

**FEDERAL ASPECTS OF PETROLEUM REGULATION AND  
MANAGEMENT IN IRAQ**

***A Discussion Paper***

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## Summary

1. This paper examines key issues of petroleum regulation and management that arise in a federal setting, with a view to extracting some lessons that may be useful for Iraq. It identifies four sets of issues: who regulates, what is to be regulated, how will the regulatory structure operate and when will key decisions be made. It answers these questions by means of a comparative analysis of seven federal systems that have addressed the management of domestic petroleum resources. These are the UAE, Canada, Argentina, Australia, Nigeria, Indonesia and the Sudan.
2. A key lesson is that over-centralisation of decision-making in the petroleum sector can lead to severe and increasing tensions that become very hard to resolve over time. The more settled federal regimes considered in this paper have allowed a significant degree of decentralisation of petroleum management to the sub-units in the federal system. At the same time, they have taken various steps to reduce the risk of a patchwork of widely differing conditions emerging within their countries as a result of that decentralisation. In all cases, overall strategic decisions and key policy making decisions (such as relations with OPEC) are taken at the central level.
3. The dynamic effect of petroleum development is likely to impose considerable strains on a federal regime, with potential to create divisions. This has been evident in settled federal structures such as those of the UAE, Canada and Australia, in the fairly well established federal structures of Nigeria and Indonesia, and particularly in an unsettled regime such as The Sudan where centrifugal tendencies are strong and violent. The response to these tensions may be to centralise decision-making in petroleum management to a very high degree (Nigeria and Indonesia), until, faced with opposition from regions and provinces, efforts have been made to permit some decentralization, with few results evident so far. However, by that stage, a 'centralisation culture' has taken root in the government structures which proves hard to change. In Australia, by contrast, a decentralized approach has survived a dispute on jurisdiction between the two levels of authority, encouraged by a mutual concern to design the kind of petroleum management arrangements that would attract large-scale investment.
4. Who regulates? This paper suggests that (1) **the overall framework for regulation is normally set by the central authorities**, with in some cases provision for a consultative role for regions or provinces. This may be carried out by a Ministry or by a Federal Petroleum Council or a combination of both. It does not preclude input from expert advisors; (2) **the functions of regulation require the existence of a distinct regulatory body at the central level**: the current Federal Oil and Gas Council in Iraq is in line with

such practice; (3) there has to be an **interface between the parties responsible for regulation and the other set of parties responsible for operations**. As in Iraq, both the Indonesian and Nigerian cases illustrate the continued importance of an NOC in petroleum operations (representing the state's commercial interest as distinct from its petroleum administrative role). In these cases, the use of local subsidiaries of the NOC has also been favoured, but these remain until tight control by the parent company. Although this suggests that some form of operational decentralization is workable, the autonomy of these subsidiaries is circumscribed.

5. Clarity in the making of rules. Clear rules on who makes regulations (and who enforces them) and in particular which parties are to be involved in the contract negotiation process up to and including its approval. The Australian case – with its concept of ‘mirror legislation’ - is the most helpful in underlining the importance of the objective of coherence in such rule making. The aim was to avoid the creation of two different and potentially conflicting legal and regulatory frameworks that have no clear primacy and that may generate a lack of clarity as to the areas that are covered by each one. In Iraq's case there is a strong argument for ensuring that regional autonomy in rule-making is carried out on the basis of the principles in the centrally adopted petroleum law and model contract. This need not preclude some variation to adapt to regional or local circumstances and to allow changes due to learning from experience or changed priorities. The centrally adopted framework (including petroleum regulations and model contract) would however have a greater force than a set of ‘guidelines’. Contract negotiation could be carried out on the basis of one or more centrally authorized models. Negotiation could be best carried out at the decentralized level (where there is evidence that local competence exists) and approval or award be given by the central body (the FOGC) with signature by a separate, higher authority (the Council of Ministers) or on instructions from the National Assembly. The supremacy of the central body at this final stage should be clear however to ensure the legitimacy of the contract.
6. What is to be regulated? Where petroleum is an industry of central importance to the country, it is a federal government body that will approve field development plans, and main pipeline development plans, will sign the relevant contracts that are necessary for petroleum operations, and negotiate and prepare E&P contracts for signature.
7. A pragmatic approach should be adopted to issues of ownership, including disputes arising from the discovery of petroleum deposits in unsettled border areas. This should be based on the recognition that an economic solution can proceed on the basis of an *adequate* definition of ownership and can avoid what may otherwise prove to be a legal quagmire, and a brake on petroleum resource development.

## **1. The Purpose of this Paper**

The adoption of a new petroleum law in 2007 offers an opportunity for a renewal of the petroleum sector in Iraq. It conveys many signals about how business in the petroleum sector is to be conducted in the coming years. It sets out a reallocation of authority for the oil and gas sector among the institutions of government and, most originally, lays the basis for an interaction between Federal and Provincial authorities in line with the new Constitution. However, the federal structure of government which it assumes is of very recent origin and does not yet have a widespread legitimacy. It is not clear how this will impact upon the implementation of the new petroleum law. This paper examines key issues of petroleum regulation and management that arise in a federal setting, drawing on experiences in several countries to make comparisons and contrasts, in an attempt to extract some lessons that may be useful for Iraq.

At the outset, it may be noted that there are at least three aspects of the new petroleum regime that raise questions about the interaction between federal and provincial authorities:

- The making of implementing regulations under Article 27 of the Petroleum Law. The INOC, the regions and the producing provinces are to be involved in the design of such regulations, which are to be approved by the Ministry of Oil;
- The role of INOC in petroleum activities will involve the establishment of wholly owned subsidiary companies to perform common services in participation with partners from regions and producing provinces (Article 5E, seventh), and
- There is a general commitment in the Petroleum Law to the promotion of transparency in all activities related to oil and gas.

These aspects of the new petroleum regime will figure in this paper's review of the international experience of petroleum regulation and management in a number of federal contexts. The overall intention is to identify what worked, what did not work and what so far has been ambivalent in terms of working or not working. From this a series of options will be derived which Iraq might consider. The study points out the advantages and disadvantages of these options in relation to current trends in regulation in Iraq.

