Journal of Advanced Social Research Vol.4 No.9, Septemper 2014, 15-48


# Security criteria and its effect on FDI Patterns in Petroleum sector in Iraq

Aysar Y. FAHAD
College of Administration and Economy ,Tikreet University
tradepolicies@yahoo.com

Article Info

Received:25.07.2014
Accepted:16.08.2014
Published online:01.09.2014

ISSN: 2231-8275

## ABSTRACT

Terrorism can negatively impact growth, investment and trade flows. This paper attempts to test the impact of Conflict on State Fragility and on FDI inflows to the LDC receiving countries in all economic sectors with a special look into Natural resource. Political instability plays an important role in investment decisions and investors believe political instability in the host country is important for choosing investment locations and the same applies on terrorist attacks. We define three major types of political risk discourage foreign investment in oil sector since they damage its profitability and survival: first, nationalization, second, policy instability and arbitrary regulation in FDI-related policies, and, third, war and political violence, including terrorist activities. There is a compound role of political instability, corruption and bureaucracy in making the host country unattractive to foreign investors by increasing the cost of entry and adding uncertainty, as well as by distorting incentives to investment which came to be a reality in the oil sector in Iraq where we looked into its investment environment using Business Climate Development Strategy (BCDS) and International Country Risk Guide (ICRG) to show the retreating stand of Iraq on the overall investment environment and on the risk criteria in particular, which is still discouraging foreign investment in the oil sector despite numerous auctions held by Iraq's oil ministry.

To add to the current problems that Iraq is facing now, a dispute between Iraq’s federal government and Kurdistan’s regional government over foreign investment in Kurdistan’s oil reserves have risen even more with very fast developments in the country which will show its effect on the FDI patterns in petroleum sector.

**Keywords:** Foreign Direct Investment, security Risks, oil sector, Developing Nations, Iraqi Economy.

## 1. Introduction

Since 2003, Iraq has witnessed a very big change in its policies and methods in all aspects of it economy, which includes the backbone of it, which is the oil industry. Iraq has huge oil and gas resources in terms of hydrocarbon reserves and high levels of expected production and export capabilities, and Iraq has the fourth-largest oil reserves in the world behind Saudi Arabia, Canada and Iran, the fact of which has improved the macroeconomic environments in the oil sector. Despite all these facts, Security in Iraq is a major holdup to investment there, sometimes second only to the lack of a law governing Iraq's vast oil and gas reserves. This fact is clearly defined by Many top executives in the Government of Iraq (GOI), that we find many Iraqi officials like Ibrahim Bahrul-Uloom, a former oil minister said once that “the security situation is a fundamental part of the development process, whether the oil sector or the other sectors”. Another factor that is hindering investment in oil sector is the long waited for oil law to outline investment guidelines for foreign and private firms which seems until today stuck between various factions who either want a heavy central control or strong regional and governorate rights and either extremely limited foreign investment to be directed into service contracts or the unbridled free market. This internal political struggle reflected on the Iraq's oil exports which makes more than 90 percent of the federal budget and such uncertainty will reflect on long term plans like the Iraqi government’s Five-Year National Development Plan NDP (2013-2017) and Integrated National Energy Strategy INES (2013-2030).

## 1.1. Foreign Investment in a Post-Conflict Environment

In order to obtain the benefits of foreign investment and attract investors, a host country must assure investors that they can safely invest in that country. In post-conflict economies, concerns related to physical safety and investment security, combined with a general distrust with post-conflict governments are among the key considerations for foreign investors. While seeking to attract investor, however, the host state must be careful to identify areas in which foreign investment would be favorable, and not to go so far as to limit its future ability to regulate in the public interest (Moloo & Khachaturian, 2009).

Bringing Foreign Investment to Post-Conflict Countries, several factors attract foreign investment and, from a policy perspective, there are many things that a host government can do to create an environment that is inviting to investors

1.1.1. The Existence and Creation of Business Opportunities, clearly, the overriding factor for drawing foreign investment is the existence of actual business opportunities and the potential for profit. The sheer existence of genuine economic opportunities can attract investors (Hewko, 2002).

1.1.2. Legal Protections, A clear and transparent legal system for adjudicating disputes and guaranteeing rights also helps to stimulate foreign investment

(Hewko, 2002, PP74-75). Foreign investment laws should account for the interests of a broad range of stakeholders—lawmakers should avoid catering to the desires of a designated, elite group with the resources to influence legislators (Hewko, 2002, P. 76). While an inadequate legal system may not always be a dissuasive factor for FDI, the lack of legislative and institutional reform can be a significant barrier to investment—even the most entrepreneurial investor has a limit to the level of systemic difficulties that it is willing to go through (Hewko, 2003, P. 78).

Because FDI is foreign in the host economy, subject to laws and regulations by the host government, inter-jurisdictional issues arise. Cross-border jurisdiction implies that foreign investors operate in an unfamiliar foreign environment. In the unfamiliar territory, foreign investors necessarily care about the expected return to their investments and the ease to exit the host country when the security of their property is threatened which is usually limited by inter-jurisdictional of the host government.

1.1.3. Political Risk Insurance, Another reliable source of protection for foreign investors in post-conflict economies is political risk insurance. This includes government-sponsored foreign investment programs provided by investors' home states (such as the Overseas Private Investment Corporation, an independent U.S. government agency) (Opic, 2014) as well as organizations such as the Multilateral Investment Guarantee Agency (―MIGA‖), which is part of the World Bank Group (MIGA, 2014). Private insurers also are also an option for political risk insurance coverage. While private insurers may be more flexible and are not limited by the same political constraints, they do not offer the same level of expertise as MIGA and cover for shorter periods (Khachaturian, 2006).

1.1.4. Physical Security, The decision to invest in a post-conflict environment will always be impacted by the status of the physical conflict in that region, and whether it is actually over. It is difficult to invest in a state where the physical safety of the investor‗s personnel and the investment itself is uncertain (Wells & Ahmed, 2007, pp 685-695). Foreign investors—particularly those in the manufacturing industry—cite physical security of their staff as a major concern in investing abroad, because even if fighting has ceased, the threat of violence remains (MIGA, 2013).

In an empirical analysis of FDI inflows covered about 129 countries from 1976 to 1996, (LI, 2006, pp. 231-255) Unanticipated civil war has a negative ex post effect on investment choices over location and magnitude, but anticipated civil war does not. Unanticipated interstate war decreases the chance of a country chosen as an investment location, but not the size of investment. Anticipated interstate war does not influence ex post investor choices over either location or magnitude. Likewise, anticipated terrorist attacks do not have such ex post effects. But unanticipated terrorist attacks are not found to have any effect on investment choices either.

1.1.5. Anti-Corruption, Corruption, in this context, refers to the abuse of public office for private benefit. It is often the case that post-conflict environments are riddled with corruption, which will often impair a foreign investor‘s ability to conduct business. In Transparency International‘s 2013 Corruption Perceptions Index, countries such as Iraq, Libya, South Sudan, Sudan, Afghanistan, Korea (North), Somalia (all countries recently plagued with conflict) rank in the bottom 10 of 180 countries.

### 1.2. Foreign Direct Investment and State Fragility

Ghani, Lockhart, & Carnahan (2006, pp. 101-123) proposed ten core functions a state must perform in modern world. They are: “(1) legitimate monopoly on the means of violence; (2) administrative control; (3) management of public finances; (4) investment in human capital; (5) delineation of citizenship rights and duties; (6) provision of infrastructure services; (7) formation of the market; (8) management of the state’s assets (including the environment, natural resources, and cultural assets); (9) international relations (including entering into international contracts and public borrowing); (10) rule of law.”

State-building strategy must be directed at making sure each of the functions is performed rather than the level of the performance (Ghani, Lockhart, & Carnahan, 2006, 124) .In being capable of performing all the essential functions, a state will gain legitimacy both at home and abroad. Building an all-encompassing state that serves its citizens in an accountable and transparent way is a key factor in avoiding and curtailing persistent conflicts (Wolff, 2011, pp 1785-1789).

The two key domains of state-building are constitutive and output domains. The constitutive domains include political settlement, security, rule of law, and administrative governance The output domains include service delivery and the range of public services that a state provides (e.g., health, education, utilities), justice system (e.g., administration of justice, transitional justice), and economic governance (e.g., institutional underpinnings of markets, natural resource management, infrastructure/regulation, employment) (Fritz & Menocal, 2007, pp. 5-7). The economic governance is the area where the state should look for FDI to support its activities (OECD, 2011).

Fragile states transitioning to stability require multitude of challenges to be addressed and resolved. Parties to a conflict must agree on a political mechanism to resolve differences without resorting to violence. The security of the lives of the citizens, their property, and movement should act as a good measure of the success of any political agreement (Dabo, Salmon, Venancio, & Keuleers, 2011).

To earn legitimacy, a post conflict state should engage in management of public finances in a transparent way. It should be capable of nurturing human capital and delivering sustainable services to its citizens. In order to attract foreign investment and improve the living standards of its citizens, the post conflict state must undertake the creation or rebuilding of the destroyed infrastructure, transition from war economy to market, resume relations with the international community, and finally transition to the rule of law, all of which requires the implementation of a state-building strategy (Ghani et al., 2006, P. 120). A state in transition represents a major challenge to FDI since it exasperates the investment risks due to the lack of the institutions and systems required to guarantee an investment.

