FROM GLASS BOX TO

SMOKE-FILLED ROOM

How BP secretly renegotiated its Iraqi oil contract, and how Iraqis will pay the price

Oilfields and Facilities

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This briefing has been made possible by support from the Joseph Rowntree Charitable Trust.
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SUMMARY

During the second half of 2009, Iraq held two auctions of its largest oilfields, awarding them to multinational companies such as BP, Shell and ExxonMobil to operate under 20-year contracts. Between them the oilfields account for over 60% of Iraq's reserves. The contracts were service contracts rather than the companies' preferred production sharing agreements, which had been proposed for Iraq but rejected as giving too much away.

Media reports of the auction focused on the headline remuneration fees. These sounded so low – between $1.15 and $5.50 per barrel – that many commentators questioned the profitability of the deals. But as always in oil contracts, the devil is in the detail. And whereas the auctions were billed by the Iraqi government as among the world's most transparent contracting processes, this briefing reveals what subsequently happened behind closed doors to make the contracts much more attractive to the multinational companies, at the expense of the Iraqi people.

The first contract awarded, for the Rumaila field in southern Iraq, was privately renegotiated between the Iraqi government and the winning BP/CNPC consortium for more than three months after the auction. PLATFORM has obtained the renegotiated Rumaila contract, and can reveal its contents for the first time. We find that the terms changed significantly from the published model contract on which the auction was based.

The most important changes are:

1. If Iraqi oil production is restrained by a future OPEC quota, the Iraqi government would pay BP/CNPC as much for not producing oil as they would for producing it. Under the model contract, the cost of complying with any quota had been shared between government and company.

2. If Iraq's transport and export infrastructure is not expanded sufficiently in time for production, the Iraqi government would again pay BP/CNPC for not producing oil. Again, the model contract had shared these risks between the two sides.

3. The threshold for requiring the Iraqi South Oil Company's (SOC's) approval of expenditures – vital to prevent corruption and cost-inflation for the purpose of tax avoidance – is increased from $50 million to $100 million; SOC's ability to reject or challenge expenditures is restricted; and its approval is automatically assumed after 45 days.

4. If a natural disaster, industrial action, war or terrorist incident ('force majeure') prevented oil production for more than 90 days, the Iraqi government would compensate BP/CNPC for their lost income, rather than the costs being shared as in the model contract.

5. BP/CNPC are not held liable for any geological damage to Iraq's oil reservoirs as a result of producing oil too quickly or inefficiently.

The effect of these changes is to transfer the most significant risks from BP/CNPC to the Iraqi government, making the contracts considerably more attractive to the companies. In all of these changes, it is the Iraqi side that loses out. As a result of the enhanced compensation provisions, the Iraqi government could find itself paying BP/CNPC (and likely other companies) even when it is not earning oil revenues to offset those payments. Meanwhile, the changes undermine the Iraqi ability to ensure that it achieves value for money, and that oil is developed in the national interest.

The Iraqi government is now considering asking the oil companies that signed contracts during the two auctions to renegotiate, so as to reduce their combined production target from 12 million to 6-7 million barrels per day, as the higher original target would crash the oil price and overload Iraqi infrastructure. But since the secret changes to BP's contract, the Iraqi government is obliged to pay oil companies as if they were producing at the higher rate, whether or not they actually do. The companies therefore have no incentive to reduce their targets, unless significant concessions are offered in return. As the government belatedly realises its 2009 mistakes, the BP renegotiation leaves it little option other than to offer more money.

The auction however was based on a model contract that specified very different terms. If the final terms had been known in the auction, companies might have made lower bids and the result could have been quite different. The process cannot therefore be seen as having been meaningfully transparent. It appears that the Oil Ministry belatedly posted a generalised version of the revised contract on its website in April 2010, with no announcement or explanation. It has still not published the specific contracts for Rumaila or any other fields, despite its promises to do so. Iraqis are left not knowing which is the final version, nor what changed or why. There is now an urgent need, both for the sake of public accountability and to help prevent abuse, for the Iraqi government to publish the final versions – as signed – of all of the contracts it has awarded.

Oil workers at the Rumaila field.

