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New Iraqi oil law: some facts on PSAs

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The lefty blogosphere is all a-flutter after the article in the Independent about the new Iraqi oil law, which will allow foreign companies to invest in the oil sector via PSAs (production sharing agreements).

These are presented as unfair contracts, which will give the majority of the profits to the Western oil majors, and highly unusual. This is all **untrue**, and it obfuscates the wider truth that no major Western company will invest in Iraq (under these contracts or under any other scheme) as long as American troops are there and that a civil war is under way.

I've written about this as comments in various diaries, but it's time to have a full diary on this. So here goes.

(Quotes from the article in *The Independent*)

> The US government has been involved in drawing up the law, a draft of which has been seen by The Independent on Sunday. It would give big oil companies such as BP, Shell and Exxon 30-year contracts to extract Iraqi crude and allow the first large-scale operation of foreign oil interests in the country since the industry was nationalised in 1972.

- That the US government is involved is no big surprise, considering that it is occupying the country and de facto running it - or the bits that can be run by the central power in Baghdad anyway (i.e. not much). While this is indeed the biggest scandal, and the biggest breach of Iraqi sovereignty, it is essentially irrelevant as that power does not apply to anything within Iraq. It applies to whatever US forces directly control, but will not apply to even that as soon as US forces leave. And, I'll get back to this later, that current power may apply to existing oil production, but it will not apply to future investments.
- Similarly, it is true that this would be the first involvement of Western companies in Iraq since 1972. This, in itself, is not *necessarily* a bad thing. A number of countries have nationalised their oil production, but others do authorise foreign investment, and it is not obvious which ones do better, and which ones have the most actual control over thie industry. The important thing is that investment today will not be done in the conditions prevailing before 1972, which were indeed a lot more favorable to Western oil majors. So reminding us that we exploited these countries in the past is true, but not necessarily relevant. What matters are the actual terms of the agreements today.
- The fact that contracts are meant to last 30 years is nothing surprising. In fact, it is a

requirement of the industry, which simply reflects the fact that a lot of money needs to be spent upfront and that it can take time to get a return. An oil project, typically, from the date of signature of a contract, will need a few years of exploration (i.e. ascertaining if there is actually enough oil in the designated area to make production commerically viable), then, once decision to go ahead is taken, a few more years to build the facilities, and then only actual production. So out of thirty years, you will have 5 to 10 years (and sometimes more - check the ACG project in Azerbaijan: the contract, a PSA, was signed in 1994 and large scale exports started only this year) where you only SPEND money, with no income, and then only 20 years to recoup that investment cost, plus the massive financing costs of carrying that cost over many years. And this is the oil business - we're talking billions of dollars that need to be spent upfront. These are massive amounts at risk for a long time, even for wealthy companies like the oil majors. So 30 years contracts are not scandalous - they are a feature of the business (and as a banker that has financed these kinds of projects, I can tell you that we would not put a cent without such long term contracts in place).

So the only bit a significant news here is the fact that Iraq may be open to Western investment in the oil sector - a significant bit of news for oil companies that are shut out of an increasing number of countries and desperate to get their hands on projects, and a decision that might not be taken by a sovereign Iraq, but the fact that a soveriegn Iraq does not exist also means that this law is meaningless (see below). It also does not mean that the terms would necessarily be bad for Iraq.

> Oil industry executives and analysts say the law, which would permit Western companies to pocket up to three-quarters of profits in the early years, is the only way to get Iraq's oil industry back on its feet after years of sanctions, war and loss of expertise. But it will operate through "production-sharing agreements" (or PSAs) which are highly unusual in the Middle East, where the oil industry in Saudi Arabia and Iran, the world's two largest producers, is state controlled.

The first sentence, on which many focused, is meaningless. I am going to explain below, in a lot of detail, how PSAs work and thus why that assertion tells us nothing about the underlying profit arrangements. What is true is that PSAs are rare in the Middle East - for the simple reason that most Middle Eastern oil produers simply do not allow any kind of private involvement in their oil industry, national or foreign. So PSAs are just as rare as concessions, licenses or any other kind of contractual arrangement with private companies in the region - because there are none.

