

Nationalizing risk, privatizing reward: The prospects for oil production contracts in Iraq

By Greg Muttitt, Co-Director of PLATFORM

Published in the International Journal of Contemporary Iraqi Studies
Volume 1 Number 2, September 2007

Available at: <http://www.intellectbooks.co.uk/journalissues.php?issn=17512867&v=1&i=2>

Keywords: Iraq policy, oil law, oil contracts, production sharing agreement or PSA, investment risk international oil companies

Abstract

This article analyses the problems inherent in the long-term oil production contracts proposed by Iraq's draft oil law. The article examines the means by which oil companies attempt to avoid risk: price risk, security risk and political risk. Meanwhile, the same companies insist on securing the corresponding 'upside': the chance of ever-higher profits. As these risks are externalized to the host state, respectively they impact on revenues, the human rights of the state's citizens and the state's sovereignty to manage its natural resources, or even to pass legislation. The article examines the use of such contracts in a number of countries, focusing especially on the Middle East, and on the contracts signed by former Soviet republics in the 1990s during their own period of rapid change. The article proposes some contractual mechanisms – with precedents – which might limit these problems. However, the current draft oil law is a permissive one, which empowers the executive branch of government to sign away as much as it chooses, with few restrictions to protect the public interest, nor any requirement for further parliamentary approval. The conclusion is that the prospects for contracts signed in the current circumstances – in particular, the occupation, the security situation and political fragmentation – do not look good.

PART I – INTRODUCTION

In early March 2007, the US White House announced some apparent good news from Iraq. 'Iraq's Council of Ministers approved a national hydrocarbon law that provides for an equitable distribution of oil revenues throughout the country', it stated (White House 2007).

In fact, the law did nothing of the sort. At the time of writing, a revenue-sharing law is still being drafted; the hydrocarbon law (or oil law) the White House referred to rather set up a framework for foreign investment in the oil and gas sector. As such, it would break from the normal

practice in Iraq and its neighbours, whose oil production has been in the public sector since the 1970s.¹

While there were disputes between Kurdish and other (Shi'a and Sunni) political parties on the relative authorities of regional and federal governments to sign contracts with multinational oil companies, in this article we will focus rather on the implications of the investment contracts themselves.

As early as 2002, a member of the US State Department's Future of Iraq working group on oil and energy, the first forum in which a restructured Iraqi oil industry was planned, commented 'everybody keeps coming back to PSAs' (Hoyos 2003). Production sharing agreements – long-term contracts under which multinational companies would provide investment in return for operating and managing the oilfields and taking a share of revenue – have featured in official thinking on oil policy ever since.

At the time of writing, the oil law is awaiting debate in the Council of Representatives. The approved draft (Iraq 2007) specifies that only the fields which have already been developed (a minority of known fields, and none of those yet to be discovered) will remain exclusively in public hands – the rest being developed by the multinationals under contracts of up to 30 years.

Unlike earlier drafts of the law (Draft Oil Law 2006), the approved version does not mention the term 'production sharing agreement'; instead referring to 'exploration risk contracts' and 'development and production contracts', which are not well-understood oil industry terms, and are believed to be simply PSAs by another name. Indeed, one official involved in the drafting told a journalist that the reason for the change of language was to 'avoid media fuss', due to the controversial nature of PSAs (Hafidh 2007).

For example, in December 2006, leaderships of all five of Iraq's trade union federations made a joint statement on the future of Iraq's oil (Hassan Jouma'a Awaad et al. 2006):

We strongly reject the privatization of our oil wealth, as well as production sharing agreements, and there is no room for discussing this matter. This is the demand of the Iraqi street, and the privatization of oil is a red line that may not be crossed.

Meanwhile, in February 2007, over fifty senior Iraqi oil experts met in Amman, and declared: 'Long-term contracts with international companies are better avoided now' (al-Rasheed et al. 2007).

In this article, we explore this polarized territory, applying an economic analysis of law approach to examine both existing contractual practice, and potential options for Iraq.

¹ Of the 43 articles of the draft law, only one (Article 11) deals with revenues. That states only that a separate law on revenue distribution will be presented to the Council of Representatives, and that two bank accounts will be established for receiving the revenues.

Does Iraq need international oil companies?

Few would dispute that Iraq's oil sector needs investment. But does this investment need to come from foreign companies?

In simple terms, the answer is no. The capital requirement is quite achievable from public budgets: Oil Ministry figures call for an annual investment of 4–6 billion dollars:² not a great deal higher than the *unspent* investment budget provided to the Oil Ministry in 2006.³ Meanwhile, Iraq has some of the world's highest levels of technical education, and Iraqis' ability to manage their industry is amply demonstrated by their success in the 1970s.⁴ Iraq does lag behind international oil industry technology, as a result of the sanctions; however, this gap could be filled – as is normal practice in the Middle East – through technical services contracts, hiring foreign contractors (to install a piece of technology, train Iraqis in how to use it, or even operate it), for a fixed fee.

The huge barriers faced by the Iraqi oil industry – corruption, poor security, a 'brain drain' of experts leaving the country – are unlikely to be helped, and may be worsened, by a policy of emphasizing foreign investment.

There are two more sophisticated arguments that some have made for using foreign capital: first, that use of public capital carries an 'opportunity cost': each dollar spent on oil development is a dollar not spent on roads, electricity or hospitals (ITIC 2004a); second, that foreign capital could allow faster development of oil resources than Iraqi public finance (Chalabi 2007). While the first point is true, and the second might be, neither of these is an argument of economic necessity: in both cases, the choice of whether to use foreign capital is a political decision, and these potential advantages must be weighed against the costs – which we shall explore in this article.

Risk and reward

It is evident that a central consideration for any investment in Iraq is that of risk. This article analyses the terms of contracts, beginning from the investor's perception of risk, and aims to project their likely costs and benefits to the Iraqi state.

In any investment, capital is expended up front, with the aim of achieving a profit in the future. Yet the future is uncertain, so the investor will want to bear in mind the chances of things going either better or worse than anticipated, giving higher or lower returns on the investment.

² Different Oil Ministry estimates put the requirement at \$20 billion to increase production to 4.5 million barrels per day by 2010 or \$25 billion to increase to 6 million barrels per day by 2015.

³ According to the US Government Accountability Office (2007: 3), the Ministry of Oil spent less than 1 per cent of its 2006 capital budget of \$3.5 billion.

⁴ Between 1970 and 1979, the Iraq National Oil Company increased production from 1.5 million to 3.7 million barrels per day and discovered the four super-giant fields: West Qurna, East Baghdad, Majnoon and Nahr Umar; and at least eight giant fields. This success really began with nationalization in 1972, and ended with the Iran war in 1980.

In the field of physics, Newton's Third Law of Motion states that to every action there is an equal and opposite reaction. In economics, a no less fundamental maxim is that for every potential risk, an investor will expect a corresponding potential reward.

The uncertainties in an investment comprise not just 'downside' – the risk that things go worse than planned – but also 'upside': the chance that things in fact go better. The economics of oil production are characterized by 'economic rents': excessive profits, over a reasonable return on capital.⁵ The terms of a contract will determine whether these rents are received by the investor or by the host state.

In oil and gas projects, five main types of risk can be identified:

- *Exploration risk*: that oil will not be found in economically recoverable quantities and conditions
- *Project risk*: that things might not go to plan: cost of inputs (such as steel) increases, economic factors change (such as interest or exchange rates), or due to management or technical failures the project falls behind schedule, delaying the point at which income starts to flow
- *Price risk*: that the future price of oil falls – one of the biggest elements in an oil project's economics
- *Security risk*: that war or terrorism might add to the costs of the project, might lead to kidnapping of project staff, or even might prevent the project from operating
- *Political risk*: that a future government seeks more favourable economic terms, or that new laws, regulations or taxes are introduced, which affect the profitability of the investment⁶

For the first three of these risks, there is a corresponding potential 'upside'; investors aim to compensate for the other two by aiming for higher profits.

In Iraq, there are around 80 known fields, with proven reserves of 115 billion barrels (BP 2006: 6) Of these, only around 20 fields – accounting for about 40 billion barrels (Ghadban et al. 1995: D4) – have been fully developed. For the undeveloped fields, appraised by the Oil Ministry – which should naturally be the priority areas for investment – exploration risk does not exist.

The second type, project risk, is a normal risk of doing business, and should be carried by the investor. While there are cases where such risks have effectively been transferred to host states, these took place more by accident (on the part of the host government) than by explicit agreement to do so. Indeed, if even these most basic risks are not carried by an investor, it is difficult to see why profits are earned at all.

This leaves three major risks. Whether these are carried by the investor or the state – that is, whether reduced overall project revenues result in deductions from investor profits or from

⁵ Economic rent is a reflection of the value of the natural resource – independent of anything that is done to it by human beings.

