

# **Legal, Fiscal and Regulatory Frameworks Governing Upstream Petroleum in Iraq**

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## **Introduction**

Iraq upstream petroleum witnessed three unprecedented interrelated developments post-2003: A grand opening to FDI; offering the most prized petroleum fields in a rather short period of time; and formulation of the basic model for LTSCs.

I would argue that if things go as planned and contracted, Iraq would become major contributor to world petroleum market; a magnet for FDI through the involvement of the IOCs, specialised service companies and other related activities; and could introduce new but significant element in the legal and governing framework, which might have wide and lasting implications for relationship between host developing countries and the IOCs. However, more often than not reality seldom coincides with expectations.

As a matter of methodology this paper is confined to LTSCs for upstream petroleum development, and due to space limitation the corresponding matters in the Kurdish region of the country were excluded though few references to the region were made. The analysis is based on the model contracts and, for verification purposes, consult “scanned” copies of the signed contracts. But due to pledge of non-disclosure, no formal referencing will be made to any signed copies of these contracts. Also the paper does not address the contracting matters of sub-contracts, FEED, EPC or any other types of contracts. Finally, space limitation prevents providing necessary data, statistics, annexes, maps and charts that are available on matters covered by this paper.

Part one provides updated review of the petroleum upstream activities in exploration, development and production sub-sectors. However, due to the importance of exports brief paragraphs were added on the expansion and diversification of exports outlets.

The complexities, components and intertwinement of the petroleum legal regime are addressed in part two. This part elaborates on three major issues: Petroleum law and relevant provisions; Government take and payment to and privileges of the IOCs.

Part three sheds lights on the main features of and the new development in the model service contracts

Further insight is provided in part four on three critical current issues: the legality of the concluded contracts; the situation of IOCs who concluded contracts with KRG, and reduction of production plateau targets and renegotiating the contracts. The paper ends with few conclusions. Acknowledgment and list of abbreviation are at the end of the paper

### **Part one: Petroleum Upstream Activities**

Petroleum upstream sub-sector constitutes the main pillar for the Iraqi economy. The national development plans and annual state budgets (for current and investment purposes) depend largely on oil production and exports revenues. These revenues also determine the balance of payments and trade balance. Hence the level and prospects of all economic activities in the country are affected seriously and effectively by the development in the upstream petroleum.

The periodic and annual plans of the MoO provide detailed information on the main components and direction of various activities within the upstream petroleum, while concluding contracts manifest the actual modalities of implementation.

#### **1.1-National Exploration Program**

Official Iraqi data announced on October 2010 increased oil proven reserves from 115 to 143 billion barrels from known 66 oilfields, and this represent only 28% of the estimated OiP.

Considering that total accumulated production at 1/1/2010 mounted to 7% of the estimated OiP the remaining 65% points to the high potential of the country.

Proven gas reserves are estimated at 127 tscf of gas, out of which 71% associated gas, 20% non-associated and 9% dome gas. Probable gas reserves are estimated to be 275-300 tscf.

MoO announced in February 2011 its new four years' plan 2011-2014. The first objective of the Plan is, "To attain significant increase in the oil and gas reserves". Sources at the ministry quantify these objectives to adding around 29 tscf of gas and 10 billion barrels of oil to offset the expected depletion of fields, offered in the first three bidding rounds.<sup>1</sup>

Funds allocated for the exploration program, under the Plan, mounts to \$644 million<sup>2</sup> earmarked annually at: \$120 million, \$144 million, \$173 million and \$207 million for the years 2011 to 2014 respectively.<sup>3</sup>

Though annual investment allocation in the exploration program is on the upwards trend, their proportion to total plan's investment allocation remains constant at 3.73% on both aggregate and annual levels. This would lead to suggest that investment allocation was formulated on sheer fiscal measure, being fixed percentage of the total plan's investment allocation, more than on specified cost-itemised exploration activities.

The Plan says investment allocation does not cover payments due to IOCs for the three bid rounds, and thus it also does not cover the annual financial requirements of the four contracts concluded pursuant to BR4 if they are executed within the duration of the plan.

The exploration program, according to MoO, would be implemented in three phases: first phase is to hold BR4 regarding exploration blocks (took place on May 2012, and the contract of which is discussed below); second to launch massive exploration operations throughout the country using national efforts and capacities, and third is to drill 12 exploration wells (in other areas) across Iraq.<sup>4</sup>

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1 <http://www.upstreamonline.com/live/article253707.ece> Accessed 26 April 2011.

2 Original data in ID converted at 1\$= 1168 IDs

3 See, MoO (Feb 2011).

4See <http://www.upstreamonline.com/live/article253707.ece> Accessed 26 April 2011. However, the Plan refers to 10 not 12 exploration wells.

During BR4, 12 exploration blocks were offered seven are gas-prone and five are oil-prone.

Only four blocks were contracted and three of them are classified as oil-prone.<sup>5</sup>

In the immediate aftermath of BR4 the Oil Minister made two statements one related to a new fifth bid round and the other on the exploration program. Regarding the proposed new bid round he reportedly said Iraq has more than 60 blocks ready for offer, and preparations would start in few months for the launch of the round in which 10 to 15 oil and gas blocks would be put on offer and this requires more than a year of preparation. It's worth mentioning that Dr. Shahrستاني has reportedly asked MoO, "to sweeten the terms of the model contracts offered to foreign oil companies" for the new bid round.<sup>6</sup>

Actually there are no compelling reasons for holding a fifth bid round in such a pace, especially for oil-prone blocks.

Few remarks are worth mentioning regarding the minister's second comment on the exploration program. As stated above the said program is already incorporated in the plan 2011-14. In this regard OEC has increased the number of its seismic crews to three, and additional two would join soon.<sup>7</sup> However, so far only one exploration well was completed in "Dima" oilfield east of Missan province.<sup>8</sup> Obviously more is needed to accomplish the number of exploration wells targeted in the program.

## **1.2- Expanding of Development, Production and Export Capacities**

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<sup>5</sup>For analysis of the fourth bid round pre and post the bidding event see Jiyad (June 2011 and June 2012).

<sup>6</sup> [http://www.iraqoilreport.com/politics/oil-policy/baghdad-re-asserts-itself-8522/?utm\\_source=Email](http://www.iraqoilreport.com/politics/oil-policy/baghdad-re-asserts-itself-8522/?utm_source=Email) Update Subscribers accessed 13 August 2012

<sup>7</sup> On work and performance of OEC see [http://www.iraqoilreport.com/oil/production-exports/iraq-to-expand-own-exploration-capacity-8143/?utm\\_source=Master](http://www.iraqoilreport.com/oil/production-exports/iraq-to-expand-own-exploration-capacity-8143/?utm_source=Master) Subscribers: Active. Accessed 8 June 2012. Also Uqaili (2012) provides further insights on exploration strategy for the country.

<sup>8</sup> As stated by the minister in his interview with the government owned AlSabah Newspaper on 2 June 2012 <http://www.alsabaah.com/ArticleShow.aspx?ID=28344> Accessed 4 June 2012.

The second pillar of upstream activities comprises development, production and export capacities.

Post 2003 development and production uses two main modalities: cooperation with IOCs and national efforts. Most of the highly prized oilfields and three gas fields were offered to IOCs through three bid rounds and one by direct negotiation. National effort could be confined to the remaining petroleum fields that were not offered during the three bid rounds and those offered but were not awarded either due to non-bid or the bids were not accepted by MoO.

IOCs involvement began through direct negotiation with the Chinese CNPC to convert the production sharing agreement for Alahdab concluded in 1997 into LTSC concluded in November 2008, and this is the only oilfield awarded through direct negotiation.

Contractually, the production plateau at full development of the field was put at 115 kbd, but recent information indicates that production plateau could be at least 200 kbd.<sup>9</sup>

The other oil and gas fields contracted to IOCs were awarded through three bid rounds between June 2009 and October 2010. A total of (15) contracts were signed covering (17) fields including 3 gas fields and 14 oilfields.

Oilfields contracted pursuant to BR1 include brown fields with known history of production: Rumaila, WQ1, Zubair, and Missan group (comprising three oilfields: Buzorgan, Abu Gharab and Fakka). If these fields are developed as contracted within the timeframe their PPT would reach 7.25 mbd. IOCs contracted are CNPC (China), BP (UK), ExxonMobil (USA), Shell (Netherlands), ENI (Italy), Occidental Petroleum- Oxy (USA), and Kogas (Korea).

BR2 comprises seven oilfields known as green-fields, which are discovered but not yet commercially developed. These are WQ2, Majnoon, Halfaya, Garraf, Badra, Qaiyara and

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<sup>9</sup> [http://www.iraqoilreport.com/oil/china-brings-ahdab-field-online-5996/?utm\\_source=Email+Update+Subscribers&utm\\_campaign=b921a682d6-Email\\_Update&utm\\_medium=email](http://www.iraqoilreport.com/oil/china-brings-ahdab-field-online-5996/?utm_source=Email+Update+Subscribers&utm_campaign=b921a682d6-Email_Update&utm_medium=email) accessed 26 July 2011

Najma. The full development of these fields would provide additional 4.765 mbd. IOCs contracted include Lukoil (Russia), Shell, Petronas (Malaysia), CNPC, Japex (Japan), Gazprom (Russia) and Sonangol (Angola).