Major conflicts undermine economic growth directly and indirectly; directly, by destroying lives and property, and indirectly, by diverting resources from productive investment in human and physical capital to that of destructive military activities (Bolnick, Greenbaum, James, & Hendry, 2009). Conflict also disrupts partially or completely essential public services. It also, impacts the state’s administrative and financial ability for post conflict recovery. This forces the state to borrow heavily to reconstruct what was destroyed, leaving huge debts that burden future budgets (Brahimi, 2007). In most post-conflict countries, economic governance issues such as policies, laws, institutions, and human capital that determine the context in which a country's economic activity takes place, are inextricably intertwined with security and political issues (Del Castillo, 2010, p, 10).

Conflict and growth are two constructs that work in opposite direction to each other, as the risk of violence is accentuated by poor economic performance which further complicates efforts to achieve political reconciliation (Del Castillo, 2010, p.43).

Country risk factors, such as political, economic, and financial risks have adverse effects on the cash flows generated by an FDI project (Jones, 2010, p.12). Governments interested in attracting FDI need to lower their countries risk factor. An important economic justification for treating foreign capital favorably is the fact that FDI inflows could result in technology spillovers that hasten economic growth in recipient countries (Liu, 2008, pp. 176-193).

The U. S. reconstruction strategy in Iraq was built on the assumption that a sand safe environment was going to prevail throughout most of the rebuilding efforts; the ongoing insurgencies and sectarian violence have clearly toppled that assumption (Turner, 2007). Immediately following the 2003 war, Iraq faced countrywide looting and arson causing an estimated $12 billion in damages (Rathmell, 2005, p 1018) and after the events that Iraq witnessed in 2014, some $20 billion more is estimated. Government buildings were burned, Iraqi government records were stolen or destroyed, and thousands of top government bureaucrats fled the country fearing persecution by the U.S. (Coyne, 2010).

Countries emerging from protracted wars have to confront the normal challenges of socio-economic development while simultaneously accommodating the additional burden of national reconciliation and peace consolidation (Del Castillo, 2008, P 23). The effects of conflict on the economy are widespread and well documented in the literature (Dabo, Salmon, Venancio, & Keuleers, 2011; Manning & Trzeciak-Duval, 2011) such as diversion of resources towards unproductive activities, destruction of country's infrastructure, reduction in size of investment due to uncertain outcomes or the risk of expropriation, and an increase in military expenditures that take public resources that could otherwise be invested in infrastructure, education or health. In post-conflict countries, the governments need to play active roles (including the use of subsidies and price support mechanism) to promote private investment and economic inclusion (Del Castillo, 2010 p. 27).

Conflict usually results in the collapse of state structures and institutions necessary for promoting sustained development for its citizenry. The weakening of state capacity or accountability leads to failure to provide services or generate economic growth in an accountable and inclusive way, which in turn creates political instability and return to conflict

(The World Bank, 2005, P. 45). In post conflict situations, state rebuilding is at the heart of the requirement for achieving lasting peace, delivery of basic social services, and core economic governance (Manning & Trzeciak, 2011).

The international community should help states to move out of fragility by committing necessary political, financial and human resources long enough to ensure success (Manning & Trzeciak, 2011). The involvement of the international community should be sensitive to the local players and directed at a constructive state-society engagement (OECD, 2011). It's important to understand and support the political, social, and economic processes to construct the relationship between state and society.

Extraction of natural resources, such as oil and gas, is usually done by foreign MNEs which bring in capital and know how. FDI in natural resources is very capital intensive and has fewer spill-over effects on other sectors of the economy since it uses few local suppliers and subcontractors (Poelhekke, & van der Ploeg, 2010). With resource abundance comes the hypothesis of “resource curse", a widely discussed thesis in literature. Resource curse refers to the phenomena that many countries with abundance of natural resources have lower economic growth rates than countries with poor resources (Isham, Woolcock, Pritchett, & Busby, 2005, P.164; Bannerman, 2007; Buccellato & Alessandrini , 2009; Hodler, 2006, P1367-1386).

Natural resource curse could damage economic growth in several ways. With changes in oil prices comes volatility in government revenues which could lead to inflation and varying government spending (Frankel, 2010). Natural resource revenue could make countries vulnerable to Dutch Disease – the inclination for the country's currency to get overly appreciated compared to other foreign currencies– which leads to decline in competitiveness of the manufacturing sector and its eventual contraction (Frankel, 2010, P.12). Revenue from natural resource could damage institutions (legal system and governance) by removing incentives to improve infrastructure and reform the bureaucracy leading to a weaker, more corrupt, and less accountable government (Alexeev & Conrad, 2009; Frankel, 2010, P.10). This in turn provokes wars and conflicts for control over those resources.

While resource curse is widely discussed, recent literature questions the entire hypothesis and concludes that resource abundance could impact economic growth either positively or negatively depending on several factors, paramount among them is the health of the country's institutions (Mehlum, Moene, & Torvik, 2006, P.508; Stijns, 2005, PP.107-130).

Countries, such as Nigeria and Libya, with bad institutions, dictatorships, and undeveloped financial systems have experienced low levels of economic growth while others with more advanced institutions, such as Norway and Botswana were able to utilize their natural resources and experience high growth rates (Buccellato & Alessandrini, 2009; van der Ploeg, 2011, PP.366-420; Ross, 2012). In both cases, foreign investment was instrumental in enabling the resource rich countries to exploit their resources, which they otherwise would not have been able to undertake. Multinational enterprises with their deep pockets and technological know-how spared local governments and firms the high costs of research and extraction. Actually, Bannerman concluded that FDI could reverse the Dutch disease if utilized correctly to induce growth in the manufacturing sector (Bannerman, 2007).

### 1.3. Institutional uncertainty

Survey evidence shows that multinational executives take into account political instability in making investment decisions and investors believe political instability in the host country is important for choosing investment locations and deciding the investment amount. As expected, forward-looking investors constantly anticipate the effect of political violence in the host country, while econometric studies produce conflicting findings. Political violence comes in different types, some of the most extreme of which include civil war, interstate war, and transnational terrorist attacks. Because different types of political violence have different characteristics, their effects on FDI inflows may differ.

Politicians often commit tremendous manpower and financial resources to deal with them. They are also less likely to give in or compromise on these issues. As a result, these types of political violence can cause economic recession in a host country, impose financial constraints on the government, and damage the country's infrastructure.

Political instability and violence−both domestic and international−discourage MNCs from investing in the host economy that is subject to such risk

It has been found, that there is an influence of policy-related indicators on FDI flows for example, that there is a negative link between institutional uncertainty [1] and private investment (Aymo & Weder, 1998, PP.5-8), a positive relationship between FDI and intellectual property protection, and a negative impact of corruption on FDI flows.

[1] Institutional uncertainty is a broad concept, encompassing very different forms of uncertainties within the political environment which we can divide roughly into four categories, Government instability, Political violence, Policy uncertainty and Enforcement uncertainty.

Among the political indicators that are statistically significant, the estimated coefficients for government stability, investment profile, law and order and democratic accountability of the government are somewhat larger than those for the other indicators. Foreign investors are also highly sensitive to changes in political stability and the framework in which governments operate (Busse & Hefeker, 2005, PP.12-13). Through revising the indicators for political risk and institutions, it became clear that the most closely associated with FDI are government stability, law and order, and quality of the bureaucracy (Busse & Hefeker, 2007, PP.397-415).

### 1.4. Terrorist attacks

Terrorist attacks in countries of origin seem to have a significant negative impact on FDI. Foreign investors are trying to avoid the countries which are subject to frequent terrorist attacks. They cause “a loss of human and non-human capital,” “uncertainties,” and “retrenchment of certain industries” like travel and recreation industries. In the long run, they increase "uncertainties of any permanent threat of terrorism"(Alomar & El-Sakka, 2011, P.116).

A model built by Alberto and Javier emphasizes that beyond increasing uncertainty, terrorism reduces the expected return to investment, and so international investors are diversified against other types of country risks. The model suggests that in an integrated world economy, where international investors are able to diversify other country risks, terrorism may induce large movements of capital across countries (Abadie & Gardeazabal, 2008, PP.1-27).

### 2.1. Determinants of FDI Flows to Developing Countries

Dunning put theoretical framework for, FDI determinants. The framework posits that firms invest abroad to look for three types of advantages (Dunning & Sarianna, 2008): Ownership (O - The ownership-specific advantages “of property rights/patents, expertise and other intangible assets” allow a firm to compete with others in the markets it serves regardless of the disadvantages of being foreign because it is able to have access to, and exploit and export natural resources and resource-based products that are available to it.), Location (L – are those that make the chosen foreign country a more attractive site “such as labor advantages, natural resources, trade barriers that restrict imports, gains in trade costs and strategic advantages through intangible assets” for FDI than the others ), and Internalization (I – arise from exploiting imperfections in external markets, including reduction of uncertainty and transaction costs in order to generate knowledge more efficiently as well as the reduction of state-generated imperfections such as tariffs, foreign exchange controls, and subsidies) advantages; hence it is called the OLI framework. The framework identified four main categories of motivation for investment abroad by MNEs from developed economies: resource-seeking, market-seeking, efficiency-seeking, and strategic asset or capability seeking. Although no comprehensive theory of FDI exists, researchers have identified a number of variables as critical to FDI flows to developing countries. These include the openness of the economy, rate of return on investment, natural resource availability, political stability, infrastructure, corruption, human capital, bureaucracy, and macroeconomic indicators (Onyeiwu , 2003).

