OSI

REVENUE WATCH
REPORT NO. 4

Controlling Iraq's Skies:

The Secret Sell-off of Iraq's Air Industry

In this report, part of a series on the restructuring of Iraq's economy, Iraq Revenue Watch looks at the national air transport sector, presently under foreign authority[I]. The report examines how Iraqis can regain control of this sector and its revenues. The official story is that American consultants are working to launch a modernized national carrier while the industry remains mired in Saddam-era litigation. IRW has discovered, however, that behind closed doors a contract has already been signed, selling off 75 percent of Iraq's air transport sector to a single family without competitive bidding or public notice. This report serves as a cautionary case study for other state-owned enterprises whose fates are being determined in the chaotic aftermath of war.

Introduction

After the fall of Saddam Hussein and the lifting of nonmilitary United Nations sanctions, Iraqis expected that the surge of reconstruction activities and the opening of the country would prompt a significant rise in air traffic, providing opportunities for the revival of the air transport sector. Coalition Provisional Authority (CPA) air transport consultants at the Middle East Aviation Finance Conference recently made the case for increased investment in the air transport sector, arguing that the millions of Iraqis abroad after years of exile would now want to visit their homeland, guaranteeing strong traffic growth in the future.

But the reality has been different. While the CPA and the Iraqi Governing Council formally have halted privatization, secretly the selling off of Iraq's air industry is going forward.

Iraq Revenue Watch has obtained a confidential document that reveals plans to privatize Iraq's air transport industry despite the CPA's recent pledge to postpone privatization until a sovereign Iraqi government is in place. The powerful Khawwam family, which had close ties to Saddam's regime, is set to assume control of 75 percent of Iraq's air transport industry—bypassing any public bidding process. The deal, brokered by a senior official with the Ministry of Transport, would include the assets of Iraqi Airways, the national carrier, which at the same time is seeking to revive its operations. U.S. carriers are reportedly looking to partner with these post-war oligarchs-in-the-making.

This agreement is indicative of a larger trend. The CPA has turned a blind eye to insider deals, threatening to create a new class of oligarchs in post-war Iraq. The country risks following a similar path as Russia, where rapid mass privatization in the early 1990s transferred valuable state assets at below market prices into the hands of individuals well-connected to party structures. Fearing a possible re-nationalization of their cheaply acquired companies, many new oligarchs found it more profitable to strip and sell the assets rather than investing and building them up.[2] They used their wealth to block government reforms that might constrain their actions.[3] Russia's experience makes clear that privatization should not take place without first developing regulatory institutions.

The CPA risks violating articles 53 and 55 of the Hague Convention, which require occupying powers to protect the capital of the "public buildings, real property, forests, and agricultural works belonging to the hostile State." They must administer these according to the rules of usufruct—they may use property belonging to another as long as it is not altered or damaged in any way. As the CPA's own legal counsel Scott Castle said recently: "We recognize that any process for privatizing state-owned enterprises in Iraq ultimately must be developed, adopted, supported and implemented by the Iraqi people."

These issues raise serious questions about the process of restructuring Iraq's economy and require an official investigation by the newly formed International Advisory and Monitoring Board, the Iraqi Governing Council, and the Office of the Inspector General for the Coalition

Provisional Authority, who is yet to be named. Iraq's air transport industry currently is being run by foreigners at Iraq's expense, even though Iraq has a grounded but potentially operational national carrier and over 2,000 staff who have been laid off and want to resume work. Iraqi Airways employees recently staged demonstrations in the streets of Baghdad, demanding to be reinstated and the return of their airport to Iraqi control.

The following brief summarizes the recent history of Iraq's air transport industry, examines the secret developments in the country's civil aviation sector, and finally, offers recommendations on how to restore control of Iraq's airspace and air revenues to the Iraqi people.

