A Position Statement: Towards Sound Oil Plans, Policy and Governance

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Through our constant follow-up of the development in the petroleum sector and particularly the activities, statements and information from/ by the Ministry/Minister of Oil during the last six months we are alarmed by clear perpetual state of chaos. The causes and examples are many, they include incompatible statements, capitulation, immature plans and policy that could not have passed the test of Law 84 of 1985, which requires economic and technical feasibility before they qualify for adoption under unhealthy environment of increasing return of unjustified secrecy and anti-transparency, among others which are being discussed below.

We have often separately or jointly offered our professional services and rarely declined whenever the reasons are of the kind of contractual improprieties that could compromise our professionalism or credibility. However, we are convinced that the present state of chaos of political nature and/or lack of sound governance call for moral responsibility and patriotic obligation to make this statement to alert against any, consequences that could inflict serious impacts.

New Offering of Oilfields to IOCs

The Ministry/Minister has expressed readiness to offer oilfields for IOCs in three different occasions:

1. 12 discovered oilfields last year with dubious and costly contractual modalities, which the Ministry postponed the offering to mid-this year following published and private criticism;
1. Three Middle-Euphrates oilfields to be contracted by Karbala province with IOCs but the Ministry responded vaguely on this matter;
2. Two oilfields allocated to Basra local government under an “Oil for Development” proposal by Basra Province, but the Ministry provided no feedback in this case.

We had expressed our opposition to and concerns on the above proposals and we formed our opinion on various grounds:

1. Iraq does not need to award any new oilfields to IOCs as there is enough oil production capacity available and even more could be made easily available through oilfields currently producing, both those with IOCs or by national efforts
2. All three proposals not only contravene with the practice and the contractual modality that have been followed so far by the Ministry; they in fact call upon IOCs to specify the contractual modality they prefer! Such a call is very clear puts IOCs interests before the country interest;

3. Allocating oilfields to specific provinces violates the basic constitutional principle of collective undivided ownership of oil and gas by all Iraqi people and Islamic Shari'a, which dictates that all natural resources, petroleum is key that feeds the very bulk of the government budget, are common undivided ownership (mulk musha'a).
   Such a move could divide the country, create border dispute, weaken the unity of the people and create antagonism between the haves and have-nots.
4. Such actions could generate a risky domino effect by prompting other provinces to pursue their own way regarding petroleum endowment located in these provinces. The final outcome of such uncoordinated petroleum upstream development could lead to chaotic costly and excess capacities. This path would very well create corruption-enabling environment for the benefit of the powerful political blocks and politicians.
5. Finally, the contractual modality for these proposed fields is, implicitly or explicitly, a production sharing contract that gives IOCs more and lucrative advantages. And, above all: contrary to the Constitution and, moreover, legalize KRG concluded contracts.

For all the above, we are emphatically against all three proposals and any similar proposals; and we call upon the Ministry/ Minister of Oil to refrain from making such unfeasible, damaging and corruption-prone proposals.
Instead, we highly recommend the Ministry to focus on the already contracted oilfields, especially those done through the first two bid rounds to ensure and protect the Iraqi interests effectively and efficiently.

<u>Contract revision</u>

We are aware of calls to revise service contracts concluded under the bid rounds; we further realize the politically oriented nature of such calls, especially behind the insertion of specific provisions in Budget Laws. These calls are legitimate, as shown below, and normally desirable but impractical under the present Iraq unstable circumstances and state of the oil market. We also fear disappointing results going by the pervious negotiation of Minister Abdu Kareem Al-Luabi which was carried out during relatively stable state of the country and market- reference is made under in the following section.

Though we have our differences in assessing the service contracts, we are mindful of numerous structural flaws raised by many, including us, of the Service Contract, such as:

- Its misnomer as Service Contract while it is a hybrid PSA/Service Contract (the contractor being investor shares in the decision-making). Has the advantage of PSA in sharing decisions and long term duration and the prompt payment of a Service Contract;

- Its long duration of 25 years (service contracts is characterized by its short duration and decision-making remains in the hand of the sovereign);
- It encourages ‘gold plating’ purchase practice instead of pragmatic saving to enhance company remuneration (the contractor’s remuneration increases with expensive items resulting from the “R” factor formula in use governing the company remuneration).