**2.1.1. Rate of return on investment**. The decision to invest in a country depends on risk-return tradeoff on investment in a host economy. Rate of return on investment is defined as gain or loss of an investment over a specified period (Bodie, Kane, & Marcus, 2009). Foreign investors seek profit on their investment. Capital tends to flow to economies with low risks and high rates of return. In very risky countries, and in order to attract FDI, the risk-adjusted rate of return on investment must be reasonably high. Capital scarce countries, which also tend to have a low per capita Gross Domestic Product (GDP), usually have higher rates of return on investment which attracts higher flow of FDI (Onyeiwu, 2003, P. 20).

**2.1.2. Openness of the economy**. Studies have shown a positive relationship between FDI flows and economy's openness (Saif & Choucair, 2009; Shirazi et al., 2008). Openness of the economy refers to openness to trade and openness to capital flows. Openness to trade refers to the ease by which goods and services are imported and exported, while openness to capital flows refers to the absence of controls on the movement of capital (Onyeiwu, 2003, P. 33). Export-oriented FDI is attracted by trade openness, while trade restrictions attract tariff-avoiding FDI which is interested in taking advantage of the local market (Krogstrup & Matar, 2005, PP.1-18).

**2.1.3.** Natural resource availability. Poelhekke and van der Ploeg showed the importance of natural resources in attracting FDI (2010). Jenkins and Thomas observed that "resource-seeking investors will locate subsidiaries abroad to secure a more stable or cheaper supply of inputs, generally raw materials and energy sources, but also factors of production the objective are to lower production costs and enhance competitiveness in domestic as well as foreign markets (Jenkins & Thomas, 2002, P.6). Increase in oil prices tends to increase FDI flows to economies with natural resource endowments.

**2.1.4. Political stability**. The political stability of a country is determined by the type of existing regime (democratic or dictatorial), the stability of its government, the relationship between existing political groups as well as the state of its democratic institutions (if any); combined they play a major factor in attracting foreign investment (Baek & Qian, 2011; Busse & Hefeker, 2007, PP.397-415). Political stability has been found to have a direct impact on FDI (Bannerman, 2007; Li, 2006, PP. 231-255). Other things assumed constant, democratic and political stable economies attract more FDI than undemocratic and unstable countries. FDI is attracted to democratic countries, since their regimes will more likely respect the rule of law, civil liberties and property rights which are encouraging features to FDI flows (Onyeiwu, 2003, p 26). Countries that are characterized as lacking political and institutional stability are considered as high risk which tends to discourage FDI flows.

Three major types of political risk discourage foreign investment since they damage its profitability and survival: first, nationalization or expropriation of foreign assets, which tends to be rare, and breach of contract, which occurs more often, threaten foreign investment; second, policy instability and arbitrary regulation in FDI-related policies create uncertain investment environments and hurt the profitability of foreign investments; and, third, war and political violence, including terrorist activities, can damage foreign assets immediately and discourage the productivity of a host economy in the long run

**2.1.5. Infrastructure.** Foreign investors prefer economies with a well-developed network of roads, transport networks, water supply, electrical power, and telecommunication services (i.e., phone, fax, and internet). Poor infrastructure tends to increase the cost of doing business which reduces the profitability of investment (Ngowi, 2001, PP. 1-22). Production costs are usually higher in countries with poor infrastructure than those with well-developed infrastructure. Consequently, FDI will tend to prefer countries with good infrastructures (Jenkins and Thomas, 2002).

**2.1.6. Corruption and bureaucracy**. Corruption and bureaucratic red tape have a negative impact on FDI even with the existence of favorable investment environment in the host country (Onyeiwu, 2003, P. 29). Governmental legal, judicial, and administrative corruption tend to increase costs of doing business by increasing the time to obtaining business permits necessary for operation in the host country (Caetano and Caleiro, 2009). In order to lower corruption's impact, Transparency International has been compiling data on corruption on different countries since 1995.

Corruption has constantly been listed by numerous studies as a deterrent to foreign investors (Nowaczynski, 2013; Seldadyo & De Hann, 2011, 196-206; Zhou, 2007). Corruption may deter FDI by making the host country unattractive to foreign investors by increasing the cost of entry and adding uncertainty, as well as by distorting incentives to investment. Bribes paid by MNEs act as taxes, and corruption practices add extra costs due to the inability of MNEs to enforce contracts, resulting in further waste of resources(Qian , Sandoval-Hernandez, and Garrett, 2012). On the other hand, smaller number of studies has found that in countries entangled by bureaucratic processes and weak institutions, corruption could act as an FDI incentive when bribes lead to more host government projects with more favorable terms resulting in increased profits (Chang, 2012; Egger & Winner, 2005, PP. 932-952). It could also act as a lubricant or a helping hand to obtain the legal permissions for setting up foreign operations (Chang, 2012, P. 53).

**2.1.7. Human capital**. The presence of a skilled workforce to perform modern business transactions is an important factor impacting FDI flows. Israel, for instance, and despite its Arab conflict, has been a major recipient of FDI, and mainly due to the presence of highly educated workforce in the country (Aharoni, 2011).

**2.1.8. Macroeconomic indicators**. In addition to the above factors, FDI is also impacted by country economic indicators, such as real GDP growth rate, inflation, corporate tax rate, and external debt. Countries that undergo a growth in their GDP tend to attract more FDI, while those imposing high corporate tax and suffer from high rates of inflation and external debt of host country usually deter FDI (Anyanwu, 2012).

### 2.2. Investment in oil sector

The petroleum industry is one of the most important industries in the world. This industry has special characteristics and requirements for it; huge capital, advanced technology, senior specialists, high risks, specific skills and experience, long term projects and high sensitivity to political and economic events.

Oil investment is becoming an industry in which the amount of available cash was running ahead of the ability of the service and technology industries to satisfy demand rapidly. Countries that have experienced political instability during this decade are beginning to see lower output growth (Hvozdyk & Mercer-Blackman, 2010, P.30).

Generally, the petroleum industry has diverse activities related to the exploitation of oil and gas resources under and above the ground, starting from the pre-exploration efforts, exploration, development and production, transportation, refining, gas processing, local distribution and external marketing. In spite of the specific features, especially the issues that pertain to capital requirements and the number of employees, type of inputs and outputs, location, and level of risks, .etc, most of the issues are interrelated and integrated.(Shaallan, 2012, P.29).

The logic of international production suggests that foreign direct investors in oil sector typically have a long time horizon when operating in the host country. Their investments cannot be easily reversed without paying some cost. A long time horizon implies that foreign direct investors have to be forward-looking, constantly anticipating ex ante how political violence affects the expected returns of their investments and the political barrier to exit.

The objective of oil companies are to build equity and maximize wealth by finding and producing oil and gas reserves at the lowest possible cost and highest possible profit margin. In order to do this, they must search for huge fields (Daniel, 1994, P.18). Unfortunately for these companies, the regions where huge fields are likely to be found, including Iraq, are often accompanied by tight fiscal terms. The oil industry is comfortable with tough terms if they are justified by sufficient geological potential. This is the birthplace of dynamic negotiations.

In general, the drives of petrol investment come from a number of needs; finance, experience, technology, efficiency, modern management, also the need to joint with well-known participations, customers and markets. In contrast, the investment parties look for to achieve a diversity of objectives, for example in upstream activities; Government seeks to maximize wealth from its natural resources and maximize the revenues to meet their economic and social needs, Foreign Companies also seek to build equity and maximize wealth by finding and producing oil and gas reserves at lowest cost and highest returns (Daniel, 1994, PP.17-18).

### 3.1. Investment environment in Iraq

To reach a full view of the situation of the business environment we will adopt the indicators adopted by Business Climate Development Strategy (BCDS), which was prepared by the Department of private sector development in the Organization of Economic Cooperation and Development (OECD, 2010; MENA-OECD, 2010).

Table (1)
Business climate in Iraq According to indicators of (OECD)

| Section | index | level |
|---|---|---|
| Foreign investment policy | restrictions on national treatment | 3 |
| | Approval procedures | 3.5 |
| | Entry of foreign businessmen supporters of foreign direct investment | 4 |
| | Transfer of capital related to foreign direct investment | 3 |
| | Incentives for foreign direct investment | 3 |
| | Performance requirements of work | 2 |
| | Ownership of land | 2 |
| | Estate and Land Area | 1 |
| | Property rights, property | 3 |
| | Safeguards in cases of expropriation | 3 |
| | Investment agreements, International | 1 |
| | International arbitration to handle disputes between the investor and the Government | 1 |
| Investment Promotion and Facilitation | Investment promotion strategy | 3 |
| | Foundation Executive | 4 |
| | Monitoring and Evaluation | 3 |
| | Local cooperation and regional levels | 1 |
| | Links between foreign direct investment and small and medium | 2 |
| | One stop shop | 4 |
| | Consumer Relations Department | 4 |
| | Resolution making authority | 2 |
| | Services after the grant of licenses | 3 |
| | Economic zones | 4 |
| Transparency | publications and tools Information | 5 |
| | Information and prior consultation | 1 |
| | Transparency of procedures | 4.5 |

Source: Aysar, Fahad (2011); "The reality of the business climate in Iraq within the framework of the Business Climate Development Strategy of the OECD, Proceedings of the eleventh Scientific Conference/ School of Administration and Economics / University of Mustansiriya.

