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Considerations For the Management Of Oil In Iraq: A Human Rights Watch Background Briefing April 2003

One of the most pressing issues for a post-conflict Iraq will be the management of the country's oil revenues. While the country has more than 112 billion barrels of proven oil reserves, the second largest in the world, its oil infrastructure is underdeveloped or deteriorating and will require considerable investment to realize its full potential as the economic engine of a post-war economy and a democratic government that respects human rights. There is a need to ensure that the country's reliance on oil revenues does not lead to poor governance and widespread human rights violations that have plagued many oil revenue dependent states. Equally important is to ensure that there is enough revenue available for a postwar Iraqi government to provide for humanitarian needs and reconstruction.

This briefing paper first discusses the nexus between oil revenues, governance, and rights. It then examines the current situation in Iraq, including the role of the United Nations-supervised Oil-for-Food Program. The briefing concludes with a list of guidelines for post-conflict oil revenue management. Human Rights Watch takes no position on the current conflict but believes that, in any post-conflict scenario, oil revenues must be managed transparently and responsibly on behalf of the Iraqi public.

Background

In many cases, a country's reliance on petroleum revenues leads to a lack of economic diversification when the government is the direct beneficiary of economic activity and is therefore not reliant on domestic taxation or a diversified economy to function. In such an economy, those who rule the state have unique opportunities for self-enrichment and corruption. Because achieving political power often becomes the primary avenue for achieving wealth, the incentive to seize power and hold onto it indefinitely is great. This dynamic has a corrosive effect on governance and ultimately, respect for human rights. In this context, a key indicator of the quality of governance is whether a government is committed to transparency, accountability, the rule of law, and human rights. When a ruler or a governing elite are undemocratic or otherwise unaccountable to their citizens, poor management, poor economic decision-making, corruption, and human rights abuses thrive. Instead of improving the overall situation, the existence of a centrally controlled stream of revenue—such as oil revenue—can serve to reinforce or exacerbate an undemocratic or otherwise unaccountable ruler's or governing elite's worst tendencies by providing the financial and political wherewithal to entrench and enrich those rulers without any corresponding accountability.

Research at the World Bank supports the linkage between increased respect for human rights and better economic performance.[1] Similarly, the 2002 Monterrey Consensus of the International Conference on Financing for Development recognized that there is a clear linkage between good governance, including respect for human rights, and economic performance.[2] It also noted that "[a]n effective, efficient, transparent

[1] Jonathan Isham, Daniel Kaufmann, and Lant H. Pritchett, "Civil Liberties, Democracy, and the Performance of Government Projects," World Bank Economic Review, Washington, D.C., May 1997, pp. 219-242.

and accountable system for mobilizing public resources and managing their use by Governments is essential" in order to achieve sustainable development.

Control over resources and revenues without accountability can also marginalize certain sections in society. If economic or social conditions deteriorate, there is the possibility of increased public dissatisfaction with government and hostility toward foreign investors because the government and its business partners are seen as mutually reinforcing actors in a situation that does not benefit society as a whole. This can also lead to further human rights violations because of a general climate of instability that can include abuses in the context of civil unrest or conflict; because the government chooses to adopt repressive measures to suppress any opposition to its rule; or because insurgents seek to control resources and territory.[3] It can also have a negative impact on economic performance as well. For example, World Bank research found "an indication that countries in which all modes of expressing discontent are repressed experience worse performance on investment projects than countries in which public expression of social tensions is tolerated."[4]

A lack of accountability plagues all of the members of the Organization for Petroleum Exporting Countries (OPEC). Seven OPEC member-states: Algeria, Iran, Iraq, Kuwait, Libya, Qatar, Saudi Arabia, and the United Arab Emirates are undemocratic with poor human rights records and limited economic diversification. Indonesia, Nigeria, and Venezuela, also members of OPEC, are nominally democratic but plagued with widespread corruption and poor human rights records. Non-OPEC energy exporters such as Angola, Azerbaijan, and Kazakhstan are quickly becoming models of corruption, mismanagement, and human rights violations. Sudan has set new standards in abuses related to oil development and Burma is infamous for abuses that occurred when it developed its natural gas reserves. Economic and political problems related to energy revenues have exacerbated civil conflicts, such as the one in Indonesia's gas-rich province of Aceh.

This is not to say that energy development inevitably leads to poor economic performance, corruption, and political repression, but that a revenue stream of this sort is a major risk factor. Conversely, functioning institutions that can manage revenues would minimize such risks and also show that government is not reliant on the whims of a single ruler or elite, but that public oversight and adequate management of resources could be exercised during peaceful and democratic transitions. Similarly, functioning institutions that can investigate and hold officials accountable for the misuse of revenue, such as an independent judiciary, are also the same institutions that need to be strong in order to protect human rights. If natural resource revenues are managed properly (as oil revenues have been in Norway and diamond revenues have been in Botswana), a post-war Iraq could become a model for other petroleum economies, proving that it is possible to benefit from oil wealth without sacrificing human rights, democratic freedoms, or fueling massive corruption.

