

Kurdistan's Politics Issues Regarding Production Sharing Contract with Iraqi Central Government and Analyses Whether This Contract Best Suits Kurdistan or Iraq as Whole

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Doi:10.23918/icabep2018p3

Abstract

This study analyses the various types of contracts which have been awarded within the modern global petroleum industry and considers how far the different exploration and exploitation rights set out in contracts which may best suit Iraq-Kurdistan in the context of the country's current legal-political environment. It will also examine whether the people of the Kurdistan region of Iraq are legally entitled to the right to enter into contracts with foreign oil companies. Finally, the study will propose that the production sharing agreements employed within the Kurdistan region of Iraq appears to be legal and best suits for the Kurdistan and Iraq as well as whole since that it is the contract model best well-matched to; attract foreign investment, develop future and prospective oil fields, deliver consistent economic rents to the state and provide greater involvement in the country's hydrocarbon industry to the Iraqi people as required under Article 112 of Iraqi constitution as well as creating better political friendships with foreigner countries.

Key words: Politics issues between Iraq and Kurdistan Region, trips of petroleum contacts, evaluated nuclear reasons for KRG to do PSC contacts, Iraq's right and responsibilities

1.1 Introduction

Opposition over natural resources between Central Government "Baghdad" and the Kurdistan Regional Government (KRG), has been a vital component in the complicated relations between Arabs and Kurds in post-2003 Iraq. Particularly over the KRG's oil politics with regard to control over, and exploitation of, oil reserves in the Kurdistan Region. Such oil politics has been established in independent hydrocarbon legislation and the signing of independent extraction and production sharing contracts with transnational energy companies (Mirtorabi, 2016). The KRG's formulation of its own oil policy and laws, often in disagreement to the federal government in Baghdad (Mills, 2016). The KRG has been challenged on a number of fronts both internationally and domestically. In December 2013, the KRG announced the completion of the Kurdish-Turkish pipeline and its commitment to using it to export oil starting that month. However, since then the use of the pipeline for the exportation of Kurdish crude

has been at best limited and its sale non-existent. The Iraqi Government's policies have been significant in thwarting the KRG's use of the pipeline. Amongst these policies is Baghdad's threat that it would file lawsuits against any third party that buys the crude exported through the Kurdish pipeline. This particular threat has been particularly effective, as most international oil companies (IOCs) prefer to maintain their goodwill when dealing with Iraq as a number of the largest oil and infrastructure projects are in Iraq such as firms like Exxon-Mobil, in this particular occasion its success is based on two differences and other IOCs and Turkey do not want to get involved in a situation where they are perceived to be threatening the sovereignty of Iraq (Eskerie, 2014).

Thus, in this way Iraq has placed significant limits on the international clout of the KRG. However, Baghdad has also been knowingly successful in creating challenges to the KRG's interests through the creation of domestic pressures. The freeze of the KRG's portion of the annual Iraqi budget is the most significant example of this. While, Article 112 (Iraq. Const, 2015 art. 112) Article 111 (Iraq. Const, 2015 art. 111) of the same Constitution states that all Iraqi people own the nation's oil resources. Article 109 states that 'the federal government with the producing governorates and regional governments shall undertake the management of oil and gas extracted from "current fields, provided that it distributes oil and gas revenues in a fair manner. The Article asserts that working in collaboration across the region, governing authorities "shall together formulate the necessary strategic policies to develop the oil and gas wealth in a way that achieves the highest benefit to the Iraqi people using the most advanced techniques of the market principles and encourages investment" (Iraq. Const, 2015 art. 113). Therefore, one can easily see that this is what exactly KRG doing by signing Production Sharing Contracts with IOCs. Thus, Constitution is uncertain and problematic in many respects including the division of powers between the federal government, regions and governorates. Whether by intention or interpretation, the constitution has allowed the formation of two distinct, and theoretically incompatible, legal regimes for the award and implementation of rights to the country's petroleum resources (Gunter, 2005). Although on a number of occasions, the KRG and its key leaders have voiced their voluntary membership to the Iraqi Government. They have argued that they are in a contract with Iraq simply because it suits the national security interests of the Kurdish people and once it stops doing that, they are willing to declare their independence.

1.2 History to Iraq's Oil Industry and current dispute

Since ancient days the issues surrounding ownership, ability to gain permission to extract natural resources, and the paying of 'rent' or the extraction of these resources, have been crucial to the two parties involved; those owning the resources, and those wishing to extract them – investors or entrepreneur/businesses (Alalade, 2004). These days, these problems seem to be as important as those long-gone times. Indeed, they may even take on a greater importance now, as globalisation and

industrialization have increased people's interdependence on naturally-occurring resources such as petroleum oil and gas (Alalade, 2004).