## **2. Analytical Framework**

### **2.1 What Federalism Implies**

#### **2.1.1 The Centralization Issue**

Typically, a political system is *federal* if legislative power is divided between a central or federal legislature and a number of sub-units such as regional or provincial

legislatures (or both). The federal government will have jurisdiction over the entire national territory and population, while a regional or provincial government will only have jurisdiction over particular portions of territory and population. Both levels of government normally draw their authority from a written constitution. There are different types of federation however. Some are *centralized* federations, in which the powers of the regional or provincial governments are defined in a relatively narrow manner and others are *decentralized* federations in which the regional or provincial sphere of authority is wider.

The axiomatic relationship in a federal setting is the manner in which the constitutional arrangements allocate powers between the central and the regional institutions. In Canada's case, the federal model has been a decentralized one, with significant powers allocated to the sub-units (provinces). This has allowed the main petroleum producing province, Alberta, a relatively large degree of freedom in designing and implementing its legal regime for petroleum management. By contrast, the federal model in Nigeria appears to have a very high degree of centralization, particularly with respect to the management of petroleum resources; in effect, it is a unitary state. However, on closer inspection it appears that a transformation took place since the discovery of petroleum from a balanced federal regime with a high degree of decentralization to the current structure. The result is one that is subject to frequent challenge from within the country, involving the use of organised violence, and which leads to occasional and growing disruption to petroleum operations in some parts of the country.

### **2.1.2 The Roots of Federalism**

In some countries the federal structure of government has been established very recently. Iraq is an example of this. The regime cannot therefore be regarded as *settled*; indeed, the opposite is clearly the case. It may therefore be convenient to distinguish settled from *unsettled* federal regimes. Examples of regimes with a settled form of federalism include Australia and Canada. In such cases one would expect the discovery of large scale petroleum resources (with the prospect of relatively quick financial rewards) to be easily accommodated into the existing federal structure. However, there are cases where petroleum development has triggered forces that have contributed to undermine a settled federal regime: Nigeria is an example of this. In other cases, the regulation and management of the domestic petroleum sector by a federal government has been seriously questioned. Examples of this are Nigeria and Indonesia. Such federal regimes may be experimenting with measures to accommodate the centrifugal pressures within a still highly centralized regime. They may be described as *transitional*.

### **2.1.3 The Dynamic of Petroleum Discovery**

The prospect of large-scale economic benefits from petroleum development has always excited the imagination of actual and potential stakeholders. Both federal and unitary states and settled and unsettled federal structures have been impacted by the dynamic element of large-scale petroleum development. For many years this dynamic was viewed as part of a broadly positive process, offering a chance for developing

countries to power ahead in economic growth and social development. In recent years the negative aspects of petroleum development have attracted more attention<sup>1</sup>. In Iraq's case, the federal structure was introduced at a time when the existence of large-scale petroleum deposits was already well-known. However, in most cases, the choice of a federal structure has pre-dated the discovery of commercial amounts of petroleum resources, as in federal states such as Nigeria but also in Argentina, Canada and indeed, with respect to offshore petroleum resources, Australia. In such cases, questions have arisen about the adequacy of existing federal structures and procedures to meet the challenge of petroleum development: as both a panacea for economic and social problems and a destabilising force for a political system.

## 2.2 Regulation: Who, What, How and When?

There are a number of key regulatory tasks that must be provided for in any competent regime for regulation and management of a petroleum sector. These include the negotiation and approval of new contracts or licences, the setting of particular conditions covering work programmes, field development and environmental protection, and the monitoring of petroleum operations. Such regulatory tasks are normally kept separate from commercial ones, which are handled typically by a state or private company or both. This is reflected in the Iraq Petroleum Law, Article 7, where a separation is envisaged between the regulatory and supervisory functions carried out by ministerial departments and the production and service companies. However, in a federal regime, the allocation of regulatory tasks to the respective levels of authority will present particular challenges, not least because of the unique, strategic character of the petroleum industry and the impact of petroleum revenues or the uses to which they can be put. In Iraq's case, for instance, about 90% of the central budget derives from petroleum revenues. The precise allocation of key rights has implications for the economic viability of the federal institutions and the unity of the state, which usually (but not always) leads to a favouring of the centre over regional or provincial interests.

In a federal context there are *three* sets of issues that need to be addressed:

- **Who regulates?** There are issues concerning which level of authority in a vertical structure is responsible for particular regulatory and operational tasks. How is the national authority distinguished from the regional, provincial or local in the negotiation of contracts with prospective contractors and with their award? Who decides on the form and degree of participation by a state or regional petroleum company (or subsidiaries of the state holding company)? Who determines acreage licensing? Who sets the fiscal terms? Who determines capacity plans? At each level, however, there is another (horizontal) issue of which authority is responsible for particular tasks at that level (is there a separation between policy-making and monitoring of

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<sup>1</sup> There is a wide range of literature on the so-called 'resource curse': see for example 'Resource Impact: curse or blessing? A literature survey', *Journal of Energy Literature*, vol. IX No 1 June 2003, 3-42; Terry Lynn Karl, 'The Paradox of Plenty: Oil Booms and Petro-States', University of California Press, 1997.

petroleum activities, for example). Broadly, these issues about vertical and horizontal exercise of authority are concerned with *who* regulates.

- **What is to be regulated?** There are issues concerning the scope of activities that are appropriate for regulation in the interests of good petroleum management: *what* needs to be regulated and *what* may be left alone? In Iraq's case, the rate at which petroleum is to be produced is a relevant matter, given the country's OPEC membership. Other activities would include reservoir management and the approval of investment plans under PSAs.
- **How will the regulatory structure operate and when will key decisions be made?** There are various procedural issues concerning the operation of the regulatory structure: *how* and *when* approvals are to be granted, contracts are to be signed, when consultation with regional and provincial authorities is to take place and when opinions of relevant bodies are to be sought and given, and importantly how disagreements over competence are to be resolved. Under this heading may be added the different issue of what happens when a petroleum reservoir straddles the territory of two (or more) distinct sub-units within the federal structure.

