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978-0-521-76661-6 - The Legal Dimensions of Oil and Gas in Iraq: Current Reality and Future Prospects

Rex J. Zedalis

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THE LEGAL DIMENSIONS OF OIL AND GAS IN IRAQ

Current Reality and Future Prospects

This book is the first and only comprehensive examination of current and future legal principles designed to govern oil and gas activity in Iraq. This study provides a thorough-going review of every conceivable angle on Iraqi oil and gas law, from relevant provisions of the Iraqi Constitution of 2005; to legislative measures comprising the oil and gas framework law, the revenue-sharing law, and the laws to reconstitute the Iraq National Oil Company and reorganize the Ministry of Oil; to the Kurdistan Regional Government's 2007 Oil and Gas Law No. (22) and its accompanying Model Production Sharing Contract; and to the apposite rules of international law distilled from both controlling UN resolutions addressing Iraq and more generally applicable principles of international law. This text is essential to the reading collection of every practitioner, business executive, government official, academic, public policy maven, and individual citizen with an interest in the details and controversial aspects of Iraqi energy law.

Rex J. Zedalis is a member of the faculty at the University of Tulsa, College of Law, where he has received numerous awards for his outstanding teaching, including an award in 2004 for the university's most outstanding professor. He has also been recognized for his extensive publication record in both U.S. and European international law journals. He has served as Director of the Comparative and International Law Center (CILC) at the University of Tulsa and as a Fellow with, and a former Assistant Director of, the College of Law's National Energy Law & Policy Institute. Professor Zedalis has also acted as a consultant to international organizations, foreign governments, and domestic as well as international law firms during his nearly 35-year career.

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CURRENT REALITY AND FUTURE PROSPECTS

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*Comparative and International Law Center
University of Tulsa*



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This book is dedicated to my wife, Cathe, and my sons, Ian and Bryce, who have taught me the most important, valuable, and enduring lessons in life; to my closest personal friend, kindred spirit, and former colleague, John Forrester Hicks; as well as to those men and women of indefatigable courage who have labored both on the ground and in the negotiating room to mold what is in their vision a more stable, just, and equitable system of governance for Iraq, an integral component of which is the development of a rational legal regime for the exploitation of Iraqi oil and gas.

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FOREWORD

As any lawyer knows, the law is not only illusive but transitory. To define it at one point-in-time is to attempt to put a living thing under the lens. This is particularly so with law in Iraq, a country not only in turmoil and transition, but in formation; a country poised between autarchy and democracy, between dictatorship and the rule of law. Despite the troop “surge,” sectarian violence continues and the viability of the Iraqi Central Government itself is not assured when U.S. troops finally depart. Some in government seek to right the wrongs to their brand of the faith over the last decades; others attempt to regain prewar dominance; yet another group seeks to establish an Iranian-style theocracy. Many want only to attain personal wealth in this turbulent era.

Into this maelstrom steps Professor Rex J. Zedalis to detail and discuss the developing oil and gas law of this troubled nation. Rather than decry or be intimidated by this volatile and transitory state of affairs, Zedalis has proceeded to outline the current state of the oil and gas law in Iraq and its various possible futures with a perceptiveness and thoroughness that is admirable if not astounding.

The author faces another unique challenge. For more than a year, the Iraqi framework oil and gas law, thought to be a hard-won consensus between factions, has languished unadopted, yet unrejected. The end of this legal purgatory into which this law was cast in February 2007 cannot be predicted. Furthermore, the current state of the statute can only be partially relied upon to indicate the state of Iraqi oil and gas law in the future. Although it is clear that this pending statute contains many elements that will eventually find their way into the law that is settled upon, it is also clear that some will not. It is also known that sentiment for a substantial change in the Iraqi Constitution itself is not insignificant.

Since February 2007, the political middle ground seems to have shifted a bit, making it likely that the now-pending framework law will be changed. Word on the street, as it were, for the past 18 months is that there is a grand compromise brewing. During this period of stalemate on the framework law, much has occurred. The Kurds have signed more than two dozen production-sharing

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contracts, and the Central Government has declared them to be unlawful. At the same time, the Central Government has unsuccessfully attempted to negotiate technical service agreements with major international oil companies (IOCs), but has entered tentative service agreements only with the Chinese and the Indians. The Status of Forces Agreement with the United States has been reached, setting forth a deadline for withdrawal. This withdrawal, and the end of the UN resolutions supporting U.S. presence, will usher in another new era in Iraq. Basra now seems to be seeking status as a region on par with the KRG. Sectarian violence seems to have subsided only to remain barely below the surface.

