Midyear Review of the State Budget and Oil Export Revenues

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Introduction

State budget for 2015 was based on an oil export volume of 3.3 million barrels per day (mbd) and a price of $56 a barrel. Accordingly, oil export revenues were estimated to finance 83% of budget revenues.

Despite marked improvement in oil production and exports, data for the first half of this year shows, once again, reality does not coincides with budget's expectation. I would argue, in this brief intervention, for oil export revenues to reach a budget breakeven the equalizer threshold for Iraq is ca. 4mbd and for KRG it is ca. 800kbd for the entire second half of the year. Both these equalizer thresholds are, most likely, unattainable under current national and international conditions causing serious budget fiscal deficit, increases uncertainty and economic difficulties in the country.

This paper begins by highlighting the mismatching of the main revenue parameters in budgetary planning during the last ten year, then focus on the accumulated deficit during the first half of this year. Basra and Kirkuk oil exports and their price differential are addressed in part three, and the relationships between Federal Government (IFG) and KRG are dealt with in part four. The paper ends with concluding and final remarks in part five.

I- Budgetary Planning: a Decade of Off-Target

All state budget laws during the ten year period from 2006 to 2015 have been off-target when it comes to their estimation of oil export revenues by either on volume of oil exports or oil price or both.

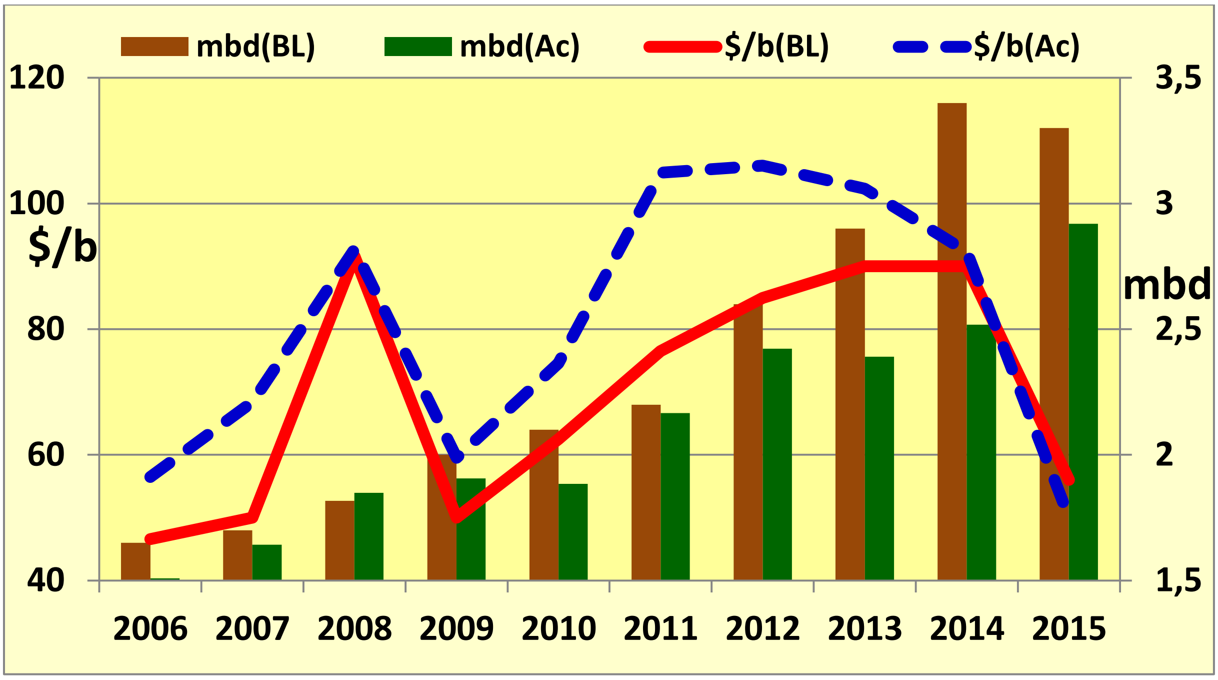
Such fact is exhibited in the following chart 1when the estimation of oil export quantities (mbd-BL, brown column) have been, with exception of 2008, all the way much higher than what actually was exported (mbd-Ac, green column) indicating a negative divergence, while the budgeted assumed oil prices ($/b- BL, red curve) have been much lower than what was actually realized ($/b-Ac, broken blue curve) indicating a positive divergence, except during the first half of 2015.