### 2.3 Analyzing Regulatory Issues in the Iraqi Context

In Iraq's case, the recent establishment of a federal authority and its current efforts to create legitimacy place it in what we have called the category of an 'unsettled' federalism. The constitutional provisions that establish a federal separation of powers date only from 2005 and have therefore had little time to establish roots in Iraqi society. Admittedly, an element of federalism has been in practice with respect to the Kurdish region from the 1990s onwards even if it has only recently been formally recognized as such. However, the form of government in Iraq has been a highly centralized one for several decades, and the current federal approach marks a potential departure from such centralization. 'Potential' is the appropriate word here since the precise sharing of powers among central and regional institutions with respect to petroleum development remains in need of elaboration, even after the adoption of a petroleum law. Many of the provisions in the 2005 Constitution that concern the sharing of authority over petroleum development are not crystal-clear (at least not to all) and their detailed implications are left to be worked out in specific petroleum laws and regulations. The key provisions are in Articles 111, 112, 114, 115 and Chapter 5 of the Constitution. Ownership of oil and natural gas resources is vested in the Iraqi people but this is made ambiguous by the addition of the words "in all of the regions and provinces". The Petroleum Law 2007 is more specific, vesting ownership in "the entire Iraqi Federal Oil and Gas Council in all provinces and regions" (Article 1). This pragmatic approach may prove a workable foundation although it appears to move in a more centralized direction than the Constitution implies. However, the involvement of regional and provincial authorities in the operation of the Iraq National Oil Company (INOC) and the making of regulations under the Petroleum Law illustrate the wide-ranging role of several levels of authority in the practical operation of the regime established by the Petroleum Law.

Related to this is the horizontal aspect of petroleum management that intersects with the vertical line linking central and regional authority. In Iraq's case, this has two aspects. Firstly, there are the consequences of a separation between operational and regulatory functions, represented by the revived state company, INOC, on the one hand, and the Ministry of Oil on the other. Secondly, there are the consequences of a reorganisation of the traditional state regulatory body, the Ministry of Oil, and the establishment of a body with a very significant role in the management of the petroleum sector, the Federal Oil and Gas Council (FOGC).

In Iraq the 'dynamic' of petroleum development is dramatically evident, appearing as both the single panacea for the country's problems and a highly destabilising force for national government. Moreover, it is complicated by the fact that there are both existing petroleum developments and also significant potential for new discoveries. The developing federal framework has to accommodate both sources of impacts. There are two sources of difficulty here. Firstly, administration of petroleum from *current* fields is shared between the federal and regional and provincial authorities, but the details of this division of competence have yet to be set out. Policy-making for the development of oil and gas is to be made jointly by the federal authorities and the regional and provincial authorities which have production. However, no provision has yet been made for the development of *new* fields. A second area of difficulty is that a sound policy of resource development cannot neatly separate the development of new discoveries from the development of current production. In Iraq's case, to avoid excessive production rates from existing fields and to raise the national level of production, it would be appropriate to establish supplementary production from new sources. This requires a national policy and a high degree of coordination between the relevant authorities. A much looser federal regime will encourage short term gain through development of existing production and make such coordination very difficult to achieve.

### ***3. Federalism & Petroleum Regulation & Management – in Practice***

Other countries with federal structures have tackled some of the above issues before, albeit in contexts that differ radically in many respects from that of Iraq. They may therefore have some lessons to offer about what worked and what did not work. The following short case studies highlight elements that are relevant or potentially relevant to Iraq's next steps in designing its petroleum regime. The order in which they are presented follows the line from settled to transitional to unsettled federal regimes. Only a brief sketch of the federal context is provided since the aim is to focus on the interaction between federalism and the petroleum regime.

### 3.1 The Practice of Decentralization

#### 3.1.1 United Arab Emirates (UAE)

In the Middle East there is already an example of a federal approach to petroleum resource management. This is the United Arab Emirates (UAE), which has had a *decentralized* and stable federal regime in place and operational for more than 35 years. The benefits of the federation experiment for the participating States have clearly been sufficiently advantageous for a distinct, permanent Constitution to be adopted in 1996.

The Federation dates from 1971-72 when the rulers of seven Gulf Emirates established the Federal State of the UAE. Common institutions were established such as a system of courts and a supreme legislative body. Two member countries have a dominant role in the Federation: Abu Dhabi and Dubai provide for over 80% of the UAE's income, and were the driving force behind the establishment of the UAE. Abu Dhabi is the dominant partner in terms of petroleum production with about 85% of the total oil production in the Federation. Dubai has a much smaller share of petroleum reserves and Sharjah, the other petroleum producer, has an even smaller share. However, Dubai has played a major (and highly successful) role in economic diversification into non-petroleum activities.

Under the federal arrangements, each Emirate retains considerable autonomy over its petroleum resource management. This includes the power to negotiate and award petroleum rights, and control over the rate of production, although the UAE has a production quota under OPEC. In addition, each Emirate retains powers over tax matters: it may issue tax decrees and set rates of income tax in each oil and gas concession agreement. The federal regime is based neither on common federal petroleum legislation nor on a consensus about the form of petroleum administration and management. For the most part, rules on petroleum operations are set out in individual tax/royalty concession agreements, although a measure of standardisation exists in many of these agreements<sup>2</sup>. Moreover, there is no broad agreement on the necessity or value of national petroleum companies. Three of the Emirates have NOCs and four do not. Abu Dhabi falls into the first category and Dubai falls into the second. In some cases, overall direction is granted to a body known as the Petroleum Council (Abu Dhabi, Sharjah) but in others it is a ministerial department (Dubai, Ajman). The Abu Dhabi NOC (ADNOC) was restructured into several business divisions in 1998 with exploration and production in a distinct division. ADNOC is run by an Executive Committee. Petroleum agreements have usually been concluded with foreign oil companies but with participation rights for the NOC in Abu Dhabi's case of up to 60% in the event of a commercial discovery. ExxonMobil concluded a contract in March 2006 for a series of upgrades to the Upper Zakum field to raise capacity and introduce EOR technologies.

