Dear all

Please find attached papers for tomorrow’s meeting:
Future of Iraq oil sector
Management change in the Iraqi oil sector

A third paper on Iraq production scenarios will be circulated and discussed during the meeting.

Regards
Subject: Update - Oil sector liaison group

Dear all,

These are the final details for the meeting tomorrow. The meeting will start at 11.00 am and will be held in the DTI Conference centre, 1 Victoria street in room C20. I have arranged passes for all external attendees at the conference centre reception (not the main reception) so please proceed accordingly.

Thanks and Regards,

[Redacted]

DTI (Energy Markets Unit)
1 Victoria Street
London, SW1H 0ET
Management Change in the Iraqi Oil Sector

Summary

In order to meet international expectations of professionalism and transparency the management of the Iraqi Oil Industry will need to undergo a major process of attitudinal and behavioural change.

Current State

- The structure is very similar to that which pertained during sanctions and for many years before that.
- Managers themselves may or may not have been Ba'thist activists.
- Managers will certainly have had to acquiesce to the Ba'th way of operating over a long period of time.
- Managers in the Iraqi oil business are likely to have been isolated from serious access to the Western evolution of management thought and techniques since the beginning of the Iran war and quite possibly for rather longer than that.
- The Ba'thist philosophy is essentially socialist. It is unlikely that Iraq has possessed a private sector of any commercial significance for many years.

- We know that institutionalised corruption was endemic in Iraqi commerce and that this would have included the oil sector.
- It is more than likely that corruption and party loyalty were more important drivers of success and promotion than ability or honesty.
- Saddam came to power in 1973 but the Ba'th party had been in power for some 10 years before that.
- Therefore very few managers working now have ever worked under any system other than Saddam’s and none would remember the systems of pre Ba’th days.

It would seem not unreasonable to conclude that certainly most, and very likely all, managers in Iraq’s Oil Industry have spent their entire working lives in an environment which valued secrecy above openness, the status quo against change, party loyalty over ability and corruption over honesty.
Future State

It is stated policy that the Iraqi people will make the long term decisions regarding their oil industry. However if asked the UK government may well cite the following parameters as being desirable both for the Iraqi people as well as for the international community.

- A modern, well managed and transparent oil sector that acts a role model for how other Middle East countries might open their oil sectors to foreign and private participation;

- Iraq as a reliable world oil supplier where production is robust to potential disruptions caused by political unrest, strikes, breakdown of infrastructure etc;

- Iraq as a member of OPEC but on the dovish side - favouring greater output at more sustainable prices;

- An oil sector using modern technologies with oil produced in a way which balances sustainability, efficiency and environmental objectives;

- Arrangements for the management of oil revenues that ensure they are used in an efficient, equitable and sustainable way in the interests of Iraqi people;

- An oil sector open and attractive to foreign investment, with appropriate arrangements for theexploitation of new fields (e.g. well designed PSAs);

- A level playing field in which all interested parties can bid for development contracts on an open and equal basis with investment decisions based on commercial considerations and not clouded by previous negotiations or politics.

Other Salient Factors

It is inevitable that there will be a temptation for INOC or its successor to use regional role models as opposed to international (Western?) ones. It must be said that it is unlikely that such a comparison would lead INOC down a road of management professionalism and transparency particularly in the area of financial reporting. Nor would be likely to lead to the adoption of structural models using a high proportion of JVs.

Oil is critically important to the redevelopment of Iraq and almost anything the coalition does to move the industry towards a Western management model may well give rise to accusations of interventionism.

Bridging the Gap

Even a cursory reading so far leaves little doubt of the task in hand if the oil industry is to be moved from its current state to even an approximation of what the coalition would like to see.
Reference may usefully be made to the current change programme at DTI in order to get an idea of the extent of the change envisaged and by extension an idea of the time and money which may be required.

It will also be useful to refer to current and future state criteria in existing change programmes in the UK. It will rapidly become clear that if the coalition is serious about driving deep and permanent change in the management of Iraq’s oil industry a properly conceive and executed Management Change Programme is a necessity.

**Recommendation**

This issue is put onto the agenda for the next Oil Sector Group meeting for exploration in more detail. The desired result of this exploration would be that a preliminary scoping study is carried out possibly jointly by DTI and DFID.
POSSIBLE FUTURE STRUCTURES FOR THE IRAQI OIL SECTOR

What are our objectives for a future Iraqi oil sector?

