

Iraqi Oil, Today and Tomorrow

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Now that the United States can be characterized no longer as a liberating force but instead an occupying force, how can the Iraqi oil industry be characterized? The following summarizes where matters currently stand.

The southern and northern oil fields are in the good hands of the coalition forces. Both major oil fields, north and south, made it through the fighting with limited damage. Iraqi forces had set afire 7 wells in the south, just one in the north, far less than had been anticipated. Damage to other oil-related infrastructure, such as pipelines, refineries, and storage tanks also appear minimal. In sum, the coalition strategy to seize and isolate the oil fields in the very stages of the conflict, to protect the infrastructure and prevent the Iraqi military from repeating what had happened to the Kuwaiti oil fields, proved very successful.

Unfortunately, destruction from continued looting has not been contained. Facilities have been damaged or stolen and oil field documentation destroyed. Much of the supporting systems are gone. Equipment and machinery has been lost. Importantly, employees are finding it difficult to get to their former place of work, either gasoline is not available or the means of transportation have been stolen.

Communications remain difficult. In many instances, a return to normal will reflect the availability of electricity—not just to run the oil pumps and pipelines, but as a way of reassuring the population of a return to normal activities.

Shortly after the intervention, all oil wells were shut in. The Southwestern Division of the Army Corps of Engineers took on that responsibility, as well as responsibility for closing the oil and gas separation plants and pipelines. Wellheads were found to be in reasonably good shape, but other infrastructure requires attention. The task of the Corps is to return the oil sector to its pre-crisis position, ready to produce and to export.

Limited production has now begun at both the northern and southern fields, with the crude to be refined for the domestic market. Petroleum products continue in short supply and the distribution system is not yet fully operational. LPG—liquefied petroleum gas—is a major source of fuel for cooking and heating. LPG in turn is based on natural gas produced in association with crude oil, but because only minimal volumes of oil are being produced, shortages of LPG appear around the country.

It is very obvious that much rehabilitation must be undertaken to reverse the effect on the oil sector of three wars and years of sanctions. For example, the Basra representative of the Iraqi Oil Ministry has estimated that just 25 percent to 30 percent of the Rumaila oil field is in good condition. Any industry, neglected and underfunded for more than 20 years, bearing the impact of three wars and 12 years of UN sanctions, would suffer greatly, and the oil sector is no exception.

Clearly, those Iraqis who have been working in the oil fields for the past years are asking that the United States recognize their expertise and authority. After all, they argue, we know the oilfields better by far than the Americans and are ready to work. At the same time, locals are not apt to offer a particularly warm welcome to those Iraqis who have been in exile the past years and who seek to return, hopefully to senior positions. Where have you been, while we have been suffering, they would ask.

UN “Oil-for-Food” Program

Resolution 986 of the United Nations Security Council, passed in 1995, authorized the export of Iraqi oil, with the revenues earned to be spent to meet the humanitarian needs of the Iraqi people. This approach became known as the “Oil-for-Food” program.

According to the CSIS report *A Wiser Peace: An Action Strategy for a Post-Conflict Iraq, Supplement II: An overview of the Oil-for-Food Program*, dated February 14, 2003, since the program began in December 1996 Iraq has exported 3.3 billion barrels of oil valued at \$62 billion. The report notes that over a quarter of the oil revenue pays for compensation costs associated with the Gulf War, UN administrative costs, and the cost of UN weapons inspectors. Of the funds provided to Iraq out of the UN escrow account, only 25 percent have been allocated to purchasing food. The remaining 75 percent were allocated across 23 different sectors and involved at least 13 Iraqi government ministries.

The report also notes that the Sanctions Committee had approved \$42 billion in humanitarian supply contracts, including \$3.6 billion in oil industry spare parts. Of these goods, \$26 billion had been delivered and a further \$10.8 billion were in the production and delivery pipeline.

Again referencing the CSIS report, from the beginning of the program until mid-2000, Iraq awarded contracts to potentially sympathetic permanent members of the UN Security Council, primarily France, Russia, and China. In 2000, Iraq began to focus on strengthening ties with its neighbors. As public opinion against sanctions grew and oil revenue increased, Iraq increasingly favored Egypt, the United Arab Emirates and Jordan for supply contracts. Because Iraq primarily awards contracts based on politics rather than the quality of the goods, the Iraqi people have often received inferior goods, including medicines.

The UN “Oil for Food” program was shut down upon military intervention by coalition forces but then resumed under the supervision of the UN Secretary-General, spending funds already accumulated. Food and other aid are being provided by funds earned from earlier oil sales but deliveries have been discouragingly slow, largely because of bureaucratic entanglements.

The program is scheduled to end on June 3, but a resolution just introduced by the United States, and supported by Great Britain and Spain, proposes instead that the program be phased out over a period of four months.