The table above shows us that amongst the main weaknesses in the business climate in Iraq is the relationship with the Iraqi authorities with International bodies, where there is a weakness in the indicators of bilateral investment agreements, and international arbitration and local and regional cooperation all of which are technical measures that can be overcome through the simple issuing of a legislation, law or a decision in the parliament. There was also a decline in the level of Iraq in terms of the classification of index for land titling and classification, in spite of the existence of detailed records of the type and the ownership of land in Iraq, but the many title suits that emerged after 2003 may have worked to destabilize the property and raise doubts on it.

As that dealing with the foreign investors requires a different and new mentality from those that have grown within the bureaucracy of government institutions through the adoption of new mechanisms to deal with them to treat them as a partner in the resolution, which appears very well in the mechanism of information and consultation prior to issuing instructions or amendments to the Investment Law, which has been worked in isolation from the investors and without prior consultation with them.

### 3.2. ICRG criteria for Iraq

Since 1980, International Country Risk Guide (ICRG) has provided expert financial, political and economic risk analysis for investors and international business professionals. The ICRG evaluates both the obvious developments and the subtle factors that cursory annual reviews all too frequently miss. In this guide, we find that the political risk is given (100 points) which is twice the weight of financial and economic risk (50 points).

The system is based on a set of 22 components grouped into three major categories of risk: political, financial, and economic, with political risk comprising 12 components (and 15 subcomponents), and financial and economic risk each comprising five components. Each component is assigned a maximum numerical value (risk points), with the highest number of points indicating the lowest potential risk for that component and the lowest number (0) indicating the highest potential risk. The maximum points able to be awarded to any particular risk component is pre-set within the system and depends on the importance (weighting) of that component to the overall risk of a country(PRS, 2014).

This is becoming logic if we look into research by Paul Collier and Anke Hoeffler at the World Bank (Paul & Hoeffler, 2000, P.13) suggests that countries whose wealth is largely dependent on the exportation of primary commodities are highly prone to civil violence. In explaining the correlation between primary commodities and conflict, Collier and Hoeffler argue that conflict may be explained either by greed or by grievances, such as feelings of ethnic or political marginalization. They conclude (in large part based on the correlation between primary commodities and conflict) that to understand the causes of contemporary civil wars we should forget about political and cultural arguments and focus instead on the greed of rebels and especially on their trade in natural resources (2000, P.16).

**TABLE ( 2 )**

**POLITICAL RISK POINTS OF IRAQ BY COMPONENT - JUNE 2012**

This table lists the total points for each of the following political risk components out of the maximum points indicated. The final columns in the table show the overall political risk rating (the sum of the points awarded to each component) and the change from the preceding month.

| A | B | C | D | E | F | G | H | I | J | K | L | Risk Rating 06/12 | Change from 05/12 | Rating in 06/12 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 7.0 | 0.5 | 8.5 | 6.0 | 8.5 | 1.0 | 0.0 | 1.0 | 1.5 | 2.5 | 4.5 | 1.5 | 42.5 | 0.0 | 42.5 |

| | | | | | |
|---|---|---|---|---|---|
| A | Government Stability | 12 | G | Military in Politics | 6 |
| B | Socioeconomic Conditions | 12 | H | Religious Tensions | 6 |
| C | Investment Profile | 12 | I | Law and Order | 6 |
| D | Internal Conflict | 12 | J | Ethnic Tensions | 6 |
| E | External Conflict | 12 | K | Democratic Accountability | 6 |
| F | Corruption | 6 | L | Bureaucracy Quality | 4 |

Source; the PRS Group, Inc.: *an Extract from International Country Risk Guide*. Retrieved from https://www.prsgroup.com/about-us/our-two-methodologies/icrg

The indicators in the criteria show clearly the weak ranking of Iraq in many components:

**3.2.1. Government Stability** This is an assessment both of the government's ability to carry out its declared program(s), and its ability to stay in office. The risk rating assigned is the sum of three subcomponents; Government Unity, Legislative Strength, and Popular Support. Iraq is given 7 points to indicate a medium risk.

**3.2.2. Socioeconomic Conditions** socioeconomic pressures at work in society that could constrain government action or fuel social dissatisfaction with subcomponents: Unemployment, Consumer Confidence and Poverty. Iraq is given 5 points to indicate a high risk.

**3.2.3. Investment Profile** to assess factors affecting the risk to investment that are not covered by other political, economic and financial risk components which include Contract Viability/Expropriation, Profits Repatriation and Payment Delays. Iraq is given 8.5 points to indicate a medium risk.

**3.2.4. Internal Conflict** this is to assess political violence in the country and its actual or potential impact on governance which sum up Civil War/Coup Threat, Terrorism/Political Violence and Civil Disorder. Iraq is given 6 points to indicate a low risk.

**3.2.5. Corruption** this is related to corruption within the political system. Iraq is given 1 point to indicate a very high risk.

**3.2.6. Military in Politics** to assess the possibility of military become involved in government because of an actual or created internal or external threat. Iraq is given no points to indicate a very high risk greater degree of military participation in politics.

**3.2.7. Religious Tensions** The risk involved in these situations range from inexperienced people imposing inappropriate policies through civil dissent to civil war. Iraq is given 1 point to indicate a very high risk.

**3.2.8. Law and Order** to assess the strength and impartiality of the legal system, while the Order sub-component is an assessment of popular observance of the law. Iraq is given 1.5 points out of maximum 6 points to indicate a high risk.

**3.2.9. Ethnic Tensions** to assess the degree of tension within a country attributable to racial, nationality, or language divisions. Iraq is given 2.5 points to reflect nationality tensions are high because opposing groups are intolerant and unwilling to compromise.

**3.2.10.** **Democratic Accountability** is to assess how responsive government is to its people. Iraq is given 4.5 points to indicate a on the basis that the more responsive it is, the less likely it is that the government will fall, peacefully in a democratic society, but possibly violently in a non-democratic one.

**3.2.11.** **Bureaucracy Quality;** high points are given to countries where the bureaucracy has the strength and expertise to govern without drastic changes in policy or interruptions in government services. Iraq is given 1.5 points out of maximum 4 points to indicate a high risk of possible change in government tends to be traumatic in terms of policy formulation and day-to-day administrative functions.

**Table (3 )**
**FULL POLITICAL RISK POINTS OF IRAQ BY COMPONENT - JUNE 2012**

| | | | |
|---|---|---|---|
| Ranking Status Index | 107 | Ranking Management Index | 95 |
| S \| Status Index | 4.07 | M \| Management Index | 4.06 |
| SI \| Democracy Status | 4.10 | Q13 \| Level of Difficulty | 8.0 |
| Q1 \| Stateness | 4.3 | Q13.1 \| Structural constraints | 9 |
| Q1.1 \| Monopoly on the use of force | 4 | Q13.2 \| Civil society traditions | 8 |
| Q1.2 \| State identity | 4 | Q13.3 \| Conflict intensity | 9 |
| Q1.3 \| No interference of religious dogmas | 5 | Q13.4 \| GNI p.c. PPP rescaled | 8 |
| Q1.4 \| Basic administration | 4 | Q13.5 \| UN Educ. Index rescaled | 7 |
| Q2 \| Political Participation | 5.3 | Q13.6 \| BTI Stateness & Rule of Law | 7.1 |
| Q2.1 \| Free and fair elections | 7 | MII \| Management Performance | 4.25 |
| Q2.2 \| Effective power to govern | 4 | Q14 \| Steering Capability | 4.3 |
| Q2.3 \| Association / assembly rights | 6 | Q14.1 \| Prioritization | 3 |
| Q2.4 \| Freedom of expression | 4 | Q14.2 \| Implementation | 5 |
| Q3 \| Rule of Law | 3.5 | Q14.3 \| Policy learning | 5 |
| Q3.1 \| Separation of powers | 5 | Q15 \| Resource Efficiency | 3.0 |
| Q3.2 \| Independent judiciary | 3 | Q15.1 \| Efficient use of assets | 3 |
| Q3.3 \| Prosecution of office abuse | 2 | Q15.2 \| Policy coordination | 3 |
| Q3.4 \| Civil rights | 4 | Q15.3 \| Anti-corruption policy | 3 |
| Q4 \| Stability of Democratic Institutions | 4 | Q16 \| Consensus-Building | 4.0 |
| Q4.1 \| Performance of democratic institutions | 4 | Q16.1 \| Consensus on goals | 6 |
| Q4.2 \| Commitment to | 4 | Q16.2 \| Anti-democratic | 5 |

