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## **Iraq's Oil Tomorrow**

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## Introduction

Public perceptions that the American-led military campaign against Iraq is fuelled by oil are widespread in Europe and in the Middle East. Oil is indeed important to America's foreign policy in the Middle East, alongside protection of Israel and general stability in the area. American interest in Iraq, in particular, is tied to its influence as a regional power and its potential role as a major oil producer. It is also driven by concerns about the use of oil revenues by the Iraqi regime to develop the capacity again to threaten the stability of the whole region. However, the present US-led military campaign against Iraq is not a war *for* Iraq's oil.

The previous Gulf War had a clear oil incentive. Protecting the totality of Middle East oil supplies from Saddam Hussein's control was an important US objective of the Gulf War of 1990-91, and is still important. By invading Kuwait, Iraq controlled the production of 5 million barrels of oil a day, doubling its reserves. Iraq's own oil is much less important.<sup>1</sup> With sustained investment over several years, Iraqi production could be raised to around 6% of the world total, compared with Saudi potential of nearly three times that and Russian potential of nearly double that. If energy security - understood as ensuring a steady flow of cheap oil to the market - were the prime driver for American foreign policy and war in the past months, the United States would have intervened in Venezuela to bring an end to the strikes against Chavez's regime that brought Venezuelan oil production to a grinding halt. Arithmetically, Venezuelan oil is more important to America's oil security than Iraq's, taking up a share of 14% of imports against Iraq's 7%.

A second element of public concern over America's motivations for striking Iraq is the suspicion that Washington wants to seize Iraq's oil fields to pump the oil itself. Seizing oil fields doesn't do anything for American oil security. The crucial requisite for energy security is to get the oil on the market and to prevent any disruptions to supply. In terms of the energy security of importing states, it is irrelevant who sells the oil and who buys it. Oil is a global commodity and the price is not set in Baghdad.

A third concern is that if the US overthrows the Iraqi regime it will open Iraq's oil potential to exploitation by US private-sector companies. American oil companies have voiced their preferences in Washington, but so far, American foreign policy has not done very much for the oil majors. US sanctions against Iran and Libya have barred access of American companies to those markets, while European and other companies have had a freer hand to invest in these oil rich countries. More generally, widespread public resentment of American policy in the Middle East (*vis-à-vis* both Palestine and Iraq) has made it more difficult for US companies to do business in the region. Arguably, their capacity to enter politically sensitive markets is negatively affected by Washington's unpopular policies.

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<sup>1</sup> By the US Geological Survey's own estimates published in 2000, Iraq is a poor third to Saudi Arabia and Russia in terms of potential oil supply. Iraq's much quoted 'second largest reserves in the world' are based on the Iraqi government declarations and are less than half the figure for Saudi Arabia.

Common assumptions regarding the commercial competition for Iraq's oil bounty are in sharp contrast to industry concerns about the future oil regime in Iraq. There is a great deal of uncertainty about how Iraq will govern its oil industry. Will it be built on the existing concept of 'production sharing' with private-sector contractors? Will there be a 'level playing field' for investors from all countries? What will be the role of the Iraqi National Oil Company (INOC) in the future? Oil companies are acutely aware that access to the promising fields of Iraq may be delayed for some time while these issues are resolved. Furthermore, oil companies will not invest in Iraq's fields until they have some assurance of political stability. This paper will seek to understand how the difficult process of political consolidation and reconstruction is likely to slow investments in Iraq's oil sector and the re-emergence of Iraq as a major oil producer.