An example of federalism at work may be the mechanism whereby each Emirate is to pay a percentage of its revenues to the central budget of the UAE. Each of the

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<sup>2</sup> Abu Dhabi has a law No. 8 of 1978 on the Conservation of Petroleum Resources which regulates petroleum operations in some detail.

Emirates earns its revenue from oil income, other fees or from transfers from the oil rich Emirates. Although each is required to contribute one half of its income to the federal government, in practice this does not happen<sup>3</sup>.

The UAE is therefore more like a federation of sovereign states that have identified a sufficient level of common interest to see benefits in working together on a common approach to certain economic and political issues (not especially petroleum)<sup>4</sup>. The tiny populations of these States, plus their very small geographical space, provided a strong sense that 'going it alone' was not a viable option. Moreover, the stability that has resulted from the UAE federal structure has probably facilitated the considerable infrastructure investment in the natural gas industry in recent years. In contrast, the countries considered below have a more centralized state structure in which the independence of the sub-units is deliberately and expressly constrained in key areas.

### 3.1.2 Canada

Canada can be seen as having a settled (i.e. long-established and largely non-contested) federal system. Each province has a distinct system of petroleum rights, and the federal government only holds title to petroleum deposits in the federally owned lands (sparsely inhabited) and offshore areas<sup>5</sup>. The principal province with petroleum production is Alberta. It is the source of about 85% of Canada's oil and gas production and has a mature industry. When it was first established as a province (the regional unit) in 1905 the federal government retained all the rights to natural resources owned by the Crown. These rights to non-contracted natural resources were transferred to the province in 1930, putting it on a par with other provinces. As a result, Alberta can award petroleum contracts, use royalties from petroleum production for its own purposes and if it wishes operate its own state petroleum company. To all intents and purposes, it operates an independent petroleum regime.

For the more recently attractive areas in offshore waters, there has been a considerable practice of cooperation between levels of authority. For example, in the release of new acreage for licences, the release programme is concluded only after consultation between the federal and state authorities. The authorities seek input from industry and individual companies to make requests for the release of particular areas so that the overall result is highly consultative. However, it should be noted that this cooperation only appeared after it was found that two sets of governing legislation administered by two sets of government created intense difficulties for operating companies<sup>6</sup>.

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<sup>3</sup> Carnegie Endowment for International Peace, Arab Political Systems: Baseline Information and Reforms – UAE at [www.carnegieendowment.org](http://www.carnegieendowment.org) (at page 7).

<sup>4</sup> At the international level this would include the UAE role in the Gulf Cooperation Council and the WTO.

<sup>5</sup> Cameron, P, 'Petroleum Licensing: A Comparative Study', Financial Times, 1984, 91-103; Harrison, R, "The Legal Character of Petroleum Production Licences in Canada", in Daintith, T, 'The Legal Character of Petroleum Licences: A Comparative Study', University of Dundee, 1981, 148; CD Hunt, 'The Offshore Petroleum Regimes of Canada and Australia', Canadian Institute of Resources Law, 1989.

<sup>6</sup> Hunt (1989) at 53.

The Constitution envisages considerable decentralization; the practice in the petroleum sector has not been accompanied by any major problems. However, the petroleum sector has generated centrifugal tendencies here too. After 1972, for instance, increasing natural resource revenues led some provinces, especially Alberta, to demand additional powers in a revised constitution, leading to a series of inter-governmental conferences on constitutional change. The tensions remain largely unresolved. Nonetheless, petroleum is but one sector in a highly diversified economy and the enormous geographical distance between the centre of government and the petroleum province makes decentralised petroleum management realistic.

### **3.1.3 Argentina**

A radical approach to decentralization has been taken recently in Argentina, which has some, unevenly distributed deposits of petroleum. The Constitution was amended in 1994 to state that “It pertains to the Provinces the original domain of all natural resources existing in their respective territories” (Section 124). Conflicts between federal and provincial authorities continued however, as the federal government imposed a high sliding scale export tax on crude oil, depressing the revenue to each operator, which in turn depresses the royalties to regional governments.

The Federalization Law which entered into force on 3 January 2007 transfers to provincial governments the full exercise of original ownership and management over the fields located in their territories. This is in line with the amended Constitution of 1994. The general principle established in the 2007 Law is that petroleum fields (oil or gas) belong either to the federal or provincial government, depending on the territory in which they are located. All exploration permits and exploitation concessions (and related transportation concessions) are transferred to the provinces where the relevant areas are located, including any other exploration and/or exploitation contracts already concluded by the federal government (with no impacts upon the rights or obligations of permit and concession holders). The procedures for royalty payments were already decentralized. From now on, they have the power to grant permits and concessions over the fields located in their territories and to establish the enforcement authorities. An agreement on petroleum data transfer between the relevant authorities is also required by the law.

In the area of national policy-making over petroleum, the federal authority retains control however. This also includes the management of domestic prices of liquid and gaseous hydrocarbons, the administration of hydrocarbons exports authorizations and the collection of taxes on hydrocarbons exports. Decisions on when, whether and what volumes of oil and gas may be exported are taken by the federal authorities. Similarly, the federal authority retains control over authorisations for hydrocarbon transportation facilities involving two or more provinces. The federal government is also owner of a controlling stake in the state energy company, Enarsa, with 53% of the shares against the provinces’ aggregate share of a maximum of 12%.

A disadvantage noted by local commentators on this measure of decentralization is the scope for corruption it offers, given the lack of independent advice or transparent, objective criteria in the allocation of licences by the provincial authorities. However, the recent legal change is still untested in practice.

### 3.2 Renegotiating Federalism: Australia

As a federal state, the basic constitutional distinction is between the Commonwealth, representing the central, federal authority, and the States (and Northern Territory), representing distinct regional entities with their own legislatures. In the Commonwealth Constitution petroleum is not listed among the subjects on which the Commonwealth Parliament may legislate. So, the power to control petroleum exploration and production within a State lies in the first instance with the State Parliaments. A decentralized form of federation is the inevitable result, with petroleum operations being conducted under the supervision of the State authority.