BR3 includes three gas fields-Akkas, Mansuriya and Siba. The winning IOCs are Kogas, Kuwait Energy and TPAO. When these three fields are fully developed their combined plateau gas production would be 820 mcf.

Total oil production from oilfields offered under BR1 and BR2 and from Alahdab mounts to 12.215 mbd when the contracted plateau targets are realized. Total oil production in the country would be even higher if oil production from other oilfields and those from KRG are added.

Oil production would also produce proportional volumes of associated gas. Technical information reveals that each one mbd of Iraqi crude oil produces associated gas of 0.8 bcf.<sup>10</sup> Accordingly, there will be significant volumes of associated gas that have to be properly utilized requiring substantive investment and IOCs involvement. Moreover, development of these gas fields has strategic importance being independent from oil production.

Official data from MoO indicates 73% of the associated gas produced in the first ten months of 2012 was flared.

Oil production destined mainly to satisfy world demand as domestic demand for oil is limited and any future expansion in economic activities and improvement in standard of living would not absorb even two tenth of the plateau production. Thus, most of the produced crude has to be exported. Hence expanding and diversifying export outlets are prerequisites to realizing any level of production capacity expansion.

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<sup>10</sup> This was based on an average gas oil ratio for Iraqi crudes after discussions with Dr. Thamir Uqaily on September 2012.

Without going into too many details on likelihood success, MoO adopted the ICOEE to expand and diversify export facilities through Arabian Gulf, Turkey, Syria and even Jordan. According to ICOEE total oil export would increase from 2.4 mbd in 2011 to 5.65 mbd in 2014. In the long run, it aims at export capacities of 8.5 mbd through Arabian Gulf by installing 5 SPMs, rehabilitation of BOT and KOT; 4.5 mbd through Syria by: rehabilitation of the existing pipeline with capacity of 1.25 mbd; new pipeline for light and medium crude with capacity of 1.25 mbd and another new pipeline for heavy crude with capacity of 1.5 mbd. Also there is plan for a pipeline to deliver surplus gas to Syria and the Arab Gas Pipeline with a possibility for connection to port of Ceyhan (Turkey) on the Mediterranean or through Egypt and then to European network.

The current pipeline from Kirkuk to Ceyhan would be upgraded to 1.6 mbd. Moreover there were talks for new oil and gas pipelines following the same route to Ceyhan.<sup>11</sup> Also official agreement was reported regarding oil and gas pipelines to Jordan. A crude pipeline of 1mbd to city of Zarga and then to Aqaba for export, when finished would replace export by trucks running at 10 kbd with a possibility to increase to 15 kbd.<sup>12</sup> Finally, to optimize pipeline network to attain export targets the MoO signed a \$13.3 million contract on May 2011 with the Canadian consulting firm SNC-Lavalin.<sup>13</sup>

## **Part two: Petroleum Legal Regime**

Legal regimes governing petroleum upstream (and midstream) subsectors are both complex, multi-layered and some of the components are ambiguous.

### **2.1- Petroleum Law and Relevant Provisions**

<sup>11</sup> [http://www.energyintel.com/print\\_me.asp?document\\_id=714298&pID=31](http://www.energyintel.com/print_me.asp?document_id=714298&pID=31) accessed 25 April 2011.

<sup>12</sup> <http://www.iraq-businessnews.com/2012/09/26/iraq-jordan-to-build-oil-pipeline/> accessed 27 Sept 2012

<sup>13</sup>[http://www.iraqoilreport.com/oil/production-exports/iraq-moves-forward-on-strategic-pipelines-5673/?utm\\_source=rss](http://www.iraqoilreport.com/oil/production-exports/iraq-moves-forward-on-strategic-pipelines-5673/?utm_source=rss) Accessed 13 May 2011.

The development of Iraq's upstream petroleum sector is undoubtedly be affected by the complexities and intertwinement of various legal, constitutional, institutional, agency and policy frameworks.

The pyramid of legal and regulatory frameworks governing the petroleum sector policy and development impacting its formulation and execution is composed of many levels each has distinct authority with legal and legislative instruments.

At the top level of the pyramid stand the federal Constitution, which provide basic principles and constitute the heart of the mandatory framework. Collective 'ownership' (Article 111) and 'highest benefit' (Article 112:2) are most powerful core principles; participatory 'co-management' (Article 112: 2) is basic operational principle; 'encouraging' private sector involvement both domestic and foreign (Article 112: 2) is necessary promotional principle; finally, existing laws remain 'in force', until such laws are annulled or amended (Article 130), is important transitional validation principle.

The second level includes legislative instruments specific to petroleum up and mid-stream subsectors. This level comprises three broad categories of laws. The first category comprises all laws that existed prior to the adoption of the Constitution but remain valid, and which the Constitution refers to in Article 130 referred to above. These laws are Law 80 of 1961 (promulgated 99.5% of concessions areas), laws number 97, 123 and 130 of 1967 on INOC (which was dissolved in 1987), MoO Law 101 of 1976 and its amendments, Law 84 of 1985 for preservation and protection of Hydrocarbon Endowment, Law 3 of 1997 for the Protection of the Environment; Income Tax Laws 113 of 1983 (and its amendment by law 19 of 2010) and Public Company Law 22 of 1997.

This second category comprises "drafts" of laws that have been captured by political deadlock since early 2007, and thus none of them enacted yet. This includes the known "package of

laws”, namely FOGL<sup>14</sup>, Iraqi National Oil Company Law (INOCL)<sup>15</sup>, Ministry of Oil new Law, Revenue Sharing Law and the Public Commission to Audit and Appropriate Federal Revenues Law.

The third category comprises other laws of particular relevance and could have direct and indirect implications for petroleum-related projects. Among them are Investment Law 13 of 2006, which created the National Investment Commission-NIC and the Provincial Investment Commissions, Private Investment in Oil Refining Law 64 of 2007, and Provincial Law 21 of 2008.

There is a considerable degree of legal uncertainties, ambiguities and disparities that could lower the legal predictability in upstream arrangements, especially those involving IOCs.

Ambiguities and imperfections, different interpretations of certain constitutional provisions had and could generate daunting uncertainties on one hand and referral to older, though still valid, laws on the other. This has generated serious rifts between the legislative and executive branches on their respective roles in the development of upstream petroleum. With the proposed FOGL stalemate, the executive branch (CoM and MoO) relied primarily on its own interpretation of selective old instrument to move forwards with its actions, causing further legal uncertainty.

The principles enshrined in the constitutions have caused serious difference of interpretation, opinions, and generate ambiguities to the extent that observers find it necessary to resolve these ambiguities and make the required constitutional amendments.

The most apparent and lingering problem is the legal status of the concluded contracts. While the executive branch, CoM and MoO, considers the enactment of these contracts falls within its mandate and authority, others within the legislative branch – CoR and outside it think the

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14 For further analysis of FOGL see Jiyad (2008: Jan 2011: Dec 2011)

15 More analysis on INOCL is available from Jiyad (2009: May 2011)

government illegally intrudes on the parliament prerogatives. Informed legal and professional opinions extend support to the position taken by CoR. Furthermore, IOCs expressed concerns about the legality of these contracts in the absence of clear legal framework, though they accept the risk associated with such legal uncertainty. But many have even worried that future governments and parliaments might cancel or radically modify these contracts, which might affect the economics of the related contracts. Actually, during March 2010 election campaign and in the immediate aftermath political parties and groups declared their dissatisfaction with these contracts, and called for revising them once the new government assumes office. That's proved to be only election rhetoric.

That said, in the absence of specific, clear and functional hydrocarbon law, vague and ambiguous provisions of the current Constitution and selective invoking of pre 2003 laws, the legal framework governs the upstream petroleum projects remains shaky and thus generates good deal of legal uncertainty.

a) Regulatory bodies

Pursuant to the Constitution all such legal instruments referred to above are usually propose by the government through the CoM (the Executive Authority), approve and enact by the CoR (the Legislative Authority), and enter into force upon publication.

Accordingly, both the executive and legislative branches of government have their regulatory bodies each with defined, assumed role and responsibilities.

The regulatory bodies within the executive authority begin with the relevant sector ministry, which in the case of upstream activities is MoO. MoO prepares draft law and refers it to the Energy Committee of CoM, and CoM approves the draft law after the State Consultative Council [*Majliss Shaura Aldawlah*] confirms the text of the proposed law is in conformity with the Constitution. Once CoM approves the draft of the law, the council formally refers the draft law to the Parliament for enactment according to the constitutional process.

