)

\*\*\* KRG Ministry of Finance and Economy – KRG 2010 Budget

\*\*\*\* Per capita expenditure is calculated by dividing Kurdistan’s ministries’ expenditures by KRG population (see Tables 8.3 and 8.6 for KRG census information)

Kurdistan does not spend as much on its services as the other provinces for the reason that it already has a good infrastructure in place. This was demonstrated by the findings of a 2011 survey, in which the Iraq Ministry of Planning collected data from around 29,000 households at the district level in all 18 governorates and found that in general, there was a higher level of satisfaction with Kurdistan’s services than with those offered in Baghdad and the other Iraqi provinces (see Table 8.13). Thus, while 48.6% of respondents thought Baghdad’s electricity service was poor, only 12.4% felt the same in Kurdistan. The results were similar for municipal services like rubbish collection, drinking water and sanitation. However, Table 8.13 also shows that a higher percentage of the population is illiterate in Kurdistan than in the other provinces – almost double the level in Baghdad. This explains the KRG’s higher per capita expenditure on education.

**Table 8.13: Socio-economic indicators survey in Iraq’s provinces and Kurdistan (December 2011)**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **Illiterate**  **%** | **Evaluation of drinking water**  **(very bad) %** | **Sanitation**  **(very bad)**  **%** | **Garbage disposal**  **(very bad)**  **%** | **Electricity service**  **(very bad)**  **%** |
| **Average KRG** | 26.3 | 4.5 | 8.3 | 7.7 | 12.4 |
| **Average Baghdad** | 11.9 | 13.7 | 24 | 27.6 | 48.6 |
| **Average other provinces** | 22.4 | 24.6 | 38.3 | 34.8 | 51.7 |

Source: Iraq Ministry of Planning – Living Conditions Survey - Findings of Iraq Knowledge Network Survey (December 2011), <http://cosit.gov.iq/en/>

**8.8 Revenue collection in the KRG and Iraq’s provinces**

Zedalis (2009), in his book *The Legal Dimensions of Oil and Gas in Iraq*, points out that although sub-national governments are actively involved in the oil and gas industry and engaging in activities that are capable of generating large revenues, the constitution does not identify which of these revenues should be collected nationally and which should stay in the local regions and provinces. Since no data are publically available on who collects what, clarification was sought from the interviewees.

According to INTER1 (energy consultant to Iraq’s PM, see appendix1), bonuses and upstream oil tax are federal (collected solely by the central government), but provinces may profit from downstream activities and some local taxes: *“Signature bonuses are federal; nothing to do with governorates, but when it comes to sales of oil products this is different”.* This means, according to INTER1, that the federal government collects: upstream taxes including signature bonuses and corporate tax (35%, collected from foreign and local companies alike); any tax paid at Iraq’s entry borders and airports; 70% of the profits of local oil/gas companies; and any other tax if there is no specific legislation for sharing with governorates (see appendix 1). Local provinces/regions can collect some specified local tax. Local oil/gas companies keep 30% of their profits, to be divided between specified functions such as Research and Development and bonuses for personnel. These local companies also have their own revenues to spend on expenditures. INTER4 (a member of the Iraqi Parliament) confirmed that revenues from downstream activities stay in the regions and provinces, especially if they are the result of local investment (see appendix 1). Thus, oil-rich provinces gain additional revenues from downstream taxes, widening the gap between regions even further. These revenues help raise living standards and foster economic activity in Kurdistan and oil-rich provinces but do nothing to benefit the rest of Iraq.

The only information available on tax collection in Kurdistan is in Kurdish. The KRG’s website reveals that in 2013, local revenue from taxes was around ID851 billion ($711 million) (see Table 8.14), which was around 6% of the central government transfer to KRG. However, the revenues from Kurdistan’s independent exporting activities (which began in 2012) were not included. As is explained below, these revenues are creating more inequality and disputes with other provinces.

**Table 8.14: KRG’s total revenue, expenditure and deficit, 2010-2013 (ID billions)**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | **Federal government transfer**  **ID billions** | **KRG local revenues (taxes and others)**  **ID billions** | **Expenditure**  **ID billions** | **Deficit**  **ID billions** |
| 2010 | 10,597 | 394 | 11,432 | 835[[50]](#footnote-49) |
| 2011 | 11,180 | 1,206 | 13,940 | 1,564 |
| 2012 | 12,604 | 596 | 13,200 | 2,004 |
| 2013 | 14,406 | 851 | 16,942 | 1,684 |

Source: KRG Ministry of Finance and Economy – KRG 2010 Budget; Ministry of Planning, Kurdistan Region – Budget Law and Regulation 2010-2013 <http://www.mop.krg.org/>

**8.9 Current disputes between central government and the KRG**

The current revenue distribution system has been the cause of several disputes between the central government and Kurdistan, even though the government has met the KRG’s demands in terms of revenue share. These disputes are discussed in the following sections.

**8.9.1 Dispute over the 17% share**

Kurdistan’s share – 17% of total revenues after subtraction of the federal government’s sovereign expenditures and the cost of strategic projects for the benefit of all – is meant to reflect the size of its population. There is a lack of reliable population data in Iraq; the last census count was taken in 1997, so the government bases its calculations on the number of food coupons it distributes. According to the Ministry of Finance, Iraq’s population stands at 33.2 million, with Kurdistan accounting for 4.1 million or 12.6% of the total (Iraq Ministry of Finance, 2012). However, Kurdistan still by law takes 17% of the revenues.

When asked why this was the case, INTER4 (a member of the Iraq Parliament) said that the 17% reflects the damage done to Kurdistan during the Saddam regime. The damaged areas criterion is mentioned in Article 112 of the constitution, but the article does not specify where these damaged areas are; in fact, “damaged area” seems to be a generic term. If it was meant to refer to Kurdistan, the decision to increase its share from 12.6% to 17% appears to have been fairly arbitrary – it seems to have been based on political considerations rather than any estimates of actual damage. Furthermore, it is not clear whether Kurdistan is actually benefiting from this compensation. The 12.6% share was based on the population figure in the 1997 census, but if the current population is much bigger than this, then even the 17% may not be enough to qualify as compensation at all. On the other hand, if the current Kurdistan population is similar to that in the 1997 census, then only Kurdistan has been compensated since 2003. Nor is it clear when this compensation will end.

However, Kurdistan is not the only area to have suffered; many areas of Iraq suffered damage under the Saddam regime. Article 112 in fact refers to regions that were damaged later on, which means after the end of the Saddam regime, but nothing has been earmarked in the budget for compensating these areas. INTER1 **(**see appendix 1)admitted that this provision has been very difficult to implement:

“*We have found difficulties in implementing the provision of the constitution about compensating for the damage inflicted on people in the governorates, because everybody was saying they had suffered during the Saddam regime. Thus, we have put this aside; the provinces and regions get a percentage of money allocated to them according to population, and now we have introduced the new concept of the petrodollar”*.

The interviewee’sremarks show that the stipulation that revenue be distributed to damaged regions is not being implemented. Instead, the government has implemented the reconstruction transfer – based on population – and the petrodollar system. His comments may refer to the claims by Kurdistan and the Shiite south that they suffered the most under the Saddam regime, but Sunnis would argue that all of Iraq suffered after 2003 as a result of the war and the subsequent terrorism. The introduction of the petrodollar was designed to appease Shiite regions (where most of the oil is located) and the KRG, while the reconstruction budget was meant to pacify Sunni areas and the rest of Iraq. However, the constitution already stipulates that revenues should be distributed according to population and that they should take account of resource status. In other words, the government is acting in a manner that is inconsistent with the constitution because it is using these mechanisms as a substitute for rather than an addition to the damaged areas provision. Kurdistan is the only area which receives revenues under all three provisions.

Article 112, which began as part of the TAL, was originally written to satisfy the KRG (see Chapter four), but subsequent events have rendered it obsolete; since 2003, all of Iraq has suffered damage. The money provinces receive according to their population for development is their own rights and does not compensate them for the article of damaged areas. INTER1 described the petrodollar as one form of compensation for damage, but some of the most affected areas are not resource-rich and so end up with only a fraction of the government budget. In any case, Article 121stipulatesthat the extra share given to resource-rich provinces is compensation for environmental damage, not damage resulting from civil war or terrorism.

At the 2014 Iraq Petroleum Conference, Ahsti Hawrami (KRG Oil and Gas Minister) argued that Kurdistan does not in fact receive its 17% share of the budget, and that agreed budget principles are being breeched in the absence of a constitutionally enacted revenue sharing law[[51]](#footnote-50). He added that in 2013, the KRG share was only 10.4%, or $12 billion, when it should have been 17%, or almost $20 billion. The KRG does not consider the Law of Financial Resources to be constitutional, as it stipulates that the KRG’s share should be calculated after sovereign expenditures have been subtracted. Furthermore, there is a dispute between the federal government and the KRG over whether these expenditures should be capped (see section 8.9.2). Mr Hawrami’s argument that the KRG’s share should be calculated before sovereign deductions may be an attempt to start the bargaining at a higher point in the hope of achieving a better compromise for the KRG, but allowing this for the KRG andHawrami not the rest of the provinces would further undermine the principle of national ownership enshrined in Article 111, and the principle of equal revenue distribution.

**8.9.2 Sovereign expenditure disputes**

In 2013, Kurdistan’s revenue share, after the subtraction of sovereign and ruling expenditures, amounted to 10.4% of the central government’s total budget (see Table 8.7). This mechanism, as mentioned above, is written into the Law of Financial Resources (Council of Representatives, 2007). As explained above, the KRG does not agree that its share of the revenues should be reduced by these expenditures. In 2007, it suggested a cap of 20% on sovereign expenditures and 5% caps on deductions for the Kuwait compensation fund and the future generation fund; in other words, it wanted prior expenditures to be capped at 30% (Zedalis, 2009). In reality, sovereign expenditures totalled 30% in 2013, though ruling expenditures, reconstruction and petrodollars increased the deductions to 42%. Kurdistan’s 17% share was calculated after these deductions. The 5% compensation to Kuwait was included in the sovereign expenditure, but no money was transferred to the future fund. Capping deductions at 30% would have given the KRG a share of $14 billion, almost $2 billion more than it actually received, while capping sovereign expenditures at 20% would have given it $16 billion in 2013. Kurdistan’s real expenditures for 2013 were $14 billion, which, added to its $1.4 billion deficit, made its total expenditures $15.6 billion (see Table 8.14). If the KRG’s share had been calculated directly from the budget without upfront deductions, this would have given it $20 billion in 2013. This would have created even more inequality between Kurdistan and the other Iraqi provinces and led to even more disputes.

Since Kurdistan’s direct transfer is larger than that of other provinces, and it is responsible for more of its own expenditure, the upfront deduction of sovereign expenditures affects it more than any other province. The Kurds have accused the central government of inflating its sovereign expenditure figures in order to reduce the KRG’s share, but INTER1 refuted these claims, insisting that the government deducts only what is required to meet Parliament’s needs. He claimed that the KRG is the only governorate that wants to put a cap on these expenditures (see appendix 1):

*“When we calculate the sovereign expenditures there is always an argument - the KRG government is trying to set a ceiling of no more than 2% or $2 billion but there has been no agreement on that*”.

INTER3 confirmed this:

*“KRG have some reservations about the expenditure on sovereign projects which is deducted upfront; the Kurds were objecting to the deduction of this cost; the cap to limit expenditures is still under dispute”*.

