Iraq's Oil History: Prospects & Limitations

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Iraq: the nation

Iraq's make-up is a mosaic of tribes, ethnicities and religious sects. It is a nation of people whose reactions to events reflect, consciously or unconsciously, its instinctive culture, pride and historical sense of survival.

Iraq is a God-gifted country, with an unmatched wealth of culture, oil, water and soil. Iraq's history goes back 12,000 years. It is the cradle of civilization, known as Mesopotamia, and derives its name from its two rivers, the Euphrates and Tigris, along which one of the richest oil and gas resources are deposited. It is the land of the Sumerians, Babylonians and Assyrians, and where many of the profits were born or buried. It is the land where Islam and Christianity prospered. It is the land from where the Islamic Abbasid Empire extended for centuries.

Iraq's oil: the jewel in a global context

Iraq may prove to have one of the greatest endowed petroleum resource base in the world, with potential oil reserves in excess of 215bn barrels and ultimate proven reserves in the region of 150bn barrels. Moreover, its findings and development costs are low, amongst the lowest in the Middle East. However, its historical maximum production rate in any one year has not exceeded 3.5mn b/d.

Country or Region	Production Bb	Production % Total	Proven + 15% & Potential	Resources Oil Base Total
UAE	24	15.1	135	159 (55.5 Bb from Peak)
Kuwait	35.8	20.3	140	176 (55.2 Bb from Peak)
Iran	58.3	23.5	190	248 (65.7Bb from Peak)
Iraq	30.5	8	380*	410 (174Bb from Peak)
Saudi Arabia	106.4	22.6	365	471 (129 Bb from Peak)
MEM	255	17.4	1209	1464 (477 bb from Peak)
World	1016	34.1	1964	2980 (474 Bb from Peak)
World Excluding MEM	761	50.2	754	1515 (-3.5 Bb from Peak)

Iraq post-March 2003, inherited a production capacity of 2.8 mbpd and a reserve base estimated at some 410 Billion barrels (Bb), remaining reserves of some 380 Bb, and a potential contribution to the global energy market of some 174 Bb, before its peak sets in. Its proven reserves amount to 115+ Bb, capable of producing 10 mbpd and beyond to 12+mbpd, when fed with additional new reserves at an annual rate of some 3 Bb from its huge potential reserves. However, Iraq has been since undergoing difficult economic and geopolitical circumstances, which include failed-state conditions and power struggles, especially from the Kurdistan

Regional Government (KRG), who legislated their own petroleum law and constitution, and pursue a grant of exploration and development rights independently from central government's oil plans and policies.

If oil and politics are closely intertwined, this is certainly exemplified by the era of Middle East concession acquisition exploration and development, and more so in Iraq than anywhere else. The concession agreements were negotiated between the powers of the day, and enforced on the embryonic governments of the time. Production plans and policies were based on the consuming powers' needs, with little consideration given to the concessionaires.

The concession era in Iraq is characterized by: the slow-go approach of the Iraq Petroleum Company (IPC) & Associated Companies and the Major oil companies' abilities to shift their activities where it best served their interests and to strengthen their negotiating powers, thus sitting on discovered and potential reserves way beyond market production requirements and developing production capacity to meet the oligopolistic Majors' downstream needs.

Iraq's politically motivated decision-making and confrontational oil policy following the July 1958 overthrow of the Monarchy, during the Ba'ath Party take-over post 1968, during the Nationalized Era and years of sanctions and unnecessary and destructive wars, has proven to be a serious impediment to the development of Iraq's oil industry, to catch up with its real production potential. However, the 1970s decade following nationalization, achieved a historical maximum production rate of 3.5 mbpd and reserve additions at a world record of 6+ billion per year.

Today, Iraq's production rate is around 3 mbpd, as part of a plan to build 12 to 13.5 mbpd from 11 service contracts, whose reserves are some 83 Bb with IOCs in 7 years from 2009, though as highlighted there are serious challenges to overcome.