It is a rather usual practice in many countries to be cautious and conservative by adopting in budget preparation lower oil prices than what prevails in the market. Also actual volume of oil exports reflects the marketing efforts on one side and international oil market fundamentals on the other. But to be off-target for a decade long in budget preparation causes concern on the professional capacities in this critical economic function.

Chart 1

Budgeted oil export quantities (mbd-BL, brown column), Actual oil export (mbd-Ac, green column), Budgeted Oil Price ($/b- BL, red curve) and Actually realized ($/b-Ac, broken blue curve):

2006-2015



Source and notes for Chart 1: Author's compilation based on own data base compiled from various official sources. Data for 2015 refers to first half of the year only.

The high realized oil prices during the period from early 2009 to September 2014 had in fact not only compensating the off-target budgeted export volume during the same period, but also generating actual surplus in oil export revenues; thus relieving the concerned authorities from the responsibility of their failure and incompetence.

But the situation during the first half of 2015 is dramatically different from previous years in many aspects: first, for the first time in a decade that both actual oil export volume and oil prices are below what was adopted in the state budget, causing serious deficit in export revenues; second, all accumulated surpluses in the DFI that was resulted from higher oil revenues prior to mid-2014 have been practically exhausted; According to MEES[1], DFI had a balance of $18bn at the end of 2012; and statement at the end of an IMF Mission on Iraq asserts that DFI was already down to $6.5bn at end-2013, and declined further to around $4bn in November 2014.[2] Moreover, on 5 February 2015 Iraq Oil Report-IOR wrote, "The DFI has dipped to $1 billion, according to two officials with access to the data."[3] Third, despite the crash in oil price since June 2014, Iraq state budget expenditures were not restrained by low

[1] MEES, Vol. 56. No. 42, 18 October 2013

[2] Statement at the End of an IMF Mission on Iraq, Press Release No. 14/560; December 9, 2014 http://www.imf.org/external/np/sec/pr/2014/pr14560.htm accessed 8 January 2015.

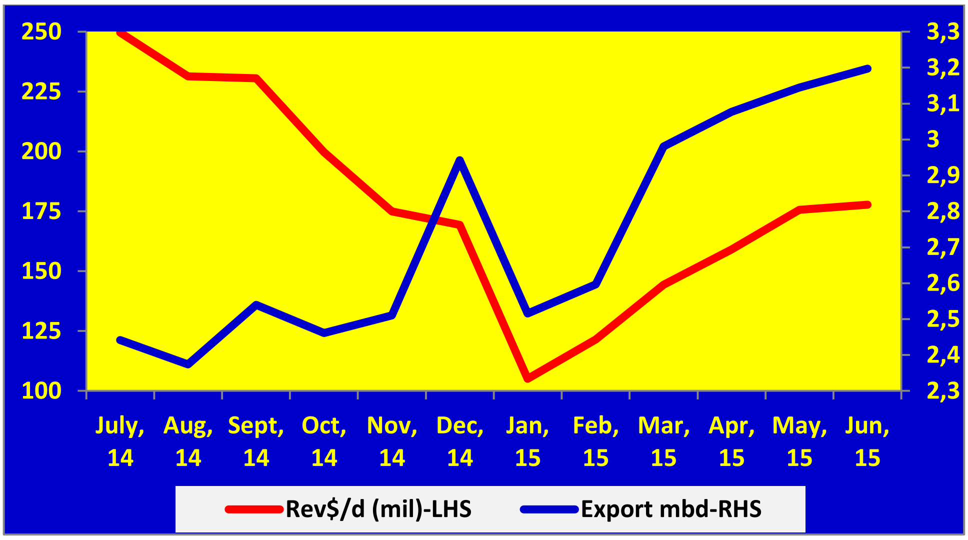
[3] http://www.iraqoilreport.com/news/iraq-financial-crisis-prompts-emergency-action-14051/?utm_source=IOR+Email+Update+Subscribers&utm_campaign=aae5f90b37-Email_Update&utm_medium=email&utm_term=0_f9870911e6-aae5f90b37-162279986 accessed 7 February 2015

revenue reality, fourth, the “Da’esh factor” and its serious impacts on security situation represents effective drain on the economy and the annual budget.
Excluding Da’esh effect and leaving the escalated expenditures aside, which in my humble views is a reflection of Iraqi politics premises rather than economically sound, the above persistent divergence between budgeted and actual oil export volumes and oil prices could reflect chronic weak institutional and governance capabilities in the budget process and resource-revenue management at large.