BACKGROUND

The then Oil Minister Husain al-Shahristani said in December 2009, shortly after the second oilfield auction, "I pride myself that the deals in the first bid round and the second bid round have been more transparent than any other deals I am aware of in any of the other OPEC member countries. As a matter of fact, we have set the standard for transparency."[1]

On the surface, it looked like he was right. A model contract was published before an auction, with just two elements left blank: the remuneration fee (the amount paid to the companies on top of reimbursement of their costs) and a targeted plateau rate of oil production. Companies were invited to bid on these two parameters, and the contracts awarded accordingly to whichever bidder offered to produce the most oil for the lowest remuneration fee. In a televised auction, companies posted bid envelopes in a glass box, which were then projected on a screen as they were opened.

The first round centred on an auction in Baghdad in June 2009 at which only one of the eight offered contracts was awarded, for the Rumaila field in southern Iraq. The winner was a consortium of BP and the China National Petroleum Corporation (CNPC). Wvhilst bids were made for all but one of the contracts, all exceeded the maximum remuneration fee that the Oil Ministry was prepared to pay. When the Ministry announced its maximum, BP/CNPC accepted $2 per barrel (compared to their initial bid of $3.99); all other bidders declined to reduce their bids as far as the Ministry asked.

At the time, many observers wondered why BP had accepted such a low fee, as BP and CNPC "were beaten down – it looks pretty marginal at $2."[2] But three months later, BP's then Chief Executive Tony Hayward stated that the company projected a 15-20% internal rate of return from the Rumaila project[3]: a very healthy rate of profits for a known field where there was no risk of not finding oil. A subsequent study by Deutsche Bank put the return even higher, at 22%.[4]

The auction's rules required the contract to be finalised by mid-July and signed during August[5]: after all, it only needed to insert the two bid parameters into the model contract. But instead, discussions dragged on for more than three months before it was agreed on 8 October 2009. It was then approved by the Iraqi Cabinet on 13 October, and finally signed on 3 November.

In the mean time, bidders on two of the other southern fields held a series of discussions with the Oil Ministry: an ExxonMobil/Shell consortium for the West Qurna Phase 1 project, and an Eni-led consortium for Zubair. In October, those companies announced that they had decided to accept the Iraqi Oil Ministry's maximum remuneration fees of $1.90 for West Qurna 1 and $2 for Zubair, compared to initial bids of $4 and $4.80 respectively.

A second licensing round was held in December 2009, in which seven contracts were awarded. Finally, in March 2010, two Chinese companies accepted the Oil Ministry's terms for a fourth first-round contract, for the Maysan group of fields: this time the companies cut their bid by a staggering 90%, from $21.40 to $2.30.

WHAT CHANGED?

While this sequence of events sounded strange, Iraqi oil experts have since been asking what changed to make the ExxonMobil and Eni consortia accept the Oil Ministry's remuneration fees, which they previously considered uneconomic. That is, what happened between the beginning of July and the middle of October 2009?

The Ministry of Oil has insisted that no significant changes were made. Shahristani said in October 2009 that the three months of discussions had been only for a clarification on the Iraqi tax regime, rather than a material change. "Other than that, there has been no changes to the contract, and we do not negotiate contracts. Contracts are presented in the bid rounds. They are either accepted or rejected."[6]

The companies gave a different story. Rob Franklin, President of ExxonMobil Upstream Ventures, commented that, "we've negotiated hard with the Iraqi government and the Ministry of Oil and we've come to an arrangement that we're happy with and they're happy with."[7] Alessandro Bernini, Chief Financial Officer of Eni, told financial analysts in a conference call that, "we accepted $2 because, basically, the fiscal terms are different now." He added that the new terms with a remuneration fee of $2 were equivalent to the pre-bid terms at a fee of $4.50.[8]

PLATFORM can now answer this question. We have obtained, from a source believed to be reliable, a version of the Rumaila contract with BP/CNPC dated 8 October 2009. On that date, the contract was agreed and initially signed, and then submitted to the Iraqi Cabinet for aproval, which was given on 16 October. Apart from any minor changes requested by the Cabinet, we believe this to be the final version as signed. We compare it in this briefing with the official model contract, dated 23 April 2009, which formed the basis of the first bid round.

In a competitive process, companies make their bids based on their evaluation of the risks and rewards of the project on offer. The full set of contractual terms is important: if one of the terms changes such as to decrease the risks inherent in the project, then companies will re-assess the profits they accept, and submit correspondingly lower bids. So important are some of the changes that had they been written into the model contract before the bidding took place, the result of the auction could have been very different. As such, the claims that the process was transparent are fatally flawed.