<u>The concessions</u>

The IPC and its associated companies, MPC and BPC, were the concession holders who managed Iraq's oil industry until their nationalization in 1972 to 1975, when the government took over ownership and management. The history of the creation of the IPC and its associated companies and the acquisition of their concessions through power politics before and after the First World War is a fascinating but sad episode in Iraq's history.

Following the First World War, the British occupied and controlled most of the Middle East. They took over Germany's 25% share in the Turkish Petroleum Company (TPC), whose 'concession' was granted in the form of a letter issued by a senior Ottoman Minister in June 1914, to cover only the Mosul and Baghdad provinces, which remained unauthorised with the collapse of the Ottoman Empire in the World War I. The French share was negotiated after the war, in December 1918, prior to the peace conference, when the Mosul province was removed from the French sphere and placed under British control in return for the German interest in TPC, and was authorized at the San Remo Conference of April 1920.

The same conference stipulated the allocation of a 20% share to Iraq, but this was worded in such a way as to make its application impossible, creating a long-standing but unrealized right. This became one of the two thorny issues brought up by Iraq during the negotiations of 1958 to 1961 and 1964 to 1965 (the second was relinquishment of undeveloped areas).

In supporting Iraq's right to retain within its borders the Mosul district against the Turkish claim at the League of Nations, Britain succeeded, in March 1925, in convincing the Iraqi government to endorse the Concession Agreement, which had been negotiated between the Allied governments outside of Iraq and against Iraqi popular opposition. Gulbenkian, who was instrumental in these negotiations from the beginning, managed to retain 5% in contribution from Shell and CFP in equal shares.

The American companies, supported by their government, objected to their exclusion on the grounds of the 'open door' policy and managed, in July 1928, to acquire 23.75% from the Anglo-Persian Oil Company (later to become BP), whose share was originally set at 50%. In exchange for this, the Americans had to relinquish any future interests in the ex-Turkish Empire territories independently of the others. This agreement was formalized in October 1927 in the 'Red Line Agreement' with respect to virtually all the Arabian Peninsula.

The new Iraqi company thus allocated equal shares of 23.75% to BP, Shell, CFP and Esso/Mobil, leaving 5% to Gulbenkian Partex, and was accordingly re-named the IPC.

The IPC did not extend its area until March 1931, when it revised its concession to cover all the area east of the Tigris River. In the same year, the area above the 33rd line of latitude and west of the Tigris was granted to the IPC affiliate, MPC, for 75 years. The remaining area to the south was granted to another IPC affiliate, BPC, in 1938, also for a period of 75 years.

The concessions of 1931 and 1938 covered almost all of Iraq and eliminated the relinquishment terms and work obligations that were present in the original TPC agreement. The absence of relinquishment terms was the second major thorny issue in negotiations, which began in 1958, before and after the end of the Royalist regime, and terminated in 1961 with the issue of 'Law 80' enforcing the relinquishment of 99.5% of the areas.

Production growth

Iraq is endowed with large enough oil and gas resources to be on par with Saudi Arabia. However, neither its past nor present developed production capacity has been commensurate with the wealth of its reserves. Iraq's truncated production history is a witness to its geopolitical history, and illustrates how oil and politics are intertwined.

In 1928, Iraq's oil production began at 2,800 bpd with the major discovery of the supergiant Kirkuk oil field in 1927. Export in commercial quantities had to await the completion of pipelines and terminal installations to the Mediterranean in 1934.

By 1935, production reached a level of 78,010 bpd, which amounted to half the production level of Iran, which began to export in 1913 and was Iraq's only rival at the time.

By 1938, crude oil production commenced in Saudi Arabia, which overtook Iraq by 1946 at a rate of 164,200 bpd, while Iraq was producing at a rate of 101,800 bpd.