Leaking Revenue

The history of Iraqi Airways mirrors that of Iraq itself. After Iraq invaded Kuwait in August 1990, the UN Security Council imposed sanctions on Baghdad, which included a ban on operating passenger or cargo flights. During the 1991 Gulf War, Iraqi Airways moved its 17 jets to secret locations in Iran, Tunisia, and Jordan to save them from damage. Until sanctions were lifted 13 years later, these countries were required to keep Iraq's planes at their airports, entailing significant expense. They now refuse to release the planes without compensation. The repatriation of the planes is further complicated by lawsuits filed by the Kuwaiti government, which claims that components of the planes grounded in Tunisia had been plundered by Saddam's troops when they invaded Kuwait. Iran, which was at war with Iraq from 1980 to1988, has repeatedly insisted that Iraq pay $200 billion in war damages, and says that it considers the commercial and military planes held in its territory part of these reparations.

While the value of Iraqi Airways' fleet is seriously in doubt, aviation experts believe the flying routes entrusted to it by the state could yield a profit for the airlines.

Iraq's airports are state property, and traditionally have been run by the civil aviation authority, a subdivision of the Ministry of Transport. In addition, ground support vehicles, maintenance facilities, and repair and fueling facilities are the property of the state and have been run by Iraqi Airways, a separate subdivision of the Ministry of Transport. Royal Jordanian airlines, the only commercial airline flying into Baghdad, currently is allowed to use all these assets. The CPA is also using the civil aviation authority's property, and Iraqi Airways' support equipment and facilities without compensation. The staff salaries and costs of office maintenance for Iraqi Airways are being paid from Iraq's national budget, while the lucrative contracts to service the working airports have been given to foreign companies.

The country's three major international airports (Baghdad, Basra, and Mosul) are all under U.S. military control with minimal Iraqi personnel. DHL cargo delivers to Baghdad and Mosul. Kellogg, Brown & Root, a subsidiary of Halliburton, handles Baghdad airport security. Skyline Air and Logistic Support, a Washington-based company, was awarded a $17.5 million contract from the U.S. Agency for International Development (USAID) to manage the airports. The airports' reconstruction is being run by Bechtel Corp. Royal Jordanian Airlines is not paying fees to use Baghdad's airport, although Saddam's regime charged $700 per plane. Meanwhile, Iraqi airspace has become an attractive flyover destination for long-haul international flights, which do not have to pay for its use. Although the idea of flyover fees is relatively recent, the United States and most other countries have come to charge them as a matter of course. The CPA in August said it will collect $750 from each airliner that transits Iraq's airspace, but it is unclear whether these fees have been collected on Iraq's behalf—they do not appear in the accounts of the Development Fund for Iraq. The CPA, however, easily could secure the flyover fees. It has declined to answer queries about them.

If, as it appears, the CPA has failed to get flyover fees, Iraq's civil aviation service is losing a valuable source of revenue. The Iraqi government is supporting the air transport sector with Iraqi funds, but earning nothing from the use of its facilities. Iraq's air transport industry could be a viable economic prospect, in terms of revenue and employment generation. At the same time, opening Iraq's airports to greater traffic would be a vital step in connecting Iraq to the outside world, particularly in resuming trade.

Security is a legitimate concern in weighing whether to allow increased traffic, non-military carriers, and local Iraqi workers at Iraq's s airports. According to several aviation experts, the air threat in Iraq, particularly around Baghdad, is said to be increasing, specifically from manpads (man-portable air-defense missiles). However, Airserv, DHL, and Royal Jordanian are already using Baghdad airport on a regular basis and, according to USAID, there are up to 50 non-military flights a day in and out of Iraq—making it difficult to justify a claim that security concerns require that Iraqi Airways remains grounded.[4] Iraqi Airways is seeking the right to lease planes to fly along the same routes as the foreign carriers, and to be paid for the use of their equipment by foreign carriers. There are more than 70 airports in Iraq, some very small that pose low security risks, and others that can handle international flights (Basra, for example) that are reasonably secure. It is possible that an Iraqi-controlled carrier could operate with acceptable risks out of these facilities, especially if it were given the same protections afforded the international carriers now operating in Baghdad.