It will be noticed that there is some inconsistency from the Kurds regarding the proposed cap on deductions; while the KRG suggested 20% in 2007, INTER1 spoke of the KRG wanting a cap of 2%, and Mr Hawrami wanted the KRG’s share to be calculated before any deductions. There is clearly a big gap between the 2% cap on government expenditures being suggested by the KRG and the real sovereign and ruling expenditure of the government, which was 42% of the total budget in 2013. The defence budget alone accounts for 6% of the total, which shows that a 2% cap is not realistic.

The Law of Financial Resources specifies no cap and no limit, so the government is able to increase or decrease expenditure as much as it wants (see Table 8.6). In other words, although Kurdistan controls how it spends its revenues, it is the central government that controls the revenues that Kurdistan receives. Boadway and Shah (2009) identify this as another disadvantage of revenue sharing (see Chapter Seven). The Iraqi government’s control over oil revenues is crucial to its ability to control Kurdistan. The KRG may be signing contracts with IOCs without federal government approval and exporting independently, but sovereign expenditures remain under the control of Baghdad, which is increasing them to suit its own ends. The evidence suggests that this is what is happening; decisions on this type of spending are being made according to political criteria and/or the availability of oil revenues rather than economic criteria. The political motivation underlying the government’s spending decisions was clearly highlighted when it reduced its payments to IOCs working in Kurdistan in retribution for the KRG’s failure to fulfil its export commitment of 250 000 b/d.

The terms “sovereign expenditure” and “strategic project for the benefit of all” are open to interpretation; they can include bridges, dams, or expenditure by INOCs and SOMO (Zedalis, 2009). For example, the $198 million for settling the debts of Iraqi Airlines, added in 2013, looks more like an investment project than a sovereign expenditure. Furthermore, what benefits one province may not benefit others; weather forecasting projects, also added in 2013 at a cost of $1.1 billion, may not be of interest to Kurdistan, which may want to set up its own projects in this area.

The disputes about sovereign expenditure might be eliminated if the KRG received its share directly from oil revenues. In 2012 and 2013, increasing production and rising prices meant that oil revenues were high. Oil revenues for these two years were around 80% of total budget (see Table 8.5). Total budget expenditure in 2012 and 2013 was $99 billion and $117 billion respectively, while Kurdistan’s share for the same years was $10.6 billion and $12 billion respectively. Oil revenues in 2012 and 2013 were $80 billion and $94 billion respectively; if Kurdistan’s 17% share had been deducted directly from oil revenues then its share for these years would have been $13.6 billion and $16 billion respectively (see Table 8.5). Ashti Hawrami, during his presentation at the 2014 Iraq Petroleum Conference, claimed that the KRG would have been better off under the pre-2003 system, when it received 13% of oil revenues according to the population (see Chapter Three).If Kurdistan does indeed have 13% of Iraq’s total population, and if it took its share directly from oil revenues, then its share for the years 2012 and 2013 would have been $10.4 billion and $12 billion respectively, almost the same as its current share of the total budget. However, calculating shares directly from oil revenues means that the amount received would fluctuate from year to year, making it impossible to plan expenditure (though a short-term fund would help protect expenditures to some degree). The other possible solution to this dispute is to place a legal cap on sovereign expenditures, though the government may need to spend more on sovereign expenditures in some years than in others. The solution again is a short-term fund to protect sovereign expenditure spending.

**8.9.3 Kurdistan’s exports, oil smuggling and the State Oil Marketing Organisation**

The sharing of oil revenues is the underlying cause of the disputes over exports and oil smuggling by the KRG. On its part, the federal government faces pressure from the other provinces, who complain that they are not benefiting from Kurdistan oil, and that the revenue should be distributed equally among all provinces/regions (Al Rafedien Centre, 2012).

For political reasons, Kurdistan does not always send all of its oil revenues to the central government for redistribution. It is able to exploit the fact that there is no binding revenue distribution law, and that the constitution gives priority to regions in the event of a dispute, to benefit its own interests.The central government and the KRG appeared to have resolved their dispute over Kurdistan’s exports in January 2011, when the Iraqi government agreed to pay for Kurdistan’s production-sharing contracts on condition that the region exported 150,000b/d. However, the petrodollar payment made in 2012 indicates that Kurdistan exported much less than 150,000 b/d in that year. In fact, Kurdistan stopped exporting again in April 2012, citing the federal government’s failure to pay for its IOCs as the reason. Mr Shahrastani, a former Oil Minister, and Mr Alaibi, the current Oil Minister, still consider these contracts to be illegal and argue that Kurdistan should pay for them from its 17% allocation (Ahmad, 2012; Chazan, 2012). This export management contradicts Kurdistan previous interpretation of the Constitution. Kurdistan interpretation limited the central government to marketing and transportation. This argument was initiated to defend the Kurds signing of contracts with IOC’s. However, KRG changed the interpretation to include marketing.

In the meantime, Kurdistan started to build a pipeline with Turkey to export its oil independently. Speaking at the Iraq Petroleum Conference in London in June 2012, Ashti Hawrami argued that the constitution gives no automatic right to the State Oil Marketing Organisation (SOMO) to market all of Iraq’s oil and gas and confirmed that Kurdistan planned to take its oil and gas direct to Turkey via an independent pipeline. When the KRG started exporting to Turkey, this soured relations even further(Peg, 2012).It is not clear where the revenues from these exports will end up.

The central government has accused the KRG of smuggling large amounts of oil from Kurdistan to Turkey and Iran. In 2012, Prime Minister Nouri Al Malike argued that the KRG owes $8 billion to the Treasury and threatened to deduct this amount from Irbil’s share of the national budget (*Gulf States Newsletter*, 2012:1). President Barzani responded that any cut in budget would be seen as a declaration of war and threatened to seek independence if dialogue failed (*Gulf States Newsletter*, 2012). The KRG’s boycott of the 2013 budget did indeed look like a war between central government and Kurdistan. One of the main triggers was the shortfall in the government payment for IOC contracts in Kurdistan; in response, in April 2013, the KRG Parliament passed a law stipulating that: “if the federal government defaults on payments then the KRG is authorized to sell oil produced in the Region to recover unpaid dues” (MEES, 2013b:2).

In 2013, Kurdistan exported only 23 b/d via SOMO, which was reflected in its low petrodollar receipts (ID42 million, or $35,000) (see Tables 8.9 and 8.14). Ashti Hawrami, in his presentation at the 2014 Iraq Petroleum Conference, argued that Baghdad cut Kurdistan’s budget because of its low exports, but that the balance is needed for local consumption; Baghdad expects the KRG to shut its refineries and consume only 3% of Iraq’s oil (equivalent to 8,641,055 b/d), but its real share should be 17% (see appendix 4). In 2013, the KRG produced 214,000 b/d, of which it sent 181,500 to local refineries and sellers, trucked 30,000 to Turkey (the central government considers this smuggling, but Kurdistan considers this swapping with refineries) and exported 1,300 b/d via its controversial new pipeline.

**Table 8.15: Kurdistan production, refineries and exports (2010-2013)**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | **Gross**  **KRG oil production b/d** | **Oil processed in main KRG refineries**  **b/d** | **Oil processed in local plants/local sales**  **b/d** | **Oil exports via KRG pipeline b/d** | **Oil exports via SOMO b/d** | **Oil exports via trucking-swaps b/d** |
| 201 0 | 75,911 | 35,626 | 33,203 | - | 5,947 | - |
| 2011 | 186,424 | 52,890 | 31,455 | - | 10,1754 | - |
| 2012 | 209,579 | 60,917 | 79,106 | - | 66,959 | 2,170 |
| 2013 | 214,381 | 96,673 | 84,846 | 1,341 | 23 | 30,827 |

Source: Ashti Hawrami (2014), *KRG/Government of Iraq: Issues and Future*, Iraq Petroleum Conference 2014, CWC London 18 June

According to Ashti Hawarmi, the federal government assigns oil export quotas for Kurdistan which are impossible to fulfil. Table 8.15 indicates that Kurdistan only produced 214,000 b/d in 2013, which is less than the 250,000 b/d quota in the budget. The KRG is left with no choice but to send its crude oil to local refineries. Kurdistan is behaving like a devolved region in that it is taking all its energy resources for itself; on the other hand, it is still taking revenues from the central government. Ultimately, its decision to start exporting independently, first by truck (in 2012) and then via pipeline (in 2013), may have economic consequences not just for the central government but also for itself; if it inspires other oil producing regions such as Basra to follow suit, the central government pot from which Kurdistan’s share comes will be reduced.

It is the contention of this thesis that central government should indeed pay for contracts in Kurdistan, as the oil fields in Kurdistan belong to all Iraqis (Article 111 of the constitution), just as their revenues should be shared with all Iraqis (Article 112). For its part, Kurdistan must be transparent about its oil and gas exports. It is in the national interest to standardise the contracts used throughout Iraq, and to ensure that oil and gas revenues are handled in a transparent way and that their division is agreed by all parties and benefits all Iraqis.

**8.9.4 The unsolved problem of the oil-rich city of Kirkuk and the disputed areas of Mosul and Diyala**

The long-term aim of the Kurds during the 1960s was to take 33% of Iraq’s oil revenues. It seems that they arrived at this percentage by including the disputed areas of Kirkuk, Mosul, Diyala and Salah-al-Din within their regional population. Ownership of the province of Mosul Vilayet, within which lie all of Iraq’s northern cities, including Kirkuk, has been disputed ever since the state of Iraq was formed by the British. The area, which contains around 17% of Iraq’s proven oil reserves, much of it around Kirkuk (EIA, 2013), has over the decades been a bone of contention between the British and the French, the British and the Turks and the Kurds and the Arabs (see Chapter Three for the origins of the dispute and for a map of the currently disputed areas).It is clear that the current dispute between the central government and the Kurds is essentially a struggle for control over Kirkuk’s vast oil revenues.

The census to determine who will control Kirkuk and the other disputed areas of Mosul and Diyala should have been held in December 2007, according to Article 140 of the constitution (seeChapter Four). However, the census has not yet been held, at the time of writing. The delay has been caused by mistrust between Kurdistan and the central government and arguments over who will conduct the count. There is also disagreement over who should be included in the count, given that there have been so many population shifts since the fall of Saddam Hussein. In the late 1950s, the constitution recognised the Arabisation of Kirkuk by previous regimes and demanded that those who had been forced out of Kirkuk should be able to return. Anderson and Stansfield (2009:221) claim that under the Arabisation policy, 70,000 Kurds were thrown out of Kirkuk, all of whom have the right to return. However, the authors found that by the time of the 2005 election, 175,000 new Kurds had been added to the electoral register. In all, Anderson and Stansfield estimate that 230,000 to 250,000 Kurds have migrated to Kirkuk since April 2003. At the same time, Arabs have been offered payments to leave Kirkuk. Some 8000 Arabs left in 2007, but others have refused to go (IRIN News, 2007). If the trend continues to the point that Kurds outnumber Arabs, the city is likely to join Kurdistan, making the KRG even stronger economically.

