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Answers to questions provided

Option 1

Should the Coalition do more to shift additional economic development resources and emphasis from Baghdad to the provinces?

The issue of decentralization is a sensitive and potentially dangerous one. Given the fragility of the central government in Iraq – bureaucratic disarray, financial shortages and the lack a coercive means to assert authority – and the centrifugal forces in the regions, an overt shift of emphasis and support by the Coalition away from the center could have a disruptive effect at this point. This is particularly true in terms of the oil sector. Gaining control over local assets which are part of a larger integrated whole and attempts to then grab the revenue streams from crude oil, gas and refined products sales and exports will become the objective of the regional governments or authorities. Once regional governments gain sufficient financial independence a push for greater autonomy and eventually secession is quite possible.

Short of this eventuality, an uncoordinated investment/development program which gives regions priority over a national one could lead to greater problems for the economy from an operational point of view. This to a certain extent already happened with the electricity sector when transmission lines leading from the south were cut off to ensure that the region had sufficient supplies. In order to rebalance the national electric power system, the Coalition had to rebuild these lines at great expense. This is one example but one could see the same problems in other infrastructure, transport, trade and services areas. Without a national system, fragmentation and increased inequality will impair long term growth and prevent recovery in the short term.

Will strengthening regional and local authorities outside Baghdad speed delivery of services and broaden the tangible benefits of aid? Are the recently formed Provincial Reconstruction Councils up and running and having a desired impact?

Picking up on the point above, if the objective is long term peace and stability in Iraq, then a national development program which is produced by a democratic government at the center and administered by a national and regional bureaucracy is essential. Beyond enhancing local security, an essential short term and long term goal for the Coalition should be to build up the capacity of both the national and regional institutions in implementing economic development plans. Here the Provincial Reconstruction Councils could play a constructive role especially if they enhance local capacity to carry out national plans, provide effective feedback and advise the center on local conditions. A dual role for national and local institutions in the development process will ensure national integration, economies of scale, be a check on local power monopolization and lessen the potential for corruption. It will also ensure the spread of best practices and reduce regional disparities.

In this process of enhancing the capacity of both national and local institutions, the Coalition and other aid donors should coordinate their efforts and play from the same score. An uncoordinated aid effort would have the same effect on Iraqi long term development and short term recovery as uncoordinated regional economic efforts.

Option 2

Should the Coalition, in conjunction with the Iraqi government, increase resources and emphasis on creating jobs and demonstrating tangible progress on the ground?

A major increase in short-term funding for jobs programs, micro-credit and small business development is highly advisable particularly if it is done through national institutions (in coordination with regional/local institutions). Moreover, it must be done on an equitable basis across the country and targeted at the most needy groups. Emergency response funds distributed by the US military have been effective in the absence of national and local institutions and should be continued and expanded. However, these must be portrayed for what they are: short term relief. Already the Iraqi state budget provides massive subsidies and income support to the Iraqi population, which is to some extent crowding out longer term investment. Short term relief should not become long term income support. That will lead to a sense of entitlement typical of most of the Gulf countries surrounding Iraq.

In the longer term, as a national development programs takes off, contracting practices have to be improved to ensure a larger part of the reconstruction effort benefits local companies which employ Iraqis. Local content regulations also have to be implemented to achieve this objective. It is through local content requirements that the aid used to rebuild the infrastructure of the country will create backward linkages into the economy and enhance longer term employment, which the shorter term work programs and emergency funding get off the ground.

Option 3

Should the Coalition put more emphasis on overcoming the twin curses of the oil sector: corruption and sabotage?

The twin curses of corruption and sabotage could result in further debilitating the only source of government revenue and, given the size of government expenditures in the national economy, it is virtually the largest source of private income as well. In the recent past and in the short term, sabotage is the biggest problem the oil sector faces. It has prevented the use of the Ceyhan pipeline through Turkey and reduced exports by around 300,000-400,000 b/d from the northern oil fields. It is a constant threat to oil production and export facilities in the south. Through attacks on power infrastructure, feeder pipelines and refineries themselves sabotage has reduced the amount of refined products that can be supplied to the local market and imposed an additional burden on the treasury because of the need to import product from a tight regional and global oil/products market. Corruption has been a lesser problem but theft and misuse of resources have been contributors to supply disruption and the prevention of rebuilding the sector. Political interference in the sector for reasons of financial gain or control over decision making has also been a big problem from time to time and has led to inappropriate personnel decisions and ultimately to hampering reconstruction efforts.