Above all, the service contracts further fail on three major faults:

- The bid’s proposed summary- development plan was won and adopted on the basis of highest ‘Plateau’ oil production rate (despite it cannot technically be ascertained) instead of achieving optimum recovery of oil from its reservoir formation at the lowest unit cost;
- The adoption of long-term contracts, devoid of pre-defined percentage of ‘Local Content’, (subcontracting to local firms and assisting them to carryout and perform efficiently) results in the exporting of greater portion of national wealth while retarding the transfer of technological know-how to national private enterprise. Local Content importance is such as that Iran and Russia demands 51% given to locals and goes up to 70% in Norway;
- The quarterly payment of costs and remuneration is downloaded up to 50% of the gross income, which makes it burdensome on the government especially during low prices. The old Concession Agreements and many PSAs pay operating costs and profit annually while the tangible investment (could include the producing wells) paid over a period of time commensurate with their life of, say, 10-20 years.

The above quarterly payment condition has demonstrated to become burdensome on the government coffin, which requires remedial solution to be negotiated.

However, the contracts structural flaws are so numerous that require a complete revision, which is neither possible nor practical under the present warfare, social and financial conditions or the state of the global market condition.

Furthermore, past Ministry of Oil revision to lower the plateau to 9mbpd (million barrels per day) has given IOCs unjustifiable too many expensive concessions to the detriment of Iraqi interest, the like of which could very well take place under the present country and market condition.

<u>First:</u>

During the term of the former Minister Abdul Kareem Al-Luabi through secretly revising some of the service contracts, Iraq not only benefited nothing at all by giving these concessions, Iraq has, in fact, weakened its negotiation position for any improvement in these contracts. The revision:

1. Made the long contract duration longer by 5 more years;
2. Eliminated the “R” factor remuneration formula which would increase the company remuneration by some 25-30%;
3. Reduced the carried national participation of 25% to 5%, which granted its remuneration to the Companies; and
4. Recently, one Russian company announced that it “expects to negotiate a revised contract with Iraq with the aim of getting additional profit”. It’s worth mentioning that this company, like all other IOCs, was relieved from an up-front capital requirement by $7 billion due to reducing plateau production.

Second:

International experience tells that when a host country renegotiates a contract while it is under financial stress, the outcome will be in favor of the IOCs.

Third:

Modification of the contracts’ downloading up to 50% of the quarterly income to pay for costs and remuneration to IOCs, in order to relieve the government from too high payment level in proportion to the reduced total income during low oil price level, by relating the payment to the price level, which seems to be an option under consideration, has its own limitation, as discussed below.

Empirically, “low-price periods” are less frequent and shorter than “high-price periods”; revising a contract based on low-price period could deprive the country from billions of revenues to the IOCs benefit over the entire duration of each contract.

Most oil industry international leaders, ministers and head of related agencies attending recently (7 March 2017) the CERAWeek annual conference in Houston, Texas seems to agree on predicting international oil price ranging between $50 and $60 during the coming three to five years.

In its March STEO, EIA (US) forecasts Brent price at $55/b in 2017, increasing by two dollars in 2018. Furthermore, latest IEA 5-year oil market forecast suggests global oil supply could struggle to keep pace with demand after 2020, risking a sharp increase in prices, unless new projects are approved soon. However, IEA’s data point to considerable excess capacity next year, which has implications on oil prices. Iraq, according to IEA, will retain its position as OPEC’s second-biggest producer by adding 700kbd to reach 5.4mbd in 2022, which is much lower than even the revised contracted plateau target.

However, Shell’s chief executive Ben Van Buerden warned, at the CERAWeek, that falling oil use as soon as the 2020s the threat of climate change will exhaust public tolerance for fossil fuel companies if they are not careful. “We have to acknowledge that oil demand will peak and could already be in the next decade. It could happen.”

Based on the above, we strongly stand against revising the concluded service contracts if such revision inflicts further harm to economic interest of the country. In this regards, it is important to remember that Budget Law 2017 mandates the federal government and the Ministry of Oil to amend the service contracts to: protect Iraq economic interests; to increase oil production; to reduce cost and to find a mechanism that links cost recovery to oil prices.