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[2] The Monterey Consensus states: "Good governance is essential for sustainable development. Sound economic policies, solid democratic institutions responsive to the needs of the people and improved infrastructure are the basis for sustained economic growth, poverty eradication and employment creation. Freedom, peace and security, domestic stability, respect for human rights, including the right to development, and the rule of law, gender equality, market-oriented policies, and an overall commitment to just and democratic societies are also essential and mutually reinforcing."

[3] For example, poor management of Nigeria's oil revenues by successive governments has led to widespread civil unrest in the oil-producing Niger Delta region that includes abductions and violence by local communities, human rights violations by security forces responding to unrest, and in some cases, corporate complicity in those violations. In Kazakhstan and Azerbaijan, leaders have refused to cede political authority and economic control in the wake of oil-booms and have harassed and intimidated journalists and civil society when they try to scrutinize the government's use of oil revenues. In both countries, the undemocratic heads-of-state exercise almost sole control over the use of oil revenues.

[4] "Civil Liberties, Democracy, and the Performance of Government Projects," pp. 219-242.

The implications for a post-conflict Iraq are clear: Even if a new government starts out on paper as a democracy committed to human rights and the rule of law, it may not achieve those goals unless mechanisms are found to manage the country's oil wealth in a transparent and accountable manner. This mechanism requires a firm grounding in respect for the rule of law, and the human rights of all of Iraq's citizens to ensure adequate public oversight over revenues and to ensure that the oil of Iraq would indeed belong to the people of Iraq.

Considerations for a Post-Conflict Iraq

Iraq attempted to diversify its economy beginning in the 1970's. Although the state-owned Iraq National Oil Company (INOC) had a reputation for professionalism and was largely free of corruption, the process of diversification was interrupted in the 1980s as the government channeled resources to fight the war it had started with Iran. The comprehensive economic embargo imposed by the U.N. Security Council on Iraq after its invasion of Kuwait led to a sharp deterioration of the production and export infrastructure. Currently, oil is the main source of revenues for Iraq's imports of goods and services and, until the recent outbreak of war, the oil sector was overseen by the United Nations.

The cornerstone of Iraq's post-Gulf War oil revenue management has been the U.N.-administered Oil-for-Food Program that was established by the Security Council in 1995. Since 1996, the program has overseen delivery of approximately $26.7 billion in humanitarian supplies and equipment. Currently 72 percent of Iraq's oil exports are spent under this program while the remainder is spent on Gulf War reparations, the U.N.'s administrative and operational costs, and the U.N. weapons inspection program.[5] There are also reports of illicit oil income from smuggling and other activities. Although Iraq has the second largest proven oil reserves in the world, its actual production is currently far below its potential. In 2002 Iraq produced some 2.014 million barrels of oil per day (bpd), worth approximately $13.3 billion. Between 1996 and 1998, Iraq was allowed to sell approximately $2 billion worth of oil every six months under the program. In 1998, the country was permitted to spend $5.26 billion every six months under the Oil-for-Food Program. In December 1999, the Security Council removed the ceiling on Iraq's oil exports and technically allowed the country to sell as much as it can produce. Even without the ceiling, the U.N. continued to be responsible for the management of revenues.

However, there has been an approximately $2.99 billion shortfall in revenues since 2000 because of politically motivated production stoppages by the government and fluctuating oil prices. As a result of the revenue shortfall and other factors, there are approximately $4.5 billion in approved contracts under the Oil-for-Food program that have not been fulfilled due to the lack of funds. Prior to the outbreak of war, the U.N. reported that Iraq was producing approximately 1.8 million bpd, far below its peak of 2.7 million bpd in 2000. Even with these shortfalls, approximately 60 percent of Iraqi families received their sole sustenance from the Oil-for-Food program prior to the onset of war. Because of the conflict and the initial suspension of the Oil-for-Food program, humanitarian needs will increase substantially. In the immediate conflict and post-conflict

[5] According to the U.N., the breakdown of the use of funds is as follows: 72 percent of Iraqi oil export proceeds fund the humanitarian program. Of this amount, 59 percent is designated for the contracting and supplies of equipment by the government for fifteen central and southern governorates. The remaining 13 percent is designated for three northern governorates. The balance of funds is designated as follows: 25 percent for the Compensation Fund for war reparation payments (the U.N. Compensation Commission); 2.2 percent for U.N. administrative and operational costs of the program; and 0.8 percent for the weapons inspection program.

phases of a war and once oil production resumes, humanitarian needs should be fully funded and must take priority over any other claims on Iraq's oil revenue.