Edmunds (1957) estimated that in 1949, before Arabisation, Kurds made up just 25% of Kirkuk’s 25,000 population, the majority of whom were Turkmens. By the 1957 census, however, Kirkuk’s total population was 388,829, with Kurds representing 48%, Arabs 28% and Turks 21% (Anderson and Stansfied, 2009:43). There is a big difference between Edmund’s estimates and the 1957 population figures, but he may have been referring only to Kirkuk city (Kirkuk province is divided into four districts: Makhmur, Daquq, Al-Hawiga and Kirkuk). By the time of the 1997 census, Arabs made up around 58% of the city’s population (751,331); only 10% were Kurds and the rest were Turkmens and others (Iraq Central Organisation for Statistics, 2010-2011). However, the Kurds have claimed that these data are inaccurate as Kurds ran the risk of losing their land if they did not identify themselves as Arabs (Beehner, 2006).

**8.9.5 Ambiguity regarding ownership, future fields and power sharing**

As discussed in Chapter Six, the federal government, academics, oil consultants and energy lawyers all agree that the wording of the constitution is confusing and even deliberately ambiguous. Article 112 increases the confusion even more by stating that the principle of shared management (itself interpreted differently by the KRG and central government) applies only to currently productive fields. In other words, revenues from future fields could theoretically go entirely to the producing regions. If, after the census, Kurds emerge as the majority population in the disputed areas, then the management and revenues of any future fields in current Kurd territory or any other area which might possibly be included in Kurdistan in the future will be exclusive to Kurdistan. Other oil-rich regions, such as Basra, have the same rights under this article.

Further confusion arises over power sharing, as defined by Articles 110, 112, 114 and 140. The four articles are mutually contradictory; with the result that the central government and the KRG interpret the rules on power sharing differently (see Chapter Four). For example, it is unclear who has the rights and power to sign contracts with international oil companies (see Chapter Six). New oil and gas laws are meant to iron out the ambiguities of the constitution, but at the time of writing, these are still going through Parliament, held up mainly by the power sharing and KRG contract issues.

**8.10 Conclusions**

Since 2003, the regional distribution of revenues throughout Iraq has taken on a different form from the central revenue distribution that applied during the Saddam regime. The new system is one of asymmetrical revenue sharing, with some central elements. The criteria for revenue sharing are identified in the constitution but are, in practice, only applied to the KRG. Kurdistan, as a semi-autonomous region, receives an indirect share of the oil revenues from the central budget (96% of its revenue is transferred from the government). This share is calculated according to its population, resources and the damage it sustained under the Saddam regime; in this last respect it is unique among the provinces/regions. While some members of the central government have argued that Kurdistan’s population has historically been overestimated and that its share should be revised downward, in line with recent estimates, others have countered that any overpayment should be seen as compensation for previous damage. The region also receives a share of the reconstruction fund and petrodollars for its oil exports.

In contrast, other provinces receive the bulk of their revenues in the form of services funded by the central government, with only a small proportion arriving as direct transfers (6.8% of the total budget in 2012). The amount of revenue to be directly transferred is calculated according to population size, governorate responsibilities and level of resources, as stipulated in the constitution. However, other constitutional conditions, such as the damaged area provision and the requirement to address local need, are not being met.

The revenue sharing system has delivered two main benefits: it has kept Kurdistan within Iraq, and it has given the other provinces autonomy over how they spend their direct transfer. However, as this chapter shows, the revenue distribution formula is politically motivated and the system has several disadvantages. This confirms the views expressed by academics such as Ahmad and Singh (2003), Searle (2007) and Boadway and Shah (2009). In 2005, Iraq was still under American occupation, the central government was weak and Baghdad was being ruled by the Interim Government. In contrast, the Kurds were well established, and they were able to influence the writing of the new constitution in such a way as to achieve their own long-held goals. The result has been disputes and inequality between Kurdistan and the remaining provinces.

The revenue sharing system is empowering Kurdistan. Ross (2007) argues that offering sub-national areas direct transfer/revenue sharing might appease those agitating for independence, but giving them this taste of economic power might just as easily have the contrary effect of strengthening their aspiration for independence. This may well be the case in Kurdistan, especially if disputes with the central government continue and it is joined by the oil-rich city Kirkuk. On the other hand, the KRG may decide that it will be financially better off staying with the central government. Iraq’s oil production is expected to increase to 8 mb/d and there are medium to long-term plans to start exporting gas. As more revenue is generated for the country, Kurdistan’s share of the budget will also increase.

As Kurdistan becomes more powerful, it is increasingly acting like a devolved and independent region and demanding full control over the exploration, production and export of oil discovered in the region. It has either consumed or independently exported most of this oil since 2013. In addition, it is demanding that its share of the total budget should not be reduced by the deduction of sovereign and ruling expenditures (although this would leave the central government running a higher deficit, meaning Kurdistan would lose out as well). It accuses the central government of inflating these expenditures in order to reduce the KRG’s share.

The 17% share given to Kurdistan is clear evidence of the political thinking that underlies the distribution formula. The share is based on estimations of Kurdistan’s population rather than actual numbers, but the government would rather give the KRG 17% than conduct a census for Kirkuk and risk the city joining Kurdistan. Thus, political expediency overrides the socio-economic need to create a formula that reduces poverty in all Iraqi provinces and makes them all (including Kurdistan) equal. Instead, the system has created inequality and resentment. Kurdistan’s access to direct oil revenues, which contravenes the principle of ownership expressed in Article 111 of the constitution, creates big revenue gaps between Kurdistan and the other provinces. On top of this, the government distributes a greater per capita share of revenue to Kurdistan than to the other provinces, making the revenue gap even wider. Kurdistan’s per capita income in 2007 was higher than that of all other provinces. This has led other provinces, especially resource-rich provinces such as Basra, to agitate to become regions and/or keep a bigger share of their resources. This is similar to what has happened in Indonesia, where resource-rich provinces such as Riau and East Kalimanatan have been inspired by the special treatment given to Ache and Papua to demand larger shares (see Chapter 7).

The Iraqi government responded to the demands of resource-rich provinces like Basra with the political decision to introduce the petrodollar, but this has only served to increase the gaps between Kurdistan and the other provinces, and between resource-rich provinces like Basra and Kirkuk and resource-poor provinces like Baghdad and Babil. Meanwhile, socio economic indicators in the latter – such as high levels of poverty – are being ignored. Even so, the oil producing regions, especially Basra and Kirkuk, want more. They want the government to increase the petrodollar from $1 for each barrel produced to $5. This would further widen the gap between provinces, leaving Baghdad, which is home to most of the country’s poor, with only 10% of the amount given to Kirkuk. The experiences of Colombia, Indonesia and Canada demonstrate the difficulty of addressing unequal revenue distribution among sub-nationals, even with an equalisation system. The problem is likely to be even worse in Iraq, which has no such system.

The asymmetric nature of the revenue sharing system means that only 6.8% of the total budget is transferred to provinces (this includes petrodollar payments). This is less than their real expenditures. Oil price volatility also affects the amount that they receive, especially as there are no short-term funds to protect the money transferred. The volatility of prices affects the other provinces more than Kurdistan because, unlike Kurdistan, there is no binding formula protecting their transfer. The literature indicates that the revenue sharing system is designed to match revenue to expenditure needs (Seale, 2007; Boadway and Shah, 2009), but this is not happening in Iraq. Transfers to the provinces are not being made according to the needs criterion, which one assumes should be based on the number of people living in poverty or the fiscal gap. Poorer areas do not receive larger transfers, especially if they are not resource-rich.

**Chapter Nine: Conclusions**

**9.1 Introduction**

This chapter presents the main conclusions and implications of this study. It begins with an overview of the study’s main purpose and the research questions, before examining the contribution it makes to the literature and policy analysis. The final sections consider the limitations of the study and offer recommendations for future research.

**9.2 Overview of the study**

This study aims to characterise Iraqi oil governance since the 2003 invasion and the toppling of Saddam Hussein, focusing mainly on the distribution of oil revenues among regions. To fully understand Iraq’s current regional distribution model, it is necessary to first understand its revenue collection policy. Accordingly, the thesis examines Iraq’s petroleum fiscal regime, comparing the collection policies of the central government and the KRG, before moving on to the main research question of the regional distribution of oil revenues.

The thesis draws on a range of legal documents including Iraq’s permanent constitution, the draft hydrocarbon law, contracts with international oil companies and Iraq’s annual budget laws, plus other secondary sources in Arabic and English. A series of interviews was also conducted with key players in the reconstruction of Iraq’s oil governance. The main findings of the thesis are presented below, structured according to the thesis chapters.

**9.2.1 Key events in the development of the Iraqi oil industry from its inception until 2003**

The aim of Chapter Three is to explore the first structures that were put in place for the governance of Iraqi oil and to trace how these changed up until 2003. The chapter shows that Iraq’s oil governance was repeatedly modified throughout this period, mostly in response to dissatisfaction with foreign oil companies, political changes and civil and external wars.

The first concession contracts were signed with international oil companies in 1925. Very generous terms were granted to the international companies, Iraqi oil governance had non-proprietorial governance characteristics (Mommer, 2002). However, when it realised it was only receiving 6.7% of the total net profit from Iraqi oil, the government sought to make changes to the contracts, including the introduction of dead rent in 1931 and 50-50 profit sharing in 1952. Although these dramatically increased the government’s take, the IOCs still took the lion’s share of revenues. Consequently, in 1961, the government took away the IOCs’ 99.5% concessionary area. Iraqi oil governance adopted proprietorial model characteristics where the state assumed greater control over development and revenues (Mommer, 2002). Finally, in 1971, the Iraqi oil industry was completely nationalised.

Chapter Three also describes the origins of the regional dispute between Iraq and the Kurds. When the Ottoman Empire collapsed, the Kurds, most of whom live in northern Iraq around the Mosul Vilyate, demanded a territory of their own. However, this request was denied by the British in 1920, mainly because the region was believed to contain oil. Over the years that followed, the Kurds continued to demand the establishment of an autonomous region within Iraq, and there were repeated rebellions against the central government. They were finally granted an autonomous region in the north of Iraq in 1991, after the Gulf War. The region, which comprises the provinces of Sulymania, Irbil and Dohok, receives its revenues from the central government, but the Kurds have complete control over their own spending.

**9.2.2 The principal characteristics of the governance of Iraqi oil since 2003**

Chapter Four shows that the governance of Iraqi oil has changed in many ways since 2003 and the American invasion. During the American occupation (April 2003-June 2004), the control of the industry and its revenues was in the hands of the occupation forces, and contracts for rehabilitation of the industry were given to American companies such as Halliburton. The CPA (Coalition Provisional Authority) would have preferred these contracts to be PSCs, but Iraqi oil industry experts and consultants objected on the grounds that PSCs would give too much to the international oil companies. They preferred service contracts, which pay the oil company a service fee but leave full ownership of the oil in the hands of the state. When CPA rule ended it was still unclear what type of contracts or management would reign in the oil industry; what was evident, however, was that the oil industry was no longer nationalised, and that IOCs would play a big role in its development.