An interesting approach to managing the two levels of authority occurred with respect to petroleum found in offshore waters deeper than three miles from the coast. There, the separation of powers appeared to favour a greater role for the federal authority but this was initially disputed by the States. Negotiations were held between the central and state authorities in the 1970s and the result was a ‘political settlement’ in 1979. Under the settlement the States agreed to enact offshore petroleum legislation based upon the Commonwealth offshore petroleum legislation, and containing virtually identical terms. The dual approach meant that States granted title to explore for and exploit petroleum simultaneously on their own behalf and as ‘designated authorities’ under the Commonwealth petroleum law. The provisions were very detailed to ensure that the States did not go their own way. However, this did not extend to operational and safety rules which were regarded as being too complicated to adopt in this way. So, the device of ‘mirror’ legislation was adopted to establish a uniform system of regulation for petroleum exploration and production within the coastal areas. A system of **joint** administration and supervision of petroleum operations was put in place. The vehicle used is a Joint Authority arrangement, comprising the federal and the State ministers. Most of the day-to-day administration is taken care of by the latter minister. This basic legal framework sets out the rights and responsibilities of the levels of authority, including the following:

- Issue of directions and regulations;
- Issue of invitations to apply for licences;
- Award of production and pipeline licences;
- Determination of licence conditions;
- Renewal of licences, and
- Grant of infrastructure licences for various processing activities.

The impetus to agreement among the central and state government bodies was to remove an obstacle to rapid offshore exploration and to subject offshore operations to a common legal code, providing prospective title-holders with an element of security, and hastening investment. It may be noted that in the event of a disagreement, the view of the Commonwealth Minister always prevails.

A recent study of the Australian petroleum regime has claimed that the trend over the past few decades is towards a restriction of residual discretion for authorities to act<sup>7</sup>. This is evident, for example, in the award of exploration licences, where there has been a convergence on the idea of a single criterion for award such as work programme bidding (this is long established in the US in the form of cash premium bidding). The trend favours co-decision by the two levels of authorities and follows a general change in government action in favour of transparency.

### **3.3 Risks of Over-Centralisation**

#### **3.3.1 Nigeria**

An important difference between the federal structure in Nigeria and that of both Canada and Australia is that revenues from petroleum resources form an overwhelming part of the national income. A difference with Argentina lies in the sheer scale of petroleum reserves and production in Nigeria, making it the sixth largest producer in OPEC and giving petroleum an enormous strategic significance for the country's future. A difference with all three is a preference in Nigeria for a much tighter degree of central government control, especially by means of participation interests in the Nigerian National Oil Company, a wholly owned corporation of the federal government with the sole responsibility for managing the country's upstream and downstream investments as well as the regulation and supervision of the petroleum industry: although 12 subsidiaries were created in 1988, and the supervisory functions considerably reduced by the creation of the Department of Petroleum Resources.

A federal structure first emerged as early as 1954 with three principal regions, and thrived until the first military coup in 1966 and the period of civil war from 1967 to 1970. In that early phase the state authorities were able to earn significant revenues from petroleum development. During and following the war, all land and mineral resources became held in trust by the central authorities. This was strengthened by the Land Use Decree 1978. The management of petroleum resources is vested in the Nigerian National Petroleum Company on behalf of the central government, leaving no significant role for regional authorities. This highly centralized approach has remained the norm ever since. Negotiation and signing of joint venture agreements is done by the central authorities. As far as petroleum management is concerned, the regime is federal in name only.

This degree of centralization in petroleum management has led to increasing tensions with the regions. As a result, oil companies have entered into land acquisition agreements with local landlords or communities whereby they pay rents for drilling and LNG sites and for pipeline routing. At the central level, some key appointments are made to persons from the oil producing communities (like the current petroleum

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<sup>7</sup> T Daintith, 'Discretion in the Administration of Offshore Oil and Gas: A Comparative Study', AMLPA, 2006.

minister, Dr Edmund Daukoru). There appears to be no current effort to modify this high degree of centralization in spite of growing evidence of the instability it creates, evident in rising trends of violence in the Niger Delta region towards central government and industry, including the kidnapping of oil industry staff.

### **3.3.2 Indonesia**

For many years Indonesia – like Nigeria – preferred a highly centralized federated structure with a single national oil company (Pertamina). Over the last decade there have been serious pressures for change in the direction of a more decentralized political structure. Regional autonomy laws came into effect in 2000, but oil and gas matters remain, in principle, within the jurisdiction of the central government as the holder of the general mining authority for the people of Indonesia. Under Government Regulation No 25 of 2000 certain matters in mining and energy are expressly stated to fall under the authority of the central government. Recent legislation requires the central government to consult with the relevant regional governments on matters such as co-operation agreements and revenue sharing. However, it does not explain how that consultation is to take place, and the precise relationship between central and regional governments has to be spelled out in implementing regulations. There has been much tension between central government and the regions, and the Regional Autonomy Law, that governs this relationship, is being revised.

Supervision of oil and gas activities is to remain with the relevant central government departments; a body charged with implementing the new legislation will supervise the upstream business through cooperation contracts and the regulatory body supervises the downstream business under the various licences. The duties of the implementing body include the following:

- Advising the Minister of Energy and Mineral Resources on the preparation and offering of operational areas and cooperation contracts;
- Executing the cooperation contracts on behalf of the government;
- Reviewing or approving field development plans as required;
- Approving work programmes and budgets;
- Monitoring and reporting on the implementation of the cooperation contract to the Minister, and
- Appointing the seller of the State's portion of oil and/or natural gas.

The Regulatory Body for Downstream Activities called “BATUR” or “BPH MIGAS” is in its initial phase of implementation. “BATUR” Committee members are currently split into two Directorates: a Directorate Oil and a Directorate Gas and assisted by a Secretariat. This Regulatory Body is a new institution in the oil and gas downstream sector, initiated by Articles 7(2) and 28(2) of Law N° 22 of 2001 giving mandate on downstream business activities with a view on controlling a clear separation between policy makers, regulatory function, and business players.