According to the constitution the parliament has two main functions- legislative and oversight. The legislative function begins when the parliament receives the draft law from the executive branch. The Parliament places the draft of laws in three categories: the first includes laws that are received and referred to the relevant committee(s), the second comprises draft laws tabled for the “first reading”, and the third covers draft laws tabled for the “second reading”. Once the readings and discussions of the draft law are completed and if voted positively the draft law will be listed in a fourth category of ‘approved laws’. However, the laws enter into force upon publication in the Official Gazette [*Alwaqee aliraqia*] unless stipulated otherwise (Article 129 of the Constitution).

The above demarcation between the authorities, roles and functions of both the executive and legislative branches pertaining to laws are not without ambiguities. The cause of such confusing affairs is the wordings and terms used in Article 60 of the constitution. The said article in its (first sub-paragraph) mandates the President of the Republic and CoM to present ‘draft laws’, and (in its second sub-paragraph) authorizes ‘ten members of the Council of Representatives or by one of its specialized committees’ to present ‘proposed laws’.

The terms ‘draft laws’ and ‘proposed laws’ created rift and different interpretation between the executive and legislative branches, which camouflages the positions and attitude of the main political blocks in the country. The above differences in interpreting Article 60 became so apparent in July-August 2011 when two different versions of FOGL were submitted, one was suggested by OGNRC and the other by MoO adopted by CoM<sup>16</sup>, adding further confusing and causing more rifts in the political environment that persisted until the time of writing this paper.

The other role of the parliament is the oversight function which gives the parliament powers and authority to assess the work and performance of the executive branch, according to

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16 For discussions of both versions of FOGL see Jiyad (Aug 2011: Aug 2011a)

Article 61 of the Constitution. As far as upstream petroleum the ministers of oil and some senior officials of the ministry made few submissions before the parliament regarding for example the bid rounds, INOCL and BGC.

More often than not, the relationship between the two most important regulatory bodies- the MoO and OGNRC is affected by the political situation in the country since the chairman of the latter should, according to the established political order, not be from the same political block of the former. Therefore it is normal to hear very different views among the members of OGNRC on the same issue, reflecting their political affiliations. Moreover, the same members sometimes express contradictory positions depending where their political block stands on the same issue at different times, such as election times or tensions between these dominating political blocks. Therefore, within post 2003 political order oil related laws are treated and perceived by the politicians as “political” instead of “legal” instruments, hence without compromises and “political horse-trading” the possibility of promulgating upstream petroleum law becomes very remote.

#### b) Types of agreements

MoO concluded between 2004 and 2008 some 50 MoCs with many IOCs to provide, according to Al-Olom, support in three major activities: joint technical studies; training and development; and technical consultancy. IOCs covered costs related to these MoCs, and their overall assessment is positive.<sup>17</sup>

MoCs had helped the formulation of the TSCs, which were thought for implementation by the IOCs during two years 2008/9. TSCs focus first to capture the production decline of the major oilfields (Rumaila, Zubair, WQ1, Missan fields and Kirkuk), and then increase production by 400-500 kbd. The Iraqi side pays for both investment requirements and IOCs’

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<sup>17</sup> I am very grateful to Dr. Ibrahim Al-Olom (former minister of oil) and Mr. Abduljabbar Al-Waggaa (former deputy minister of oil) for useful discussions and information through direct communication on these MoCs.

fees to achieve that target. Negotiation of the TSCs lasted from the last quarter of 2007 to mid-2008 without conclusion due to differences on serious issues (Al-Ammedi, 2009).

MoO then reduced the duration of the TSCs to one year since, at that time they would overlap with the timing of bid rounds. The IOCs refused the one year period as too short for such contracts. Accordingly, MoO abandoned the TSCs to focus on the bidding round.<sup>18</sup>

Based on the previous experience with the TSCs and the expected bid rounds the ministry began formulating and drafting the “model” contracts, which would constitute the contractual framework governing the relationship with the IOCs (Al-Ammedi, 2009a)

That had contributed to the development of long term DPSCs for the oil and gas fields and EDPSCs for exploration blocks. The first step was to convert the contract for Alahdab oilfield with CNPC from production sharing of 1997 to service contract signed in November 2008.

The model contract for each of the four bid rounds was based primarily on Alahdab contract in structure, composition, main principles and clauses. Each contract has 43 Articles, 6 Annexes (8 Annexes for the exploration contracts) and 4 Addendums. They differ only to reflect the particularities of the related fields or blocks, and few substantive matters. The variations pertaining to some components across these models will be identified and explained in different parts of this paper.<sup>19</sup>

These DPSCs and EDPSCs are the backbone of any future relationship with the IOCs resulting from the bidding rounds and licensing arrangements pertinent to the development of oil and gas fields as well as for the exploration blocks.

### c) Acquisition of Acreage

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<sup>18</sup> According to Jabbar Luaibi, former DG of SOC, it was “a grave mistake” to call the TSCs off, and he had recommended five-year long TSCs, but the minister refused that. See <http://www.iraqoilforum.com/?cat=7> Accessed 21 May 2009.

<sup>19</sup> Earlier versions of my assessment based on the model contract GSDPC were posted on many websites such as <http://www.iraq-enterprise.com/rep/jiyad62009.htm> (Posted 22 June 2009), and published on MEES. See Jiyad (2009a)

All DPSCs and EDPSCs concluded by the MoO were awarded through bid rounds except, as mentioned above, Alahdab.

For Alahdab and all contracts conclude pursuant to the first three bid rounds the acreages were defined by the area of the related field as defined in annex A: Description of contract area and annex B: Map of the contract area. As for the exploration blocks offered under BR4 the acreage of each block is defined in km<sup>2</sup> in addition to the annexes A and B of the related service contract.

The agreement with Shell/Mitsubishi regarding utilization of flared gas from oilfields Rumaila, Zubair and WQ1 is totally a class of its own, though this contract could be considered as downstream not upstream, and thus not discussed here. The agreement was concluded through direct negotiation leading to establishing BGC as joint venture with participation interests of Iraqi South Gas Company, Shell and Mitsubishi of 51%, 44% and 5% respectively.

All the four bid rounds of the MoO followed similar procedure comprising the following steps in the bidding process of each round:

- 1- Announcement of the fields and exploration blocks offered under the related round;

- 2- Request the IOCs to apply for pre-qualification;
- 3- Specify the parameters for pre-qualification and announcement of the qualified IOCs;
- 4- Prepare a profile and data package for each offered field, and sale such information to the interested qualified IOCs;
- 5- Hold workshops for the IOCs to discuss the data package, the draft of the model contract and review the bidding process and bidding parameters. These workshops are usually open for the media and attended by senior officials from the ministry. The last bid round was attended also by representatives of the local authorities of the related exploration blocks;
- 6- All the bidding events were held in Baghdad with full publicity, TV coverage and the bids are made, opened and announced in public with full competitiveness.
- 7- Each contract has to be approved by the CoM.

The above indicates to good degree of openness and transparency of the process. However, two important aspects could undermine such transparency:

- 1- The actual signed contracts are not yet available for public access, and this has generated doubt and suspicion that the model contracts have been amended behind closed doors in favor of the IOCs. Example of WQ1 contract was cited by which the plateau target and remuneration fee were adjusted upward beyond what was announced during the time of awarding the contract to ExxonMobil/Shell.
- 2- All these signed contracts became effective without the approval of the parliament, and this could generate serious legality issue especially in the absence of oil and gas law. However, the ministers of oil made frequent submissions before the parliament pertaining to the bid rounds, the nature of the signed contracts and the premises, which the ministry uses to justify the legality of its actions.

The Final Tender Protocol for each bid round specifies the bidding parameters and the formula to estimate bidding scores. For the first three bid rounds the bidding parameters are Plateau Production Target (PPT) and Remuneration Fee Bid (RFB), while for BR4 there is one parameter- (RFB).

For the evaluation of bids in BR1, for example, used the following formula:

$$\text{Bid Score} = (\text{PPT} - \text{IPR}) \times (100 - \text{RFB})$$

As for BR2 (where no IPR to consider) the formula became:

Bid score = RFB bid score + PPT bid score, where

$$\text{RFB bid score} = 80 \times (\text{lowest RFB} / \text{bidder RFB})$$

$$\text{PPT bid score} = 20 \times (\text{bidder PPT} / \text{highest PPT})$$

For BR4 the only parameter was RFB, the lower is the winner provided it is equal to or less than Maximum Remuneration Fee- MRF, pre-defined anonymously by the MoO.

For all bid rounds MoO accepts the high scoring bidder for the related Contract Area provided that the RFB of the high scorer does not exceed MRF. MRF is disclosed only if RFB of the high scorer exceeds MRF in order to give opportunity for the concerned bidder(s) to revise downward RFB to that of MRF. Actually, MoO did not disclose its MRF in many occasions when RFB of the high scorer was lower than its MRF.