The CPA period saw the writing of TAL (Law of Administration for the State of Iraq), which in turn formed the basis of the permanent constitution. Unfortunately, the ambiguity which characterised TAL was also transferred to the permanent constitution. Crucially, the question of who owns the oil industry was left open to interpretation by academics, industry experts and the Iraqi authorities. While some interpreted TAL (and subsequently, the constitution) to mean that ownership of the resource rests with all Iraqis, others interpreted it to mean that ownership is regional. Everyone agrees that the law is deliberately ambiguous. TAL was the first legislation to set out criteria for revenue distribution among governorates and regions – again, these were reproduced in the permanent constitution. TAL stipulated that revenue was to be distributed firstly, according to population and secondly, to take into account the hardship suffered by some areas under the previous regime. The second criterion has been the subject of debate, however, as not only were these damaged areas not identified, but no timescale was set for their compensation. The criterion also raises the question of what if anything should be done for those areas which sustained major damage during the 2003 war. Finally, TAL was the first Iraqi law to recognise the Arabisation of Kirkuk under Saddam’s regime and to suggest mechanisms to resolve the issue. It gave the Kurds administration rights not only over the current Kurdistan (Irbil, Dohok and Sulymania) but also over the disputed areas of Kirkuk, Diyala and Nineveh.

The ambiguities within the constitution have led to the central government and Kurdistan interpreting key articles differently, especially those parts that deal with the division of power, control and revenues between federal and regional governments. These conflicting interpretations have left the oil and gas law stuck at the draft stage in parliament, and allowed a situation where two different kinds of contract are being signed in Iraq: the production sharing contracts favoured by the Kurdistan Regional Government and the service contracts signed by the central government. Matters are not helped by the fact that the constitution’s criteria for determining how oil revenues should be allocated to regions are also ambiguous. The ambiguities of the Constitution came as a result of the different interests of the political groups that were writing the constitution; namely, Kurds, Shiites and Sunnis.

**9.2.3 How successful are the federal government and Kurdistan Regional Government likely to be in capturing the rent from oil and gas operations?**

Chapter Six explores Iraq’s petroleum fiscal regime, the central pillar of oil governance, in order to establish whether there are any obstacles which are affecting the disbursement of oil revenues among regions. It investigates in detail the performance of the fiscal regime since 2003, looking at both the service contracts signed by the Baghdad government and the KRG’s PSCs.

The 2007 draft of the oil and gas law identified the PSC as one type of petroleum contract the government might use in its dealings with IOCs, but Iraq’s oil consultants and politicians quickly objected to this on the grounds that PSCs would be too generous to the foreign oil companies. The Baghdad government compromised by opting instead for service contracts which are similar to the Buy Back Contracts used in Iran. In these, the contractor pays all costs, which are later paid back at an agreed rate of return in the form of recovery costs and remuneration fees. This practice is also similar to Production Sharing Contracts. Other similarities between Iraq’s service contracts and PSCs are the 50% limit cost payment of deemed revenues, the splitting of the remuneration fee by the R factor (similar to profit splitting in the PSC) and the fact that service fees can be paid in kind.

The analysis of Baghdad’s and the KRG’s contracts shows that they share similar basic characteristics. In both cases, costs are borne by the contractor and recovered when oil is discovered, and the state’s take is high by international standards – over 90% of the whole project’s NPV which is based on oil price assumptions (though the government does not report the financial data necessary to be sure that it does in fact receive the amount we estimated. The only available information is in the IEITI report, which refers to disputes between central government and IOCs about cost recovery but gives no details about the final settlement). Both contracts do not give much incentive to keep costs to a minimum, and local content is weak. In both cases, the company’s internal rate of return is high, though there seems little point in trying to reduce this profit rate, given the already very high state take. On balance, both forms of contract appear to be proprietorial and non-liberal proprietorial, as the IOCs are actively involved in developing Iraq’s oil industry - although their desire to excessively accelerate production has been noted by numerous authors including Wells (2009) and Jiyad (2010). This is not what authors such as Rutledge (2005) and Muttit (2006), or the CPA, expected would happen; they anticipated that that international oil companies would sign profitable production sharing contracts.

The chapter shows that Kurdistan exercises its own political will, despite the central government’s insistence that all decisions should be made in Baghdad. In accordance with its interpretation of the constitution, Kurdistan signs contracts with oil companies, exports its oil and keeps the oil revenues.

**9.2.4 Provisions for the distribution of the mineral rent tothe different regions of Iraq, particularly the Kurdish region**

Chapter Eight shows that since the end of the Saddam regime, the way revenues are distributed among the provinces and Kurdistan has changed. Whereas revenues were previously distributed from the central budget, with the central government controlling all expenditure, since 2003, revenue sharing has been asymmetrical with some central elements. The constitution sets out the criteria for revenue sharing, ostensibly for all Iraq’s provinces, but in practice, the full set of criteria is only applied to Kurdistan. As a semi-autonomous region ruled by its own regional government, Kurdistan receives an indirect 17% share of oil revenues via the national budget. This is determined according to the population of the region and is allocated after the deduction of sovereign expenditures (national expenses such as the cost of running the presidency, the Council of Ministers, foreign affairs and defence). Some members of the central government have argued that the 17% is inflated and that the KRG’s share should actually be no more than 13%, in line with recent estimates of its population share. Others have countered that the extra amount should be seen as compensation for Kurdistan, which was badly affected during the Saddam regime.

The other provinces receive revenue from central government in the form of services such as education, health and domestic affairs. On top of this they receive a share of oil revenues in the form of a direct transfer; in 2012, these direct transfers added up to 6.8% of the government’s total budget. The transfer is calculated according to population, the provincial government’s responsibilities and its resources, as indicated in the constitution. However, other constitutional conditions, such as the injunctions to compensate negatively affected areas and address local needs (by tackling poverty and the income gap) are not being met for these provinces as they are for Kurdistan.

The findings show that Iraq’s current revenue distribution system is politically driven. This confirms the findings of authors such as Ahmad and Singh (2003), Searle (2007) and Boadway and Shah (2009). When the permanent constitution was being written in 2005, Iraq was still under American occupation and Baghdad was being ruled by a weak temporary government. The Kurds, who in contrast had a well-established leadership, were able to influence the writing of the constitution and ensure that it met their long-held demands. Not only did they make sure it was written in such a way that the revenue distribution system would work to their benefit, but it also offers the possibility that long-standing territorial disputes may finally be settled in Kurdistan’s favour. If, when the census to determine the fate of the disputed areas is finally held, these areas decide to join Kurdistan, the region will become financially independent and easily able to secede from the rest of Iraq (although Kurdistan may decide it will be financially better off staying with the central government as the country’s oil and gas revenues rise and its share increases accordingly).

The current revenue distribution system was designed to appease the secessionist movement and discourage the KRG from seeking independence, but it has nevertheless given rise to a number of disputes between the KRG and the central government. Kurdistan has objected to the scale of the central government’s deductions for sovereign expenditures and proposed these be capped, and there have been repeated clashes over who should pay for Kurdistan’s PSCs. The government initially refused, arguing that the KRG should bear the costs from its 17% share. It subsequently relented and agreed to pay for the contracts, only to change its mind again later. Kurdistan responded by halting its exports. Even when it is cooperating, Kurdistan supplies less than the 150,000 b/d it agreed with the central government.

The Kurds, in accordance with their interpretation of the constitution, effectively operate as a devolved regime, managing their own contracts, selling some of their oil independent of the central government (which the latter regards as smuggling) and operating their own export pipeline to Turkey. Thus, they have both *ex ante* access to oil revenues (via their autonomous sales and fiscal regime) and *ex post* access (via their indirect share of oil revenues from the central budget). This has created problems elsewhere in Iraq. Other provinces, especially oil-rich areas like Basra, are increasingly resentful of the government’s unconditional transfer of revenues to Kurdistan and are now demanding their share of Kurdistan’s oil income.

The government introduced the petrodollar system to appease the oil-rich provinces, but the mechanism has only exacerbated the inequality between the provinces that have resources and those that do not. Colombia, Canada and Indonesia have all experienced similar problems and have found them impossible to overcome, even with an equalisation system. In Colombia, the distribution system – which gives a large share of revenues to less populated provinces – has created poverty and great inequality. In Indonesia, the government has an equalisation system but still cannot bridge the gap between regions’ fiscal capacity, while in Canada, the distribution system has increased the fiscal imbalance between Alberta and the other provinces beyond the capacity of the equalisation system. The problem is likely to be even worse in Iraq, which has no equalisation system at all.

**9.3 Significance of the results**

Both the revenue distribution system and the collection of oil revenues are highly politically driven and contentious. Both are backed by a constitution which is open to interpretation. As far as the collection of oil revenues is concerned, the constitution is unclear on the question of who has the power to sign and manage contracts. This has led to dispute between the central government and the KRG, which signs its own contracts – a move that is considered illegal by Baghdad. The problem is likely to be compounded if other oil-rich provinces follow the KRG’s lead and also seek to exploit the constitutional ambiguity by demanding to sign their own contracts. This will lead to further and more complex disputes with the central government.

The constitution stipulates that oil revenues should be fairly distributed between all provinces and regions, and the government has set a distribution formula for this purpose, but in reality, this formula is only applied to Kurdistan. Furthermore, the revenue distribution law does not explain clearly how Kurdistan’s share is calculated. Once again, ambiguity is a problem; every year, the prior deduction of sovereign expenditures is a source of contention between the central government and both oil-rich and non-oil provinces, all of which have their own interpretation of the rules. The danger is that disaffected oil-rich provinces may follow Kurdistan’s example and demand greater autonomy or even independence. Such a fragmented Iraq would struggle without the revenues from the oil-rich provinces.

The other problem with the revenue distribution system is that it does not prioritise socio-economic indicators such as poverty or poor infrastructure. As a result, it is creating major inequality between Kurdistan and other provinces in terms of per capita expenditure. The petrodollar does not take much from the total budget (0.9% in 2013), but 65% of the transfer goes to Basra and 31% to Kirkuk. This has created a situation where oil-rich provinces, which have less need of it, are receiving a much higher per capita transfer than the poorest, non-oil producing regions. What is more, this inequality will only grow if the petrodollar transfer rises as projected.

**9.4 Contribution to the literature**

This is the first study to characterise Iraq’s post-2003 revenue distribution system and analyse the challenges that it is facing. The study creates a link between the different types of oil governance: sovereignty over resources, petroleum fiscal regime, Iraqi political governance and the distribution of oil revenues among regions. The following sections outline the contribution made by the study to the relevant areas of the literature.

**9.4.1 Iraq’s petroleum fiscal regime**

This study fills some of the gaps left by previous research by Van Meurs (2008; 2009), Jiyad (2010) and Wells (2009). Van Meurs’ (2008; 2009) study of Iraq’s petroleum fiscal regime was conducted before the central government began awarding service contracts. Moreover, his conclusions were based on general assumptions rather than specific figures. Jiyad (2010) also studied Iraq’s petroleum contracts, but included no computational analysis, while Wells (2009) compared the fiscal terms of the West Qurna contract to KRG contracts, but gave no detailed computation for the different financial parameters of the field; he showed only the state take and the contractor’s real rate of return. In contrast, this study analyses the contracts for West Qurna1, calculates the discounted net present value, internal rate of return for the company and state take for the whole project, and compares these with the KRG’s contracts.

The analysis of these contracts shows that Iraq’s petroleum fiscal regime is essentially proprietorial in nature (Mommer, 2002). If Rutledge (2005) and Muttit (2006; 2010) are correct in their view that the Iraqi war was fought to ensure the West had access to oil on easy terms, this result suggests it may have been disappointed. However, the regime is not as purely proprietorial as it was under Saddam; rather, it is a non-liberal proprietorial system in which IOCs are involved in developing the industry. It has one non-proprietorial characteristic in the way that it encourages higher (some have said unrealistically high) production – this is one of the bidding parameters and a key condition in Iraqi service contracts. According to Mommer, proprietorial regimes promote the interests of the owner over those of the investor. However, this does not seem to be entirely the case in Iraq. While the state’s take is high – more than 90% – both Baghdad’s service contracts and Kurdistan’s PSCs have been criticised as weak in terms of local content and cost control.