This Regulatory Body will have to face major challenges linked to the complexity of oil and natural gas activities in Indonesia, in particular:

- The geography of the country involving huge distances to bring oil and natural gas fuels to market areas,
- The demographic concentration with very high density areas (Java)
- The current difficulties to develop transport infrastructure, particularly for natural gas
- The critical question of pricing for both natural gas and some petroleum products, linked to social problems and affordability.

In order to overcome these difficulties “BATUR” will need a very clear application of its role and authority, and establishing a climate of certainty with respect to practical implementation of regulation mechanisms.

A consequence of having two strong regulatory authorities in this new system (one for upstream and one for downstream, covering petroleum products and natural gas) is that some tension may be expected between them and decisions that involve both authorities are likely to take longer, a matter of concern to investors.

### **3.4 Unsettled Federalism: The Sudan**

Sudan is a federal republic comprising 16 states in the north and 10 in the south with ‘South Sudan’ constituting an autonomous region. A civil war has racked the country for years and disputes over petroleum resources have played a part in this. As a way of resolving differences between the parties, new constitutional arrangements have been made with respect to political and administrative representation on the one hand and wealth sharing (covering the division of oil and non-oil revenues and the management of the petroleum sector) on the other hand. A Framework Agreement on Wealth Sharing was concluded in 2004 between the Government of the Sudan (GOS) and the Sudan People’s Liberation Movement/Sudan People’s Liberation Army (SPLM/A)<sup>8</sup>.

Several features of these arrangements are relevant to and comparable with the situation in Iraq. Firstly, there is considerable disagreement about the ownership of petroleum resources; paragraph 2.1 of the Agreement states that the parties have agreed to establish a process to resolve this issue. However, while this process is underway (called the Interim Period), they have agreed to set up a framework for the regulation and management of petroleum development (para. 3.1.8). Secondly, an institutional innovation has been introduced to implement this arrangement called the National Petroleum Commission (NPC). It is charged with five main functions:

1. To formulate public policies and guidelines in relation to the development and management of the petroleum sector in relation to the national interest, the environment and the needs of the local population;

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<sup>8</sup> Framework Agreement on Wealth Sharing During the Pre-Interim and Interim Period Between The Government of the Sudan (GOS) and The Sudan People’s Liberation Movement/Sudan People’s Liberation Army (SPLM/A), 7 January 2004 (US Institute of Peace Library). This Discussion Paper does not consider the revenue-sharing aspects since that is the subject of another paper.

2. To monitor and assess the implementation of those policies to ensure that they work in the best interests of the people of the Sudan;
3. To develop strategies and programmes for the petroleum sector;
4. To negotiate and approve all oil contracts for the exploration and development of oil in the Sudan, and ensure that they are consistent with the NPC's principles, policies and guidelines, and
5. To develop its internal regulations and procedures.

Thirdly, the NPC is the only body authorised to enter into petroleum contracts and carry out functions on an inter-state supranational level, but may do so only on the basis of (rather vague) criteria set out in the Agreement, concerning benefits of the development to local communities and the degree of local participation in the project. At this stage, **the members of the NPC must include the representatives of the State/Region for which the contracts are being negotiated and considered for approval.** The national Minister of Petroleum signs the contract once the NPC has approved it. Fourthly, disagreements within the NPC on contract approval lead to the matter being referred to the Council of States/Regions (the upper house in the legislature), which may override the objections and require the Minister of Petroleum to sign it. If the Council does not overrule the objection (which requires a two-thirds majority in the Council), the matter may be referred to an ad hoc body for arbitration. Finally, there is a provision for one of the parties (from the South) to appoint a limited number of representatives to review the terms of existing petroleum contracts, although these are not to be renegotiated.

Two further aspects of the Sudanese arrangements merit comment. Firstly, the only provision for independent review by experts appears to be in relation to the review of existing contracts. Secondly, arrangements have been made for a disputed enclave called Abyei, which is thought to be petroleum bearing. It is either in the north belonging to the south or vice versa, depending on which side one takes on the issue. The inhabitants are from both the north and the south. A complex wealth sharing arrangement has been put in place<sup>9</sup>. This is therefore an example of wealth sharing and administrative organisation in an unsettled federal state which has an autonomous region. An important caveat is that the regime is untested in practice, severely limiting the extent to which it may yield lessons for Iraq. However, as an attempt to involve regional units in decision-making at the federal level, it is innovative in terms of design at least.

#### **4. Cross-border Issues**

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<sup>9</sup> Protocol between The Government of the Sudan (GOS) and the Sudan People's Liberation Movement/Army (SPLM/A) on The Resolution of Abyei Conflict, 26 May 2004 (US Institute of Peace Library).

## 4.1 How Issues Arise

Issues of how to develop petroleum reservoirs that straddle boundaries may arise between regions within a federal structure and between the federal state or a region and a neighbouring state or region. In each case, the usual principles governing development of the reservoir will seek to achieve a cooperative development between the parties, establishing a priority of economics over politics.

Within a state there are two kinds of situation that may give rise to unitization issues. Firstly, a discovery or existing field may extend from one region or province into the territory of another where such territory is **not** already subject to a petroleum contract. This raises issues of contract award for the territory in which the extension is found, who is to award such a contract and to whom. Secondly, a discovery or existing field may extend into the territory of another region or province where such territory has already been awarded to a contractor. In Iraq's case, the likely presence of INOC in all contracts – even in the form of its regional subsidiaries - may establish a common interest that facilitates a negotiated solution in this second case. In each of these cases, the establishment of clear rules in advance that limit the discretion of authorities (in regulations) would appear the sensible solution. However, there is always the risk that such rules have the effect of being unduly constraining or inappropriate to the particular case, since each unit development will have unique features.

## 4.2 Principles of Cooperation

The body of knowledge based on unitization practice has been growing in recent years, driven as much by developments in offshore waters as on-land (where there are a great many disputes about national boundaries, such as in many parts of the Middle East). They may be grouped into three categories: principles aimed at conservation; principles aimed at good neighbourly behaviour and principles aimed at ensuring equity<sup>10</sup>:

1. With respect to the first, a goal of unitization projects, especially from the government point of view, is to avoid the kind of rapid exploitation of the resource that leads to reservoir damage and sub-optimal recovery. In the North Sea that has led to the design of a 'carrot-and-stick' provision in all model licences that requires parties in such situations to agree on a unit development or face the prospect of having one imposed upon them by government. In practice, however, any such imposition by the government would have to be 'fair and equitable' to the contractors involved, who have would have recourse to arbitration, if necessary. In public international law discussions, the notion has been mooted of the 'unity of the deposit' which argues against unilateral action by one state on the ground that it is likely to damage the common petroleum deposit.