II- Accumulated Deficit in Oil Revenue

Daily oil export revenues during the period June 2014 –June 2015 was on a declining trend from July 2014 reaching its lowest level of $105 million in January 2015 before it recovers gradually to reach $178 million in June 2015; on a half yearly base daily oil export revenues during the last half of 2014 was $209.3 million declining to a daily revenues of $147.3 million in the first half of 2015- a 31.7% decline. But the daily export volume was on, interrupted, increase during the same period: from 2.545 mbd during last half of 2014 to 2.919 mbd during the first half of 2015; and increase of 14.7%.

Chart 2
Daily Revenues ($/d, million) and Daily Exports (million barrels): July 2014-July 2015



Source and notes for Chart 2: Author’s compilation based on own data base compiled from MoO website. LHS: left hand side, RHS: Right hand side

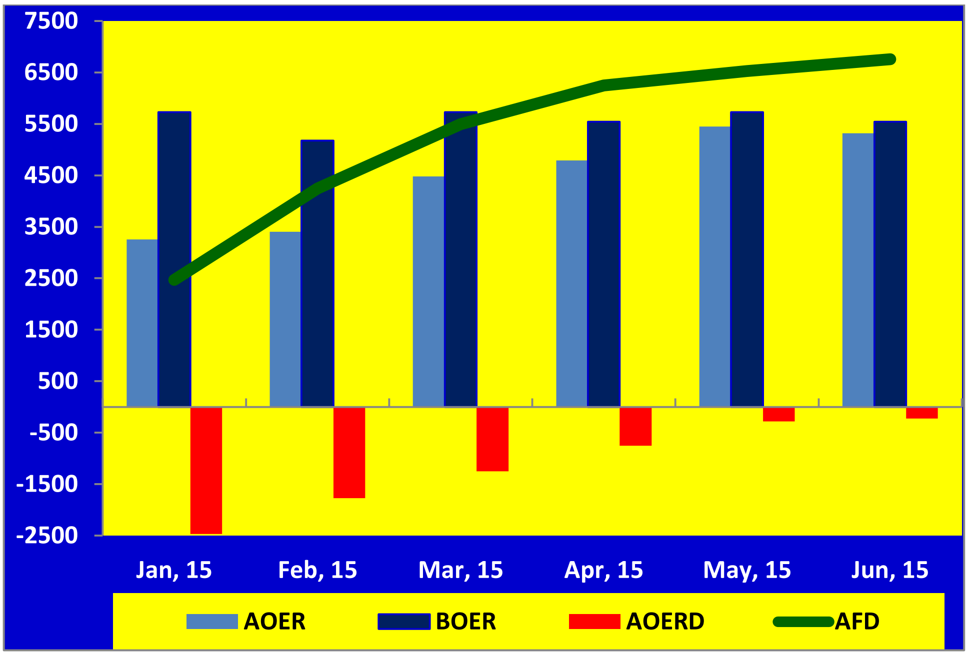
This increase in oil export while oil revenues decline reflects the impacts of the crash in oi-prices. Average Iraqi oil price was at its peak of $102.3 a barrel in July 2014, then plummeted to its lowest at $41.8/b in January 2015 then began picking up to the vicinity of $55.9/b in May then declined slightly to$55.6/b in June 2015. The question remains unanswered on whether oil prices had finally reached its bottom before picking up unabated.

Such a decline in both oil prices and oil export revenues had worsen the fiscal crisis in the country by accumulating actual deficit in oil export revenue (AOERD).