Obviously, Iraqi energy potential is huge. Currently at almost 2.5 million barrels per day (mbpd), it is not unreasonable to anticipate 6 mbpd of production within the decade or sooner. Current production levels result in more than \$100 million per day of net inflow. Much of Iraq's wealth will have to go to developing additional production and the hydrocarbon infrastructure – refineries, pipelines, gas plants, and so forth. A petroleum boom of historic proportions is in the offing. If this boom is to proceed, it is essential that the law of Iraq be understood and accepted as reasonably reliable. Exploration of such is the object of this book.

Part One provides a useful summary of the Iraqi oil industry (Chapter 1), after which Zedalis addresses the energy-related portions of the Constitution (Chapter 2). These provisions are critical not only to understanding future energy development, but to several major issues in the larger complex of Iraqi governance. Revenue sharing, Iraqi federalism in regard to oil and gas development agreements, and the difference between “present” and “future” oil fields are examples that are discussed in detail. Part Two pertains to the federal Oil and Gas Framework Law (Chapter 3), the Model Iraqi and KRG Production-Sharing Agreements (Chapter 4), the Revenue-Sharing Law (Chapter 5), and the likely shape of the Iraq National Oil Company and Ministry of Oil (Chapter 6).

In Part Three, Zedalis addresses four critical future issues. First, he considers the thorny issue of the massive creditor claims against Iraq that remain to be paid. UN SC Resolutions 1790 and 1859 provide immunity from attachment and creditor claims but they are destined to expire, presenting the possibility of an era of vigorous litigation and attempts to attach Iraqi petroleum assets. This is sure to be one of the more useful portions of the book.

Second, in Chapter 8, he considers the critical issue of the central government's ability to strike oil and gas development agreements in the absence of a framework law. This chapter also should prove to be one of the most important in the book. Third, in Chapter 9, Zedalis discusses the distribution of oil profits in the absence of a binding and final revenue-sharing law. Finally, in Chapter 10, the author analyzes the worst-case scenario: the state of the law in the fractured federalist country or the absolute Iraqi breakup.

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In brief, Zedalis has faced head-on and with scholarly vigor the challenge of the unstable status quo and varied Iraqi futures. He has considered every conundrum of current law and every mystery of the law to come. In the process he has made a significant contribution to legal scholarship. What is more, he has contributed to an understanding of Iraq itself. Such understanding is essential to a positive future for this struggling country.

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PROLOGUE

From all indications, Iraq's proven oil reserves are in the 115 billion barrel (bbl) range,¹ which, depending upon how one runs the numbers, would rank it as having somewhere between the second and the third largest proven reserves in the world.² It is also speculated that Iraq may possess an additional 45 to 100 bbl in its largely unexplored western desert.³ As far as natural gas reserves are concerned, information suggests Iraq has proven reserves of around 112 trillion cubic feet (Tcf), placing its proven reserves at tenth in the world, with probable

¹ See Energy Information Administration, U.S. Department of Energy, Official Energy Statistics from the U.S. Government (Aug. 2007), available at www.eia.doe.gov/emeu/cabs/Iraq/Oil.html (accessed Oct. 9, 2007) (hereinafter Official Energy Statistics). For other estimates, see Iraq: Oil and Economy – Sands of Iraq Hold World's 2nd Largest Oil Reserves (112 billion barrels), available at <http://usgovinfo.about.com/library/weekly/aaIraqoil.htm> (accessed Oct. 10, 2007); Gal Luft, How much oil does Iraq have? Global Politics Iraq Memo 16 (May 12, 2003), The Brookings Institution (indicating Center for Global Energy Studies and Petrolog & Associates suggested proven and unproven of 300 billion barrels), available at www.brookings.edu/views/op-ed/fellows/luft20030512.htm (accessed Oct. 10, 2007).

