Budget Law 2017 and OPEC Production Cut Impact- Preliminary Remarks

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On 7 December, the Iraqi Parliament passed Budget Law 2017 by a majority voting with 186 attendances, before the House went into a month recess. The passing of the Law was immediately condemned severely by Barzani bloc though it was supported by other Kurdish groups; indicating to a new phase of political reality in the Kurdish region and doubtful compliance of KRG to budget provisions. Some skeptics (among parliamentarians) considered budget debate nothing but early-election rhetoric; others think the draft does not deserve even the "ink it was written by" and others question the "integrity and accuracy" of some provisions of the law itself.

In the meantime, the apparent failure of Iraq during recent OPEC meeting could increase the economic burden, of passivism and mentality of secrecy that dominate the Ministry of Oil, estimated to $3.1billion during first half of 2017 one side and by making revenue side of 2017 budget highly susceptive to multiple sources of uncertainty. Thus, international oil prices has to be at least $54.73/ b for Iraq to attain a breakeven price of $46.6/b on its oil export revenues to accommodate the impact of oil production cut. Hence, both Iraq (by conceding) and IMF (by imposing) took a gamble by adopting $42/b. Time will tell!

This intervention is based on unofficial text of the Budget Law waiting for the approval of the Law by the President of the Republic and the publication of formal text of the Law on the Official Gazette- *Alwaqaee aliraqiya*. It covers four items: Revenues, Expenditures and fiscal planned deficit; KRG Budget Share with conditions attached; The Petrodollars Issue; Entitlements for Oil Companies and the Compliance with OPEC Obligations.

I- Revenues, Expenditures and Fiscal Planned Deficit

The Revenue side comprises oil export revenues and non-oil revenues. Non-oil revenues constitute almost 14% of total revenues while oil exports provide the rest.

Oil export revenues were estimated at roughly $57.5 billion based on 3.75 million barrels per day (mbd) on full 365 days and at a price of $42/b (a barrel) using an exchange rate of ID1182 per US dollar (though market rate is consistently higher).

The breakdown of total exports is as follows:

250 thousand barrel per day (kbd) from oil produced by KRG; 300kbd from oil produced by North Oil Company (in Kirkuk) and transported via KRG pipeline to Turkey, (both these are subject to stringent conditions as discussed below), and the remaining 3.2mbd comes from the rest of Iraq; meaning all the inveseged increase of 150kbd in oil exports over those in budget law of 2016 would come from rest of Iraq only despite the claimed increase in oil produced by KRG during 2016.

While Iraq, technically and theoretically, is capable to export much more than budget threshold of 3.75 mbd (as official data for November tells), the realization of that threshold depends, as recent history also tells, depends largely on the KRG behavior and the political relationship between Erbil and Baghdad. If history repeats itself and KRG refuses to deliver, then the rest of Iraq could produce 3.4mbd and the Budget will be relieved from paying KRG the 17% (adjusted for sovereign obligations). But Iraq could breach latest OPEC obligations if KRG continues producing and exporting independently and at will.

The uncertainty on the price side is also significant, and thus both IMF (by imposing) and Iraq (by conceding) took a gamble by adopting $42/b for Iraqi oil export, as discussed in the last part of this paper.

Budget expenditure was estimated at $85.2 billion(which is 5% less than budgeted expenditures in Budget Law 2016 in ID); as expected current expenditures take the bulk of 74.7% while "project expenditures" (investment allocation) take the remaining 25.3%, though current expenditures in 2017 is lower by 6.3% their levels in 2016 budget. Projects or investment allocation in 2017 is only 1% lower than what it was in 2016.
The reduction of current expenditures in 2017 indicates to the austerity measures that are highly linked to the decline in oil export revenues and the concluded arrangement with the IMF.
Payment of domestic and external debts began to show its significance and impact when reaching more than $4.7 billion and since they are included under "current expenditures", they constitutes some 7.5% of budget current expenditures.

Planned deficit is $18.3 billion; constituting 21.5 % of budget expenditures. The deficit is to be financed by domestic and external borrowings; indicating further slip into debt-trap unless oil revenues improve and fiscal management enhances. External financing comes from multilateral sources (such as IMF, World Bank; Islamic Bank and the European Union), many sovereign (bi-lateral) sources and few commercial financing (bonds and bills).