CHANGE 1 – Foreign companies compensated for OPEC quotas

AT TIME OF AUCTION:

The published model contract stated that in the event of a government-imposed curtailment of production (such as to comply with a future OPEC quota), the barrels not extracted during the period of curtailment could be extracted later.[9]

AFTER RENEGOTIATION:

In contrast, the renegotiated contract states that BP/CNPC[a] will be "fully compensated" by either of those means or by "payment of lost income to Contractor in respect of the estimated volumes not produced during the period for which the production levels are decreased."[10] In other words, the Iraqi government could have to pay the foreign company remuneration fees for the barrels it does not produce, as well as those it does. This could constitute a considerable expenditure, given that the compensation would (by definition) not be taken from oil revenues, but from other government budgets. The costs of meeting quotas (from which both sides benefit) are no longer shared but placed entirely on the Iraqi government. For BP/CNPC, their revenues are guaranteed against the eventuality of OPEC quotas[b], making the contract considerably more attractive.

SIGNIFICANCE:

One of the most criticised aspects of the licensing rounds is the impact they will have on the global oil market. Between the two rounds, contracts were signed that would boost Iraq's oil production from the current 2.5 million barrels per day (bpd) to around 12 million by 2017.

Most oil experts believe that the market cannot absorb so great an increase. The likely impact of such a rate would be a collapse of the oil price: so that what Iraq gained in rates of production it could lose in price per barrel. The net result could in fact be a decrease in Iraqi oil revenues.

Some estimates suggest the market could absorb only around 5.5 – 7 million bpd of Iraqi production, even if other OPEC producers did not increase production at all in face of rising global demand.[11] Shahristani has said that Iraq need not produce the full contracted amount, which between 12 contracts with multinational companies amounts to 12 million barrels per day – that will rather be its production capacity. But if it does not, it will have to pay BP and CNPC.

[a] Iraq is not currently subject to an OPEC quota, because as a result of the sanctions from 1990 to 2003, and then damage and instability following the 2003 invasion, the country has not been able to produce oil at a rate commensurate to its reserves. Iraq's last quota traditionally matched Iran's (around 4 million bpd) – a higher quota might be expected to compensate for Iraq's misfortunes, but it is unlikely to be more than, say, 6 million barrels per day.

[b] To be precise, 'Contractor' refers to the consortium of BP and CNPC with their Iraqi partner, SOMO

CHANGE 2 – Infrastructure risks transferred to Iraqi side

AT TIME OF AUCTION:

The published model contract contained provisions for the foreign companies to upgrade the pipelines and other infrastructure as required, and to treat their costs of doing so as 'supplementary costs'.[12] But the risk of the export infrastructure not being expanded sufficiently in time for the increase in oil production was shared between the Iraqi and foreign sides: both would lose revenues in that event.

AFTER RENEGOTIATION:

The renegotiated contract, in contrast, provides that BP/CNPC would be compensated – by the same mechanisms as for OPEC quotas – if the Iraqi distribution and export infrastructure is unable to receive the full produced amount, of either oil or associated gas.[13] The previously shared risk and cost is now fully allocated to the Iraqi government. Again, the Iraqi government is likely to end up paying companies for oil that is not produced – payments that must therefore come from other public budgets.

SIGNIFICANCE:

Most analysts,[14] including some inside the Iraqi government,[15] believe that Iraq will be unable to meet the ambitious targeted rates of production. One of the biggest reasons is that Iraqi infrastructure is struggling to cope even with current rates of production. The pipelines to the southern tanker terminals, for instance, were built in 1975 with a 20-year shelf-life. No 'pigging'[a] has been done since 1991, because the pipes could not take the pressure.[16]

Construction contracts have been awarded to increase Iraqi southern export capacity by 2.4 million bpd, and the Oil Ministry plans to expand northern export capacity via Turkey by 1.1m bpd, and to build new pipelines through Syria carrying 2.5m bpd. Even if all of these ambitious plans were achieved, they would still fall well short of the 10 million or more barrels per day of increased exports if production targets are met (allowing for some domestic use).

[a] Cleaning and inspecting the pipes by sending a 'pig' (pipeline inspection gauge) along it.