² See Iraq: Oil and Economy, *id.* (2nd largest proven reserves); Lawrence Kumins, CRS Report to Congress – Iraq Oil: Reserves, Production, and Potential Revenues (Apr. 13, 2005) (2nd largest proven reserves at 11% of world's total reserves), available at www.fas.org/spg/crs/mideast/RS21626.pdf (accessed June 27, 2008); Energy Information Administration, U.S. Department of Energy, Official Energy Statistics from the U.S. Government (Aug. 2007), available at www.eia.doe.gov/emeu/cabs/Iraq/Background.html (accessed June 27, 2008) (3rd largest proven reserves).

³ See Official Energy Statistics, *supra* note 1. See also Weshah Razzak, Iraq: Private ownership of oil and the quest for democracy, MPRA Paper No. 54 (Oct. 2006), available at http://mpa.ub.uni-muenchen.de/54/01/MPRA_paper_54.pdf (accessed Oct. 10, 2007) (suggesting unproven reserves of at least 100 billion barrels); Foreign firms covet Iraq oil reserves, global energy, Iranxe Daily (Feb. 6, 2006) (suggesting as much as 265 billion barrels), available at www.iran-daily.com/1384/2494/html/energy.htm (accessed Oct. 10, 2007). See also Report paints pretty picture of Iraqi oil reserves, Iraq Updates (Apr. 23, 2007), available at www.iraqupdates.com/p_articles.php/article16673 (accessed Oct. 17, 2007) (doubling of Iraqi reserves); Iraqi oil: more plentiful than thought, Iraq Updates (Apr. 25, 2007), available at www.iraqupdates.com/p_articles.php/article16789 (accessed Oct. 17, 2007) (215 billion barrels); Iraq's enormous unexploited oil wealth, Iraq Updates (Jul. 31, 2007), available at www.iraqupdates.com/p_articles.php/article20112 (accessed Oct. 17, 2007).

additional gas reserves at 275 to 300 Tcf.⁴ As will be seen in the materials that follow, Iraq has been capable in the past of producing as much as 3 million to 3.5 million barrels of oil per day (mbpd), but most recently has struggled to produce in the 2 to 2+ mbpd range, though it plans to increase that number in the near future. Its domestic consumption of crude oil demands about one quarter of its recent production,⁵ and an extremely large portion of the natural gas produced in Iraq is associated with the lifting of crude oil and simply winds up being flared or reinjected to assist oil recovery.⁶

In terms of world demand for crude oil, it has been suggested by the internationally acclaimed energy scholar and chairman of Cambridge Energy Research Associates, Daniel Yergin, that between the years of 1998 and 2002, world demand for oil increased by 4+ mbpd, to a level of 78+ mbpd by 2002.⁷ By way of comparison, however, between the years of 2003 and 2007 it accelerated by 8+ mbpd,⁸ to a level of nearly 87 mbpd by 2007.⁹ This is an increase of 100% in the span of 5 short years, an increase due in large part to booming economic development in places such as China and India and a resumption of economic progress elsewhere following the turnaround of financial markets after their collapse in 2000 and the suffering of a follow-on blow with the rise of international terrorism in 2001. Though prices have fallen substantially of late, at the end of 2007 and the first half of 2008, oil prices experienced a completely unimaginable run-up, reaching levels in the vicinity of (U.S.)\$150 per barrel, with some opining that, in the near term, \$200 to \$250 per barrel was not beyond the realm of possibility.¹⁰ All along, natural gas prices have also increased markedly, in some respects in sympathy with oil prices. A variety of usual suspects – for example, domestic political disturbances in places such as Nigeria, and geopolitical developments in places such as Iran – and new forces – for example, the decline of the U.S. dollar relative to other currencies, and the “commoditization” of oil by investors and speculators looking to now make another move along the chain that extends from the “dotcoms” to real estate to basic materials – have contributed importantly to oil’s price jump. Fundamentally, however, in recent years, oil-consuming nations have been confronted with the reality of

⁴ See Energy Information Administration, U.S. Department of Energy, Official Energy Statistics from the U.S. Government (August 2007), available at www.eia.doe.gov/emeu/cabs/Iraq/NaturalGas.html (accessed June 28, 2008).

⁵ See Chapter 1, text accompanying note 53.

⁶ See Chapter 1, text accompanying note 24.