Iraq's oil industry, exploration and production began in the 1920s under the terms of a wide-ranging concession granted to a group of international oil companies known as the Turkish Petroleum Company (TPC) (Jaffe, 2007). In 1925, the Constitution of the Kingdom of Iraq was promulgated and for the first time, the Iraqi government granted a 75-year oil concession to the foreign owned TPC, Following a major oil discovery at Baba Gurgur, just outside of Kirkuk (Jaffe, 2007). This concession covered the entire Mosul and Baghdad provinces, which constituted most of Iraq, except for the southern Basra province (Jaffe, 2007). Beginning in 1934, the aforementioned crude oil began to be shipped by pipeline to the Iraqi town of Al-Hadithah, where the pipeline then exported it from Iraq to either the Lebanese port city of Tripoli (Zedalis, 2009). After the end of World War II, the crude was transported through the new discovered pipelines from fields in the southern portion of Iraq with discoveries in Zubair in 1948, Rumaila, Bai Hassan in 1953 and Jambur in 1954 (Johnson, 2008). Thus the history/pattern of natural resource clearly highlights the significance points of early oil and gas explorations and development in Iraq and by reviewing this aspect of history can help a modern-day analysis of oil and gas management and transportation (Johnson, 2008). Since those very pipelines are in fact currently disputed by the federal government and denying the KRG's right to sell and export oil to international markets via these pipelines, claiming that the KRG contracts do not comply with the Iraqi Constitution. In response to this the KRG is shortly to complete their new, separate pipeline which goes from KRG directly to Turkey in order to sell their crude oil to Turkey, and from there to other international countries. This issue raises yet more complexity, which will be discussed in Chapter 3 below

1.3 This part intends to examine the types of oil and gas contracts which are established by Iraq and its region 'Kurdistan' and will attempt to examine their differences with reference to the experience of other countries. It will go on to comment on the impact of such contracts, including the place of Kurdistan within this, and will end by highlighting the most recent developments in energy production, and the main principles behind Kurdistan's primary contract types.

1.4 Contract terms and types

In practice, there are three basic types of contractual arrangements commonly used for oil and gas explorations and development in Iraq. These are: Concessions, Production Sharing Contract (PSC) and Technical Service Contracts (TSCs). While each works differently (Pellegrini, 2011), their differences can usually be seen in the level of government involvement, how much control over operations and production is given to foreign contractors over operations and production, and the proportion of revenue share-out between government & foreign contractors.

1.5 Concession contract

Concession contracts are thought to be the oldest type of petroleum contract, originating in the USA's 19th Century 'oil boom'. In its purest form, it provides 'ultimate control in all resources underground and air above land', giving the licensee exclusive rights of exploration and exploitation of petroleum within a specified area for a specified duration which was also employed by the Iraq from early founded oil in Iraq in 1920s. Ownership rights to mineral deposits at the wellhead along with rights to freely dispose of the produced mineral assets are vested to the concessionaire. The state generally gains its revenues from cash royalties (land rental), income taxes and other similar payments and taxes to the host country based on production and operational profits (Cameron, 2010). All equipment and installations used in the petroleum exploitation belong to the contractor who was granted the licensee, sometimes along with rights to any extractable resources covered the whole of country, such as in the Middle East (Smith, 1992). Usually there is no state involvement with an IOC or licensee in this kind of contract who own and use all equipment. The host country simply receives royalties, tax income and other related payments (Jalo, 2012). Traditionally, concession was a simple agreement, often consisting only of royalties (12.5%) and with an unreasonably long period, often 50 years or more.) (Duval C. L., 2009). IOCs haven't tended to favour long-standing concessions due to the autonomy it brings, including access to, as it was termed, 'hydrocarbons in situ'. An example can be seen in 1920s, when King Faisal rule of Iraq granted three concessions to a consortium of British and French companies & the Iraq Petroleum company for 75 years. They received the right to all hydrocarbons giving them in the country (Turbrvill, 2009).