Since, as mentioned above, both actual oil export volumes and oil prices were lower than what the budget envisaged, there was actual deficit on each month of the first part of the year-though on a declining trend. The following chart 3 presents comparison between budgeted oil export revenues (BOER, light blue column), actual oil export revenues (AOER, dark blue column), actual oil export revenue deficit (AOERD, red column) and accumulated fiscal/ oil revenue deficit (AFD, green curve)

Chart 3

Budgeted oil export revenues (BOER), Actual oil export revenues (AOER), Actual oil export revenue deficit (AOERD) and Accumulated fiscal/ oil revenue deficit (AFD): January-June 2015 ($million)



Source and notes for Chart 3: Author's compilation based on own data base compiled from MoO website and State Budget Law 2015.

Deficit in actual monthly export revenue was at its peak of $2.471 billion in January 2015 then began declining due to improved oil prices and increase in export quantities (primarily from the southern Iraq) reaching its lowest of $226 million in June when both thresholds for oil exports and prices are approaching the vicinity of what was adopted by the budget, despite the marked reduction of Kirkuk oil due to KRG failure to fulfil its obligations under 2015 budget law (as discussed next).

Anyhow, total deficit in oil export revenues during this six month period reached $6.756 billion; and to reach their breakeven during the second half of the year at $56/b, oil export has to reach 3.959mbd; and even more if oil price falls below this threshold. Can Iraq's production capacity support an export level of such magnitude? Most likely not!

III- Basra and Kirkuk Oil Exports and their Price Differential

Iraq exports its oil to three main market destinations: Asia, Europe and the Americas, in addition to minor quantities to MENA region. SOMO (state oil marketing entity) has developed different pricing formula for each of these market destinations for its main crudes: Basra and Kirkuk. As from June 2015 SOMO introduced, at last, a distinct Basra Heavy and thus Iraqi oil is exported under three brands of crude oil.[4] Available unofficial information indicates that first Basra Heavy shipment of 0.592mbd, at an average API of 23.88, was exported during June 2015.[5] But SOMO export data still refers to the aggregate of monthly exports and revenues for the two brands: Basra and Kirkuk.

For known reasons export of Kirkuk crude was stalled between April and end September 2014, and when restarted in October it was modest until end November 2014 at 29,000 barrels per day. After the two "political agreements" of November and December 2014, exports of Kirkuk crude began to increase gradually to reach 0.452mbd in May then fall sharply to 0.165 mbd in June; and again for political reasons.

On the contrary to that, export of Basra crude during the last three quarters shows that it increased in the second quarter of this year by 8.6% over last quarter of 2014, and even higher at 24.3% between October 2014 and June 2015. This means that the surge in the country's oil export is mainly attributed to the increase in Basra crude during the second quarter of this year.

Export price of both crudes reflects the marketing complexities involving qualitative aspects (API and particulars contents), location advantages (the netback values) the prevailing market conditions (entailing premium or surcharges), geopolitical considerations (regional and international) among others.

Generally Kirkuk crude fetches slightly higher price than Basra. During their actual trading in the period between end of June 2008 and end May 2015 average Kirkuk price was $86.25/b while Basra was $84.99/b giving a price differential of $1.26/b in favor of Kirkuk, though there were 22 months when Basra export price was higher than Kirkuk's.

