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### Iraq: Oil and Gas Strategy

#### Summary

1. I enclose an Oil and Gas Strategy for Iraq, which has been agreed at senior official level between FCO, DTI and DFID. The Strategy sets out key HMG objectives for Iraq's oil and gas sector, covering the role we want it to have for Iraq's future development, for the UK commercially and in international oil and gas markets. It also covers the key challenges Iraq's oil and gas sector faces and sets out in detail (Annex A) what we should do, across government, to achieve our objectives.

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#### Detail

2. Successful development of Iraq's oil and gas will take time, and is dependent on continued progress on security and the political process. Oil and gas will inevitably form the economic foundation for Iraq's future and remains important for the UK commercially and in terms of energy security. Foreign investment is badly needed and we need to continue to support Iraq to create the right framework for investment, while also supporting UK companies to engage. And we should continue working with the Iraqi Government to ensure the oil sector develops transparently and along lines of international best practice. One of our key objectives is for Iraq to sign up to and implement your Extractive Industries Transparency Initiative (EITI).

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Ensuring the World Bank and IMF are fully engaged in advising the Iraqi Government on how to best use their oil and gas resources will also be important.

3. I am copying this to John Reid, Peter Goldsmith, Hilary Benn, Des Browne, Ann Clwyd, CDS, and PS/"C" also to Nigel Sheinwald, William Patey (Iraq) and William Ehrman (Cabinet Office).

(JACK STRAW)

Foreign and Commonwealth Office  
12 July 2005

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IRAQ: OIL AND GAS STRATEGY

**OBJECTIVES**

1. Key HMG objectives are:

- i) The development of an efficient, outward-looking and transparent oil and gas industry, capable of delivering sustainable export revenues to meet the development needs of the people of Iraq and meeting domestic needs for energy in an efficient, equitable and secure manner.
- ii) Increasing involvement of the private sector, leading to sustained investment over the next 5 to 10 years and substantial business for UK companies. This depends on progress on objective i).
- iii) To promote Iraq's role in international oil and gas markets and as a constructive influence within OPEC.

Outcomes and schedule for engagement in Annex A.

**CONTEXT**

- 2. The oil and gas sector is the economic foundation for Iraq's future (accounting for around 95 percent of government revenues and possessing 11 percent of total world oil reserves). However after decades of mismanagement, warfare and sanctions, it remains fragile and antiquated. Its development will require successful implementation of the political process and improved security before the International Oil Companies (IOCs) will be prepared to seriously engage. Any slippage in the political process would result in further delay.
- 3. The Iraqi Transitional Government (ITG) is a fully sovereign but the general perception is that politically key long-term issues (legal, regulatory and fiscal reforms affecting the oil industry and production goals) should await a constitutionally elected government. This however should not prevent detailed provisional plans being drawn up and announced. The key will be whether the ITG has the political will to push reform and look beyond short-term objectives.
- 4. Progress also requires a sustained reduction in acts of sabotage on the oil infrastructure (estimated to have cost over \$7 billion in 2004). Since Iraq does not have a large crude oil storage capacity even short-lived disruptions to the pipeline network can cause significant loss of oil revenues (estimated at over \$800 million since the beginning of 2005). Without improved security the private sector will not engage to the extent necessary.

**KEY CHALLENGES FOR IRAQ'S OIL AND GAS SECTOR**

- 5. One of the principal challenges facing the ITG and subsequent governments will be to institute structural, fiscal and regulatory reform to attract foreign direct

investment (FDI) into the sector. These reforms should form part of a coherent energy strategy, which does not exist at present. Little progress was made under the IIG. Existing Iraqi law does not allow for foreign investment in the energy sector. It has been estimated that USD 20 billion is needed to increase oil production from present levels (2.0-2.3 million barrels per day) to 4 million barrels per day, and up to USD 50 billion for 6 million barrels per day. In the absence of an extremely high oil price, Iraq would only be able to finance this investment if it is prepared to make substantial cuts in government spending in other areas (unrealistic given the scale of pressing needs). Therefore Iraq will need to engage with IOCs to achieve rapid rehabilitation or significant new development.

6. Improved energy sector governance and capacity building also remain key to ensure transparent practice in all areas of oil sector operations<sup>1</sup>. Reform will need to be sensitive to the need of IOCs to manage their reputational risk when considering investment options. It must observe international best practice and promote transparency, such as through the Extractive Industries Transparency Initiative (EITI). The World Bank have extensive experience supporting legal and regulatory reforms in the oil and gas industry and would be well placed to provide such support. Iraqis in the oil sector also need training (eg in English language skills and modern management and technical practices) to improve output.