⁶ In Iraq, one dimension of political risk, related to security risk, is the risk that political and military forces may tear the country apart, such that the state that has signed a contract ceases to exist – raising questions over the continued validity of the contract. For many investors, this is a more harrowing risk than the physical security threat.

host state revenues – will be determined in the contract. We examine these in turn, after we have first (Part II) reviewed some historical experiences of oil production contracts.

In Part III, we examine the allocation of price risk, and economic rents, through the fiscal terms of contracts. Then, in Part IV, we note the risk premia that would be demanded in Iraq's current security situation, and explore the possibility of later renegotiation of contractual terms. In Part V, we turn to the legal terms of contracts, looking through the investor's lens of political risk.

Having analysed contractual treatment of risks – and its implications for investors and host states – in Part VI we examine possible contractual mechanisms available to Iraq, which might help protect the national interest. Finally, in Part VII, we analyse the draft oil law, and assess the prospects of Iraq achieving such mechanisms, given the current political dynamics.

PART II – HISTORICAL BACKGROUND

'Negotiation' under occupation

In understanding the political economy of negotiations for oil contracts, a key factor is the relative bargaining power of the sides. This lesson is well illustrated by the early history of the Iraqi oil industry.

For its first half-century, Iraq's oil was developed by a consortium of multinational companies (the precursors of BP, Shell, Exxon, Mobil and Total), collectively named the Turkish Petroleum Company (TPC) (later renamed the Iraq Petroleum Company (IPC)).⁷

TPC obtained a concession contract in 1925, at a time when Iraq was occupied by Britain under a League of Nations Mandate. The contract followed a colonial model, in common with all of the other Middle Eastern countries, in all of which concessions covered enormous areas (and in several cases the entire country). Like many others, TPC's contract was for a term of 75 years.⁸

The concessions were unbalanced not only in terms of their scope. They gave to the foreign companies complete control over decision-making (including on output and export levels), a monopoly on information and even the right to dictate the price.⁹

They deprived the governments of the right to tax the concessionaires, specifying instead a fixed royalty to be paid. Company profit figures were never published, nor made available to the

⁷ The TPC/IPC concession covered the entire area east of the Tigris river. There were two other concessions, which together with IPC's covered the entire country, apart from a small strip on the border with Iran. The second concession, covering the area west of the Tigris and north of the 33rd parallel, was awarded in 1932 to the British Oil Development Company (BODC) – in which IPC acquired a majority share in 1937, and outright ownership in 1941 (through its Mosul Petroleum Company subsidiary). The third concession, covering the remainder of the country, was awarded to Basrah Petroleum Company (BPC), another subsidiary of IPC, in 1938. Thus, by 1941, IPC controlled virtually all of the oil in Iraq.

⁸ The BODC and BPC concessions were also for 75 years.

⁹ Indeed, the axis of negotiations determined whose interests were reflected in the final deal, and reflected the imbalance of power: the major disputes were not over the role of Iraqis, or over what Iraq would give or receive, but rather between the 'Great Powers'. From 1904 to 1914, extensive negotiations tried to resolve the respective roles of Turkey (then the imperial power), Britain and Germany in the consortium. After the First World War, Britain was the dominant power, but French participation was negotiated between 1918 and 1920; meanwhile it took a further eight years of diplomacy to settle the role of US companies – thus the membership of the TPC consortium was finally resolved in 1928.

governments; however, it is clear that the vast majority of the revenues went to the companies.¹⁰

The roots of the unfair terms lay in Britain's control of Iraq, and the Iraqi state's weak position. As George W. Stocking (1970: 124–25) observes,

IPC's initial bargaining for the Iraq concession represented basically negotiations between representatives of the mandated country and representatives of the holders of the mandate. So circumscribed, the outcome of the bargaining, no matter how fair it may have been, was inevitable.

Yet, while terms were negotiated under occupation, they were fixed by contracts, such that they long outlasted the occupation.

It is not uncommon for international oil companies to use periods of state weakness to achieve long-lasting highly profitable contracts. For example, during the Asian financial crisis of the late 1990s, an editorial in *Petroleum Review* (1998) commented enthusiastically:

The misfortunes of some often produce opportunities for others and the Asian crisis is unlikely to prove an exception. For the international companies the crisis offers the possibility, even the likelihood, that some countries will have to reduce their very high tax rates on upstream development to sustain interest.

The rejection of colonialism

While colonialism intrinsically facilitated the role of the imperial countries' corporations in extracting colonies' resources, the period from the 1950s to the 1970s was marked by a strong push by developing countries and former colonies to reclaim (or perhaps, claim) control over their natural resources.

The concept of permanent sovereignty over natural resources was enshrined in a number of resolutions of the United Nations General Assembly (1962, 1966, 1974). It gives producing countries a right not only to make decisions about how to extract or manage their natural resources, but also to expropriate or nationalize where it is in the public interest to do so, as long as compensation is paid (Mughraby 1966).

In parallel with these discussions, terms of oil concessions were being successively renegotiated. In the 1940s, when Venezuela's Acción Democrática government pushed for a greater share of the revenue, the international oil companies were keen to avoid a repeat of their experience in Mexico, where their assets had been nationalized in 1939, and readily agreed in 1948 to share profits on a 50-50 basis (Mommer 2002: 116).

¹⁰ For example, the US Federal Trade Commission's 1952 investigation into the 'international petroleum cartel' found that in Iraq during the period 1934–39, consortium member Exxon (then called Standard Oil of New Jersey) received 52 cents of profit per barrel, whereas the Iraqi government received a mere 25 cents per barrel (US Federal Trade Commission 1952: 95).

The 50-50 principles quickly spread, and countries of the Middle East successively applied it through the 1950s – after which a leapfrogging process began, with contracts being repeatedly renegotiated to give a higher percentage to the governments. During the 1960s, attention turned to state participation in development and production, leading to further renegotiations; and finally, mostly during the 1970s, oil production was nationalized in the major producing countries.

Oil companies were forced to relocate their production, especially in the high-cost North Sea and Alaska, helped by the generous US and UK tax and regulatory environments, and by the high oil prices. OPEC members responded to this non-OPEC expansion by restraining their production, in order to maintain the price. But as their share of world oil production fell from 48 per cent to 30 per cent, between 1979 and 1985 (British Petroleum 1990: 4), OPEC had to switch objectives from defending prices to defending its market share, creating a glut of oil.

For many authors, the resulting 1986 oil price collapse, followed by the demise of Soviet Communism five years later, marked the end of the nationalism of the 1960s and 1970s (e.g. Warden-Fernandez 2000; Kolo and Wälde 2000), ushering in an era of liberalization and globalization.

Corporate power resurgent

The break-up of the Soviet Union gave oil companies potential access to the largest new reserves to become available for four decades. Equally importantly, the rapid political change, the climate of keenness for economic liberalism, and the sense of starting from a blank sheet gave them an opportunity to push the boundaries of both economic and legal domination to a level not attempted before.

The justification given for the highly profitable contracts was the level of risk perceived by investors. Dan Witt, head of the International Tax and Investment Centre, one of the first corporate lobbyists to get into Russia and Kazakhstan, comments:

It is easy to forget just how difficult it was in Kazakhstan in the early 1990s – when these original big three deals were negotiated and signed – the big political, economic and technical risks. Would you offer these terms today? Probably not. However, could you have done any major oil deal in 1994 under the terms offered today? Probably not. (*Petroleum Economist* 2004)

In Azerbaijan, the same could be seen, with BP describing its deal on the Azeri-Chirag-Guneshli fields as the ‘Contract of the Century’.

One striking example was the Sakhalin II oil and gas project, on Sakhalin Island in Russia’s Far East (north of Japan), for which the Russian government signed the country’s first production sharing agreement in 1994, with a consortium of American, Japanese and European companies. So unbalanced were the terms of this contract that they prompted economist Ian Rutledge

(2004) to term it a ‘production non-sharing agreement’. The effect was to allocate virtually all risk – including even project risk – to the state.

In a normal PSA, the extracted oil is divided into ‘cost oil’ – which is used to pay back the investment and the operating costs – and ‘profit oil’, which is shared between company and state in an agreed formula. What was unusual about the Sakhalin II PSA was that it effectively guaranteed company profits, by including them in the cost oil portion.

In combination with the absence of a limit to how much of any year’s extracted oil could be treated as cost oil,¹¹ the result was that Russia would not start to receive revenues until the consortium (now led by Shell) had not only covered its costs but also made good profits (17.5% internal rate of return). Even after that point, the state would only receive 10% of profit oil for two years, and then 50% subsequently (very low by world standards). Only after the companies had achieved very high profits (24%) would the state start to receive a (more normal) 70% share (Russian Federation 1994: Article 14; Rutledge 2004: 17–18).

In the event, the project did not go to plan. Having originally been budgeted at \$9–\$10 billion, Shell announced in July 2005 that the project costs had more than doubled to \$22 billion.¹² Due to the contract’s sharing formula, the cost overrun further delayed the point at which Russia would receive its share of the oil – such that it was effectively Russia (through non-receipt of revenues) that paid for Shell’s mistakes, while company profits were guaranteed.