### **A scenario for Iraq's oil tomorrow... and the days after**

The following scenario assumes that the United States and its allies remove Saddam Hussein's regime and temporarily rule Iraq through an interim government. These outside powers will soon need to give way to an Iraqi government that will be regarded as legitimate and independent by the people of Iraq, neighbouring states, and the international community. This paper sketches out, with reference to the oil sector in Iraq, how this transition might be achieved. For convenience, we identify three phases. These differ in the degree of independence of the new Iraqi government. The timetable could be shorter if political progress in Iraq is rapid. Other scenarios are also likely, but not discussed here.<sup>2</sup>

- 1) Occupation: 6 months to 2 years
- 2) Controlled transition: 3-5 years
- 3) Legitimate, sustainable independence

The opportunities for foreign investment in the oil industry will be deeply affected by the nature of the emerging political leadership in Iraq, whether under the administration of a US occupation force, or a newly formed, consolidating regime under influence of the UN and the US, or a more entrenched and domestically legitimate national government.

A key message of the paper is that stable conditions for long-term foreign investment in the Iraqi oil sector can only be created in the third phase when the new Iraqi regime is recognized as independent of the occupying powers. Until then, foreign inputs to the rehabilitation and expansion of Iraqi oil production will depend on service and short-term contracts.

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<sup>2</sup> For instance, the 'Occupation' stage could almost be eliminated if the Iraqi military effectively resist the invasion, independently from Saddam Hussein, gaining national legitimacy. A peace could be concluded which meets the overriding US objectives of removing Saddam from power, destroying any Iraqi weapons of mass destruction and preventing their future development.

## **The transition phases**

### **Occupation phase – 6-months to 2 years**

The US/Allied priorities in Iraq are likely to be:

- Completing the destruction of weapons of mass destruction and the means to produce them.
- Maintaining order and the territorial integrity of Iraq.
- Agreeing with the UN, and with Iraq's creditors, how claims on oil revenues are to be prioritized.
- Beginning a process of political reform to lead to the transfer of power to a national government.

While the US State Department has organized a number of working groups to discuss the administration of Iraq post-Saddam Hussein with Iraqi opposition figures, the Bush administration has said little about its plans for Iraq's oil policy during the period of occupation. There is concern within oil industry circles regarding the management of oil revenues by the occupier, the future development of the oil sector and the role of Iraq in OPEC. We will discuss possible options for a US-led administration.

Until the US authorities have set up the foundations for what they call a 'broad-based, representative government', they will govern central government functions but place in public view a consultative council composed of Iraqis with little or no governing responsibility. Functions related to providing for the welfare of the population, such as health and education, will be transferred to sub-national (local and state) authorities, under the supervision of the American administration (and later UN bodies). The Interior, Petroleum, Finance, Foreign Affairs, Defence and other critical ministries will remain under control of the occupying force in the capital.

The 'day after' administration directed by the United States will effectively disarm Iraq, allowing an easing of sanctions in the following months. There will be a major political question as to whether the occupying administration will propose a new hydrocarbon law with opportunities open to all international companies. During this phase, it would be politically very risky for the US administration or Iraqi political representatives to propose terms that 'give away' future oil. In any case, many foreign companies will not engage in long-term investments in an Iraq ruled by the US, because of the risk that their investments would not survive the US occupation.

There are currently only three contracts for foreign oil investment in the oil sector, one of which (Lukoil's) has already been denounced by the Iraqi government on grounds of non-performance. Chinese state companies hold two relatively small contracts. A new government would be expected to honour existing contracts. All other so-called oil contracts are memoranda of texts that have only been negotiated and not signed. Those might be the starting points for new negotiations, but would lead to different contract terms. The terms negotiated thus far (with a

limited range of companies willing to risk negotiating with a regime under sanctions) are harder for Iraq than would be the case under open competition.

To maintain and increase oil production as soon as possible, the INOC will join with foreign contractors to get resources for the rehabilitation of existing oil fields. The World Bank, the European Bank for Reconstruction and Development (EBRD), the Japan Bank for International Cooperation and other development banks may finance infrastructure rebuilding, including infrastructure needed for the oil sector – such as power stations and lines. Foreign aid is likely to be limited in duration and may be tied to contractors from the donor country, as is required by law in the US for USAID contracts.