CHANGE 3 – Less oversight

AT TIME OF AUCTION:

The model contract required Joint Management Committee approval of all project expenditures above $20 million, and South Oil Company (SOC) approval of all expenditures over $50 million.[17]

AFTER RENEGOTIATION:

The renegotiated contract increased the threshold for SOC approval to $100 million, and further qualified it by adding that approval "shall not to be unreasonably withheld" (thus increasing the evidential onus on SOC), and that if no objection were made within 45 days, it would be assumed approved.[18] The Iraqi ability to ensure that the project is conducted in such a way as to meet Iraqi interests, and to obtain value for money, is reduced. BP/CNPC[c] conversely gain an opportunity to illegitimately increase their benefits at the expense of Iraq.

SIGNIFICANCE:

It is normal in oilfield development contracts for the investor to require state approval of its expenditures. Such oversight helps prevent corruption, ensures that the project gets value-for-money equipment and services (rather than, for instance, purchasing from an affiliate company) and avoids tax avoidance through cost inflation. In this case, the fiscal structure is such that foreign companies will earn higher remuneration fees if their costs are higher: so there is an incentive for so-called 'gold-plating.'[d] Government approval of expenditures is therefore important, to ensure that the field is developed efficiently, effectively and at the lowest cost to the Iraqi state.

There are already concerns about the capacity of Iraqi institutions to regulate and oversee the project, especially as a result of the loss of expertise from the Iraqi oil industry since 2003, and the fragmenting of its institutions. The time limit on their approval or non-approval may in this context create opportunity for tenders to be pushed through whilst the Iraqi side has insufficient time to study them fully. For example, it is common in the oil industry for affiliate companies to be registered in secretive tax havens, so time may be required to examine the identity of suppliers and subcontractors, as well as the appropriate market prices for their goods and services.

CHANGE 4 – Security, political and natural risks transferred to Iraqi side

AT TIME OF AUCTION:

The model contract specified that if oil operations are suspended for more than 90 days as a result of 'force majeure' (an unforeseen event that prevents oil production, such as a natural disaster, industrial action, war or act of terrorism), the term of the contract would be extended accordingly.[19] This meant sharing of the risks, by delaying revenues for both sides, quite reasonably as such events could not be considered either side's fault. There was no specific provision on security.

AFTER RENEGOTIATION:

The renegotiated contract added that in the event of a 90-day force majeure suspension, BP/CNPC would also be compensated from Iraqi public budgets for their lost income. If the two sides could not agree on the level of compensation, it would be resolved by international investment arbitration.[20] These risks – some of the most significant facing the project – are thus transferred in full to the Iraqi side.Furthermore, SOC is obliged to provide "adequate" security through the Iraqi armed forces, and to carry liability for their actions and conduct. BP/CNPC are entitled to hire private security if they consider security arrangements insufficient, and to charge the costs to the Iraqi state, as 'petroleum costs'.[21]

SIGNIFICANCE:

Since the oilfields awarded in the two licensing rounds are known, the risks to foreign investors are all above the ground, especially political and security risks. In the case of Iraq, these risks are significant, because of the lack of national consensus (or consultation) on the decision to award development of the fields to foreign companies, because of the inherent instability of Iraq's post-2003 political institutions and because of ongoing security risks and physical threats. Meanwhile, BP/CNPC avoid liability for any human rights abuses committed in defending their assets.

CHANGE 5 – Companies not liable for reservoir damage

AT TIME OF AUCTION:

The April 2009 model contract stated that the foreign companies would not be liable for consequential (indirect) damages.[22]

AFTER RENEGOTIATION:

The October 2009 contract broadened the scope of the damages and losses for which BP/CNPC would not be liable, and specifically listed damage to Iraqi oil reservoirs and formations.[23] This change gives BP/CNPC an opportunity to maximise their own profits during the term of their contract, at the expense of damaging future prospects for the field when managed by Iraqis.