Guidelines for Post-Conflict Oil Revenue Management

It is unclear how the oil sector will be managed in a postwar Iraq because it is not clear whether there will be an indigenous, internationally recognized government immediately in place if the current government is removed from power. The Iraq Petroleum Company, a consortium comprised of international companies that included Exxon, British Petroleum, Royal Dutch/Shell, Mobil, and the French company now known as TotalFinaElf controlled Iraq's oil industry for decades. National control of the country's major resource was one of the dominant issues in Iraqi politics until the government nationalized the industry in 1972. Any reversion to foreign control, or the appearance of foreign control, in the aftermath of U.S.-led military intervention will likely be a major issue of contention and popular opposition.

As the oil industry resumes operation, it is possible that the Iraq National Oil Company (INOC) would be largely unaffected by any conflict and could function as manager of the oil industry. However, it is also possible that domestic Iraqi institutions will not be able to function for some period. This is likely to create a situation in which third parties act as a government until a sovereign Iraqi government is in place. Once a government is in place, there is still a significant risk that economic and political power will remain extremely concentrated and will lead to serious problems of transparency and accountability: control of oil revenue could create a disincentive for those in charge to cede either economic or political control. In such a context, it is imperative to have mechanisms and institutions that manage the country's resources transparently and responsibly on behalf of the Iraqi public instead of using resources for the benefit of an opaque and unaccountable elite or for a third party. This would also help to prevent human rights violations that could occur if public dissatisfaction over the unaccountable use of public resources leads to civil unrest or efforts to suppress public criticism that would undermine the stability that is essential for a post-conflict Iraq.

The following guidelines could help in shaping a transparent and effective model for managing oil revenues after humanitarian needs are fully met:

- In the event that a foreign power is the de facto government or administering authority, a functioning INOC should manage the country's oil revenue independently and transparently. If INOC cannot, an interim—but still independent—managing authority should be charged with managing the country's oil revenue. One possibility is for the United Nations Security Council to modify the mandate of the United Nations Office of the Iraq Programme (OIP) in full consultation with Iraqi representatives so that it has authority to manage oil revenues until a government is in place. This would allow for independent management of the industry.

- All sources of revenue and the structure of those contracts should be made public.

- The current amount revenue and its expenditures should be audited and made public.

- In the event that an independent INOC is unable to manage the industry, an agreed upon third party, such as the U.N. OIP, should have the authority to tender bids to international companies for the rehabilitation or reconstruction of Iraqi oil infrastructure until a government can assume these responsibilities. Regardless of who manages the tendering and bidding process, such bids should be evaluated to ensure that they are comparable to similar contracts in other countries. The bidding and tendering process should be open and the results publicly available.

- In the case of new exploration and production agreements, the type of contract (e.g. technical services, production sharing, tax & royalty concessions) to be offered to foreign companies should be decided by INOC, given the national sovereignty concerns that underpin such a choice. In the event that INOC is not functioning for a period of time then contracting should ideally be postponed. If that would impose an unacceptable delay on revenue flows to Iraq, then whichever entity is temporarily responsible for the decision should endeavor to choose that type of contract which INOC would have been expected to choose (based on historical experience in Iraq and comparable countries), to ensure that it is comparable to other similar agreements throughout the world, and should be public.

- All current and future revenues from such agreements should be audited and made public in order to ensure adequate public oversight.

- Current and future expenditures on behalf of the government or by the government should be audited and made public and a review of those institutions' compliance with the IMF *Code of Good Practices for Fiscal Transparency* should be undertaken at least annually.

- All companies operating in the country must publish all payments made to governments as a result of their contractual or other agreements. These include any bonus payments, taxes, or royalties paid. Such a process can occur under the U.K. government's Extractive Industry Transparency Initiative (EITI), but should not be limited to the timing of this process.

- The governing authority should consider establishing a trust fund or stabilization fund, comparable to the Norwegian Oil Fund, that places a designated percentage of oil revenues into a trust invested abroad for future generations. The savings and spending rules should be fixed and only subject to modification by a sovereign and accountable government in Iraq.

- Such a fund should be subject to regular audits and the financial data regarding the fund should be publicly available as it is in the case of the Norwegian and Alaskan oil funds.

Conclusion

Because of some of the stated justifications for this conflict, most notably the desire to promote democracy, human rights, and the rule of law in Iraq, it is imperative for the authorities managing a post-conflict Iraq to focus on transparent and accountable management of revenues. The measures adopted will likely have a decisive impact on governance as a whole, public control over the use of public resources, and, ultimately, human rights practices.