New loans and investments granted by international agencies such as the EBRD and World Bank will be conditional on acceptance of a transparent allocation of export (i.e. oil) revenues. Private-sector investors such as oil companies will also need to see their future claims for cost recovery and profit secured in the revenue control mechanism. The oil-for-food programme is likely to be maintained after the war, under a modified format. Oil sale proceeds will continue to be directed to a UN escrow fund and public spending of the oil wealth will be supervised.

The US will therefore be able to control how Iraq spends its money - but will it be able to use Iraqi petro-dollars to finance its occupation and running costs in a transparent revenue system?

The United States may expect to be compensated for the invasion and occupation costs. International and US law allows the occupying power to pay for the cost attached to running the state as temporary sovereign with assets of the conquered state. The occupying administration can produce and sell oil from existing wells and use the proceeds to pay for the occupation costs and the reconstruction of the country, but there would be legal and political challenges to the use of Iraqi revenue to compensate the US and the UK for the cost of invasion and conquest. The domestic political benefits of minimizing American expenses in the Iraq venture must be set against the risks of popular resentment of US neo-colonialism leading to violence in the region. The dominant view in the region - and in particular outside the oil-producing states - is that oil is a national resource that belongs to the Arab people. Such oil nationalism could lead to terrorism and sabotage aimed at Western equipment, installations or employees within the region.

In search of revenue, the US administration has indicated that it will call on international assistance to seize Iraq's frozen foreign assets. It is also counting on substantial participation in the stability operations and the humanitarian and reconstruction effort from coalition partners, additional countries, international organizations and NGOs. The Bush administration also wants revenues from the oil-for-food programme, which amount to almost \$8 billion held in a United Nations escrow account, to be made available to the United States to buy supplies for Iraq. This use of the funds would require a specific Security Council resolution. Indeed, the UN can only participate in the reconstruction effort if it is given a specific mandate to do so. London has demonstrated a clear preference for United Nations involvement in the reconstruction and administration of Iraq - a view Washington seems to support.

There is a question as to whether, or on what terms, the UN will assist the occupation of Iraq by the US and the UK when it has not sanctioned the war (or the occupation). The recalcitrant

Security Council members could make their support conditional on a truly multilateral involvement in Iraq (thus tying America's hands in the management of the oil sector) and a role for their companies in the reconstruction effort.

By the end of this phase, an international economic conference should be held to settle competing claims made against the new regime, which amount to an estimated \$250bn,<sup>3</sup> with a schedule for repayments over the following years. This will enable the administration to draw up a development plan to rebuild the country and its oil industry and will allow the successor regime to free resources for the country's reconstruction. It will help the new regime consolidate its position domestically; as it will be able to provide much needed services to the population and opportunities for new investment. In this sense, an economic settlement will be a necessary condition for the successful re-emergence of Iraq as a stable regional economic and political force in the Middle East.

### **Controlled transition phase – 3 to 5 years**

At the outset of this transition phase, there will not have been any elections. The new regime will be engaged in a process of political consolidation and its domestic legitimacy will be tested by the various forces composing Iraq's complex political spectrum. In the past, oil revenues have paid for the distribution of favours and services to the regime's support base. The whole country turned to the capital for its welfare, employment, and economic opportunities. Iraq's dependence on oil revenues will not subside. Oil sales will pay for public services and the reconstruction of infrastructure. If Iraq follows the path taken by neighbouring producers, and its own past practices, the government will rely on public subsidies to fuel economic growth and consolidate its power domestically.

However, international institutional controls would somewhat limit the regime's capacity to build a new patrimonial system. The regime would not yet be fully trusted to use its oil revenues exclusively for civilian goals, such as the repayment of debts and the humanitarian and economic development of the country. The international community would therefore maintain institutional control of Iraq's oil export revenues. Such control could be exercised through a modification of the UN's oil-for-food programme and through conditionality measures imposed by international agencies.

Oil revenues and foreign investment from public sources would fund the national development plan. This plan would be directed at reconstructing infrastructure and laying the socio-economic foundations for future economic growth. At this stage, it would be very difficult for the transitional government to offer a sufficiently stable fiscal and legal framework or political investment climate to attract long-term private foreign investment in the oil sector.