SIGNIFICANCE:

Under the sanctions from 1990 to 2003, under-investment and lack of access to international supplies and services led the Iraqi oil industry to produce oil from its fields in a way that damaged their long-term geological integrity. Investment and careful reservoir management is required to optimise the production of oil over the whole life of a field. Super-giant fields such as Rumaila are expected to produce oil for far longer than the 20-year duration of the recently awarded contracts. However, it is in foreign companies' interests to maximise their extraction of oil during the period of their contracts, even if that is at the expense of the longer-term potential of the fields: it would be Iraq that lost out through later reduced output resulting from reservoir damage. Ironically, in 2004/5, BP and Shell were hired by the Iraqi government precisely to find ways of managing the reservoirs so as to end (and perhaps reverse) the geological damage caused during the Saddam era.[24]

[a] A higher expenditure (which is all reimbursed by the Iraqi side) will keep the R-factor down, and so prevent the remuneration fee being adjusted downwards

May 2011 – attempts to renegotiate contracts

In early May 2011, the Oil Ministry appeared to accept what most analysts had been saying for nearly 18 months, that the high production targets set in the 11 oil contracts awarded in two auctions might be unachievable due to infrastructure constraints, and undesirable for their impact on the oil price. Rather than the contracted total of 12m bpd, Ministry officials, now under Minister Abdul-Karim al-Luaibi, suggested 6-7m bpd might be more realistic and proposed renegotiating the contracts to that effect.[25] Just days later however, former Oil Minister Shahristani, now Deputy Prime Minister for Energy, rejected suggestions of a renegotiation.[26]

What commentators missed was the way in which BP's secret deal presented an obstacle to any renegotiation. Under the original contract (before the changes revealed in this briefing), the risks of production being restrained by OPEC quotas or infrastructure bottlenecks were shared by the two sides. If that model contract had been unchanged, when the government wanted to reduce the targets the oil companies would have seen their interests aligned with the government's, and would have wanted to agree a new target they could actually meet.

But under the deal agreed between July and September 2009, these risks were transferred to the Iraqi side, such that companies get paid whether or not they produce the oil.[27] Why would they accept being paid for only 1m? The answer is that they wouldn't, and would demand something else in return – most likely a doubling of the per-barrel fee.

The Oil Ministry's mistake on production rates is just being realised now. But the BP deal has deprived the Ministry of the opportunity to correct the mistake.

Oil workers at the Rumaila field.

Transparency of contracts

Iraqis have a right to know the terms on which their natural resources are managed. Furthermore, transparency of those terms is vital to allow any abuse or wrongdoing to be exposed.

It is troubling that the Iraqi contracting process was portrayed as transparent, with a set of terms published in the model contract, but those terms then rewritten in private. A version of the contract was belatedly posted on the Oil Ministry's website, dated 5 April 2010 – more than nine months after the auction. This version, generalised for all fields, contained the important changes in the final Rumaila contract, as revealed in this contract. No explanation was given of why it differed from the official model contract; indeed the Ministry continued to insist that no substantive changes were made. Nor were Iraqis informed as to which was the final version as signed.

There is now an urgent need to publish the final Rumaila contract, to confirm whether it contains the changes above, and to similarly publish all other contracts the Iraqi government has signed. In particular, it seems very likely that the unawarded first-round contracts for West Qurna 1, Zubair and Maysan, later granted to ExxonMobil, Eni and CNOOC, adopted the same terms as the BP/CNPC contract for Rumaila.

The emerging international best practice in the extractive industries is for long-term development and operating contracts to be published. For example, this is standard practice in Azerbaijan, Bolivia and Congo-Brazzavile.[28] The International Monetary Fund recommends full publication of contracts, noting that in practice, contract terms tend to be widely known within the industry soon after signing, so there is no commercial advantage lost by publication.[29] The US Treasury Department also calls for "presumption of disclosure" of contracts.[30]

Iraq's draft oil law, approved by the Cabinet in February 2007, but never enacted by parliament, would also have required publication of contracts, along with various other financial data and other information.[31] Furthermore, prior to the actual completion of the contracts, Iraqi officials repeatedly stated that they would publish them once signed. For example, in December 2009, Shahristani said on al-Jazeera "These oil contracts have been as transparent as any process in the world… A copy of the contract is available, I can send it to you by email tomorrow; a copy is available to any Iraqi citizen and I invite him to come to my office and ask for a copy, and it will be given to him".[32] However, the contracts have still not been published, and requests for copies by Iraqi oil experts and others have not been met.

Recommendations

The Iraqi Ministry of Oil should publish on its website all of the oilfield contracts, in their final form as signed. This includes the eleven contracts awarded from the two oilfield licensing rounds, the 2008 contract with CNPC for the al-Ahdab field, three gasfield contracts from the third licensing round, and (if completed) the contract with Shell/Mitsubishi for gathering, processing and marketing associated gas in Basra province.

