Debating SOMO' Transformation

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New important developments pertaining to or initiated by Iraq Oil Marketing Company-SOMO surfaced during the last few months; they seemed to be an integrated components of what was revealed as SOMO unstoppable transformation. They are: Partnership with IOCs in activities outside Iraq; Offering crude oil through regular spot/auction-trading; Contemplating oil-hedging and Change of "marker crude" in the pricing formula for Asian market only.
These initiatives could have real, effective and far-reaching consequences in both directions- positive and negative. Thus, serious, evidence-based and professional debate is urgently needed to address all matters relating to SOMO and its unique status not only for the petroleum sector but also for the entire national economy; signs of discontent with SOMO began to show visibility and generate impacts.
In this brief contribution, our Monitoring, Analyzing and Reporting-MAR (an ongoing activity covering Iraqi petroleum sector), analyses, first, these new four initiatives and highlights many key questions that have to be addressed and specifies critical issues that require further investigation. That is followed by discussing transparency, as necessary condition for SOMO transformation, and the paper ends with concluding remarks and suggests the launching of SOMO Transformation Debate and convening a special workshop.

1-Partnership with IOCs in external activities

During SOMO's regular meeting of the price setting "Ministerial Committee" held on 10 November 2016 the Minister of Oil suggested that SOMO should "explore the possibility to find other alternatives for marketing crude oil and petroleum products and participate in projects and new partnerships in addition to have offices outside the country". By 19 December 2016, the Council of Ministers approved recommendation from its Energy Committee authorizing SOMO to go ahead in the "agreement of partnership work" with the Russian company Litasco- Lukoil's international marketing and trading arm.
Obviously, there must have been much discussions and negotiation between SOMO-Litasco prior to 10 November 2016, while SOMO provides nothing, publically, on these talks with Litasco.

Iraqi and international media sources revel that SOMO-Litasco new venture, LIMA Energy, begun assembling its team working at the Dubai Multi Commodities Centre (DMCC). From SOMO side, 10 of its staff, including its head of shipping, could be seconded to Lima Energy, but no information was available regrading Litasco' staff.

Apart from the above neither SOMO nor the Ministry of Oil provides important and essential information on this partnership. Also Ministry reports on the recent visit of the Oil Minster to Moscow, at Lukoil invitation, made no reference to LIMA.
Also, nothing disclosed regarding the main provisions of the agreement between SOMO and Litasco; Ownership and management structure of the company- LIMA Energy; legal framework and governing law; company article of association; matters relating to auditing, accountability; economic feasibility and justification. These are only a few examples of basic issues that should be assessed thoroughly and factually.
Therefore, it is an obligation on SOMO and on the Ministry to disclose all information, data, documents, studies and alike relating to these issues regarding LIMA and the "agreement of partnership work" with the Russian company Litasco.

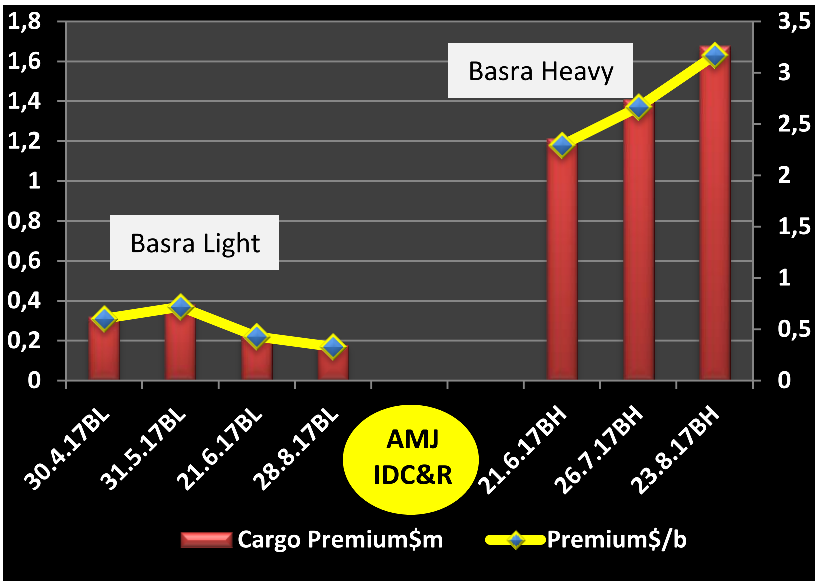
Without such information it would be difficult to assess the viability of the joint venture from SOMO and Iraq interests' point of view.
SOMO, as a public company, might have the mandate to conclude such a joint venture under Public Company Law 22 of 1997. Also this cooperation opportunity could very well bring advantages to and prove to be beneficial to SOMO in many aspects. Nevertheless, there are strong premises to argue, as elaborated latter, that SOMO is much more than a public company and, thus, these "external" activities should not be considered as "company matters"; they are not. But even if they are, then full transparency becomes a must to assess whether such an act complies with the Constitutional principle of "best interest for the Iraqi people". Finally, one could argue that if this joint venture is beneficial to SOMO and to Iraq, why then it is kept in secrecy!?