But PSAs are actually one of the most common form of investment and production contracts around the world these days - **for the simple reason that they are usually more favorable to host countries than other contract forms**.

Let me explain how PSAs work.

PSAs - production sharing arrangements are contracts between investors (oil companies) and host countries to set the rules on thedevelopment of an oil field. They determine who pays for the investment and, as their name suggests, how the revenues, once generated, are shared between the investor and the host country.

The main principle of PSAs is that oil production is split into "cost oil" and "profit oil". "Cost oil" is the oil that is used to repay the initial investment. "Profit oil", as its name suggests, is the surplus, which is pure profit from the oil production. "Cost oil" goes to the investors, but may include a slice of taxes payable to the host country. "Profit oil" is split between the investors and the host country. An important feature of PSAs is that the early production will go, for the most part, to "cost oil", to repay the investors and, as time goes by and the investment (and the agreed cost of its financing over these years) is repaid, more amounts will be available as "profit oil".

In the early days of production, most, but not necessarily all oil is "cost oil", and as time goes by, an icnreasing fraction will be "profit oil". Investors will be interested in as high a fraction of "profit oil" as they can get in the beginning, but will be willing to concede more of it in the more distant future, as it impacts their profitability today very little. Host countries, which can take a longer perspective, can benefit more form such an arrangement, and thus, the split of profit oil typically increases in their favor as time goes by (and will usually reach 90% in the end).

As the above suggests, there are many parameters that can influence what kind of income each party gets over the years. The most obvious ones are linked to the actual investment schedule: is the project on budget, and on schedule, will it produce as much as announced, and for as long. Depending on the expected technical complexity of a project, different revenue splits may be reasonable to reflect the risks taken by each side. But, very naturally, another, completely uncontrollable factor will influence the revenue split: the oil price. Higher oil prices will allow a project's costs to be reimbursed faster, and profit oil to kick in earlier (and vice versa). In the early days, prices of goods like metal and other commodities may also influence the cost of the project and the amount of "cost oil" required. In some cases, there will be mechanisms to modify project costs; in others, the numbers will be more tightly set and controlled, with less leaway for the investors, who then take risk on how much they need to spend to get the project online.

Depending on technical parameters, expected production profile (and the ability to adapt it to market circumstances, or not), price hypotheses for a number of goods, there can be a bewildering array of outcomes for the split in revenues, and it is hard to say in theory which one is better.

- for instance, the host country can insist that a fraction of early oil production be allocated to "profit oil", irrespective of where the reimbursement of cost stands, in order to get some revenues early. That will entail more financing costs for the investments not yet repaid, and a longer requirement for "cost oil", and thus less "profit oil" in the future (the split of that profit oil being still another question);
- a host country can decide to authorise very few circumstances under which costs can be updated (i.e. the investors must take the risk of cost overruns on their own) - thus ensuring that profit oil comes on the expected date. But in return, it will probably have to give up a bigger fraction of that profit oil, to reflect the higher risk taken by sponsors, and its own higher certainty of getting revenues at a given date. Conversely, it can decide to keep a bigger chunk of profit oil, but allow more flexibility on cost overruns - at the risk of delaying its income if the project runs into unexpected difficulties. A country with a lot of oil experience and the ability to supervise closely works (and expenses) during the investment phase will be more likely to choose such a path.
- a host country may decide to focus on medium term scenarios with lowish oil prices, so as not to budget more money than it can reasonably expect to get. In that case, with less revenues, "cost oil" is likely to dominate for quite a while, and the country wil want to make sure that there is profit oil right from the start, and that enough of it goes to itself. In return, it may give better terms on the financial cost of rolling over unpaid costs
- of course, in all these scenarios, we've been talking only about the "base case", i.e. the most likely outcome. But rules to split the gain, or the pain, as the case may be, if cirucmstances are more, or less, favorable, need to be defined as well. Again, many different options can be

chosen, some parties focusing on certainty of revenues, others wanting to minimize potential worst cases, and others trying to grab the most in the optimistic scenarios.