⁷ See Oil-World Oil Production and Consumption, available at www.libraryindex.com/pages/1499/OIL-WORLD-OIL-PRODUCTION-CONSUMPTION.html (accessed July 1, 2008).

⁸ See Oil at the Breakpoint, Testimony of Daniel Yergin before the Joint Economic Committee, U.S. Cong. (June 25, 2008), available at http://jec.senate.gov/index.cfm?FuseAction=Files.View+FileStore_id=6e9e2a7f-4186-47ac-a336-d47ef1961ac (accessed June 30, 2008).

⁹ See Oil Consumption Continues Slow Growth, World Watch Institute, available at www.worldwatch.org/node/5666 (accessed July 1, 2008).

¹⁰ See *id.* It should be noted that, with the world financial crisis of fall 2008, prices collapsed by half for oil and gas but were expected to resume their climb once economic growth returns.

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an ever-shrinking margin or cushion between production levels and stockpiles available and consumption demands, as world production of oil now hovers around the 87-mbpd level.¹¹ And this is where Iraqi oil and gas production comes in, because success at enhancing such and ensuring its delivery to the international market could supply just enough of an additional buffer, when operating with more thoughtful energy utilization by consumers, and possible restoration of a portion of the supply lost to domestic disturbances in some African nations in particular, to take a bit of the edge off of the overall economic consequences associated with the sudden and rapid rise in energy costs experienced in the past couple of years.¹²

Although there is no doubt that outside investment and know-how are central to enhanced Iraqi oil and gas production, it seems just as certain that the existence of a comprehensive, clear, and, at least from the perspective of most Iraqis, fair and equitable oil and gas legal regime is a *sine qua non* for attracting genuine and committed investment from the widest possible spectrum of international players. The radical change in Iraq's governing structure accompanying Gulf War II's removal of Saddam Hussein from power, the U.S.-led military occupation, and the temporary control of Iraq by the Coalition Provisional Authority, as well as the eventual reemergence of self-governance among the local population all suggest alteration of the preexistent legal situation. Uncertainty regarding the nature of any such alteration would seem to be addressed by various provisions of the Iraqi Constitution of late 2005 and the four major pieces of oil and gas legislation offered by the government of Prime Minister Nouri al-Maliki in implementation of those provisions – the basic oil and gas framework law, the revenue-sharing law, the law reorganizing the Iraqi Ministry of Oil, and the law reconstituting the Iraq National Oil Company (INOC). Similarly, the status, in relation to Iraq's creditors, of the nation's oil and gas resources and monies generated by their sale or transactions involving such, would also appear addressed by UN Security Council resolutions.

Interestingly, however, as is so often the case, the political compromises requisite to developing what might be argued as clear and unequivocal statements of law belie the fact that the statements themselves, whether in constitutional, legislative, or multilateral form, are susceptible to various interpretations. In other words, what the political branches that formulated the statements considered more than adequate to clarify controversial matters really represents but a step in a process aiming at a legal regime providing thorough, clear, and fair

¹¹ See Carola Hoyos & Javier Blas, IEA warns of tightening oil supplies, FT.com (July 1, 2008), available at www.ft.com/cms/s/0/cd683aa0-4764-11dd-93ca-000077b07658.html?nclink_check=1 (accessed July 2, 2008).

¹² The author is aware of the "Hubbard" peak oil arguments advanced by some who may suggest that today's high prices are just the beginning of a price spike trajectory, because of having finally reached optimum production levels of a finite resource, and that going forward, prices will move in only one direction.

rules; rules able to allay the nervousness and apprehension of potential investors. It is, however, not the political branches that take the final and definitive step when it comes to a legal regime's comprehensiveness, clarity, and fairness. If a particular legal regime is not found by those trained in legal analysis to be adequately complete, reasonably free from legitimate doubt, and equitable in the way it handles the matters with which it is concerned, then the advice of legal counsel provided to those making the ultimate decisions about investment could prevent one from moving forward, barring the existence of a situation where the potential rewards of investment far exceed the risks associated with such.