In case of tiebreak bid of equal to or less than MRF, and the tie is between a consortium and a single company bidder, the consortium bidder is preferred and declared the winner. In practice this case did not occur. What occurred was a tiebreak between two consortia competed for WQ1 in BR1. ExxonMobil/Shell consortium with \$4 RFB and Lukoil/ConocoPhillips consortium with \$6.49 had refused in June 2009 the MRF \$1.9. However, in late October Lukoil accepted the said MRF, and that prompted ExxonMobil/ Shell to do the same. But since the latter offered higher PPT, it won the deal.

Out of the 18 concluded deals in the four bid rounds 9 of them (comprising 10 fields and one exploration block) were done after the IOCs agreed to reduce their RFB to match the corresponding MRF. These include all 6 brown fields offered in BR1, 3 green oilfields offered in BR2, one gas field in BR3 and one exploration block in BR4. The highest reduction in RFB was \$19.1/barrel occurred when the Chinese consortium CNOOC/Sinochem reduced its RFB from \$21.4 to accept MRF of \$2.3 to get Missan fields.

In the other 9 deals IOCs actually made RFB lower than what the MoO could have offered, though the related MRF were not disclosed. These include 4 green-fields in BR2, 2 gas fields in BR3 and 3 exploration blocks in BR4.

The above would indicate to two preliminary conclusions that deserve further investigation and analysis: first, the validity and soundness of the IOCs economic/financial models and the mindsets behind them became questionable, and second, vindication of the MoO estimation of the offered MRF.

#### d) Qualification Requirements

The PCLD announces the timeline and criteria for the pre-qualification process. Interested IOCs provide detailed and elaborated data and information in more than 20 tables covering at least the last three years on each of the five evaluation criteria: technical, financial, legal, HSE and training. A range of minimum and maximum marks set-out for each criterion to achieve qualification.

PCLD asserts all data and information are studied and evaluated carefully and scientifically as per the applicable rules and regulations of the ministry, some sort of “due diligence” exercise. IOC was considered "qualified" by gaining the minimum level of marks for each category of criterion, allowing it to participate in the licensing round. For each bid round PCLD announces the number of the participated in pre-qualification and the qualified IOCs.

For every bid round MoO encourages the formation of consortia, and within each consortium the operatorship is usually given to the partner which has the highest participation interest in the consortium.

#### e) Duration of the Service Contract

All contracts concluded under bid rounds one to three have common clause “Article 3 – Term of Contract.”

This article stipulates the contract duration, “Term”, of 20 years from the “Effective Date”.

However, no later than one year prior to the contract's expiry date, the “Contractor” may submit a written request to the Iraqi contracting state company for an extension of the Term for a maximum period of five years, subject to newly negotiated terms and conditions.

As for the contracts concluded pursuant to BR4 article 3 is more lengthy, detailed and complex. Moreover, the article makes clear distinctions between oil and gas prone blocks and discoveries.

Briefly, the “Term” for all contracts of BR4 is of maximum 30 years for an “Oil Field” and 40 years for a “Gas Field”, excluding any possible extension, holding period and suspension period. The Term consists of two periods: “Exploration Period” and separate “Development Period” for each “Development Area” within the acreage of the related contract. This practically could mean much longer duration of a contract in case of more than one development area.

#### f) Minimum Work Program-MWP and Minimum Expenditure Obligation-MEO

Article 6 and Annex E in all concluded contracts regardless of the bidding round deal with MWP expected to be executed by the IOCs. In format and wording the said article and annex are identical in all contracts. However, they differ in substance pertaining to three major items: what to be executed, when and how much should be spent. Taking these three items

into consideration there seems to be common requirements for each bid round, resulting from the nature of the offered fields.

For contracts pertaining to BR1 the MWP includes the followings: (a) preparation of the Rehabilitation and Enhanced Redevelopment Plans; (b) conduct of 3-D seismic surveys, including processing and interpretation thereof; (c) conduct of detailed geological and reservoir engineering studies, including 3-D simulation for the reservoirs targeted for enhanced production; (d) drilling appraisal and/or development wells with the aim of further Appraisal of the relevant reservoirs defined in Annex D, and achieving planned production in accordance with the Rehabilitation Plan; (e) conduct of detailed laboratory and reservoir engineering studies to evaluate most suitable secondary and/or enhanced recovery mechanisms for the reservoirs targeted under the Rehabilitation Plan and Enhanced Redevelopment Plan; and (f) performing engineering studies and building/upgrading all necessary surface installations required under the Rehabilitation Plan, and initiation of engineering work and infrastructure facilities expected to be incorporated in the Enhanced Redevelopment Plan.

However, each field has its own minimum requirement, for example, in terms of: the area in square kilometer 3-D seismic survey; number of new production and new injection wells to be drilled; number of work-over wells; rehabilitate the existing water intake plant and supply pipeline to achieve a specific working capacity, among other obligations.

The MWP should be executed no later than 36 months from the approval of the Rehabilitation Plan of the concerned oilfields. The MEO is \$200 million each for WQ1, Zubair and Missan group, and \$300 million for Rumaila.

As for BR2 the MWP includes the following: (a) preparation and submission of the Preliminary and Final Development Plans; (b) conduct of 3-D seismic surveys, including processing and interpretation thereof; (c) conduct detailed geological and reservoir

engineering studies, including 3-D simulation; (d) drilling wells with the aim of appraising, developing and producing reservoirs defined in Annex D, and achieving the PPT; (e) drilling exploration wells or deepening other wells with the aim of discovering new potential reservoirs as defined in Annex D; (f) conduct detailed laboratory and reservoir engineering studies to evaluate most suitable development approaches for the reservoirs programmed to come into production with the Final Development Plan and Enhanced Redevelopment Plan; and (g) conduct engineering studies and related surface facilities and flow assurance studies. Again, each field has its own minimum requirement, for example, in terms of: the area in square kilometer for the 3-D seismic survey and number of appraisal and exploration wells, among other obligations.

The MEO has to be spent within 3 years from the date of approving the Preliminary Development Plan. MEO are as follows: \$100 million (Badra and Najma, each), \$150 million (Garraf and Qaiyara, each), \$200 million (Halfaya), \$250 million (WQ2) and \$300 million (Majnoon).

The MWP for the four blocks concluded under BR4 is much simpler and comprise the following: 1- preparation of the Exploration Plan and Work Program; 2-conduct of 2D or 3D seismic surveys for the specified area in each block, including processing and interpretation thereof; 3-drilling one Exploration Well, and 4- perform detailed geophysical and geological studies necessary for the proper exploration of the contract area.

The program has to be executed within the first 5 years of the Exploration Period, and the MEO are \$90 million (block 9), \$100 million (blocks 8 and 10, each) and \$150 million (block 12).

#### g) Assignment & Encumbrance

All versions of the model contract provide sufficient possibilities for IOCs to sign their rights and obligations, specified in Article 28. The IOC has to provide the Iraqi contracting party a

one month prior written notice of its intent to assign any of its participating interest, shares, rights, privileges, duties or obligations under the related contract to an affiliate and or to a third party. The Iraqi party considers the request and notifies its approval or otherwise within three months of receipt thereof.

Before such assignment takes effect the foreign assignee shall first provide the Iraqi partner with a guarantee in the form set out in a standard Annex F in all contracts. However, the Iraqi side has the option to take such part and assign it to a nominated Iraqi entity on the same terms and conditions offered to the third party.

Moreover, for the purpose of financing petroleum operations, the company may pledge, or otherwise encumber totally or partially, its rights under the related contract to an internationally recognized bank and/or financing institution acceptable to the Iraqi party provided that such pledge or encumbrance shall not in any way affect the rights or interests of the Iraqi party.

In the event a company (or the affiliated company that provides a guarantee) becomes bankrupt, or makes an arrangement with or assignment in favour of its creditors or makes a composition with creditors, or if it assigns to a third party any of its interests/shares in the related contract contrary to the provisions in Article 28, or goes into liquidation other than for reconstruction or amalgamation with a wholly-owned and controlled affiliate, the Iraqi party shall have the right to terminate the participation of such company by a written notice. The rights and obligations of such company shall be assigned to the remaining companies of the consortium proportionately to their respective participating interests or as they may otherwise mutually agree.

Finally, the SP to the contract shall have the right to assign its participating interest only to an entity that is entirely owned and controlled by the Iraqi Government otherwise any

assignment by the SP of its participating interest shall require the consent of the companies parties to the related contract.

So far Article 28 was invoked once when Statoil withdrew from WQ2 and Lukoil assumed all participation interests.

#### h) Local Content-LC

The term LC covers many components all of which are related to local capacities meeting demands by upstream petroleum activities and value chain. Four basic components of LC are considered: Employment, human resource capability development, sub-contracting, and procurements of supplies and other services.<sup>20</sup>

The first component of LC is employment. Article 9 (20, a & b) obligates IOC to give “first priority to Iraqi nationals” qualifications and experience; and “adhere to employment and training programs which shall aim at the Iraqization of manpower; all pursuant to a plan to be submitted for approval no later than six years from the Effective Date”. Also Article 26 asserts IOC “to the maximum extent possible, employ, and require Sub-Contractors to employ, Iraqi nationals having the requisite qualifications and experience.”

