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Iraqi Oilfield Development Contracts: Implications

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Summary

Baghdad's award of several oil field development contracts augers well for Iraq's economic future. But there are substantial security, technical and constitutional challenges to be met, to say nothing of the problem that is likely to confront OPEC.

Analysis

An increase in crude oil production is vital to Iraq's development. Currently receiving some \$US60 billion a year in oil revenues, this is not sufficient to rebuild a country still recovering from the Iran-Iraq war of the 1980s and decades of economic neglect under Saddam Hussein, to say nothing of the two Gulf wars, UN sanctions and more recent sectarian and other forms of violence. The government must also continue to maintain law and order with a military force of some 275,000 and an equally numerically impressive police force.

In December 2009, the Iraqi government offered 10 oil field development contracts to 11 foreign oil firms in its second oil auction. Seven eventually were awarded. The result, according to Iraq's Oil Minister, Hussain al-Shahristani, would be to increase oil production from the present 2.5 million barrels per day to some 4.7 million barrels per day within 10 years.

If this level of production is added to the pledges made by companies who won earlier contracts, then the figure could rise to 12 million barrels per day and could overtake Russia and challenge Saudi Arabia for the position of the world's largest oil producer.

But these production figures need to be reviewed with some caution. There are numerous security, technical and constitutional challenges to be faced. Nor is the Organisation of Petroleum Exporting Countries likely to accept such an increase without considerable opposition.

Security risks remain high. In early December 2009, over 120 people were killed in Baghdad in a series of bomb blasts. Even the Oil Minister admitted that these actions were designed to send a message to oil companies that Iraq is "unstable and investment will be overshadowed by risks." Oil pipelines are frequently disrupted and many of the fields are located in areas that are not necessarily under complete government control.

The Shiite dominated government has prevented Sunnis from fully entering the political and security process, causing the Sunni faction to be wary of giving up its insurgent card. Indeed, industry analysts suggest that security concerns were the reasons why there was a lack of bids on three of the contracts.

A further security issue may have been highlighted in the purported recent temporary occupation of an oilfield by Iranian forces for several hours along a disputed section of the Iraq-Iran border. Although not proven, some analysts

claim this may have been the result of Iran attempting to divert attention from its own internal problems and that further clashes could occur.

A further concern is that of Iraq's uncertain political future. Parliamentary elections are now scheduled for March 2010. Factional differences are likely to worsen and there is no certainty that a functional government will emerge. There is also the possibility that a new government might attempt to renegotiate the contracts or even invalidate them.

Even before the election, in a reminder of the political problems confronting Iraq, a politician has filed a petition, claiming that the cabinet signing of a government deal with BP and China National Petroleum is illegal without parliamentary approval.

Of greater concern, however, is that the government is yet to pass a hydrocarbons law. This aims to establish a legal framework for exploration and development by foreign companies. Regional disagreements and differences between sectarian groups have caused the delay. There are also concerns that a new government, in crafting such a law, might raise objections to the current contracts.

Another issue relates to the Kurdish provinces, which have established their own processes and have generally been shielded from much of the internal conflict in Iraq. The Kurdish Regional Government (KRG), for instance, is at odds with the central government over energy contracts it has made with foreign firms to whom it has offered more lucrative arrangements.

Baghdad's response has been to threaten to blacklist such firms. In turn, the KRG halted oil exports from the fields it controls and deprived Baghdad of revenues it might have accrued from some 100,000 barrels per day.

Kirkuk also remains a potentially destabilising issue. This highly contested multi-ethnic state contains vast oil reserves. Under Saddam Hussein, thousands of Kurds were replaced by Shiite Arabs in an attempt to separate Kirkuk from the Kurdish region. Since the end of the Second Gulf War, however, many Kurds have returned.

Iraq is required to hold a referendum to determine whether Kirkuk joins the Kurdish region or not. This process has been delayed twice and there are fears that a referendum may further inflame Kurdish-Iraqi tensions.

There is also a niggling sense that the untapped fields offered in this round of negotiations may be more "technically challenging." Certainly, Iraq has 115 billion barrels of proven reserves and an estimated 45 to 100 billion additional barrels from largely unexplored territory. Its oil is also generally perceived to be of high quality and easily extractable.

But the fact remains that, although ranked fourth in world terms of total oil reserves, it has not been able to develop the necessary infrastructure to exploit this potential. Some fields, of course, may have been irreparably damaged as a result of overproduction and poor management.

Some observers have also pointed out that apart from Exxon Mobil, Iraq has tended to deal with national oil companies. Such companies may be influenced more by future political outcomes and state interests than purely by profit.

Finally, there is the issue of OPEC.

Iraq was one of OPEC's founding members. It was exempted from output targets in the 1990s while under international sanctions. But all this will change if Iraq is able to quadruple its output. OPEC will have little recourse but to take steps to encourage Baghdad to realign its supply policies with those of other members if the market is not to be flooded, and consumers are to continue paying what is deemed to be a reasonable price which in today's terms is considered to be \$US 75 per barrel.

Of course, Iraq may comply. But if it does not, there is little OPEC can do about it and other OPEC members may be encouraged to act in a similar manner, thus further undermining its control over market prices.

Much of this is speculative. But the issues above will bear watching as Iraq moves into uncharted waters in terms of its oil field development. Certainly Baghdad could be a winner but there are several factors that will need to play out before this can be assured.