A New Carrier Hijacked by Saddam-Era Investors

Plans to launch a new Iraqi national airline in 2004 were crafted by the well-respected U.S. consulting firm Simat, Helliesen, and Eichner (SH&E). It is unclear whether the recent contract signed by the Ministry of Transport and the Khawwam family are part of that design. Frank Willis, the CPA official in charge of aviation matters in Iraq, has said these plans are now ready for execution.

SH&E, which examined civil aviation dynamics in Iraq, recommended the participation of a regional carrier as well as code-sharing arrangements with an international airline for the new Iraqi airline. The new Iraqi airline, according to SH&E, might be part of a regional group of carriers that could include Royal Jordanian, Middle East Airlines, and Syrian Air. The US airline Delta has been mentioned as a possibility for the international airline. This new airline will not, according to SH&E, be a resurrection of Iraqi Airways, which it views as too embroiled in Saddam-era legal disputes to be worth salvaging. It is unclear whether the CPA and SH&E participated in brokering this deal to establish a new Iraqi carrier, or if the Ministry of Transport and the civil aviation authority were acting on their own accord.

IRW has obtained a confidential document which reveals that Iraqi Airways' assets may end up in the hands of the powerful Khawwam al Abdul Abbas family, which, according to local news reports, had close ties with the Saddam regime and were oil smugglers under sanctions. Iraqi Airways' planes, support facilities, and route awards were sold without public bidding in a deal where Iraqi Airways was not even represented. The contract had not been made public as of January 2004.

The document is a contract signed on December 2, 2003, to establish a joint venture named al Iraqiyya Air. The contract was signed by the Ministry of Transport, represented by the general director of the civil aviation authority, M. Fakher Fareg Mohammed, and three members of the Khawwam family. The ministry's share in the company's capital of $25 million will be less than 25 percent (article 5). This share would be paid from the assets of Iraqi Airways. It is unclear what role, if any, the CPA has played in the process of negotiating and signing this contract. Since the CPA has been working with SH&E to revamp Iraq's air industry and launch a new carrier in cooperation with the Ministry of Transport, it seems unlikely that a contract signed by a representative of the Ministry of Transport to establish a new carrier would take place without the knowledge of the CPA, and indeed may be part of those plans. If the Ministry of Transport has signed a contract selling off Iraq's state assets and launching a new aviation venture without the knowledge of the CPA, this raises serious concerns about the CPA's ability to manage Iraq's economy.

Since this contract has been signed with the Jordanian Alia Co., ownership of the airline is also a potential problem. The ownership structure of this new airline plays a key role in determining the nationality of the airline in the eyes of other countries. When countries make bilateral air service agreements, each government has the right to accept or reject the various airlines able to fly under those rights. In the future, any country negotiating Iraqi route rights with the government of Iraq could refuse to accept this new air carrier, al Iraqiyya, on the basis that it is not sufficiently Iraqi. If even 26 percent of the air carrier was held by a Jordanian company, despite the Iraqi nationality of its owners, many countries would likely consider the air carrier Jordanian. Hence, the part-Jordanian ownership of this new airline could very well jeopardize its rights to fly to certain countries.

The contract also stipulates that the Ministry of Transport must hand over to this new company all royalties and rights acquired through past agreements with any international carrier, company or government. Moreover, the contract protects the new owners share by prohibiting any new entry or participation into the newly established carrier, unless approved by two-thirds of Iraq's general assembly. The new carrier does not have to pay any debts, obligations, compensations or salaries owed to Iraqi Airways (article 7), which is a matter of concern since no representatives from Iraqi Airways were involved in negotiating these concessions. Finally, the Ministry of Transport takes on the sole burden of compensating all other parties for any loss due to sabotage that is not covered by insurance (article 8).