The coalition had spoken of establishing an Interim Iraqi Authority, but Iraqi delegates have chosen to term a new governing body as a “transitional government,” reflecting their desire to move more quickly than an interim authority might imply.

The referenced resolution gives the occupying powers (that is, the United States and Britain) the power to sell Iraqi oil, with the income to be placed in an administered trust, with appropriate oversight.

It appears that an advisory committee is to be set up, to be headed by Philip Carroll, formerly of Shell Oil. This advisory committee, where Iraqis are to hold at least a plurality, will relate to the Iraqi Oil Ministry in much the same way as a board of directors functions in a corporate structure. The senior person in the Ministry would report in turn to the advisory committee.

But in all this, the United States must take great care in conducting itself in a way that does not allow critics of the war to be able to say, “See, I told you so, it really was all about oil.”

Rebuilding the Oil Sector. What Will It Take?

Until experts have had the opportunity to closely inspect the oil refineries, the pipelines, the oil and gas separation plants, storage farms, ports of export, the general product distribution network, and the oil fields themselves, including a well-by-well approach, only guesses can be made as to what it will take, in terms of time and money, to restore the Iraqi oil sector to a normal state.

Saybolt International, a Dutch firm, has visited Iraq on two occasions—March 1998 and January 2000—at the request of the United Nations, to evaluate the health of the Iraqi oil sector. Their findings, in both instances, underscored the sector’s lamentable state. Observations from the report of the January 2000 visit noted a continuing deterioration.

The group has to report that the previously noted lamentable state of the Iraqi oil industry has not improved. It is apparent that the decline in the condition of all sectors... continues, and is accelerating in some cases. This trend will continue, and the ability...to sustain the current reduced production levels will be seriously compromised, until effective action is taken to reverse the situation.

Past shortages of spare parts, a need to maximize income that led to overproduction of the major fields, the absence of modern technology, closing then opening oil wells damages the producing reservoir, and water encroachment define an oil producing sector whose prospects of any early return to a leading role in the world oil market are measurably dim. On average it appears that the oil producing capacity of Iraq has been declining by 100,000 b/d annually. That decline first has to be halted then reversed if growth is to be resumed.

But what defines a “normal state” of the Iraqi oil sector? Was 1979 the last normal year

for the industry, just preceding the war with Iran, when production hit its all-time peak of 3.5 million b/d? Or was it 1990, when crude oil output, having fallen because of the war with Iran to barely one million b/d, had by then returned to 3 million b/d, only to decline sharply once again following the Iraqi invasion of Kuwait?

The initial effort will be focused on raising oil production to 3.2 to 3.5 million b/d and that may require 1.5 to 2 years and an expenditure of at least \$5 billion if not more. Then, attention can be directed on plans for further expansion, to a stated 6 million b/d. To accomplish that may require \$35 to \$40 billion, and at least 5 to 6 years, if not longer, reflecting what detailed assessments of the individual segments of the oil industry find.

Who Owns the Oil? Who Can Sell It?

How soon might exports resume? Based on present field conditions, exports might resume within several months, possibly a bit sooner from the north, if not further delayed because of the damage inflicted by looters.

But then, other considerations arise. Who owns the oil, who has title to it? Who would buy the oil, absent, say, UN approval? No oil tanker owner could be expected to load up, absent a title guarantee.

Can Iraqi oil be sold if the UN sanctions remain in place? Under the UN “Oil for Food” program, it was the United Nations that gave legal title to the oil. UN sanctions prohibit oil exports except under this program. But, as noted, the “Oil for Food “ program comes to an end on June 3.

The referenced U.S. resolution addresses this question by
The UN has stated that no Iraqi oil can be exported unless there is a new authority in Iraq to serve as the legal agent for the oil, and until the UN Security Council recognizes that new authority. Presuming a recognized interim authority is established and oil exports resume, but then, what happens to the oil revenue? How can its distribution be monitored?

As noted, production of crude oil has been resumed on a limited basis, with the crude delivered to refineries to produce fuels needed by the local economy. Are the refineries paying for the crude oil they receive? If so, at what price, and what happens to that income? Where does it go? Most probably the United States believes it controls the industry and thus the revenues and will continue to do so until an interim authority is in place. Once that happens, the funds could be placed in trust with the Iraqi Central Bank, and a designated international financial institution could monitor distribution of these funds. But, does monitoring also provide an input into how the funds are spent?

What About the Geneva Convention?

A number of interested observers make the interpretation that, under the Geneva Convention, the occupying power has the right to sell the oil and to use the income for

the restoration of order and the benefit of the Iraqi people. Not all would agree. Nonetheless, is the United States today an occupying power, having shifted from that of a liberating power? Apparently so, and that means the Geneva Convention can apply.