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<sup>10</sup> For a discussion of this issue in (largely) offshore areas, see Cameron, PD, *The Rules of Engagement: Developing Cross-Border Petroleum Deposits in the North Sea and the Caribbean*, in *International and Comparative Law Quarterly*, vol 55 (2006) 559-586. The article argues for a pragmatic approach to the international law on this subject by states.

2. The second set of principles is largely procedure-based: in the event of discovery of a common reservoir, the parties should initiate negotiations and conduct them in good faith. A problem with this in the Middle East context is that there is likely to be considerable mistrust between the parties, which makes progress difficult. An illustration of the state-state problems is the approach to exploiting the South Pars/North Field by Iran/Qatar, in which unilateralism prevails over joint action. Similarly, in the Sudanese Abyei enclave, a climate of suspicion means that provisions have had to be developed that specify as much as possible how wealth is to be shared in the event of a petroleum discovery. Unfortunately, this is not likely to be more than a small step in the direction of a workable solution, as the third set of principles indicates.
3. This concerns the consequences of uncertainties in the parties' knowledge of the resource base. In the North Sea, with respect to Frigg, Statfjord and Murchison fields, provision was included for redetermination when an initial sharing of the deposit turned out to be based on incorrect knowledge. At a later date, the parties would discuss the respective stakes in the deposit and agree on a revision of the shares. In practice, this proved to be expensive and acrimonious in several cases (especially Statfjord). Even a detailed specification of the rules in advance (and an awareness of common interest, a history of cooperation) cannot close off this source of disputes.

The appropriate course of action would seem to be to provide in the relevant petroleum law that negotiation of a unit approach to development of a straddling reservoir is essential, and then to provide a framework for the negotiations. Given the diversity of circumstances in such cases, detailed rules are difficult to provide. However, a recent development in the UK-Norway sector of the North Sea may be noted. Instead of seeking to conclude a distinct inter-governmental treaty for each field (however small) that crosses an international boundary, a framework agreement was concluded by the two governments which then allows each development to be fast-tracked with a minimal role for the two governments. This mechanism might be adapted to apply to cross-border developments within a federal regime.

One complicating factor may also be relevant in the Iraqi context. If a revenue-sharing scheme has been set up that allows a regional government to benefit in large part or exclusively from production, this may create an incentive for the region or province to encourage rapid production from a field that extends into another region's territory rather than seek unit development. If all revenues are first assigned to the central government and then flow to regional governments according to some formula not linked to production (based instead on, say, population, past oil revenue assignment), this is less likely to occur.

## ***5. The International Experience and its Relevance to Iraq's Emerging Regulatory Structure***

Even in an ideal federal setting, without security issues or legitimacy challenges, the dynamic effect of petroleum development is likely to impose considerable strains on a federal regime, with potential to create divisions. This has been evident in settled federal structures such as those of Canada and Australia, in the fairly well established federal structures of Nigeria and Indonesia, and particularly in an unsettled regime such as The Sudan where centrifugal tendencies are strong and violent. The response to these tensions, as section 3 shows, may be diverse. In Nigeria and Indonesia the response was to centralise decision-making in petroleum management to a very high degree, until, faced with opposition from regions and provinces, efforts have been made to permit some decentralization, with few results evident so far. A ‘centralisation culture’ has taken root in the government structures which is proving hard to change. In Australia, by contrast, a decentralized approach has survived a dispute on jurisdiction between the two levels of authority, encouraged by a mutual concern to design the kind of petroleum management arrangements that would attract large-scale investment.

In seeking to identify lessons, positive and negative, that may be beneficial for Iraq from the experiences outlined in Sections 3 and 4, it may be helpful to classify them according to the list in Section 2.2. It identified four sets of regulatory issues: who regulates, what is to be regulated, how will the regulatory structure operate and when will key decisions be made?

### 5.1 Who regulates?

Many key issues about the appropriate level of authority in decision-making have been addressed in the Iraq Petroleum Law. However, the detail of implementation especially in the making of regulations, for example, has yet to be worked out. A consultative role for the regions and provinces is envisaged but the precise manner in which this is to be done is not yet clear.

From the case studies in section 3, it is apparent that **the overall framework for regulation is normally set by the central authorities**, with in some cases provision for a consultative role for regions or provinces. This may be carried out by a Ministry or by a Federal Petroleum Council or a combination of both. It does not preclude input from expert advisors. The activities of basic rule-making, such as legislation and the final form of regulations, as well as export matters, and all relations with other States including on unitization matters are ones that the central authorities are normally responsible for. While the Sudan is experimenting with greater involvement of regions in petroleum management, the regime is untested as yet. It represents a radical contrast to the approaches in Nigeria and Indonesia. The UAE is an exception to this since responsibility for petroleum operations have been reserved to the Emirates themselves from the outset.

**The functions of regulation require the existence of a distinct regulatory body at the central level:** the current Federal Oil and Gas Council is the instrument for this in Iraq. However, as currently envisaged, this body may prove too heterogeneous a body for rapid decision-making. It is a long way from the expert-dominated regulatory

body in Canada (the National Energy Board) and closer to the kind of body found in Nigeria, reflecting the enormous strategic importance of petroleum to these countries. There may therefore be a case for establishing regional branches of the FOGC to promote efficiency. If that proves difficult or appears likely to lead to the emergence of practice inconsistent with the principles established by the FOGC, there is a probability that the style of rule-making will eventually become highly detailed.