Russia is now no longer in the weak position it was in when it signed the contract. However Vladimir Putin’s government knows that it has no legal basis to push for a renegotiation of the terms of the contract. Instead, it has used breaches of environmental law to put pressure on the consortium.¹³ Ultimately, following a high-profile showdown with the environmental regulator in autumn 2006, the issue was resolved not by changing the terms of the contract, but by securing state participation in it, through majority state-owned Gazprom purchasing a 50 per cent stake¹⁴ (at market price). Thus, the imbalance in the contract remained, but with the state now effectively on both sides of the table – so a share of the consortium’s profits come back through Gazprom.

PART III – PRICE RISK AND THE FISCAL TERMS OF OIL CONTRACTS

Types of oil industry fiscal structures

¹¹ Usually (although not always), there is a limit to how much of any year’s production can be counted as cost oil – in the Middle East the cost oil limit averages 37 per cent (Bindemann 1999). This is to ensure that the state receives a share of revenue, even in the early years while the investment is being recouped.

¹² Shell gave a number of reasons, including an increase in the price of steel and extra environmental measures, but certainly one central factor was the failure of planning and project management. For example, in April 2004, Shell announced that it would have to change the timing of the development plan because it needed extra time to redesign sub-sea pipelines, to be buried under the seabed, rather than sitting on the seafloor. The reason was that winter ice reaches all the way to the bottom, and scouring action risked snapping unburied pipes. It would seem that in an ice-bound location, checking the depth of ice would be one of the most elementary engineering measures!

¹³ The environmental issues relating to the project are indeed serious (see for example the website of Sakhalin Environment Watch, <http://www.sakhalin.environment.ru/en/sakhalin2/msakhalin.html>). However, Putin is not known for his environmental concern, and most analysts agreed that the true motivation was economic (Dow Jones 2006; Macalister and Mainville 2006).

¹⁴ To be precise, 50 per cent plus one share.

The oil price plays one of the biggest roles in shaping a project's economics. It is a highly unpredictable factor, and its fluctuations can change a project from being marginal to being highly profitable (or vice versa) within the space of a couple of years.

The allocation of price risk is determined by the economic structure of the project, codified in the contract – with different fiscal mechanisms responding differently to the profitability of the project.¹⁵

In some mechanisms, the state¹⁶ receives the revenue from the project, and pays the foreign oil company:

- *Service fee*: the oil company is paid a fixed fee for carrying out an agreed piece of work (as happens in drilling, seismic, engineering and other services contracts around the world).
- *Risked service fee*: the company is paid a fee per barrel extracted, as a reward for investment.

In other mechanisms (concessions), the foreign company receives the revenue and pays the state:

- *Bonus*: a fixed payment, at defined moments in the project (such as signing, achievement of first oil, or of specified rates of production)
- *Royalty*: a percentage of the value of oil extracted
- *Taxes*: a percentage of profits (that is, value of oil extracted, minus the cost of extracting it); roughly equivalent to profit taxes is the sharing of profit oil in production sharing agreements

We can see how risk – as well as 'upside' – are allocated in these different models.

At one end of the scale, if the investor is paid a fixed fee, regardless of the economic outcome of the project (as is the case in many service contracts), the investor's return is then known, and it is the state that carries all of the risks of the project being unprofitable. Conversely, all of the economic rents (excess profits) from the project are received by the state. At the other end, if the investor were to receive all of the revenue from the project, and pay the state a fixed per barrel royalty (or even more extreme, a fixed bonus irrespective of production rates), the state would have certainty of income levels, with the investor carrying all of the risk. Meanwhile, all of the rents would go to the investor.

Fixed, per-barrel royalties are not used anymore,¹⁷ having been replaced by a percentage royalty, which gives the state some degree of price risk, and rents, but rather less than profits taxes or production sharing.

¹⁵ For a fuller explanation of the structures of oil fiscal systems, see Johnston (1994).

¹⁶ Usually the national oil company.

¹⁷ Fixed royalties were used in the early Middle East concessions, although in those cases the companies' risk was limited by their not being held to any work plan (if the price made production unprofitable, they would not produce anything), and also by the oligopolistic nature of the market (they largely controlled the price).

Heads I win, tails you lose

Multinational oil companies dislike royalties – which allocate price risk to them (although what is often overlooked is that there are numerous hedging measures – such as futures and options contracts – which reduce their price risk).

Conversely, they are even more strongly opposed to fixed-fee service contracts, which shield them from price risk almost completely. The reason is that whereas fixed fees avoid ‘downside’ (risk of a less profitable outcome if things go wrong), they do not allow ‘upside’ (the chance of achieving huge profits if things go well). The aims of an oil company in negotiations on economic terms are to maximize upside, while minimizing downside.

As Thomas Wälde (1996: 203) puts it:

Companies will try to obtain a flexible regime, but flexible only with respect to downside developments. Rare the financial analysis presented to the government team which does not use a ‘marginal’ base case and rare the tax package proposed which will not ‘just’ allow the development of a marginal project. The psychology of negotiators, particularly in an organisation, will tend to strive for a bargaining victory advertised to the corporate home front, and such bargain victories will rarely be famous for ‘upside flexibility’, i.e. for increasing the government share when the project turns out to be a big success.

The oil companies achieved precisely this in the Sakhalin II contract: an effectively guaranteed internal rate of return (IRR) of 17.5 per cent, plus a good chance of up to 24 per cent IRR, and the possibility of even higher profits if the project went well.

In many discussions of appropriate fiscal structures, the risk aspect is emphasized – for example, Seymour and Anthill (1998: D7) and International Petroleum Enterprises (2004: 46–47) argue that since the major multinational companies hold diverse and balanced portfolios, they are better able than host states to manage price risk, by offsetting it between their different operations – while neglecting the corresponding upside. What such arguments miss is that the cost of stabilizing state revenues would usually be to deny the state access to economic rents. For a country like Iraq, with enormous oil reserves and a highly oil-dependent economy, the price risk concerns (that income fluctuates) are small compared to the potential gain or loss of rents.

It is precisely because oil companies want to offload downside, while securing upside, that discussions tend to focus on risks rather than rents. Since natural resources are the property of the country where they are found, these excess profits – going beyond a reasonable return on investment – should rightly be received by the country’s public purse.

The conclusion is that the host state should aim to capture as much of the rents as possible.

By definition, fiscal structures based on company profits will obtain greater shares of rent than those (royalties) based purely on the total value of oil production. However, one concern with

profit-based systems is that their relative complexity often leads states to receive less revenue than they expected.

It is normal practice for companies (in the language of production sharing agreements) to profit from 'cost oil'. Indeed, this is the reason multinational companies spend so much money on accountants.

Whereas a royalty is a simple concept, and is easy to calculate (if the rate of production and oil price are known), the calculation of taxes on profit (and of the sharing of profit oil) necessarily depend on the definition of profits – including such factors as how assets are depreciated, which costs are allowable and disallowable, the treatment of financing costs (such as bank interest) and so on.

Complexity naturally favours those with the most accounting resources, but also tends to favour the company over the government, as the company knows far better the details of its business. Conversely, it makes the operations somewhat inaccessible to scrutiny by civil society.

A classic method is the manipulation of transfer pricing: for example, a subsidiary of the same company (possibly not identifiable as such, perhaps registered in a tax haven) leases equipment at an artificially inflated price to the company subsidiary working on the project, reducing the apparent (taxable) profitability of the project, while in fact transferring the profit to a different country with lower taxes¹⁸ (Murphy 2007: 42–56).

Avoidance of such problems will fundamentally depend on the country's institutional capacity to manage and regulate investment (Mommer 2002: 91–94), as well as the capacity of civil society and parliament to scrutinize a government's performance in this.

More broadly, there is a wealth of evidence that most oil-dependent economies tend – paradoxically – to show poorer economic development outcomes than those of countries without oil; the key determining factor as to whether positive or negative outcomes are achieved is 'the type of pre-existing political, social and economic institutions available to manage oil wealth as it comes on-stream' (Karl 1997: 213–21). Indeed, the World Bank-commissioned Extractive Industries Review (Salim 2004: 46) recommended that the Bank 'should not promote increased private investments in extractive industries [...], where governance is inadequate. [Rather,] governance should [first] be strengthened until it is able to withstand the risks of developing major extractions.'

Thus if there is a lack of public sector capacity to develop the oil, the solution is not so simple as just bringing in foreign companies to do the work – as the lack of capacity will almost certainly extend also to regulatory functions, negotiating contracts and monitoring and regulating performance – crucial elements in obtaining a positive outcome from investment.

¹⁸ The better-known use of manipulated *export* transfer pricing (whereby a company 'exports' a product at an artificially low price to its own subsidiary in a low-tax country, in order to receive highest profits where taxes are lowest), is more difficult in the oil industry, because there is a well-known commodity price for oil.