1. Ministers have already agreed that we should leave future decisions about the shape of the oil industry and management of oil revenues to the new Iraqi Government, while advising on best international practice, including openness and transparency in procurement and management of revenues. However, there is still scope for shaping Iraqi thinking as it evolves, both to help ensure appropriate decisions are taken and to protect UK commercial interests. Our objective should be the development of an Iraqi oil sector guided by the following principles:

- A modern, well managed and transparent oil sector that acts a role model for how other Middle East countries might open their oil sectors to foreign and private participation;

- Iraq as a reliable world oil supplier where production is robust to potential disruptions caused by political unrest, strikes, breakdown of infrastructure etc;

- If Iraq is a member of OPEC, then on the doves side - favouring greater output at more sustainable prices.

- An oil sector using modern technologies with oil produced in a way which balances sustainability, efficiency and environmental objectives;

- Arrangements for the management of oil revenues that ensure they are used in an efficient, equitable and sustainable way in the interests of Iraqi people;

- An oil sector open and attractive to foreign investment, with appropriate arrangements for the exploitation of new fields (e.g. well designed PSAs);

- A level playing field in which all interested parties can bid for development contracts on an open and equal basis with investment decisions based on commercial considerations and not clouded by previous negotiations or politics.

Historical structure – see Annex A

2. Previous to the conflict the Iraqi oil and gas sector was a nationalised industry and entirely controlled by the state through the Oil Ministry. The Oil Ministry operates production and exploration work through the Iraq National Oil Company (INOC), which itself oversees a series of autonomous companies with responsibility for different industry sectors:

- Oil Exploration Company (OEC) - Oil and gas exploration work throughout Iraq.
- State Company for Oil Projects (SCOP) - Design and engineering across all sectors of the Iraqi oil and gas industries.
• Northern Oil Company (NOC) - Oil and gas production in Iraq's northern and central regions - Kirkuk, Jambur, Bai Hassan and Khabbaz.
• Southern Oil Company (SOC) - Oil and gas production in Iraq's southern region - Rumaila, Zubair, Majnoon.
• State Organisation for Oil Marketing (SOMO) - Controls crude oil sales, sets monthly prices with the UN sanctions committee on Iraq, handles relations with OPEC.
• Iraqi Oil Tankers Company (IOTC);

In addition to that, there were various departments within the Ministry of Oil which ran Iraq's internal pipeline systems, distribute oil products, operate downstream natural gas/LPG projects and gas bottling plants. The deterioration of the sector since the Gulf War had partially changed this sector structure; the oil ministry in fact increased its power to the detriment of national oil company.

**Current temporary arrangements**

3. Currently the structure of the new oil ministry is very similar to the pre-conflict one, with Thamer Ghadhban acting as *de facto* oil minister. This has been done to facilitate a quick restart of operations. Iraqis have been appointed to the senior posts (see Annex B), although some of these have already been changed¹. The only difference is the absence of the Iraq National Oil Company (the new line of management runs straight from the oil ministry to the various autonomous companies) and the presence of an advisory board (chaired by Phillip Carroll) to the oil ministry.

**Future structure of the oil sector**

4. There are various options open to the new Iraqi administration for the restructuring of the oil sector in terms of the sector structure and organisation, and the issue of revenue management.

5. The former is directly linked to the issue of the legal framework for foreign investment and is discussed in more detail below. The latter is linked to the issue of allocation of oil revenues and, more generally, fiscal policy framework. The options here would be between a fully centralised model, fully decentralised model or some solutions in between. [This will become crucial to determine how sub-national governments (i.e. a Kurdish area in the north or Shi‘ia in the south), or federal states if such a political structure is adopted, are financed and the control they exercise on their natural resources.]

6. The structure of the oil sector and management of revenues are closely inter-related but this paper only considers the former. The HMT led Economic and Finance Issues group has already begun thinking about wider fiscal issues, including management of oil revenues.

**Possible Oil sector structures**

¹ Notably the SOMO director Ali Hassan has been replaced with Mohammed al-Jibury.
7. There are many possible models and examples for the structure of the oil sector; the crucial issue is likely to be the extent of government, private and foreign involvement. These models range from entirely state controlled to entirely privately operated.