| | | | |
|---|---|---|---|
| democratic institutions | | actors | |
| Q5 \| Political and Social Integration | 3.5 | Q16.3 \| Cleavage / conflict management | 2 |
| Q5.1 \| Party system | 4 | Q16.4 \| Civil society participation | 4 |
| Q5.2 \| Interest groups | 3 | Q16.5 \| Reconciliation | 3 |
| Q5.3 \| Approval of democracy | 4 | Q17 \| International Cooperation | 5.7 |
| Q5.4 \| Social capital | 3 | Q17.1 \| Effective use of support | 6 |
| SII \| Market Economy Status | 4.04 | Q17.2 \| Credibility | 4 |
| Q6 \| Level of Socioeconomic Development | 3.0 | Q17.3 \| Regional cooperation | 7 |
| Q6.1 \| Socioeconomic barriers | 3 | Q14.2 \| Implementation | 5 |
| Q7 \| Organization of the Market and Competition | 4.3 | Q14.3 \| Policy learning | 5 |
| Q7.1 \| Market-based competition | 4 | Q15 \| Resource Efficiency | 3.0 |
| Q7.2 \| Anti-monopoly policy | 3 | Q15.1 \| Efficient use of assets | 3 |
| Q7.3 \| Liberalization of foreign trade | 6 | Q15.2 \| Policy coordination | 3 |
| Q7.4 \| Banking system | 4 | Q15.3 \| Anti-corruption policy | 3 |
| Q8 \| Currency and Price Stability | 6.5 | Q16 \| Consensus-Building | 4.0 |
| Q8.1 \| Anti-inflation / forex policy | 7 | Q16.1 \| Consensus on goals | **6** |
| Q8.2 \| Macro stability | 6 | Q16.2 \| Anti-democratic actors | **5** |
| Q9 \| Private Property | 4.0 | Q16.3 \| Cleavage / conflict management | **2** |
| Q9.1 \| Property rights | 4 | Q16.4 \| Civil society participation | **4** |
| Q9.2 \| Private enterprise | 4 | Q16.5 \| Reconciliation | **3** |
| Q10 \| Welfare Regime | 3.0 | Q17 \| International Cooperation | **5.7** |
| Q10.1 \| Social safety nets | 3 | Q17.1 \| Effective use of support | **6** |
| Q10.2 \| Equal opportunity | 3 | Q17.2 \| Credibility | **4** |
| Q11 \| Economic Performance | 5.0 | Q17.3 \| Regional cooperation | **7** |
| Q11.1 \| Output strength | 5 | | |
| Q12 \| Sustainability | 2.5 | | |
| Q12.1 \| Environmental policy | **2** | | |
| Q12.2 \| Education policy / R&D | **3** | | |

**Source; collected by researcher from data retrieved from** https://www.prsgroup.com/about-us/our-two-methodologies/icrg

### 3.3. Iraq and its oil deterring foreign investors

The projections in the Central Scenario require very substantial cumulative oil and gas sector investment during the period 2012-2035 amounts to almost $400 billion (IEA, 2012, P.75) although the report of Iraq Energy Report (IER, 2012) expect that more than 90% of future investment in oil and gas will ultimately be paid for by the Iraqi treasury, either directly or via the cost recovery and fee arrangements made with the various companies operating in the Iraqi upstream (the main potential exception to this is the refining sector, where Iraq is looking for private investment) the responsibility for managing and executing projects at each stage of the value chain varies to reflect a change in division of responsibilities to allow privet investment and their responsibilities in accordance. The economic development of oil sector in developing countries and Iraq in particular to a large extent on the possibility to make profitable investments and accumulate capital in it.

Technocrats in the ministry have quietly been taking some cautious steps towards turning Iraq into the global hydrocarbon giant it says it wants to be.

Oil-ministry officials have recently tweaked plans for a long-awaited license auction in December, to make it more attractive. International bidders will be able to take part in several—rather than just one—of the ten Greenfield projects on offer, including Majnoon in the south-east, one of the country's two largest fields. Officials met an array of oil bigwigs from around the world in Istanbul to discuss terms in 2009. Most of the prospective buyers were persuaded that they have a chance of winning contracts, with more than one-third of Iraq's reserves up for grabs. The United States Energy Information Administration, a statistical agency in the US Department of Energy, reckons that oil in those ten undeveloped Iraqi fields would fill about 41 billion barrels, worth nearly $3 trillion at today's price.

Yet Iraq's government is still by insisting on offering rock-bottom fees to companies bidding to get the oil out. In June 2009, at the first oilfield auction since the American invasion, the government offered $2 a barrel against the $4 proposed by the companies. As a result, only one field, Rumaila, was sold. Even so, BP and the China National Petroleum Corporation (CNPC), which won the contract, are still waiting for it to be signed, Oil majors such as Exxon which has been pulling expatriate workers out of its West Qurna 1 field in the south, and BP which has taken non-essential staff out of nearby Rumaila as Sunni insurgents continued to advance through the north of the country and surrounded its largest oil refinery (Chazan, 2014b). This shows that western oil companies are changing their assessment of the risks of operating in Iraq.

Meanwhile, no work at the field is going on. Five other fields in the first auction may be offered again, but not until next year—and only if back-channel talks with unsuccessful bidders come to nothing.

In March 2009, the government of Iraq decided to hold its first oil field auctions. The auctions were for service contracts on the country's southern oil fields; the winner would obtain the right to produce oil above a certain target for a fixed fee. The bidders competed on the fee charged per barrel and the amount by which they promised to increase production. At the same time, the Kurdish regional government continued to sign Production Sharing Agreements with foreign companies for its oil fields, unrecognized by the national government. In a context of continuing (if much reduced) political violence and legislative deadlock in the national parliament, three actors needed to make key decisions. Jean Claude Gandur, the CEO of Addax Petroleum, needed to decide whether to continue investing in the Kurdish region in light of Baghdad's continuing opposition. The Iraqi oil minister, Hussein al-Shahristani, needed to design the oil auctions in such a way that oil companies would be moved to invest, and invest quickly, despite the lack of a national oil law.

### 3.4. Current statue of oil companies in Iraq:

#### 3.4.1. Ownership

All the companies and other entities in the Iraqi petroleum industry are owned by the GoI, no foreigners are allowed the ownership of land in Iraq for industrial use, and 90% of these lands are owned by Ministry of Finance. Assets for oil industry are fully owned by the government because they have been already bought by central budget of the government through the Ministry of Finance to finance the capital expenditures of companies, academic institutes and R&D center along with self-funding from companies' own budgets to finance most of their operating expenditure.

#### 3.4.2. **Pricing Systems:** The pricing systems are unique and can be divided into four classes (Shaalan, 2014, P. 29):

- The prices of crude oil among Extracting and Refining Companies and the Ministry of Electricity are administrated with roughly fixed levels.
- The second system is between Refining and Distribution Companies also the prices of products are very low and set only for accounting purposes.
- Product prices between the Distribution Company and final consumers are subsidized, whether produced locally or imported.

- The pricing of crude oil for export is subject to world market conditions.

**3.4.3. Petroleum Investment in Iraq** the new investment patterns are homogenous with the new philosophy of a market economy in Iraq, but the pillars are still limited, especially the background of existing laws and regulations, also the nature of the society and culture.

There are a variety of patterns which characterized the Iraqi upstream oil sector which has changed a lot since 1920s which is now taking the form of Standard Service Contracts[2] resulted during 2009 – 2012 into four license rounds have been signed for oil and gas exploration, development and production activities **(Table No.4)**.

**Table (4):** Four Oil and Gas Licenses Rounds in Iraq

| Bid round | Project or licensing block | Operator | Type | Production Plateau Target (kb/d) for oil, (bcm/year) for gas | Max. fee* |
|---|---|---|---|---|---|
| 2008 | Ahdab | Petrochina | Oil | 140 | 6.00 |
| One (2009) | Rumiaila | BP | Oil | 2850 | 2.00 |
| | West Qurna I | ExxonMobil | Oil | 2825 | 1.90 |
| | Zubair | Eni | Oil | 1200 | 2.00 |
| | Missan Fields | CNOOC | Oil | 450 | 2.30 |
| Two (2010) | West Qurna II | Lukoil | Oil | 1800 | 1.15 |
| | Majnoon | Shell | Oil | 1800 | 1.39 |
| | Halfaya | Petrochina | Oil | 535 | 1.40 |
| | Gharraf | Petronas | Oil | 230 | 1.49 |
| | Badra | GaspromNeft | Oil | 170 | 5.50 |
| | Qaiyarah | Sonangol | Heavy Oil | 120 | 5.00 |
| | Najmah | Sonangol | Heavy Oil | 110 | 6.00 |
| Three (2010) | Akkas | KOGAS | Gas | 4.1 | 5.50 |
| | Mansuriyah | TPAO | Gas | 3.1 | 7.00 |

[2] There are 4 different type of contract between Governments and oil companies; The most typical one is the Production sharing agreement. http://en.wikipedia.org/wiki/Oil_and_gas_agreement

| | | | | | |
|---|---|---|---|---|---|
| | Siba | Kuwait Energy | Gas | 1.0 | 7.50 |
| **Four (2012)** | Block 8 | Pakistan Petroleum | Gas-prone | n/a | 5.38 |
| | Block 9 | Kuwait Energy | Oil – prone | n/a | 6.24 |
| | Block 10 | Lukoil | Oil – prone | n/a | 5.99 |
| | Block 12 | BashNeft | Oil - prone | n/a | 5.00 |

*The maximum remuneration fee (Max. fee) is in US dollars per barrel of oil equivalent.

- Source: IEA, (2012): *Iraq Energy Outlook*, Special Report. France. P37, Retrieved from: http://www.worldenergyoutlook.org/media/weowebsite/2012/iraqenergyoutlook/Fullreport.pdf.

