



Production sharing agreements: oil privatisation by another name?

By Greg Muttitt



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Introduction

Oil is Iraq's most important asset. Handled correctly, it will be the basis of the country's future development.

Yet it is not only Iraqis who hope to benefit from the oil. With around 10% of the world's oil reserves – the equal second largest in the world, the oil-hungry West has a keen interest in those resources; indeed, oil was the central reason behind the US-led invasion and subsequent occupation.

For these reasons, discussion of privatisation of Iraq's oil is understandably sensitive. In Paul Bremer's sweeping privatisations of the Iraqi economy in 2003, oil was one sector that was not included.

However, behind the scenes, much work has been done throughout the occupation to formulate a structure for Iraq's oil industry – and most of this work has been geared towards giving Western corporations access to Iraq's reserves for the first time in more than 30 years.

Western oil corporations do not have a good record on workers' rights or workplace safety. Very often, they insist on bringing in their own foreign workforce, especially managers and technical staff. And the pay and conditions – including workplace safety – are often considerably worse for workers from the countries where they operate than for their foreign counterparts in the same roles.

However, while this kind of treatment is unfortunately common to privatisation and foreign investment in all sectors, when it comes to extraction of Iraq's oil reserves, it is also the revenue – and the prospects for broader economic development – which are at stake.

The author of this paper believes that these decisions are too important for the future of Iraq to be made behind closed doors. Indeed, if Iraq is to be considered democratic, it is fundamental that these decisions be open to public scrutiny, including by oil workers and by civil society organisations. The author is therefore honoured to have been invited by the General Union of Oil Employees to present this paper at its important conference on privatisation.

There are numerous important issues that should be considered in relation to oil development – including political issues, economic issues and environmental issues, especially climate change.

In this paper, we will focus on one key plank of Iraq's developing oil policy – the proposal that foreign companies should be given access to oil reserves through the mechanism of production sharing agreements – and its implications for Iraq and its people.

What is “privatisation”?

Much of the public debate about the future of Iraq’s oil industry has centred on the prospect of “privatisation”.

For example, Oil Minister Ibrahim Bahr al-Uloum (who was recently reappointed into the role) commented in September 2003 that "The Iraqi oil sector needs privatisation, but it's a cultural issue,"¹ noting the difficulty of persuading the Iraqi people of such a policy.

But Interim Oil Minister Thamer Ghadban, who served in between Bahr Al-Uloum’s two terms, stated in February 2005 that "As for the extraction sector, that is, dealing with the oil and gas reserves, which are 'assets,' privatization is completely out of question at the moment."²

In fact, this discussion hides more than it reveals: these two men have similar views on oil policy – that new fields should be operated by foreign companies, through the mechanism of production sharing agreements.

When Ghadban said the reserves will not be privatised, he was referring to their legal status: whether – legally and constitutionally – they are owned by the state, or by private owners.

Only certain neoconservatives in the USA ever proposed that the legal title to oil *reserves* (prior to their extraction) be in private hands, and there is no realistic prospect of it happening in Iraq. In fact, the USA is one of the only countries in the world where oil reserves are privately owned (by the landowner) rather than state-owned.

That the state owns the oil reserves however does not necessarily mean that the state obtains all the revenue from the oil, nor even that it has control over the development. The important distinction here is between the privatisation of the oil *reserves* and private control of the *industry* that extracts them.

In the UK, for instance, oil in the ground is legally the property of the state, but oil companies extract it under license. The oil then becomes their property once it is extracted, and they are free to then sell it. For most of the 1990s, they did this with no payments to the state for that publicly owned oil – paying only corporation tax, the usual tax on doing business.^a It is as though the government allowed a company to use a publicly owned field to grow crops, and did not charge any rent for the field, only charging business taxes on the company’s profits (the same taxes that would apply if the company rented the field from a private owner).

The reality of Iraq’s oil future does not simply come down to whether reserves below the ground are “public” or “private”. The key questions to look at are:

- 1) who gets the **revenue** from the oil, and
- 2) who **controls** the way in which oil is developed?

^a Now, the companies pay a special rate of Corporation Tax, of 40%, compared to the 30% for other industries – a small improvement

What is currently proposed?

The West began working to redesign Iraqi oil policy well before the invasion of March 2003. In 2002, the US State Department set up a Future of Iraq working group (of which Bahr al-Uloum was part) to plan what to do with Iraq's oil.

