PRODUCTION SHARING AGREEMENTS – MORTGAGING IRAQ'S OIL WEALTH

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INTRODUCTION

OIL IS IRAQ'S MOST IMPORTANT ASSET, and the powerhouse of its economy. Handled correctly, it will be the basis of the country's future development.

But not only are Iraq's oil reserves huge in relation to the country's economy, they are also the third largest in the world, accounting for 10% of known world oil reserves. Furthermore, Iraq has the greatest unexplored potential of any country, with possible unknown reserves matching or exceeding the known reserves. In theory, Iraq should be a rich country.

However, the history of Iraq's oil industry has not been a positive one. Ever since Iraqi oil was discovered 80 years ago, it has been eagerly coveted by foreign companies and countries who have used a range of economic, political, legal and military measures to obtain access to it on generous terms. Conversely, during the three decades of national control over the industry, oil wealth was used to sustain a brutal dictatorship and its internal security apparatus, and to finance devastating wars with Iraq's neighbours.

Now, in 2005, Iraq's oil policy is once again going through radical change. Decisions made in the coming months will set the development trajectory of the next few decades and determine whether the Iraqi economy thrives or struggles.

In this essay, we will examine the implications of one key plank of Iraq's developing oil policy – the proposal that foreign companies should be

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given access to oil reserves through the mechanism of production sharing agreements.

IRAQ'S OIL POLICY

Although oil was excluded from the sweeping privatisations enacted by US administrator Paul Bremer in 2003, major moves to open the sector to multinational oil companies are now imminent.

A Petroleum Law has now been drafted by the Energy Council together with the Oil Ministry, and will be enacted soon after the elections in early 2006, assuming the Constitution is approved in the October referendum. According to officials in the Ministry, long-term contracts will be signed with foreign oil companies during the first nine months of 2006.[1] In order to achieve this goal, officials have stated that negotiations should begin with the companies during the second half of 2005 in parallel with the writing of the Petroleum Law, in order to be able to sign soon after the law is enacted.[2]

According to sources in the government, although some details are still being debated, the draft Petroleum Law specifies that while Iraq's currently producing fields should be developed by state-owned oil companies (under a reconstituted Iraq National Oil Company, INOC), all other fields should be developed by private companies through the contractual mechanism of production sharing agreements (PSAs), the mechanism favoured by the oil companies.[3]

Only 17 of Iraq's 80 known fields, and 40 billion of its 115 billion barrels of known reserves, are currently in production.[4] Thus the policy potentially allocates to foreign companies 64% of known reserves. If a further 100 billion barrels are found, as is widely predicted, the foreign companies would control 81% of the total, and if 200 billion were found, as some suggest, they would have 87%.

This policy has been some time in the planning and its roots lie in the US State Department prior to the 2003 invasion. In 2002, the State Department established its Future of Iraq project in which Iraqi exiles and members of the then opposition met with US officials to plan for the future of Iraq after regime change. The project's Oil and Energy subgroup, whose members included current Oil Minister Ibrahim Bahr al-Uloum, met four times between December 2002 and March 2003. The group argued that:[5]

> [National oil companies] no longer serve the best interests of their countries. Rather, ... their inherent inefficiencies, born of their protection from competitive forces endowed by their monopoly status, cost the countries in which they survive billions of dollars.

The subgroup went on to recommend production sharing agreements with favourable terms to attract the companies:

> Key attractions of production sharing agreements to private oil companies are that although the reserves are owned by the state, accounting procedures permit the companies to book the reserves in their accounts, but, other things being equal, the most important feature from the perspective of private oil companies is that the government take is defined in the terms of the [PSA] and the oil companies are therefore protected under a PSA from future adverse legislation… PSAs can induce many billions of dollars of foreign direct investment into Iraq, but only with the right terms, conditions, regulatory framework, laws, oil industry structure and perceived attitude to foreign participation.

During his first period as Oil Minister under the Coalition Provisional Authority and the Iraqi Governing Council, Ibrahim Bahr al-Uloum told the *Financial Times* that he was preparing plans for the privatisation of Iraq's oil sector, but that no decision would be taken until after the 2005 elections. He commented that: "The Iraqi oil sector needs privatization, but it's a cultural issue", noting the difficulty of persuading the Iraqi people of such a policy. He further announced that he personally supported production-sharing agreements for oil development, giving priority to US oil companies "and European companies, probably."[6]

The first more concrete policy began with Interim Prime Minister Ayad Allawi in August 2004. He issued a set of guidelines to the Supreme Council for Oil Policy, from which the Council was to develop a full petroleum policy – a policy that would eventually develop into the Petroleum Law. Allawi's guidelines specified that existing fields would be developed by INOC and new fields by private companies through production sharing agreements; but he went considerably further, in a number of respects:

- New fields would be developed *exclusively* by private companies, with the policy ruling out any participation of INOC;[7]
- The Iraqi authorities should not spend time negotiating good deals with the companies, but should proceed quickly with terms that the companies will accept, while leaving open the possibility of later renegotiation;[8]
- INOC should be part-privatised.[9]

It is not known whether these details have been carried forward into the current draft oil policy.