Further, Article 9.22 (a) requests IOC to prepare and submit for approval, “employment procedures and personnel regulations for locally recruited personnel including scales of salaries, wages, benefits, and all allowances applicable to the respective grade of staff and employees, together with employment requirements such as standard job descriptions and qualifications to fill the jobs, all in accordance with the Law and local market conditions.”

The same article calls for relative equitable treatment of all employees and asserts that “Salaries and terms of employment between Iraqis and non-Iraqis of similar qualification and experience shall be equitably handled; differences being the compensation regulated in the

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<sup>20</sup> UNCTAD study defines LC as the “total value added to, or created by the local economy through the utilization of local human and material resources and services at all stages of the value chain” See Laudine Sigam and Leonardo Garcia (2012).

Contractor's compensation policy, reflecting the home country compensation level;” The text of the last paragraph is different in the contracts for BR2 (Article 9.21, a) and BR3 (Article 9.22, a) though the meaning is the same.

Finally, Addendum Three (Article 8.6) stipulates IOCs shall have the right to fill up to 15% of the positions with secondees from Contractor, the remaining 85% shall be filled by secondees from the contracted ROC and/or directly recruited through the related FOD.

The second component of local content is related to human resource capability development through professional education and training. In this regard all contracts provide a provision to establish a TTTF (Article 26). The purpose of TTTF is to offer and facilitate for an agreed number of Iraqi nationals, as designated by the Iraqi contracting parties in consultation with the related IOCs, the opportunity, both inside and/or outside Iraq, for on-the-job training and practical experience in petroleum operations, and academic education. The Fund shall also be used for supporting oil and gas related technology and research including the establishment or upgrading of research institutes inside Iraq.

TTTF is funded by annual “minimum” contributions, which shall not be recoverable as Petroleum Costs, however accounted for the calculation of the R-factor (as shall be discussed later). The amount of such contribution varies according to the contracts:- for Alahdab it is \$200,000; for contracts of BR1 and BR2 it is \$5 million each, and for contracts of BR3 and BR4 it is \$1 million each. Hence the annual income for TTTF is \$62.2 million during the duration of the contracts.<sup>21</sup>

The third component of local content is local sub-contracting. Article 30.1 gives preference to Iraqi entities and firms, or foreign firms in association with local ones, provided that their relevant capabilities and prices are competitive with those available in the international market.

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<sup>21</sup> In Alahdab contract it is called “Training Budget”, with “the purpose of training a number of personnel from NOC in various specialties related to oil industry.” (Article 26.4)

The fourth component is procurement of local supplies and services, which as was the case with local sub-contracting, receives preference but only if they are competitive internationally. Such conditionality of international competitiveness would in all practicality work against the Iraqi firms, which admittedly are uncompetitive. Moreover, compliance mechanisms and modalities are lacking.

Apart from the above mentioned provisions there is no specific strategy for local content and no specialized agency/ entity to promote, certify, audit and confirm compliance. Finally, apart from the TTSF, no clear and well defined plans and established frameworks to enhance the contribution of the local content in the development activities of the upstream petroleum exist. Considering the number and the long term duration of the concluded service contracts it is for the best interest of the country to maximize the contribution and participation of the local content, and to consider such efforts as basic ingredients of national sustainable development. To this end the followings are suggested:

- 1- The MoO should take the lead in close cooperation with the related ROCs and the IOCs to formulate specific program of action designed to utilize TTSF in the most effective way, and specifies the entity that would be responsible for its proper implementation and follow-up;
- 2- Create special entity and related legal and institutional framework with a vision to maximize the local content in value chain of the petroleum sector, with prime focus on upstream sector initially then cover all other petroleum sub-sectors;
- 3- Formulate strategy and plan to enhance the pillars of local content within the sustainable national development plan. This should take into consideration the international practices with local content learned lessons from such experience.

i) National reservation

Since these concluded are service contracts and the IOCs receiving remuneration fees for their services, therefore the national reservation does not apply to these contracts. In other words the IOCs have no ownership claim on the petroleum assets. In fact all assets acquired and/or provided by Contractor or Operator, in connection with or in relation to Petroleum Operations, the costs of which are subject to cost recovery in accordance with the provisions of the Contract, shall become the property of the ROC upon their landing in Iraq (Article 22.1).

j) Health, Safety and Environment- HSE

The environmental issues in upstream petroleum are governed by many provisions and guidelines enshrined in the constitution, the environment law, the related international instruments and the concluded contracts.

Article 33 of the constitution obliges the State to protect and preserve the environment and its bio-diversity. Also Article 114 asserts the shared competencies of the federal and regional authorities, “To formulate environmental policy to ensure the protection of the environment from pollution and to preserve its cleanliness, in cooperation with the regions and governorates that are not organized in a region”. The Ministry of Environment is responsible for the proper implementation and follow-up of the Law for Protection and Improvement of the Environment-EL Nr. 27 of 2009.

In addition to its general provisions this law has specific Article 21 for the upstream petroleum. All exploration, production and transportation activities are under the scrutiny of the councils for the “Protection and Improvement of the Environment” in each province and the “ministerial” council (comprising 20 ministries) (Articles 3 and 7). The Law, in Article 10, obliges the inclusion of EIA in the economic and technical feasibility of any project as a priority before the commencement of its implementation. Violation of the law leads to temporary work suspension (Article 33-one), to financial penalties (Article 33-two and Article

34), and to imprisonment (Article 35). There will be a special “Environment Police Division” (Article 25), and “Environment Protection Fund” (Articles 26:30). Also Iraq is a signatory of many international legal instruments pertaining to variety of environmental issues, which the IOCs are obliged to observe.<sup>22</sup>

Therefore, the adopted models of the service contracts give considerable attention to the environmental issue through Article 41. This article requires at least two EIA studies before the commencement of the final development plan of the related field; adherence to “Best International Business Practices”, provisions for addressing the consequences of “Gross Negligence and Willful Misconduct”; and cost treatment of related activities are elaborated further in Annex C – Accounting Procedure.

The early version of Article 41 (for Alahdab and BR1 contracts) focuses primarily on protection of the environment and natural resources. But all contracts pertaining to BR2, BR3 and BR4 contain also provisions related to Health and Safety and thus Article 41 addresses wider issues of HSE.

#### k)- Governing Law and Dispute Resolution

All contracts shall be governed, interpreted and construed in accordance with the Law (Article 37.1). The term “Law”, in these contracts, is broadly defined to mean, " any constitution, law, decree, resolution, statute, ordinance, rule, directive, order, treaty, code or regulation and any injunction or final non-appealable judgment, as adopted, enacted, issued, promulgated or ratified by the Republic of Iraq or, unless otherwise provided for herein, as such from time to time, be amended or repealed.” (Article 1)

Dispute settlement mechanism has many phases with specific procedures and timelines.

Amicable resolution will be attempted first. If no resolution reached with 30 days, then the matter referred to the “senior management” of the contracting parties. Failure to reach

<sup>22</sup> For a list of these international instruments see Donovan (Jan, 2011)

resolution within 30 days the case goes to an independent “Expert” if the dispute is on “technical matters” or to be settled under the Rules of Arbitration of the International Chamber of Commerce. The seat of the arbitration is Paris, unless agreed otherwise by the parties. Article 37 provides further details pertaining to international arbitration.

## **2-2 Government Take**

By their nature service contracts imply the government bears all risks, have full equity and acquires all income generated from upstream petroleum after paying investment and operating costs, the remuneration fees and other expenditures to the contracting IOCs. Also the government receives payment from the IOCs in forms of bonus, taxes and other deductibles as elaborated hereunder.

### a) Royalties.

No royalties are incorporated in all Iraqi service contracts concluded so far by the MoO. And as long as this type of contracts remains the possibility of introducing royalties is remote. However, the versions of FOGL contain a provision for royalty and even state its value at 12.5%. The explanation is that the drafters of FOGL in late 2006 had anticipated a possibility for production sharing contracts, which usually caters for royalty payment.

### b) Bonuses

The concluded service contracts include only SB. Payment of SB is normal practice in oil industry especially in the developing countries (UNCTAD (1995) intends to provide an “up-front” income, and generally they are non-recoverable. However, it is highly likely that IOCs “factor-in” the amount paid as SB, and thus recovers it back indirectly through various ways and means during the contract period. In spite of this real possibility, there could be a rather heavy “political price” if the host government accepts or asks for low SB especially when information indicates to high bonuses paid elsewhere. Furthermore, where oilfields are high prized and allocated by competitive tendering or bidding, the SB offered/asked may become a

key factor, and thus could be very significant. However, MoO did not use SB as a bidding factor in its rounds. Finally, with the growing and aggressive role of State owned/ supported companies, such companies demonstrate willingness to pay record high SB to win a foothold in energy rich locations.