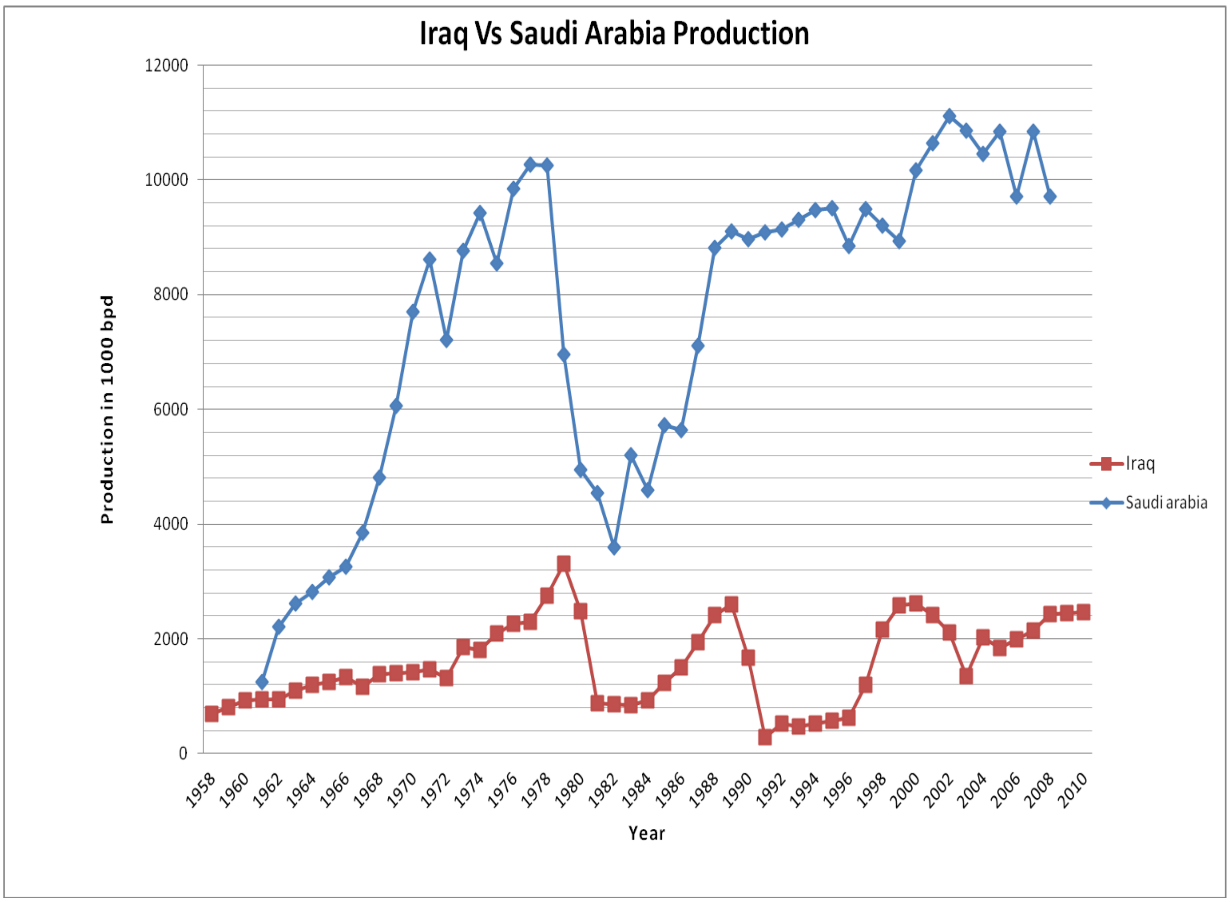
The relative shares of the four leading producers, Iraq, Iran Saudi Arabia and Kuwait clearly illustrates two factors, the race for market shares mainly between BP and the American consortium, Aramco, and the ability of the major companies to switch supplies as and when required.

Throughout the 1940s, Iran's leader position gave way to Saudi Arabia. Iraq's share, however, reversed its decline, assuming a 22% share in 1955, but only as a result of Iran's production stoppage during the nationalisation crisis of 1950 to 1954. Kuwait's share (50% BP) also increased to a record high of 35.5% in 1955.