In June 2005, Ministry officials announced that they were actively seeking discussions with multinational oil companies on the development of 11 oilfields in the south of Iraq. They held preliminary talks with BP, Chevron, Eni and Total.[10] The following month, the Ministry announced that alongside these direct discussions, it was also considering a licensing round in which oil companies would bid for production sharing agreements on both known fields and exploration blocks.[11]

Options for oil policy

There are essentially three models a country may choose from for the structure of its oil industry, plus a number of variations on these themes.

1) The system currently in place in Iraq, which has largely been the case since the early 1970s, is a **nationalised industry**. In this model, the state makes all of the decisions and takes all of the revenue. The extent of involvement of foreign private companies is that they might be hired to carry out certain services under contract (a **technical service contract**) – a well-defined piece of work, for a limited period of time, and for which they receive a fixed fee. This is the model used throughout most of the Gulf region.

One variant on the technical service contract is the **buyback agreement**, which has been used on some fields in Iran. In this system, a foreign company provides capital to invest in a project, but is paid a fixed rate of return, agreed in the contracts (thus preventing excessive profits). Companies have a right to buy the oil or gas.

2) In the **concession** model, sometimes known as the **tax and royalty system**, the government grants a foreign company (or more often, a consortium of foreign companies) a license to extract oil, which becomes the company's property (to sell, transport or refine) once extracted. The company pays the government taxes and royalties for the oil. An extreme version of this system existed in Iraq until nationalisation took place in 1961 and 1972.

3) The favoured system of the oil corporations is the **production sharing agreement** (PSA). This is a more complex system. In theory, the state has ultimate control over the oil, while a foreign company or consortium of companies extracts it under contract. In practice, however, the actions of the state are severely constrained by stipulations in the contract.

In a PSA, the foreign company provides the capital investment, first in exploration, then drilling and the construction of infrastructure. The first proportion of oil extracted is then allocated to the company, which uses oil sales to recoup its costs and capital investment – the oil used for this purpose is termed 'cost oil'. There is usually a limit on what proportion of oil production in any year can count as cost oil. Once costs have been recovered, the remaining 'profit oil' is divided between state and company in agreed proportions. The company is usually taxed on its profit oil. There may also be a royalty payable on all oil produced.

Sometimes the state also participates as a commercial partner in the contract, operating in **joint venture** with foreign oil companies as part of the consortium – in this case, the state provides its percentage share of capital investment, and directly receives the same percentage share of cost oil and profit oil.[12] The foreign company's share of the profit oil is then subdivided according to the production sharing terms.

Many of these systems are complex, and often 'the devil is in the detail': it is more the precise terms of any legal agreement or contract that determine the balance of control and revenues between the state and foreign companies, rather than which type of model is employed.

PRODUCTION SHARING AGREEMENTS

The development of Iraq's oil industry began in the aftermath of the First World War while the country was occupied by Britain, under a League of Nations Mandate. In 1925, Iraq's British-installed monarch, King Faisal, signed a concession contract with the Turkish Petroleum Company. The contract had a clear colonial character. It was for a period of 75 years, over which terms were frozen. Combined with two further concessions granted in the 1930s, one to a subsidiary of the (by then renamed) Iraq Petroleum Company, and the other to a company that was subsequently bought out by it, IPC obtained rights to all of the oil in the entire country. Even the Iraqi call for a 20% participation share in the concession was denied, despite having been specified in earlier agreements.

Iraqi frustration at the unfair terms of the deal grew. In the 1950s the contract came under pressure. Through the 1950s and 1960s, disputes continued between the Iraqi government and IPC, centring mainly on three issues: Iraq's continued desire for a participation share; disagreements in the posted price set by IPC for selling Iraqi oil to its overseas associates (when IPC set it too low, Iraq was denied tax income); and IPC's apparent suppression of Iraqi production, in order to boost the oil price, and make the IPC member companies' production in Saudi Arabia and Iran more profitable.