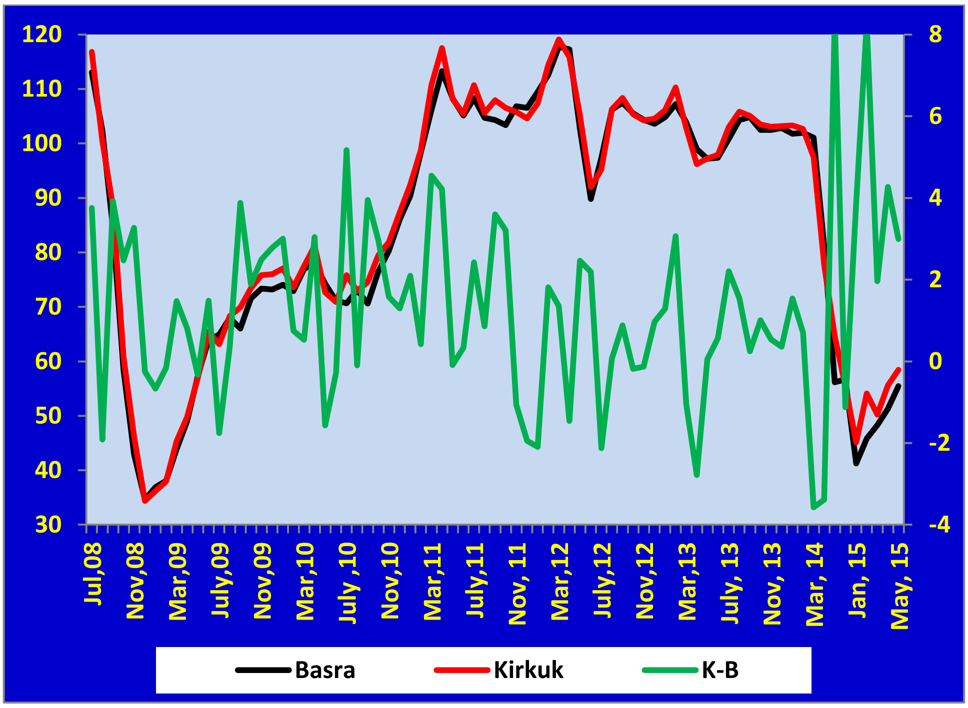
During the recent period, end September 2014 to end May 2015, average Basra price was $54.51/b against Kirkuk price of $57.67/b giving average price differential of $3.16/b in favor of Kirkuk. There were two months, November 2014 and February 2015, when Kirkuk price differentials exceed $8/b and two months, October 2014 and December 2014, when Kirkuk was sold at a lower price than Basra, reflecting SOMO's marketing reality and procedure.

The following chart exhibits Basra brand export price (Basra), Kirkuk brand export price (Kirkuk) and the Kirkuk price differential over Basra (K-B).

[4] On October 2014 SOMO announced plan to offer two grades of crude for exports from its southern terminals: "light" with an API gravity of 29 degrees, and "heavy" with an API gravity of 24-25 degrees, see http://www.iraq-businessnews.com/2014/10/20/basra-light-crude-may-split-into-2-grades/ In fact the Integrated National Energy Strategy-INES (2013-2030) had proposed such a split.

[5] See: Iraq Oil Report- IOR, 1 July 2015.

Chart 4
Basra & Kirkuk Oil Prices (Left Side) and Kirkuk Price Differential (K-B, Right Side): July 2008-June 2015 ($/barrel)



Source and notes for Chart 4: Author's compilation based on own data base compiled from MoO website

When addressing Kirkuk-Basra price differentials one needs to remember the transit-fee that Iraq pays to Turkey in accordance with the related concluded agreements between the two governments. These fees are not disclosed officially, but based on the related parameters of 2015 budget I estimate a transit fee of $0.64/b. But what is more critical is whether Kirkuk crude will be exported by the federal government through SOMO; and this takes us to address, next, the relation with KRG.

IV- Federal Government (IFG) and KRG Relationship

Generally, the relationship between IFG and KRG has been awkward, difficult and mostly acrimonious post 2003. Though both sides trade accusations and with elaborated amounts, the successive annual state budgets unambiguously indict to KRG's persistent failure to meets its legal obligations and commitments; 2015 is no different.

Under the current government of Dr. Haider Al-Abadi IFG and KRG conclude two agreements: the first was a temporary one concluded in November 2014 between the Minister of Oil, Adil Abdul Mahdi, and KRG Premier, Nechirvan Barzani, according to which KRG exports 150 thousand barrel per day (kbd) from Kirkuk oilfields for the IFG in exchange of $500 million to be paid to KRG.

The second was concluded between IFG and KRG on 2 December 2014 and a diluted version of it was incorporated in 2015 State Budget Law. In previous two articles I thoroughly addressed both agreement and 2015 budget,[6] therefore, there is no need to repeat them again.

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[6] Ahmed Mousa Jiyad, Iraq's budget 2015- It Deserves Careful Reading But Needs Serious Revision. Posted 30 Dec 2014 on IBN website: http://www.iraq-businessnews.com/reports/budget-2015-needs-serious-revision/ and

Thus, in the remaining space the focus will be on the KRG fulfilment of its obligations in the first half of this year and the implication for the remaining part of the year.