The study confirms Johnston’s (2003) finding that the main difference between PSCs and TSCs is the method of payment. This suggests that TSCs are chosen over PSCs for political reasons only. Iraq’s risk service contracts have a lot of similarities with Kurdistan’s Production Sharing Contracts; in both, costs are initially paid by the contractor and recovered later, while the splitting of the remuneration fee by R factor in the TSC is similar to profit splitting in the PSC. Finally, in both TSC and PSC, service fees can be paid in kind.

**9.4.2 Distribution of oil revenues to regions**

This is the first study to examine the distribution of oil revenues among Iraq’s regions. Comparison of Iraq’s experience with those of other countries such as Colombia, Canada and Indonesia shows that centralised distribution has the advantage over other forms of revenue distribution; it helps cushion the effects of oil revenue volatility, reduces disparities between sub-national governments and fosters fiscal discipline and accountability. This confirms the findings of a number of authors including Ahmad and Mottu (2002), McClure (2003), Brosio (2006), Ross (2007) and Boadway and Shah (2009). However, how effective the central distribution is depends on the government in question. It is possible to have a good decentralised regime and a bad centralised regime.

The Iraq case shows that where there is a political dispute between the central government and resource-rich regions, revenue sharing is an effective distribution mechanism. This supports Ross (2007), who identified it as the second best mechanism for distribution in these circumstances. Revenue sharing leaves control with the central government but gives some responsibility to sub-nationals. It is particularly difficult for Iraq to implement a centralised, standardised distribution system because the Kurds, who have been semi-autonomous since 1991, will not accept it. By giving the KRG the revenue sharing system it asked for, Baghdad hopes to minimise Kurdish agitation for independence. The other advantage of revenue sharing in Iraq’s case is that it gives provinces control over some of their expenditures, allowing them to spend on the projects they think best meet local needs. Having said this, the fifteen provinces (excluding Kurdistan) combined receive less than 10% of the government budget. This is barely enough to cover their operational budgets.

On the other hand, the revenue sharing system has had some adverse consequences in Iraq. As Ross (2007) points out, revenue sharing can strengthen secessionist movements; in Iraq’s case, having direct access to resource revenues has emboldened the KRG to demand an even greater share and more control over the management of the industry. The problem is compounded by the constitution’s ambiguity on the issues of ownership and revenue distribution, which Kurdistan has been able to exploit to its own advantage. Since 2003, the Kurds have had their terms met on revenue distribution (though it is not clear what will happen to the revenues from future fields or even how these should be defined), opened up the possibility of acquiring Kirkuk and held up the oil and gas law in the Iraqi parliament. They have initiated their own oil and gas law and entered into their own contracts with IOCs, in defiance of the central government, which they have then got Baghdad to pay for. They have exported oil without central government approval, then agreed to export a quota in return for the contract payments from the central government, only to fail to meet the agreed quota. Finally, they have built their own pipeline and started exporting independently. All this shows that the KRG has the upper hand in its relationship with Baghdad; its chief weapon is the threat of secession, and this weapon will become even more powerful if Kirkuk becomes part of Kurdistan.

The other disadvantage of revenue sharing is that disputes may arise if the system does not treat all provinces equally. This is already happening in Iraq’s case. Giving special treatment to oil-rich provinces and/or regions with a distinct identity and language (like Kurdistan) can foster resentment in other provinces. At the very least, measures such as equality budgets should be introduced to ensure that living standards are equal across all provinces.

Ahmad and Singh (2003), Brosio and Jimenex (2009) and Fedelino and Ter-Minassian (2010) have all argued that revenue sharing leaves sub-national governorates subject to volatility. The volatility of resources affects Kurdistan and the other provinces in Iraq. For Kurdistan, it controls all its expenditures, so its shares fluctuate as a percentage of the total government budget. This may lead to more disputes between Baghdad and the KRG, or to Kurdistan withholding oil revenues from the central government and demanding its share of the central budget, as it did before. The provinces are even more susceptible because no formula exists to protect their transfer. Furthermore, the government can argue that as these provinces already benefit from central distribution, the direct transfer is not a priority. Again, this is likely to lead to disputes. The solution is to protect Kurdistan’s and the other provinces’ share by setting up a short-term fund.

The literature indicates that revenue sharing systems are a way of overcoming fiscal deficits, or the gap between a state’s revenue and expenditure needs (Searle, 2007; Boadway and Shah, 2009). However, this study shows that the current revenue sharing system in Iraq has not overcome these fiscal deficits. It has also failed to reduce poverty in the provinces, as revenues are distributed according to population without taking into account the province’s needs or level of poverty. In fact, it has fostered inequality between the KRG and the rest of Iraq’s provinces, with the KRG receiving a higher per capita income and more transferred revenues than any other province. This encourages misspending and corruption, as has been seen in Colombia. The situation has been further exacerbated by the introduction of the petrodollar mechanism. The examination of Iraq’s case shows that although revenue sharing may theoretically be the second best way of distributing oil revenues, it will only be effective if a) revenues are spread evenly across all regions and b) the expenditure needs of each individual region are assessed and covered.

**9.4.3 Contribution to policy analysis**

The results of the study may give policymakers an insight into both the nature of the governance regime which has been established and how it might be changed.

**The Iraq permanent constitution** is the root of disputes between central government and Kurdistan because of its ambiguity. This is especially the case in the articles addressing ownership, revenue distribution and power. Either the constitution must be rewritten so as to remove this ambiguity, or a definitive interpretation of these articles must be published. This interpretation should be approved by all the provinces and the KRG. It should clarify who is responsible for managing oil/gas contracts and the collection of revenues, and set out a definitive formula for revenue distribution among regions.

The analysis of the **petroleum fiscal regime** shows that there are no major differences between the PSCs signed in Kurdistan and the Technical Service Contracts signed in Baghdad. Both of these contracts are profitable for Iraq, but they do carry some disadvantages for Iraqis. For example, the government needs to have greater control over the cost of developing oil fields. Although the R factor is a good way to limit profitability, it also encourages IOCs to increase their costs; under the TSCs signed in Baghdad, companies receive more remuneration when their costs go up. Oil companies should therefore receive incentives to reduce costs, such as a profit percentage of cost saved. There is also little in either type of contract to make companies use local services and goods. Oil consultants such as Park suggest that contracts should clearly specify the companies’ obligations in this regard.

Although the best way of averting secession by Kurdistan, the current **revenue sharing system** is creating problems both with Kurdistan and other provinces. The research has identified a number of changes which might address these problems. Firstly, Iraq should adopt the hybrid transfer of revenues. Nugfoho and Siagian (2012) have already suggested this system for Indonesia. The asymmetric distribution of oil revenues to the KRG should continue, though the dispute over the formula needs to be resolved. An equalisation system should be introduced to offset inequality among the provinces/region, and direct distribution of revenues to citizens should be increased to overcome the imbalance between revenue means and expenditure needs of the provinces/region and help the poor.

There are a number of ways in which the revenue distribution formula could be improved, although each has potential drawbacks. Iraq and Kurdistan have regular disputes about the level of sovereign expenditures deducted before calculation of the KRG’s share. These change every year, depending on perceived needs and/or Baghdad’s economic objectives (though political considerations may also play a role). In contrast, Ross (2007) argues that any distribution formula should remain stable over time, so that the issue of revenue sharing does not need to be constantly revisited. Ross acknowledges that decisions about revenue shares will be largely politically motivated, but argues that ideally, they should be based on an objective assessment of the level of fiscal stress faced by each region. In this scenario, the KRG’s share would be calculated according to its fiscal needs, as determined by factors such as population, size, geography, income levels and poverty. It would be less likely to complain about the deduction of sovereign expenditures if it was sure of receiving a share calculated to meet its fiscal needs. The problem with this scenario is that the KRG, or indeed the other provinces, might be tempted to increase its budget as it wanted, in the expectation that the government would pay. This system would require transparency and for budgets and projects to be centrally approved, which might create further disputes.

**Figure 9.1: Suggested Federal budget transfer to KRG and other provinces**

KRG share of reconstruction and petrodollars

KRG share of direct distribution

Provinces’ share of direct distribution

Provinces’ share of equalisation

Budget/ revenues

What’s left from the budget

KRG share based on fiscal needs

Provinces’ share of petrodollars and reconstruction

Ministries’ expenditures

A second option would be for the KRG’s share to be calculated directly from the oil revenues according to population, after these revenues have been stabilised (see Figure 9.2). There are two major problems with this suggestion. First, it would require the establishment of a stabilisation fund in Iraq to cushion transfers against the effects of revenue volatility, and second, there is uncertainty about Iraq’s population figures; there is a big difference between the Ministry of Finance’s population estimate for Kurdistan of 12.6% and the 17% which the KRG currently takes. Boadway and Shah (2009) identified another drawback of revenue sharing formulas in general, which is that the formula bears little relation to actual regional expenditures. While this is true (the KRG received less than it spent in 2010)**,** the government can only share out what it can afford.

**Figure 9.2: Suggested Federal budget transfer to KRG and other provinces**

Oil revenues

Government revenues

Stabilization fund

Stabilization Fund

KRG share

Petrodollar and reconstruction

Provinces’ budget

Equalisation

Direct distribution

The third option would be for the government and Kurdistan to agree on a reasonable cap to sovereign and ruling expenditures. Anything over the cap amount could be funded from the difference between the real oil price and the price which is calculated to do the budget, from the stabilisation fund, or treated as a deficit. The difficulty here is that the central government and Kurdistan cannot agree on a cap; the KRG is suggesting a figure significantly below what the government needs. Even if agreement were reached, if actual expenditure significantly exceeded the agreed cap, the government might end up with a larger deficit.

The resources criterion within the formula (the petrodollar introduced in 2010) should continue to be given to producing provinces as compensation for environmental damage. The problem with the petrodollar is that it has created inequality among provinces, which is likely to get worse as oil production rises to the proposed 8 million b/d. Most of the poor areas in Iraq – apart from Basra – are non-producing regions or regions where the income from petrodollars is very low. In 2012, petrodollars accounted for only 1.4% of the total budget, but this share will get bigger as oil production goes up. To offset the fiscal inequality between provinces, therefore, an equalisation system should be introduced.

Iraq should follow Indonesia’s example and adopt an equalisation system which takes into account the differences between the fiscal needs and fiscal capacity of sub-national governments. Fiscal needs are determined by population, size, geography, income levels and poverty, while fiscal capacity is determined by the available resources. An Iraqi equalisation system should look first at poverty, then at population, infrastructure and income levels. This is what Colombia has done since it modified its equalisation system in 2010, shifting the primary focus from resource-rich regions to poverty indicators to ensure that poor areas receive their fair share of the country’s resource revenues. The resource capacity of individual provinces may be judged by their petrodollar transfer, allowing areas that do not qualify to be eliminated from the equalisation system. This is what has happened in Canada, although as Boadway and Shah (2009) argue, there is still a big gap between Alberta and the other provinces, because the system gives to those who don’t have, but it doesn’t take from those who have. However, this does not apply to Iraq because the KRG and the other provinces alike depend almost entirely on government transfers.