I

Suzanne Nossel, a former senior advisor to U.N. Ambassador Richard C. Holbrooke, writing in the May-June 2003 issue of *Legal Affairs*, asks the question: can the law of occupation, long disputed and then largely disregarded, be useful in Iraq? She then answers by noting that the law of occupation could provide cover for more controversial maneuvers. Taking over the oil fields, rebuilding them, and even upping production could be justified if the proceeds were used to accomplish the United States' purported aim, that is, channeling the reserves to meet the people's needs. In her judgment, as long as the Administration sticks to using the oil to foster reconstruction—and scrupulously avoids favoring American oil interests above those of others—taking control would be justified and even expected.

She concludes by stating that if in administering the oil fields the United States were found to favor American oil companies over existing concessions belonging to France or Russia, for example, the American action would be judged an unwarranted departure from the status quo, invalid under the Geneva conventions.

II

An analysis provided by IHL Research Initiative (under the Harvard Program on Humanitarian Policy and Conflict Research) underscored that the law of occupation is perhaps one of the oldest and today the most developed branch of international humanitarian law (IHL). The law of occupation applies whenever, during an armed conflict, a territory and its population comes under control of the enemy of the State authorities previously controlling that territory. In the case of Iraq, obligations of the occupying power, among other things, extend to the administration of the Iraqi resources for the benefit of its people.

The analysis concludes with the following:

“If Iraqi oil wells were government-owned, the U.S. may administer them and sell the oil. According to some opinions, it may use the proceeds not only for the benefits of the local population, but also, similar to levies, to cover the cost of the occupation (but not of the whole war).”

Importantly, the analysis underscores that occupation ends whenever one of the conditions of occupation is no longer met. That is, when an agreement has been signed between the parties at conflict bringing to an end the armed conflict. Or, foreign military forces have withdrawn from enemy territory or are no longer exerting control over the population of that territory.

III

Prof. Mary Ellen O'Connell, Moritz School of Law, Ohio State University, offering her opinion as a guest columnist in the *Jurist* (a publication of the University of Pittsburgh School of Law), writes that "occupants are required to manage resources under the law of usufruct. HR, art. 55. That law calls for managing resources so as to prevent waste. If profits accrued from such management, they may be used to pay for the occupying power's costs for local administration. An occupying power may not enrich itself from the occupied territory's resources. With particular relevance to Iraq, the United States has taken the position in the past that an occupant may not award new oil development concessions."

IV

R. Dobie Langenkamp, professor of law and director of the National Energy-Environment Law & Policy Institute at the University of Tulsa, in an interview with *The Oil and Gas Journal* (February 3, 2003), offered the following observation.

'Under international laws governing warfare going back to the Hague Convention of 1907 and the Geneva Conventions of 1929 and 1946, the U.S. and its allies would have the right to produce Iraq's existing oil and gas wells and to use the proceeds to pay the costs of occupation but not the costs of the war itself.'

Professor Langenkamp added that:

- Prolonged use of troops or foreign contractors to replace Iraqi workers is forbidden by international law;
- The law prohibits unnecessary damage to Iraq's wells, which means they can't be produced so rapidly or carelessly as to damage formations;
- The properties must be returned to the proper government authority in reasonable condition;
- Iraq's current production likely can be increased through workovers and by drilling existing wells deeper or through extensions to new formations. (The U.S. Department of State is on record as claiming that drilling new wells in a military-occupied territory is unlawful.)

Contract Status

Accepting the role of an occupying power raises an associated question. What is the status of those oil contracts that have been signed with Russia and with China? Will they be honored? Under international law, it would seem that these rights should be protected, in that contract sanctity is maintained in the event of a change in government.

Russia has been very vocal in its effort to preserve the contract it has signed with Iraq to develop the West Qurna oil field. At its peak this field should be able to produce 600,000 to 700,000 b/d, a prize that will not be given up quietly. China, conversely, has been quiet and has not yet taken a position publicly. But the field it would develop is comparatively small, with a potential on the order of 60,000 b/d.

Several options are available. The interim Iraqi government could just review the contract terms, to determine whether these terms were acceptable, that they met the interests of the Iraqi people. Now, given the course of events in Iraq, the Iraqi authority might not be so charitable, and might be prepared to tear up all contracts, based on the fact they were concluded with a regime that in no sense represented the Iraqi people.

There most likely will be no contracts let to foreign oil companies during the coming transition period. Simply because the investor runs the risk that a contract signed during that period might be rejected by whatever form of government is put in place at the end of the transition period.

What Happens to the Oil Revenues?

What happens to the revenue when oil exports resume? How to safeguard that revenue? Who will determine how these revenues are spent? Will the “Oil for Food” program, slightly tweaked to reflect changing circumstances, still be in play, or might some kind of substitute take its place? After all, it is Iraqi oil, owned by the Iraqi people. Shouldn’t they have the final say in all this?