At the start of the occupation, the Coalition Provisional Authority appointed senior executives from oil companies to help create oil policy for Iraq. First, there were Phillip Carroll, formerly of Shell, and Gary Vogler, of ExxonMobil. In October 2003, they were replaced by Bob McKee of ConocoPhillips, and Terry Adams of BP.

Meanwhile, throughout the occupation, the oil companies have worked hard to build relationships with the Oil Ministry, in order to influence its policies, and to be viewed favourably when it comes to the awarding of contracts. To this end, they have appointed lobbyists, provided training (often for free) for Iraqi officials and technicians, sponsored Oil Ministry participation in international conferences, and entered contracts (again, often for free) to analyse oilfield geological data.

Oil companies have repeatedly called for Iraqi oilfields to be opened up to them, using the mechanism of production sharing agreements.

The US and UK governments have been busy too. For example, the British Foreign Office is working with the Oil Ministry on "fiscal and regulatory issues"³ – in other words, how the revenue is shared, and how much control the government has over operations.

The official forum in which long-term decisions on oil policy should be made is in the drafting of the Constitution in 2005. The Constitution is intended to be ratified by the parliament in August 2005, and presented to the Iraqi people in a referendum in October.

However, former Interim Prime Minister Ayad Allawi tried to pre-empt the election and the constitution, by setting Iraqi oil policy on his own course.⁴ His plan was that:

- all new reserves should be developed by foreign multinationals, through the mechanism of production sharing agreements.
- that the national oil company (which manages existing fields) should be part-privatised.
- that the domestic marketing and sale of petroleum products should be transferred to the private sector.
- that new refineries and refinery expansions should also be carried out by private companies.

In a sinister remark, he added that these issues should not be debated in the Iraqi parliament, as that would slow progress.

Allawi's economic adviser Hilal Aboud al-Bayati told journalists that the January elections would not change what Allawi had put in place.⁵ Certainly, the 10-week delay in forming a government can only have helped the interim government in firming up its own plans. And as we noted above, new oil minister Bahr al-Uloum has stated that he favours production sharing agreements.

In this paper, we will examine the implications of this policy.

Options for oil policy

There are essentially three models a country may choose from for the structure of its oil industry, plus a number of variations on these themes.

1) The system currently in place in Iraq, which has largely been the case since the early 1970s, is a **nationalised industry**. In this model, the state makes all of the decisions, and takes all of the revenue. The extent of involvement of foreign private companies is that they might be hired to carry out certain services under contract (a **technical service contract**) – a well-defined piece of work, for a limited period of time, and for which they receive a fixed fee. This is the model used throughout most of the Gulf region.

One variant on the technical service contract is the **buyback agreement**, which has been used on some fields in Iran. In this system, a foreign company provides capital to invest in a project, but is paid a fixed rate of return, agreed in the contracts (thus preventing excessive profits). Companies have a right to buy the oil or gas.

2) In the **concession** model, sometimes known as the **tax and royalty system**, the government grants a foreign company (or more often, a consortium of foreign companies) a license to extract oil, which becomes the company's property (to sell, transport or refine) once extracted. The company pays the government taxes and royalties for the oil.

An extreme version of this system existed in Iraq until nationalisation took place in 1961 and 1972. A relic of the colonial era, it gave companies ownership and control over all of the oil in the entire country, for a period of 75 years, and give the government minimal influence over development decisions, regulation or tax.

3) The favoured system of the oil corporations is the **production sharing agreement (PSA)**. This is a more complex system. In theory, the state has ultimate control over the oil, while a foreign company or consortium of companies extracts it under contract. In practice, however, the actions of the state are severely constrained by stipulations in the contract.

In a PSA, the foreign company provides the capital investment, first in exploration, then drilling and the construction of infrastructure. The first proportion of oil extracted is then allocated to the company, which uses oil sales to recoup its costs and capital investment – the oil used for this purpose is termed 'cost oil'. There is usually a limit on what proportion of oil production in any year can count as cost oil (commonly 40-60%). Once costs have been recovered, the remaining 'profit oil' is divided between state and company in agreed proportions. The company is taxed on its profit oil. There may also be a royalty payable on all oil produced.