Underpinning this was the question of whether the split of revenues between company and state was a fair one – an argument that was echoed in all of the major oil-producing countries at the time, most of which had similar deals with the multinational companies. Whether – as in post-revolutionary Iraq – the governments were themselves antagonistic to the foreign oil companies, or – as in Saudi Arabia and Iran – under pressure from nationalist movements within their countries, the 1950s, '60s and '70s saw successive renegotiations of the contracts, in the host countries' favour. The ultimate conclusion was the nationalization of their industries. In Iraq's case, 1961 saw the nationalization of the oil within 99.5% of the country that was not then in production; the remaining 0.5% containing the producing fields was nationalized in 1972, and the final pieces in 1975.

In Indonesia, a different path was followed. The status quo was maintained while relieving nationalist pressures. In the late 1960s, while contracts in the Middle East and elsewhere were being renegotiated, Indonesia introduced a new form of contract, the production sharing agreement.

An ingenious arrangement, PSAs appeared to shift the ownership of oil from companies to state, and invert the flow of payments. The mechanism is based on the division of the extracted oil into "cost oil", which is used to repay development and production costs, and the remaining "profit oil", which is shared between company and state in agreed proportions.

Whereas in a concession system, foreign companies have rights to the oil, and must compensate host states through royalties and taxes; in contrast, in a PSA, the oil is defined as the property of the state, and the foreign companies are compensated both for the costs they have expended (through "cost oil"), and for the risk they have taken in investing their capital (through "profit oil").

In practice however, the issues of legal title and ownership are less important than their implications – in particular, in relation to revenue, and to control over development. A production sharing agreement can offer a variety of proportionate shares of profit oil between state and company, just as a concession system can employ either high or low taxes and royalties. In fact, it is widely recognised within the oil industry, even among the proponents of PSAs, that the difference between PSAs and concessions is more about giving the appearance of state control, than about any practical implications.

Professor Thomas Wälde, an expert in oil law and policy at the University of Dundee, has commented,[13]

> A convenient marriage between the politically useful symbolism of the production-sharing contract (appearance of a service contract to the state company acting as master) and the material equivalence of this contract model with concession/licence regimes in all significant aspects is what makes, in our view, this contract so popular: It gives to the government political and to the company commercial satisfaction. The government can be seen to be running the show - and the company can run it behind the camouflage of legal title symbolising the assertion of national sovereignty.

Nor does the arrangement necessarily change the economic balance of a project, or improve the level of revenue a country earns from its oil. In one of the standard textbooks on petroleum fiscal arrangements, industry consultant Daniel Johnston commented,[14]

> At first [PSAs] and concessionary systems appear to be quite different. They have major symbolic and philosophical differences, but these serve more of a political function than anything else. The terminology is certainly distinct, but these systems are really not that different from a financial point of view.

COMPANY AND STATE – CONFLICTING INTERESTS

In Iraq, there is powerful public opposition to the ceding of any ownership rights to oil reserves, which are generally seen as the property of the Iraqi people. These views are especially strong among the oil-workers, who have rebuilt their industry from the wreckage of three wars in the last twenty years. Any moves to hand reserves to foreign companies will thus be met with stiff opposition. Given the workers' ability to shut down production, the government might ask whether they consider this political risk worth bearing.

Bernard Mommer, an oil industry expert formerly at the Oxford Institute for Energy Studies and now the Venezuelan deputy Oil Minister, identifies a difference in taxation behaviour between net oil exporting countries and net oil importing countries. Net oil importers have an interest in minimizing the cost to their economies of oil imports (the balance of payments), and in maximizing secure supplies: thus they aim to maximize the level of investment in order to maximize oil production in their countries. Oil exporters such as Iraq, on the other hand, for which oil is primarily a source of revenue, have less concern for the scale of investment *per se*, and more for the scale of their income from it. In contrast to the importers, they have no interest in developing fields which provide no revenue to the state.[15]

It is thus surprising that in all the discourse around Iraq's future oil development, targets are set for levels of production (for example, 6 million barrels per day by 2015, as stated in the Oil Ministry's current 10-year plan), rather than for levels of revenue. Of course, revenues are dependent on the oil price. However, oil companies analyze revenues under a range of price and other scenarios. Given that the highest level of production does not necessarily lead to the highest level of revenue (as greater investment will be stimulated by more generous terms), it is not clear why such revenue targets and scenarios do not feature in the debate.

It is worth considering the differing interests of foreign companies and the state in the issue of oil production in order to assess whether there is sufficient overlap to even make co-operation desirable. If it does, these considerations will be key in the negotiation of contracts.

