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MEMORANDUM

June 26, 2007

FROM: Joseph C. Bell
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RE: Iraq Law of Financial Resources

The June 20 draft of the Law of Financial Resources leaves open a number of issues and in some places, at least as translated in the English version, uses terminology to which it is hard to give concrete meaning.¹

The basic points are clear enough: “oil” revenue and external assistance to the federal government goes into an external account and domestic federal revenue goes into an internal account. From these accounts there is a waterfall of payments, first for the sovereign expenditures of Iraq, second for a future generations fund, 17 percent of the remaining balance to the KRG, and the rest to support the activities of the federal government and the departments in the governorates not included in a region.

There are, however, a number of areas where the draft leaves open critical questions or uses language that could benefit from further clarification. Some of these issues may be the result of the English translation and the Arabic draft may be clearer.

“Financial Resources” The key definition of Financial Resources is very open in nature especially as it may apply to national oil companies. It would appear to capture all of the revenue from third-party sales of crude oil by the national oil company (as does the DFI currently for sales by the ministry) with the company being funded from the budget. It does not address what payments if any go into the fund if oil is delivered to domestic refineries. Simply by way of an example the more comprehensive definition of federal oil revenue included in the KRG draft is set out in the footnote.²

¹ Earlier drafts that were circulated were clearer on many of the critical points. See, e.g., KRG May 10 draft.

² “Federal Petroleum Revenue” shall mean all monies payable to a Federal Government from Oil Operations and shall include but not necessarily be limited to all taxation, interest, petroleum royalties, profit petroleum, petroleum signature and production bonuses, participation rights, fees, customs duties,

In addition Financial Resources include external grants, aid and international loans as well as all other revenues of the federal (but not the regional) government. This is consistent with Article 106 of the Constitution.

Direct Deposit. Article 3 provides for external financial resources and oil revenue to be deposited in the “External Account.” This can reasonably be interpreted as requiring direct electronic deposit, but the act could be clearer on the point. Article 3 Fourth provides for the deposit of other federal revenues in “locked” accounts at the regional and governorate level with the amounts to be transferred monthly to the “Internal Account.” One could have provided for direct deposit into the Internal Account without the intermediate step, but this procedure may be more consistent with current revenue collection processes.

Sovereign Expenditures. In the waterfall of payments out of the account what is to be included in sovereign expenditures is not clear. It could be interpreted to include only sovereign debt obligations and obligations pursuant to UN resolutions, but that would mean that national defense and other national obligations such as funding the national oil company would have to be funded by the federal government from funds available only after the 17 percent allocation is made to the KRG. Presumably this was not intended but the draft would benefit from clarification of this point. It is also not completely clear in the English version whether the conditions of the remaining part of the section, e.g., agreement with the governments of the Regions and the Governorates not organized as regions, apply to sovereign expenditures. The better reading of the English version is that the conditions do not apply, but that would also benefit from clarification.

Strategic Projects. Strategic projects are included in the first distribution tranche but are subject to two conditions. The first is agreement with the Regions and the Governorates. This on its face would allow a single governorate to block expenditures on a strategic project thereby giving each individual governorate significant leverage over national activity. Of equal concern is the condition that such expenditures not impact the “balance and needs of the governments of the Regions and the Governorates which are not organized in a region.” There is nothing in the law indicating who makes that determination, e.g., the Ministry of Finance, the Council of Representatives. Thus a critical element in the distribution chain is left undefined and subject to challenge.

Federal Budget. In the absence of any further definition in the law, it would appear that the decisions regarding amounts to be allocated to sovereign expenditures and strategic projects would be determined by the Council of Representatives through the adoption of the Federal budget. Pursuant to Article 3 Third withdrawals from the accounts are to be

forward oil sales, the sale of revenue rights, and, where petroleum is received by the Federal Government in kind, the International Market Price of that petroleum, as well as any item defined as “Petroleum revenue” and “Petroleum export revenue” in the Financial Management Law, and in the cases of INOC, any item which would be Federal Petroleum Revenue if payable by a private entity, any Federal income tax, any royalty payment, and any monies received from the sale of petroleum in excess of the amount that INOC is permitted to receive in accordance with Article 5E Section First of the Oil and Gas Law, and any monies received by SOMO.

based on instructions by the Prime Minister and the Minister of Finance “according to the Federal budget of the State.”

Dual Accounts. Although the law appears to envision that both the external and internal accounts will be fully distributed each month, there is nothing indicating any priority of the use of external and internal resources in satisfying the distributions mandated pursuant to Article 4. This may not be a problem in practice, but could become significant if convertibility of domestic currency is restricted.

Mid year Adjustments. Article 4 Third appears to provide for mid-year adjustments in the budget to be reflected in subsequent distributions. Instead of referring to the budget, however, reference is made to a completely undefined “adjustments . . . in accordance with constitutional measures.”

Account Sweep. Based on earlier drafts and discussions, I believe that both the internal and external accounts each month will be fully distributed each month. The law, however, is only explicit on this point with respect to the KRG. For transparency and administrative facility and consistency it would make sense to also have the distributions to the federal government and the future fund account once established also be made on a monthly basis.

Allocation of Shortfalls and Surpluses. Under Article 4 Second, the transfers to the KRG are specifically limited to its share of actual receipts. The sharing rule in case of shortfalls could be subject to two interpretations. The first would require all category of expenditures including sovereign expenditures and items above the distribution to the KRG to be proportionately reduced. The second, and preferred reading, would share any shortfall or surplus between the KRG and the federal government after payment of the priority categories. This was explicit in certain earlier circulated drafts.

Monitoring of Regional Budgets. Article 5 provides procedures for implementing and monitoring federal budget allocations. No similar provision exists for the KRG.

Independent Commission Membership. The appointing authority of the three employees with the rank of minister and deputy minister to serve on the independent commission is not clear. The implication is that they are appointed by the federal government but even if that is the case one still needs to designate the appointing authority within the federal government. The commission membership is also seriously over weighted to the governorates not included in regions, each of which is entitled to a representative (again with no clarity as to the appointing authority).

Transparency. Article 6 provides for a “public” annual report by the independent commission and has a general injunction in Article 6 Sixth that the Commission is to “ensure transparency and disclosure in financial operations in accordance with international accounting standards and the extent of their applicability to all accounts mentioned in Article 3 [the external and internal accounts, the locked accounts for receipt of federal resources, and two accounts for the KRG]” While this expresses some general

intent, the provision is at once too vague and too limited. First, international accounting standards relate as to how particular items of expense, income, etc. should be recorded, but do not in themselves create standards of transparency except as they dictate what items public companies must disclose in their public financial statements. Secondly, it is unclear what the words of limitation “to the extent of their applicability” are intended to mean. The article also provides for additional information to be provided the Council of Representatives and other governmental bodies. Such information may be intended to be public as well, but there is nothing in the law that specifically requires that such information be made public; not is there any mechanism for assuring the actual distribution of such public information. For instance, the Commission or the governments could be required the information, both summary reports but also the underlying information, on a web site.

The provisions in Article 6 appear to be condensations of ideas on transparency in earlier drafts, e.g., the KRG draft of May 10, but the fuller statement and clarity of the earlier drafts would be preferable given the central importance of transparency to give all parties comfort that the law is being fully and fairly implemented.