## KEY CONSIDERATIONS

7. The oil and gas sector in Iraq is important to UK objectives on energy security as well as to our commercial and development goals.

### Energy Security

8. The UK's economic well being depends on secure oil and gas supplies at affordable prices. The UK is expected to be a net importer of oil by around 2010 (we are already a net importer of gas). The International Energy Agency projects that OPEC's worldwide oil market share will rise from 37% in 2002 to 53% in 2030. Within OPEC, Middle East countries will account for most of the production increase with Saudi Arabia, Iraq and Iran the most significant players. Iraq is generally accepted to have the second or third largest proven oil reserves in the world (estimated at around 112 billion barrels) and considerable potential in unexplored areas of the country (possibly in excess of 100 billion barrels). Iraq also has significant reserves of natural gas (estimated at 2 percent of world reserves) which remain largely untapped. Sustainable increases in Iraqi oil and gas production would make a large contribution to global energy security. Against a backdrop of volatile oil prices and little spare global production capacity, an increase in Iraq's current level of production could have a significant impact on markets.

<sup>1</sup> It is likely that the future scale of investment in the hydrocarbon sector over the next 20 years may be served by non-traditional financing methods, such as project bonds or the participation of very large investment funds. Iraqi knowledge of international investment norms and the market's appetite for risk are low. This heightens the need for high levels of governance and transparency.



9. Iraq's relationship with OPEC will also be important<sup>2</sup>. Although Iraq remains an OPEC member, its production has been independent of OPEC quotas since the 1991 Gulf Conflict and remains well below its nominal quota of 3.14 mbpd. Iraq is therefore unlikely to play a leading role in debates – at least in the immediate future – over price levels or quota ceilings. But it harbours long-term ambitions to compete with Saudi Arabia as a swing producer and picking up any shortfall in output from OPEC as a whole.
10. A modernised, transparent and investment friendly oil and gas sector in Iraq will be a strong exemplar to other Middle East oil and gas producing countries. We should continue to encourage the strengthening of Iraq's economic and trade ties with its neighbours and other countries in the region to help promote stable economic and political systems. Iraq's main export route for oil is through terminals in the Persian Gulf and the Kirkuk-Ceyhan pipeline through Turkey. There are also oil pipelines through Syria, Jordan and Saudi Arabia that are currently closed. Iraq will also look towards its neighbours as markets in the longer-term.

## Commercial and development goals

11. Our energy policy objectives for Iraq need to be dovetailed with HMG's commercial and international development goals in Iraq. Iraq's oil and gas sector should provide considerable market opportunities for the private sector, including UK firms and the export of UK equipment, services and best practice. The success of ECL/Shell and BP respectively in winning tenders to provide technical studies of the Kirkuk and Rumaila oilfields points the way for future commercial opportunities.
12. Economies that rely wholly, or to a large degree, on oil revenues to fund their national budget need mechanisms (such as a stabilisation or savings fund) to cope with the negative exchange rate impact on non-oil sectors and fluctuations in oil prices and export revenues that inevitably occur. Given the continuing need to finance reconstruction this is likely to be a key issue for future Iraqi governments. We should encourage the IMF to advise how Iraq's oil revenues can be managed for its economic development.
13. The idea that Iraq's energy development needs are best served through FDI will be politically sensitive, both in Iraq – touching on issues of sovereignty – and internationally. Pushing legislation on foreign investment through the National Assembly may be difficult given the sensitivities involved. We will wish to promote the message on FDI to the Iraqis in private, but it will require careful handling to avoid the impression that we are trying to push the Iraqis down one particular path.

## Energy price reform

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<sup>2</sup> A sudden break-up of OPEC would not be in the UK's interest since it would add to oil market and geopolitical instability. Joint FCO/DTI/HM Treasury analysis in late 2002 concluded that it would be preferable that Iraq remained within OPEC, but that its future production levels are such that they put pressure on OPEC in terms of the price levels it is able to target.

14. Domestic energy price reform, both for petroleum products and electricity, remains key. Current subsidies on fuel products (gasoline is only 20 ID, ie \$0.015 per litre) cost up to \$10 billion per annum, encourage unsustainable levels of demand and create significant opportunities for corruption. Iraq's 2005 Budget contains a commitment to \$1.5 billion of subsidy price reform. Substantial progress against this target is a key requirement of the IMF assistance programme Iraq agreed in September 2004. We want to see early moves to gradually increase gasoline prices this year, while the ITG develops a broader domestic energy reform strategy, implemented to protect the less well off.