Iraq's production, which maintained its share reasonably well until 1960 (when it reached 19%), began its decline as a result of the majors switching away from Iraq (which was a crisis area as a result of the forced relinquishment of Law 80), to supply areas where they had larger interests, thus giving way to Iran (40% BP share) and Saudi Arabia (Aramco partners).

Iraq's production was 1 mbpd when Saudi Arabia's was 1.5 mbpd in 1961. Iraq's production doubled to 2 mbpd when Saudi Arabia's climbed to 8.5 mbpd, and when Iraq reached its historical maximum of 3.5 mbpd, Saudi Arabia produced 10 mbpd.

Figure 1. Iraq Truncated Production Build-Up



The lack of incentive for investment by the IPC in Iraq, which, in the meantime, had maintained financial pressure on the government, continued until its nationalisation in 1972 to 1975. Thus, Iraq lost out on the fast growth years during the boom for the late 60s and 70s. It had barely doubled its production during the period 1960 to 1974, whilst Saudi Arabia had grown six and a half times and Iran five and two-third times the rate of Iraq. Kuwait's declining share was entirely due to the conservation policy adopted by the government.

The clear competition amongst the majors was not, it seems, taken advantage of by Iraq, particularly since Shell, CFP and Mobil were crude deficient and had to buy from the crude surplus companies BP and Esso at a higher cost than the tax-paid price.
The conclusions are clearly that:

- Any confrontation, instability or crisis condition in Iraq promoted investment in Iran and Kuwait (being the areas of larger interest and greater control for BP), in Saudi Arabia (being the area of greater interest to Esso, but to a much lesser degree to Mobil) and in Abu Dhabi (being another IPC area and the only other refuge for Shell and CFP). Such is the nature of the market and will remain so.

- No member of a consortium should have incompatible interests with the other members or with the host country's vital oil industry objectives, which could curtail the consortium's exploration and development obligations.

However, most of the disadvantageous features of the concession era were improved during the 1950s, 1960s and 1970s, under changing circumstances and collective bargaining by the host countries through OPEC, but these improvements often were either too little or too late.

By the late 1960s and early 1970s, nationalization through gradual share acquisition by the other members of OPEC was achieved through negotiation and not legislation as a result of collective bargaining under the OPEC umbrella, with the exception of Iraq, which was negotiating outside OPEC.

The draft settlement agreement of 1964 to 1965 over relinquishment and a host of other issues, but minor ones, was concluded and agreed formally between the negotiating teams, but did not see the light of day. The settlement would have formed a new joint stock company between the IPC parents (with the exception of Esso, which saw the agreement as an unacceptable compromise), BP, Shell, CFP and Mobil, having each16.67% of the shares, and 33.67% left to INOC, with a 'sole risk' clause to resolve possible differences over operating and investment plans. The Joint Venture area of operation was limited to 8% of the country, which left 91% relinquished to Government control. Half a per cent was allocated to the IPC, thus retaining only 1% area containing the producing fields already developed and were producing, conditional on the recognition of Law 80.

This agreement would have set a precedent in 1965 for the Majors entering for the first time into participation with the host countries and accepting relinquishment principles, which would have had to be offered to other Middle East host countries in accordance with the 'nations most favoured' clause. However, the politicians chose otherwise and the authoritative Revolutionary Council rejected the proposed agreement at a time when the government of the day had already lost its zeal in an era where socialism was the fashion.

Politics, once again, dictated over commercial and economic wisdom. And, Iraq paid a high cost for it in terms of income from the improved terms given to the OPEC countries except Iraq and the loss of huge market, best taken advantage by Saudi Arabia; see the production graph.

Iraq's failure to reach a negotiated agreement was due to its acting alone (outside of OPEC) and adopting confrontational demands, which led to unilateral legislative action to enforce relinquishment of 99.5% of the concession area through Law No. 80 in 1961. Law 20 followed in 1970, which made it illegal to give up an additional 0.5 % of producing acreage to the

Companies (permitted originally in Law 80), and closed the door against any possible negotiated settlement, and which left Iraq's oil industry frozen.