The following table summarizes the main indicators pertaining to KRG budgetary commitments and performance, followed by brief review of its contents.

Table 1

KRG' Budget Commitments Indicators (End: January-June 2015)

Commitments for Delivery to IFG through SOMO	550 kbd (1000 barrel per day)
Total Actual Delivery to SOMO	53.742 mb (million barrels)
Deficit in Total Actual Delivery to SOMO	46.358 mb (million barrels)
Daily Actual Delivery to SOMO	296 kbd[1]
Deficit in Daily Actual Delivery to SOMO	253 kbd (1000 barrel per day)
Total Value of Actual Delivery to SOMO	2.923 $billion
Average Export Price of Actual Delivery to SOMO	54.39$/b
Deficit in Export Revenues due to Non- Delivery to SOMO	2.398$billion
Budget-Equalising Delivery During 2H-2015	800 kbd (1000 barrel per day)

Source and notes for Table 1: Author's computation based on own data base; [1]= calculated on the calendar number of days in a month not the actual export days and downtime considerations.

Under budget law, KRG is committed to deliver to IFG, through SOMO, 550 kbd: 300 kbd from Kirkuk oilfields, which is legally and constitutionally belongs to the IFG, and 250kbd from oil produced by KRG, against IFG commitment to pay 17% of actual budget expenditures, adjusted for sovereign obligations.

The "KRG oil delivery obligations" of 550kbd represents 16.7% of the 3.3mbd oil export adopted by the budget law; but KRG own oil (of 250kbd) represents only 7.6% against which KRG receives 17% actual budget expenditures. This, among other flaws in the related state budget, was one of the reasons why so many Iraqi oil professionals, parliamentarians and politicians had expressed their resentment and opposition to such a deal.

But KRG did not deliver during the first quarter of the year arguing that the budget commitment of 550kbd is an "annualized" base, implying that the remaining months of the year will compensate for any deficit. Months of April and May witnessed marked increase of KRG deliveries to SOMO, but they were far short of the budgetary commitment. By June KRG (and KR parliament) returned to the unilateral threatening approach, reducing drastically oil deliveries through SOMO to only 165kbd, calling for a new deal!

Thus, during the first half of 2015 KRG actually delivered to SOMO 53.7 million barrels of oil (possibly all of it from Kirkuk oilfields) at a rate of 296kbd, sold (by SOMO) at $54.39/b, generating total oil export revenues of $2.923 billion.
Obviously, these deliveries are much lower than committed under the annual budget. Accordingly, the deficit resulting so far from KRG non-compliance with budget law was 253kbd, accumulating 46.358 million barrels and thus causing a loss of oil export revenues totalled $2.398 billion to national budget.

While KRG causing such losses to the national coffer, it actually maximising its independent export of oil. Available data on KRG independent exports shows dramatic increase during the

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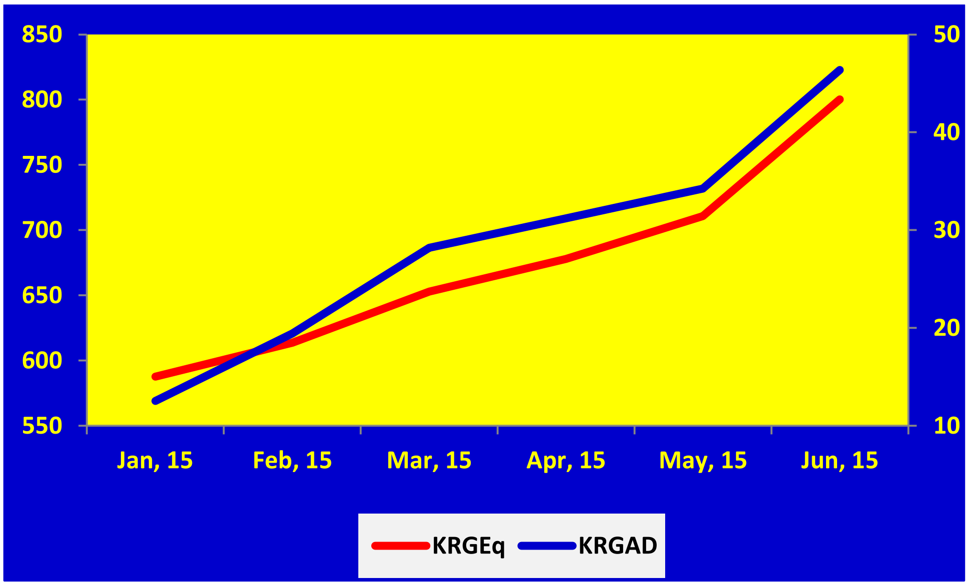
Ahmed Mousa Jiyad, The Balance Sheet of the Recent IFG-KRG Oil Deal in Iraq. Poste on IBN website on 11 December 2014 http://www.iraq-businessnews.com/reports/the-balance-sheet-of-the-recent-ifg-krg-oil-deal/