In the case of Iraq, the substantial fragmentation of political authority (Herring and Rangwala 2006: chapters 2 and 5), and its disconnection from the reality of what is happening in most of the country, bodes ill for the prospects of effective regulation and hence also of successful economic development.

At the very least, Iraq would be wise first to develop its governance capacity (whilst developing existing oilfields in the public sector) before considering bringing in foreign investment. The question remains of whether, even then, Iraq would benefit from foreign investment. Helmut Merklein (2006a), an oil consultant and former US government energy analyst, argues that

Iraq would do well to keep its oil and gas exploration and production operations under state control, since that is where all of its oil-related rents are reaped. These rents, also known as windfall profits, should accrue in principle to the resource owner, the people of Iraq. But they won't, at least a substantial part of them will not, unless upstream operations are conducted by a state-owned company. Under currently used oil production contracts, especially production-sharing agreements, huge rents escape capture by the resource owner.

PART IV – SECURITY RISKS AND THE IMPORTANCE OF CONTEXT

Paying a risk premium

The most obvious risk for any company working in Iraq is the security risk. Wracked with daily violence, Iraq is simply not a safe place for a foreign company to operate in (although, with the backup of mercenary companies, it is a somewhat safer place for a foreign company than for an Iraqi person). In consequence, any investor would demand a 'risk premium': higher rates of profit to offset the security risks.

Thus some commentators are talking credulously about terms that would be unthinkable even in oil-producing countries far less economically favourable than Iraq. Some reports suggest that foreign companies would receive 20 per cent of profit oil¹⁹ – terms that would lead to immense profits – simply off the scale of what is normally achievable – at the expense of the Iraqi people (Whitaker et al. 2007: 8).

David Horgan, managing director of Irish independent oil company Petrel Resources, and one of the few international oilmen prepared to speak publicly about Iraqi oil policy, has responded to these terms by saying:

They are reasonable rates of return, and take account of the bad security situation in Iraq. The government needs people, technology and capital to develop its oil reserves. It has got to come up with terms which are good enough to attract companies. The major companies tend to be conservative. (Whitaker et al. 2007: 8)

¹⁹ And even more in the early stages of production.

Yet while security problems may provide an excuse for higher returns, companies will still look to transfer these risks to the state party, by making the state liable for providing security. Whereas we argued in the previous section that the Iraqi state should accept price risk, in order to capture the maximum rents, to do the same with security risks would come at a high social cost, as we shall see in the next section.

Securing profits, risking human rights

Would companies invest in the current Iraqi environment? Many have claimed that they would not. The extent to which this is genuine, or whether it is partly a bargaining position, is unknown.

There are some suggestions that the oil companies' fears for safety are overstated. Iraqi Oil Minister Husayn al-Shahristani has said that, regardless of the security situation, 'The international companies keep contacting me – every week, without exception. They are all very, very keen' (Glanz 2007).

US Deputy Treasury Secretary Robert Kimmitt told journalists in September 2006 that big oil companies had informed the US government they were willing to send crews to Iraq to explore for and produce oil in spite of the violence, as long as there were legal ground rules for their participation (Krane 2006).

Dan Witt of the International Tax and Investment Centre, who has lobbied on behalf of the oil companies in Iraq, comments, 'Security is an issue – but everyone's realistic, you're not going to wait until it's perfect' (Rowell 2006). On this, Witt is probably right – whether that time is now or later, it is likely to be at a time when there is still serious violence in the country.

The past record of the companies shows that they are able to operate in conflict zones – although often with a devastating impact on local people. For example, BP started producing oil in Colombia in the early 1990s, more than three decades into a civil war that has killed over 30,000 people. In order to protect its facilities, BP provided funding to units of the Colombian army that were implicated in serious human rights abuses, including the XI Brigade, which according to British journalists Michael Sean Gillard and Melissa Jones (1997), employed

a US-designed counter-insurgency strategy of dirty war, known locally as 'quitarle agua al pez' or draining the fish tank. Instead of fighting the guerrillas, the army and pro-government paramilitary death squads target people they consider sympathisers.

There are also allegations – denied by BP – that the company handed the army photos and videos of local protesters against the company.²⁰ Many protesters were later assassinated,

²⁰ On a September 1996 delegation to Colombia, Member of the European Parliament Richard Howitt was handed an unpublished report, written in July 1995, by a commission including the President's human rights advisor, the Attorney General and the Ombudsman. According to journalists who saw the report, an army colonel described in it how videotapes recorded by the oil companies at community meetings were used by military intelligence. He explicitly mentioned BP as sharing such information with the military (Harrison and Jones 1996; Fidler 1996). BP claimed in 1997 that the colonel had since denied that he had named BP, but has refused to make copies of his supposed letter available to journalists. BP has

kidnapped or beaten by the army or, more often, by paramilitary groups (Harrison and Jones 1996; Fidler 1996).

Often the relationship between oil company and security forces is written into the contracts themselves, combined with indemnification of the company against liability for any human rights abuses arising.

An example is the agreement between Turkey and a BP-led consortium for the Baku–Tbilisi–Ceyhan (BTC) pipeline – which was completed in 2006, to pump crude oil from the Caspian Sea offshore Azerbaijan to Turkey’s Mediterranean coast. That agreement (Turkey 2000) places a duty on the Turkish government to ‘ensure the safety and security’ of the project, and protect it ‘from all Loss or Damage resulting from civil war, sabotage, vandalism, blockade, revolution, riot, insurrection, civil disturbance, terrorism, kidnapping, commercial extortion, organized crime or other destructive events’ (Article 12.1). The inclusion of ‘civil disturbance’ – which could presumably include peaceful, political demonstrations – is especially troubling (Carrión 2002).

It further specifies (Article 12.3) that this protection shall be provided by the security forces: this responsibility was given to the gendarmerie, a police force that has been repeatedly criticized for its human rights abuses by the European Court of Human Rights. Meanwhile, the agreement makes the government ‘solely liable for the conduct of all operations of the security forces’.

These provisions, combined with another (Article 10.1(i)) that the state must provide monetary compensation for any failure to carry out its obligations under the agreement, are likely to incentivize the state to prioritize security interests over the human rights of local populations.

In the case of Iraq, a new set of interests protected by well-armed force is perhaps the last thing the country needs in the current situation.

Renegotiation – a door closed?

From the perspective of the investor, the measures discussed above might be seen to ‘mitigate risk’; however, they do not remove it. And each risk – or perception of one – creates a potential justification for a ‘risk premium’ reflected in the economic terms. In spite of the importance of the current context to the economic terms, these terms would persist for the length of the contract. The current draft of the Iraqi oil law specifies contracts for up to 20 years of production²¹ (Iraq 2007) – throughout which period oil production would take place under highly profitable terms, which reflected the risk situation in 2007.²² But if the contractual terms no longer reflect the circumstances, can they be renegotiated?

also claimed to be exonerated by an investigation by the Colombian Public Prosecutor’s office in 1998. In fact, the investigation was closed because of lack of evidence, even though it did not interview the colonel, or the authors of the 1995 report given to Howitt, prompting several NGOs including Amnesty International to complain that the issue had not been properly investigated (Gillard et al. 1998).

²¹ This is on top of up to eight years of exploration and two years of appraisal. There is also provision for an optional five-year extension to the production period, following a renegotiation.

²² The Oil Minister has stated that he plans to launch a bidding round soon after the passing of an oil law (expected in spring 2007), with an aim of signing contracts by the end of 2007.

It is not uncommon for contracts to be renegotiated, where mutually agreed by both parties. Indeed, renegotiations took place in the 1950s and 1960s in relation to the Middle East concession contracts. In that case, companies agreed to renegotiate because of the political circumstances of the time. Companies wanted to avoid a repeat of Iran's 1951 nationalization of the concession held by BP²³ under populist leader Muhammad Mossadegh. Meanwhile, the home governments of the oil companies – especially the United States of America – were concerned about the spread of Soviet influence into the Middle East, and were keen to see a deal done.

But what happens where both sides do not agree on a renegotiation – in particular where the political hand of the companies is stronger, so that they do not feel the need to?

Most writers on contract law agree that while there are some legal arguments for a general right of renegotiation, unless it is either specifically provided for in the contract, it is unlikely to be enforceable, with the principle of sanctity of contract overcoming considerations of public interest (Berger 2004).

For example, Stefan Kröll (2004: 36) notes that there are a number of legal arguments – often made by capital importing countries – that 'the obligation of the state party to act in the public interest should override contractual obligations that, due to changed circumstances, are no longer considered to be in the public interest'. However, most international arbitration tribunals have rejected this argument. One reason they have given is that the foreign investor – as a foreigner – does not share in the public interest in the host state: thus the foreign investor's interests must be protected by international law. The exception is where a contract contains a specific clause, stipulating that renegotiation will take place after a number of years, or if circumstances change.