Oil development and the Constitution

15. Oil development will also form part of the Constitutional debate within Iraq about the control of resources within Iraq and between regions. Under Iraqi law, natural resources belong to the national government, which alone has power to conclude agreements for the development of these resources. However, the bulk of Iraq's oil and gas is located in the South and around Kirkuk. The South, neglected under the former regime, wishes to secure a fair share of oil revenues. In the North the status of Kirkuk and equitable distribution of revenues in Kurdish areas will raise similar challenges.

Annex A**KEY DESIRED OUTCOMES AND SCHEDULE FOR ENGAGEMENT**

In order to achieve HMG's interlocking objectives we need to see:

1. **Good governance and development of a transparent fiscal and regulatory structure governing the oil and gas sector** – Our objective is to see an Iraqi oil sector that is stable, efficient, free from corruption and transparently managed. We aim to see a) the adoption of principles highlighted in the BearingPoint report presented to the MoO in December 2003 and of work completed by UK oil consultants to the CPA (Terry Adams and Bob Morgan); and b) the Iraqis sign up to EITI principles. Iraq will also need to develop a sound fiscal and legal/regulatory framework to attract international financing and investment. This applies to encouraging foreign investment in Iraq in general. Iraq also needs to decide on the type of petroleum contract to use to facilitate long-term FDI. Petroleum legislation should include a contract model consistent with Iraq's economic potential, drawing on accepted industry norms and best practice.

**ACTION:**

- 1.1 Continue to stress to the ITG the importance of action on these issues. We should continue to develop relationships with and target senior members of the MoO and the Higher Energy Committee (chaired by Ahmad Chalabi and overseeing the Ministries of Oil and Electricity). We should also build up a relationship with the MoO's Inspector General, responsible for ensuring accountability and tackling corruption within the Ministry. Baghdad to report back (in co-ordination with Basra as necessary) on progress every 3 months or when significant developments arise.
- 1.2 Continue to facilitate a programme of UKTI funded visits of MoO personnel to strengthen dialogue on key oil and gas issues and Iraqi needs. Before the end of the year UKTI are seeking to organise visits by:
  - The Oil Minister, Ibrahim Bahr al-Ulum.
  - Senior representatives from the MoO, including the DGs from the South and North Oil Companies and representatives of the State Company for Oil Projects (SCOP).
  - A number of senior MoO officials attended the UKTI sponsored Iraq Petroleum Conference in London 29-30 June.
- 1.3 Engage with the Iraqis at key international/regional fora on energy issues – eg OPEC, IEA, and GCC.
- 1.4 DTI/FCO to continue to identify and assist UK companies (particularly UK members of OC5) who may wish to comment on particular aspects of the petroleum law.
- 1.5 IPU/DTI/Baghdad to facilitate start of GOF project on model petroleum contracts and reform of the INOC in June – commencing with visit of project

implementers to Baghdad. Baghdad to report back on further opportunity for the UK to assist and advise on best practice/good governance.

- 1.6 DFID/FCO/Baghdad to share with the MoO information on EITI, how it works, and how it might benefit Iraq. We should ensure Iraqi representation at the next EITI conference (date tbc).
- 1.7 Baghdad to continue to push the MoO to install oil meters on oil wells, the lack of which currently prevents accurate reconciliation of how much oil is produced, exported and consumed domestically.
- 1.8 Baghdad to discuss with the Ministry of Trade (and views from MoO and Ministry of Finance) the possibility of the UK and Iraq signing an Investment Protection and Promotion Agreement (IPPA).
- 1.9 DFID's two advisers to the Ministry of Electricity in Baghdad to support development of policy and strategies for the sector, including linkages with the MoO and development of an energy strategy.
- 1.10 Baghdad to ensure MoO attendance at the Chatham House workshop on Good Governance in September 2005.

2. **Separation of powers** – between a reconstituted Iraq National Oil Company (INOC) and the Ministry (which would continue to set overall policy and act as regulator). There are also economic and governance benefits for Iraq of establishing a single NOC by combining the North and South Oil Companies, and the various state-run gas and refinery companies. We need to keep a close watch on sensitivities in Iraq on this issue, most notably unease from Basra at the proposals for establishing an INOC.

## **ACTION:**

- 2.1 As 1.1-1.3 and 1.5 above.