Oil corporations are looking for three things when they invest in a country:

- A right to oil reserves. Companies want a deal that guarantees their right to extract the reserves for many years – thus ensuring their future growth and profits. Furthermore, they want a contract that allows them to "book" these reserves, to demonstrate them to financial markets, and thereby boost their share price. For example, in 2004 when British/Dutch oil company Shell was found to have lied about how much reserves it had in its global portfolio, overstating them by over 20%, it lost the trust of the financial markets. Shell is desperate now to acquire new reserves – which is a key reason why Shell has made more effort than most oil companies to make friends in the Iraqi Oil Ministry.

- An opportunity to make large profits. Generally, oil companies achieve large profits by investing and risking their capital in a calculated way. In many cases, their capital will be lost, for example when they drill a 'dry well'. But in some cases, they will find huge amounts of oil. In this sense they are very different from oil service companies like Halliburton, which make money from the fixed fees of predictable contracts. Oil companies aim for deals which may be more speculative, but which give them a chance of super-profits.
- Predictability of tax and regulation. While companies can manage exploration risk (that they won't find oil) or price risk (that the oil price falls), they try to avoid "political risk" (that tax or regulatory demands will increase). They thus seek to lock governments into long contracts that fix the terms of investment.

It is for these reasons that multinational oil companies favour production sharing agreements (which meet all of the above requirements) over technical service or buyback contracts (which generally do not).

However, for the Iraqi government, there will be considerable political costs to ceding ownership, as we have noted. These political tensions will only be heightened if foreign companies are to earn excessive profits. Nor can it be seen as in the country's economic interest to allow excessive profits to be made, as by definition, a higher profit for a foreign company means less revenue for the state.

Perhaps most problematic of all, however, is the loss of flexibility that would arise from fixing rates of tax. Production sharing agreements typically last for periods of 25 or more years, and it is difficult to imagine that Iraq's political and economic priorities will be the same in two or three decades time as they are now.

These problems were seen, for example, in Russia. The rush to privatise in the immediate post-Soviet period of the early 1990s is now being strongly questioned. Although the state has made some moves against the enormous privatised companies of the oligarchs, in the case of the PSAs, it is more difficult. Once they are signed, it is too late to change direction.

NATIONAL OR FOREIGN CONTROL?

The proposal to open Iraq's oil industry to foreign companies is a radical departure. Although Saddam Hussein courted French, Russian and Chinese companies for political reasons and signed two production contracts, these were never realised because of the sanctions. In practice, Iraq's oil industry has remained state-controlled for 33 years.

It is also a departure from common practice among the major oil producers of the region. Although their proponents claim that PSAs are standard industry practice, in fact they are only common in countries with far smaller reserves and higher production costs. Indeed, International Energy Agency figures show that just 12% of world oil reserves are subject to PSAs, compared to 67% developed solely or primarily by national oil companies.[16]

Although Iraq's neighbours Iran, Kuwait[17] and Saudi Arabia[18] have recently allowed some limited foreign investment in their oil and gas industries, none of these have allowed equity involvement (such as a PSA or concession), but have used some form of technical service agreement or buyback, in which the state maintains ownership and control. These countries – Iraq and three of its neighbours – are the world's top four countries in terms of oil reserves, with 51% of the world total between them.[19]

Together with the United Arab Emirates, Venezuela and Russia, seven countries hold 72% of the world's oil reserves. These latter three all have some foreign involvement through concession agreements, although both Venezuela and Russia are currently drawing back from it, following unsuccessful expansions in foreign investment in the 1990s. Of these seven countries with major oil reserves, only Russia has any production sharing agreements. Russia signed three PSAs in the mid 1990s; however, PSAs have been the subject of extreme controversy ever since, due to the poor deal the state has obtained from them, and it now looks unlikely that any more will be signed.

So why introduce such a radically different policy in Iraq?

Iraq is endowed not just with the world's second largest oil reserves, but also with a highly skilled workforce. Indeed, it has largely been the skill and dedication of oilworkers that have put the industry back on its feet, following the 2003 invasion and subsequent looting. Many have seen the American contractors introduced under the occupation as ineffectual.

Although thirteen years of sanctions have left Iraq lagging on some aspects of oil industry technology, that deficit can be made up through technical service agreements, and does not require equity involvement of foreign companies.

Even when it comes to the capital requirements, the arguments are not convincing. Iraq's oil development cost is among the smallest in the world, making it achievable from public funds, and indeed minimizing the risks to those public funds.