- Parties have different priorities, and they also may have access to different information: the most competent host countries will understand the oil field just as well as the oil major, while others will need to rely more on information provided by such oil major (with less ability to check it independently).
- To add to complexity, some host countries will set requirements in terms of employment of local workers, or use of local contractors. That will influence the cost of the project, or its timetable, or the likelihood of work being done as required (and thus the importance of downside scenario planning), but it also changes the amount of money that stays in the country;

I've only touched the surface of these contracts (if you are interested to see the content of one of these, the PSA for the ACG project in Azerbaijan is public and available on BP's website here), but they are extremely complex documents, that usually set all the parameters for a project, including the whole tax package applicable, the specific environmental, labor and security standards applicable, and many other things. If relevant, they need to be compatible with the requirements of banks or multinational institutions (like the World Bank) that may finance all or part of the project, and they will need to reflect the conflicting priorities of the various investors (it is extremely rare to see one single oil company signing such contracts - most of the time, it's a consortium of oil companies, with one taking a leading role (the "operator"), and the others a slightly more passive role).

What I mean to convey here is that PSAs, per se, or even a given profit split, are not necessarily disadvantageous for the host country. If the sharing is well negotiated, and the project well supervised, they can be extremely profitable for the host country.

Countries will a long experience of oil production have a stronger hand: they know their assets, they may have enough qualified people to understand the intricate details of any project, and they may even have experience handling the subcontractors (companies like Halliburton or Schlumberger that do a lot of the actual engineering work). On the other hand, countries with little oil experience will be a lot more dependent on outsiders bringing in expetise. They can hire experts to help them, however. Similarly, countries with sufficient financial resources will require less of the investment burden to be borne by outsiders, and thus can make "cost oil" a lot smaller. Conversely, poor countries that need full external financing of the project will, per force, see revenues come to them later in the project (unless they manage to procure financing independently, which, again, is possible). Some projects (in particular those that require transport infrastructure to be built at the same time as the upstream facilities) require more complex contractual structures - and an entity able to make commitments to all third parties on the whole chain. The most complex projects, like LNG facilities (which require simultaneous investment in a gas field, gas pipelines, the LNG plant, the LNG tankers, and a regazification plant) cannot be managed by the host country and require the presence of one of the top oil majors - so far the only entities able to put in place the full chain of commitment by credibly shouldering the tens of billions of dollars of commitments that need to be made to all parties in the chain so that they do their bit of the project.

All these projects require contractual arrangements with third parties, often very long time commitments to cover the likely repayment period of the investments and reflect the fact that big multi-billion projects cannot be implemented with a minimum of oconfidence on their outcome.

Which brings us back to Iraq.

One thing that should be obvious from the above is that oil companies will invest in oil project only if they have reasonable confidence to make money in the medium term - which means, naturally, that they have acceptable contractual conditions, **but also** that such contractual conditions have a very high chance of being respected and/or enforced. That means dealing with stable government with a modicum of interest in seeing these conditions fulfilled.

In the bad old days, that could mean a dictator, appropriately interested, on a personal level, in the project. Today, it still means a willingness to deal with unpleasant regimes, provided that they are reasonably stable, because you have to go find the oil where it is, and not all places with oil are democracies, nor friendly (the discussion about how much linkage between oil and dictatorship or corruption will be left to another diary). But it means that oil companies will only invest in countries that are stable enough - and, more to the point, where the entity in charge of oil resources is likely to remain so, either because it is a legitimate bureaucracy or because it is, say, in control of the armed forces that protect the oil fields.

In Iraq, these conditions are not fulfilled. There is no legitimate government, and what government there is controls little of the country, including not enough of the oil infrastructure. And THERE WILL BE NO LEGITIMATE GOVERNMENT AS LONG AS US FORCES REMAIN IN IRAQ - and, in all likelihood, not until the civil war has run its course,and some form of new power structure is put in place by consensus or by force. And that new power structure will certainly not be bound by contracts, nor even by laws, put in place at the time of the US occupation. So today's law is unlikely to have any practical application.

In summary:

- PSAs are not an evil plot by Western companies - they are a normal tool of business;
- bringing foreign investment in a country's oil sector is not necessarily a bad thing, it all depends on the industry experience of the country and its ability to fiannce investment on its own;
- the current law is unlikely to ever be implemented and thus is mostly irrelevant, except perhaps as another demonstration of the short-sightedness of the Bush administration.