The most relevant precedent was perhaps the 1961 supplementary agreement to Kuwait's 1948 concession granted to the American Independent Oil Company (Aminoil), which specified (Article 9) that the contract terms should be renegotiated in the event that other concessions in the Middle East changed to give more favourable terms to the state party. Indeed, the legality of this provision was confirmed by an arbitration tribunal, when the parties failed to agree new terms following the 1974 oil price rise and OPEC announcement that government take should increase (Kröll 2004: 6–7, 16; Berger 2004: 11–12).

A more recent example was Russia's 1995 PSA law (which came after the Sakhalin II and two other PSAs had been signed, and so did not affect their terms). It gave the government the right to modify terms if 'major economic changes' or 'significant change of circumstances' occur during the term of an agreement (King & Spalding 2004: 13; Berger 2004: 8–9).²⁴

²³ Then called the Anglo-Iranian Oil Company.

²⁴ Other examples are the 1974 Petroleum Production Agreement between Ghana and Shell, which contains a clause allowing for renegotiation where 'changes in the financial and economic circumstances [...] materially affect the fundamental economic and financial basis of this Agreement' (Berger 2004: 12). Also, the 1974 renegotiation of the agreement between Papua New Guinea and Bougainville Copper company (majority owned by mining giant Rio Tinto) provided that the parties would meet at intervals of seven years 'with a view to considering in good faith whether this agreement is continuing to operate fairly to each of them' (cited in Kolo and Wälde 2000).

Some international institutions also recommend providing for renegotiation. For example, the United Nations Conference on Trade and Development (UNCTAD 2004: 45) recommends finding a balance 'between the legitimate commercial expectations of the investor party and the right of the host country party to oversee the evolution of the resulting relationship in a manner that is consistent with national development priorities'.

Still, most investors dislike the prospect of renegotiation. According to John Gotanda (2003: 1464), the International Chamber of Commerce wrote rules for the adaptation of contracts; they withdrew the rules in 1994, stating that no one had used them, investors preferring instead the principle of sanctity of contracts. Clearly, renegotiation will only be possible if Iraqi negotiators insist on it at the time of writing the contract.

PART V – POLITICAL RISK AND THE LEGAL TERMS OF OIL CONTRACTS

Loss of legislative sovereignty

The use of the term 'political risks' in infrastructure and extractive projects can commonly be characterized as a somewhat patronizing 'We don't trust the government not to change the rules'. By definition, this risk is carried by the foreign investor, rather than the state party. However, far from remaining open to potential renegotiations, companies aim to reduce political risk by contractually tying the hands of the government as firmly as they can.

The classic mechanism by which this is done is through stabilization clauses – which effectively immunize an investor from future changes in both fiscal terms and even legislation. To an investor such changes constitute political risks – to a state they constitute exercise of its sovereignty.

This is investment colonialism at its most extreme. For example, Azerbaijan's 1994 PSA contract with a BP-led consortium for the Azeri–Chirag–Guneshli fields (SOCAR 1994) – the 'Contract of the Century' – states that (Article 23.2) if a future government tries to change its taxes, laws, regulations or administrative practice – even if it does so to comply with an international treaty – either the economic terms of the contract will be changed to protect the companies' profits, or the State Oil Company will pay the cost of the change.

If it is not enough to exempt investors from future laws, there is an increasing trend to exempt them even from existing laws, except those that the contract specifically acknowledges and requires compliance with. The Azerbaijan PSA (Article 26.3) points at vague 'international petroleum industry standards and practices' at the time of signing the contract, and requires only compliance with Azerbaijan's laws on health, safety and environment if they are no stronger than those self-defined standards.

These exemptions are made possible by 'internationalizing' the contracts, to give them a higher status than domestic law (combined with exemption clauses from domestic laws). Furthermore,

such internationalization will place the contract within international, rather than national, law – which gives investors greater certainty that their interests will be defended.

One of the first attempts at such an approach was following Iran's 1951 nationalization. The company's legal counsel advised that a special clause should be added to its new contracts which would nestle the contracts in a bilateral treaty, to ensure that they would be covered by international law. The result would be to transfer any dispute between BP and Iran into a dispute between the United Kingdom and Iran – allowing the powerful UK government to bat on behalf of the company (Sinclair 2005). Ultimately, the clauses were not included, the UK government judging that such a role could be a burden for it, and could exacerbate any dispute – especially since anger at Britain's imperialist attitude was a major cause of the original problem.

Since then, however, the development of investment dispute resolution has instead given the investors themselves those powers through international treaties, bestowing upon them many of the powers of a state, but none of the responsibilities. Nathalie Bernasconi-Osterwalder (2006) explains:

Unlike home state governments, investors have no reason to consider how their arguments might be held against them in other subsequent arbitrations, or how they might affect the political relationship between two countries.

In most legal systems, there is a hierarchy of law, in which the constitution comes first, followed by ratified international treaties, followed by domestic laws, followed by regulations. Thus, if a contract can achieve the status of – or be supported by – an international treaty, it will trump domestic laws and regulations that conflict with it (Hildyard and Muttitt 2006).

For example, the host government agreements (HGAs) for the Baku–Tbilisi–Ceyhan pipeline, the BP-led export route for the Azerbaijan oilfields achieved treaty status as annexes to an intergovernmental agreement (IGA) between the three transit countries, Azerbaijan, Georgia and Turkey (1999). The IGA was drafted by BP's lawyers but signed by the three governments, overseen by the then US President Bill Clinton.

In Georgia, the consortium's choice of pipeline routing through the 'support zone' of an ecologically important national park led to objections by the Minister of the Environment that the project would violate Georgian law (Chkhobadze 2002). However, since the HGA has a higher status than other Georgian laws, the environment laws the Minister referred to were simply irrelevant. Ultimately, on the day of the deadline, the President – pressured by BP and the US government – called the Minister into his office, and kept her there until she signed the environmental permit, in the early hours in the morning (Woodward and Aliyev 2002; *Rustavi-2* 2002; AFP 2002).

Commonly, internationalization is achieved through an 'umbrella clause' in an investment treaty, which shelters investment contracts²⁵ signed in the country, with its own (treaty-status)

²⁵ It may protect all contracts, or certain types of contracts, or those in a particular sector – for investors that are nationals of other signatory states to the treaty.

protection. The treaty may be either multilateral (such as the Energy Charter Treaty, NAFTA and other regional free trade agreements) or bilateral, between two countries.

In recent decades, there has been a profusion of investment treaties, the total number in existence expanding from 385 in 1990 to 2,495 in 2005 (UNCTAD 2000: 1; 2006: xix).

To date, Iraq is currently subject only to three bilateral investment treaties, with Kuwait (1964), Morocco (1990) and Syria (2002); however in November 2006, Iraq began trade negotiations with the European Union, which are expected to arrive at an investment treaty, and other nations will almost certainly follow.

Luke Peterson (2006), of the International Institute for Sustainable Development, observes:

As a rule, investment treaties are one-sided instruments. They are concerned with limiting the measures that may be taken by governments against foreign investors or foreign-owned investments. The treaties contain a series of rights for inward capital – protection against expropriation, guarantees of non-discrimination, and freedom to transfer funds out of a host state – but they lack any counter-balancing investor responsibilities.

Arbitration – enforcing corporate power

The increasing sophistication of legal stipulations in investment contracts, and the mushrooming of bilateral and multilateral investment treaties, have been matched by an extension of their enforceability. Contracts commonly specify that any dispute between the state party and the investor will be resolved not in the country's courts, but by international investment tribunals – the most popular being the International Centre for the Settlement of Investment Disputes (ICSID), or various Chambers of Commerce.

Chamber of Commerce rules, originally designed for arbitration between two private parties in a business dispute, treat the state party as a purely commercial entity, removing concepts of public interest or of sovereignty from the role of the state. Furthermore, in the tradition of commercial confidentiality, they do not require any public record of the arbitrations (Peterson 2003).

ICSID, on the other hand, was purpose-built for investment disputes. It was established by the World Bank, of which it remains a part, through an international treaty. During its 41-year history, 230 disputes have been registered at ICSID – more than half of them (131) in the last five years (ICSID 2007).

ICSID rules do provide for disclosure of the existence of all the disputes that take place under its auspices, and on many occasions the arguments submitted in the course of a particular dispute will be published on its website. At the same time, ICSID can be legally tougher than other arbitration bodies in upholding investor interests. ICSID proceedings are conducted solely under the provisions and rules of its founding convention. Arbitral awards are binding, and not subject to any appeal, except on grounds of purely procedural violations (such as that the tribunal did

not observe ICSID's rules), and even then may not challenge the correctness of the decision. The role of national courts is limited to enforcement of financial penalties; they have no right to review the judgment (ICSID Convention 1965: articles 35, 53, 54).