The Ministry of Oil's 10-year plan, issued in June 2005, calls for $25 billion of investment in order to increase oil production from the current 2.2 million barrels per day (mbpd) to 6 mbpd in 2015.[20] In other words, this would require $2.5 billion per year. This could fairly comfortably be financed out of Iraq's own revenues, and is within the range of budget allocations to date. Alternatively, it could be raised as relatively short-term loans, using Iraq's substantial reserves as collateral.

WHO BENEFITS? – THE ECONOMIC IMPACT

Conversely, there can be significant loss of revenue for Iraq by allowing in private companies. To simplify: let us assume that in 2015, Iraqi oil production is 6 million barrels of oil per day, half of it produced by INOC and half by multinational oil companies under production sharing agreements. Even if we take the most generous (to the state) profit oil split used in PSAs worldwide, of 80-20, the Iraqi state would lose nearly 10% of its total revenue.[21]

While some proponents of PSAs argue that foreign direct investment would free up the state's resources to devote to other budgetary priorities,[22] this ignores the converse loss of state resources slightly later. Given the low development cost, payback of any investment will be over just a few years. Thus the state's saved investment of $2.5 billion per year could be offset by lost income of, say, $5.8 billion per year just a few years later (at $30/barrel oil price).[23]

Worse, Iraq could find itself losing revenue also from the INOC (publicly)-controlled fields, due to compliance with OPEC quotas. When Iraq receives a quota, if it has to restrict production to shore up prices, contracts may prevent it from doing so in any foreign-controlled fields. As a result, to comply with OPEC decisions, Iraq would instead have to cut production from fields controlled by the national oil company – and lose the revenue from those as a result.

The energy economist Ian Rutledge points out that it is not enough to look only at the state's percentage share of the "take" to judge fairness – much depends on a country's geological, political and infrastructural attractiveness. A key measure of whether the state has got a fair deal is what level of profits a company is making. In the oil industry, profit on an investment is best measured by the internal rate of return (IRR).

For example, Rutledge applies the PSA terms used in Oman (based on a 80-20 split plus bonuses) to a 300-million barrel field in Iraq (a relatively small field, by Iraq's standards). He finds that companies would be receiving an enormous 59% IRR at an oil price of $25, and 66% IRR at $30, compared with a usual target for companies of 12-15%.[24]

Ultimately, how revenues are split comes down less to what is considered "fair" than to what either side feels it can get away with, in the industry language, "what the market will bear." Company negotiators will of course always play down the attractiveness of a country in order to strengthen their bargaining position. In the case of Iraq, if the government were to hold negotiations with foreign oil companies, the companies would highlight security concerns and political risks. They would push for a deal comparable to, or perhaps even better than, that in other countries in the world. This would ignore Iraq's huge reserves and low production costs.

Furthermore, once a deal is signed, its terms are fixed. Thus the contract terms for the next 40 years would be based on the bargaining position or political balance that exists at the time of signing. So, in Iraq's case, the arguments about political and security risk could land Iraq with a poor deal that long outlasts those risks, and would not be suitable to a potentially stronger Iraq of the future.

THE CHALLENGE OF COMPLEXITY

The simplest form of payment on oil revenues is through royalties, in which a company pays to the state a percentage of the total value of the oil it extracts. With royalties, it is very clear what should be paid – it is a fixed percentage of the value of oil. As long as the number of barrels extracted and the oil price is known, it is easy to work out what royalty is due. Thus, if the royalty is 15% for every $100 of oil extracted, $15 is paid to the state.

Profit taxes, on the other hand, are based on the profit remaining when costs have been deducted from the total revenue. As such, they depend on complex rules for what costs are allowed to be deducted, how capital costs are to be treated, and so on.

Oil companies dislike royalties, and prefer taxes based on profits. The reason is that when it comes to taxation, they want what they call "upside" (i.e., opportunities for greater profits) ways in which they can reduce their tax payment. The more complicated a tax system, the more opportunities there are for a company to avoid tax by clever use of accountancy techniques. Not only do multinationals have access to the world's largest and most experienced accounting companies, they also know their business in more detail than the government that is taxing them. A more complicated tax system tends to give them an upper hand.

Thus a company can obtain profit not just from the *profit oil*, but also from cost oil. Although that is not intended in the deal, careful accounting and financial management can allow the companies to exploit loopholes in the tax rules. For this reason, the details of how profits are calculated, what costs are allowable etc, are very important.

Furthermore, while it is possible to devise ever more sophisticated tax systems which respond better to both circumstances and policy priorities, the drawback is that complexity removes transparency. If only the experts can understand the meaning of a tax system, there is little chance of public accountability. Production sharing agreements often consist of several hundred pages of technical legal and financial language. Even when they are not treated as commercially confidential (which often they are), they do not lend themselves to public scrutiny.