An expose in *al Mu'tamar*, the Iraqi National Congress (INC) daily newspaper, reprinted documents from Saddam Hussein's presidential office outlining the Khawwam al Abdul Abbas family's dealings with the former dictator.[5] The family was said to run two front companies, al Huda and Alia, for Saddam's regime. Al Huda was a partner of the Iraqi State Oil Marketing Organisation, and was implicated in the smuggling of oil under the sanctions. U.S. forces in the Gulf in 2000 also seized an oil tanker owned by the Khawwam al Abdul Abbas family. The newspaper printed photocopies of documents disclosing how this family was involved in oil smuggling, bribing of Iraqi and non-Iraqi officials, and importing expired food items to Iraq under the oil-for-food program.

Out in the Cold

As of January 2004, no new national carrier has been launched, and Iraqi Airways' employees report no changes. Official statements from the CPA and the Iraqi Governing Council about Iraq's air industry are ambiguous. Royal Jordanian's Amman-Baghdad charter flights currently provide the sole commercial service in and out of the Iraqi capital, along with Airserv, a charter service with two daily flights of no more than 10 passengers each. The CPA has suggested that the new airline will not be a revamped version of Iraqi Airways.

Regardless of the CPA's position, Iraqi Airways' management on May 30, 2003, announced it plans to resume international service. Under Iraq's existing laws, Iraqi Airways owns the planes, the commercial name, and the crews' contracts as part of its legal status. Despite CPA statements indicating that Iraqi Airways is not being restored, Iraqi Airways' website gives the impression that it is ready to do business. There are rumors of a possible future deal between Iraqi Airways and the European Airbus Company, in which the Iraqi company would acquire Airbus jets, most likely for use on domestic flights. This is confusing, given that Iraqi Airways is currently struggling for the right to run a few small flights and lease small planes, which the CPA and the Governing Council will not grant. Airbus and its rival plane manufacturer, Boeing, have both expressed interest in Iraq's air transport sector, however, so it is quite possible that Airbus is attempting to promote a future for Iraqi Airways, while the CPA and Boeing envision an alternate Iraqi flagship carrier.

In a memo from Iraqi Airways to the Governing Council, the company complained that since the fall of Saddam's regime it has been deprived of financing and support that it could have received through the reconstruction funds allocated to the Ministry of Transport.[6] Iraqi Airways was denied these funds under the pretext that its legal status is that of a "self-financing" company.[7] The staff of Iraqi Airways in December 2003 was informed that the next month the state would pay salaries and that as a self-financing company, Iraqi Airways now had to find the resources to cover its costs. After an uproar from employees at dozens of such self-financing state enterprises, the CPA's ultimatum has been extended until May 2004. Until then the central Iraqi budget will continue to provide for the salaries of those employed in self financing enterprises.

Although it is expected to become self-sustaining, Iraqi Airways has not been given the freedom to manage its business as a self-financing company, and the various contracts that it could have fulfilled have instead gone to foreign companies. The memorandum to the Governing Council requested that Iraqi Airways be allowed to use other, potentially more secure airports in Iraq, such as Mosul, Basra, Najaf, and Arbil, rather than confining the use of Baghdad airport to certain foreign carriers. Although Baghdad's airport is currently classified as vulnerable to hostile military operations and therefore unsafe, it would be possible for Iraqi Airways to use the numerous other airports in Iraq. Kerbala, for example, is only 110 km from Baghdad, and capable of running domestic and international flights.

Iraqi Airways had requested the right to lease commercial planes to run flights from Iraqi airports other than Baghdad's to transport the tens of thousands of Iraqis going to Mecca for the Hajj. The Governing Council and the CPA rejected this offer and gave the business to an American-Kuwaiti company instead. The concern is that Iraqi Airways is being deliberately grounded to keep down the price that its future buyers will pay. Other non-Iraqi companies are now hiring and leasing planes, but the CPA has prevented Iraqi airways from doing so. Under Iraqi law, a self-financing state corporation can conclude agreements and raise money, which Iraqi Airways was seeking to do in order to lease planes for this year's pilgrimage.