Even when specified in a contract that arbitrations should take place within the law of the country concerned (as is often the case), arbitration tribunals may rule that the law is only applicable in so far as it does not conflict with 'international law' (specifically investment law), and in case of conflict, the applicable law would be international law (Kolo and Wälde 2000: section D).²⁶

The investor's hand is further strengthened by the profusion of treaties under which they can seek an arbitration, allowing them to 'treaty-shop' between multilateral treaties and a whole range of bilateral treaties, among which a multinational company can choose by adopting a 'home state of convenience' – that is, for the purposes of litigation, to claim a favourable nationality, via a subsidiary company (Peterson 2003: 22).

Arbitration was used effectively by French company Total to override regulation of its development of the Kharyaga field in Siberia, under a production sharing agreement (Russia's third) signed in 1995. That PSA specified that the development required regulatory approval of its budgets and development plans – a common provision in many contracts.

In December 2003, the regional and federal governments did not approve Total's expenditure budget for the previous two years, objecting to the inflation of costs on the project. The regional governor warned, 'The state should control investment and the state should know exactly how much and where investments have been made. I am against investments planned in order to avoid taxes' (Interfax 2004a).

Total took the case to the Stockholm Arbitration Court. Although Total later admitted that some of its costs were indeed inflated,²⁷ eventually the Russian authorities backed down in August 2005, and approved the two disputed budgets, in exchange for Total dropping the arbitration case.

Accountable to whom?

Investment contracts, although generally written by the investor's legal department or counsel, have a serious impact on wide areas of public law – including relating to human rights, the environment, labour and the economy.

²⁶ For example, the ruling of the Iran–US Claims Tribunal (an arbitration tribunal set up to settle claims arising from Iran's 1979 detention of US Embassy staff, and the United States' subsequent freezing of Iranian assets) in the *Mobil v Iran* case, the tribunal had to interpret Article 29 of the Agreement between the parties, which stated that 'This agreement shall be interpreted in accordance with the laws of Iran'. However, the tribunal ruled that the Agreement did not specify the *substantive* (only procedural) applicable law, and concluded that in view of the character of the Agreement and the parties involved, it did 'not consider it appropriate that such an agreement be governed by the law of one party'; instead, it should be governed by 'the general principles of commercial and international law' (cited in Kolo and Wälde 2000).

²⁷ According to news agency Interfax (2004b), Total E&P Russia General Director Jean-Pierre Dolla said that the difference arose because of accounting practices, wherein the French company includes as costs a number of items that are posted differently in Russia.

Susan Leubuscher (2006: 15–16), one of the first researchers to highlight to civil society the implications of investment agreements, identified the problem thus:

International commercial arbitration closes the circle of MNE [multinational enterprise] ascendancy [...] 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 affected populations [...] It thereby creates a system of private justice which leads to a ‘compartmentalisation of the market that the state judicial system is powerless to control’ and ensures that each holder of economic power is ‘fortified with its own custom-made justice’.

Since many arbitrations are secret – even after the event – many disputes involving states, the outcome of which will inevitably affect the public interest, are kept completely out of the public gaze.

It is the combination of the three legal provisions we have looked at – stabilization, internationalization and access to arbitration – that is particularly deadly.

Legal opinion on contracts increasingly treats any change of economic terms, or of countries’ broader laws and regulations that affect investor profits, as a ‘creeping expropriation’.²⁸ Whereas a right of nationalization does still exist in international law,²⁹ this right remains tempered by a duty to pay compensation. In cases of ‘expropriation’, including of the ‘creeping’ kind, it will be up to the arbitration tribunal to decide on the amount payable.

An investor may argue that according to a stabilization clause, its benefits (profits) must remain unchanged by the change in legislation, and so the compensation amount should be not just the value of its investment (perhaps, the amount invested plus a reasonable rate of interest), but rather the profits that would be lost throughout the lifetime of the project. While such an interpretation will depend on the legal terms of the contract and on the particular circumstances surrounding the dispute,³⁰ it would effectively cancel out the right of nationalization, and deprive a government of its sovereign role to pass legislation, let alone manage the country’s natural resources.

PART VI – POSSIBLE CONTRACTUAL MECHANISMS TO PROTECT THE NATIONAL INTEREST

A ‘production sharing agreement’ is not a unique formula; rather there is significant variation in both legal and economic terms, from country to country, and from contract to contract. Nor is the PSA the only form of contract available. (In fact, each type of contract has such variation that its terms can be adjusted to be equivalent to another ‘type’ – thus there is a spectrum of

²⁸ Bede Nwete (2005: 10), for instance, includes ‘progressive labour legislation’ as a form of ‘creeping expropriation’.

²⁹ Arising from the 1974 Convention.

³⁰ For more discussion of different interpretations of the compensation requirement, see Bishop (1998: 1175–85).

possibilities, with names such as PSA or risk service agreement only giving a rather vague meaning.)

In the previous sections, we have seen some of the problems that commonly occur with contracts such as PSAs, and how oil companies seek to capture high profits, whilst externalising risk to host states. But need such problems always occur? In this section, we examine what contractual provisions might help reduce these problems in Iraq, noting some of the precedents for such provisions. These are summarized in the table below.

1. Economic terms

Iraq has the world's largest untapped fields, combined with some of the lowest potential development and operating costs. Thus, Iraqi fiscal terms should be expected to be significantly tougher than those on offer elsewhere.

Iraq should aim to capture all of the economic rents from its oil. The best way to do this is either by offering investors a fixed fee per barrel (as in Kuwait's proposed operating service agreement, for example), or by an explicit agreement as to the internal rate of return (IRR) that will be achieved (as in Iran's buyback agreements). Contrary to the claims of some PSA advocates that such approaches will insufficiently incentivize investment, such incentives can be achieved by setting the IRR higher, and shielding them from most risks – without conceding potentially unlimited amounts of revenue.

In a situation of normal risk, companies expect an internal rate of return of 12–15 per cent. Where perceived risk is higher, companies might expect up to around 20 per cent. A cashflow analysis will allow this to be assessed. It is outside the scope of this article to carry out that exercise; the reader is referred to Muttitt (2005) and Shafiq (2006) for some sample calculations.

2. Length of contract

If companies invested in Iraq in the current situation, risk premia would be demanded – yet these would reduce the Iraqi state's revenues for the whole lifetime of the contract. One obvious solution would be to limit contracts to a relatively short period: say, five to eight years. This is probably the minimum period in which oil companies can develop the fields and get a return on their investment. Shorter contracts are quite common in risk service contracts. The Iranian buyback contracts, for example, are for eight to twelve years.

Alternatively, a weaker protection would be to include clauses specifically allowing for a renegotiation of the terms, say after six years, to assess whether they are still considered fair by both sides. It is quite common for contracts to allow renegotiation if circumstances become less favourable (i.e. unprofitable) for the investor, so there's a good argument for doing the same for both sides. There are several cases where contracts have made renegotiation available to

both sides, and some even available just to the state – such as the Kuwaiti concession to Aminoil, or Russia’s 1995 PSA law.

3. Parliamentary approval

Iraq is heavily dependent on oil income, which accounts for over 70 per cent of GDP and 95 per cent of government revenue (IMF 2005: 19, 27). The largest fields being considered for foreign investment could account for huge shares of this – so a requirement for parliamentary approval of how those revenues are shared with investors would seem quite appropriate.

A requirement for parliamentary scrutiny of major contracts would provide an extra check on whether the terms are in the national interest. Such approval is required in a number of countries – often (but not only) those without a specific oil law, where the contract itself has to be given its full legal basis by the legislature, such as Azerbaijan, Syria, Egypt and Yemen.

Russia, which following the three disastrous PSAs signed in 1994 and 1995 (Sakhalin I, Sakhalin II and Kharyaga), passed a PSA law in December 1995 that included a requirement for parliamentary approval of ‘strategic’ contracts (King & Spalding 2004: 13). In Venezuela, the 2002 Organic Law of Hydrocarbons provided that the principal manner in which foreign companies can invest in oil development is a form of joint venture, known as a ‘mixed company’: the formation of such companies requires parliamentary approval (Article 33).

4. State participation

Depending on how it is structured, state participation in a project can provide a mechanism for technology transfer and training of nationals of the host country. Participation also provides an insurance policy against unforeseen imbalances in any contract – if the oil company consortium receives excessive profits, some of these return to the state as a shareholder (as we saw in the final resolution of the Sakhalin II case). Since the reforms of the 1960s and 1970s, state participation is the norm in oil-producing developing countries, ranging from around 10 per cent (e.g. Azerbaijan) to 89 per cent (Libya)³¹ – with most requiring at least 51 per cent.

5. Control over decision-making

The most effective participation mechanisms involve either joint operatorship or transferred operatorship. In Iran’s buyback agreements, operatorship is transferred to the national oil company (NOC) once the facilities have been developed;³² in the United Arab Emirates, the NOC

³¹ In the 2005 EPSA-IV round, participation shares were established by bidding. They ranged from 61.1 per cent to 89.2 per cent (average 81.5 per cent), determined by bidding.

