

IRAQ –TOWARDS A VIABLE NATIONAL ENERGY POLICY

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Energy Potential vs. Reality

Oil and Gas

According to recent international estimates Iraq is expected to earn \$5 trillion from oil exports up to 2035. Yet despite having reserves of 143 billion barrels, and awarding concessions to international oil companies (IOCs) for field development both in the north and south, it has yet to exceed its peak production of approximately 3.8mn b/d in 1979.

Obstacles to oil production have included the ongoing renegotiation of contracts awarded to IOCs to reduce development production rates, which is a complex, time-consuming exercise. This state of affairs may seriously undermine the international community's confidence in the government's ability to stand by its obligations. Furthermore the federal government has been unable to attract private investment in modernising Iraq's refining sector, which is an urgent priority to keep up with growing domestic demand, develop the supply chain of the industry and create labor intensive employment.

Natural gas is positioned to contribute significantly to Iraq's future by reducing the importance of oil in Iraq's management of natural resources. Currently nearly 1 billion cubic feet of gas is flared every day in southern Iraq as a by-product of oil production. As a result, Iraq loses about \$3 billion in flared gas annually because it lacks gas processing capacity. The billions of dollars being lost could have been used to build up the underlying oil and gas infrastructure and fuel the growth of the national economy in sectors such as agriculture and industry.

Policy makers and investors will also have to decide how to balance the trade-off between the low value of gas supplied to the domestic market, which is an urgent priority, and the higher premiums on exports.

Downstream

Iraq's downstream sector and in particular its refining capacity continues to be unable to produce sufficient high grade products to meet domestic demand and for export owing to a legacy of inadequate investment. Gasoline and diesel, which are increasingly required for domestic consumption and exports, account for a relatively small fraction of production, which has resulted in large quantities being imported on a daily basis. The ongoing trend towards importing large

quantities of gasoline and diesel is clearly a waste of federal revenues which could instead be spent on upgrading and modernising Iraq's refining capacity.

Electricity

The fundamental problems in this sector consist of a degraded distribution network, power generation dependency on liquid fuel feedstock, high subsidies which inhibits private sector investment and competition and an inadequate system of electricity metering, billing and collection of payments. The impact of these issues have resulted in a fragmented electricity policy and strategies between Baghdad and the KRG as evidenced by the KRG's entry into independent power producer contracts. In addition, Iraqi citizens continue to be highly reliant on private generators to make up the shortfall in respect of consumption requirements. Power generation waste also continues to inhibit the growth of the industrial, manufacturing and agricultural sectors. Finally the Federal Government is further inhibited to reinvest tariff revenue to upgrade the national grid owing to inefficiencies in electricity metering and tariff revenue collection.

The federal government is constrained in increasing prices for domestic electricity consumption by the historically low quality of service. It is also constrained in collecting revenue by the many areas with illegal connections.

Iraq's national development is intrinsically linked to its electricity consumption. As a matter of priority it needs to significantly increase its generation capacity, improve transmission and distribution and move from oil-fired power sources to efficient gas-fired generation.

Industry

Oil and gas are economic multipliers which are capable of supporting broader economic development in affiliated sectors such as industry, power and transportation. Increased oil and gas revenues are critical in creating a healthy framework which encourages greater private sector participation in these industries, which will in turn create more labour intensive employment opportunities in sectors such as agriculture, housing and manufacturing.

Job Creation

The diversification of Iraq's economy in order to reduce its dependence on oil and gas related revenues is a fundamental prerequisite for job creation. It can therefore be argued that both the rapidity with which jobs can be created and the issue of social inclusion must be considered as one of Iraq's top priorities to ensure long-term political stability.

Iraq's oil and gas sector represents the country's single most important source of income, accounting for more than 70% of GDP while employing less than 2% of the 8 million-strong Iraqi workforce. The revenues generated have, however, enabled the government to maintain a huge public sector in comparison to Iraq's total population whose contribution to the national economy is negligible. Clearly the policy of increasing job creation by maintaining an oversized public sector is not sustainable in the long term. The Iraqi government will therefore have to create greater economic opportunities by modernising and expanding its energy sector at all levels and attracting greater foreign direct or private investment in the production and services supply chain.