In the long term, corruption could become a critical factor in the underdevelopment of the oil sector and the Iraqi government. In fact, if oil sector corruption is not prevented, it will undermine the goal of building a democratic society in Iraqi. Iraq is the last huge oil frontier. This distinction is magnified by perceptions around the world that oil reserves are peaking, especially in those countries where private oil companies have easy access. Therefore, many private companies and consuming country governments concerned about the scarcity of resources will be tempted to offer what ever it takes to secure resources in such a potentially prolific oil sector. The situation is equally desperate for the Iraqi political class. The need for resources, the ambiguity and uncertainty of power dynamics in the country and the need and temptation to use money to secure power to fill the vacuum created by the invasion has increased the receptivity of Iraqi officials to engage in corruption. The combination of factors makes it more likely than not that the development of the sector and the country will be distorted by this reality unless enormous efforts (some which we recommend below) are made to prevent it.

Beyond these two sets of problems, another issue is emerging rapidly and could severely exacerbate problems in the oil sector and reduce revenues to the government. Due to sabotage, lack of funds, disorganization and physical aging of the oil fields, below the ground problems with Iraq's oil fields are resulting in a stagnation of crude oil output and the potential for catastrophic declines in the near future. The Kirkuk oil field's production capacity has fallen to 600,000 b/d from a pre-war level of 700,000 b/d and could, under conservative estimates, collapse quite sharply to half the current capacity.

In the south, 12 years of sanctions combined with a lack of well workovers to maintain production post-invasion have taken their toll. Foreign contractors report high water cuts, clogged well strings and declining productivity per well. Iraqis are apparently using hand-made shaped charges for re-perforations, there is little if any functioning well instrumentation and there is no current seismic data or reservoir modeling work (although some foreign companies have attempted to begin work on the latter). Some wells have responded to re-completion work, but there is a real need for fracturing and acidizing techniques to be applied. The Oil Ministry has either been unable to organize such efforts or has pursued other priorities, and given security concerns in the relatively benign south, the cost and logistics of bringing in such large-scale operations may prove insurmountable. The result has been lower production, higher water cuts, and more lower-quality Mishrif Pay output. According to reports, the quality of Basra light has declined from 32 API and 1.95% sulfur to 31.5 API and 2.7%-2.8% sulfur.

As production has declined at the workhorse Rumaila field, the Southern Oil Company, which is in charge of operations in the south, has sought to increase production at West Qurna field to make up the difference. However, work delays there threaten production. Meanwhile, the water injection facilities (particularly Garmat Ali) that were meant to help restore production in Rumaila and elsewhere are running at only 55%-60% of pre-war capacity, causing further production and well losses. Bureaucratic impediments have also made it difficult to procure the chemicals and spare parts needed to operate revamped facilities.

Even with the current high oil prices, the Iraqi oil ministry must find some way to efficiently spend its capital budget to sustain production capacity in the one area capable of more or less unhindered exports. The recent reshuffle of personnel by the Oil Minister Bahr al-Uloum elevated less-experienced managers at the expense of seasoned technocrats. This has reduced the effectiveness of what little funds the government has. The result may be a greater reliance on foreign expertise. The Iraqi Drilling Company's recent announcement that it is seeking an international strategic partner should be seen in this light, and is likely to be a precedent followed by a number of other Oil Ministry companies.

That said, relying on foreign expertise will necessitate improved security, even in the south. Security problems have slowed and undone some of the work already carried out by western contractors and the US Army Corps of Engineers after the invasion, and failing to improve the situation will hold back western international oil companies with the necessary expertise and capital back going forward. However, Coalition military forces are unlikely to protect the foreign oil workers and their sophisticated equipment, particularly in the south where UK forces are seeking an accelerated handover to Iraqi security forces. International oil companies, meanwhile, are likely to regard the cost of providing private security on the scale necessary as prohibitive, even if they were willing to take the risk with their personnel. Thus, the sub-surface work necessary to prevent declining production will simply not get done fast enough in the medium term, if at all.

The oil sector has four critical roles to play in the future development of the Iraqi economy.

- First, it will provide the revenues to support and later revive what is now essentially a failed state. That will buy Iraq time from a humanitarian and institutional point of view to get its true economic development process going.