**9.5 Limitations of the research**

This research focuses on a single industry. This may limit the extent to which it is possible to draw wider generalisations from its findings. However, for the distribution of revenues among regions, a single generalisation was made because other examples were studied in this research; although the study of these cases was limited. The findings of the study should be read within the context of the specific industry and country in which it was conducted, though they may give general insights into petroleum fiscal regimes and oil revenue distribution at regional levels. They may also offer new examples and lessons for the literature and other producing countries.

Another potential limitation arises from the nature of the interpretive approach; the researcher’s interpretation of the data can never be entirely objective. Recognising this, the thesis theory, examples of other countries were considered as ways of seeing the data. Yet the possibility of other ways of seeing, that is, alternative explanations, is accepted.

A cash flow analysis was conducted for the central government’s West Qurna1 contract, but lack of financial data made it impossible to do the same for a KRG contract. However, it was possible to compare the terms of contracts signed by Baghdad and the KRG.

**9.6 Further research**

As discussed above, it was not possible in this study to conduct a detailed cash flow analysis of the KRG’s contracts. Any future study able to obtain the financial data for Kurdistan’s oil fields will be able to compare them to Iraq’s other fields, adding to our understanding of Iraq’s petroleum fiscal regime. Similarly, this study contains a cash flow analysis for only one field. If data are available for other fields signed with international companies, especially that Iraq has several bid rounds for brown, green fields and blocks, analysis of these data and comparison of the different bidding rounds will provide a richer picture of Iraq’s petroleum fiscal regime and how successful the government is in obtaining rent.

A comprehensive study of regional oil revenue distribution in other oil-producing countries facing regional disputes (e.g. the UK) might confirm or disprove this study’s findings and provide instructive examples for Iraq. Researchers might also employ stakeholder analysis to investigate how best to distribute revenues among Iraq’s regions. Treating each province as a stakeholder, researchers might investigate their perceptions and views on the issue.

Finally, this study about Iraq oil governance ended in 2013. There is therefore a need for study of the changes that have happened in Iraq’s oil governance since then, especially in regard to the petroleum fiscal regime, the distribution of oil revenues among regions and the distribution of oil revenues to the Iraqi people as a whole.

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Appendix **1**

**Table A1.1: List of Interviews and data**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| code | Date | Location | Function | Length | Status | Notes |
| INTER1 | 01.12.2010 | Iraq Petroleum Conference- CWC -London | Energy consultant to the Iraqi prime minister, ex minister of oil, one of the authors of Hydrocarbon law, he was working during Saddam regime as well | 30 minutes | Recorded |  |
| INTER2 | 30.11.2010 | Iraq Petroleum Conference- CWC -London | one of the authors of the current draft of Iraq’s Hydrocarbon law and one of the establisher of INOC in 1964 | 30 minutes | Recorded |  |
| INTER3 | 29.11.2010 | Iraq Petroleum Conference- CWC -London | Iraqi government Spokesman | 20 minutes | Recorded |  |
| INTER4 | 30.11.2010 | Iraq Petroleum Conference- CWC -London | Iraqi Member of Parliament | 15 minutes | Recorded |  |
| INTER5 | 29.11.2010 | Iraq Petroleum Conference- CWC -London | Iraqi Member of Parliament | 10 minutes | Non-Recorded |  |
| - | 30.11.2010 | Iraq Petroleum Conference- CWC -London | Kurdistan Energy Minister |  | Non-Recorded | Questions to Energy minister during his presentation in Iraq Petroleum conference- London |

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Year | Date | Baseline Production Rate (1000, b/yr) [DF = 5%] | Exxon-Shell Planned Bid: Oil production (1,000 b/yr) (DF=13%) | Incremental Production (1000 b/yr) | Oil Price ($/b) | Total Revenue from Oil sales ($1,000) | Incremental revenues (Deemed revenues) | 50% deemed revenues | Signature Bonus ($1,000) | Estimated CAPEX ($1,000) | OPEX $1.95/b | OPEX ($1,000) | Total 'Petroleum Costs' ($1,000) | Cumulative 'Petroleum Costs' incurred ($1,000) |
| 1 | 2010 | 198,696 | 198,696 | 0 | 100 | 19,869,600 | 0 | 0 | 100,000 | 200,000 | 2.00 | 397,392 | 597,392 | 597,392 |
| 2 | 2011 | 188,761 | 270,000 | 81,239 | 100 | 27,000,000 | 8,123,880 | 4,061,940 |  | 2,000,000 | 2.00 | 540,000 | 2,540,000 | 3,137,392 |
| 3 | 2012 | 179,323 | 360,000 | 180,677 | 100 | 36,000,000 | 18,067,686 | 9,033,843 |  | 2,000,000 | 2.00 | 720,000 | 2,720,000 | 5,857,392 |
| 4 | 2013 | 170,357 | 450,000 | 279,643 | 100 | 45,000,000 | 27,964,302 | 13,982,151 |  | 7,000,000 | 2.00 | 900,000 | 7,900,000 | 13,757,392 |
| 5 | 2014 | 161,839 | 630,000 | 468,161 | 100 | 63,000,000 | 46,816,087 | 23,408,043 |  | 6,000,000 | 2.00 | 1,260,000 | 7,260,000 | 21,017,392 |
| 6 | 2015 | 153,747 | 720,000 | 566,253 | 100 | 72,000,000 | 56,625,282 | 28,312,641 |  | 6,000,000 | 2.00 | 1,440,000 | 7,440,000 | 28,457,392 |
| 7 | 2016 | 146,060 | 800,000 | 703,146 | 100 | 84,920,600 | 70,314,618 | 35,157,309 |  | 1,800,000 | 2.00 | 1,698,412 | 3,498,412 | 31,955,804 |
| 8 | 2017 | 138,757 | 849,206 | 710,449 | 100 | 84,920,600 | 71,044,917 | 35,522,459 |  |  | 2.00 | 1,698,412 | 1,698,412 | 33,654,216 |
| 9 | 2018 | 131,819 | 849,206 | 717,387 | 100 | 84,920,600 | 71,738,701 | 35,869,351 |  |  | 2.00 | 1,698,412 | 1,698,412 | 35,352,628 |
| 10 | 2019 | 125,228 | 849,206 | 723,978 | 100 | 84,920,600 | 72,397,796 | 36,198,898 |  |  | 2.00 | 1,698,412 | 1,698,412 | 37,051,040 |
| 11 | 2020 | 118,967 | 849,206 | 730,239 | 100 | 84,920,600 | 73,023,937 | 36,511,968 |  |  | 2.00 | 1,698,412 | 1,698,412 | 38,749,452 |
| 12 | 2021 | 113,018 | 849,206 | 736,188 | 100 | 84,920,600 | 73,618,770 | 36,809,385 |  |  | 2.00 | 1,698,412 | 1,698,412 | 40,447,864 |
| 13 | 2022 | 107,367 | 849,206 | 741,839 | 100 | 84,920,600 | 74,183,861 | 37,091,931 |  |  | 2.00 | 1,698,412 | 1,698,412 | 42,146,276 |
| 14 | 2023 | 101,999 | 849,206 | 602,842 | 100 | 70,484,098 | 60,284,196 | 30,142,098 |  |  | 2.00 | 1,409,682 | 1,409,682 | 43,555,958 |
| 15 | 2024 | 96,899 | 704,841 | 607,942 | 100 | 70,484,098 | 60,794,191 | 30,397,096 |  |  | 2.00 | 1,409,682 | 1,409,682 | 44,965,640 |
| 16 | 2025 | 92,054 | 585,018 | 492,964 | 100 | 58,501,801 | 49,296,390 | 24,648,195 |  |  | 2.00 | 1,170,036 | 1,170,036 | 46,135,676 |
| 17 | 2026 | 87,451 | 485,565 | 398,114 | 100 | 48,556,495 | 39,811,354 | 19,905,677 |  |  | 2.00 | 971,130 | 971,130 | 47,106,806 |
| 18 | 2027 | 83,079 | 403,019 | 319,940 | 100 | 40,301,891 | 31,994,007 | 15,997,004 |  |  | 2.00 | 806,038 | 806,038 | 47,912,844 |
| 19 | 2028 | 78,925 | 334,506 | 255,581 | 100 | 33,450,569 | 25,558,080 | 12,779,040 |  |  | 2.00 | 669,011 | 669,011 | 48,581,855 |
| 20 | 2029 | 74,979 | 277,640 | 202,661 | 100 | 27,763,973 | 20,266,108 | 10,133,054 |  |  | 2.00 | 555,279 | 555,279 | 49,137,135 |
| TOTALS |  |  | 12,163,726 |  |  |  |  |  |  | 25,000,000 |  | 24,137,135 | 49,137,135 |  |

**Appendix 2**

**Table A2.1: West Qurna1 Cash flow at price of $100/b**

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Costs recovery required | Costs carried over ($1,000) | Company Receipts: (1) Petroleum Cost recovery ( Provided column N < column I) ($1,000) | RF $/b | Company Receipts: (2) RFs ($1,000) | Total Company Cash Receipts ($1,000) | Cumulative company cash receipts ($1,000) | R factor | Company After Tax & After State share Profit @ 48.75% of RFs | Company Cash Flow ($1,000) | State Cash flow ($1,000) |
| 597,392 | 597,392 | 0 | 1.9 | 0 | 0 | 0 | 0.00 | 0 | -697,392 | 19,969,600 |
| 3,137,392 |  | 3,137,392 | 1.5 | 123,483 | 3,260,875 | 3,260,875 | 1.04 | 60,198 | 657,590 | 23,925,893 |
| 2,720,000 |  | 2,720,000 | 1.52 | 274,629 | 2,994,629 | 6,255,504 | 1.07 | 133,882 | 133,882 | 33,420,747 |
| 7,900,000 |  | 7,900,000 | 1.52 | 425,057 | 8,325,057 | 14,580,561 | 1.06 | 207,215 | 207,215 | 37,317,842 |
| 7,260,000 |  | 7,260,000 | 1.52 | 711,605 | 7,971,605 | 22,552,166 | 1.07 | 346,907 | 346,907 | 56,104,697 |
| 7,440,000 |  | 7,440,000 | 1.52 | 860,704 | 8,300,704 | 30,852,870 | 1.08 | 419,593 | 419,593 | 65,001,111 |
| 3,498,412 |  | 3,498,412 | 1.52 | 1,068,782 | 4,567,194 | 35,420,064 | 1.11 | 521,031 | 521,031 | 81,969,939 |
| 1,698,412 |  | 1,698,412 | 1.52 | 1,079,883 | 2,778,295 | 38,198,359 | 1.14 | 526,443 | 526,443 | 83,775,628 |
| 1,698,412 |  | 1,698,412 | 1.52 | 1,090,428 | 2,788,840 | 40,987,199 | 1.16 | 531,584 | 531,584 | 83,781,032 |
| 1,698,412 |  | 1,698,412 | 1.52 | 1,100,447 | 2,798,859 | 43,786,058 | 1.18 | 536,468 | 536,468 | 83,786,167 |
| 1,698,412 |  | 1,698,412 | 1.52 | 1,109,964 | 2,808,376 | 46,594,434 | 1.20 | 541,107 | 541,107 | 83,791,044 |
| 1,698,412 |  | 1,698,412 | 1.52 | 1,119,005 | 2,817,417 | 49,411,851 | 1.22 | 545,515 | 545,515 | 83,795,678 |
| 1,698,412 |  | 1,698,412 | 1.52 | 1,127,595 | 2,826,007 | 52,237,858 | 1.24 | 549,702 | 549,702 | 83,800,080 |
| 1,409,682 |  | 1,409,682 | 1.52 | 916,320 | 2,326,002 | 54,563,859 | 1.25 | 446,706 | 446,706 | 69,544,030 |
| 1,409,682 |  | 1,409,682 | 1.14 | 693,054 | 2,102,736 | 56,666,595 | 1.26 | 337,864 | 337,864 | 69,429,606 |
| 1,170,036 |  | 1,170,036 | 1.14 | 561,979 | 1,732,015 | 58,398,610 | 1.27 | 273,965 | 273,965 | 57,619,779 |
| 971,130 |  | 971,130 | 1.14 | 453,849 | 1,424,979 | 59,823,589 | 1.27 | 221,252 | 221,252 | 47,817,963 |
| 806,038 |  | 806,038 | 1.14 | 364,732 | 1,170,770 | 60,994,359 | 1.27 | 177,807 | 177,807 | 39,682,778 |
| 669,011 |  | 669,011 | 1.14 | 291,362 | 960,374 | 61,954,732 | 1.28 | 142,039 | 142,039 | 32,930,881 |
| 555,279 |  | 555,279 | 1.14 | 231,034 | 786,313 | 62,741,045 | 1.28 | 112,629 | 112,629 | 27,327,098 |
|  |  | 49,137,135 |  | 13,603,911 | 62,741,045 |  | NPV 10% |  | $3,387,589 | $489,213,654 |
|  |  |  |  |  |  |  |  |  | -$697,392 | $19,969,600 |
|  |  |  |  |  |  |  |  |  | $2,690,197 | $509,183,254 |
|  |  |  |  |  |  |  | IRR |  | 59.28% |  |
|  |  |  |  |  |  |  |  |  | TOTAL | $511,873,451 |
|  |  |  |  |  |  |  |  |  | state take = | 99.47 |