Furthermore, we think that the former Oil Minister Abdul Kareem Al-Luaibi should be held accountable for the concessions he gave to the IOCs, which compromised severely Iraqi interests.
And, the procedure of any Government Cabinet approval, which is liable to miss or allow negligence leading to high order of financial magnitude should be reexamined to ensure protection of the national wealth against careless and/or fraudulent outcome.

Uncalled for plans and capitulation
First:
Soon after increasing **proven reserves** from 143 to 153Bb, billion barrel, (appears to be have been based on new discovery at….. which is technically too soon and wrong to ascribe it to proven reserve) the MoO called for uncalled for plan to exploration offshore.
The increase of Iraq’s proven reserves is not something new:
Back in April 2013 the then Minister of Oil- Abdul Kareem Luaibi made official statement confirming Iraq’s proven reserves of 150 billion barrels. Even BP Statistical Review of World Energy, editions 2014 and 2015 adopted that figure at end 2013 and end 2014 respectively. However, BPSRWE in its 2016 edition reduced that figure to 143.1 billion barrels at end of 2015. This last figure of 143.1 was close to the publically announced estimate by the Iraqi Ministry of Oil in October 2010.
However the Ministry should provide the details and argument supportive of its new estimate, which should account to the annually produced oil before asking OPEC to adopt it since such a request could discredit the Ministry of Oil and the current Minister in case of incompatibility with previous announced figure, which could tarnish the credibility of the Ministry of Oil.
Verification and validation of a new proven reserves estimate are what matter more than just a declaration!

Second:
Shafiq has demonstrated as early as 1997 Iraq’s proven reserves at the time of over115Bb (billion barrels) can support a plateau of 10 mbpd (million

barrels per day) and maintain it for a decade without the need for one barrel of new reserves.
Iraq's immediate present need is to rehabilitate its infrastructure, concurrently with the development of the current IOCs service contracts and national effort. And, further exploration for reserves equates to additional frozen-investment, generating no return to the nation**.**

The idea of including an **offshore exploration** block is not new. Back in 2010, the initial exploration blocks map for bid round four incudes 54 blocks with one offshore; but that was dropped from the final list of the offered blocks.
The justification given by the MoO for offshore exploration is hardly convincing and could be very damaging financially and contractually. Moreover, we do not think that such exploration attracts IOCs interest unless lucrative terms are offered to them.

There are absolutely no compelling reasons, especially under the current fiscal crisis that is facing the country, to pursue such expensive offshore exploration especially when offshore development cost multiples of on land and when the country already has 153Bb of proven reserves, as claimed by the Ministry. Economics of oil exploration and production suggest a start with the least expensive on land and know high potential before moving to the expensive offshore.

Third:
It is regrettable that the Ministry/Minister of Oil performed rather poorly prior and during OPEC 30 November 2016 accord that led to deciding Iraq production at 4.351mbd during the first half of 2017. Iraq export revenues in January 2017 were less than those for December 2016; February export revenues are lower as well on daily basis.

The most ironic in this matter is the capitulation evident by the admission that: "Iraq should have been exempted from the production cut due to the extenuating circumstances the country is going though" and another recent contradictory statement that: "We are satisfied somewhat, but we are looking forward for improvement in the price," which was reiterated firmly in CERA Week. He also asserts that Iraq complied "fully" with OPEC accord, though all international sources indicate to the contrary; then he retreats by stating Iraq compliance at 85% and by saying "our production increases, but our export is within OPEC accord"!! He also gave conflicting views on whether Iraq agrees to extend oil cut accord for another six months or not by saying Iraqi will reduce production if OPEC decides so!!

Such inconsistency, capitulation and misunderstanding of OPEC accord compromise the credibility and erode trust in Iraq's position as the

second larger OPEC exporter. Iraq should be concerned to maintain a position of reliable long term supplier, otherwise refiners and consumer countries would loose faith to maintain Iraq their long term supplies. We highly recommend taking OPEC cut issue and issues of and with the international concern more seriously, by the Ministry of Oil, than the case has been so far.

Fourth:

A pragmatic view of OPEC cut is needed

The **financial crisis** in the country is very serious and the damage inflicted due to Da'esh effects is very significant and daunting.