Conclusion

While IRW is not arguing for a new national carrier or for Iraqi Airways to be revived, it is critical that Iraq begins to receive the revenue and trade benefits of a revived air transport industry. Whatever air carrier emerges cannot resume operations without a sovereign Iraqi government reaching agreements with neighboring countries on its various air carriers' legal status, which includes publicly resolving the status of Iraqi Airways and its stranded assets abroad. These are not impossible tasks, but accomplishing all of the above requires that the CPA and the Governing Council are transparent about their intentions for the industry.

Any privatization conducted under the auspices of the CPA should be subject to a legal analysis. A Congressional Research Service report recently asserted that the sale of state assets by an occupying power violates the 1907 Hague Convention on the laws of war, and that Iraqi law still on the books—which the CPA is allowed to change only if necessary—strictly limits foreign investment.[8] Any plans to go ahead with privatization by a sovereign Iraqi government should be preceded by a valuation of the company to determine its worth and the solicitation of multiple bids before any contracts are signed.

The CPA is required by United Nations Security Council resolutions to act in the best interests of the Iraqi people and to operate transparently. Yet recent actions do not support those aims. Ensuring the ability of potentially competitive Iraqi air carriers to contend with foreign carriers and airline services is in the best interests of the Iraqi people. Specifically, the ability of Iraqi Airways to be truly self-financing is undermined by the use of its machinery and the damage to its property that occurred when the airport was taken by the Coalition forces with no compensation to the company.[9] Similarly, private deals to transfer control of Iraqi Airways assets to insiders who profited handsomely under the regime of Saddam Hussein undermine the goal of transparent and open competition. Below are several recommendations intended to ensure the viability of a future Iraqi-based carrier.

1. The current contract—yet to be disclosed—should be frozen per an examination by legal experts to determine its validity. A full investigation into the contract's awarding procedures by the yet-to-be-appointed CPA Inspector General as well as the appropriate Iraqi counterpart should commence as soon as possible.

2. Any plans to privatize Iraqi Airways should be preceded by an estimate of the company's fair market value. Multiple bids should be sought. Representatives from the former national carrier (Iraqi Airways) and civil aviation authority should be full members in any negotiations regarding the possible licensing of private carriers or the privatization of their activities.

3. It is unrealistic for the CPA to demand that Iraqi Airways be self-financing while denying the company the business basis on which to achieve this. Moreover, with the United States and other nations increasingly supporting their own airline industries in response to increased security needs in the post-September 11 world, it is not unrealistic to ask the CPA or the Governing Council to help the airline get back on its feet. At a minimum, the CPA must pay the Ministry of Transport compensation and fees for the use of and damage to its facilities for the nine- month period that followed the U.S. occupation of Iraq. Charging reasonable flyover fees for use of Iraq's airspace is a resource that is not being capitalized on at present. As for reparations, American officials have acknowledged that Coalition troops vandalized and looted the former Saddam International Airport upon arrival, and U.S. estimates of the cost of the damage and theft "begin at a few million dollars and go as high as $100 million."[10]

4. If airports are deemed safe enough for foreign airlines or charters to fly passengers or cargo, they should be opened to Iraqi Airways to fly as well. Iraq's airports and their facilities and equipment are the property of Iraq's civil aviation authority. The staff of this authority should be allowed to run Iraq's property and gain revenues from these operations.

APPENDIX

The Hague Convention[11]

Hague Convention IV (October 18, 1907) Convention Respecting the Laws and Customs of War on Land

Relevant Clauses:

Art. 53. An army of occupation can only take possession of cash, funds, and realizable securities which are strictly the property of the State, depots of arms, means of transport, stores and supplies, and, generally, all movable property belonging to the State which may be used for military operations.