<u>2- Monthly crude oil auctions or spot-trading</u>

The second development, which seems closely linked to the first one, is the declared readiness by SOMO to offer for "spot-trading" two cargos of 1 million barrel each per month. The plan, as stated by SOMO DG, covers Basra Light, but if the operation succeeds over the next two or three months, then SOMO may increase the quantity or include Basra Heavy. That actually what has been done and the auctions were at Dubai Mercantile Exchange-DME.

Based on DME data, SOMO has between 30 April (for June loading) and 28 August (for October loading) 2017 sold 14 million barrels/mb divided between Basra Light and Basra Heavy at 8mb and 6mb respectively. 2 million barrels were auctioned in each of April, May and July while 4 million barrels were auctioned in each of June and August.
Basra Light cargos were bid at a premium ranged between 17 Cents to 31 Cents a barrel over SOMO' official selling price- OSP for the corresponding two months future loading; giving an average premium of 26.8 Cents/ barrel.
Basra Heavy gained much higher premium ranging between $1.18/b and $1.63/b over SOMO's OSP, giving an average premium of $1.393/b.
From these premiums SOMO generated extra revenues of $10.5 million (the red columns) over its OSP for the corresponding future loadings. The following chart exhibits these auctions

Chart 1: SOMO Auctions at DME (April-August 2017)



Source and notes on Chart 1: compiled by the author based on DME data. Premium (yellow curves) is in US Dollar a barrel and reads on the left-side of the chart; Cargo premium (red columns) is in total million US Dollar per each cargo and reads on right-side of the chart. Basra Light auctions are on the left part while Basra Heavy auctions are on right part of the chart.

Undoubtedly, these auctions have many advantages for SOMO and for Iraq.

First, such premiums or price-differential between "auction" and "Term-Contracts" means sizeable extra revenues (estimated as mentioned above at $10.5 million so far), especially at current fiscal crisis in the country;

Second, they provide SOMO with new "marketing flexibility";

Third, there is an indirect benefit as well in terms of "learning curve" in case SOMO decides, as mentioned above, to deepen such auctions, by magnitude or frequency or both;

Fourth, they could provide more and direct market-based indicators that could be used to refine and enhance the validity of price setting modes operandi of the "Ministerial Committee", among others.

But these benefits should not divert the attention away from what such price–differentials could cause or imply and what questions they actually raise, some of them are highlighted bellow.

First, media sources gave the impression that these offerings were done by LIMA, though DME refers to SOMO only. If LIMA was involved, then it is important to know the "net return" for Iraq from these premiums post all deductibles such as LIMA operating cost, DME fees (at 1.5 cents a barrel), salaries and allowances of LIMA staff (Iraqis, Russians and others) and Litasco's share, among others? And why Litasco benefits from Iraqi oil only? SOMO has to provide clear statement and information if LIMA was involved in these auctions.

Second, why, in SOMO view, such price-differentials occur and how sustainable are they? But most importantly, does price-differential indicate "wrong" or "inaccurate" OSP formula and setting process, which practically means extremely high loss of revenues?

And are “correction measures” possible to prevent loss of revenues, and if so why such measures have not been taken? Case in point that causes concerns and requires deep assessment by SOMO is the increasing magnitude of premium or price-differential of Basra Heavy cargos offered in June, July and August auctions from $1.18/b to $1.37/b and to $1.63/b respectively (the yellow upward curve); but opposite pattern exist, since second auction of 31 May for Basra Light when it declines from 37Cents/b to 22Cents/b and to 17Cents/b for May, June and August auctions respectively (the yellow downward curve). Also, how could, or should, these premiums, be used to reexamine the validity of OSP formula and adjust it accordingly?