One result of this complexity can be that even when a government thinks it has a good deal, it may later find itself receiving less income than it had bargained for. For example, Chad signed a "convention agreement" with neighboring Cameroon and with a consortium led by ExxonMobil in 1988. This was a broad contract covering both production sharing terms on Chad's Doba oilfields, and a pipeline through Cameroon to the coast. Even though outside observers commented that the government's agreed share of revenue was low[25], the government found itself getting even less than it expected. In October 2004, a year after the oil started flowing, the Chadian government accused the consortium of under-paying the revenues agreed in their contract. Oil Minister Youssouf Abassalah announced:

> Regarding the application of the contract, we have different views on what should be going to Chad in terms of the share of oil revenues.[26]

For Iraq, there are echoes here of the experience with the concession contracts. During the 1950s and 1960s when the Iraqi government was unhappy with the Iraq Petroleum Company's level of production, or with the posted price that was being used, the IPC always had resort to economic arguments about the nature of the market. For example, low production rates compared to Iraq's neighbors were blamed on port tariffs, and a low posted price compared to Libya was blamed on Iraqi oil's higher sulphur content. With the IPC so firmly in control of its business in Iraq and its member companies of production across the Middle East, it had an effective monopoly on economic information, which it was difficult for the Iraqi government to challenge. Nowadays, the oil market may be more transparent. However, contracts and taxes are far more complex, resulting in a similar dynamic where control of economic information gives power in negotiation and against regulation.

Even countries with much experience in oil development are not immune to these problems. For example, in the Sakhalin II project in Russia's Far East, currently being developed by a Shell-led consortium, the way the PSA is written, all cost over-runs are effectively deducted from the state's revenue, not the consortium's profits.[27] During the planning and early construction of the project, costs were dramatically inflated. In February 2005, the Audit Chamber of the Russian Federation found that cost over-runs, due to the terms of the PSA, had already cost the Russian state $2.5 billion.[28]

WHO CONTROLS THE OIL?

While PSAs give the impression of giving the state ownership and control over oil resources, in practice, the states hands are tied by the restrictions in the contract. As with revenue sharing, the key is in the detail.

Most production sharing agreements specify that any disputes would be resolved not in the courts of the country concerned, but in international arbitration tribunals, such as ICSID in Geneva or the International Chamber of Commerce in Paris. These arbitration hearings are often held in secret and presided over by tribunals consisting generally of corporate lawyers and trade negotiators. As such, they tend to narrowly favour the investment interest rather than broader issues of national interest or sovereignty.

The researcher Susan Leubuscher comments,

> That system assigns the State the role of just another commercial partner, ensures that non-commercial issues will not be aired, and excludes representation and redress for

> populations affected by the wide-ranging powers granted [multinationals] under international contracts.[29]

Furthermore, Leubuscher points out that investment contracts are largely self-standing and self-referential: they are judged by the goals and conditions that each individual contract sets for itself, rather than by external standards within the broader body of law.

Rulings against Iraq in an international arbitration tribunal could lead to the seizing of Iraq's assets by any other country that recognizes the tribunal concerned.

Even worse, many of these contracts contain so-called "stabilization clauses", which can prevent future laws or tax policies applying to the project. This is generally achieved by one of two mechanisms in the contract:

1) giving the production sharing agreement a higher legal status than other laws (except the Constitution). Thus, if there is a conflict with a future law, the PSA takes precedence; or

2) including clauses that allocate certain risks such as tax or legislative change to the state oil company – in other words, if tax is increased, the state oil company pays, not the foreign company.

As a result, laws and regulations relating to labor standards, workplace safety, community relations or the environment would be unable to be strengthened[30] in relation to a project during the life of the contract (25 or more years), and may even be weakened, depending on the contract.

One example is the case of Georgia. In November 2002, when BP's Baku-Tbilisi-Ceyhan pipeline was seeking environmental approval, the Environment Minister said she could not approve the pipeline routing through an important National Park, as to do so would violate Georgia's environmental laws.[31]

Both BP and the US government put pressure on the Minister, through then President Shevardnadze.[32] The Minister was forced to concede the routing with environmental conditions, and then to water down her conditions. Part of the reason for her weak bargaining position was that two years earlier Georgia had signed the host government agreement for the project (a pipeline contract in some ways legally comparable to PSAs) which set a deadline for environmental approval within 30 days of the application. Since that agreement has a higher status than other Georgian laws, the environment laws the Minister referred to were irrelevant. Ultimately, on the day of the deadline, the President called the Minister into his office and kept her there until she signed, in the early hours of the morning.[33]

Of course, with control over the oil comes power, and it is clearly not enough simply to achieve "sovereignty" by placing it in state hands. Iraq's experience of the last 25 years provides ample evidence of those risks. Indeed, there is well-documented literature on the "resource curse", in which oil wealth has in numerous countries been seen to strengthen undemocratic regimes, lead to an increase in corruption, and damage the wider economy.