Sometimes the state also participates as a commercial partner in the contract, operating in **joint venture** with foreign oil companies as part of the consortium – in this case, the state provides its percentage share of capital investment, and directly receives the same percentage share of cost oil and profit oil.^b The foreign company's share of the profit oil is then subdivided according to the production sharing terms.

Many of these systems are extremely complex, and often 'the devil is in the detail': it is more the precise terms of any legal agreement or contract that determine the balance of control and revenues between the state and foreign companies, rather than which type of model is employed.

Even mainstream commentators admit that the difference between PSAs and concessions is more about giving the appearance of state control, than about any practical implications. Daniel Johnston, a recognised industry expert on PSAs, comments⁶

“At first [PSAs] and concessionary systems appear to be quite different. They have major symbolic and philosophical differences, but these serve more of a political function than anything else. The terminology is certainly distinct, but these systems are really not that different from a financial point of view”.

^b For example, in a 50-50 joint venture, the state provides 50% of the investment and directly receives 50% of the cost oil and profit oil.

The West's interest in Iraqi oil

Five countries in the Gulf region hold almost two thirds of the world's oil reserves. But since the nationalisations of the 1970s, these reserves have been out of the control of the West, and off the balance sheets of its companies.

Oil companies have filled the gap since then, first by moving into the North Sea and Alaska in the 1970s and 1980s, and then in the 1990s by opening new 'frontier' areas, such as in the Caspian Sea and offshore West Africa. But with the North Sea and Alaska now in decline, and the frontiers offering only limited, and expensive, growth, the West is again looking to the Middle East.

In a speech to the Institute of Petroleum in London in 1999, US Vice President Dick Cheney commented,

*"By 2010 we will need on the order of an additional fifty million barrels a day. So where is the oil going to come from? ... Oil remains fundamentally a government business. While many regions of the world offer great oil opportunities, the Middle East with two thirds of the world's oil and the lowest cost, is still where the prize ultimately lies."*⁷

During the occupation, development of Iraq's oil was divided into two phases. The first phase was to repair and restore the country's existing oil infrastructure, damaged by war and sanctions.

The much larger prize of long-term production contracts, it was decided, would come later. Security was of course one concern for oil companies. But their biggest fear was that contracts awarded by either the Coalition Provisional Authority or the Interim Government would not have the legal legitimacy to stand up to challenges in international courts; for this reason, they decided to wait until after the elections.

On this subject, as with many issues of foreign policy, the interests of the world's largest oil corporations mesh closely with those of their home governments. While the governments seek secure and affordable supplies of oil to feed their economies, the corporations need control over reserves to ensure their future profitability, to feed their shareholders. For the

governments, "secure" often means in fact controlled by major oil corporations based in their countries.

The keenness of the corporations to gain access to Iraq's reserves can be seen from some of the comments they have made. For example, Archie Dunham, chairman of US oil major ConocoPhillips, said of Iraq in February 2003,

*"We know where the best reserves are [and] we covet the opportunity to get those some day."*⁸

British companies BP and Shell also stated their interest prior to the invasion, both calling on Prime Minister Tony Blair to ensure that there were a "level playing field"⁹ – meaning that they should have as many opportunities as American companies.

Oil corporations are looking for three things when they invest in a country:

- A right to oil reserves. Companies want a deal that guarantees their right to extract the reserves for many years – thus ensuring their future growth and profits. Furthermore, they want a contract that allows them to 'book' these reserves, to demonstrate them to financial markets, and thereby boost their share price. For example, in 2004, when British/Dutch oil company Shell was found to have lied about how much reserves it had in its global portfolio, overstating them by over 20%, it lost the trust of the financial markets. Shell is desperate now to acquire new reserves – which is a key reason why Shell has made more effort than most oil companies to make friends in the Iraqi Oil Ministry.
- An opportunity to make large profits. Generally, oil companies achieve large profits by investing and risking their capital, in a calculated way. In many cases, their capital will be lost, for example when they drill a 'dry well'. But in some cases, they will find huge amounts of oil. In this sense they are very different from oil service companies like Halliburton, which make money from the fixed fees of predictable contracts. Oil companies aim for deals which may be

more speculative, but which give them a chance of super-profits.

- Predictability of tax and regulation. While companies can manage exploration risk (that they won't find oil) or price risk (that the oil price falls), they try to avoid

'political risk' (that tax or regulatory demands will increase). They thus seek to lock governments into long contracts that fix the terms of investment.