Third, do auctioned shipments adhere to the same conditions applied to term-contracts by specifically should go to the destine refineries in the Asian market and use vessel-tracking technologies accordingly, or they could be sold to “oil traders”, against SOMO’s declared marketing and contracting practices? And why the names and nationalities of the auctioned buyers are not disclosed?

Fourth, considering the fact that Iraq does not have spare production and export capacities, does SOMO’ auction actually means SOMO is competing with itself? Could this competition eradicate SOMO’s image and reputation in the eyes of its long standing IOBs through the usual term-contracts, which could also leads to risking market share? And, if such thing occurs what then are the practical measures to prevent such self-inflicting damages?

Fifth, it is probably relevant to write a few words on DME oil auctions and SOMO’s contribution in these auctions.

DME “Historical Data” indicates 10 auctions only within 20 months; the first was on 4 January 2016 and the last was on 28 August 2017 with a total of 16.6 million auctioned barrels. Two auctions, of one million barrel each, of “Oman Crude Oil Blend” were in 2016 while the rest auctioned in the first eight months of 2017.

For the entire 20 months (January 2016-August 2017) SOMO counts for 7 of the 10 auctions with 14 of the 16.6 million barrels. The importance of SOMO’ auction became the dominant in 2017; it has 7 of 8 auctions with 14 of 14.6 million barrels.

The above clearly indicates that DME auction is becoming increasingly dependent on SOMO offering. And this raises questions on why other Gulf producers are absent from DME auctions? Do they auction somewhere else or they do not auction at all? If other Gulf producers do not auction, why does SOMO?

Finally, LIMA Energy actions, if it was actually involved, focused so far on auctioning cargos of Basra crudes; but this could not be the main or only function of this new joint venture.

SOMO DG was reportedly said, “The plan is to build Lima from a marketer into full-service trader of both crude and products” and “transfer SOMO from marketing to trading its oil.”

This shift in SOMO' functions from "marketing" of to "trading" in crude oil carries with it all the known risks (and gambling) and uncertainties associated with oil trading and, accordingly, it should take necessary measures to mitigate them. The questions then, should a state company pursue risk-taking activities and thus put the entire country in jeopardy? Also should the company pay high cost to insure against trading risks? But the fundamental question remains whether this state company, i.e. SOMO, is legally and constitutionally authorized to do so? This takes me to address the third development below.

3- Contemplating Oil Hedging

According to what SOMO DG has reportedly stated, "Iraq is interested in creating an oil price hedging program that would lock in prices for future trades far in advance."

Should Iraq entertain oil hedging?

Hedging business is among the known financial derivatives especially in the US economy. Though it basically looks like insurance against risks, in reality it is much more complex than that. There are different types of "hedging": oil and non-oil more; for oil hedging there are "sovereign" and "corporate/commercial" oil hedging, and when it comes to sovereign oil hedging it becomes even more complex, highly secretive and involves a few big known international banks.

Business and financial sources indicate to only two countries involved in sovereign oil hedging: Mexico and Ecuador. The first had many acclaimed "successful" cases while the second, has one failed case with heavy political price.

Briefly, the "successful" Mexican sovereign oil hedging shows that from 2001 to 2017 the country hedges generated $14.1 billion in gains; Mexico also had to pay out $11.7 billion in fees to banks, to brokers and, for 2017, to the trading unit of Royal Dutch Shell, the first non-bank to join the hedge. So who benefited more Mexico or the banks? Under hedging terms, "gains" mean actual oil prices were higher than the "locked in" oil prices of the "locked" volume of oil, and thus the gains are shared between Mexico and the involved banks and brokers.

The above amounts clearly indicate a gain-split of 17% and 83% for Mexico and the banks respectively. Looking at the matter from different angle one could argue that had Mexico did not hedge it could have gained the entire $14.1 billion for itself only!

Therefore, the intriguing questions remain why Mexico keeps on oil hedging despite such apparent "foregone revenues"? Why these hedges were praised as "successful" examples? And why the international banks keep close eyes, encourage and maintain full secrecy on Mexican oil hedging?

Ecuador oil hedging of 1993, is a case study in how an oil hedge gone wrong cost the country $16 million; paid to the international banks in hedging fees and for the swap, with absolutely nothing in return for Ecuador. Apparently, that caused a political storm and Ecuadorean lawmakers appointed a special committee to investigate allegations of corruption against - several officials involved in the hedge.