According to the Prime Minister, Da'esh effects damage to the infrastructure is estimated now at $35billion. Moreover, national debt mounts, CBI reserves decline, oil revenues shrink and budget deficit persists. According to the Ministry of Planning, total Iraqi debts reached $110billion ($46billion domestic debt and $64billion external, including $41billion to GCC dated back to pre-2003). CBI own estimate of its currency reserve stood at $50 billion in September 2016; most likely lower by now. With 40% of budget expenditures go to fight Da'esh and its effects, lack of investment allocation and the prospect of moderate improvement in oil price even with OPEC cut, the fiscal crisis of the state could be deepen further.

Iraq is fighting Da'esh not only for sake of Iraq security but also the security of others including the nearby Middle East OPEC producers and the distant countries of the Western world in addition to the honorable blood sacrifices of the thousands of Iraqis; and that with mounting debts and shrinking CBI currency reserves making it imperative to present these matters effectively and forcefully during any possible debate on prolonging OPEC cut for a second six months period, which could very well prove necessary.

Therefore we are of the opinion that Iraq should consider not accepting any extension of OPEC. It is time we take a page from the Iranian who are far remote from Da'esh and its financial and human sacrifices who succeeded in excluding their oil production from OPEC production cut.

Inconsistency, contradictions, anti-transparency

In addition to what we mentioned above, we have identified further and frequent incidents that cause deeper concerns;

While the Ministry pays less attention to the modern Karbala refinery, under construction, and proposes the privatization of the remaining stages of this refiner; it concluded recently a dubious deal with KAR regarding old (pre 2003) Erbil refinery with payment in US Dollars not Iraqi dinars and a production which fuel oil constitutes 61%. It is worth mentioning that Iraqi refineries produce significant surplus that cannot export! Moreover, the supply of oil to this refinery comes from NOC, which means a cut from export, while

KRG continue exporting what it gets from NOC oil!

Moreover, while the Ministry offers all new refineries for private investors, both national and foreign, the Minister call to expand **Iraqi Oil Tankers Company** (IOTC) by," *building and buying a large fleet of tankers to transport and market oil to all parts of the world,".*

Such call is another example that ignores Law 84 of 1985 which requires through feasibility studies that takes the actual record and performance of IOTC since early seventies, whether current financial conditions in the country tolerate such expensive proposal and how the Minister justifies this apparent contradiction; proposing privatization of a very needed modern refineries while calling for deeper state involvement doubtful and expensive expansion of IOTC with very high international competition.

Since last September, there has been dangerous anti-transparency, censorship and secrecy environment dominating the Ministry's website; all essential and important data and information, which used to exist since 2003, disappeared. At the directives of the Minister, it is only he or the Ministry spokesperson can declare such information; but neither made regular and timely declaration of such vital information.

Since that month, statements from or even appearance of both Deputies on the Ministry website have disappeared comparing with previous months. Moreover, since that month, there has been very frequent non-availability of and non-accessibility to the Ministry website.

There is apparent lack of institutional system of organization that should facilitates optimum use of available information from the databank such as the one of the MoO. Its proper use as reference would save falling into misinformed incidents such as the Minister's statement regarding gas utilization inside Iraq and the progress in international gas trade; he said recently that, "the delay in gas utilization projects in Iraq in the previous years was due to factors including fluctuation of gas prices in the international markets!"

<u>Neglected plans and policy:</u>

<u>First:</u>

Border fields, especially those with Kuwait and Iran

Increasing data and information from industry and media sources indicate to active efforts by both Kuwait and Iran on oilfields bordering Iraq. But no solid and credible evidence that suggest Iraq is taking real and effective measures to protect the country's interest in these cross-border fields.

Iran-Iraq border fields and related issues are many decades old and the two countries signed many memoranda of understanding and alike. But that did not prevent both countries from accusing each other, in 2009, for syphoning its oil from these fields.

Recently, Iran seems to have prioritized many boarder fields with Iraq for quick development. This orientation was supported further by many factors such as lifting of nuclear program related sanctions; the adopting of a new contract with IOCs for downstream petroleum and the favorable OPEC threshold.