II- KRG Budget Share with conditions attached

Though the 17% KRG share of <u>actual</u> expenditures (adjusted by deducting the sovereign obligations) remains as before, the Law has stricter and specific terms compared with previous budgets:

1- KRG <u>commits</u> exporting <u>at least</u> 250Kbd produced from KR oilfields to be marketed <u>exclusively</u> <u>by SOMO; export revenues will be delivered to the Federal Public Treasury</u>;
2- KRG <u>commits</u> transporting <u>at least</u> 300kbd from Kirkuk Province fields to be marketed <u>exclusively</u> <u>by SOMO; export revenues will be delivered the Federal Public Treasury</u>;
3- KRG commits to pay the <u>salaries</u> of its employees before paying any other item in its operating expenditures;
4- Unless KRG fulfil commitments 1, 2 & 3 above, the Federal Government will not be abide by stated payments obligations to KRG.

The passing of such conditions with the support of Kurdish parliamentarians (excluding Barzani bloc) reflects a new and impacting political reality in Kurdistan-Iraq and manifestation of growing discontent with the political order dominating the Region.

Moreover, other provisions in Budget Law impose further restricting conditions; new and old. A new provision gives the federal Supreme Auditing Board-SAB the final say regarding revenues and consolidating accounts in case Kurdistan Auditing Board "do not cooperate" on these matters. An old provision compels KRG to deliver to the Federal Public Treasury any revenues generated from oil exports that exceed 550kbd.

Hence, by virtue of this budget Law all revenues from KRG oil exports should be delivered to the federal Ministry of Finance as a condition (or pre-condition) for having its adjusted 17% of actual expenditures. The above provisions affirm SOMO's exclusivity for marketing Iraqi oil including. Time will only tell if KRG comply with such provisions!

III- The Petrodollars Issue

Draft budget law presented by the government proposed (5%) of oil price instead of $5/ barrel as a base for calculating petrodollar allocation for the producing provinces. That was strongly opposed by oil producing provinces spearheaded by Basra, and many heated statements were delivered during the last days until the time of voting. Some of the counter arguments suggest that petrodollars have been paid since many years back but without noticeable infrastructure or service improvement, and thus all such outcry is a form of early-election rhetoric.

Some parliamentarians from the southern oil producing provinces (Basra, Missan, Nassiriya and Wassit) boycotted the voting though after securing some gains; The old $5/barrel remains and the provinces gets treasury bills covering their petrodollar entitlements payable "when fiscal conditions improve conditional also on using these bill for investment purposes exclusively". The last part of the conditional bills to be used "for investment purposes exclusively" is, if strictly adhered to, strong measure against using these significant funds for non-investment, privileges and wasteful purposes.

IV- Entitlements for Oil Companies and the Compliance with OPEC Obligations

There is a new but strange provision in Budget 2017, different from similar text in the previous budget 2016. The new provision authorizes the Minister of Oil requesting the issue of Treasury Bills or Bonds of no more than $12bilion to cover the <u>entitlements</u> <u>of</u> <u>national</u> or international oil working in Iraq.

Two specific issues with this provision:

1- Why and what are the dues to Iraqi (national) oil companies that are payable in US Dollars and how come they will be due in 2017 and for the first time in the history of the Ministry of Oil?
2- Since Iraq will adhere to OPEC reduction; its production (including KRG) will be fixed at 4.351mbd (which is much lower than what would be production capacity at year end) for at least during the first half of 2017. Under such condition it is expected that the half yearly work programs and related budgets for all IOCs working will be reduced to bar-minimum just to maintain the production capacity at end year 2016. In that case why budget law maintained the same upper threshold of $12billion?

Furthermore, neither the government nor the Ministry of Oil did publically address the possible fiscal impacts (positive or negative) of OPEC decision on budget 2017, apart from very general (mostly optimistic) opinion expressed by a couple of government officials.

Most business and industry analysts and commentators on post- 30 November OPEC outcome would agree that OPEC decision could increase oil price; but when and how much that depends on many factors.
Leaving geopolitical considerations and the new possible conducts of the new American Precedent aside, among these factors are:

1- the degree of compliance within OPEC itself (which is historically rather poor or discouraging to say the least);
2- how much increase in oil production by the two exempted OPEC members (Libya and Nigeria);
3- the impact of oil production of the "suspended" member, Indonesia;
4- how reliable is Russia to cut 300kbd when and how;
5- how committed are other 11 Non-OPEC oil producers in cutting the 300kbd;
6- what would be the reaction of the Shale-oil producers in the US, who "have learned to become resilient to the low-price area by cutting costs and making their operations more efficient", to any price improvement; Hedge fund activities registered significant increase indicating to quick response of the Shale-oil producers in the US to price improvement;
7- the prospect of global demand for energy and for oil and the expected speed and volume of reduction in global inventories among others.