Two main types of oil and gas contracts namely PSC and RSC which are currently performed by Iraq and Kurdistan which also caused hostility:

1.6 Production (or Product) Sharing Contract:

A Production Sharing Contract is commonly defined as a private agreement between the International Oil Companies and National Oil companies under legislation, giving authorisation and access to NOCs to explore, exploit and produce hydrocarbons (Ataka, 2013). PSCs are amongst the most corporate type of contractual agreements and the concept goes back to Bolivia in the early 1950s. Using legal regulation between state and vetoes, PSCs gained popularity, especially in the Middle East, after their early use in Indonesia in the 1966 (Bundemann, 1999). Nowadays, PSCs are recognised by leading International oil and gas companies and used in over 40 countries, including Egypt, Malaysia, Syria, Oman, Angola, Gabon and Vietnam. More recently, this type of contract has been used in dominant countries such as Russia, Azerbaijan and Iraqi Kurdistan, with most of these in some economic transition (Brinsmead, 2007). The PSAs in Iraq were initially signed and implemented with major oil companies in 2005 implemented in 2005 (Ciarreta, 2009).

Normally, under the PSCs the title to the oil and gas remains vested in the host state or the NOC. The idea is that the foreign company agreement with host state or NOC, will explore for petroleum resources within a specified contract, and the host state or NOC pays the necessary expenses and expertise as may be required from their own expense. By working at its sole risk and expense, the company will benefit by gaining a proportionate share to what is recovered, (often in the range of 30-50 per cent like now in Kurdistan). The sharing is typically done according to a PSC formula or sliding scale, which distributes a majority share of balance to the state, either of petroleum remaining after cost recovery or a share or production of profit oil if commercially produced (Cameron D. , 2010). For example, Ashland Oil Company Nigeria PSA provides that after 40% cost recovery, the remaining production should be shared between the Nigerian National Oil Company (NNOC) and IOC based on the percentage agreed formerly. Generally, income tax and royalty is imposed on contractor's operations. Occasionally the state also contributes as a commercial partner in the contract, operating in a joint venture with foreign oil companies as part of the group, based on either a concession or a PSA model. In this case, the state generally provides a percentage share of development investment and directly receives back the same percentage share of profits (Muttitt, 2009).

PSCs can offer great advantages to foreign investors, such as investors can include in their accounting and financial statements, details of petrol reserves it finds, thus enhancing share values (Tienhaara, 2011). The PSC can also define and customise its own legal regime, especially desirable in countries where foreign investment is unsettled or not yet clearly ring-fenced. This has relevance for Kurdistan's difficult position (see the section below).

In terms of advantages, all financial and operational risks lie with IOC, yet the Host Government (HG) does receive benefits without making investments. Also, as noted above, it can be argued that PSAs are superior to present and future laws, hence, the government cannot adopt new laws and regulations if they adversely impact any rights of the oil company under PSA, since it will be tied by the restrictions in the contract for a long period. So, if the government or political climate changes, the terms of PSC cannot be changed to reflect the state's new legislation as can occur in a TSC where government usually take control over at the production phase (Cameron P. , 2010).

1.7 Service contracts:

The third regime is the Risk Service Contracts (RSCs). This type of agreement is simply where a company reach agreement to perform certain services for a monetary payment, for example, a private oil company agreeing to provide all the risk capital and services for exploration and development. The IOC is then repaid for its costs and services through payment of cash, usually after the oil is produced, otherwise all investment is sacrificed (Jennings, 2008). For instance, Article 7.1 of the Argentinean model contract obligates the contractor 'to provide services in matters of accounts, technology, capital,

equipment, machinery and investment, on its own risk (Smith, 1992). When commercial productivity is proclaimed, the company must receive compensation and any additional for the risk undertaken (Smith, 1992). Likewise to a PSC, the IOCs carry the burden, and will not receive repayment unless oil production succeeds and is profitable. Service contracts were first employed in Latin America; concessions were no longer acceptable to emerging NOCs who wanted more control (Duval, 2009). For example, Brazil created Petrobras in 1953, and Argentina created in 1958 (Duval C. L., 2009). Some Middle Eastern countries also began to use RSC, such as those signed with the French national oil company ERAP-Elf (now merged with Total), and with the Iraq National Oil Company (INOC) in 1966. Later, in 1968 under the terms of these contracts in Iran and Iraq, the IOC acted as a general contractor, not as a concessionaire owner of petroleum and thus carried all the exploration risk and associated costs and services (Duval C. L., 2009). However, the HG and the contractor can also establish a Joint Supervisory Committee, before commercial production begins.

1.8 Critical analysis of PSC contract and why is could be seen as best suit for Iraq and Kurdistan in particular:

To start with, legal terminology, Iraqi constitution stated that Article 111 Oil and gas are owned by all the people of Iraq in all the regions and governorates. In addition Article 112 stats the federal government, with the producing governorates and regional governments, shall undertake the management of oil and gas extracted from present fields,shall together formulate the necessary strategic policies to develop the oil and gas wealth in a way that achieves the highest benefit to the Iraqi people using the most advanced techniques of the market principles and encouraging investment (Duval C. L., 2009).