**Table A2.2: West Qurna1 Cash flow at price of $100/b - continued**

**Appendix 3**

**Table A3.1A: Total Budget Allocations to Provinces 2009-2012**

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Province  /Region | Population | | % of total population | Year | Reconstruction Projects  Billion ID | Petro  Dollar  Million ID | Total Allocation  Billion ID | Per capita budget Allocation  000 ID | Per capita Budget Allocation  USD |
| Baghdad | 7357572 | | 22.1 | 2009 | 825 | - | 1,045 | 142 | 122 |
| 2010 | 304 | - | 9,45 | 128 | 110 |
| 2011 | 645\* | - | 737 | 100 | 86 |
| 2012 | 1,366 | 37,617 | 1,532 | 208 | 178 |
|  | |
| Basra | 2562579 | | 7.7 | 2009 | 203 | - | 249 | 97 | 83 |
| 2010 | 134 | - | 448 | 174 | 150 |
| 2011 | 1,130\* | - | 1175 | 458 | 393 |
| 2012 | 476 | 877,572 | 1,396 | 545 | 486 |
|  |  | |  |  |  |  |  |  |  |
| Nineveh | 3365787 | | 10.1 | 2009 | 251 | - | 327 | 97 | 83.5 |
| 2010 | 305 | - | 461 | 137 | 117.7 |
| 2011 | 288\* | - | 340 | 101 | 86 |
| 2012 | 625 | 7,758 | 684 | 203 | 174 |
|  |  | |  |  |  |  |  |  |  |
| Dhi-Qar | 1906861 | | 5.7 | 2009 | 164 | - | 213 | 112 | 96.1 |
| 2010 | 163 | - | 259 | 136 | 116 |
| 2011 | 169\* | - | 208 | 109 | 93.6 |
| 2012 | 352 | 137,848 | 408 | 214 | 183 |
|  |  | |  |  |  |  |  |  |  |
| Anbar | 1519386 | | 4.6 | 2009 | 132 |  | 188 | 124 | 99 |
| 2010 | 153 | - | 225 | 148 | 117 |
| 2011 | 123 | - | 239 | 218 | 174 |
| 2012 | 284 | 24 | 324 | 304 | 242 |
|  |  |  |  |  |  |
|  |  | |  |  |  |  |  |  |  |
| Missan | 1034815 | | 3.1 | 2009 | 979 | - | 139 | 127 | 101.5 |
| 2010 | 105 | - | 153 | 143 | 113 |
| 2011 | 236 | - | 277 | 268 | 213 |
| 2012 | 192 | 42,585 | 265 | 250 | 199 |
|  |  | |  |  |  |  |  |  |  |
| Diyala | 1435707 | | 4.3 | 2009 | 128 | - | 159 | 111 | 93 |
| 2010 | 49 | - | 163 | 114 | 96 |
| 2011 | 119 |  | 156 | 108 | 91 |
| 2012 | 265 | 1,377 | 303 | 211 | 178 |
|  |  | |  |  |  |  |  |  |  |
| kirkuk | 1332025 | | 4.0 | 2009 | 118 |  | 150 | 112 | 95 |
| 2010 | 87 |  | 128 | 96 | 81 |
| 2011 | 460 |  | 490 | 368 | 412 |
| 2012 | 247 | 517,648 | 794 | 596 | 502 |
|  |  | |  |  |  |  |  |  |  |
| Diwania | 1157880 | | 3.5 | 2009 | 115 | - | 155 | 134 | 113 |
| 2010 | 73 | - | 145 | 125 | 105 |
| 2011 | 97 | - | 133 | 114 | 96 |
| 2012 | 216 | 2,328 | 253 | 218 | 184 |
|  |  | |  |  |  |  |  |  |  |
| Wasit | 1196893 | | 3.6 | 2009 | 95 | - | 135 | 112 | 95 |
| 2010 | 50 | - | 115 | 96 | 80 |
| 2011 | 95 | - | 127 | 106 | 86 |
| 2012 | 222 | 15 | 253 | 211 | 178 |
|  |  | |  |  |  |  |  |  |  |
| Najaf | 1287216 | | 3.9 | 2009 | 132 | - | 173 | 134 | 113 |
| 2010 | 111 | - | 168 | 131 | 110 |
| 2011 | 109 | - | 173 | 134 | 113 |
| 2012 | 241 | 8,410 | 366 | 284 | 239 |

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Province  /Region | Population | % of total popul-  ation | Year | Recons-  truction Projects  Billion ID | Petro  Dollar  Million ID | Total Allocati-on  Billion ID | Per capita budget Allocation  000 ID | Per capita Budget Allocation  USD |
| Muthana | 753489 | 2.3 | 2009 | 55 | - | 82 | 109 | 92 |
| 2010 | 56 | - | 92 | 123 | 103 |
| 2011 | 66 | - | 94 | 125 | 105 |
| 2012 | 142 | 11,317 | 175 | 233 | 196 |
|  |  |  |  |  |  |  |  |  |
| Salah al-Din | 1321092 | 4.0 | 2009 | 80 | - | 145 | 109 | 92 |
| 2010 | 177 | - | 269 | 203 | 171 |
| 2011 | 228 | - | 279 | 211 | 178 |
| 2012 | 247 | 113,348 | 404 | 306 | 257.5 |
|  |  |  |  |  |  |  |  |  |
| Babil | 1794677 | 5.4 | 2009 | 175 | - | 240 | 134 | 112.5 |
| 2010 | 80 | - | 166 | 93 | 78 |
| 2011 | 147 | - | 209 | 116 | 98 |
| 2012 | 34 | - | 306 | 287 | 241 |
|  |  |  |  |  |  |  |  |  |
| Karbala | 1044060 | 3.1 | 2009 | 132 | - | 160 | 153 | 129 |
| 2010 | 107 | - | 164 | 157 | 132 |
| 2011 | 85 | - | 126 | 120 | 101 |
| 2012 | 192 | - | 229 | 219 | 185 |
|  |  |  |  |  |  |  |  |  |
| Kurdistan | 4189702 | 12.6 | 2010 | - | - | 10,609 | 2532 | 2132 |
| 2011 | - | - | 11,180 | 2668 | 2247 |
| 2012 | 779 | 42,400 | 126,050 | 3008 | 2533 |

**Table A3.1B: Total Budget Allocations to Provinces 2009-2012 Continued**

Notes: \* 2011 Reconstruction projects Include petrodollar amount

\*\* Provinces’ total allocation is the sum of operating expenditure plus reconstruction and petrodollar payments

Sources:

Ministry of Finance/ Iraq - Federal Budget – appendix tables –Iraqi census

Ministry of Finance/Iraq – Financial Statements- Provincial total expenditures 2012

Provinces’ total allocation is the sum of operating expenditure plus reconstruction and petrodollar payments.

**Appendix 4 for chapter 8**

**Figure A4.1 Poverty share and per capita budget transfer (assumed petrodollar $5/ barrel transfer in 2012)**

Source: Author Calculation based on petrodollar transfer in 2012, See table 8.9 and 8.10

**Figure A4.2: Budget transfer to provinces and assumed petrodollar $5/barrel transfer in 2012**

Source: Author Calculation based on petrodollar transfer in 2012, See tables 8.8, 8.9 and 8.10

**Appendix five for chapter 8**

**Table A5.1: Iraqi Ministry of Oil (MoO) Refined & Used versus Supplied to KRG (2006-2013)**

|  |  |  |  |
| --- | --- | --- | --- |
| **Year** | **Total MoO Refined & used**  **B/D**  **000** | **MoO Products Supplied to the KRG B/D**  **000** | **Percentage Supplied to KRG of all MoO Refined and Used (%)** |
| 2006 | 152,205 | 10,731 | 7.1% |
| 2007 | 124,100 | 10,767 | 8.7% |
| 2008 | 193,815 | 14,235 | 7.3% |
| 2009 | 187,975 | 17,155 | 9.1% |
| 2010 | 241,255 | 11,680 | 5.5% |
| 2011 | 231,410 | 13,505 | 5.8% |
| 2012 | 235,544 | 7,300 | 3.1% |
| 2013 | 253,125 | 8,641 | 3.4% |

Source: Ashti Hawrami (2014), *KRG/Government of Iraq: Issues and Future*, Iraq Petroleum Conference 2014, CWC London 18 June