In the pages of this study, an attempt will be made to provide just such a legal analysis of the relevant rules affecting Iraqi oil and gas law as set forth in the provisions of the Iraqi Constitution, the framework law on oil and gas, the national revenue-sharing law, and the laws reorganizing and reconstituting both the Iraqi Ministry of Oil and INOC. Additionally, an examination of important UN Security Council resolutions will be undertaken to determine their particular effect on the various aspects of Iraqi oil and gas law, including the effect they may have produced for ensuring that both the resources and the revenues generated from transactions involving such serve to benefit the Iraqi people. With greater specificity, this study is separated into three major parts: the contextual background surrounding Iraqi oil and gas law; the various Iraqi legislative measures designed to address the matter of oil and gas; and an examination of some of the more prominent legal problems that will have to be addressed by those endeavoring to create the Iraqi oil and gas regime. At the outset, however, it must be cautioned that Iraq's law on some of these matters has not completely solidified in final legal texts. This certainly appears so with respect to the federal government's oil and gas framework law, which is still undergoing some revision and new undisclosed drafts, and the laws reconstituting INOC and reorganizing the Oil Ministry – both of which have been negotiated in great secrecy and have not yet even been leaked to the public. The existence of these “loose ends,” however, should not detract from the significant value of an early and very close examination of what is known so far. This prompts another important caution. In view of the fact that many of the chapters in this study will subject legal texts that have been produced by negotiators to careful and extremely detailed scrutiny, one should be prepared to periodically make the intellectual shift from reading general background and contextual information, to carefully and assiduously parsing the precise language of specific legal measures.

The contextual background surrounding Iraqi oil and gas law involves both the factual situation concerning such, including the legal status of the oil and gas at the time of the resumption of Iraqi self-governance, as well as the position of the Iraqi Constitution on the distribution of powers over the country's hydrocarbon patrimony. The factual situation requires attention be devoted to

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the historical evolution of, and the present statistics related to, Iraqi oil and gas production, pipelines, and refining capacity. The historical evolution, of course, begins with the Turkish Petroleum Company's (TPC's) 1925 oil and gas concession from the Iraqi authorities. Regarding the present statistical situation, it bears noting that what is presented is a summary or overview of those relevant aspects of the industry, not a detailed and exhaustive account. Just by way of illustration, in the context of discussing the pipeline and refining capacity of Iraq, little if anything is said about pipelines or refineries that supply the internal domestic needs of the Iraqi people, or local pipelines within oil and gas fields; the focus is principally on those that serve, or are capable of serving, external needs of export markets. Rounding out the contextual background also requires reference to the legal situation in which oil and gas resources in Iraq found themselves following the combination of UN sanctions imposed after Gulf War I, the removal from power of the Saddam Hussein government and the U.S.-led military occupation of Iraq after Gulf War II, and the interregnum political control of Iraq by the Coalition Provisional Authority. After all, to the extent it might be found that gaps exist in the Iraqi Constitution, the oil and gas framework law, or other measures, it would be critical to know whether the UN, the military occupant, or the Coalition Provisional Authority changed the nature of the legal regime applicable to Iraq's oil and gas resources. And with specific regard to the relevant provisions of the Iraqi Constitution that speak to the matter of oil and gas, reference is made in the materials that follow to the distribution of constitutional authority between federal and subcentral governmental entities. This has been a matter of virtually interminable debate between the central government in Baghdad and regional government entities in Iraq's Kurdish north.

Switching to the study's second part, that concerning the various legislative measures designed to deal with Iraqi oil and gas, attention will be focused on a couple of groups of items. One of these groups involves the aforementioned four major pieces of national legislation that, as a unit, are designed to establish the fundamental parameters of Iraqi oil and gas law for the ensuing years – the oil and gas framework law, the federal revenue-sharing law, the law reconstituting INOC, and the law reorganizing the Oil Ministry. The other group involves the terms of the basic contractual instruments to be utilized in the most aggressive or ambitious sorts of legal undertakings between appropriate government authorities and international oil companies interested in providing know-how and assistance in developing Iraq's oil and gas in return for obtaining a share in the country's hydrocarbon deposits. These are the contractual instruments referred to as exploration, development, and production contracts or “production-sharing” agreements. With respect to the four pieces of national legislation, various nuances and complications will be examined. Illustrative would be questions about whether the revenue-sharing law applies to oil and gas activities of subcentral governmental agencies, or only those at the federal