All of these requirements would be met by production sharing agreements.

Iraq's share of revenue

For many people in oil-producing countries, the question of who should benefit from oil revenues is one of principle. In countries such as Kuwait, Iran and Saudi Arabia, oil production sharing agreements are ruled out by the constitutions or by national law, and foreign companies are only able to participate in technical service agreements, for fixed fees. In Russia, although three PSAs were signed in the mid 1990s, PSAs have been the subject of extreme controversy ever since, and it now looks unlikely that any more will be signed. In Venezuela, the *apertura* policy of 1993-8 to allow foreign oil companies in is now being reversed.

Bernard Mommer, an oil industry expert formerly at the Oxford Institute for Energy Studies, and now the Venezuelan deputy Oil Minister, identifies a difference in taxation behaviour between net oil exporting countries and net oil importing countries.

Net oil importers (essentially, major oil-consuming countries) have an interest in minimising the cost to their economies of oil imports (the balance of payments), and in maximising secure supplies: thus they aim to maximise the level of investment, in order to maximise oil production in their countries.

Oil exporters such as Iraq, on the other hand, for which oil is primarily a source of revenue, have less concern for the scale of investment *per se*, and more for the scale of their income from it. In contrast to the importers, they have no interest in developing fields which provide no revenue to the state.¹⁰

Although restricted and carefully controlled private sector involvement is not *necessarily* incompatible with maximising government revenue, in this paper we will explore some of the challenges.

Many governments that do allow private investment in oil favour the use of a royalty (a percentage of the total value of the oil), which can be seen as a company paying the state for its oil – effectively ‘buying’ it.

The advantage of a royalty is that since it is a percentage of production rather than of profits, it gets paid whatever the profitability of a field – the state is assured the payments. The

disadvantage is that when profits are extremely high, that state gets less of the revenue than it could.

Oil companies dislike royalties, and prefer taxes based on profits. The reason is that when it comes to taxation, like with all of their business management, they want what they call ‘upside’ (ie opportunities for greater profits) – ways they can reduce their tax payment, rather than being subject to a fixed level.

With royalties, it is very clear what should be paid – it is a fixed percentage of the value of oil. As long as the number of barrels extracted is known, and the oil price, it is easy to work out what royalty is due.

Profit taxes, on the other hand, are based on the profit remaining when costs have been deducted from the total revenue. As such, they depend on complex rules for what costs are allowed to be deducted, how capital costs (the big payments which occur in the early years) are to be treated, and so on.

The more complicated a tax system, the more opportunities there are for a company to avoid tax, by clever use of accountancy techniques. Not only do multinationals have access to the world's largest and most experienced accountancy companies, they also know their business in more detail than the government which is taxing them, so a more complicated system tends to give them more of an upper hand.

Furthermore, while it is possible to devise ever more sophisticated tax systems, which respond better to both circumstances and policy priorities, the drawback is that complexity removes transparency: if only the experts can understand the meaning of a tax system, there is little chance of public accountability.

Production sharing agreements consist of often several hundred pages of technical legal and financial language. Even when they are not treated as commercially confidential (which often they are), they do not lend themselves to public scrutiny.

One result of this complexity can be that even when a country thinks it has got a good deal, it

may later find itself receiving rather less income than it had bargained for. For example, Chad signed a 'convention agreement' with neighbouring Cameroon and with a consortium led by ExxonMobil in 1988 – this was a broad contract covering both production sharing terms on Chad's Doba oilfields, and a pipeline through Cameroon to the coast. Even though outside observers commented that the government's agreed share of revenue was low¹¹, the government found itself getting even less than it expected. In October 2004, a year after the oil started flowing, the Chadian government accused the consortium of under-paying the revenues agreed in their contract. Oil Minister Youssouf Abassalah announced:

"Regarding the application of the contract, we have different views on what should be going to Chad in terms of the share of oil revenues".¹²

Even countries with long experience of oil development are not immune to this problem. For example, in the Sakhalin II project in Russia, the way the PSA is written, all cost over-runs are effectively deducted from the state's revenue, not the Shell-led consortium's profits.¹³ During the planning and early construction of the project, costs have inflated

dramatically. In February 2005, the Audit Chamber of the Russian Federation published a review of the economics of the project, finding that cost over-runs, due to the terms of the PSA, had already cost the Russian state \$2.5 billion.¹⁴

The changing view of PSAs in Russia in general illustrates another problem – that if the government or political climate change, the terms of a PSA cannot change to reflect the country's new priorities. PSAs generally last for between 25 and 40 years. In Russia's case, the rush to privatise in the early 1990s is now being questioned – but with the PSAs already in force it is too late.