³² In Iraq’s 1995 and 1996 model contracts too, which were based on a modified form of Iran’s buyback agreements, operatorship was transferred from IOC to a non-profit joint operating company after payout. The approach is not common, but has also been used in Egypt, Syria, Yemen and Vietnam, and considered in Kazakhstan (Alexander 2000).

is the operator on most fields: foreign company investments consist in acquiring shares in the NOC.

While participation gives the state a formal role in decision-making, as a shareholder,³³ it is also important to provide in the contract for *regulatory* oversight of work plans and budgets. While some countries do not require this,³⁴ many do – including the Iraqi contracts negotiated and signed in the 1990s.

6) Stabilization clauses

Stabilization clauses are highly controversial, and there are powerful arguments that given the extent to which they encroach on sovereignty, they should not be used at all.

While some recommend limiting their scope to fiscal terms, and/or very specific legislative changes,³⁵ for many countries, including most industrialized countries and also some developing countries such as Venezuela, the ability to freely determine levels of taxation (let alone legislation) is considered a sovereign right.

The United Nations Commission on International Trade Law makes the rather obvious point that corporations, like citizens, should expect changes in the law³⁶ (UNCITRAL 2001: 141 para. 123): indeed such change is part and parcel of democracy (Hildyard and Muttitt 2006: 50). Far from fixing legislation to that specified in a contract, it would not be unreasonable to specify that all oil companies are subject to the laws of Iraq (indeed, such clauses often appear in contracts), and that Iraq will preserve its sovereignty in passing laws as it sees fit.³⁷

7. Arbitration

Equally controversial in relation to sovereignty are provisions for international arbitration outside the country. While international arbitration is used in the majority of cases, there are exceptions – including Iraq’s model contract of 1995,³⁸ which specified Iraq as the ‘country place of arbitration’³⁹ (Alexander 2000). China’s 1982 (revised in 2001) offshore oil regulations (Article

³³ It is not without its problems – such participation can lead to blurring of regulatory space, or even encourage the government to side with the consortium in disputes with third parties (in particular, citizens of the country) (Leubuscher 2003: 11–12).

³⁴ In Venezuela’s 1995 model contract, during the *apertura petrolera* period of extensive liberalization of Venezuela’s oil industry (which is now being reversed by President Hugo Chavez), no government approval was required. In Indonesia’s 1989 model contract, government approval could not be ‘unreasonably withheld’ (Alexander 2000).

³⁵ For example, the OECD recommends that stabilization clauses should not grant blanket exemptions or rights to compensation, but should be restricted to clearly specified legislation, with clearly specified compensation terms (OECD 2002).

³⁶ The recommendations made with regard to stabilization clauses are found at pp.140–42. UNCITRAL notes: ‘All business organizations, in the private and public sectors alike, are subject to changes in law and generally have to deal with the consequences that such changes may have for business [...] General changes in law may be regarded as an ordinary business risk [...]’.

³⁷ Amaechi Nwokolo (2003/04), for instance, proposes such a formulation: ‘Nothing in this clause shall be read or construed as imposing any limitation or constraint on the scope, or due and proper enforcement, of legislation of general application that does not discriminate, or have the effect of discriminating against the Contractor, and provides in the interest of safety, health, welfare or protection of the environment [...] provided, however, that the state will ensure that such measures are in accordance with the current international petroleum industry standards and are not unreasonable.’

³⁸ These provisions did not carry forward into the 1996, 2000 or 2002 model contracts in Iraq.

³⁹ If the arbitrators appointed by the two parties could not agree on a third arbitrator, the third would be appointed by Iraqi courts.

24) specify that in case of disputes, ‘mediation and arbitration may be conducted by an arbitration body of the People’s Republic of China’⁴⁰ (China 2001). Venezuela’s Organic Law of Hydrocarbons (Article 34) states that ‘All disputes shall be decided by the competent courts of the Republic, and no foreign claims shall arise for any reason’ (Venezuela 2002).

A weaker alternative would be for contracts to explicitly recognize that the role of the Iraqi government in upholding and advancing the public interest – through legislation, regulation, licensing and other measures – is inviolable; arbitration should be available only in cases where the government acts in bad faith; arbitration should not restrict the exercise of its sovereignty in the interests of the Iraqi people.

Summary of possible contractual provisions available to Iraq

Problem	Possible solution	Example of solution
Companies receive excessive profits, at the expense of state revenues.	State to capture all rents: 1. Offer fixed fee per barrel. 2. Specify acceptable internal rate of return.	Kuwait operating service agreements Iran buyback agreements
Long-lasting contract fixes the terms to reflect bargaining power and risk premium at time of signing.	Shorter contracts Include renegotiation clause	Iran: 8–12 years (3–4 as operator) Kuwait Aminoil concession, Russia 1995 PSA law
Unsuitable contracts signed by government entity, reflecting its political priorities or pressures on it.	Require parliamentary ratification of contracts.	Russia (1995 PSA law), Syria, Egypt, Yemen, Azerbaijan
State remains in weak position relative to investor. Due to regulatory/ negotiating capacity, it is only realized later that detailed terms were unsuitable.	Require high level of national oil company participation in contracts.	Very common – up to 89% (Libya); Venezuela (2001 Hydrocarbon Law) sets 50% minimum for all contracts. Partial mitigation of Sakhalin II problems (Russia), via Gazprom.
State has no role in decision-making.	Within joint venture, give state either full operatorship (possibly post-development), or joint	Full: Iran buybacks Joint: Egypt, Syria

⁴⁰ It also allows that ‘the parties to the contract may agree upon arbitration by another arbitration body’.

	operatorship. Require regulatory approval of budgets, work plans etc.	A common provision – usually the state has majority of votes on a management committee.
State loses sovereignty over economic terms and even legislation.	Maintain sovereignty over economic terms (avoid stabilization clauses). OR limit stabilization clauses to fiscal terms.	Venezuela, United Kingdom UNCITRAL recommendations
Investors' rights are more enforceable than state's, via international arbitration.	Specify that disputes will be settled in-country, and that national law is applicable law.	Venezuela, China

PART VII – IRAQ'S PROSPECTS

Iraq's draft oil law

At the time of writing, a draft oil law has been approved by the Iraqi cabinet, and is awaiting approval by the National Assembly (Iraq 2007). Only 'existing producing fields' – accounting for a minority of Iraq's known fields – would remain exclusively in public hands. The remaining known fields, plus areas still to be explored, would likely be developed by foreign companies.

The draft empowers executive entities⁴¹ to sign contracts, without any requirement for parliamentary approval. Most aspects of the law are quite open – allowing the executive to proceed however it sees fit.

For example, the draft specifies a contract term of up to ten years of exploration and appraisal, followed by up to twenty years of production⁴² (Article 13). No minimum is specified, but that maximum is a high one, allowing the possibility of Iraq's oil being signed away for a generation.

The types of contract are the undefined 'development and production contract' and 'exploration risk contract' (Article 9) – which most commentators believe include the possibility of PSAs or similar.

No minimum level is set for state participation in contracts (Article 12). Again, this leaves open a range of possibilities, to be decided by the executive bodies – a minimum level, of at least 51 per cent, might have been expected in the law itself.

⁴¹ Specifically, contracts would be negotiated and 'initially' signed by the Oil Ministry, the Iraq National Oil Company or a regional entity, and ratified by the newly established Federal Oil and Gas Council.

⁴² There is an option to extend this for a further five years, subject to negotiation.

The draft law does require that model contracts meet a set of criteria relating to the national interest.⁴³ One of these is ‘national control’, which suggests requirements that regulators approve work plans etc. However, the qualitative nature of most of the criteria leaves available terms very open: in practice, just about any set of terms could be claimed to be ‘optimal’ or ‘reasonable’ in certain circumstances.

In the first (July 2006) draft of Iraq’s oil law, the drafters included a note to legislators that ‘For consideration: Some countries do not accept arbitration between a commercial enterprise and themselves on the basis of sovereignty of the state’ (Article 32). The warning was evidently ignored, with the final draft specifying that any disputes may be submitted ‘to arbitration or to the competent judicial authority’. The ‘or’ may leave open the possibility of contracts themselves selecting Iraqi courts for dispute resolution, but the law permits international arbitration, which many investors would now insist on. The arbitration rules of either the Paris or Geneva Chamber of Commerce or the ICSID Convention are specified in the draft. (The latter is somewhat odd, as Iraq has not signed the ICSID Convention (Article 25(1)), which makes clear that only disputes relating to signatory states and their nationals (investors) are within the jurisdiction of ICSID.)