The results of these auctions have been dramatic in terms of oil field development and increased production by national and foreign companies, most of them are through two licensing rounds over the period (2009 – 2010), and additional two rounds over (2011 – 2012) of oil and gas (development and exploration). For the Refining activity, the changes have been moderated in increasing petroleum products outputs, which still not satisfy the local demand (for transportation, heating, power generation), as a result the import rates have been continuing at high levels especially gasoil and gasoline.

Elements serving numerous considerations have been implemented in those four rounds. First of all, the oil and gas reserves and production remain owned by the government. The role of foreign companies (Contractors) is centered on providing experience, technology, technical and financial expertise to develop oil and gas fields, and increase the production to the specified rates. Also with the exploration blocks, companies should carry the same requirements within the tasks of exploration and production. In contrast, those companies receive Service Fees included their capital and operating costs (Petroleum Costs), and they receive profit (Remuneration Fees) according to what is termed the R-Factor and according to Sliding Scale Techniques

In May, 2014 the Iraqi cabinet agreed on a law to set up a national oil company. The ministry will be split into a regulator and a producer, embracing the 16 companies it now runs. Presently, North Oil Company, focusing on the area around Kirkuk, and South Oil Company, around Basra, produce most of the oil. But they do not drill, explore or refine the oil and process gas. Those activities fall to other companies supervised by the ministry, few of which co-operate with each other. Instead, they have separate fiefs, each competing in age-old turf wars. The latest idea is to bring them together under one management.

That would be progress. Yet there are repeated setbacks. Royal Dutch Shell expected to clinch a deal to get natural gas from oil extracted in Basra province. But locals loath to let foreigners make profits have forced a delay until after the general election which was held in April 2014. The new government that will then emerge will also have to decide the fate of two foreign consortia, led by DNO, a Norwegian company, and Addax, a Canadian one, which have both recently begun to export oil from Iraqi Kurdistan without the approval of the federal oil authorities.

In any event, the Kurdish regional government in Erbil, the Iraqi Kurds' capital, is arguing with Baghdad over how payment is allocated. As a result, Addax and DNO have yet to be paid for their exports. And this week the Kurdish government dramatically halted co-operation with DNO after dealings in its shares were temporarily suspended by the Oslo Stock Exchange over alleged irregularities.

Further south, CNPC has had trouble in Wasit province, where local Iraqis, demanding a bigger share of the profits from their own field, have protested by destroying generators and cutting electricity lines.

But insecurity is no longer the biggest factor deterring foreigners. Most vociferously they complain about the new Iraqi establishment's lack of political will. Politicians feeling obliged to beat a nationalist oil drum are unable to tell voters that the country will earn more from its oil only if foreigners are drawn in. If the second international oil auction flops as badly as the first one did, Iraq risks deterring investors for a long time.

Oil companies earn fees on oil they produce and for a specific contractual period. When lease ends oil companies leave, and equipment they own and buildings erected will be handed over to the varmint. The oil investment takes the shape of service contracts not any ownership projects like joint ventures. Actually, there’s only one joint venture allowed in Iraq, that of Basra Gas Company. It’s different in Kurdistan where all oil contracts are production sharing which is a joint venture investment.

## 3.5. Dispute between GoI and KRG

### 3.5.1. The core of the dispute

Disputes between Iraq federal government and Kurdistan's regional government over foreign investment in Kurdistan's oil reserves had political as well as constitutional dimensions to it. A multi- national enterprise interested in investing in the oil sector in Kurdistan region of Iraq (or any other governorate) had to consider the challenges resulting from different interpretation of the Iraqi constitution. According to the Iraqi constitution of 2005, it gave the right exclusively to the federal government to manage oil and gas deals with foreign companies, and hence the basis for the federal government argument of considering KRG production sharing contracts (PSCs) as illegal and void that it stipulated in Article 109-second that "The federal government with the producing regional and governorate governments shall together formulate the necessary strategic policies to develop the oil and gas wealth in a way that achieves the highest benefit to the Iraqi people"(UN, 2014).

KRG"s position claims that Iraqi constitution gave the exclusive rights to federal government to manage only "existing" oil and gas fields at the time the constitution was approved in 2005 where it is stipulated in Article 109-first that "The federal government with the producing governorates and regional governments shall undertake the management of oil and gas extracted from current fields provided that it distributes oil and gas revenues in a fair manner in proportion to the population distribution in all parts of the country" , and hence, management of all "future" fields would fall under the autonomy provisions allocated to KRG by the constitution (Hanna, 2013, P148).

Negotiations over a new hydrocarbons law, which was expected a long time ago, have stalled over deep differences about the state's economic role, as well as a struggle between rival nationalisms. Central government is getting the impression that the Kurds pursuing broader autonomy which is becoming a reality in the current security situation with the taking over of armed Sonnies' forces large areas in the middle and northern part of Iraq. To accomplish this, the Kurds seek the right to extract their own oil without interference from a central state with a full control over their mineral resources.

The KRG considers PSCs an indispensable tool for exploration, which is the Kurds' top priority, having had no development in their region whatsoever (ICG, 2008, P.24). Moreover, the Kurds say, PSCs enhance performance: a company will seek to increase its oil intake by pursuing maximum exploration, so Kurdistan will receive more oil to export.

In the aim of harmonizing the central and regional proposal for contracts, risk service contract for exploration, development and production EDP-RSC developed by the Ministry of Oil of Iraq proposed to KRG to replace their PSC which are seriously accused misaligned on most issues. These include (Meurs, 2008, P.2):

- There is no incentive for investors to explore for large low cost fields, the main driver would be to find high cost small fields;
- There is no incentive for investors to have low cost operations, in fact there is a strong incentive to have high cost operations based on poor development plans;
- There is no incentive to achieve a maximum recovery of the oil and gas and in fact a lower recovery could be more profitable to the IOCs; and
- The IOCs have an interest in low oil prices.

On the Technical Services Agreements (TSAs) currently being proposed as a stop-gap measure by the Ministry of Oil but widely criticized recently, the van Muers report points out that these contracts have already been tried in Kuwait for more than a decade with no positive results:

“It should be realized that under Technical Services Agreements, the international oil companies are merely consultants.” It points out that “IOCs do not really have an incentive to give good advice. They receive the same consulting fees regardless of the results of the field production.” (Meurs, 2008, P.21)

On the other side, critics charge that PSCs are the worst kind of con-tracts because they lock in fiscal and legal terms for an extended period – 32 years in some KRG contracts – and freeze the political, legal and economic situation that existed at the time of signature; this could have a long-term adverse impact on human rights and the environment and would seriously encroach on the KRG’s, and Iraq’s, sovereignty (Muttitt, 2008).

### 3.5.2. The new developments in the dispute

In November 2013, Turkey announced the signature of a series of energy cooperation agreements with the Kurdistan Regional Government, and they began loading a cargo of crude oil onto a tanker at Ceyhan port on the south- eastern Mediterranean coast of Turkey on 21 May 2014, Turkish state-owned pipeline operator BOTAŞ A tanker loaded with over one million barrels of crude oil departed on 22$^{nd}$ of May from Ceyhan port towards Europe which was followed by three more tankers.

KRG announced on June 2014 that this is the first of many such sales of oil exported through the newly constructed pipeline in the Kurdistan Region. The revenue from the sales will be deposited in a KRG-controlled account in Halkbank in Turkey and will be treated as part of the KRG's budgetary (KRG, 2014).

The MoO of the GoI announced on 23rd of May that it has filed a Request for Arbitration against the Republic of Turkey and BOTAŞ, seeking to stop the what it calls "unauthorized" transportation, storage and loading of crude oil pumped into the Iraq-Turkey pipeline by the KRG which the last announce it started exporting the stored at Ceyhan to Italy and Germany. The Request for Arbitration was filed today with the International Chamber of Commerce (ICC) in Paris in accordance with the agreements that govern the pipeline and related facilities (MOO, 2014).

In addition to the oil reserves explored in KRG, the very recent takeover of Kirkuk[3] on June, 2014 Baiji refinery, Iraq's largest, on June 18th which produces 170,000 b/d of petrol and other products and Imposition of control of the field Ajil oil near the Hamrin mountains northeast of Tikrit province which is one of the largest oil fields in Iraq, which includes 91 wells produces 2.200 million $ft^3$/d of gas, and there was a plan to develop the field to produce up to 70,000 b/d of oil, which caused an even bigger sensitivity in the relation between central Iraqi government and KRG in concern with the right model to be adopted for oil contracts which will reflect its self on the strength of oil contracts and its enforcement on all Iraqi regions.

Minister of Natural Resources in the Kurdistan Regional Government, Mr. Ashti Hawrami, said at his first visit to Kirkuk that his ministry and the provincial government are planning to increase its exports by eight times at the end of 2015 and double the exports of the region of crude oil produced from the fields of the region and Kirkuk to reach about a million b/d. He expressed the readiness of the region to share the revenue with Baghdad according to new standards (KRG, 2014b).

One more thing to add to the problems that oil companies are facing in Iraq is bureaucracy; they are putting more time and adding extra costs on investment companies. According to the cumbersome rules of operating in Iraq, BP and its partners in the Rumaila Operating Organization – the Chinese state-owned oil group CNPC and Iraq's Southern Oil Company – have to send all big-ticket contracts related to the project to the Iraqi Oil Ministry for

[3] An Iraqi city and governorate that lie atop an oil field holding as much as 13 per cent of Iraq's proven reserves

approval. But in the early months of 2014, for reasons that remain unclear, the ministry has refused to approve a number of critical drilling, construction and well contracts for Rumaila. As a result, BP has had to lay off about 100 contractors hired to carry them out. ENI, the Italian oil major, which is rehabilitating the nearby Zubair field, is another casualty of this bureaucratic tangle (Chazan, 2014a).