- Second, if done correctly with the appropriate local content regulations, investment by the Iraqi National Oil Company (INOC) to rebuild capacity to around 3-3.5 million b/d (pre-invasion capacity) and by international oil companies (IOCs) to build new capacity beyond 3-3.5 million b/d in conjunction with INOC could massively contribute to the local economy. Creating strong ties between the oil and non-oil sector is critical for employment generation, skills development and in order to retain a greater part of the oil rents at home. Oil and gas as an industrial input could also serve as an important incentive to invest in Iraq, especially for energy intensive industries such as petrochemicals, steel, aluminum and copper.
- Third, as Iraq seeks external investment to develop its huge untapped oil reserves, foreign investors in the non-oil sector will look at developments in the oil sector with great interest. In the first case they will view relations between international oil companies and the government as an indicator of how they will be treated and what investment conditions could be like. Moreover, as foreign investment goes in they will view this as an expansion of the local market and be interested in taking advantage of new economic opportunities.
- Fourth, the institutional development of the national oil company into an efficient and dynamic business unit could set the pace for corporate development in the economy. Around the world, national oil companies that have developed talent and strategic prowess have become the domestic pace setters and transferred and spread these skills to other industries. As the sector develops and matures, the national oil company could also be the pace setter in privatization programs. This is a powerful signal to international capital markets that Iraq would be open for business.

Putting Iraq on this virtuous cycle of development – oil sector restoration leads to revenue increases which leads to infrastructure development and ultimately to the spawning of a self generating private sector – will require effective political and institutional arrangements, security and international initiatives to reduce corruption.

For an effective institutional set up two issues are critical.

- First, a political deal has to be struck between the principal political parties so that an effective oil sector development model can be chosen. An effective oil sector development model includes several key ingredients including high level political and economic strategy coordination (in order to answer the question “what does Iraq want from its oil/gas sector over time?”), operational autonomy for the NOC (choosing best practices), transparency in contracting, access to the best skills from the private sector and democratic control over oil/gas receipts.
- Second, since the oil and gas assets are national assets, are spread through out the country and needed for national development, national government control is essential for optimal development of the sector. This will ensure national unity (see above), seamless integration, rational sectoral operations and enhance optimal long term development potential. Breaking the sector apart and managing it regionally will be disastrous for Iraq as a political entity and lead to increasing regional divergence, monopolization of revenues by key groups for parochial purposes and ultimately lead to greater instability.

The design of the sector will determine the future viability of a democratic unified Iraq. If the sector is controlled by a few it will serve the needs of a few. This was clearly apparent in the Saddam Hussain regime. Ensuring democratic control should not be mistaken for operational autonomy. National policies can be set by the central government in coordination with the regions and then the sector can follow these policies in the most effective manner. Breaking the operations up regionally would fracture the sector and possibly lead to local control which in turn would lead to political problems. Similarly, revenues should not be divided by region. This is the

situation in Nigeria and has led to countless problems of regional competition for resources. But as in Nigeria during the 1960s, oil producing regions should not be neglected to point where the region is compelled to violently gain control over its part of the sector. Today, in Nigeria local groups extort money from private companies working in their regions. This is also a possibility in Iraq in the future. So a balance between meeting central and regional needs with effective democratic controls is essential for the optimal development of the sector and the political economy of Iraq.

Security is the single biggest impediment to smooth operations of the Iraqi oil and gas sector and a huge blockage to further development. For the most part, the national oil company, the oil ministry and local and national security forces have struggled to keep the sector operational with mixed success. More effective security in protecting pipelines, refineries and ports will require more not less support from the Coalition forces and a larger presence of the Iraqi security personnel. A wider political resolution to the internal conflict will also be critical. At present the expectation in the sector is that there will be less Coalition involvement in security of infrastructure and that the Iraqi forces will take some time to become fully effective. Moreover, there are fears that the violence against the oil and gas sector is moving south so there could be more disruptions in the larger of the oil producing regions of Iraq. Over the longer term, no foreign company will be willing to invest in Iraq without effective security. In fact, the fear is that the presence of foreign personnel will exacerbate the security situation if a long term political solution has not been struck.

Preventing corruption is essential for the future development of the sector and for ensuring the Iraqi people gain the most from their national patrimony. One effective means of preventing the misuse of the sector for private or political gain would be to set up effective constitutional constraints and systems. The Coalition could guide the various Iraqi political parties to ensure the constitutional provisions meet this requirement. Another effective means of preventing corruption would be to enlist the help of international companies, multilateral institutions and governments to come together to set up conventions to stanch it from the outside. There are a number of international transparency initiatives which could be subscribed to. However, a specific initiative with Iraq in mind could reduce the competitive pressures to indulge in corruption and greatly enhance the development process.

Option 4

Should the Coalition and the Iraqi government create a reliable set of indicators of when and where economic progress has been made?

Improving public information is essential to improve the trust of the Iraqi people in the new government. However, the most important set of metrics that the Iraq people are looking for are reduction in actual crime and political violence, improvement of physical deliveries of public services and jobs/income growth. An improvement in all three of these variables will have a marked improvement on public perceptions of the new government and its ability to deliver progress.