3. **Improved infrastructure security** – We need to see a credible infrastructure protection force established – responsible for guarding the key nodes of all oil, electricity and rail liner infrastructure – that has a clear command and control structure and is properly financed from the national budget. Plans agreed by the IIG to form a new Strategic Infrastructure Security Force (SISF) of 18 battalions have partially stalled due to bickering between the MoD, MoI and MoO over how the force will be run and funding (\$600-700 million is needed to set up the SISF plus \$200 million annual sustainment costs). There are also concerns that the new force could divert regular Iraqi troops from counter insurgency operations, particularly if more funding cannot be found.

## **ACTION**

- 3.1 FCO to consider with MOD whether UK consultants to the Iraqi MOD could help the Iraqis develop an infrastructure security strategy.



4. **Increased UK IOC engagement in the development of Iraq's oil and gas sector** – Iraq is currently one of the top two priorities for UKTI's oil and gas team for Middle East and Africa and amongst the top eight worldwide.

**ACTION:**

- 4.1 UKTI to continue to seek UK oil company input into 1.2 above.
  - 4.2 FCO/DTI to continue to explore options for the appointment of a UK oil company secondee to the Embassy in Baghdad.
  - 4.3 UKTI to continue to support activities under the UK-Iraq Joint Board for Learning in partnership with UK industry on ELT, development of IT and HR strategies, and assistance with learning needs analysis.
  - 4.4 FCO to further develop HMG's capacity on Middle East energy policies and OPEC by appointing a Middle East energy adviser.
5. **Energy price reform** – To push for initial (but measured) movement in gasoline prices, ensuring the Iraqi Government meets its IMF Emergency Post Conflict Assistance (EPCA) programme commitments. In the longer-term we want to see the implementation of a comprehensive domestic energy price reform programme, aimed at cutting subsidies and ensuring fiscal sustainability and more effective use of Iraqi resources, while protecting the living standards of the less well-off.

**ACTION**

- 5.1 FCO/DFID/HMT to continue to press the ITG (including MoO, Ministry of Finance) on the need for an early (initial) move this year to reduce subsidies, ensuring the ITG meets its EPCA targets/commitments.
6. **Increased refining capacity and improved Iraqi technical and management capacity** – It is important we continue to help Iraq establish its capability in reservoir management to improve their ability to exploit oil fields to maximum effect. UKTI are currently exploring further training needs in this area with the Iraqis. We have also assisted with training aimed at maximising refinery output. Iraq needs to increase its refining capacity to reduce dependency on fuel imports (which cost Iraq up to \$200 million per month). The work of the Iraq-UK Joint Board in helping the Iraqis devise a training and HR development plan will help. UK companies bidding to provide this refining capacity in Iraq should be supported as far as possible.

**ACTION:**

- 6.1 As 1.2 above.
- 6.2 UKTI to continue to meet Iraqi training needs through the work of the Joint Board on Education and training. Continue to support the ELT/IT capacity training project.

6.3 Identify Chevening scholars in energy related areas.

6.4 Consider whether ECGD support should be made available to UK firms bidding for energy sector projects, particularly on the refining side.

6.5 Encourage donors, particularly the World Bank to provide support to the regulatory and legislative reform necessary to create conditions for FDI in the oil and gas sector.

7. **Development of Iraq's gas potential** – The MoO has said that development of natural gas is one of its medium-term priorities and is reported to be planning development of Iraq's first natural gas field near Kirkuk. The provision of a secure gas supply to the Iraqi power sector will help relieve Iraq's chronic power supply shortfall – Iraq currently flares around 1 billion standard cubic feet of gas each year, which could be used to supply 6000 MW of electricity generating capacity.

The lead-in time for either gas pipelines or liquefaction plants to be built will be significant. We will need to consider in future options for a UK gas strategy on Iraq. We should also keep abreast of IOC plans to help the Iraqis with a gas plan. In formulating a gas strategy we would need to distinguish between three aspects:

- i) Development of Iraq's gas industry for domestic purposes. In the nearer-term we want to see substitution of gas for oil in domestic power generation and a sharp reduction in the use of diesel and fuel oil in gas turbine generating plant.
- ii) Development of Iraq's gas infrastructure for export
- iii) Development of the regional market for gas

## **ACTION:**

7.1 As 1.1-1.3 above.

7.2 Following discussion with UK companies looking to provide assistance in this area, Baghdad to encourage the MoO to develop a gas master plan. We should also help facilitate the provision of expert advice from UK firms and encourage the MoO to appoint a DG for Gas.

7.3 Encourage close co-operation between the Ministries of Oil and Electricity on securing gas supply for domestic power purposes.

FCO/DFID/DTI  
June 2005