second quarter of the year from 28kbd in April to 184kbd in May and 421kbd in June. KRG-MNR in June 2015 reports that its total export through Turkey was 17.131 million barrels out of which 4.493 million barrels through SOMO and the rest, 11.638 million barrels were exported independently.[7] But MNR monthly Report provides neither total export revenues nor the export price for the independently exported oil. This obvious absence of transparency makes it difficult to assess the economic burdens on national or regional economies of KRG policy.

As the following chart demonstrates KRG independent oil export has led to increasing monthly accumulated deficit on its part and also to increasing the equalization factor for future KRG monthly delivery obligation to breakeven its budgetary obligations.

Chart 5
KRG Monthly Accumulated Deficit in Oil Delivery to IFG (KRGAD, mb-Right Side) and KRG Equalizing Factor (KRGEq, kbd-Left side)
January-June 2015



Source and notes for Chart 5: Author's compilation based on own data base compiled from MoO website

Due to KRG's failure to face its 2015 budget oil delivery obligations its deficit began to accumulate monthly to reach 46.358 million barrels by end June 2015. Accordingly, the equalizer of its future monthly oil delivery (KRGEq) increases proportional to monthly deficit. At end January KRGEq value was 588kbd increasing to 800kbd by end June. In other words, to compensate for such non-compliance (and apply the annualized argument presented by KRG, as mentioned above) KRG has to deliver to IFG through SOMO **800kbd** during the second half of 2015 to equalize their budget commitment.

There are strong reasons to believe that KRG will not do that, intentionally and logistically. One could suspect that KRG knew that when they propose the annualization idea early in the year. The question is how was it possible that IFG accepted such a flawed argument during

[7] http://mnr.krg.org/index.php/en/press-releases/462-krg-publishes-the-monthly-export-report-for-june-2015 accessed 3 July 2015

the first half of this year? Probably this is why KRG proposed recently different arrangement than was agreed upon in 2 December 2014 and incorporated in state budget 2015.[8]

V- Concluding and Further Remarks

Quarterly export data indicates significant surge of 17% during the second quarter of the year compared with its previous quarter due to an increase in Basra crude by 30.6 million barrels and Kirkuk crude by 11.1 million barrels. It is worth mentioning in this respects that such an increase in Iraqi oil exports confirms PRIX Global Index prediction for Iraq.[9]
Also Iraq's export prices increased from an average of $45.56/b during first quarter to $54.47/b during first quarter.
Nevertheless, both oil export volume and oil prices have been much lower than anticipated in state budget for 2015, worsening further the fiscal deficit.
For oil export revenues to reach its budgetary breakeven the equalizer daily exports at a price of $56/b should be ca. 4mbd. Moreover, if Iraqi oil price during the second half of the year continues to be under that threshold, which is likely, then the equalizer value increases accordingly. But under prevailing conditions production and export capacity in Iraq it is unlikely that the country deliver a daily export volume of4mbd for the entire second half of this year.

Indications on the relationship between IFG and KRG could make the above situation even more difficult with painful consequences. The silent data for the first half of the year clearly points to non-fulfilment of KRG to its budgetary obligations on one side and increasing its independent oil exports on the other; causing serious financial losses to national treasury. Expectedly, KRG puts much of the blame on IFG, both current and formers!
As computed above, KRG has to deliver SOMO ca. 800kbd for the entire second half of 2015 to equalize its budgetary obligation. But again, and as recent political statements tell, KRG will not do that for whatever reasons.