All appliances, whether on land, at sea, or in the air, adapted for the transmission of news, or for the transport of persons or things, exclusive of cases governed by naval law, depots of arms, and, generally, all kinds of munitions of war, may be seized, even if they belong to private individuals, but must be restored and compensation fixed when peace is made.

Art. 55. The occupying State shall be regarded only as administrator and usufructuary of public buildings, real estate, forests, and agricultural estates belonging to the hostile State, and situated in the occupied country. It must safeguard the capital of these properties, and administer them in accordance with the rules of usufruct.

Notes

1. This report has benefited from industry expertise provided by Michael Lehrman, Airline Transport Pilot, Federal Aviation Administration; and MBA, Harvard University.

2. Bernard Black, Reinier Kraakman, and Anna Tarassova, "Russian Privatization and Corporate Governance: What Went Wrong?" *Stanford Law Review*, Vol. 52, pp.1731-1808, 2000.

3. Ibid.

4. USAID Accomplishments in Iraq: Airports, http://www.usaid.gov/iraq/accomplishments/airports.html

5 *al Mu'tamar*, January 5-7 and January 13, 2004.

6. Memorandum by the acting General Director of the Iraqi Airways to the Governing Council on November 15, 2003.

7 Like the centrally planned economies of Eastern Europe and Russia, Saddam's government cut subsidies to some state enterprises, so that they would have to make a profit to stay afloat. These enterprises, including Iraqi Airways, were classified as "self-financed."

8 *Associated Press*, Experts: "Shock-Restructuring of Iraqi Is on Shaky Ground," NewsMax.com Wires, November 17, 2003.

9 See Simon Robinson, "Grounding Planes the Wrong Way," *Time*, July 14, 2003. Robinson goes on to note specific damage to Iraqi Airways assets: "The airplanes suffered the greatest damage. Of the 10 Iraqi Airways jets on the tarmac when the airport fell, a U.S. inspection in early May found that five were serviceable: three 727s, a 747 and a 737. Over the next few weeks, U.S. soldiers looking for comfortable seats and souvenirs ripped out many of the planes' fittings, slashed seats, damaged cockpit equipment and popped out every windshield."

10 Ibid.

11 http://www.lib.byu.edu/~rdh/wwi/hague/hague5.html

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Iraq Revenue Watch monitors Iraq's oil industry to ensure that it is managed with the highest standards of transparency and that the benefits of national oil wealth flow to the people of Iraq. Iraq Revenue Watch complements existing Open Society Institute initiatives that monitor revenues produced by the extractive industries.

In many parts of the world, the lack of proper stewardship over oil resources has resulted in corruption, the continued impoverishment of populations, and abuses of political power. By prompting governments to tackle these problems early, the Open Society Institute hopes to help Iraq avoid this plight.

The Open Society Institute currently supports a recently launched initiative, Caspian Revenue Watch, which monitors the development of oil production in the Caspian basin. The goal is to promote transparency, accountability, and public oversight in the management of oil and natural gas revenues.

Iraq faces even greater challenges than the Caspian region. If Iraq is to become an open, democratic society it will need to develop transparent accountable institutions for ensuring honest management of oil revenues.

There is an urgent need for Iraq Revenue Watch given the current occupied status of the country. The Coalition Provisional Authority and the Iraqi Governing Council should establish rules that ensure complete transparency regarding Iraqi oil revenues. So doing will foster a stable, democratic Iraq, and will protect the Coalition Provisional Authority from charges of misappropriation during this period of trusteeship over Iraq's reconstruction.

The **Open Society Institute**, a private operating and grantmaking foundation based in New York City, implements a range of initiatives throughout the world to promote open society by shaping government policy and supporting education, media, public health, and human and women's rights, as well as social, legal, and economic reform.

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