Based on the above, in my humble view, Iraq authorities (the government, the Ministries of Finance and Oil and SOMO) need to be extremely cautious when considering any hedging option, and preferably they should not consider such options at all. Both cases of sovereign oil hedges of Mexico and Ecuador clearly indicate that, in success or failure, it is only the international banks that actually benefit from sovereign oil hedges.
Fiscal and political cost of sovereign oil hedging are rather high in either case, and thus it should be avoided; when the country in a midst of severe fiscal crisis it is definitely not the time for experimenting in risk taking adventures or gambling in the country's meager revenues!

4- Changing "marker crude" in the pricing formula for Asian market

SOMO has, in a letter dated 20 August, informed its customers that it plans to switch its price benchmark for Basra crude in Asia to Dubai Mercantile Exchange-DME Oman futures from January 2018, dropping the average of S&P Global Platt's' Oman-Dubai quotes as their benchmark for decades. The new formula uses DME Oman contract two months before the cargoes are scheduled to load. SOMO asked its clients for feedback by end August.

At the outset, neither SOMO nor the Ministry posted on their websites or communicated through the usual press release the text of the above mentioned letter. SOMO's Energy News Brief (nr.61 issued 24 August 2017) made no reference to that letter or any of its contents. In his recent email to Reuters dated 28 August, SOMO DG was reportedly said the matter is still in internal discussion and final position will be announced in due time.

The announcement received mixed reactions; some praise it, some expressed skepticism and some suggest SOMO to improve it deliveries instead. For refiners and International Oil Buyers-IOBs, many issues surfaced on the consequences of the proposed shift. Some of the raised concerns are related to hedging cost; to time gap between notification and actual loading of cargos; improvement of loading schedule; price comparative with other Gulf producers that keep using Platt's Oman-Dubai quotes, among others.

For Iraq's interest, it is vital for SOMO to address and answer a set of why, what, what-if, and how questions; why it made this move now, what are the possible consequences and, in case of backfire, how it mitigates them.

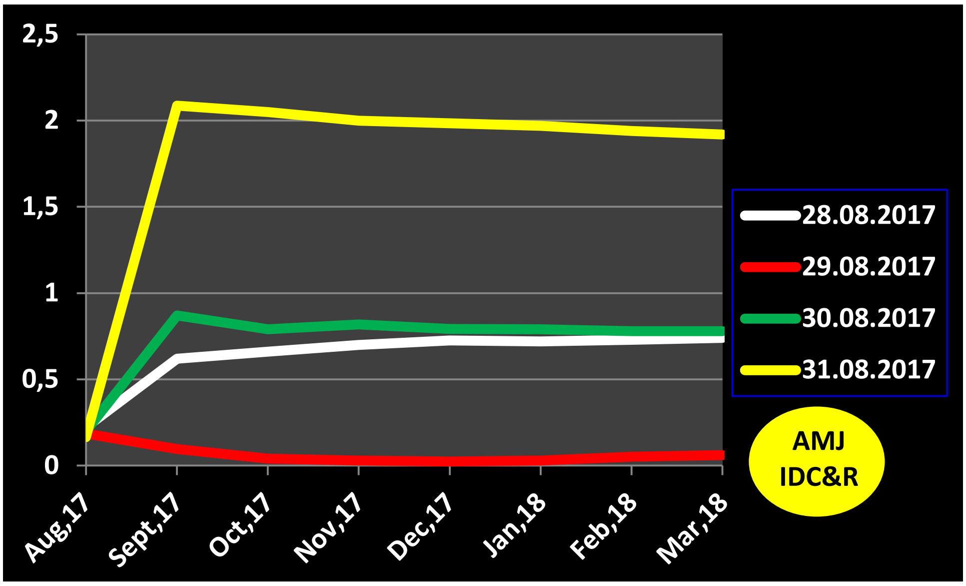
The consequences, positive or negative, resulting from this change in Basra pricing formula should be assessed thoroughly and objectively taking into consideration the following facts and circumstances:

First, with exports from NOC/ Kirkuk at standstill, most of Iraq oil export goes to the Asian market;

Second, there is a high degree of competitiveness to maintain and consolidate market share not only by other Gulf producers but also with Russian benchmark crude- Urals;

Third, the price-differential of DME Oman futures vs. Dubai Platt's shows abnormal volatility as demonstrated in the following chart 2.