The model contracts have provisions for SB but they differ in substance reflecting a rather inconsistent attitude by MoO in deciding the magnitude, form and rationale on this issue.

For Alahdab the amount of the SB is only (\$3) million. This in comparison with those under other oil related model contracts and what has been paid somewhere else is unreasonably low.

Unlike Alahdab, the contracts for BR1 initially called for much higher SB- Rumaila: \$500; WQ1: \$400, and for Zubair and Missan group \$300 million each. However, instead of being income and non-recoverable they were considered interest bearing loans (at LIBOR+1) payable with interest over five years in quarterly installments commencing two years after the contract's effective date.

Many, including this author, considered this not only giving away what should have been revenue but also set costly precedent for the country at large. Furthermore, converting SB into loan could be unconstitutional, and thus was challenged legally.

The BR2 generated \$850 million of unrecoverable SB, reflecting the effects of the criticisms on the way SB was handled under the BR1, the requested amounts do not reflect the quantitative aspects of the oilfields in terms of potential of the fields (measured by production plateau, its duration and total proven reserve) and the qualitative aspects (such as quality of the crude, type of reservoir formations and location of the field.) Obviously, the comparative proportionality for this group of oilfields is not very clear and thus the amounts of the requested SB are questionable here again.

However, MoO agreed, in April 2010, to reduce signature bonuses on WQ1 and Zubair oilfields from \$400 million and \$300 respectively to \$100 million each but converting the SB from loans to unrecoverable upfront payment.

The decision by MoO was seen as a preemptive measure intended to weaken lawsuit that was before Federal Supreme Court. However, that decision did not cover Rumaila contract because the amount was paid in January 2010. That position did not last long, and during July (2010) MoO asked BP/CNPC to follow other IOCs for WQ1 and Zubair oilfields. MoO's DG was reportedly said in justifying the request, 'If it stayed as a soft loan, we have to get parliament's approval for it, and there is no (functioning) parliament right now'.<sup>23</sup>

As for the gas fields offered under BR3 MoO abandoned SB as one of its concessions to induce IOCs, and thus MoO attracted criticisms for this unexplained u-turn on SB. However, MoO, in the fourth bid round, re-imposed SB at \$15 million each for Blocks 8 and 12, and \$25 million each for Blocks 9 and 10.

SB is payable within 30 days of the "Effective Date", thus MoO had generated \$1333 million in SB from all the concluded service contracts. It is worth mentioning in this juncture the Chinese company "Sinopec" paid in 2006 a record high SB of \$2.2 billion to outbid its competitors for getting the exploration rights in two blocks in Angola (UNCTAD (2007)). Two exploration blocks, with all risks involved, in Angola generate \$2.2 billion in SB revenues, while the Iraqi oilfields (producing 1.6 million b/d, and upon full development they could produce 11.2 mbd) and four exploration blocks generate in SB \$1.3 billion!

### c) Rental Fees

The government receives no rental fees. On the contrary the contracts oblige the contracting ROC, under Article 7, to provide IOCs with all available pertinent technical data, the

<sup>23</sup> <http://www.upstreamonline.com/live/article222503.ece> Accessed 20 July 2010.

inventory and equipment in its possession used in maintaining petroleum operations prior to the effective date, and use of all existing wells and facilities related to the field within the contract area.

d) Special participation

concluded , excluding those for BR4, [REDACTED]

[REDACTED]

[REDACTED]

e) Corporate Income Tax

All IOCs working in Iraq pay unified CIT according to Iraqi income tax laws and regulations. ITL nr.19 of 2010 has three articles: increase CIT for IOCs from 15% to 35%; link this new law with still valid ITL nr.113 of 1983, and finally mandated the Ministries of Finance and Oil to issue the operational directives to facilitate its implementation.

The model contract provides protection, through stabilization clause, from any “change to the Law,..., or by revocation, modification, or non-renewal of any approvals, consents or exemptions granted to Contractor, .., in order to maintain contractor's financial interests under this Contract reasonably unchanged.”

This stabilization or pre-emptive regulatory capture clause could have recourse effects with substantial financial impacts on the Iraqi interests. The application of this clause can best be illustrated by Alahdab contract, which has 15 % tax rate. If the new ITL applies to this contract and CNPC pays the extra 20% but invoke the stabilization clause, it could then ask the NOC for reimbursement. No information is available on whether CNPC had or will invoke the stabilization clause.

With contract duration of 20-plus years any government decision or legal instrument over this long period could affect the financial interest of the contractor one way or the other. Therefore, the final cost of the contract depends entirely on the number and magnitude of

claims that could be made by the contractor and the outcome of the arbitration process. The expression ‘reasonably unchanged’ is rather vague, open-ended and lacks precision and thus requires further qualifications. Furthermore, this implies that MoO has acted on behalf of other ministries and even the legislative authority by providing exemptions from any future laws.

### **2-3 Payment to and Privileges of the IOCs**

This part attempts to provide comprehensive and comparative analyses of the components of fiscal regimes of the model contracts, which has direct implications on how much IOCs would get for their services in addition to recovering their capital investment.

A thorough examination of the Iraqi “Model Contracts” would indicate to a complex fiscal regime comprising many important variables that are effective in determining the final direct revenues/cash flow to the IOCs from their involvement in these contracts. Significant indirect benefits, such as long term secured access to oil resource, the possibility for further business opportunities through contractual provisions related to the so-called ‘exclusive/first rights’, establishment of strategic alliances and partnerships etc., are referred to but no attempt was made to quantify them in this occasion.

All payments to the IOCs are calculated and donated in the US dollar only, but the IOCs have the right to “buy” crude oil by their recovered investment and earned RF. This obviously implies that Iraq captures all economic rent/ windfall of higher oil prices.

**a) Remuneration Fee (RF)** is the fee paid to the contractor (composed of the IOCs and the Iraqi SP) per barrel for the “Incremental/ Improved” production above the baseline initial production rate (for BR1) and or upon reaching the “Commercial Production” as quantified in the contract (for BR2 and BR3) and stipulated and calculated in the clauses therein.

Each oilfield has its final/bid RF that was agreed upon during the bidding event. Moreover, contractually (for BR2) the IOCs are entitled to receive the same remuneration for oil

barrel and for the processed associated gas from the same field based on boe. For the BR4, the contractor is entitled to separate Remuneration for each “Development Area” (if more than one) and shall start charging only from the “First Commercial Production Date for that Development Area.” The Remuneration Fee Bid shall remain the same for all Development Areas of the related contract. (Article 19.3)

RF is field/block related and considered as one of two major bidding parameters, which IOCs had to compete against each other and against a predetermined MRF the Ministry is willing to pay, and minimum production plateau targets set beforehand by MoO. For BR4, RF is the sole bidding parameter.

#### **b) R-factor (R-f)**

##### *Progressivity*

A serious criticism of R-f is that it encourages ‘gold plating’ by IOCs on the expense of cost-effectiveness of the operations in order to keep the R-f at the upper range as long as possible to insure receiving higher portions of RF.<sup>24</sup> There is some validity in this view, though R-f is not peculiar to the service contracts under consideration. However, the contracts themselves provide (or should provide) sufficient protection against cost inflating if implemented efficiently and managed effectively. The issue then is not the R-f itself but, as has been recognized earlier, the national capacities responsible for oversight and administration of these contracts (UNCTAD 1995a). To overcome gold plating or cost exaggeration MoO attempts (in BR4) to link remuneration fees to realized cost.

The application of R-factor would eventually leads to significant reduction in the realized RF for the related IOCs.<sup>25</sup>

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<sup>24</sup> See [http://www.iraqoilreport.com/politics/oil-policy/ministry-unveils-tough-terms-for-4th-bid-round-6172/?utm\\_source=Email Update Subscribers](http://www.iraqoilreport.com/politics/oil-policy/ministry-unveils-tough-terms-for-4th-bid-round-6172/?utm_source=Email%20Update%20Subscribers) accessed 14 Sept 2011.

**b) i**

■ PPT. PF formula imposes reduction in RF corresponding to the percentage deviation of production lower than the PPT.

The inclusion of this condition was to prevent IOCs from inflating PPT to gain higher score to outbid other competitors in the bidding. Hence, PF is applicable only during the PPP.

However, the provision of PF ceases to apply when production is curtailed or suspended through no fault of the Operator or Contractor. The contracts provide further details on the applicability of production curtailment or suspension.

**c) Net RF Formula**

After deducting the effects of (R-f) and (PF) the remaining amounts of RF would be divided between the IOCs and the Iraqi SP at 75% and 25% respectively. Moreover, the IOCs have to pay 35% tax on their income (RF earnings). The combined effect of the equity and tax, since both are constant percentages, is a dividing the payable remuneration fee between Iraq and the IOCs at 51.25% and 48.75% respectively. The implication of this is that each dollar paid in RF Iraq deducts 51.25 cents from it.