Middle East concessionary agreements did not live out their term, since from the start they were not balanced, and some clauses (Iraq's 20% participation for example) were written in bad faith so as to make their application impossible. The agreements were passed under duress just after the First World War, when the national governments of the day were being established or were in the process of gaining their full sovereignty.

The Companies in their general pursuit in the Middle East took corrective measures but these often were too little or too late which lead to the inevitable end of their concessions.

The concession major oil companies were technically and economically superior and had little, if any, communications with local governments and people. They formed economic and technical enclaves devoid of to-day's vital Local Content or tangible return to the nation. With the emancipation of the nations and OPEC's role, decision-making to set posted prices transferred to the governments, and tax and royalty increased to a point where nationalisation through partial or total share transfer brought to an end the concession era, through negotiation, Iraq though was the exception.

The oil concession agreements in the Middle East were the product of the First World War. The return of the oil companies to Iraq appears to be the product of the Gulf Wars, the sanctions and the politically motivated move by the Bath inviting the IOCs and the dilapidated or destroyed Iraq's infrastructure, institutions and human resources. Can agreements in Iraq under such circumstances be balanced? Will they endure the test of time under changed circumstances?

The lessons are clear:

- Agreements should be written and applied in good faith.
- Long term contracts without review may struggle against the dynamic changing world.
- The oil industry should conform to a business model in which decisions governing its fate should be primarily based on business criteria not political criteria. The sooner this principle is accepted in Iraq and the industry is planned accordingly, the healthier and more efficient the oil industry is likely to become.
- For an agreement to endure the test of time, it must be negotiated and played as a fair positive-sum game where there are no winners and losers. Can companies and governments of the post-March 2003 era rise to the occasion by refusing the temptation to play a zero-sum game?

The new era post-March 2003

Iraq has held three bidding rounds and the fourth is in hand. The first two, in June andDecember 2009, saw 11 long-term oil development service contracts awarded to the world's largest oil companies, including ExxonMobil, Royal Dutch Shell, BP and CNPC which commits to increasing Iraq's oil production capacity from around 2 million barrels per day (bpd) to more than 13.5 million bpd in seven years.

A third bidding round, held in October 2010, awarded three gas fields development contracts. The fourth is being awarded in which companies will compete for 12 oil and gas (mostly gas) exploration and development service contracts. The decision making process though resembled the PSA's, and more so in the latter fourth round than in the former three rounds.

It stands to reason that where the service contractor is the investor the ultimate decision can only be jointly made, and the PSA caters for such a joint decision-making. It suggests the title is more of a form than real.

The above long-term service contracts were the result of a failure or a radical change of plans and policy to negotiate Technical Support Contract (TSC) of short duration, applicable to the further development of the major super giant oil fields long in production.

The serious impediments of the concessionary era provide historical lessons to consider. Old timers of the oil industry have learned from the lessons of the concessionary period of becoming isolated economic enclaves. Local Content of this era not only assist in the transfer of technology but also assists in the creation and promotion of national enterprise, carries out locally many tasks saving cost and it integrates IOCs with the community. Local Content of the day commits up to 70% in local content obligations to national enterprise.

Iraq has a history of three and a half decades of state-owned national oil and gas development, as most of the other major oil producing countries in the Middle East. The concept of privatization goes against the national culture for most Iraqis. Service contracts are generally designed for some 5 years. Iraq's service contracts of 20 to 25 years for the further development of major oil fields are a challenge to the national culture, especially when they do not include a Local Content clause.

Iraq's average recovery of reserves has been in the region of 25 to 31%, whilst technology elsewhere has achieved 50 to 60% and 70% targets. The Iraq of today lacks the latest state-of-the-art technology and know-how in a new era which is characterized by embryonic government and management based on ethno-sectarian divides; a context which justifies and welcomes the IOCs' know-how under service contract model. However, the absence of a national oil company to partner with the IOCs makes serious shortcomings. It is contrary to the draft petroleum law and generally accepted practices. The days are long gone of the monopoly of the MoO carrying out the technical and commercial role of the national oil company, NOC, besides its regulatory and supervisory functions.