Once elections have taken place, the new government would try to bring about a consensus on legal and fiscal reform proposals. Important public debates will be needed to determine Iraq's oil

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<sup>3</sup> This estimate includes claims made for compensation for the Iran-Iraq war, the Gulf war and foreign debts.

policy on investment and production and to define the respective territory of the INOC and international oil companies. It is likely that the INOC would remain the principal institution responsible for the oil sector. The legislature would eventually be asked to ratify a hydrocarbon law.

Necessity may force a compromise between a transitional government, hungry for cash to fund the reconstruction of the economy, and the oil authorities and Iraqi politicians, concerned about maintaining sovereign control over natural resources. As a result, oil authorities would offer initial contracts to oil service companies to rehabilitate existing oil fields, as planned in the Oil Ministry's development and expansion plans in 1997. Beyond that, we may find short-term Iranian-style buyback contracts that offer oil companies and oil service companies a fixed fee to develop already discovered fields, with some rights to buy oil. These short-term contracts could bring sufficient investment capital and technology to restore Iraq's production capacity slightly beyond its previous level of 3.5mnb/d and to maintain it.

A similar compromise is possible on the question of OPEC quotas and membership. Politically, the transitional government could not afford to renounce its past nationalist oil policy and 'leave OPEC' as a result of US/Allied influence. Moreover, OPEC does serve exporters' interests. Iraq would probably prefer to remain in OPEC - provided its production quota does not handicap its return as a major producer and its capacity to fund its reconstruction. OPEC, for its part, will prefer to keep Iraq close at hand, but will not want to renegotiate quotas. They could arrive at a temporary solution where, formally, Iraq stays in OPEC, but is exempted from a cap on its production.

### **Third transition phase - legitimate independence**

In this phase, the regime would be viewed as politically acceptable to the extent that it enjoys domestic and international recognition. Iraq would offer a stable investment climate and foreign direct investment could take off. But what kind of a regime would it be?

First, it is likely to be an OPEC regime. It is unlikely that any terms would be offered to foreign companies (on the lines offered by an earlier regime in Venezuela) that would effectively exempt foreign companies from the effects of quotas by placing the whole burden of any production restraint on the INOC. Because of uncertainties about the speed of expansion of Iraqi oil production, the question of OPEC quotas would be particularly important in Iraq.

At this stage, we can only speculate as to a future regime's intentions regarding fiscal and contract terms. However, it seems important to question any assumption that a legitimate independent regime would maintain the generous contract terms that the regime of Saddam Hussein offered under the pressure of international isolation and embargo. Although the new regime will be desperate to increase its oil revenues to fund the country's reconstruction, this consideration must be set against its need to safeguard its nationalist credentials by protecting its oil from foreign interests.

## Conclusion

What opportunities will foreign companies find following a change of regime?

- After rehabilitation work on existing fields, Iraqi authorities will turn to the development of discovered fields such as Majnoon, West Qurna, and Nahr Bin Omar - and later still, they will turn to the discovery of new fields in the Western Desert. They will need foreign assistance for this development.
- The international private-sector companies can offer extensive technological, financial and managerial capacity to develop the oil potential of a field from discovery to development and export. The problem is that the stable long-term conditions for investment cannot be offered by a government of occupation or a transitional government that is under foreign control. Yet there will be an imperative need for revenue which will require that oil production be increased during these phases.
- The likely option is a combination of contracts with service companies and short-term Iranian-type contracts with quick but limited paybacks for foreign companies. There may be sufficient takers of contracts on these terms to achieve production levels up to around 4 million barrels a day, with the development of one or two new fields of intermediate size or the phased development of large fields.
- The major investments necessary to achieve a production of 6 million barrels a day will have to wait for the emergence of an truly independent Iraq willing to engage major international oil companies on terms with credible stability. Without this (or in the meantime), we may see a slow piecemeal progress orchestrated by the INOC and companies willing to accept short-term, limited projects in the hope of better deals in future.

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