Can a means be devised whereby citizens of Iraq will be able to share immediately in the oil wealth of the country? A cash dividend perhaps, especially helpful to the economy at this time of stress, but also giving the population a stake in the future of the oil sector, an interest in seeing that it prospers, for, if it does, then they will too.

Most oil exporting nations, despite good intentions, end up catching the dreaded “Dutch disease.” That is, the economy becomes overly dependent on the sale of a single commodity—oil. When oil prices are high, the economy flourishes and there is little or no effort to diversify away from oil. But at some point oil prices will decline and when that occurs, the failure to diversify becomes apparent as financial stresses emerge, often followed by civil unrest.

How to avoid such circumstances?

A variety of approaches are available for consideration. One attractive approach would be the creation of a stabilization fund. Designated oil-related income would be allocated to a stabilization fund when the world oil price exceeded, say, \$20 per barrel. If the per barrel price declined below \$20, then funds would be withdrawn in amounts to offset losses to the national budget. Dividends deriving from investments made by the fund would then be passed on to individual Iraqis, comparable to corporate dividends payable to shareholders.

The Department of State appears to favor an oil revenue sharing arrangement similar to that adopted by Alaska. Stated simply, a portion of the state's oil royalty revenue is placed into a permanent fund, and dividends from this account are paid out annually.

Transparency and adequate public oversight are essential for whatever arrangement might be chosen. Would a "new" Iraqi government be comfortable and accepting of the needed transparency and oversight?

Privatization

There really is no hope of rebuilding Iraq if foreign capital is not forthcoming. Thus, a key objective is to secure the large, rapid inflow of investment in all sectors. Reality, in turn, requires privatization.

If the indicated production goal of 6 million b/d is to be attained as quickly as possible, the requirement for new investment—estimated to fall between \$35 to \$40 billion—will far exceed the capabilities of the oil sector itself. Where might the investment be found? In the pocketbooks of foreign oil companies. But that means privatization, and a move to privatize might run counter to the nationalistic feelings of the Iraqi people. Thus, if privatization is deemed necessary for the future of the oil sector, then the matter will have to be handled very carefully.

Looking Ahead

There are two objectives regarding the future of Iraqi oil. First, to return production to a level between 3.2 to 3.5 million b/d. To do so may require 1.5 to 2 years and an expenditure of between \$5 to \$7 billion, depending in part on what an assessment of the operating fields at Rumaila and Kirkuk finds. It is generally thought that these fields may not be in the best of shape, with little investment over the years and facing a continuing lack of spare parts, plus probably having been over-produced, with water encroachment now limiting recovery levels.

There is a particular concern regarding the Kirkuk field, where the quality of the crude oil has been somewhat degraded, as surplus fuel oil has been re-injected into the producing horizons.

If production can be raised to 3.5 million b/d, that would match the level of the last normal year for the industry, reached in 1979. Since then, three wars and some 12 years of sanctions have gotten in the way.

Then, to embark on an effort to expand production to not less than 6 million b/d. Proven reserves clearly would more than support this higher level. But, will the market? At the moment, production sharing agreements seem to be the acceptable approach to securing foreign investment. But, given the attraction of Iraqi oil—good quality, low production costs, easy access to ports of export—and with this attraction known to both sides, the

terms offered by Iraq likely will be pretty tough.

Circumstances would seem to dictate that Iraqi oil production might reach 4 to 4.5 million b/d by the end of this decade, clearly not the flood that some have speculated.

OPEC: Stay or Leave?

Iraq was a founding member of OPEC. Indeed, the organizational meeting was held in Baghdad. The question now asked is: Does Iraq keep its membership in OPEC, or does it leave?

For the interim, Iraq will keep its membership, as nothing would be gained by leaving. But it is quite possible that in the future, when continued membership might be perceived as constraining plans for growth in production and exports, then departure might be addressed. When might that come about? Perhaps not this decade, but national interests will be the ultimate decision-maker.

How Far Will \$20 Billion Go?

When Iraq returns to its prewar level of production and exports, and assuming a price per barrel of \$25, how much might the country earn from these exports? About \$20 billion. Of that, a portion, possibly 20 percent, will have to be returned to the oil sector to cover costs of production, pipeline transport to a port of export, and storage at the port, leaving, say, \$15 billion. That sum falls far short of covering rebuilding not just the oil sector, but the entire infrastructure of the country—roads, hospitals, schools, housing, and the like.

Moreover, how to address the debt that Iraq has accumulated, a debt exceeding some \$320 billion (\$199 billion in Gulf War compensation claims and a foreign debt of \$127 billion)? Clearly, to the “new” Iraqis, taking on these obligations will be regarded as unacceptable, and requests for cancellation and rescheduling likely will come forward early on.