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There Will Be Oil

Iraq's very important, very unpredictable recent petrol deal.

Michael Makovsky January 27, 2010 | 12:00 am



Last month marked a turning point in the United States-Iraq relationship. American influence is waning, while Iraq is taking steps to get on its feet economically. We suffered no combat deaths in December, and continue to reduce our presence, expecting to withdraw all combat troops by August. And Iraq concluded a major round of production deals with oil companies.

This last development is a big deal. Oil is the key to Iraq's economic growth and reconstruction, and, after several years of postwar stagnation, Iraqi oil production returned in 2009 to pre-war levels: 2.5 million barrels per day, of which 2 million are exported. But are these recent deals good news—for Iraq or for the United States?

The Bush administration pressed hard for the enactment of petroleum laws that would encourage foreign investment, reorganize Iraq's oil sector, and distribute oil revenue fairly across the country—to no avail. The Kurdistan Regional Government, meanwhile, boosted its economy in the north by concluding more than two dozen oil deals in the last several years, thanks to production sharing agreements, which give companies a negotiated share of production. The federal Iraqi oil minister, Hussain al-Shahristani, decided to

cut some deals even without new oil laws, before the national elections slated for March. The first round of deals began last summer, the second in December. Shahrستاني did not offer production sharing agreements. Instead, he held an auction for less appealing 20-year service agreements under which Iraq would pay companies a very low fee—most successful bids ranged from \$1 to \$3 per barrel per day (before taxes and government fees)—for production beyond a specified level.

This approach was a boon to state or national oil companies, such as China's. National oil companies are less focused than private companies on profits, and were therefore better able to meet Iraq's unattractive terms and offer lower bids. Some private oil companies did bid, although Chevron, despite its many dealings with Iraq before and after the war, did not. According to Lawrence Goldstein—a leading energy expert and member of the National Petroleum Council, which advises the U.S. Secretary of Energy—with national companies controlling up to 90 percent of global oil reserves, and with foreign opportunities scarce and the need to “book” additional reserves urgent, private companies wanted to get involved even on terms that were less than ideal. But the result of the auctions, unsurprisingly, was that only one U.S. company, ExxonMobil, was a winning bidder as a majority partner, and only one other U.S. company, Occidental Petroleum, won as a minority partner. Chinese national companies, by contrast, were part of half a dozen winning bids.

What has gone largely undiscussed is American culpability in this failure to increase U.S. business, jobs, and influence. Early in the summer of 2008, Shahrستاني sought to award several shorter-term service contracts to mostly Western oil companies on terms far better than those offered in 2009. But several U.S. senators and some in the media criticized those impending deals as lacking transparency and legitimacy, especially without passage of a national oil law. This criticism, according to a former senior State Department figure, emboldened the Iraqi opposition, and it took Shahrستاني another year to put forward a new arrangement.

Fadhel Othman, a highly regarded former senior Iraqi oil official, argues that the use of an auction was unfortunate for Iraq because greater involvement of private oil companies would have advanced Iraqi oil production. Private companies are generally technologically superior to national companies, and their need to book reserves is an important incentive for them to perform in a timely fashion. Thus, here was an unusual instance where an emphasis on transparency was counterproductive.

Still, on balance, the deals offer many advantages for Iraq and ultimately even for the United States. First, the entry of the conservative ExxonMobil, after years of an arms-length relationship with Iraq, offers promise for Iraq's oil sector and is an expression of confidence in its postwar society. Second, any increased investment by oil companies should boost security for southern Iraq, as they seek to protect personnel. Third, Iraq's treasury stands to benefit. If subsequent Iraqi governments and the winning bidders fulfill their commitments—a big “if”—and if Iraq improves its energy infrastructure, then oil production could jump from 2.5 million barrels per day to 12 million barrels per day within ten years. This would bring in over \$200 billion per year in oil export revenue, based on current prices and adjusting for rising consumer demand, versus about \$39 billion in 2009 and \$62 billion in 2008.

Anything that improves Iraq's economy and security benefits the United States, especially after we have invested so much blood and treasure in the country. Our economy also benefits from more oil on the market, and thus lower prices; and it is especially advantageous to our national security when supply growth derives from a more diverse range of countries. Indeed, even if Iraq achieves only about half its stated goal, it will meet, according to Goldstein, a whopping 40 percent or more of estimated global oil demand growth over the next decade.

Finally, the global oil market is a zero-sum game, and it is perhaps Iran, which threatens U.S. interests on several fronts, that stands to be hurt most by Iraqi oil growth. Whereas Iraq seeks greater energy wealth through increased

production—and the Saudis through relatively moderate prices for their ample supply—Iran requires higher prices for its shrinking output. Iranian production has declined from 6 million barrels per day in 1974 under the shah to 3.8 million barrels per day recently because of the Islamic Republic's technical deficiencies and its inability to attract sufficient foreign investment (owing partly to sanctions and partly to the government's difficult negotiating approach). Oil revenue in 2007 accounted for over half of Iranian state revenue. This income is essential to a repressive regime's ability to calm an increasingly restive population.

Of course, while Iran may be threatened by Iraqi oil production, it can also turn the tables. Iran's recent temporary takeover of Iraq's Fakka oil well could be just another border dispute. Or it could be Tehran's way of letting it be known that it could easily disrupt Iraq's growing energy sector.

So while there's plenty of good news in the growth of Iraqi oil production, there are also reasons to be concerned—whether about the minimal role of the U.S. private sector, or the potentially large role of the country next door.

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