These are serous sources of concerns and could have their impacts on future oil prices. Hence, so far many price ranges start emerging pending more information and indication on the conducts of all involved actors in the coming few weeks.
Goldman Sachs asserts full compliance with quotas by OPEC and non-OPEC could send oil prices above $60/b; Morgan Stanley said crude may trade from $50 to $60 if the group sticks to its commitments, while Wood Mackenzie sees a price of $55 to $60 as long as OPEC is "very careful to meet the terms of the agreement." SOMO's DG does not think oil price in 2017 "will jump past $60 or $65" and US' EIA in its latest Short-Term Energy Outlook' December issue forecasts Brent crude oil prices to average $52/b in 2017and the Iranian Oil Minister thinks oil price will range between $50 and $55 a barrel. It is worth recalling that Russian budget 2017 adopts a $40/barrel, but so far that remains unchanged since Russian Central Bank believes that price threshold remains so on average for next few years.

Sunday's 10 December OPEC & Non-OPEC meeting has strengthened the likelihood for price improvement. Non-OPEC production cut will be 558kbd (less than what was declared earlier by 42kbd) and it will not occur fully by 1 January 2017, but gradually towards and during second quarter, implying possible price improvement towards the upper level as we move closed to the end of first half of the year.

The above indicates to a range of international oil prices between $50 and $60 (or $65 if one considers SOMO's DG; a $15/b or 30% over the lower band); but what matters most for Iraq is the price of its oil exports to its main market destination: East Asia, Europe; and Americas. Historically, Iraq's oil prices are usually lower than Brent; the average monthly price differential (in favor of Brent) during the first 9 month of 2016 was $8.13/b. If this pattern

persists for 2017, Iraq will not reach its budget-price threshold if international oil price is less than $50.13/barrel (excluding production cut impacts as discussed below). Moreover, the situation could be even worse if KRG fail to deliver as envisaged under budget law (which is highly likely as experience tells).
It's worth remembering that OPEC decision is about oil production not export and its does not cover the condensates; meaning Iraq could maximize exports of condensates as per available capacity it has.

Production reduction from 4.776mbd (as officially presented by the Ministry of Oil as per October 2016) to 4.351 (as decided within OPEC) leads to 425kbd reduction. If one assumes that oil production at 31 December 2016 remains at 4.776mbd (though technically and contractually it could be higher) such a reduction will have the following consequences:

1- According to MoO concluded service contracts with IOCs, production curtailment clause could cost the country "curtailment net remuneration fee cost-CNRFC" at <u>least $250401 a day in net remuneration fee payment</u> (based on Net Remuneration Fee; natural decline effect on Base Line Production for the six oilfield under bid round one; field-based contribution at end 2016 is, proportionally the same as it was at end 2015; and *pari-passu* treatment of all producing oilfields, including National Efforts and KRG).

   Contractually, Iraq could choose the "prolongation" option instead of cash payment; but this requires careful calculation by the Ministry of Oil. Also Iraq could confines the reduction to oilfield operated by National Efforts, but this option also needs even further and serious consideration.

   There will be no CNRFC for oilfield operated by National Efforts.

   As for KRG the Production Curtailment Cost-PCC (in comparison to CNRFC) could be much higher and substantive since the "penalty" for capex recovery postponement of "cost oil" and the monetization of IOCs-take in "profit oil under PSC" are both complex and could increase proportionally with oil price increases; and thus curtailment cost to KRG could be much crippling (this matter is not included in my calculation due to time constraint).
2- Iraq's lost income caused by such reduction at $40/b (average November price according to SOMO's DG) is estimated at $17million per day.
3- The cost of maintaining the "idle capacity" of 425kbd is not included in the calculation due to time constraint.
4- Therefore, the <u>minimum cost to Iraq</u>, including lost income and CNRFC only, during the first half of 2017 is calculated at $3.1billion (mostly in lost income); and to compensate such a burden, Iraqi actual oil export prices has to be $46.6/barrel (i.e., $4.6/b over the price adopted by the budget law and imposed by IMF). And if we consider the above mentioned Brent price differentials of $8.13/b, then international oil prices has to be at least $54.73/ b for Iraq to attain a breakeven on its oil export revenues and accommodating the impact of oil production.

I must emphasis that the above calculations are preliminary and based on some assumptions since the Ministry of Oil did not disclose any scenarios or related data and had, in fact, terminated releasing data that used to be posted monthly since at least 2007. I might comeback to address this issue with further data and analyses.

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