This implies that the political agreement of 2 December 2014 failed miserably (for the IFG side only) and, thus, state budget faces unattainable targets.
Accordingly, the government and the Ministry of Oil might become obliged to take effective legal measures on the international level by re-activating previous legal actions pertaining illegal independent oil exports outside SOMO against all involved parties: sub-state, states, companies, tankers and buyers.[10] On the budget law side, the Council of Ministers might invoke relevant provisions for reciprocal relief from corresponding payments to KRG.[11]

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[8] Oil Minister, Adil Abdul Mahdi, confirms that KRG had assured IFG through two official letters dated 3 and 20 June 2015 that KRG will obey itself to deliver 550 kbd but they didn't. See *ShafaqNews*, شفق نيوز Sunday, 5 July 2015

[9] The PRIX global index is a quarterly assessment aiming at forecasting political developments that can affect oil exports from the world's 20 largest oil exporters since exports from these countries are in turn an important factor in determining the oil price. PRIX draws on input from 261 country analysts (including this author). The range of possible index values is 0-100, where 0 represents a maximum reduction in oil exports, 100 represents a maximum increase in exports, and 50 represents no change. Iraq's index for the first two quarters of 2015 was 58.33 and 80.43 respectively. For more on PRIX see prixindex.net

[10] As examples on the effects of international legal action by the Ministry of Oil are the "outside-court" settlement agreement by which the Marine Management Services –MMS committed to refrain from lauding and transporting oil from KRG without SOMO's prior. See, http://www.oil.gov.iq/index.php?name=News&file=article&sid=803 accessed 2 April 2015; also the arbitration case launched by Iraq, on 23 May 2014, against the Turkish government and its pipeline operator Botaş before the Court of Arbitration at the International Chamber of Commerce in Paris,

On other economic issues there has been increasing debates inside Iraq on the role of the Central Bank of Iraq- CBI and the necessity for sound, effective and real coordination between fiscal and monetary policies when addressing state budget and development needs in the country.[12]
In a recent presentation by the Governor of the Central Bank of Iraq- CBI, he asserts that currently there is "un-useful" 40 trillion Dinars (or $34.3 billion) that belongs to different state entities because "there is no central account to manage them".[13]

This is very serious issue deserving in-depth analysis, careful attention and a decision on how to address it considering the fact that this "un-useful" amount constitutes 33.5% of total approved budget expenditures for 2015 or it is more than planned deficit by 57.5%.

In other words, if what the CBI Governor have said is correct, then this actually manifests very crippling capacity gap in public finance management. Such a challenge represent in the same time an opportunity that must be explored. The Governor proposes the opening of such an "account" at the CBI for the purpose of utilizing these significant trillions IDs; more coordination and streamlining between the fiscal and monetary authorities is critical for addressing such issues and to improve public finance management.
The formal follow-up by CBI, the Ministry of Finance and the Cabinet on what the Governor of CBI has proposed has not been on the public screen despite the fiscal significance of the claim at the current financial difficulties.

Moreover, the Da'esh (ISIS/IS/ISIL) factor impacts have undoubtedly been effective, costly and significant from many aspects; and with lower oil prices they constitute very serious and crippling double-whammy causing further drain of the financial resources and increasing uncertainty for the remaining part of the year.

Finally, despite the obvious improvements in Iraq's oil production and exports, the deficit in oil export revenues during the first half of the year had accumulated and the needed equalizer to reach a budgetary breakeven in oil revenues for the second half is likely unattainable. But the government has to take bold actions to face such difficulties.

Norway
7 July 2015

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after the KRG shipped the first cargo from Ceyhan on 23 May on first the MMS tanker United Leadership. See, MoO, Press Release, 223 May 2014, **http://www.oil.gov.iq/**

[11] Unofficial data indicates that IFG paid to KRG a minimum of $1925 million, depending on $/ID exchange rate, up to end May 2015.

[12] The Progress Institute for Development Policies-Baghdad, has been spearheading such debates by organising seminars on these issues.

[13] Presentation delivered by CBI Governor, Mr. Ali Al-Alaq, on Saturday 7 March 2015, before Progress Institute for Development Policies, Baghdad. http://www.newsabah.com/wp/newspaper/40502 accessed 8 March 2015