level, as well as whether the activities involving oil and gas must take some particular legal form in order to trigger the law's requirements. Similarly would be numerous questions about the manner by which the law requires the distribution of revenues that have been collected from appropriate oil and gas activities. With respect to the terms of exploration, development, and production contracts or "production-sharing" commitments obtained in return for helping Iraq develop its petroleum resources, both the peculiarities and the general nature of what the national government might settle upon in its model oil and gas field contracts and what has made its way into the Kurdish region's model production-sharing agreement and accompanying regional petroleum law all merit attention. However, as with the federal government's framework law on oil and gas, and its measures reconstituting INOC and reorganizing the Ministry of Oil, there has been a paucity of information made available regarding federal model oil and gas field contracts, apart from some early releases of what have been characterized as reflecting thinking at the federal level. The points of similarity and contrast between the approaches of the central and the subcentral governments with respect to the terms model contracts will be focused upon. Observations on similarities and contrasts would seem important, given the ever-present possibility that ethnic and sectarian tensions in Iraq could result in disintegration of extant efforts to forge a permanent "national" government with an accompanying national legal regime. Although disintegration of such efforts would prove both troublesome and unfortunate, it suggests the need for sensitivity regarding alternative visions of the legal landscape for Iraqi oil and gas.

The third and final section of the study concentrates on some of the more pressing current issues connected to Iraqi oil and gas, and some of the future problems that may confront scholars and legal advisors working in the area. As just mentioned, it would be an untoward development, but one clearly not beyond the realm of possibility, were the labors of those Iraqis committed to the fashioning of a democratic and truly federal system of government to falter and collapse. The possibility of this happening serves as an impetus for taking up the task of offering speculative comment on some of the likely oil and gas legal scenarios in the event that comprehensive federal legislation on the subject never fully takes root, or Iraq itself devolves into either a nation in name only, or several distinct and separate governing units or countries. But apart from this, the final section of the study also examines the topic of the central government's legal authority to enter into various oil and gas development agreements in the absence of effective national oil and gas framework legislation. Also examined is the question of creditor claims against either Iraqi oil and gas proper or revenues generated by the sales of such. As will be noted, the Gulf Wars, and the commercial and business dislocations associated with them, led to substantial economic claims, many of which remain outstanding. Various UN Security Council resolutions, including resolutions 1790, adopted during the last two weeks of 2007, and 1859, adopted on December 22, 2008, address the

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matter of such claims, and, in doing so, touch on the susceptibility of Iraqi oil and gas, and revenues from its sale, to various sorts of legal actions. The terms and impact of these resolutions, and their related predecessors, receive extensive consideration in the materials that follow. Finally, because it is possible that, like the framework law on oil and gas, the federal revenue-sharing law could wind up failing to take hold, an assessment is provided of legal requirements from other sources applicable to the question of the distribution of oil and gas revenues. It is not inconceivable that few such requirements may exist. However, given the substantial and increasing levels of income the producing regions of Iraq can expect from hydrocarbon activities, it is critical to know whether or not, and if so, how, revenues are to be shared.

The significance of a complete understanding of the legal dimensions of the three broad and general areas that comprise the various sections of this study cannot be too strongly emphasized. Iraq's proven oil reserves alone constitute approximately 10% of the world's total proven reserves, and fully restoring that nation's contribution to the consumption demands of a growing international economy could prove extremely beneficial in approaching the inflationary and price strains constantly confronting the international marketplace. And, to the extent that the nature of the oil and gas legal regime in Iraq is comprehended, deficiencies, gaps, problem areas, and possible improvements in that regime can more readily be addressed, thereby providing the opportunity for increased Iraqi oil and gas production. No doubt, the reality of witnessing comprehension of such matters being translated into alterations and changes in the legal regime is complicated by the ethnic and sectarian rivalries that have riven that nation's political system over the past few years. Without the existence of a genuine national will tending toward rationality, compromise, and tolerance – and not just a public persona uttering the trite platitudes of such – the chances of lasting success on that front seem reduced. The way forward demands authentic flexibility and open-mindedness, not the external appearance of such followed by reversion in private to the narrow-minded, rigid, and atavistic ways that have long been familiar. A clear, thorough, and sensible oil and gas regime can attract investment from outside, improve the efficient operation of indigenous government and quasi-government enterprises functioning in that sector, and facilitate greater Iraqi contribution to world energy demands.

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