BP should call on the Iraqi government to publish the Rumaila and other contracts, and should post the contract also on its own website.

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2. David Strahan, 'Thirty contestants, only one winner in the Iraqi oil licence gameshow', Independent on Sunday, 5-Jul-2009
3. PIW, 'Tony Hayward: Getting BP Back On Track,' 5-Oct-2009
4.Paul Sankey, David T Clark and Silvio Micheloto, Iraq – The Mother of All Oil Stories, Deutsche Bank, 4-Oct-2010
5. Ministry of Oil, Final Tender Protocol for Iraq's First Petroleum Licensing Round, 23 April 2009,p.5
6. Iraqi Oil Minister Hussain al-Shahristani on Bloomberg TV - 21 oct 2009.
7. Ben Lando, 'Exxon exec optimistic in Iraq entry,' Iraq Oil Report, 4-Feb-2010
8. Eni SpA, Q3 2009 Earnings Conference Call, 29-Oct-2009
9. Model Producing Oil Field Technical Service Contract, 23 April 2009, Article 12.5
10. Technical Service Contract for the Rumaila Oil Field, between South Oil Company of the Republic Of Iraq (SOC) and BP Iraq NV and Petrochina Company Limited and Oil Marketing Company of The Republic Of Iraq (SOMO), 8 October 2009, Article 12.5
11. Fadhil Chalabi, 'Iraqi Capacity Expansion Relative To World Oil Market Trends', Middle East Economic Survey, 52:51/52, 21/28 December 2009, pp.26-9
12. Model contract, Articles 10.6-7, 17.7-8, 19.2
13. Rumaila contract, Article 12.5(b) and (f)
14. Eg IHS CERA, 'Iraq Oil Production Goals Overly Optimistic Amidst Significant Challenges', 31 March 2010; Lianna Brinded, 'Iraq's oil output targets 'impossible'', Energy Risk, 25 Mar 2010; Peg Mackey, 'Iraq: Hitting Bottlenecks', Energy Compass, 11 February 2011
15. Eg Tim Webb, 'Iraq halves oil output as reality replaces ambition', The Times, 5 May 2011
16. Interviews with Iraqi oil experts, Amman, November 2010
17. Model contract, Article 9.20(c)
18. Rumaila contract, Article 9.20(c)
19. Model contract, Article 31.4
20. Rumaila contract, Article 31.4
21. Rumaila contract, Article 7.5
22. Model contract, Article 24.4
23. Rumaila contract, Article 24.4
24. Ruba Husari, 'Iraq Awards Studies for Top Reservoirs', International Oil Daily, 18 January 2005
25. Tim Webb, 'Iraq halves oil output as reality replaces ambition', The Times, 5 May 2011
26. Rania El Gamal, 'Iraq won't cut 12 mln bpd oil output capacity goal', Reuters, 8 May 2011
27. To illustrate (rounding the figures to simplify), if everyone cuts equally, BP/CNPC would cut their increment from nearly 2m to about 1m bpd. So currently BP/CNPC are entitled to be paid for an increment of 2m bpd, even if they only produce 1m. Unless it offers extra payment, BP will be unlikely to accept only being paid for that 1m
28. See Heike Mainhardt-Gibbs, 'Transparency of Extractive Industry Contracts: The Case for Public Disclosure', Bank Information Center, Oct-2007; Revenue Watch Institute, 'Contract Transparency,' HYPERLINK "http://resources.revenuewatch.org/en/backgrounder/contract-transparency" http://resources.revenuewatch.org/en/backgrounder/contract-transparency, accessed 4-Oct-2010
29. IMF, 'Guide to Resource Revenue Transparency, 2007', p.14
30. U.S. Department of Treasury, 'Statement Concerning the Extractive Industries Review', JS-1841, 2-Aug-2004
31. Draft oil and gas law, dated 15 February 2007, Article 36(A)(3)
32. Jasim Azzawi interview with Husain al-Shahristani, Al-Jazeera English Inside Iraq, 18 December 2009, HYPERLINK "http://www.youtube.com/watch?v=u5NyqhNgYDE" http://www.youtube.com/watch?v=u5NyqhNgYDEv