8. State monopoly a la Saudi Arabia and pre-conflict Iraq:
   - A state-owned oil company has the monopoly on all oil production, exploration, marketing and distribution, as well as the refining, processing and marketing of all oil and gas products. Responsibilities for the different industry sectors lie with semi-autonomous companies subsidiaries of the national oil company or which work under the remit of the ministry of petroleum (in many OPEC countries national oil company are just another arm of the petroleum ministry). The national oil company can conclude contracts with international oil companies for exploration, drilling and production of gas and/or oil, or for the development of the downstream sector. Foreign companies could also be involved on a fee basis via deals such as Iran buy-back agreements. These however offer no incentives to foreign companies as the fee is fixed and also risks are not shared. The extent of foreign company involvement and the more or less predominant role played by the national petroleum ministry (versus the national oil company), is different from country to country, ranging from a more open structure like Mexico to a more closed, controlled one like Saudi Arabia.

9. Mixture of state, private and foreign companies (with various degrees of private and foreign participation) a la Nigeria
   - Most oil is produced through joint ventures (JVs) between the state-owned national oil company and private oil companies. The national oil company typically holds a majority stake in these ventures. Contracts with international and/or national oil companies are concluded for the development and production of oil on the basis of Production Sharing Agreement (PSAs). Nigeria is the typical example for this type of structure. Venezuela’s structure, prior to the general strike, was a combination of state monopoly and joint ventures. Recent moves from President Chavez seem to have strengthened political control on the national oil company so as to make the structure more similar to the Middle Eastern model.

10. Mixed privatisation model a la Kazakhstan;
    - Following its independence in 1991 Kazakhstan opened up its oil sector to investment and development by foreign energy companies. International projects have taken the form of joint ventures with Kazakhoil (now Kazmunaigaz - vertically-integrated state oil and natural gas company, created in February 2002), the national oil company, as well as production-sharing agreements (PSAs), and exploration/field concessions. The national oil company holds majority and/or minority stakes in all companies investing in the country. Azerbaijan oil sector has a similar structure, with the only difference being that the Oil Ministry exercises strict control on the national oil company.

11. Privatisation model a la Russia;
    - Since the collapse of the Soviet Union in 1991, Russia's oil sector has been restructured from a state-owned monopoly into large vertically integrated joint-stock companies. The state still holds considerable stakes in these
large companies, all of which are Russian. Foreign company involvement is limited to joint ventures (through PSAs?). The gas sector is still dominated by the quasi-monopoly of Gazprom where the state holds a 38% stake. Under this model a process of privatisation is initiated to transform the national oil company from a state monopoly into a private (with increasingly reducing state participation) company/companies. The final aim being to create an integrated, competitive energy market.

12. Mostly private companies but government involvement;
   - In Norway the state still maintains a majority stake in Statoil, and minority stake in Hydro-Norsk; both companies, however, operate on a commercial basis in a competitive market together with international oil companies. Similarly in Canada private companies undertake petroleum exploration and production in a competitive environment. The federal government still holds an 18% interest in Petro-Canada. The federal government and some provinces have also kept an interest in some smaller resource companies and energy projects.

13. Full privatisation a la US/UK;
   - Upstream (and downstream) oil markets are open and competitive. Oil and gas production is 100% in the hands of the private sector - all companies, both upstream and downstream, operate in the private sector on a commercial basis. Government involvement is restricted to regulation of the market through licensing procedures, environmental and safety controls and setting the fiscal framework. The US and the UK follow this model.

Some initial thoughts

14. In the past Iraq has followed the typical Middle Eastern model of state-owned monopoly (national oil company or the ministry of petroleum). Will this continue in the future?

15. Oil sectors in all OPEC Middle Eastern members are controlled by state-owned companies. This gives governments total control on the level of oil production and allows them to align with OPEC policies (i.e. quotas). Other OPEC members have tried different arrangements, where the private/foreign companies have a larger stake in oil production (Indonesia where the oil sector structure changed considerably in 2000-2001 is an interesting case – see below).

16. For historical, political and technical reasons (a completely new legal framework would have to be introduced to foster a suitable environment for foreign investment to flow in) it is very unlikely that the 100% privately run model could be adopted in Iraq. If, as we expect, Iraq is to say within OPEC, it will need to retain some form of control on its production levels. This can only be done if the state holds some (i.e. majority) stake in the company/companies producing oil. Moreover, in all developing countries the state holds some sort of control over oil production. In the medium term, we would expect Iraq to follow a typical Middle Eastern or ‘other-OPEC’ model.