## Conclusion

In conclusion, this paper has intrinsically proved the link between security criteria as a causal factor to deteriorating investment environment of Iraqi Economy in general and the role it plays in the patterns of FDI in the Petroleum sector. The first chapter established the Theoretical relationship between FDI and State Fragility, concluding that Political Risk Insurance is one of the main determinant factors affecting it specially in a post-conflict environment and that a possible civil war has a negative effect on investment choices both on location and magnitude that it undermine economic growth directly and indirectly; directly, by destroying lives and property, and indirectly, by diverting resources from productive investment in human and physical capital to that of destructive military activities along with its role in impacts the state's administrative and financial ability for post conflict recovery.

In this paper, the focus of analysis refers to the net inflows of investment in the oil sector with a special consideration into the case study of Iraq. Here we focused on extreme political violence we are experiencing of this country: civil war and transnational terrorist incidents and their effect on petroleum contracts. This is tackled in the second chapter with an introductory look into the Determinants of FDI Flows to Developing Countries risk-return tradeoff on investment in a host economy plays a big role in the decision to invest in a country to go one-step forward to look into oil investment where Foreign Companies seek to build equity and maximize wealth by finding and producing oil and gas reserves at lowest cost and highest returns.

To engage this paper with Investment environment in Iraq, which is in need for FDI due to the weak capital accumulation of its private sector, the third chapter initiated the Iraqi case study, which analyzed the connection between economic conditions, corruption, and terrorism in greater depth and their effect on Iraqi investment environment. This chapter focused on two methods that directly ensued from international criteria, Business Climate Development Strategy (BCDS) and International Country Risk Guide (ICRG) where it defines one of the weaknesses in the business climate in Iraq is the relationship with the Iraqi authorities with International bodies, where there is weakness in the indicators of bilateral investment agreements, and international arbitration and local and regional cooperation to add on the difficulties the investors in this sector are facing and putting in risk any contracts that they reach, the process of improving the investment climate in Iraq. Where we used (ICRG) to provide a financial, political and economic risk analysis where is Iraq assessed with a high risk in many of it points which examined the relationship between political risk with investment environment which was clearly indicated in deterring foreign investment in its oil sector and the changing assessment of western oil companies toward the risks of operating in Iraq which is moving into the wrong direction.

Overall, the implications of this research challenge Iraqi central government should take note of the factors attributing to FDI like resolving the political infighting between competing groups that expresses itself in violent acts like those which examined with KRG. Violence and instability results in local capital flight which requires Iraq to provide investors with incentives to encourage their expatriates return to their original home countries

Although this paper’s critique has uncovered numerous areas of improvement to deal with the many weakening of the Iraqi state institutions and a failure by the GoI to provide the appropriate economic conditions to attract foreign investments along with an unclear and incomplete legal framework, ministries and government entities' slow interaction with rapid changes lack of human experience of management and negotiation, government routine and tight controls, it does not mean to say that it is impossible to improve the conditions that attract foreign investors FDI Patterns in Petroleum sector to increase their oil revenue and utilize the financial and technological capabilities by establishing a clear and integrated strategy for the petroleum industry as a road map for current and future work.

Many needed steps to be taken by GoI, among those are, amending much of the existing legislation and completing new laws and regulations, along with a thorough review to the developmental philosophy of refineries and gas investments to insure granting real incentives to foreign investors, while balancing other goals.

## References


Abadie, A., and Gardeazabal, J., (2008), Terrorism and the World economy, European Economic Review, 1-27.

Aharoni, Y. (2011): Inward FDI in Israel and its policy context. Retrieved from http://www.vcc.columbia.edu/files/vale/documents/Israel_IFDI_Jan_31_11_0.pdf

Alexeev, M., & Conrad, R. (2009). The natural resource curse and economic transition. Duke Sanford School of Public Policy. Working Papers Series SAN09-04. Retrieved from http://sanford.duke.edu/research/papers/SAN09-04.pdf

Alomar, M., & El-Sakka, M. I. T. (2011): The Impact of Terrorism on the FDI Inflows to Less Developed Countries: A Panel Study. European Journal of Economics, Finance and Administrative Sciences(28)

Anyanwu, J. C. (2012): Why does foreign direct investment go where it goes? New evidence from African countries. Retrieved from http://www.aeconf.net/Articles/Nov2012/aef130207.pdf

Aymo B., & Weder B. (1998): Investment and Institutional Uncertainty: A Comparative Study of Different Uncertainty Measures, The World Bank, TECHNICAL PAPER, No. 4 Washington, D.C.

Baek, K., & Qian, X. (2011): An analysis on political risks and the flow of foreign direct investment in developing and industrialized economies. Retrieved from http://faculty.buffalostate.edu/qianx/index_files/PoliRiskFDI_Baek&Qian.pdf

Bannerman, E. (2007). Foreign direct investment and the natural resource curse; what is the relationship to economic development, income inequality and poverty? Do institutions and good governance matter? Retrieved from http://mpra.ub.unimuenchen.de/18254/1/FDINRCECONDEV.pdf

Bodie, Z., Kane, A., & Marcus, A. J. (2009). Essentials of investments (8th Ed.). New York, NY: McGrew-Hill Companies.

Bolnick, B., Greenbaum, A., James, M., & Hendry, K. (2009). Iraq: Economic recovery assessment. USAID. Retrieved from http://www.countrycompass.com/_docs/assessments/Iraq_Economic_Recovery_Assessment.pdf

Brahimi, L. (2007): State building in crisis and post conflict countries. Retrieved from http://unpan1.un.org/intradoc/groups/public/documents/un/unpan026305.pdf

Buccellato, T., & Alessandrini, M. (2009): Natural resources: A blessing or a curse? The role of inequality. Center for Financial & Management Studies. Discussion Paper #98. Retrieved from http://www.cefims.ac.uk/documents/research-91.pdf

Busse M., & Hefeker C., (2005): Political Risk, Institutions and Foreign Direct Investment, Hamburgisches Welt-Wirtschafts-Archive (HWWA), DISCUSSION PAPER no.315

Busse, M., & Hefeker, C. (2007): Political risk, institutions and foreign direct investment. European Journal of Political Economy, 23(2).

Caetano, J., & Caleiro, A. (2009). Economic freedom and foreign direct investment: How different are the MENA countries from the EU. IBusiness, 1(2), 65-74. doi:10.4236/ib.2009.12010

Chang, S-C., (2012): Analyzing the relationship between foreign direct investment and corruption. International Proceedings of Economic Development and Research, Vol. 39. Retrieved from http://www.ipedr.com/vol39/039-ICITE2012-K10020.pdf

Chazan G., (2014a): Baghdad bureaucracy stymies BP’s ambitions, financial times, February 23, 2014. retrieved from www.ft.com/cms/s/0/f1b5ce40-9af1-11e3-946b-00144feab7de.html#ixzz36DNJP46X

Chazan G., (2014b): BP and Exxon evacuate Iraq staff as fighting spreads, financial times on June 18, 2014. Retrieved from http://www.ft.com/intl/cms/s/0/835c4058-f8a9-11e3-befc-00144feabdc0.html#axzz36DHHwMQD

Collier, P., & Anke H., (2000): Greed and grievance in civil wars. Working Paper WPS 2000-18, World Bank, Washington, DC. Published online http://papers.ssrn.com/sol3/papers.cfm?abstract_id=630727

Coyne, C. J. (2010): The economic reconstruction of Iraq, Retrieved from http://www.ccoyne.com/The_Economic_Reconstruction_of_Iraq_-_final.pdf

Dabo, A., Salmon, J., Venancio, M., & Keuleers, P. (2011). Local governance, peace building, and state building in post-conflict settings. A UNDP Discussion Paper. Retrieved from http://uncdf.org/gfld/docs/post-conflict.pdf

Daniel J., (1994) International Petroleum Fiscal Systems and Production Sharing Contracts. PennWell Publishing Company. USA

Del Castillo, G. (2010): Rebuilding war-torn states: The challenge of post-conflict economic reconstruction. Carnegie Council – Speaker series. Retrieved from http://www.carnegiecouncil.org/resources/transcripts/0300.html

Del Castillo, G. (2008): Economic reconstruction of war-torn countries: The role of the international financial institutions. Retrieved from http://www.38.113.83.199/Students/ academics/journals/law-review/Issues/archives/upload/Del-Castillo-final.pdf

Dunning, J. H. and Sarianna M. L., (2008). Multinational Enterprises and the Global Economy. Edward Elgar Publishing limited, 2nd addition.

Egger, P. & Winner, H. (2005): Evidence on corruption as an incentive for foreign direct investment. European Journal of Political Economy, 21(4), 932-52.

Fahad, A., (2011); "The reality of the business climate in Iraq within the framework of the Business Climate Development Strategy of the OECD, Proceedings of the eleventh Scientific Conference/ School of Administration and Economics / University of Mustansiriya

Frankel, J. (2010). The natural resource curse: A survey. Harvard Kennedy School. Retrieved from http://www.hks.harvard.edu/fs/jfrankel/NRCuncorrectdproofs.pdf

Fritz V. & Menocal A. R. (2007): Understanding State-Building from a Political Economy Perspective, overseas development institute.