However, it is a myth that foreign investment in an oil industry is likely to reduce these effects – a confusion of economic with political liberalism. In fact, the opposite can be true. Oil corporations are interested in regimes that they can do lucrative deals with. The deals which give them excessive profits are very often those that would not survive in a democracy, and which depend on autocratic governments to enforce them (such as in Azerbaijan).

When the proponents of foreign investment argue that Iraq's oil industry needs capital, the extent to which they are right is that it may allow production to grow faster than under a purely national model. However, it is precisely fast development that presents the greatest risk of getting a poor deal with foreign corporations, and of failing to develop sufficient governance capacity to effectively manage oil revenues. In other words, it may benefit Iraq's long-term development to develop its oil more slowly.

This article argues that Iraq will benefit from keeping the control of and revenue from oil in the public sector and in developing the democratic institutions and proper mechanisms of governance to effectively oversee it. A key plank in this process will be the transparency of oil revenues, a point on which there is already a significant and welcome developing consensus.

CONCLUSION

Iraq's rapid moves towards handing its undeveloped oilfields to multinational oil companies through production sharing agreements are a cause for concern.

It is a question for the people of Iraq as to whether they want foreign investment in their oil at all. If Iraq were to rush into signing oil contracts, and especially if it were to do so without public debate or transparency, unfavourable outcomes could be expected.

There are certainly wide variations in the terms of PSAs worldwide. Some give a more reasonable deal, others not. In some ways, depending on the detail of the terms of a PSA, its impact can be comparable to that of the worst concession agreements, such as those in place in Iraq from the 1920s to the 1970s. PSAs stand for long periods of time They fix revenue distribution at what may be later considered unfair levels and they deny the state much of its ability to regulate.

Iraq would be well advised to maintain flexibility in how it structures its oil industry and to avoid long-term, irreversible decisions, especially at the current time. If it is decided that foreign capital is required, there are options such as the buyback agreements which maintain the majority of the decision-making control rather than surrendering to the extent of control that would occur with production sharing agreements.

The wrong contract – whether as a result of the political context or of mistakes in drafting (such as lack of clarity about implications of certain clauses) – would impact Iraq's economy for the next 25 or more years.

ENDNOTES

1. Christian Schmollinger, *International Oil Daily*, 15 June 2005, "Iraqi officials hopeful foreign oil firms will return in 2006."

2. Glen Carey & Faleh al-Khayat, *Platts Oilgram News*, 22 June 2005, "Iraq looks to woo majors for field revivals."

3. For example, Walter van der Vijver, then Chief Executive Officer of Shell Exploration and Production, stated in 2003 that "...international oil companies can make an ongoing contribution to the region [the Persian Gulf]... However, in order to secure that investment, we will need some assurance of future income and, in particular, a supportive contractual framework. There are a number of models which can achieve these ends. One option is the greater use of Production Sharing Agreements, which have proved very effective in achieving an appropriate balance of incentives between Governments and oil companies. And they ensure a fair distribution of the value of a resource while providing the long term assurance which is necessary to secure the capital investment needed for energy projects" [Speech to ECSSR conference, *A new era for international oil companies in the Gulf: opportunities and challenges,* Abu Dhabi, 19 October 2003].

Similarly, in Autumn 2004, the International Tax & Investment Centre (ITIC) – a corporate lobby group which pushes for pro-business investment and tax reform, and whose Board of Directors contains representatives of ConocoPhillips, Exxon Mobil, Shell, BP and Chevron – published a report entitled *Petroleum and Iraq's Future: Fiscal Options and Challenges,* which stated that "The most appropriate legal and fiscal form the facilitation of Foreign Direct Investment longer-term development of Iraq's petroleum industry will be a Production Sharing Agreement (PSA)."

4. US Department of Energy, Energy Information Administration, Iraq – Country Analysis Brief, June 2005.

5. US State Department Future of Iraq Project, Oil and Energy Working Group (Oil Policy Subgroup), April 2003, "Iraqi oil policy recommendations after regime change," published in *Middle East Economic Survey*, 5 May 2003, pp.D1-D11.