Chart 2: DME Oman futures vs. Dubai Platt's in four trading days ($/b)



Source & notes for Chart 2: Author compilation based on DME, "DME Exchange Products" for the stated trading days 28 to 31 August 2017.

These price differentials during the last four DME trading days in August show huge margins in both magnitude and trend. Needless to say that, due to averaging effect, DME Oman futures (the new SOMO crude marker) compared to average Oman+Dubai Platt's (former SOMO crude markers) is slightly lower for each of the four curves.
The big jump in price differentials on 31 August trading could be interpreted as Hurricane Harvey (USA) or Eid Al-Adha holiday (UAE) effects or both.
The questions here are related to what SOMO has communicated to its clients that the new formula uses DME Oman contract two months before the cargoes are scheduled to load.
Obviously, there are three bases that could be used for setting the formula:

1-The specific day of loading compared with 60 days earlier. This base of calculation faces three problems: the number of monthly calendar days; weekend closing as DME is usually closed on Saturdays and Sundays and Holiday closing such as the latest Eid Al-Adha;
2- The specific day of loading compared with corresponding week average two months earlier;
3- The specific day of loading compared with corresponding month average two months earlier.

Under the lights of the price differentials exhibited in chart 2 above, these three bases of calculation could result in very significant variations for Iraq (October) export revenues from the Asian market, which as stated earlier, takes most of Iraqi oil exports.
Thus, this is not a simple, but very important one with serious financial consequences and this is why SOMO must be fully transparent regarding practical matters relating to this change of

the marker crude, why it is good for Iraq and what if DME Oman futures vs average Oman+Dubai Platt's reverse direction.

Each of the above addressed four issues has its own complexities let be institutional, constitutional, legal premises on one side; and should have economic feasibility with sufficient considerations to various risks, vulnerabilities and uncertainties on the other side.

SOMO's Transformation, Power Play and Transparency Considerations

The above discussion brings to the fore of the debate SOMO status and prospects.

First, though SOMO is, legally, a public (State-owned) company registered under Public Company Law 22 of 1997 (and its amendments) in reality it is much more than just a public company. SOMO generates almost all export revenues and what all that implies for the trade balance, for balance of payments, for the annual budget and, broadly, for the national economy.

Second, SOMO is the only Iraqi formal entity that has, or should have, deep and thorough knowledge of the practically daily international price for Iraqi oil and its market destinations and contractual modalities; it is the knowledge center and "think-tank" on these issues.

Third, resulting from the above, SOMO acquires unique power through three interrelated venues: financial power (revenue generation), prices (power of knowledge) and marketing contractual modalities (power of contracting).

Four, these "powers" are surely decisive in the "decision making" (a process), which provide the necessary foundations for "decision taking" (an event) by SOMO's Ministerial Committee".

Therefore and to protect SOMO and its staff, it is constitutionally, logically, economically and practically wrong and deceptive to argue or consider, when discussing any of the above mentioned four issues, as "company matters"; they are not.

This is not peculiar to Iraq; rather it is an international phenomenon because power is tempting and thus could be "used ethically" or "unethically abused". Enlightened professionals are, or should be, familiar with the saying, "power corrupts, absolute power corrupt absolutely". Moreover, the discourse of the "Agency Theory" sheds lights and provides insightful thoughts on why and how the concentration of powers in state-owned companies, especially in the petroleum sector, creates an enabling-environment for wrong-doing, financial irregularities and corruption.

To counter these tendencies a series of preventive, deterring and punitive measures are becoming essential components of good governance and adopted by many countries, organizations and entities world-wide.

Transparency, which is the core of good governance in the extractive industry, should be Comprehensive, Regular and Timely.

Recently, voices questioning and concerning SOMO appeared domestically, and seemingly gaining momentum. A Kurdish parliamentarian labeled SOMO as "closed castle" prompted

SOMO to first issue a statement on 22 August refuting his raised claims and then convened a quick press conference on 23 August. More recent, 3 September, elaborated accusations came from Oil and Gas Committee of the Basra Provincial Council.

Objectively, fairly and based on MAR archive and documentation and the following facts, it is accurate to affirm that **SOMO has been transparent for some issues, non-transparent in most of its activities**.