One can easily observe that the regional government has put enormous effort into the development of economic and investment fields. Recently, the regional government signed more than 50 “production sharing contracts” for oil fields with international companies while there is no single service contract has been signed with central government all the field are those either old ones or has already oil been discovered just a matter of drilling left for the company to drill . In other hand, some political observers believe that these oil contracts are risky, especially as “production sharing contracts” allow large foreign companies to obtain a share of total oil output and exaggerated profits and also in terms of political change or government the alteration the change will not effects on the contracts and it will not full reflects the change since the contracts normally for long enough. But the Kurds see positive features related to these contracts, believing that the political future of the region is worth the sacrifice of wealth (Duval C. L., 2009). Officials feature Kurdish policy may perhaps be for two causes. Firstly, the region can obtain the protection of major international powers in the face of political threats by opening up the region to foreign companies who hold significant economic influence with their governments. Secondly, the Kurds believe they will obtain more support of those countries in the dispute over oil rich

areas such as Kirkuk because foreign powers believe they will receive similar oil contracts if the fields are under Kurdish control (Malazada, 2008). However, the opposite view about this oil policy has caused much disagreement between the regional and central governments over the past two years. While the Kurdish region moved quickly to issue an oil and gas law and sign foreign contracts, the Iraqi oil minister, says the moves were “illegal” because they were signed without the approval of the central government. The Kurdish government says it had the constitutional right to act accordingly. Nothing like the central government which has focused on “technical services” contracts, the Kurdish regional government has focused on production sharing contracts, under which the investing company receives a certain percentage of oil revenues reaches 18% of total oil production. Thus, expert on petroleum fiscal regimes, Dr Pedro van Meurs, which says that the production sharing contracts model in Iraqi Kurdistan better serves Iraqi national interests than service contracts (Malazada, 2008). The report concludes that central government model "would be unsuccessful for Iraq," and that the Iraqi people would lose trillions of dollars. The key issue for Kurds now is the control of oil fields in the province and their management. Article 108 of the Iraqi constitution stipulates that “oil and gas are the ownership of all the people of Iraq in all the regions and governorates,” and the first paragraph of the following article states that “the federal government with the producing governorates and regional governments shall undertake the management of oil and gas extracted from current fields.” However, the Kurdistan regional government avoided these conditions by issuing a special oil law for the region in August 2007, giving itself exclusive management powers of oil fields in the region. The majority of Iraqis, particularly Sunni Arabs, have strongly opposed the oil and gas law of Kurdistan region, but the Minister of Natural Resources for the Kurdistan region, Ashti Hawrami, says that the step was constitutional, saying that “according to the Iraqi constitution, the authority to manage Iraqi oil and gas is with the hands of the region and our success in this area is subject to our exercising of this right.” (Malazada, 2008).

However, if the Iraqi government violates the Iraqi constitution then the Kurds will take a decision on this matter. Kurds continue to distrust the central government policy on unsettled issues and they fear that once the central government regains strength they may lose Kirkuk and the central government may turn against them which is now, especially after the 16th of September 2017 Iraqi forces have apparently captured a military base, an airport and oilfields outside the northern city of Kirkuk then the prime minister, Haider al-Abadi, ordered the army to “impose security” on the Kurdish-held territory. Thus, the regional government appears to be strongminded in its negotiations with the central government and it has been largely successful in forcing the latter to accept the oil and gas law as a fait accompli. (Malazada, 2008).

1.9 Conclusion

This dissertation has looked at resource control in Iraq and Kurdistan but with particular focus on the sovereignty issue of KRG’s entering contracts with IOCs and legality of those contracts as well as why

is best suits for Kurdistan. These are big questions that touch on fiscal federalism in Iraq and have their origins in historical, economic, political, geographical, cultural and social factors. In many of these areas, issues remain unresolved. Throughout this dissertation, it has been established that the Kurdistan regional government have been able to sign oil and gas production- sharing contracts under their own Kurdistan law as well as under the Iraqi constitution. Through these contracts, Kurdistan has seen a huge development of its natural resources within the past few years. The companies who have invested in Kurdistan have predominantly been smaller independents and service companies all of whom were looking to expand their portfolios in a promising oil and gas province. At the end the paper recommends to the government of Iraq and KRG to reduce tensions and solve their differences by coming to an agreement over matters concerning oil and gas contracts, rather than addressing the more fundamental issues over sovereignty, in order create a successful and planned power sharing arrangement.

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