6. Nicolas Pelham, *Financial Times*, 5 September 2003, "Oil to be privatised but not just yet, says Iraqi minister."

7. "For new development of undeveloped oil and gas fields, and for exploration, all of which must start as soon as possible and in tandem with INOC's efforts, these should be accomplished through private sector investment via competent international ... oil companies... However, these new ventures should specifically not be allowed to partner with any state-owned enterprises, including INOC, in order to ensure state impartiality and avoid the pitfall of state interference in corporate enterprise management." [Cited in *Middle East Economic Survey*, 13 September 2004, "Allawi outlines new Iraqi petroleum policy: INOC for currently producing fields/IOCs for new areas," pp. A1-A4].

8. "Should we spend months and years trying to exact the last penny in negotiating the commercial terms? I would suggest that there is no need to waste time. Time is of the essence," [*ibid*].

9. "Eventually, in years to come, INOC may be partially privatised through wide distribution of ownership among Iraqis through public subscription," [*ibid*].

10. *Middle East Economic Survey*, 20 June 2005, "Iraq fast tracks upstream contract talks with IOCs," pp.5-6.

11. *Middle East Economic Survey*, 11 July 2005, "Iraq mulls bid round alongside direct talks with IOCs."

12. For example, in a 50-50 joint venture, the state provides 50% of the investment and directly receives 50% of the cost oil and profit oil.

13. Thomas W Wälde, July 1995, "The current status of international petroleum investment: regulating, licensing, taxing and contracting," in CEPMLP Journal, Vol. 1, no.5, University of Dundee.

14. Daniel Johnston. *International petroleum fiscal systems and production sharing contracts.* Pennwell, 1994, p.39.

15. Bernard Mommer. *Global oil and the nation state.* Oxford University Press, 2002.

16. Dunia Chalabi (International Energy Agency), 11-12 February 2004, "Perspective for Investment in the Middle East/North Africa Region," Presentation to the OECD, Istanbul, p.7 www.iea.org/textbase/speech/2004/dc_istanbul.pdf.

17. Still under negotiation.

18. Gas only

19. BP Statistical Review of World Energy 2005 p.4.

20. *AFX International Focus*, 14 June 2005, "Iraq unveils 10-year, multi-billion-dollar plan to boost oil output."

21. I.e., 20% of half of oil revenue. Oil income makes up the bulk of state revenue.

22. Eg., International Tax & Investment Centre (ITIC), Autumn 2004, *Petroleum and Iraq's Future: Fiscal Options and Challenges*

23. Taking the development, financing, production and transportation costs as totalling $3.50 per barrel – hence rent of $26.50.

24. Ian Rutledge. *Addicted to oil.* IB Tauris, 2005, p.185.

25. Eg., a World Bank Inspection Panel commented that "The Panel was struck by the estimated financial returns to Chad over a 28-year period, having regard to the magnitude of the Project, and is concerned that it was unable to find any analysis to justify the allocation of revenues among Chad, Cameroon and the Consortium. While the Panel recognizes that Management sought to ensure that Chad had access to reputable legal and financial services in its negotiations with the Consortium, it remains concerned about the adequacy of the allocation of revenues to Chad" [Cameroon Investigation Report (no. 25734, dated 2/5/03), para 39, p.xvii].

26. *Reuters*, 11October 2004, "Chad Criticizes Exxon-Led Consortium Over Oil Money."

27. Ian Rutledge, *The Sakhalin II PSA – A production 'non-sharing' agreement*, November 2004, Pub. PLATFORM et al available at http://www.carbonweb.org/documents/SakhalinPSA.pdf.

28. See eg. *Associated Press*, 10 February 2005, "State Audit Chamber accuses Shell consortium of overspending."

29. Susan Leubuscher, 2 June 2003, "The privatisation of justice: international commercial arbitration and the redefinition of the state." MRes thesis, Birkbeck College http://www.fern.org/pubs/reports/dispute%20 resolution%20essay.pdf.

30. Alternatively, some contracts allow such laws to be strengthened, but require compensation to be paid to investors for their loss of profits.

31. Letter of 26 November 2002 from Nino Chkhobadze (Georgian Minister for the Environment) to BP CEO John Browne.

32. Letter of 7 November 2002, from David Woodward (BP Azerbaijan) and Natiq Aliyev (Socar) to Eduard Shevardnadze. The US special envoy on energy, Steven Mann, was called in to "mediate" the dispute, and began by saying that if Georgia did not approve the routing within the deadline, it would not get investment in other big energy projects [Rustavi-2 TV, 25 November 2002, reported on BBC Monitoring, "Georgian environment minister under pressure to back pipeline impact report"].

33. *AFP*, 2 December 2002, "Georgia approves $2.9bn oil pipeline."