The issue of job creation cannot be adequately addressed without tackling the question of gender inequality and marginalised groups, including the young, internally displaced persons and Iraqi refugees living abroad. According to a recent international report, women constitute approximately thirteen percent of Iraq's labour force, mainly in the public sector or unpaid jobs in the agricultural sector. Furthermore, compared to other MENA countries, Iraq has the lowest ratio of female managers - one percent, compared to twenty nine percent in Lebanon.

Unemployment amongst Iraq's youth was put by a recent report at thirty percent, due, inter alia, to a lack of effective awareness programs and of public education resources, as well as nepotism and political favouritism.

It is a well-known that Iraq's middle class has been decimated during the past 30 years as a result of persecution, wars and sanctions. As a result a substantial number of highly skilled and experienced Iraqis, particularly in the energy industry, now live outside Iraq. The challenge this poses for the Iraqi government is to foster a business environment in which it can exploit the availability of this skilled labour to build up effective local capacity instead of outsourcing jobs to foreign expatriates whose interests in rentier states such as Iraq are mainly economic and short term.

Public Finance

Budget planning remains an essential instrument through which the government of a rentier state can, theoretically, harness the development of the natural resources sector to benefit other sectors of the economy. Given a rentier's primary dependence on oil and gas revenues, the impact of taxation as a fiscal instrument for generating public finance is negligible.

Over the past 30 year of national development planning in Iraq, allocations to certain strategic sectors such as industry and construction did not specify how they were to be financed (presumably from oil and gas revenues). Actual expenditure was grossly above planned levels and more importantly did not take into account the limited national capacity to implement these projects. All this suggests that budget planning did not take strategic economic viability into account.

As a direct result of such policies, a pattern of import dependence at the expense of local industry has served to hamper national economic development. The legacy of budget planning during the past 30 years is a serious problem for policy makers to this day.

One way to address this problem in the context of national energy policy is set out under the heading of Public Finance as part of the Federal Energy Policy Proposal below. It is also clear that the private sector must have a greater role to play in assisting the government to implement a national energy policy which suits Iraq's strategic long-term interests.

Security

Whilst security levels have improved in the north and the south, security remains the primary concern of the international community, particularly in light of the fragility of Iraq's political consensus. If citizens in oil producing areas perceive they are not benefiting from foreign oil ventures or that foreign companies are bypassing their local interests, there is a high risk of creating hostility resulting in acts of sabotage which could affect output and further delay investment in Iraq's oil industry.

Federal legislation

Due to the ongoing impasse in ratifying a federal hydrocarbon law, there are conflicting policies towards developing Iraq's resources. The KRG has adopted a production sharing model and the federal government has based its policy on technical service contracts. The result has been to heighten tensions between the KRG and federal government to breaking point, as is evidenced by the fact that some IOCs have started to farm out their investments in the southern producing oil fields in order to consolidate their investments in the Kurdistan area, which they perceive to be more business friendly.

The federal government, however, has recognised the seriousness of this impasse by setting up a special parliamentary committee to harmonise discussions on the various draft hydrocarbon laws. IEI has been playing an independent role in advising policy makers on these sensitive discussions.

At present, the federal government is seeking to bring the electricity sector under a legal and regulatory framework and accordingly has circulated a law which would in effect restructure the Ministry of Electricity and a second law to undertake all regulatory activities. How far these laws will serve a strategic national energy policy as well as reflecting international best practice remains to be seen.

Strengthening Federal Institutional Capacity

In a rentier state such as Iraq, effective management of natural resources has historically been a considerable challenge. It is clear, however, that the adoption of an effective economic policy for the management of revenues is contingent on competent and strengthened civil and public institutions and experienced human resources.

The Iraqi government would appear to have acknowledged that the issue of institutional capacity must be addressed when it stated in its National Development Plan 2010-2014 that "Iraq has struggled to create an economy that allows for progress and development."

This frank and surprising statement may be construed as a tacit admission that the government has yet to implement the intrinsically linked economic pillars of the 2005 constitution, which we believe would underpin a national energy policy, namely:

1. The ratification of a federal hydrocarbon law and fast tracking the establishment of a federal Oil and Gas Council to (a) regulate the management of the extraction of oil and gas (Article 112/1) and (b) formulate a strategic policy to develop Iraq's resources in a way to maximise benefits to all Iraqis (Article 112/2);
2. The ratification of a revenue sharing law and fast tracking the establishment of a revenue sharing commission to ensure the ideal use and allocation of federal revenues (Article 106);

3. The ratification of a constitutional court and fast tracking the establishment of a supreme court (Article 92).

The failure to ratify a federal hydrocarbon law has resulted in differences between the center and the Kurdistan region as to what 'economic viability' means as far as concerns a policy for the development of Iraq's resources. This legislative impasse has exacerbated a constitutional, political and legal vacuum, the net effect of which has been to reduce the level of trust IOCs have in doing business inside Iraq.