There is no mention of stabilization clauses – it might have been hoped that the draft would specifically exclude such measures. However, one cause for concern lies in the draft law’s definition of ‘good oilfield practices’ (Article 4, Definition 4), as those ‘generally accepted by the international petroleum industry as good, safe, environmentally friendly, economic and efficient’. This is likely to undermine the state’s ability as regulator to determine what meets those qualitative criteria. Indeed, this is almost exactly the same wording as was used in the host government agreements for the Baku–Tbilisi–Ceyhan pipeline, precisely to undermine regulatory space (Hildyard and Muttitt 2006: 48–49).

Future contracts

Most of these problems in the draft oil law consist not in explicitly giving too much away but rather in failing to restrict future contracts sufficiently to defend the Iraqi interest. What prospects are there that the contracts themselves might defend Iraqi interests?

Since the law does not require parliamentary approval, even of major contracts, it will be down to those in the government to determine the answer. However, the existence of skilled and patriotic technocrats in the Oil Ministry is not itself adequate reassurance – as just the same

⁴³ Specifically:

1. National control
2. Ownership of the resources
3. Optimum economic rent to the country
4. An appropriate return on investment to the investor
5. Reasonable incentives to the investor for ensuring solutions which are optimal to the country in the long-term related to: (a) improved and enhanced recovery; (b) technology transfer; (c) training and development of Iraqi personnel; (d) optimal utilization of the infrastructure; (e) Environmentally friendly solutions and plans.

could be seen in Russia in the early 1990s, where levels of technical education were very high, as was national pride.

The real dynamic of power in relation to Iraqi oil can be seen from the fact that the law has been drafted without the involvement of the Iraqi parliament, nor of civil society; while the US and UK governments, the International Monetary Fund and even the multinational companies themselves have been actively involved throughout the process.⁴⁴ The *New York Times* described how

Senior Bush administration officials and top American commanders here have said a new oil law is crucial to the country's political and economic development, and they have pressured Iraqi leaders relentlessly to make passage of the law a priority. (Wong 2007)

The newspaper identified US Ambassador Zalmay Khalilzad as the key person who brokered a deal on the draft. Troublingly, an Associated Press article (Hurst 2007) cited advisors to Iraqi Prime Minister Nouri al-Maliki as saying that al-Maliki had been warned – implicitly or explicitly – that if the law were not passed by June 2007, the United States of America would seek to bring down his government.

The Oil Minister has stated that the Ministry intends to open a licensing round soon after the oil law has passed, with an aim to sign contracts by the end of 2007 (Reuters 2006; Platts 2007). While timescales have been delayed somewhat, this is likely to mean that contracts would be signed while the country is still occupied, and while violence persists. Thus the concerns we have raised about bargaining power and about risk premia are likely to apply.

The oil companies' views were most comprehensively expressed in a paper published by the International Tax and Investment Centre (ITIC) (2004a) – a paper formally submitted to the Iraqi government by the British Ambassador (ITIC 2004b: 8), and presented to government officials and ministers at a meeting jointly organized with the British Embassy and the International Monetary Fund and World Bank in January 2005 (ITIC 2005: 6; Witt 2006). The openness of the Iraqi government to such views is illustrated by the Finance Minister's request that the oil companies and ITIC meet with officials again to present their views in spring 2007 (ITIC 2007: 10).

The ITIC paper (2004: 8) specifically called on the Iraqi government to 'offer to companies profit potential consistent with the risk they bear', 'assure investors of fiscal stability' and provide 'effective dispute resolution procedures'.

Furthermore, the common law approaches of both the US and UK legal systems tend to emphasize the doctrine of sanctity of contract, over that of adaptability of contracts to

⁴⁴ The US State Department began to shape Iraqi oil policy as early as 2002, through its Future of Iraq project. Both US and UK governments have been actively involved since, including through providing former executives from oil multinationals as advisors, through assisting the lobbying efforts of the companies themselves. Since the first draft of the oil law was completed in July 2006, both governments have intervened extensively in the reviewing process; nine multinational companies also saw and commented on the first draft within two weeks of its completion. Meanwhile, the IMF included completion of an oil law to facilitate foreign investment as one of its conditions in its standby agreement with the Iraqi government in December 2005 – an agreement which itself was a requirement for the cancellation of 30 per cent and later another 20 per cent of the debts to wealthy Paris Club nations accumulated by the Saddam Hussein regime – and also required the participation of IMF staff in the drafting process (IMF 2005: 14,17,18; Paris Club 2004) Most Iraqi members of parliament saw the law for the first time in March 2007.

circumstances, which can be found more in the legal systems of continental Europe and Asia (Gotanda 2003: 1464; Kröll 2004; Kolo and Wälde 2000). That the United States and the United Kingdom are the occupation powers in Iraq is thus significant.

In March 2006, Dan Speckhard, US Ambassador for Reconstruction in Iraq, also emphasized the legal mechanisms to protect investors' interests:

The oil companies will be very interested in ensuring how they have the support in terms of the legal rights to returns for their investment, and if there are any disagreements in contractual arrangements, how those are handled in courts and how they are enforced. (US State Department 2006)

These various comments provide clues pointing towards strongly enforceable, generous contracts.

PART VIII – CONCLUSION

We have seen that in current circumstances, security and political risks are so high in Iraq, that substantial risk premia would be demanded by oil companies. Meanwhile, the institutions of state are so damaged by the security situation, by internal political divisions and by the occupation that in any negotiation they would necessarily be operating from a position of extreme weakness.

A natural conclusion is that now is a bad time to be outsourcing risk, especially in long-term contractual structures – and that the Iraqi state would be better off deferring decisions on foreign investment until the country is fully sovereign and more stable, using its own capital to invest in the oil sector in the meantime. Furthermore, according to the 'sequencing' doctrine, such an approach would allow Iraq *first* to rebuild its institutional capacity and reduce corruption, in order subsequently to effectively manage and regulate oil investment.

An alternative approach, that contracts be structured such that the state carried as many risks as possible (and with them the upside), is problematic in a number of respects. This latter approach might be achieved in relation to price risk, through the choice of fiscal measures; however, when it comes to security risk and political risk, the social and political costs of limiting an investor's risks are very high.

For the state to take a large share of liability for investors' security risks would create pressures to attack any perceived threats – with severe consequences for human rights and stability. The introduction of yet another set of powerful interests into Iraq, backed with military force, is probably the last thing the country needs right now.

Meanwhile, the cost of mitigating political risks would be a significant surrender of sovereignty over Iraq's natural resources – including the ability to apply and adjust taxes in the public interest, the ability to arbitrate disputes in national courts and even the ability to pass legislation. In theory, a set of contract terms might be found that reduced these multiple costs –

of risk premia, security liabilities and loss of sovereignty. In particular, the use of short-term contracts, or the inclusion of renegotiation clauses in them, could help.

Many of the advocates of production sharing agreements in Iraq attempt to apply a two-stage argument (ITIC 2004a; IPE 2004: 34–53): first, that Iraq necessarily requires foreign direct investment, in order to provide adequate capital, technical resources and management capacity; second, that having accepted this, Iraq will have to offer generous economic and legal terms in order to attract investment away from other oil-producing countries.

Not only does this argument tend to overstate states' need to compete for investment,⁴⁵ to accept it would further weaken Iraqi institutions' bargaining power, allowing them to be dictated to in how to run their oil industry. If they are to go down the route of inviting foreign investment, they would be wise to keep open the option of investing from the public sector. Helmut Merklein (2006b: 31) argues rightly that if the oil industry will not accept a contract which would deliver the right benefits to Iraq, then 'the National Oil Company solution and the designation of that company as the exclusive oil and gas producer in the country can be implemented unilaterally'.

However, given that Iraq remains an occupied country, and given the central role of the occupation powers and international institutions in shaping oil policy to date, such appeals to the Iraqi national interest may find little traction in current decision-making. On this reading, a more natural conclusion is that it is inappropriate for such long-term decisions about the future of the country's natural resources to be made until Iraq has full sovereignty and its government is able to represent the interests of its people.

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⁴⁵ Certainly inter-state competition for investment is not greater than the competition between investors for acreage, especially while the oil price is high. Indeed, most oil-producing countries are currently toughening their terms of investment, rather than weakening them. There are good arguments too that tax competition is unacceptable on principle – as governments should be accountable to their electorate, not to the market (Murphy 2007: 23):

The theory of tax competition conflates the micro economic theory of the firm with the political economics of the state. This is a fallacious notion whose main use appears to be the justification of tax cuts for powerful companies and the rich [...] Governments do not compete with one another to provide defence, health, education and other public services to their citizens.

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Contributor's details

Greg Muttitt is a co-director of PLATFORM (www.carbonweb.org), where he has worked since 2000. PLATFORM is an interdisciplinary organization, working on development, environment and human rights issues, and specializing in the impacts of the international oil industry. Greg has been monitoring and researching Iraqi oil policy since 2003, before which his work focused on oil development in Azerbaijan and Russia.

PLATFORM
7 Horselydown Lane

London SE1 2LN
UK
E-mail: info@platformlondon.org