**d) Cost Recovery and RF Payments: Commencement and Caps**

Many factors have to be considered in this regard: payment caps, categories of cost, interest rate for unpaid entitlements, and condition for commencement of cost recovery and RF payment.

IOCs are entitled to recover their cost and fees, including the carried share of the SP, and receive their RF according to the provisions of their contracts. The contracts governing the deals are not unified on these matters. Some of the provisions are the same and applicable to all while others are different. The major differences are addressed below.

25 For calculating the R-factor impact on RF for each of the IOCs in BR1 and BR2 see Jiyad (March 2010)

For Alahdab, fee payment is subject to 100% of DR of the actual production. Unpaid fees carry 'LIBOR+3' annual interest.<sup>26</sup> For contracts of BR1, 'Service Fees' (comprising petroleum cost and RF) are paid without interest, and the payable amount is limited to (50%) of the DR of the Incremental Production, while 'Supplementary Fees' are paid to the extent of (10%) of the DR. Unpaid supplementary cost/fees bears LIBOR+1 annual interest.

RF and petroleum cost are payable only after ■

contracts of BR2 but each contract has its own First Commercial Production level, which decides payment commencement.

For the gas fields under BR3 the commencement of cost recovery and RF is subject to attaining 25% of the contracted PPT, other conditions remain effectively the same as for BR2.

Contract for BR4 is more complex since there are provisions for "holding period" in case of oil discovery. However, payment starts once Commercial Production Rate reaches 25% of the specified PPT. Payment Cap for cost recovery is fixed at 50% of DR, and for RF at 30% of remaining DR.

#### **e) Administrative overhead charges**

These are calculated at (1%) of the incurred "Petroleum Costs" and "Supplementary Costs", and shared equally between the Contractor and ROC. The corresponding percentage for Alahdab is (2%).

If these charges were subject to the CIT then Iraq would recover back some 35% of what it pays to the IOCs of such charges.

#### **f) Conditional Rights for IOCs on Additional Possibilities**

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<sup>26</sup> Payment commencement was not clearly stated however, it is assumed that it is linked to attaining commercial production of 25 kbd referred to in its contract.

the first is the 'd' This should be done The second is to 'i', which IOCs have the 'right' to negotiate a new agreement within 6 years from the effective date of the contract.

to include the discovered, undeveloped formations of Yamama, Khasib, S'adi and few smaller reservoirs to their contract. This adds 0.5 mbd, for a \$2/b in RF, bringing WQ1' PPT to 2.825mbd with RF weighted average of \$1.92/b.

### **Part three: The Main Features of and the New Development in the Model Service Contracts**

#### **3.1- The Main Features of the Model Service Contracts**

The analysis of all versions of the model service contracts would lead to identify the nature and main characteristics of the concluded contracts, though the form of the contract was considered as "unknown in the oil industry" (F. Chalabi 2010:258).

First, all contracts have similar structures in terms of equal number of articles, annexes and addendums, except those for exploration blocks of BR4 which has more addendums. Almost all the articles are identical or could be considered as "common clauses" except those pertaining to reflect the specifics of the field or the block.

Second; the contracts could be considered as hybrid category of their own since they comprise PSCs components and from the conventional service contracts. Among the main features of the PSCs that are present in model contracts are: the long duration of the; the privileges of first/exclusive rights; the payment of SB (except for BR3), and restriction on sovereignty through consensus based decision-making within the JMCs.

Third; all contracts are premised upon the principle of ToPN/L even when the host government decides to exercises its sovereign rights for production curtailment.

Fourth, all payments to IOCs (cost and RF) are denominated in US Dollars not in barrels or boe. This implies that economic rent (windfall) belongs to the Iraqi side, and the IOCs do not have any claim on rent in case of oil price increases. The IOCs benefit from higher oil prices by expediting the recovery of their capex, opex and RF through the application of the payment caps from the higher revenues. This however calls for the application of the R-f, which could reduce the RF.

Fifth, for each of the concluded contracts there is a carried “State Partner” participation interest at 25% implying no upfront payment from the Iraqi side. The remaining IOCs in the consortium cover, proportionately, this participation until they recover it as per the caps in the contract. The model contract for BR4 does not have SP participation interest since the risk of exploration is fully on the IOCs in case of no-or uneconomical discovery.

### **3.2- New Provisions in the Model Contract of BR4**

The current version of the BR4 model contract exhibits many new components reflecting the still evolving and development of the model contracts and MoO learning curve in contract formulation.

A pre-development “holding period” is introduced, subject to certain and rather complex provisions, in case of oil discovery. The rationale for this new component is explained by the fact that Iraq has too much oil to manage if the already contracted fields are developed as planned, in addition to the production from other fields.

It is also for the first time there is a “transitional” SP. Initially OEC is the SP but once the value of R-factor exceeds one then a new SP takes over. This reflects the different phases of the contracts due mainly to the distinction between the exploration and development phases, and this distinction lead to the removal of the 25% SP interest as mentioned above.

The third development is the absence of the PF because having only one bidding parameter (the RF), thus no PPT and PPP are included then there is no reason to include the PF.

An important fourth new element was introduced to reduce cost-inflating tendencies by IOCs.

A new term of “Cost Production” was included to reduce the RF entitlement in a way to induce IOCs to pursue cost effectiveness and prevent exaggerating cost.

The fifth new development is related to the application of ToPN/L principle. The contracting ROC’s obligation is confined only to 80% of the produced gas if circumstances call for the ToPN/L. It’s worth noting the application of this principle remains as it was in the previous bid rounds in case of oil discovery.

The sixth new component is provision for dry gas export subject to separate contract and marketing arrangement. This is an option for the IOCs to pursue but does not constitute an obligation on them. No such option was or is offered for oil.

A new termination provision gives ROC the right to terminate the contract if the IOCs conclude another contract with any regional or provincial authority without MoO approval.

The final new development is the establishment of Infrastructure Fund-IF to finance infrastructure projects in the province where the contract area is located. During the term of the contract the contractor deposit (10%) of the annual budget for IF, managed and controlled by MoO in co-ordination with the related local authority.

#### **Part four: Current Issues**

The development of upstream petroleum and the implementation of the concluded contracts face many serious and formidable challenges. However, three issues of particular importance are discussed hereunder due to their direct relevance to these contracts.

##### **4.1- The Legality of the Contracts in the Absence of FOGL**

FOGL is very complex and tenacious issue for many reasons, as testified by the debate pertaining to it since early February 2007. Iraqi oil professionals, Al-Ameer (2007), Shafiq (2008), Jiyad (2008) Khadduri (2012), among others, have written extensively on various aspects of the law, and the debate continues unabated.

First, there are many versions of FOGL: four pre July 2011 and two post that date. The differences between these versions are very substantive in terms of contents, coherence, functionality and implications.

Even when people refer to FOGL of February 2007 do they mean that version before or after the approval of *majlis Shura al dawla*; that version with or without the “original” Annexes of fields and exploration blocks, which have been tempered with!.

Second, all these versions are formulated on February 2007 draft. But between that date and now, many serious developments had taken place rendering 2007 formulation obsolete, overtaken by events and dysfunctional. MoO signed 19 LTSCs while KRG signed 48 PSCs covering most of Iraq’s highly prized fields and many of the exploration blocks (in KRG). Provisions of these concluded contracts deviate seriously from those envisaged in 2007.

Therefore would these contracts be revised to streamline with 2007 FOGL, or that version has to be radically redrafted to accommodate these concluded contracts? In other words would FOGL be used to legalize these contacts, which each side considers the other side’s contracts illegal? In this regards there are formidable legal, constitutional and political hurdles making it almost impossible to adopt let alone implement FOGL of 2007 (in any version);

Third, the text of FOGL implies the enactment of many other laws, and thus creating some sort of “organic linkage” between these laws: Revenue Sharing Law, INOCL, MoO Law, Revenue Commission Low, Oil Fund/Future Fund Law. Such linkage implies “all-or-non”, and thus making it unfeasible to promulgate any. Therefore, such formulation was absolutely unnecessary, legally and constitutionally impermissible, and structurally incorrect and inconsistent.

Fourth, the text of FOGL (in any version) is full of ambiguities pertaining to authorities, functions, procedural and modus operandi of many entities mentioned in the law, particularly those related to the FOGC and jurisdictions. More seriously, FOGL gives the “Foreign

Advisors” within FOGC sovereign powers over other members of FOGC including the Prime Minister!!

Adding more serious ambiguities to those of the Constitution, as already admitted by many within the executive, legislative and judicial branches of government and professional community, would render FOGL dysfunctional.

The law is supposed to address the ambiguities of the constitution, not to create even more.

But the leading politicians interpret the constitution differently and they seem to perceive FOGL as a component of the “political horse-trading” instead of “legal” instrument.