It remains critical to ensure that any decisions or judgements of the federal supreme court (once it is legally established according to the constitution) are insulated from external pressures in order to ensure that the rule of law is established in Iraqi society at large and respected by all its citizens.

Effective Leadership

Iraq's transition since regime change in 2003 from a highly centralised state-controlled system to a free market economy has been painstaking and long. What has become clear is that the only way forward for Iraq's federal government to preserve a cohesive state is to exercise effective, transparent and accountable leadership to encourage the process of political and economic dialogue and hence foster trust and inclusiveness amongst all participants in formulating economic policy. Failure to exercise effective leadership with accountability will enable international partners to circumvent national interests in support of short-term goals which clash with Iraq's long-term national economic interest and arguably tarnish the credibility of the country.

The first step towards effective leadership is for policy makers to recognise and accept that any insistence on a centralised or hierarchical command can no longer work. In other words a paradigm shift needs to occur at the highest levels. Iraq has committees and executives capable of handling negotiations on the implementation of policy at a federal and regional governorate level. Leadership should therefore be regarded as a fluid process at different levels and in different networks. Accordingly it should be undertaken by the person or groups ideally suited to achieve the particular task at any particular time.

Federal Energy Policy Proposal

To help formulate a viable national energy policy, the following steps should be taken in the areas below:

Constitution and Legislation

- The elimination of discrepancies and conflicts with the articles of the 2005 constitution owing to hydrocarbon laws predating the constitution.
- The ratification and implementation of natural resource management, procurement and regulatory laws and technological efficiency standards, protocols and conventions (particularly those related to the environment).
- The creation by the federal government of an economic management portfolio within a federal context to ensure mutual accountability between the center and regional and provincial authorities .

- Consideration of a merger of federal ministries responsible for energy policy to avoid administrative conflict and optimise implementation of national policy in coordination with the regions and governorates.

Oil and Gas

- The rehabilitation and expansion of all infrastructure related to oil and gas production, particularly refining capacity.
- The preservation of natural resources for future generations through a strategic energy policy.

Public Administration

- A high level of authority, capability and accountability among regulatory bodies and key officials.
- Benchmark tender processes and contracts based on established international models.
- Ensuring the integrity and independence of federal institutions such as the federal Supreme Court, federal Oil and Gas Council and federal Revenue Sharing Commission
- Closer cooperation between the Council of Ministers and the Council of Representatives to expedite the passage of priority laws and the legislative and economic reform initiative.
- Human resource management within the civil service, state owned enterprises and public-private partnerships based on proper qualifications, merit and performance.
- Improved governance by constructively engaging with international organisations which produce reputable and independent reports on criteria for international business activity, including transparency, regulations and laws.

Investment in national institutes to educate and train future generations.

Public Finance

- Efficient budget management through: (i) prioritising the allocation of expenditure to sectors with strategic long-term importance and broad links to other sectors of the economy in order to maximise the multiplier effect; (ii) phasing out subsidies to state-owned energy providers and recalibrating existing incentives to foster a more competitive domestic market and attract foreign direct investment; and (iii) a review of expenditure related to public administration to reduce waste and enhance service.
- Greater transparency in procurement and tendering procedures.
- Improved coordination between Ministry of Finance and Ministry of Planning in the budgeting process.

Conclusion

John Maynard Keynes' dictum that "*the difficulty lies not so much in developing new ideas as in escaping from old ones*" has some relevance for Iraq. Iraq's policy makers need to recognise that one effective way of escaping from old ideas, which clearly do not satisfactorily address Iraq's urgent energy needs, would be to engage with multilateral organisations such as the World Bank and the UN as well as think tanks and local and international experts with intimate knowledge of Iraq's energy industry and government policy. Constructive and sustained engagement would help policy makers formulate and implement a viable federal energy policy which serves the interests of the beneficiaries of Iraq's natural resources, the people of Iraq.

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