Based on MoO published information, Iraq focuses on only three oilfields, namely Huwaiza, Naftkhana and Sindbade but ignores Iran's Azadegan oilfield, which extends across the border. Also there are many references for joint development arrangements but so far none of these arrangements bears fruition and becoming functional.

Similar situation applies to Kuwait. The two countries agreed, during last December, to "activate previous agreement" regarding such fields; though the Ministry of Oil did not so far identified which previous agreement was referred to.

If the reference relates to a leaked version of "Preliminary agreement" of September 2010 examined by Shafiq, who strongly believes that preliminary agreement does not serve or protect the Iraqi interest. It is a sad example of the lack of knowledge and experience of our Iraqi negotiators, which will lead to a serious loss of revenue to Iraq if approved. We mention this with great sadness and shattered faith, and wonder how such a serious management mishap could take place under eyes of the Iraqi leadership.

Second:

The case for reinstating INOC

Separation of oil planning, policy-making and supervisory tasks from its technical and commercial operations has become almost universally accepted practice. The Ministry of Oil should be tasked with the policy-making, regulatory and supervisory roles, while INOC is entrusted with the technical and commercial roles.

The nationalized industry in Iraq has demonstrated efficient and fast expansion of the production capacity and addition of reserves. INOC gained popularity as it managed to build production capacity over a few years to a level of over 3.5 mbpd by 1979, from 1.3 mbpd, which it inherited in the early 70's from the IPC post nationalization. It also managed to add new reserves amounting to over 6 billion barrels per annum over the period1972-1979, which is equivalent to the total discovered by the rest of the world.

These accomplishments, embedded in the memory of Iraq's public, have influenced policy-making and made every act that is construed to de-nationalizing oil exploration and production development unacceptable, for good reasons.

Almost total dependence of the Iraqi state on the oil income suggests a pivotal role for a state owned oil industry, with INOC operating as its commercial and technical arm at as efficiently as IOCs and at much less cost; so history has shown. IOCs, however, are profit motivated in the service of their shareholders and their home country consumers.

It is about time that the politicians trust their own compatriots. Such trust must have been absent during Dr. Shahristani's ministerial term when his original declared plans for national oil development by INOC supported by a year or 2 of by IOCs was suddenly and without explanation turned into the custodianship of IOCs in long term Hybrid model contract for the development of 12-13mbpd plateau instead of the pre MoO studied plan of some 5-6mbpd. One can only surmises that the excuse was that the 11 years sanction and ageing have taken their toll on the Iraqi qualification. However, the present operating NOCs must have passed the test and that the last 7 years of operating in partnership of IOCs must have given them sufficient experience to manage INOC. We can assure the decision maker Iraqi politicians that their still exists numerous Iraq oilmen abroad who can contribute once the 'muhasasa' and ethno-sectarian policy is abandoned.

Reinstating INOC is welcomed development provided its law provides the company with real power, organizational structure and independence to ensure effectiveness, efficiency and prudent management of the upstream petroleum. INOC should not be perceived as or structured to be just a junior partner to IOCs with limited managerial and decision-making role.

Last but not least: An observation:

We fear that Prime Minister's Abadi's move to appointments of 'technocrats' has not fully achieved its intended objective of divorcing the policy of appointments on 'muhasasa' among the competing political parties. A nominated technocrat for a ministerial post could very well find himself in conflict of interest between his professional ethics and the political interest of his nominating party. Furthermore, the appointment of a prime minister and his cabinet ministers is based not just on the parliamentary approval of his qualifications as well as his cabinet ministers but also, essentially, on the approval of his proposed plans and policies. The appointment of a technocrat to a ministerial post, however, has been based solely on approval of the nominee's technocratic experience devoid of submission of his plan and policy for approval, particularly in the case of the present cabinet. Oil plans and policies, which are missing so far, ought to be not only economically and technically feasible but also consistent with the economic, social and political needs of the nation and compatible with the government policy. As a matter of fact, this should, however, apply to all ministerial technocrat appointees, especially the oil minister whose task and that of his ministry's institutional support goes beyond the norm of plans, policy, regulatory and supervisory roles into the technical and commercial ends of the oil industry.

We look forward to seeing an approved sound feasible plans and prudent policies from the Ministry with the hope that this commentary would have served towards sound plans, policies and governance.

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