Similarly, in neighbouring Georgia. In 2000, the government signed a host government agreement (a pipeline contract in some ways comparable to PSAs) with a BP-led consortium to build the Baku-Tbilisi-Ceyhan oil pipeline. After the corrupt and unpopular regime of Eduard Shevardnadze was overthrown in a 'rose revolution' in November 2003, new President Mikhail Sakashvili commented, "We got a horrible contract from BP, horrible"¹⁵ – but he could not change it.

How oil companies negotiate bargains

How revenues are split comes down less to what is considered 'fair'; more to what either side feels it can get away with: in the industry language, 'what the market will bear'. Thus countries with very small reserves, or high extraction costs, or high exploration risk, generally accept a lower share of revenues than those which are more attractive to companies.

For example, Nigeria, with 3% of world oil reserves, gets 81% of oil profits^c, whereas Argentina, with 0.3% of reserves, gets 44% of profits^d.¹⁶

However, company negotiators will of course always play down the attractiveness of a country, in order to strengthen their bargaining position. A standard tactic is for a company to threaten to pull out and go elsewhere. In the UK, for example, the industry has consistently warned that investment would dry up if the highly favourable tax regime were made less generous. These threats reached their crescendo in 1997, when the new Labour government instituted a review of oil taxation. BP warned:

"Any fiscal change is likely to alter the way in which oil companies view the attractiveness of the opportunities and options still existing in the North Sea... In the context of this fiscal review any change in [UK] taxation would be assessed ... from the totality of our global operations".¹⁷

Yet, at exactly the time that BP and other North Sea oil companies were 'talking down' the viability of the North Sea, oil companies voted the UK as their favourite country in the world in

which to invest for two successive years, 1997 and 1998.¹⁸ Analysis by economists Ian Rutledge and Philip Wright of Sheffield University revealed that, on top of Britain's supportive and predictable government policy, it is also one of the world's most profitable oil provinces, with a profitability 1.6 times higher than the global average. Indeed, BP's own profitability in the UK in 1997 was twice as high as its non-UK profitability.¹⁹

In the case of Iraq, if the government were to hold negotiations with foreign oil companies, the companies would highlight security concerns and political risks. They would push for a deal comparable to – or perhaps even better than – that in other countries in the world. This would ignore Iraq's huge reserves and low production costs.

Furthermore, once a deal is signed, its terms are fixed. Thus the contract terms for the next 40 years would be based on the bargaining position or political balance that exists at the time of signing. So, in Iraq's case, the arguments about political and security risk could land Iraq with a poor deal that long outlasted those risks, and not suited to a potentially stronger Iraq of the future.

For all their likely *apparent* wariness, it is very clear that oil companies are desperate to get hold of Iraq's oil. In the same survey where companies voted for Britain as their favourite place to invest, last year they voted Iraq as their third choice out of 147 countries.²⁰

^c Technically, of project cash flow

^d The rate of return depends on field size, development cost and oil price. These figures are obtained by applying the countries' terms to hypothetical 'upside' (ie profitable) fields (defined by Petroconsultants)

Fair shares?

In a production sharing agreement, looking at the split of oil between state and company does not tell us the full state revenue, because in most cases there are taxes on top of that. Combining the profit oil split, royalties and taxes, it is possible to calculate a *state take* as a percentage of the profits of a project. For example, in the case of Nigeria, the state share of profit oil is 60-65%, but state take is 81%^e of profits, for an field.²¹

However, the energy economist Ian Rutledge points out that it is not enough to look just at that figure to judge fairness – as that will vary according to a country's geological, political and infrastructural attractiveness. A key measure of whether the state has got a fair deal is what level of profits a company is making.

For example, on a field of 750 million barrels, with capital expenditure of \$1.5 per barrel and an oil price of \$23, the PSA terms in Oman would give a state take of 81%. Although this sounds high, it should be contrasted with the company internal rate of return (a measure of profitability) of 31% - compared with a usual target for companies of 12-15%. Thus, this field would be very profitable.