The national oil companies of this era have bulk of the world's reserves. They are the Majors of the day, whose contribution to their countries and to the global community are much enhanced, in the global energy and their countries' interest, through the latest state-of-the-art of technology and management. The IOCs have and can provide services in exchange for cash or crude, which could well be the better model under a new culture which welcomes their co-existence and cooperation.

With a constitution written in vague language, the articles which govern oil and gas management have already been indoctrinated by the heads of the influential political parties in a compromise process called 'muhasasa'. The KRG, with the help and presence of their expatriate diplomat and legal advisor, managed to introduce modifications, giving regions powers that weakened the role of central government, in language which has enabled dual interpretations and which has lead to a two-track oil and gas policy.

Today, the KRG has its own constitution and petroleum law, and has been grating exploration and development rights to IOCs and carrying out their execution unilaterally. The KRG has enacted some 48 PSC agreements over blocks, which in many instances, are beyond their official three governorates boundaries.

The KRG plans to produce 1 mbpd in the immediate future from estimated reserves potential of some 45 Bb, while the central Ministry of Oil has enacted 12 contracts, 11 of which commits 3/4 of the proven reserves, to take its production rate to 12 to 13.5 mbpd in 7 years. However, neither the central Ministry of Oil's service contracts (SC), nor the PSCs of the KRG have been granted the approval of the only legitimate representative body, the parliament. This is bound to leave the contracts under insufficient legal cover.

If truly Iraq's oil and gas production capacity can achieve a production rate in accordance with the combined current plans of the KRG and the central government of the order of 13 to 14.5 mbpd in less than 7 years, this will make Iraq the greatest world economy which is dependent for the major bulk of its budget on oil rent, with all its negative consequences. In the meantime it is bound to upset OPEC planning the stability of the world's oil market.

Can Iraq build a production rate of 12-13 mbpd?