Jenkins C. & Thomas L., (2002): FDI in Southern Africa: Determinants, Characteristics and Implications for economic growth and poverty alleviation Retrieved from http://www.acp-eu-trade.org/library/files/Jenkins-Carolyn-and-Thomas-Lynn_EN_102002_CSAE-CREFSA_FDI-in-Southern-Africa-Determinants-Characteristics-and-Implications-for-Economic-Growthand-Poverty-Alleviation.pdf

Jones, G. (2010): Multinational strategies and developing countries in historical perspective. Harvard Business School Working Paper. Retrieved from http://www.hbs.edu/research/pdf/10-076.pdf

HANNA G. F., (2013): Assessing Determinants to Foreign Direct Investment in Iraq's Oil and Electricity Sectors: an Exploratory Case Study, PhD dissertation Submitted to Northcentral University, Arizona.

Hewko, J.: Foreign Direct Investment in Transitional Economies (2003): Does the Rule of Law Matter? EAST EURO. CONST. REV. (73), available at http://www.law.nyu.edu/eecr/vol11_12num4_1/ special/hewko.pd

Hodler, R. (2006). The curse of natural resources in fractionalized countries. European Economic Review, 50(6), Hvozdyk L. & Mercer-Blackman V. (2010); What Determines Investment in the Oil Sector? A New Era or National and International Oil Companies, Inter-American Development Bank WP No. IDB-WP-209

IEA, (2012). Iraq Energy Outlook. Special Report. France, Retrieved from: http://www.worldenergyoutlook.org/media/weowebsite/2012/iraqenergyoutlook/Fullreport.pdf

Isham J., Woolcock M., Pritchett L., & Busby G. (2005): The varieties of resources experience: Natural resource export structures and the political economy of economic growth. The World Bank Economic review , Vol. 19, No. 2,

Ghani, A., Lockhart, C. & Carnahan, M. (2006): An Agenda for State-Building in the Twenty-First Century, in: The Fletcher Forum of World Affairs, Vol. 1, No.: 3, 2006, p. 101-123

Kent M. O'Leary (2004): A Business Guide to Political Risk for International Decisions, Part II. International Country Risk Guide, PRS Group Incorporated.

Khachaturian A. (2006): Note, “Are We In Good Hands?” The Adequacy of American and Multilateral Political Risk Insurance Programs in Fostering International Development, 38 CONN. L. REV. 1041, 1062.

KRG, (2014a): KRG statement on first oil sales through pipeline export Retrieved from (http://www.krg.org/a/d.aspx?s=010000&l=12&a=51589

KRG, (2014b): we will double our export, Retrieved from http://www.shafaaq.com/sh2/index.php/news/kurdistan-news/79235-2014-06-26-09-14-43.html

Krogstrup S. & Matar L.,: Foreign Direct Investment, Absorptive Capacity and Growth in the Arab World, graduate institute of international studies, Geneva, HEI Working Paper No: 02/2005

Li, Q.(2006): Political violence and foreign direct investment, Global Strategic Management, Volume 12, 231–255

Liu, Z. (2008): Foreign direct investment and technology spillovers: Theory and evidence. Journal of Development Economics, Journal of Development Economics Vol. 85 issues 1-2. Retrieved from http://www.sciencedirect.com/science/article/pii/S030438780600126X

Louis T. Wells & Ahmed R. (2007): Making Investment Safe, Property Rights and National Sovereignty, Journal of International Economic Law vol. 10.

Manning, R., & Trzeciak-Duval, A. (2011): Situations of fragility and conflict: Aid policies and beyond. Retrieved from http://1818france.org/2011/TrzeciakManning.pdf

Mehlum, H., Moene, K., & Torvik, R. (2006). Institutions and the resource curse. The Economic Journal, 116(508)

MENA-OECD Investment Programme (2010), Investment Reforms in the MENA Region: country progress 2006-2009.

Moloo, R., & Khachaturian A. (2009): “Foreign Investment in a Post-Conflict Environment”, Journal of World Investment and Trade, presented at 2009 Annual Conference of the British Institute of International and Comparative Law volume 10, issue 3-2009. PP 5-13

MOO: The Ministry of Oil of the Republic of Iraq announced today that it has filed a Request for Arbitration against the Republic of Turkey and its state-owned pipeline operator BOTAŞ , Press release Retrieved from http://www.moo-iraq.com/en/index.php?name=News&file=article&sid=321

Multilateral Investment Guarantee Agency. (2013): MIGA in Conflict-Affected Countries, available at http://www.miga.org/documents/conflict09.pdf

Multilateral Investment Guarantee Agency, (1014): available at http://www.miga.org/

Muttitt G.,(2008): Investors rights vs. human rights, the implications of oil contracts in the Kurdistan Region of Iraq, retrieved from: http://www.khrp.org/component/option,com_docman/task,cat_view/gid,42/dir,DESC/order,da
te/limit,15/limitstart,15/

Ngowi, H. P. (2001): Can Africa increase its global share of foreign direct investment (FDI)? West Africa Review, 2(2), 1-22.

Nowaczynski, J., (2013): Security and the Corruption-Terrorism Relationship in Indonesia, Retrieved from http://www.e-ir.info/2013/12/17/security-and-the-corruption-terrorism-relationship-in-indonesia/

Onyeiwu, S. (2003). Analysis of FDI flows to developing countries: Is the MENA region different? Retrieved from http://www.mafhoum.com/press6/172E11.pdf

Organization for Economic Co-operation and Development (2010); "Preliminary assessment of investment policies and promotion in the MENA region", OECD.

Organization for Economic Co-operation and Development. (2011): International engagement in fragile states: are we doing better? Retrieved from http://www.oecd.org/dataoecd/14/14/48697077.pdf

Overseas Privet Investment Cooperation, (2014): Doing Business with us, available at http://www.opic.gov/doing-business-us/overview

Poelhekke, S., & van der Ploeg, F. (2010): Do natural resources attract FDI? Evidence from non-stationary sector level data. De Nederlandsche Bank Working Paper No. 266/2010.

PRS Group Inc., 2014: A Business Guide to Political Risk for International Decisions, Part II. International Country Risk Guide, retrieved from https://www.prsgroup.com/about-us/our-two-methodologies/icrg

Qian, X., Sandoval-Hernandez, J., & Garrett, J. Z. (2012). Corruption distance and foreign direct investment. Retrieved from http://faculty.buffalostate.edu/qianx/index_files/CorDistFDI.pdf

Rathmell A., Planning post-conflict reconstruction in Iraq: what can we learn? International Affairs 81, 5 (2005)

Ross, M. (2012). The oil curse: How petroleum wealth shapes the development of nations. Woodstock, UK: Princeton University Press.

Saif, I., & Choucair, F. (2009). Arab countries stumble in the face of growing economic crisis. Carnegie endowment for International Peace. Retrieved from http://www.carnegieendowment.org/files/economic_crisis_wc_english.pdf

Seldadyo, H., & De Hann, J. (2011): Is corruption really persistent? Pacific Economic Review, 16(2), 196-206.

SHAALAN H. Y., (2012): Economic Feasibility Study for Petroleum Projects (Practical Aspects), Journal of Petroleum Research & Studies, NO.5 – 2012, Retrieved from http://www.iasj.net/iasj?func=fulltext&aId=58879

SHAALAN H. Y., (2014): Petroleum Investment Patterns in Iraq: The Transition Period 2003 – 2012, Journal of Petroleum Research & Studies, NO.???? – 2014, p 29, Retrieved from http://www.iasj.net/iasj?func=fulltext&aId=58879

Shirazi, A., Rodrigues, G., & Karnik, A. (2008). Determinants of foreign direct investment in MENA countries: An empirical analysis. Retrieved from http://ro.uow.edu.au/cgi/viewcontent.cgi?article=1168&context=dubaipapers

Stijns, J. C. (2005): Natural resource abundance and economic growth revisited. Resources Policy, 30(2)

Turner, C. D. (2007). U.S. reconstruction strategy in Iraq. U.S. Army War College. Retrieved from http://www.dtic.mil/cgibin/GetTRDoc?Location=U2&doc=GetTRDoc.pdf&AD=ADA469634

UN's Office for Constitutional Support,: Full Text of Iraqi Constitution, retrieved from http://www.washingtonpost.com/wp-dyn/content/article/2005/10/12/AR2005101201450.html

Van der Ploeg, F. (2011): Natural resources: Curse or blessing? Journal of Economic Literature, 49(2),

Wikipedia: Oil and gas agreement. Retrieved from en.wikipedia.org/wiki/Oil_and_gas_agreement

Wolff S., (2011) : Post-Conflict State Building: the debate on institutional choice, Third World Quarterly, Vol. 32, No. 10, 2011, Routledge - Taylor & Francis Group

World Bank. (2005): Fragile states – Good practice in country assistance strategies. Retrieved from http://siteresources.worldbank.org/INTLICUS/Resources/388758-1094226297907/FS_Good_Practice_in_CAS.pdf

Zhou, Y. (2007): *An empirical study of the relationship between corruption and FDI: With sample selection error correction*. European Trade Study Group 2007 papers. Retrieved from http://www.etsg.org/ETSG2007/papers/zhou.pdf