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An oil saviour?

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Iraq has the potential to supply much more oil

The growing concerns in the world energy market about the risks of a supply crunch have been a critical factor behind the recent surge in oil prices to a new record of US$135/barrel. Speculators are betting huge sums on the assumption that the oil market (and other primary energy markets) will remain tight for many years to come, owing to the inelasticity of demand and to the constraints on long-term supply. Saudi Arabia, the world's largest oil exporter, is doing its bit to allay these concerns, but has acknowledged that once its current crop of oilfield projects is complete in around 2013, there will be little scope for further capacity increases. Similar strains are evident in most of the other major oil-producing countries. One significant exception is Iraq, which holds (at least) 10% of the world's proven reserves, but accounts for only 2.5% of total production. Iraq has the potential to furnish a long-term solution to the oil market's long-term supply problem, but it will need to improve dramatically on its recent performance before buyers of oil futures will be convinced that it can deliver.

All about oil

If history had been kinder, Iraq could now be producing at a comparable level to Saudi Arabia. Instead, three wars, 13 years of sanctions and five years of internal conflict have eroded Iraq's oil infrastructure and human capital. However, Iraq also has a history of recovery. Production peaked at over 3.5m barrels/day (b/d) in 1980 on the eve of the Iran-Iraq war, but then averaged less than half that level during the eight-year war. It had nearly recovered to 3.5m b/d in 1990, after which the invasion of Kuwait and the subsequent UN sanctions severely limited exports, and hence production. In the five years before the US-led invasion of 2003, the sanctions regime gradually permitted greater exports, and production was often above 2.5m b/d. However, it fluctuated considerably due to the impact of years of underinvestment, restrictions on the import of spare parts and isolation from the international oil industry.

This volatility in production has continued in post-Saddam Iraq, although the average level has usually been below 2m b/d, and only exceeded the immediate pre-war level of 2.3m b/d for the first time at the end of 2007. Operations have been frequently disrupted by events ranging from the bombing of pipelines to the murder of oil workers. Moreover, the competition between political factions for influence at every level in the industry—as well as widespread corruption—has not provided suitable conditions for a revival of the industry. There is even concern that damage may have been caused to some fields in order to maintain production at modest levels.

Things may be changing. Iraq's deputy prime minister, Barham Salih, said in April that Iraq's total reserves, could be as high as 350bn barrels, triple the 115bn that has been its officially stated level for many years. The figure is aspirational and should be treated carefully but, given that there has been barely any new exploration of Iraq's promising geology in 30 years, an upward revision of the official reserves figure seems long overdue. This underlines Iraq's uniquely large reserves-to-production (RP) ratio, which was already the world's highest and, based on Mr Salih's estimate and at the expected production level of 2.3m b/d in 2008, would stand at a remarkable 415 years (compared with a world average of about 40 years). If Iraq were able to achieve the average Middle East RP-ratio of 80 years then it would be pumping 4m b/d based on the current reserves, and 12m b/d based on Salih's aspirational estimate. Getting there would take some time, around five years for 4m b/d and probably more than 20 years for the most optimistic level. It would also require Iraq to achieve a sufficient degree of stability. However, if there are promising signs of progress over the next 18 months, then it might be enough to mitigate fears of shortages next decade and dampen the futures market.

Fair share

The issue on which everything hinges is the basis on which Iraq's oil will be developed. Although at its height in the 1970s, Iraq's national oil industry would have had the capacity to implement a significant part of the exploration and development needed, it has been severely eroded since then. Therefore, it is widely recognised that foreign expertise will be needed, but Iraqis are split on two important issues which have so far held back progress. The first is whether the development and operation of the oil sector will be managed entirely from Baghdad or also at a regional level, particularly in the Kurdish region. The second is the terms under which international oil companies (IOCs) will be invited to participate. In particular, the idea of production-sharing contracts (PSCs) has aroused such considerable opposition—from parliamentarians and oil workers' unions who believe that Iraq should fund the development itself (particularly now that there is a large budget surplus)—that the government has apparently backtracked. These controversies have blocked the ratification in parliament of a national hydrocarbons law which was first approved by the cabinet in February 2007. Although no draft has so far emerged that elicits a majority of support, it may yet pass this summer as part of a bundle of laws.

Stop-gaps

In the meantime, the oil minister, Hussein Shahristani, announced plans in January for a series of two-year technical service agreements to upgrade five existing fields by 100,000 b/d each. This is a relatively uncontroversial first step, simply paying IOCs for their services without granting them any claims on revenues or reserves—but none of the contracts have yet been finalised. Then, in mid-April, Iraq released a long-delayed list of 35 IOCs initially approved to bid for more substantial long-term contracts covering exploration, development and production. Theoretically, bidding on the first round of contracts could be complete by the end of the year, and if Iraq—or at least the regions containing the respective oil fields—is sufficiently stable, then work could begin soon afterwards. However, there is a significant risk that this timeline could slip due to bureaucracy and possibly to political shifts following the provincial elections in October.

Kurdish exception

In contrast to delays at the national level, there has been a great deal of activity in the Iraqi Kurdistan region. The Iraqi Kurds had long felt that their region had been deliberately deprived of an oil industry by successive governments in Baghdad, and therefore pressed ahead with development in their essentially autonomous region. The Kurdistan Regional Government (KRG) began drawing in IOCs both because it had little capacity itself and also to provide some international leverage in the inevitable confrontation with Baghdad. Given their weak position and limited finances, the KRG has been happy to sign PSCs, and the first oil well was drilled by Norwegian company DNO in 2006 and now produces about 7,000 b/d. It has signed PSCs with other IOCs including Canada's Western Oil Sands, the UK's Sterling Energy and most recently with Niko Resources of Canada in May. Also, in frustration at the failure to agree a national hydrocarbons law, the KRG passed its own in August 2007. Until now most oil majors have avoided the KRG because of the potential backlash from Baghdad, demonstrated by the fact that companies such as the Korea National Oil Corp that have signed contracts with the Kurds were explicitly excluded from the list of 35 approved IOCs.

Hurdles

Although there is some way to go, 2008 may be seen as the year in which Iraq's oil industry began to recover and, when the markets recognise this, it may take some of the edge off the oil price. However, given Iraq's history of dashed expectations, it would be unwise to factor major production increases into oil supply projections until Iraq has passed a series of important tests. One of these is whether the Iraqi army will be able to maintain security as the US draws down its troops. Another is whether the rival Shia movements led by Muqtada al-Sadr and Abdel-Aziz al Hakim can make the transition from street fighting to purely political competition—an issue that will probably not be resolved until the next general election in December 2009. Finally, the KRG and the rest of Iraq will need to conclude that it is worth reaching a compromise on Kirkuk (the disputed northern province that contains Iraq's largest oilfield) and regional autonomy in order to share in the benefits that a major expansion in the oil industry will bring.