Therefore, unless the ambiguities of the constitution are resolved the chances of passing functional FOGL remain highly unlikely.

Fifth, a 12 member joint Special Committee was formed, late August 2012, within the Iraqi Parliament from OGNRC and Legal Committee. The composition of this special committee is purely on “political affiliations” from the main three political blocks. Two weeks later a new six-member committee was formed to review three different versions of FOGL and decide which one the Parliament will use as the starting point for debating the law. A five- member committee was formed on 17 September 2012 to "negotiate the oil and gas draft law to be referred to the Cabinet, and come out with one formula, under the supervision of the Presidency (of Parliament)". Obviously there is too much confusion as this series of “special committees” indicates.

Sixth, considering the above, if any versions of FOGL 2007 is approved “as is” or treated as “political” instead of “legal” instruments, as the composition of the three committees above mentioned indicates, it could have disastrous consequences for the upstream petroleum, the economy and the sovereignty and territorial integrity of the country.

Seventh, accordingly the legality of all concluded contracts by MoO and KRG remains questionable and subject to good degree of legal uncertainty and unpredictability.

#### **4.2- The situation of IOCs who concluded contracts with KRG**

The federal government considers all PSCs concluded by KRG illegal and, thus, does not recognise them. IOCs who concluded these PSCs are usually blacklisted and prevented from participating in any upstream petroleum project in the rest of the country. For example Sinopec was excluded from Zubair oilfield consortium; Repsol, Chevron and Hess were excluded from participating in bidding rounds after qualification.

This “blacklisting” policy had some initial success in keeping major IOCs away from the KRG deals, but this policy faced serious challenge in October 2011 when ExxonMobil signed PSCs for six exploration blocks.

Three issues make ExxonMobil/KRG deals have serious consequences on the prospects of the already concluded contracts with the MoO:

- 1- The ExxonMobil (with Shell as junior partner) has already WQ1 service contract. The MoO applied the blacklisting policy by disqualifying ExxonMobil from BR4 and remove it from the leadership of the Water Injection project. However, nothing has been done so far regarding its participation in WQ1.<sup>27</sup>
- 2- Some of the contracted blocks are located in the “disputed areas”, outside the formal borders of the three provinces of Kurdistan Iraq. Accordingly there is real and very serious legal uncertainty and high political sensitivity associated with the deals for these blocks.

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<sup>27</sup> As on end January 2013 ExxonMobil was looking for buyers to its share in WQ1, and the meeting with the Iraqi Prime Minister on 20 January 2013 reconfirmed the Iraqi position that ExxonMobil “can't keep operating on both deals at the same time and they should observe Iraq's laws.”, see <http://www.upstreamonline.com/live/article1314652.ece> accessed 22 January 2013.

3- Following ExxonMobil footsteps Total and Gazprom also concluded PSCs with KRG after they signed service contracts with MoO.<sup>28</sup> Total has a minority share in Halfaya oilfield while Gazprom is the operator of Badra oilfield.

The application of the blacklisting on ExxonMobil, Total and Gazprom could have direct effects on the development efforts and the time horizons of the related three oilfields, and absence of amicable solutions the matters could be finally resolved through international arbitration.

#### **4.3- Reduction of PPTs and renegotiating the contracts**

For the first three bid rounds plateau production was one of two bidding parameters, as mentioned earlier. This had prompted the competing IOCs to inflate their production targets to out-bid their competitors. Consequently, plateau production levels in all concluded contracts came out to be much higher than even what the MoO had envisaged. Hence, the euphoria of 12.5 mbd threshold began to surface and becomes a sacrosanct target for the few within the ministry and outside it. But many oil professionals<sup>29</sup> doubted the feasibility of attaining these plateaus within the specified timeframe and questioned the justification of constructing expensive production and export capacities based on such plateaus.

But MoO and the government are now more receptive to revise the plateau targets, especially after through study partially financed by the World Bank and IEA came to similar conclusions expressed by many Iraqi oil professionals on lower production levels, which most likely impact the formulation of the forthcoming National Energy Strategy.

Accordingly, three main parameters would be revised compared with production envisaged under the signed contracts: i- Lower plateau target (probably to maximum of 9 mbd instead of

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<sup>28</sup> For good comparison between the MoO service contracts and KRG' PSCs see Al-Mehaidi (2012)

<sup>29</sup> Including, among others, Al-Khayat (2012); Jiyad (2011); Al-Husseini (2010); Al-Chalabi (2009) and Al-Ghadhban (2009)

12.5 mbd); ii- longer development period (to be completed in 2020 instead of 2017 for BR1 fields); and iii- longer plateau production period (over 7 years for BR1 fields).

Lowering plateau targets and prolonging plateau period might impact the economics of the contracts, and this could justify renegotiating some of these contracts pertaining to oilfields, plateau targets would be reduced. Renegotiating contracts is a major undertaking requiring clear vision, practical approach and suitable strategy to ensure compliance with the Constitutional principle of “Best/ highest of the Iraqi People”.<sup>30</sup>

## **Conclusions**

- Iraqi service contracts could be an important milestone in shaping future political economy of relationship between IOCs and host government especially in the developing countries.
- The fiscal terms of these contracts indicate Iraq had, undoubtedly, made good deals. However, if the control over cost is not properly monitored and professionally audited such cost could escalate to unprecedented levels. Accordingly there is urgent need to bridge the skill and capacity gaps through multiplicity of measures comprising specific crash-programs, short term training and need-oriented professional and specialised capacity-development education. It is vital to create special unit within MoO to ensure good management of the TTSF in collaboration with other entities within the sector and outside it.
- Considering the importance of the upstream petroleum and the number and long durations of these service contracts, it is advisable to formulate national strategy

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30 As on end January 2013, the Ministry of Oil began the process of revising downward the contracted plateau targets by amending (in mid-January 2013) the contracts for West Qurna 2 with the Lukoil consortium. While keeping the remuneration fee unchanged the contract was extended to 25 years with reduced plateau production from 1.8 to 1.2 mbd, sustainable for 19 and a half years, up from 13. Moreover, IOCs operating Rumaila, Majnoon, Zubair and West Qurna 2 are involved in active negotiations with the ministry to arrive at lower plateau targets.

pertaining to Local Content. The suggested strategy could involve creating specialised agency with clear mandate, auditing, monitoring and verification procedures and institutional and legal frameworks.

- All IOCs who signed these contracts assert, initially, satisfactory level of IRR despite what they consider as tightness of the fiscal terms. But the wide deviation between “bid” and “final” remuneration fee would lead to question the validity of the economic model and its main assumption used by the IOCs. And such unexplained significant differentials could make one suspicious of the integrity and conduct of the IOCs.
- There are increasing indications that PPT could be reduced thus requiring revision of BR1 and BR2 contracts. MoO have to formulate its strategy for renegotiation to ensure the best interest of the Iraqi people as enshrined in the Constitution.
- Finally, there is a high degree of uncertainty surrounding the legality of all LTSCs (of the MoO) and all PSCs (of the KRG).

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### **Abbreviations**

boe: barrel of oil equivalent

BR1/2/3/4: bid round one, two, three and four

BGC: Basra Gas Company

CIT: Corporate Income Tax

CoM: Council of Ministers

CoR: Council of Representatives (Parliament)

DPSCs: Development and Production Service Contracts- for oil and gas fields

DR: deemed revenues

EDPSCs: Exploration, Development and Production Service Contracts- for oil and gas blocks

EIA: environment impact assessment

EPC: engineering, procurement and construction

FDI: foreign direct investment

FEED: front-end engineering and design

FOD: field operating division

FOGC: Federal Oil and Gas Council

FOGL: Federal Oil and Gas Law

ICOEE: Iraq Crude Oil Export Expansion

IDs: Iraqi Dinars

(of MoO)

IEA: International Energy Agency

IOCs: international oil companies

ITL: Income Tax Law (Iraq)

JMC: Joint Management Committee

kbd: thousand barrels per day

KOT: Kor Ala'mya Oil Terminal

LTSC: long term service contract

LIBOR: London Inter-Banks Offered Rate

mbd: million barrels per day

mcf: million cubic feet daily

MoC: memorandums of cooperation

MoO: Ministry of Oil

NOC: North Oil Company (of MoO)

OEC: Oil Exploration Company (of MoO)

OiP: oil in place

OGNRC: Oil, Gas and Natural Resources Committee (of the Parliament)

PCLD: Petroleum Contracts and Licensing Directorate (of MoO)

PPT: production plateau target

PPP: production plateau period

ROC: regional oil company (of MoO)

SP: LTSC

SPMs: Single Point Moorings

ToPN/L: Take-or-Pay/Now-or-Later

TSCs: Technical Support Contracts

tscf: trillion standard cubic feet

TTSF: Training, Technology and Scholarship Fund

WQ1: West Qurna1

WQ2: West Qurna2

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