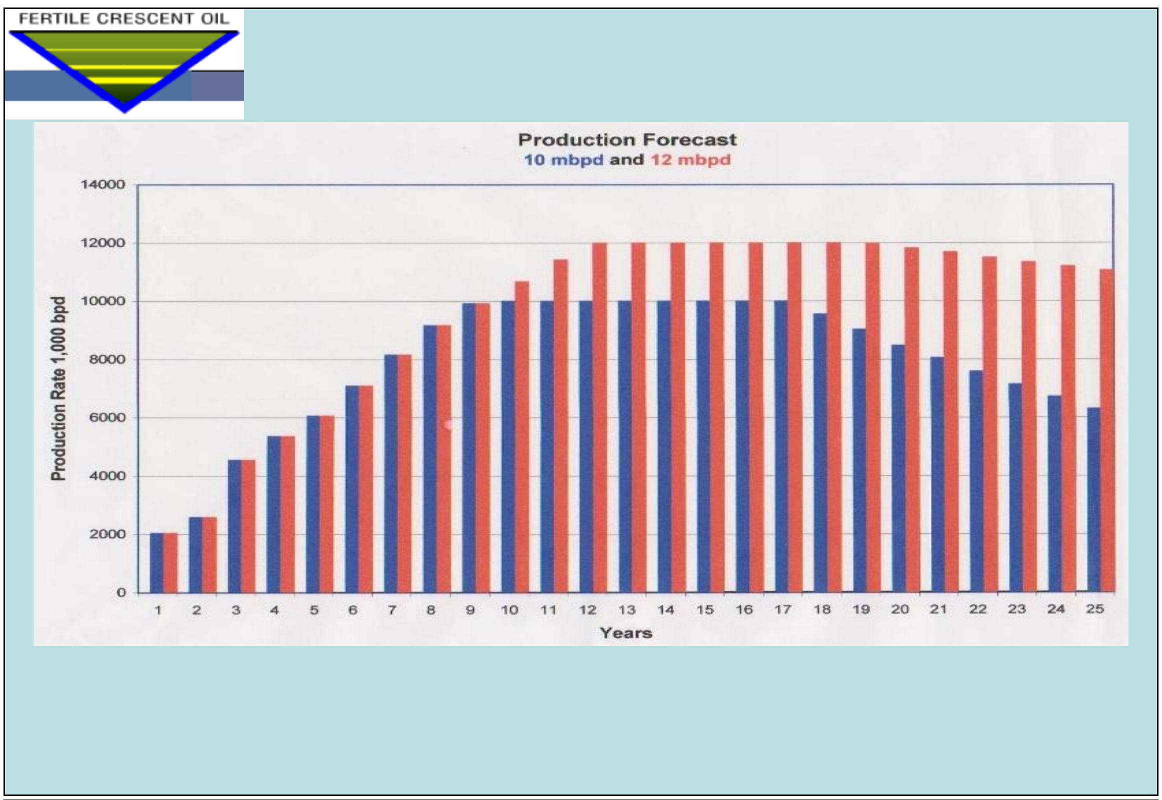


Figure 2. Production Forecast of 10 & 12 mbpd

At an annual depletion rate of 4-5%, Iraq can continue its upward production rate to 10 mbpd and beyond to12 mbpd (conditional on adding in new potential reserves so as not to exceed the above depletion rate). The IOCs' commitments to sustaining a 12 mbpd peak from 83 Bb which can only be achieved at a higher cost and potential damaged recovery.

Is it wise?

Iraq is a founding member of OPEC and rightly adopts a policy of crude oil price stabilization and conservation. An open exploration and production policy under PSC and SC contracts employing IOCs' technical support on a fee basis per daily barrel built capacity, would create the problem of having to pay IOCs' fees if and when production is capped below the incremental built production capacity. Iraq would have to pay penalties to IOCs for their unproduced capacity to live under an OPEC quota system. No doubt, Iraq's quota in OPEC cannot under any circumstances accommodate such an ambitious export rate even under the most bullish future market. As such it is unwise, unless Iraq is accounting for a future emergency of catastrophic dimensions and planning to play the role of a swinger, competing with Saudi Arabia, on the assumption that Iraq's economy can accommodate such role.

Planning oil field development for production capacity growth ought to be carried out on a composite master plan, which sets out uniform development specifications and examines the capacities of the discovered and producing fields (including each and every producing formation within each field) from a technical and economic feasibility point of view. In the mean time, it should take into consideration Iraq's economic development needs and accordingly its plans. This necessitates centralization of policy and planning.

Iraq's constitution, despite its weakness, did state the requirement for common oil and gas strategic plans and policy and optimum return to the nation for this generation and the generations to come, for this national oil and gas asset. In this light, the existing service contracts and PSAs ought to be put to a rigorous examination to ensure conformity with these criteria and under one petroleum law and regulations.

I am glad to learn from statements by some Iraqi decision makers of the government intention to modify the plateau levels and extend the production capacity build-up pace to more practical level commensurate with the time necessary for building the necessary infrastructure and market conditions. The negotiation though will prove cumbersome.

The new era post March 2003, which is already over 9 years, old has managed to place Iraq oil industry on a world track towards ambitious global dimension commensurate with the richness of its reserves, however, not without the past and similar future serious impediments and challenges of the nature of politicization, ethno-sectarian practices and failed state weaknesses.

The return by the KRG and other players to the principles of a united nation governed in peace and stability and adopting a federal model which enjoys the advantages of decentralization without the disadvantages of divisive ethno-sectarian politics, would expedite the chances of moving towards a healthy oil industry and where the government is capable of managing effectively the affairs of the country and the nation.

The Iraqi nation's deep routed culture remains the real safeguard for the long term country's return to normality. Thank you.