There has to be an **interface between the parties responsible for regulation and the other set of parties responsible for operations**. As in Iraq, both the Indonesian and Nigerian cases illustrate the continued importance of an NOC in petroleum operations (representing the state's commercial interest as distinct from its petroleum administrative role). In these cases, the use of local subsidiaries of the NOC has also been favoured, but these remain until tight control by the parent company. Although this suggests that some form of operational decentralization is workable, the autonomy of these subsidiaries is circumscribed.

From the case studies, it appears that the management of decentralization in a federal structure requires clear rules on who makes regulations (and who enforces them) and in particular which parties are to be involved in the contract negotiation process up to and including its approval. The Australian case is the most helpful in underlining the importance of the objective of coherence in such rule making. There, the central and state authorities introduced the concept of 'mirror legislation'. The original legislation was a centrally produced set of rules but – to ensure consistency – the states produced an identical set of rules under their own names over the newly important offshore areas. The aim was to avoid the creation of two different and potentially conflicting legal and regulatory frameworks that have no clear primacy and that may generate a lack of clarity as to the areas that are covered by each one. In Iraq's case there is a strong argument for ensuring that regional autonomy in rule-making is carried out on the basis of the principles in the centrally adopted petroleum law and model contract. This need not preclude some variation to adapt to regional or local circumstances and to allow changes due to learning from experience or changed priorities. The centrally adopted framework (including petroleum regulations and model contract) would however have a greater force than a set of 'guidelines'. Contract negotiation could be carried out on the basis of one or more centrally authorized models. Negotiation could be best carried out at the decentralized level (where there is evidence that local competence exists) and approval or award be given by the central body (the FOGC) with signature by a separate, higher authority (the Council of Ministers) or on instructions from the National Assembly. The supremacy of the central body at this final stage should be clear however to ensure the legitimacy of the contract.

## **5.2 What is to be regulated?**

From the case studies, it appears that where petroleum is an industry of central importance to the country, it is a federal government body that will approve field development plans, and main pipeline development plans, will sign the relevant contracts that are necessary for petroleum operations, and negotiate and prepare E&P contracts for signature. Where there are other important industries, as in Canada and

Australia, many of these matters are left to the regional or provincial level. In Iraq's case, the development of some hybrid solution may be required with these functions divided between the FOGC and the regional body (where one exists). They would have a duty, in carrying out any of the above, to consult with other Iraqi authorities such as the Ministry of Finance, the Ministry of Foreign Affairs, the Central Bank and regional and/or local bodies. Negotiation of contracts could in some cases be carried out by the regional body, but involving the INOC, and done on the basis of a clear, published model contract and set of petroleum regulations, with the final version approved by the FOGC. In this way the levels of authority would interweave with the various subjects that have to be regulated.

The same reasoning would apply to the procedure for approving a main pipeline contract. Approval of such contract by the FOGC and subsequently by the National Assembly would have to be on the basis of a main pipeline development plan already approved by the FOGC or the Ministry of Oil. It may be noted in this context that more recently established pipeline regimes tend to emphasise the issue of pipeline access, with rights granted to third parties. These regimes tend to be complex and legalistic, with narrow discretions incorporated into them, heavily influenced by procedural requirements more than are found in other phases of petroleum operations. Often they are applied in a way that places a high value on good faith negotiation and the use of industry codes of good practice.

Finally, in Iraq's case a distinction will be made between the regulation of existing fields and new discoveries. The approach adopted in Australia also showed a similar distinction, but competence was already clearly vested in the state authorities with respect to existing fields. The approach to new discoveries in offshore areas was based on a compromise between the levels of authority that reflected a concern about the higher risk in these new areas and the possibility that an inter-governmental dispute might deter investors. In Iraq's case it seems desirable that the central authorities should have greater control over the areas where new discoveries are likely, not least because of the strategic significance of such new finds. This is underlined by the fact that these are the locations that, given their higher business risk, are most likely to be offered to new players instead of being largely managed by INOC.

### **5.3 Regulation: How and When?**

The procedures for contract negotiation and approval have been discussed above. A key objective given the unsettled character of the federal regime in Iraq will be the introduction of procedures that enhance trust by creating the maximum transparency. If the local and FOGC authorities are to be responsible for most of the contract negotiation and approval, a large element of predictability could be introduced by basing this process upon detailed rules set out in regulations and a model contract (or several models) with the FOGC having the right to approve the final contract. Measures that encourage oversight, checks and balances and transparency enhancement which might appear cosmetic in a settled federal regime but could prove of great significance in the Iraqi regulatory structure for petroleum development. In

this respect, the FOGC could, for example, be encouraged to give advice on its own initiative within a specified time frame on contract matters.

There are nevertheless some disadvantages from detailed rule-making. It may limit the discretion of regional bodies, promote transparency and encourage predictability. It can also encourage a stifling bureaucratic approach and lack of flexibility in dealing with the many unique circumstances that arise in each set of petroleum negotiations or issues in petroleum development.

#### **5.4 Ownership and Control**

There are **two general lessons** relevant to Iraq can be drawn from this paper. Firstly, from both the case studies in section 3 and the examination of cross-border development in section 4, it appears to be desirable to avoid excessive concern with the meaning and implications of ownership of petroleum resources. A pragmatic approach to this – perhaps transferring disputes about this to another forum or process as in the Sudan – based on the recognition that an economic solution can proceed on the basis of an *adequate* definition of ownership and can avoid what may otherwise prove to be a legal quagmire, and a brake on petroleum resource development.

A second lesson concerns the consequences of over-centralisation. The extreme reluctance of centralized federal authorities in Nigeria and Indonesia to let go of control over petroleum regulation and management has led to increasing violence and disaffection in the first case, with an attendant collapse in legitimacy of the federal institutions. In Indonesia's case, the efforts to develop an alternative legal and regulatory framework, with a clearer separation of functions and increased role for regional bodies have in the short term at least created a regime that is confusing to investors and more complex to deal with. The Argentine case (even if too recent to yield conclusions from its operation) highlights the risks of a sudden transfer of authority from the centre to the regions without extensive provisions for transparency in operations. In the first two cases, a reluctance to seriously consider forms of decentralisation has entailed a high cost. In the third case, an over-hasty response to regional demands has created a recipe for confusion and for costs of a different kind.