17. A Middle Eastern model, however, would not fulfil the principles set out above. In addition, we need to consider the fact that Iraq is in a completely different
situation compared to other Middle Eastern states: its oil and gas industry has suffered from lack of investment, access to modern technology, decaying infrastructure and progressive depletion of resources. Just to rehabilitate current infrastructure and restore past production, let alone the task of increasing the country production capacity, will need a considerable inflow of investments that would probably need to take the form of foreign investments.

18. In fact, although Iraq could continue to rely on National Oil Company (INOC) and its subsidiaries for reconstruction and development of new fields, this scenario seems unlikely as INOC lacks cash and its technicians might lack expertise to introduce new technology (after 13 years of sanctions and isolation). Foreign companies involvement seems to be the only possible solution. Deals such as Iran buy-back agreements, however offer no incentives to foreign companies as the reward (fee) is fixed and also risks are not shared. PSAs on the other hand encourage companies to invest as they own a share in the development and a proportion of the rewards. Joint ventures or PSA contracts are thus the likely instruments available.

19. The non-Middle Eastern OPEC model has its own problems as we have experienced recently in Nigeria; the Nigerian government is under considerable pressure to renegotiate its OPEC quota in order to assuage private companies interest for increase in production and investments. Membership of OPEC does not preclude the possibility of foreign investment or joint ventures, as Nigeria and more recently Indonesia have shown. In Indonesia since the reform in 2001 Pertamina (the national oil company) still holds minority stakes in most exploration and production projects, usually in a joint venture partnership. However, its own output is low in comparison with the main foreign players. The downstream sector has also for the first time been open to foreign participation. However, OPEC membership does limit the freedom of private companies to determine their own level of production.

20. A mixed model with a centralised structure based on a national oil company and/or autonomous sub-national companies, but with participation of foreign private companies through joint ventures and PSA contracts (especially in the field of reconstruction and development of new fields) seems to be more suitable option in the medium term and would fit in with most of our guiding principles. This would also leave open the door for a more extensive process of privatisation in the longer term.

EMU
16/05/2003
Iraq's new oil officials

Oil advisory board, chairman
Philip Carroll
Oil advisory board, vice-chairman
Fadhil Othman
Oil ministry, chief executive officer
Thamer Ghadhban
Economics and Finance Directorate, director general
Radhwan al-Saadi
Technical Directorate, director general
Faleh al-Khayat
Reservoir and Fields Development Directorate, director general
Ali Hammadi
Department of National Manufacturing, director general
Katham al-Anbaki
Administration and Legal Department, director general
Medhat Abbas Kaddouri
Control and Internal Audit Directorate, director general
Sharif Muhsin
State Company for Oil Projects, director general
Hussam al-Din Kashamola
Iraqi Drilling Company, director general
Zuhair Shakir
Petroleum Pipelines Company, director general
Kamil al-Fatl
Oil Exploration Company, director general
Ibrahim Abbar Karim
LPG Bottling Company, director general
Hussain al-Haithi
North (Baiji) Refineries Company, director general
Riyadh Abd Ghasab
Central (Doura) Refineries Company, director general
Datdar Khashab
South (Basra) Refineries Company, director general
Thaer Ibrahim
North Gas Company, director general
Salah Aziz Karim
South Gas Company, director general
Najim Makhawar
Oil Products Distribution Company, director general
Samar Michael
Iraqi Oil Tanker Company, deputy director general
Falah al-Asi
North Oil Company, deputy director
Adel Qazaz
South Oil Company, director general
Jabbar al-Luabi
State Oil Marketing Organisation (Somo), director general
Mohammed al Jibury
ANNEX A

Iraq Oil Ministry:
Oil minister: Amer M Rashid

Iraq National Oil Company (INOC)

Oil Exploration Company (OEC)  
State Company for Oil Projects (SCOP)  
Northern Oil Company (NOC)  
Southern Oil Company (SOC)  
State Organisation for Oil Marketing (SOMO)

Exploration  
Developments  
Production  
Exports

Oil Ministry departments

Downstream, domestic transport and distribution