Rutledge calculates that if the same terms (80-20 split plus bonuses) were applied to a 300-million barrel field in Iraq (a relatively small field, by Iraq's standards), with capital cost of \$0.41 per barrel, companies would be receiving an enormous 59% IRR at an oil price of \$25, and 66% IRR at \$30.²²

Even then, with state take and company IRR, we do not have the whole picture. Often a company can obtain profit not just from the *profit oil*, but also from cost oil. Although that is not intended in the deal, careful accounting and financial management can allow the companies to exploit loopholes in the tax rules. For this reason, the details of how profits are calculated, what costs are allowable etc, are very important.

^e for Petroconsultants' 'upside' hypothetical fields

Who controls the oil?

While PSAs give the impression of giving the state ownership and control over oil resources, in practice, its hands are tied by the restrictions in the contract. As with the revenue sharing, the key is in the detail.

Most production sharing contracts specify that any disputes would be resolved not in the courts of the country concerned, but in international arbitration tribunals, such as ICSID in Geneva or the International Chamber of Commerce in Paris. These arbitration hearings are often held in secret, and presided over by tribunals consisting generally of corporate lawyers and trade negotiators – as such, they tend to narrowly favour the investment interest, rather than broader issues of national interest or sovereignty.

The researcher Susan Leibuscher comments,

*“That system assigns the State the role of just another commercial partner, ensures that non-commercial issues will not be aired, and excludes representation and redress for populations affected by the wide-ranging powers granted [multinationals] under international contracts”.*²³

Furthermore, Leibuscher points out that investment contracts are largely self-standing and self-referential: they are judged by the goals and conditions that each individual contract sets for itself, rather than by external standards within the broader body of law.

Even worse, many of these contracts contain so-called ‘stabilisation clauses’, which can prevent future laws or tax policies applying to the project concerned. For example, a future government may not be able to introduce stricter laws, or to change tax rates. This is generally achieved by one of two mechanisms in the contract:

- 1) giving the production sharing agreement a higher legal status than other laws (except the Constitution) – thus, if there is a conflict with a future law, the PSA takes precedence; or
- 2) including clauses that allocate certain risks such as tax or legislative change to the state oil company – in other words, if tax is increased, the state oil company pays, not the foreign company.

As a result, laws and regulations relating to labour standards, workplace safety, community relations or environment would be unable to be strengthened^f in relation to a project during the life of the contract (25-40 years), and may even be weakened, depending on the contract.

One example is the case of Georgia. In November 2002, when the BTC pipeline was seeking environmental approval, the Environment Minister said she could not approve the pipeline routing through an important National Park, as to do so would violate Georgia’s environmental laws.²⁴

Both BP and the US government put pressure on the Minister, through then President Shevardnadze.²⁵ The Minister was forced first to concede the routing with environmental conditions, and then to water down her conditions. Part of the reason for her weak bargaining position was that two years earlier Georgia had signed the host government agreement for the project, which set a deadline for environmental approval within 30 days of the application. Since that agreement has a higher status than other Georgian laws, the environment laws the Minister referred to were irrelevant.

Ultimately, on the day of the deadline, the President called the Minister into his office, and kept her there until she signed, in the early hours of the morning.²⁶

The host government agreements for the BTC pipeline have been better studied than most. They were one of the first sets of such agreements to be made public (the Azerbaijan PSAs are also public). Although in that case it took pressure from civil society and from the World Bank, such publication is now expected to become the norm.

The BTC agreement with Turkey contains a number of other features, common to many other HGAs and PSAs, on top of those referred to above²⁷:

- The consortium is exempted from any current or future domestic law that may

^f alternatively, some contracts allow such laws to be strengthened, but require compensation to be paid to investors for their loss of profits.

conflict with the project during the lifetime of the contract (40 years).

- The consortium has the power to terminate the contract at any time; Turkey does not have this power.
- The consortium has the right to decide what structures can be built in the pipeline corridor, an effective right to restrict the geographical development of villages, without compensation.
- The project takes priority over local populations in access to water.
- The only reference to compensation is to compensation to the consortium. Compensation to the state or to third parties is not provided for and thus the consortium is exempt from all liability for loss or damage.

Does Iraq need foreign investment?

As noted above, Western companies and governments – and institutions aligned with them, such as the International Energy Agency (part of the OECD group of 30 industrialised nations) – argue that foreign investment will be essential for the development of Iraq's oil.