It has been transparent with regards to the "monthly exports of crude oil and revenues" as it usually provide preliminary data at the beginning of the month and final data on the 25th of the month covering previous month; in the final data it provides names and nationalities of International Oil Buyers-IOBs; and more details through IEITI annual reports, which usually cover two years, and now one year, back. Also, SOMO provides, occasionally though, brief statement on the price setting "Ministerial Committee".

Apart from the above, SOMO is, regrettably, non-transparent on many and important matters some of which are summarized below:

1-The monthly exports disclosure does not indicate volume, value and prices per each IOB and does not provide the market destinations;

2-The monthly decision by price setting Ministerial Committee are not disclosed (on the websites of SOMO or the Ministry) regularly and not in full; it does not provide the values of the parameters of each market formula, especially the adopted price for the marker crude; it does not provide explanation for the given premium or surcharge and does not clarifies the premises for such decisions; it provides no market share monitoring;

3- SOMO does not specify the quarterly volumes, values and prices of crude designated as "payment in kind" to IOCs for cost recovery and remuneration fees in relation to concluded service contracts;

4- The company is responsible also for export of all petroleum products (except fuel oil which is assigned to the Iraqi Oil Tankers Company-IOTC! But also not disclosed), yet it never disclosed the volumes, values and prices of these products.

5- Similarly, SOMO is responsible for the imports of all petroleum products, but again never provide any information on these imports, which according to recent statement by the Minister of Oil average at $2billion a year;

6- In its export monthly reports SOMO does not provide any data or summary on the third party verifiers at oil terminals, which is responsible to calibrates meters and to endorses oil quantities loaded onto vessels;

7- SOMO did not explain the alarming increase in the occurrence and cost of "demurrage" it pays since 2014, as I repeatedly highlighted in my assessment of IEITI annual reports; and this raises issues of loading scheduling and operation efficiency and effectiveness;

8- SOMO (and DME) only mentions the premiums over the OSPs relating to the seven auctions. But it did not disclose these OSPs;

9- Finally, SOMO is not transparent enough with regards to these four new developments or initiatives, particularly when these initiatives are considered part of SOMO transformation process.

<u>Concluding remarks and suggestions</u>

1- SOMO is, undoubtedly, important entity that is much more than just a public company; thus it should be fully transparent and under close scrutiny by the government, by the parliament and by the public. This is to protect SOMO and its staff;
2- The recently adopted four initiatives seem to be part of SOMOs unstoppable transformation, as SOMO DG has reportedly told Bloomberg, "Transforming SOMO is unstoppable. It will do more than just market Iraqi crude". Contrary to that the same DG has reportedly said in SOMO press conference on 23 August, "SOMO does not have a mandate to sell oil; the Ministerial Committee does." When did the Ministerial Committee take decisions on these four initiatives? Or this is a manifestation of confusion between "decision- making" and "decision-taking" as discussed above.
3- That said, these four initiatives could very well deliver good results as well as disappointing outcomes. Two of them, e.g., LIMA and the monthly auctions, have been done; while the other two, e.g., hedging and changing the marker crude, are under considerations.
4- Throughout this contribution I raised many questions and identified matters of particular and critical importance regarding these initiatives, which deserve further deep and specialized assessment and considerations. Without such revisiting, SOMO transformation remains dubious and risky endeavor;
5- Contributions from oil professionals assessing SOMO' current and future prospect are highly needed; **SOMO's former DGs and senior staff are particularly vital and called-upon to provide "insiders" opinion and insights;**
6- I suggest launching "SOMO Transformation Debate-STD" for specific period of time ending 30 September. The purpose is to provide "outside the box" thorough, objective, professional, evidence-based and feasible assessment. This could help SOMO, the Ministry of Oil, the government and parliament in having proper and realistic understanding of the complexities of the involved issues and their possible consequences and ramifications.

   The contributions in the proposed STD should be non-party politics, should not be personalized (pro or against), without "accusations" and should be well articulated in argument, data and knowledge-based.
7- Also, SOMO could convene a special workshop for a small number of selected known oil professionals to thoroughly address the feasibility of and prerequisites for successful SOMO transformation. The workshop should be based on "background paper" prepared by external consultant, to be circulated to SOMO and the selected participants well ahead before the workshop for contributions towards articulating realistic and practical roadmap for successful SOMO transformation. The timing of the workshop is, preferably, before the year ends, and the practical matters such as guidelines, deadlines, event program and all related logistics should be finalized soonest.

5 Sept 2017