1. The discount rate represents the rate of return that investors could expect from comparable alternative investments in the market place. It is used to discount streams of cash flows and outflows to arrive at the NPV. This rate is referred to as the cost of capital (Dury, 2005: 231-233). [↑](#footnote-ref-1)
2. The Russians dropped out after the 1917 revolution [↑](#footnote-ref-2)
3. Calouste Gulbenkian –Armenian oil dealer, born in Turkey- played a major role in facilitating the western nations’ development of Middle East oil reserves. [↑](#footnote-ref-3)
4. [↑](#endnote-ref-1)
5. For historical exchange rate reference see ([www.measuringworth.org](http://www.measuringworth.org) [↑](#footnote-ref-4)
6. Government profit after two and a half years = {1,251,592/(1,251,592+17,560,000)}= 1,251,592/18,811,592= 6.7%. [↑](#footnote-ref-5)
7. Kurdish Democratic party (KDP) is a party created on 16 August 1946 in the Iraqi city of Suleimaniyah to demand autonomy for the Kurds in Iraq and led by Mullah Mustafa Barazani [↑](#footnote-ref-6)
8. Kirkuk is a province in the north of Iraq with a mixed population of Kurds, Turkmens and Arabs. Of most significance is the presence of oil in this area. [↑](#footnote-ref-7)
9. Al Ba’ath Party: was a political party founded in Syria by Michel Afleq Salah al din-al Batar and associates of [Zaki-Al](http://en.wikipedia.org/wiki/Zaki_al-Arsuzi) Arsuzi. [Ba'athism](http://en.wikipedia.org/wiki/Ba%27athism), is an ideology mixing [Arab](http://en.wikipedia.org/wiki/Arab_nationalism) nationalist, [pan-Arabism](http://en.wikipedia.org/wiki/Pan-Arabism), [Arab socialist](http://en.wikipedia.org/wiki/Arab_socialism) and [anti-imperialist](http://en.wikipedia.org/wiki/Anti-imperialism) interests. Ba'athism calls for the renaissance or resurrection and unification of the [Arab world](http://en.wikipedia.org/wiki/Arab_world) into a single state. Its motto, "Unity, Liberty, Socialism", refers to Arab unity, and freedom from non-Arab control and interference (Arab Social Party <http://wn.com/arab_socialist_baath_party>). [↑](#footnote-ref-8)
10. Arabization is a phenomenon that began in the 1960s to expel the Kurds and implant the Arabs [↑](#footnote-ref-9)
11. Rumaila is the biggest oil field in Iraq, with 17bbl reserves(eia, 2009) [↑](#footnote-ref-10)
12. ‘Posted prices’ were official prices used to calculate the royalties and tax revenues which the oil states received in the 50-50 agreements. They were meant to match more or less the market prices. However, when huge amounts of Russian oil came onto the market, the prices started to fall and the companies felt that the posted price system would cause a loss for them. They were paying taxes and royalties. They therefore started to cut the posted price to align it more closely with the actual market price. This was one of the main factors leading to OPEC’s formation in 1960 (Yergin, 2003: 514-515 and 519-520). Thus in accepting posted prices in the 1968 ERAP agreement, Iraq was losing out on royalties and tax revenues. [↑](#footnote-ref-11)
13. Shatt Al-Arab River is a river of 120 mile in length, formed by the confluence of the Euphrates and the Tigris in the town of al-Qurna (south Iraq). it constitutes the border between Iraq and Iran for its last 55 miles leading into the Persian Gulf (Geller and Singer,1998 :41. [↑](#footnote-ref-12)
14. Shia is a religious sect which represents around 60% of the Iraqi population. This group identified themselves as marginalised and oppressed during Saddam’s regime; the antagonism started with Saddam murdering Mohamad Al Sadir, an important Shia leader, at the beginning of the 1980s. [↑](#footnote-ref-13)
15. Talabani has been the leader of the Patriotic Union of Kurdistan (PUK) since the organisation's founding in 1977 and president of Iraq since 2006 [↑](#footnote-ref-14)
16. Formed after the Gulf War with US direction and aid for the purpose of overthrowing Saddam Hussein [↑](#footnote-ref-15)
17. The IAMB was established with representatives from the United Nations, the World Bank, the IMF and the Arab Foundation for Economic and Social Development to provide international oversight of DFI and CPA spending. [↑](#footnote-ref-16)
18. This was the provisional government of Iraq from July 13, 2003 to June 1, 2004, established by and serving under the US-led CPA. [↑](#footnote-ref-17)
19. Robert McKee - a former ConocoPhillips executive - was appointed on September 22, 2003 as the Coalition Provisional Authority’s senior advisor to the Oil Ministry [↑](#footnote-ref-18)
20. There is no official count for the Sunni population in Iraq. This approximate estimate was taken from the *World Fact Book (Iraq)* [<https://www.cia.gov/library/publications/the-world-factbook/fields/2122.html>]. An Iraqi local newspaper, *Al Hussaini* (2013) [http://alhussaini.org/articles/alhussaini-news/1236] quoted the Minister of Planning (Ali Shokri) as giving a similar estimate. [↑](#footnote-ref-19)
21. Article 141:Legislation enacted in the region of Kurdistan since 1992 shall remain in force, and decisions issued by the government of the region of Kurdistan, including court decisions and contracts, shall be considered valid unless they are amended or annulled pursuant to the laws of the region of Kurdistan by the competent entity in the region, provided that they do not contradict the Constitution. [↑](#footnote-ref-20)
22. Article 121- First: The regional powers shall have the right to exercise executive, legislative, and judicial powers in accordance with this Constitution, except for those authorities stipulated as exclusive authorities of the federal government.

    Second: In the case of a contradiction between regional and national legislation in respect to a matter outside the exclusive authorities of the federal government, the regional power shall have the right to amend the application of the national legislation within that region. [↑](#footnote-ref-21)
23. Article 117 - First: This Constitution, upon coming into force, shall recognize the region of Kurdistan, along with its existing authorities, as a federal region.

    Second: This Constitution shall affirm new regions established in accordance with its provisions. [↑](#footnote-ref-22)
24. Article 119 - One or more governorates shall have the right to organize into a region based on a request to be voted on in a referendum submitted in one of the following two methods:

    First: A request by one-third of the council members of each governorate intending to form a region.

    Second: A request by one-tenth of the voters in each of the governorates intending to form a region. [↑](#footnote-ref-23)
25. Article 120: Each region shall adopt a constitution of its own that defines the structure of powers of the region, its authorities, and the mechanisms for exercising such authorities, provided that it does not contradict this Constitution. [↑](#footnote-ref-24)
26. Article 140 - First: The executive authority shall undertake the necessary steps to complete the implementation of the requirements of all subparagraphs of Article 58 of the Transitional Administrative Law.

    Second: The responsibility placed upon the executive branch of the Iraqi Transitional Government stipulated in Article 58 of the Transitional Administrative Law shall extend and continue to the executive authority elected in accordance with this Constitution, provided that it is accomplished completely (normalization and census and concludes with a referendum in Kirkuk and other disputed territories to determine the will of their citizens), by a date not beyond the 31st of December 2007. [↑](#footnote-ref-25)
27. Article 112 First: The federal government with the producing governorates and regional governments shall undertake the management of oil and gas extracted from current fields provided that it distributes oil and gas revenues in a fair manner in proportion to the population distribution in all parts of the country with a set allotment for a set time for the damaged regions that were unjustly deprived by the former regime and the regions that were damaged later on, and in a way that assures balanced development in different areas of the country, and this will be regulated by law [↑](#footnote-ref-26)
28. Article 121 Third: Regions and governorates shall be allocated an equitable share of the national revenues sufficient to discharge their responsibilities and duties, but having regard to their resources, needs, and the percentage of their population. [↑](#footnote-ref-27)
29. Netback is the well head price of oil and gas less production costs, taxes and royalty ( Sterner, 1992: 123) [↑](#footnote-ref-28)
30. For example, this was evident under Saddam’s regime in Iraq: people in top managerial positions in INOC or Oil ministry needed to have a high rank in the Ba’ath party. [↑](#footnote-ref-29)
31. Work programme: oil companies make a commitment to undertake a specific exploration activity during a set period of time (Tordo et al., 2010) [↑](#footnote-ref-30)
32. R-factor: is the ratio of cumulative receipts from the sale of petroleum to cumulative expenditures. An R-factor less than 1 would mean that costs have not been fully recovered yet: total expenditure exceeds total receipts. The larger the R-factor, the more profitable the operation. The government’s share of production may increase with increasing R-factor (Johnston**,** 2003)**.** [↑](#footnote-ref-31)
33. Supplementary costs are the additional costs the government agrees to pay IOCs to cover activities such as de-mining, water injection, delivery of unused associated gas to regional companies, the construction of additional facilities and remediation of pre-existing environmental conditions (see the Iraq Oil Ministry’s *Technical Service Contracts* Article 19: Supplementary Fees And Service Fees). [↑](#footnote-ref-32)
34. Baseline production was an especially important factor in the first bid round, as the fields in question were producing ones. IOCs made their bids taking into consideration the initial production rate (IPR) provided by the Oil Ministry. For subsequent years, contracts assumed an annual decline in BLP of 5% (Jiyad, 2010a:8). [↑](#footnote-ref-33)
35. In a personal email (August 2014) [↑](#footnote-ref-34)
36. countercyclical policies cool down the economy when it is in an upswing and stimulate the economy when it is in a downturn (Feldstein, 2002) [↑](#footnote-ref-35)
37. A unitary state has a single government or sub-government. Control of all government functions rests with the central government and decision making is centralised (Broadway and Shah, 2009). [↑](#footnote-ref-36)
38. Different sub-national governments may raise funds from resource revenues in different ways. Net fiscal benefits, which are the product of the level of taxation and the level of spending on public services, will therefore also differ. The government uses an equalisation system to offset these differences. [↑](#footnote-ref-37)
39. Devolution is the transfer of power from the central to the [sub-national](http://en.wikipedia.org/wiki/Subnational) level (regional or local). Devolution can be mainly financial, e.g. giving regional governments some freedom to administer financially some areas in the local economy which were previously administered by the central government. It differs from federalism as the devolved area’s powers ultimately reside in central government, thus the state remains de jure unitary. Legislation creating devolved parliaments or [assemblies](http://en.wikipedia.org/wiki/Assemblies) can be [rejected](http://en.wikipedia.org/wiki/Repeal) or modified by central government in the same way as any other legislation (Deacon and Sandry, 2007).

    [↑](#footnote-ref-38)
40. Defacto region: effectively an independent region, but without legal recognition [↑](#footnote-ref-39)
41. Iraq Revenue Watch is an Open Society Institute established to monitor the use of Iraqi funds by the US-led Coalition Provisional Authority (CPA) [↑](#footnote-ref-40)
42. Interview with INTER1 (energy consultant to Iraq’s Prime Minister, see appendix 1). [↑](#footnote-ref-41)
43. A letter of credit is a document that a financial institution or similar party issues for payment on behalf of a third-party buyer (Credit Research Foundation, http://www.crfonline.org/orc/cro/cro-9-1.html.) [↑](#footnote-ref-42)
44. Iraq Ministry of Finance – federal budget 2013 [↑](#footnote-ref-43)
45. Iraq Ministry of Finance – federal budget 2013 [↑](#footnote-ref-44)
46. Poverty head count is based on per capita expenditure below the poverty line [↑](#footnote-ref-45)
47. Law 21 of 2013: A law issued by the central government as an amendment to provincial law of 2008 in Iraq. The law is published in the local newspaper AL Maktaba al Kanonya AL Iraqiya ll hokom al mahli, 2013 [↑](#footnote-ref-46)
48. ID8 trillion: ID 8 trillion equals 1.7 trillion (2012 petrodollar transfer) \*5 [↑](#footnote-ref-47)
49. This is the only year for which information is readily available [↑](#footnote-ref-48)
50. Kurdistan calculated its budget from government transfer without including its own local revenues. Including its own revenues for that year would have reduced the deficit to ID440 billion ($370 million) [↑](#footnote-ref-49)
51. Presentation by Ashti Hawrami (KRG Oil and Gas Minister), 17-18 June 2014 Iraq Petroleum Conference / CWC [↑](#footnote-ref-50)