Although sometimes the arguments refer to multinational companies' skills, often there is a somewhat arrogant subtext to that, which ignores Iraq's own strong skills base in the oil industry – albeit one that was damaged by Saddam Hussein's dictatorship and by the impact of economic sanctions. Meanwhile, technology, and technical capacity, can be hired through technical service agreements.

The arguments for investment are perhaps more plausible when it comes to access to capital. Certainly, multinational companies have access to capital beyond that of many oil-producing states. They also have a propensity to take risks (for example, in exploration), which many states prefer to avoid, for fear of the political repercussions of spending tax money with no return.

On the other hand, the capacities of multinationals to raise capital and technically manage projects must be weighed against their different objectives. In one sense, multinationals lack capacity compared to state companies, as their economic drivers are different. In general, their imperatives are to deliver short-term profitability to shareholders, meaning maximising production rates in the short term, and maximising profitability obtained from that production. These may conflict with a country's objectives, in undermining sustainability of revenue, and in minimising the government's tax take.

Some industry commentators point out that the accumulation of wealth and political power by state-owned oil companies tends to either destabilise or weaken democratic governments (such as in Venezuela), or conversely to strengthen undemocratic regimes, insulated from accountability to their populations (such as in Saudi Arabia). This anti-democratic effect of oil wealth is a real concern, and has been seen in numerous oil producing countries.

However, it is a myth that foreign investment in an oil industry can reduce this effect. In fact, the opposite can be true. Oil corporations are

interested in regimes that they can do lucrative deals with; the deals which give them the most excessive profits are very often those that would not survive in a democracy, and which depend on autocratic governments to enforce them (such as in Azerbaijan).

The Centre for Global Energy Studies estimates that the Iraqi oil industry needs investment of \$2.5 billion per year, to achieve production of 6 million barrels per day by 2010.²⁸ This could potentially be financed out of Iraq's own revenues, and is within the range of budget allocations to date. Alternatively, it could be raised as loans – the considerable increased reserves could be used as collateral to secure the loans. CGES estimates a financing cost of \$1.6 per barrel. Combined with production costs of \$1.5 and transport costs of \$0.4, leaving Iraq with still a net income of \$26 per barrel at an average oil price of \$30. Given the current oil price, it will be even easier and cheaper for Iraq to borrow money to finance development.

Some would argue that introducing foreign companies only to new, unexplored areas of Iraq, where the national company is not operating anyway, can only add revenue – even if it is not 100% of the profit generated. However, even in this case, the impact on revenue could be negative. When Iraq receives a quota from OPEC, if it has to restrict production to shore up prices, contracts may prevent it from doing so in any foreign-controlled fields. As a result, to comply with OPEC decisions, Iraq would instead have to cut production from fields controlled by the national oil company – and lose the revenue from those as a result.

Perhaps one potential benefit of foreign involvement is that it would allow production to grow faster than under a purely national model – in that investment could take place very quickly. However, it is precisely fast development that presents the greatest risk of getting a poor deal with foreign corporations.

However, if it were decided that foreign capital were required, there are options such as the buyback agreements which maintain the majority of the decision-making control, rather than surrendering it to the extent that would occur with production sharing agreements.

Conclusion

We have illustrated some of the features of oil taxation and production sharing agreements. We conclude that while it may be possible *in theory* for production sharing agreements and other forms of foreign involvement to be done in a beneficial way; in practice, they have often created negative outcomes for other countries.

It is a question for the people of Iraq as to whether they want foreign investment in their oil at all. We would argue that “privatisation” is best understood in terms of the concrete impacts on the revenues from and the control over oil production, rather than purely legal status. As such, production sharing agreements can be seen as presenting many threats to the country’s economy, in common with more direct or overt forms of “privatisation”.

If Iraq were to rush in to signing lots of contracts, and especially if it were to do so without public debate or transparency as to what were on the table, negative outcomes could be expected. The wrong contract – whether as a result of the political context or of mistakes in drafting (such as lack of clarity about implications of certain clauses) – would impact Iraq’s economy for the next 40 years.

When Ayad Allawi issued his guidelines for Iraq’s oil policy in 2004, he insisted that there should not be public debate on these issues, as that would delay progress. We disagree – without public debate, the outcome cannot be considered progress.

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